Northbridge v the King: FCA clarifies ITC availability on zero-rated supply of insurance

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* Since this article's release, BLG has published an update. See our discussion of the TCC decision after being referred back by FCA.

On Oct. 24, 2023, the Federal Court of Appeal (FCA) released its decision in *Northbridge Commercial Insurance Corporation v His Majesty the King* (2023 FCA 211), allowing the taxpayer's appeal against reassessments by the Canada Revenue Agency (the CRA).

The FCA set aside the Tax Court of Canada's (TCC) decision to dismiss the taxpayer's appeal and, in doing so, overturned the denial of input tax credits (ITCs) for goods and services tax/harmonized sales tax (GST/HST) relating to the administration costs of certain insurance policies issued by the taxpayer. In particular, the FCA ruled that the "risks" under the policies were accidents or insurable events ordinarily situated outside of Canada and therefore considered a zero-rated supply of financial services pursuant to Schedule VI, Part IX of the *Excise Tax Act*. This clarifies long-standing uncertainty regarding interpretation of the Act.

What you need to know

- An insurance policy covering risks ordinarily situated outside of Canada may be a zero-rated supply, meaning that GST/HST applies at 0 per cent on its premiums and the insurer is permitted to claim ITCs on its related expenses.
- For the purposes of GST/HST, the meaning of "risks" must be interpreted from the perspective of the insurer not the insured. Such risks include claims that may arise from an accident or insurable event under an insurance policy.
- The geographical scope of coverage and particular location of an accident or insurable event will determine whether the risks are ordinarily situated outside of Canada.
- Insurers should evaluate their policies, geographical coverage, and methodology used to determine ITCs and retain satisfactory documentation in case of a CRA challenge. There may be opportunities to unlock ITCs previously unavailable following this decision.

Background

Northbridge Commercial Insurance Corporation (Northbridge or the Taxpayer) is a licensed insurance provider that issues policies, including fleet insurance, to commercial trucking companies. The policies under dispute in this case provided coverage for accidents and other insurable events relating to trucking operations in Canada and the United States.

For the purposes of claiming ITCs, Northbridge characterized the policies as a zero-rated supply of financial services under the *Excise Tax Act* (see Schedule VI, Part IX, para 2(d)), to the extent they related to risks ordinarily situated outside of Canada. Accordingly, Northbridge allocated and claimed ITCs on a proportional basis for its general head office and overhead expenses.

Northbridge was subsequently reassessed by the CRA for its reporting periods between January 1, 2007 and December 31, 2016 and denied such ITCs. The CRA took the position that the policies were an exempt (rather than zero-rated) supply of financial services under the *Excise Tax Act*, which prohibited Northbridge from claiming the disputed ITCs.

Northbridge appealed to the TCC.

Tax Court of Canada

The primary issue before the TCC was whether "risks," as referred to in paragraph 2(d) of Part IX, Schedule VI of the *Excise Tax Act*, means: (a) the *objects* of the insurance policy; (b) the *perils* covered by the insurance policy; or (c) the *chance of a peril occurring* that is covered by the policy.

Applying a textual, contextual and purposive analysis, the TCC dismissed Northbridge's appeal, finding that the risks meant the "objects" of an insurance policy. In the case of Northbridge, the objects were the fleet of trucks insured under the policies. The TCC explained that apportioning a supply under paragraph 2(d), for purposes of determining the extent of zero-rated supplies, should occur on an "object-by-object basis."

In other words, Northbridge was expected to make a separate apportionment for each of the policies on a vehicle-by-vehicle basis. Since Northbridge did not provide individual policies as evidence, the TCC stated that it could not determine whether a particular portion of the policies was zero-rated under the *Excise Tax Act*.

Northbridge then appealed the decision to the FCA.

Federal Court of Appeal

The Federal Court of Appeal set aside the TCC's judgment and tasked the TCC with determining the amount of ITCs that Northbridge was entitled to within the disputed reporting periods.

Interpretation of "risks"

For highly detailed statutes such as the *Excise Tax Act*, case law demonstrates that specific terms should be afforded a meaning that is understood in the applicable industry. As a result, the FCA notably stated that "risk" should be interpreted from the perspective of insurance companies, particularly since the applicable provision under the *Excise Tax Act* is explicitly limited to financial institutions that issue insurance policies.

The FCA also stated that indemnification against risk of loss, damage or liability is a fundamental element of insurance policies. The risk, for Northbridge, was not the trucks insured under the policies; rather, the risk was that the trucks could be involved in an accident or insurable event that would lead to a claim by the businesses that Northbridge insured.

"Risks" ordinarily situated outside Canada

The FCA disagreed with the TCC's suggestion that a peril covered by an insurance policy is generally "universal," making it impossible to determine where such peril is ordinarily situated. The fact that risks are limited to those "ordinarily situated outside of Canada", does not alter the fundamental meaning of "risks". Instead, the FCA stated that, in accordance with paragraph 2(d), accidents or insurable events inevitably occur at a particular location – either inside or outside the geographic scope of coverage. The geographic scope of Northbridge's policies was confined to Canada and the U.S.

As a result, the FCA held that the policies, in part, related to accidents or insurable events that are ordinarily situated outside of Canada and may result in claims outside of Canada, with those portions of the policies qualifying as a zero-related supply for purposes of GST/HST.

The FCA also advised that the extent to which the policies related to risks ordinarily situated outside of Canada should be determined based on the likelihood of an accident occurring in the U.S. and the potential loss incurred from such an accident.

Takeaways

The FCA's decision in the Northbridge case clarifies long-standing uncertainty regarding the interpretation of the *Excise Tax Act* for insurance policies that cover risks ordinarily situated outside of Canada and provides a framework to determine exempt versus zero-rated policies. This clarification should be welcomed by Canadian insurers that issue policies providing coverage for insurable events outside Canada.

Given this decision, insurers should evaluate the methodology they use to determine ITCs and be aware that this should not be an object-by-object analysis; instead, policies must be analyzed in their entirety. Insurers should establish and retain satisfactory documentation to defend their ITC allocation in case the CRA challenges or denies their ITC claims.

If you have questions about the FCA's decision and its effect on ITCs claimed under the *Excise Tax Act*, reach out to the authors of this piece or a member of BLG's business tax team.

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