

New CRA guidance on input tax credit allocation methods for financial institutions under section 141.02 of the Excise Tax Act

JULY 29, 2021 6 MIN READ

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The Canada Revenue Agency (CRA) has released GST/HST Memorandum 17-12, "Input Tax Credit Allocation Methods for Financial Institutions for Purposes of Section 141.02" (the New Memorandum). The New Memorandum cancels and replaces GST/HST Technical Information Bulletin B-106, "Input Tax Credit Allocation Methods for Financial Institutions" (Bulletin B-106), and sets out the Minister of National Revenue (the Minister)'s current guidance with respect to the methods that financial institutions may use to allocate their inputs for the purposes of determining input tax credits (ITCs) under section 141.02 of the *Excise Tax Act* (ETA). Although the New Memorandum is currently in effect and not considered to be a draft, it is open for a three-month comment period, together with two related memoranda released at the same time: GST/HST Memorandum 17-11, "Determining Whether a Financial Institution is a Qualifying Institution for Purposes of Section 141.02", and GST/HST Memorandum 17-13, "Application of Section 141.02 to Financial Institutions That Are Qualifying Institutions."

Generally, under section 141.02 of the ETA, financial institutions are required to use certain methods to determine the "procurative extent" and "operative extent" of their inputs for purposes of determining ITCs. (The procurative extent of a property or service is the extent to which it is acquired, imported or brought into a participating province for the purpose of making taxable supplies for consideration and the operative extent of a property or service is the extent to which it is consumed or used for the purpose of making taxable supplies for consideration.) While the New Memorandum is structured differently than Bulletin B-106, the guidance it sets out is substantially similar. Like Bulletin B-106, the New Memorandum sets out particular rules with respect to four types of inputs: excluded inputs, exclusive inputs, direct inputs and non-attributable inputs. Like Bulletin B-106, the New Memorandum generally requires that a method be objective and "meaningful, unbiased and verifiable" with respect to exclusive, direct and non-attributable inputs.

New guidance on "core business"

One respect in which the New Memorandum differs from Bulletin B-106 is that it provides additional guidance about what the Minister considers it to mean for a method to be "meaningful." In particular, paragraph 41 introduces the concept of a financial institution's "core business" and states that "for a financial institution whose core business is making exempt supplies of financial services, to be meaningful, any ITC allocation method used should accurately reflect the use of the business input in the context of the financial institution's core business of making exempt supplies of financial services." Example 17 in the New Memorandum purports to apply this concept. In Example 17, a financial institution leases floor space in an office building, which it uses as follows:

- 25% rented at cost to advisors who arrange financial services for the financial institution
- 20% vacant offices that have been vacant for three years
- 20% space for common use
- 35% space for employees making exempt supplies

In Example 17, for ITC allocation purposes, the financial institution allocates the leased space on the following basis:

- The 25% rented to advisors is used to make taxable supplies of real property.
- The 20% vacant space is held for the purpose of making taxable supplies of real property as it is held for the purpose of renting to advisors.
- The 20% common space is used 75% to make taxable supplies and 25% to make exempt supplies.
- The 35% space for employees making exempt supplies is used entirely to make exempt supplies.

Based on the above allocation, the financial institution would be claiming ITCs for 60% of the tax on the leased space.

The New Memorandum explains that this allocation is unreasonable in part because the financial institution's "core business" is making supplies of financial services, not of real property, and that it is unreasonable to claim ITCs on 60% of the cost when only charging rent on 25% of the space. While the method described in Example 17 is arguably unreasonable, we note that the drafters appear to have chosen numbers that deliberately lead to an unreasonable result. Specifically, it is unclear why a financial institution would choose to allocate 75% of the common space to taxable supplies when there are no facts suggesting how the common space is actually used (e.g., is it used more by the advisors or the employees making exempt supplies? Is it physically separated from one or the other group, such as by being on a different floor?). In particular, even assuming that the vacant space is all used for commercial activities, it is unclear how reasonable it would be to allocate 75% of the common area to taxable supplies when only 56.25% of the remaining space (45%/80%) is used to make taxable supplies.

It is also unclear how reasonable the allocation of the vacant space is, as the New Memorandum specifies that the basis for allocating it to taxable supplies is that it is held for rental to the advisors, but does not explain whether this is actually the case or why the space has been vacant for three years. If the space really is being held for rental to advisors on a taxable basis, it would seem reasonable to allocate this expense to taxable supplies. This is especially the case if the vacant space is on a separate floor for advisors, or is otherwise separated from the financial institution's regular activities such that the financial institution cannot, for whatever reason, effectively use the space. It is thus unclear what, if any, the implications of the "core business" concept actually are, given that the method put forward appears numerically designed to produce an unreasonable result in any event.

Election and other changes

The New Memorandum also differs from Bulletin B-106 in that it introduces a discussion of the election under subsection 141.02(9), which allows a "non-qualifying institution" that meets certain criteria to elect to use a prescribed percentage for its residual inputs (i.e., direct and non-attributable inputs) for a particular fiscal year. Where the election is made, the consequences include that the prescribed percentage applies, that subsections 141.02(10), (11), (12) and (13) do not apply and, for the purpose of determining an ITC in respect of the residual input, that the description of B in the formula in subsection 169(1) is deemed to be

equal to the prescribed percentage for the prescribed class of financial institution. While this election was not discussed in Bulletin B-106, it was previously discussed in GST/HST Technical Information Bulletin B-099.

Further, the new Memorandum 17-13 adds certain comments, not present in Bulletin B-098, about the Minister's obligations with respect to a method being "fair and reasonable." Specifically, in paragraph 50, Memorandum 17-13 now indicates the Minister's position that the Minister is not bound to authorize a method under subsection 141.02(18) "merely because it is fair and reasonable." Further, paragraph 40 states that if the Minister directs use of a particular method under subsection 141.02(32) rather than the method used by the financial institution under subsection 141.02(14) or (15) for a year, there is no requirement that the Minister prove that the Minister's method is more fair and reasonable than the method used by the financial institution. These comments appear to be contrary to the intent of these rules, which we understand was to prevent financial institutions from retroactively changing ITC allocation methods and from changing ITC allocation methods throughout the year. The purpose was not to allow the Minister not to accept fair and reasonable methods merely because the Minister does not like the result or prefers a different, possibly less fair and reasonable method to be used.

Otherwise, there appear to be few changes from the previous guidance. Nevertheless, it is important for financial institutions to be aware of the new guidance. If you would like to discuss the application of the New Memorandum or would like help in preparing comments to the CRA by the deadline on October 29, 2021, please do not hesitate to contact us.