

# Proposed GST/HST amendments relating to drop shipments

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The drop shipment rules found in section 179 of the *Excise Tax Act* (the Act) essentially allow an unregistered non-resident person to acquire goods in Canada, or commercial services in respect of goods, on a tax-free basis, provided the goods are ultimately exported or are retained in Canada by a registrant. The Department of Finance has also stated that the drop shipment rules are intended to apply only where a registrant agrees to accept a potential liability for tax in respect of a subsequent transfer or non-commercial use of the goods. In addition, the Department of Finance has stated that the rules are intended to help “ensure that GST<sup>[1]</sup> applies to goods located in Canada that are supplied by an unregistered non-resident person for final consumption in Canada in the same way as tax would apply to the goods if they were acquired by an unregistered non-resident person outside of Canada and imported for final consumption in Canada” <sup>[2]</sup>.

Absent the drop shipment rules, an unregistered non-resident buying goods for resale in Canada would have to pay GST on the purchase of the goods, but would not be able to claim an input tax credit for the GST they paid. This would be the case even where the goods were ultimately sold to a registrant who would be entitled to claim a full input tax credit for any GST paid. In these circumstances, without the drop shipment rules, the unregistered non-resident would effectively be forced to register for GST in order to claim input tax credits for the taxes they had to pay.

Unfortunately, over the years the Canada Revenue Agency (CRA) has taken a rather restrictive view as to when the drop shipment rules apply. In order to clarify and fill some perceived gaps in the existing rules, on July 22, 2016 (the Announcement Date), the Department of Finance released proposed legislative amendments to the drop shipment rules. These amended provisions (the New Rules) are intended to ensure that the policy objectives of the drop shipment rules are being met.

While the New Rules are fairly lengthy and are extremely technical (as are the existing rules), the New Rules appear to resolve, in a consistent and logical manner, many of the issues that had arisen based on the CRA’s interpretation of the existing rules<sup>[3]</sup>.

The following is a high-level summary of some of the major changes found in the New Rules. All statutory references below are to provisions of the Act:

## Creation of a new “Owner’s Certificate”

Under the New Rules, only a consignee that purchases supplies directly from an unregistered non-resident can issue a drop shipment certificate. However, the New Rules also create the concept of an Owner’s Certificate, which essentially works in the same way as a drop shipment certificate, but allows for greater flexibility and relief relative to the CRA’s rather restrictive interpretation of the existing drop shipment rules (an Owner’s Certificate). If a GST registrant (the Registrant) supplies goods, a service of manufacturing or producing goods or a commercial service in respect of most goods, to an unregistered non-resident, the

Registrant causes the transfer of physical possession of those goods at a place in Canada to another GST registrant (the Consignee), and the Consignee is not entitled to issue a drop shipment certificate, then an Owner's Certificate can be issued if either: (a) immediately after physical possession of the goods are transferred, the goods are goods of a third person that is registered for GST (the Registered Third Party), or (b) the Consignee acquires physical possession of the goods as the recipient of a taxable supply by way of sale of the goods from a Registered Third Party, before physical possession of the goods is transferred. In these circumstances, either the Registered Third Party (in both cases (a) and (b) above) or the Consignee (in case (b) above) can issue an Owner's Certificate which should have essentially the same effect as a drop shipment certificate (i.e., the supply to the unregistered non-resident will be deemed to be made outside of Canada, so no GST is payable, and the effects of subsection 179(1) will be nullified).

For example, the Owner's Certificate should apply where a Registrant sells goods to an unregistered non-resident person, who then on-sells to a GST-registered wholesaler who ultimately sells the goods to a GST-registered distributor, and the goods are then physically delivered direct from the Registrant to the distributor. In this scenario, the CRA had taken the position under the existing rules that a drop shipment certificate could not be issued by the wholesaler because it did not receive physical possession of the goods, and the distributor could not issue a drop shipment certificate because it was not liable under Division IV of the Act. Under the New Rules, either the wholesaler or the distributor in this example should be able to issue an Owner's Certificate, such that the supply to the unregistered non-resident person should be deemed to be made outside of Canada.

## Creating new liability for Consignees and owners who issue certificates

As mentioned above, the CRA's position was that only someone who was liable to self-assess tax as a recipient of an imported taxable supply of the goods could issue a drop shipment certificate, notwithstanding there was nothing in the old rules which deemed this to be the case. The New Rules contain a number of provisions which would create a potential liability to self-assess tax on anyone who issues a drop shipment certificate or an owner's certificate.

## New rules dealing with inputs used in the manufacturing process

The existing drop shipment rules only worked for goods that were physically delivered in the same form in which they were sold. The rules did not technically apply to goods that were used as inputs or were consumed in the manufacture of other goods. Sub-paragraphs 179(2)(c)(ii) and (iv) of the New Rules now allow a Consignee to issue a drop shipment certificate for goods which are incorporated or transformed into, or consumed or expended in the manufacture or production of, other goods.

## New rules dealing with leases

Concerns were raised with respect to the existing rules that there were some gaps in cases where an unregistered non-resident leases goods in Canada. For example, if an unregistered non-resident imported goods into Canada and then leased them in Canada, the lessee could potentially claim input tax credits under section 180 for GST paid on the import of the goods into Canada. At the end of the lease, the non-resident would own the property in Canada and could supply it to a Canadian consumer under section 143 such that the supply would be deemed to be made outside Canada and no GST would be exigible. While the non-resident might be required to register for GST, this would depend on whether the non-resident was

carrying on business in Canada, which might not always be the case. New subsections 179(8) to (12) set out how the drop shipment rules will apply with respect to leases. Generally speaking, the New Rules create a potential liability on a previous lessee (under subsection 179(1)) unless the new lessee issues a drop-shipment certificate or Owner's Certificate. As there are a number of special rules, and exceptions to these rules, and as the rules are fairly complex, any non-residents dealing with leases in Canada should review the drop shipment leasing rules to determine if the New Rules apply to their particular facts.

## Clarification of the retention of possession rules in subsection 179(4)

A number of changes are proposed to the retention of possession rules in existing subsection 179(4) to deal with some timing issues, and to clarify how the rules will work in other situations.

After royal assent, the new retention of possession rules will be set out in subparagraphs 179(5)(b)(i) to (v). It should be noted that subparagraph 179(5)(b)(v) explicitly deals with a "buy-back" situation where a Registrant sells goods to an unregistered non-resident, and then repurchases the same goods from the non-resident for resale in Canada. While a strong argument could be made that the existing rules would have applied in these circumstances such that no GST should have been payable by the unregistered non-resident, the New Rules should clarify the application of section 179 in such cases.

## Coming into force provisions

We note that there are two sets of new drop shipment rules: first a set that applies from the Announcement Date forward (with some limited retroactivity as discussed below), and a second set which will apply from royal assent. Notwithstanding the two sets of rules, both sets generally function in the same way.

One concern we have with the New Rules is the coming into force provisions. In particular, most, if not all of the changes that are relieving in nature are only effective for supplies made after the Announcement Date. However, a few of the provisions, which generally do not have a relieving effect, can apply retroactively if taxes were paid. Considering the Department of Finance regularly uses retroactive legislation when it believes that taxpayers are not complying with the intent of the Act, we would have thought that the Department of Finance should allow the relieving rules to also apply retroactively since, in this case, it was the CRA's assessments which were not complying with the intent of the Act. This is especially the case as it took so long for the New Rules to be released.

Finally, we note that the Department of Finance has invited interested parties to submit comments on the proposed amendments before the end of August. If you wish to make a submission, but do not believe that you can meet that deadline, we recommend that you advise the Department of your intention and of the date by which you will make your submission.

For questions relating to the new drop shipment certificate rules, please contact any of the following members of the Osler sales tax team:

**Alan Kenigsberg** [akenigsberg@osler.com](mailto:akenigsberg@osler.com) 416.862.6659

**Marlene Legare** [mlegare@osler.com](mailto:mlegare@osler.com) 416.862.4603

**D'Arcy Schieman** [dschieman@osler.com](mailto:dschieman@osler.com) 416.862.5977

**Blake Murray** [bmurray@osler.com](mailto:bmurray@osler.com) 416.862.6444

**Alain Fournier** [afournier@osler.com](mailto:afournier@osler.com) 514.904.5390

**Sean Aylward** [saylward@osler.com](mailto:saylward@osler.com) 416.862.5901

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<sup>[1]</sup> References herein to GST include a reference to both the goods and services tax and the harmonized sales tax.

<sup>[2]</sup> As set out in the Explanatory Notes to the legislative amendments to the Act announced on July 22, 2016.

<sup>[3]</sup> One exception to this is that the amended rules do not address issues with commingled goods such as continuous transmission commodities that are transported by pipeline or wire (CTCs which include oil, gas, etc.). Our understanding is that this was purposeful, as the Department of Finance believes that the rules relating to drop shipments of CTCs should be dealt with separately under a future review of the provisions of the Act specific to CTCs.