CANADIAN INTERNATIONAL TRADE TRIBUNAL
TRIBUNAL CANADIEN DU COMMERCE EXTÉRIEUR

Ottawa, Monday, August 28, 1995

Appeal No. AP-94-167

IN THE MATTER OF an appeal heard on January 12, 1995, under section 81.19 of the *Excise Tax Act*, R.S.C. 1985, c. E-15;

AND IN THE MATTER OF a decision of the Minister of National Revenue dated February 3, 1993, with respect to a notice of objection served under section 81.17 of the *Excise Tax Act*.

BETWEEN

SECURITY CARD SYSTEMS INC. **Appellant**

AND

THE MINISTER OF NATIONAL REVENUE **Respondent**

DECISION OF THE TRIBUNAL

The appeal is allowed in part.

Charles A. Gracey
Charles A. Gracey
Presiding Member

Raynald Guay
Raynald Guay
Member

Lyle M. Russell
Lyle M. Russell
Member

Nicole Pelletier
Nicole Pelletier
Acting Secretary

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UNOFFICIAL SUMMARY

Appeal No. AP-94-167

SECURITY CARD SYSTEMS INC. **Appellant**

and

THE MINISTER OF NATIONAL REVENUE **Respondent**

The appellant is a licensed manufacturer of credit cards, primarily for financial institutions (the clients). The appellant paid federal sales tax (FST) on the embossing and encoding activities associated with making the credit cards. However, it subsequently applied for a refund of the FST paid, on the basis that it was not the legal manufacturer or producer under subsection 50(1) of the Excise Tax Act (the Act) with regard to those activities.

The issue is this appeal is whether the appellant is liable for FST under the Act with respect to the embossing and encoding activities. If not, the appellant is entitled to a refund of the moneys paid in error that were taken into account as taxes under the Act. Specifically, the Tribunal must determine: (1) whether there is a single process of manufacture or production, including both the making of blanks and the embossing services performed on the blanks, or whether there are two distinct operations, first, the manufacture or production of blanks and, second, a contract for labour with respect to the embossing services; (2) if there are two distinct operations, whether the appellant is liable for FST pursuant to section 45.1 of the Act with respect to the embossing and encoding activities; (3) if there is a single process of manufacture or production, whether the clients can be considered the legal manufacturers or producers of the credit cards and, thus, liable for FST; and (4) whether the appellant is liable for FST pursuant to section 45.1 of the Act where the clients provide the appellant with blanks made by another firm for embossing and encoding activities.

HELD: *The appeal is allowed in part. Upon review of the evidence and the law, the Tribunal is not satisfied that the making of blanks and the embossing services constitute two distinct operations for purposes of determining tax liability. The Tribunal bases its view, in part, on the lack of evidence that property in the blanks passes to the clients upon completion of the blanks by the appellant. The Tribunal further takes the position that the separation of the entire process into two distinct operations is artificial and considers the invoicing for the making of blanks to be a form of progress payment as opposed to consideration for the sale of the blanks.*

The Tribunal further considers that the making of the credit cards constitutes manufacture and that the appellant is the manufacturer of the credit cards for the purposes of paying FST under subsection 50(1) of the Act. Although the Tribunal is satisfied that the appellant's clients have a proprietary, sales or other right to the credit cards, it is not satisfied that the second condition required to be met in order for the appellant's clients to be considered the legal manufacturers of the credit cards under paragraph (b) of the definition of "manufacturer or producer" under subsection 2(1) of the Act was met. Specifically, it is not satisfied that a principal-agent relationship exists between the appellant and its clients.

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However, the Tribunal believes that, where blanks are made by a firm other than the appellant and they are provided to the appellant for embossing services only, these services are performed pursuant to a contract for labour. Therefore, pursuant to section 45.1 of the Act, the appellant is liable for FST on the amount charged under the contracts with persons other than licensed manufacturers. Where such contracts exist with licensed manufacturers, the appellant is entitled to a refund of any amounts paid, as these were paid in error.

Place of Hearing:	*Ottawa, Ontario*
Date of Hearing:	*January 12, 1995*
Date of Decision:	*August 28, 1995*
Tribunal Members:	*Charles A. Gracey, Presiding Member* *Raynald Guay, Member* *Lyle M. Russell, Member*
Counsel for the Tribunal:	*Heather A. Grant*
Clerk of the Tribunal:	*Anne Jamieson*
Appearances:	*Paul E. Hawa, for the appellant* *Christopher Rupar, for the respondent*

CANADIAN INTERNATIONAL TRADE TRIBUNAL | TRIBUNAL CANADIEN DU COMMERCE EXTÉRIEUR

Appeal No. AP-94-167

SECURITY CARD SYSTEMS INC. **Appellant**

and

THE MINISTER OF NATIONAL REVENUE **Respondent**

TRIBUNAL: CHARLES A. GRACEY, Presiding Member
RAYNALD GUAY, Member
LYLE M. RUSSELL, Member

REASONS FOR DECISION

This is an appeal under section 81.19 of the *Excise Tax Act*[1] (the Act) of a determination of the Minister of National Revenue that rejected an application for a refund of federal sales tax (FST) claimed to have been paid in error.

The appellant is a licensed manufacturer of credit cards, primarily for financial institutions (the clients). The appellant paid FST on the embossing and encoding activities associated with making the credit cards. However, it subsequently applied for a refund of the FST paid, on the basis that it was not the legal manufacturer or producer under subsection 50(1) of the Act with regard to those activities.

The refund application was rejected, and the determination was confirmed by the respondent on the basis that the appellant was engaged in a contract for labour with its clients. Therefore, under section 45.1 of the Act, the appellant was deemed to have sold the goods and was, therefore, liable for FST on an amount equal to the charge made under the contract, which it had done. Accordingly, a refund was not in order. The appellant subsequently appealed the determination to the Tribunal.

The issue in this appeal is whether the appellant is liable for FST under the Act with respect to the embossing and encoding activities. If not, the appellant is entitled to a refund of the moneys paid in error that were taken into account as taxes under the Act.

For the purposes of this appeal, the relevant provisions of the Act state, in part, as follows:

> *50.(1) There shall be imposed, levied and collected a consumption or sales tax ... on the sale price or on the volume sold of all goods*
>
> *(a) produced or manufactured in Canada*
>
> *(i) payable ... by the producer or manufacturer at the time when the goods are delivered to the purchaser or at the time when the property in the goods passes, whichever is the earlier.*

1. R.S.C. 1985, c. E-15.

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2.(1) In this Act, other than section 121, Part IX and Schedules V, VI and VII,

"manufacturer or producer" includes

(b) any person, firm or corporation that owns, holds, claims or uses any patent, proprietary, sales or other right to goods being manufactured, whether by them, in their name or for or on their behalf by others, whether that person, firm or corporation sells, distributes, consigns or otherwise disposes of the goods or not,

(f) any person who, by himself or through another person acting for him, prepares goods for sale by assembling, blending, mixing, cutting to size, diluting, bottling, packaging or repackaging the goods or by applying coatings or finishes to the goods, other than a person who so prepares goods in a retail store for sale in that store exclusively and directly to consumers.

45.1 For the purposes of this Part, a person who, pursuant to a contract for labour, manufactures or produces goods from any article or material supplied by another person, other than a licensed manufacturer, for delivery to that other person shall be deemed to have sold the goods, at a sale price equal to the charge made under the contract in respect of the goods, at the time they are delivered to that other person.

The first witness called on behalf of the appellant was Mr. Roy Dalla Zuanna, Manager of Accounting for Security Card Systems Inc. Mr. Dalla Zuanna testified that the appellant's business is divided into two distinct operations, first, the making of "blank cards" (blanks) and, second, embossing and encoding activities in which "live cards" are created (cards).

In making blanks, the clients provide the appellant with a film negative of the design for the blanks from which the appellant then develops a graphic representation. The appellant subsequently performs the following operations: (1) it creates a printing plate; (2) it prints the design on plastic sheets; (3) it applies a magnetic stripe; (4) it laminates the blanks; (5) it cuts the sheets into individual sizes; (6) it applies a hologram if requested; and, finally, (7) it applies and hot stamps a signature panel onto each unit.

Once the blanks are made, they are placed in a vault, and the clients are invoiced. Mr. Dalla Zuanna testified that, at this point, in his view, the blanks are owned by the clients. If the clients also request embossing services, the blanks remain with the appellant; otherwise, they may be transferred to the clients.

Mr. Dalla Zuanna testified that, in some cases, the clients deliver blanks to the appellant which were made elsewhere and request the appellant to provide embossing services with respect to the blanks. Conversely, the clients may just request the appellant to make blanks and subsequently take them elsewhere for embossing services.

The embossing services include embossing the names and account numbers of the clients' customers on the blanks, encoding the magnetic stripe, attaching the cards to carriers and usually mailing them either directly to the customers or to the clients. It should be noted that the specific activities for which the refund is claimed are only the embossing per se and the encoding.

With respect to the clients' involvement in the process, Mr. Dalla Zuanna testified that the clients approve the appellant's graphic representation of the design. Furthermore, the clients own the trademarks, as

well as the printing plates that are used in making the blanks, once they have paid for the plates. The clients also own the customer information, which the appellant may only distribute in accordance with the clients' instructions.

During cross-examination, Mr. Dalla Zuanna admitted that 80 to 85 percent of the clients covered by the refund application contracted for both the making of blanks and embossing services. Furthermore, he admitted that a blank has no use and that the embossing activities must be completed before the card is useful to the clients' customers. Mr. Dalla Zuanna further stated that the clients have no managerial or financial control over the appellant, nor do they maintain any persons on the appellant's premises to inspect or oversee the process through which the cards are made. Furthermore, they do not provide the appellant with any technical expertise. Mr. Dalla Zuanna also admitted that, if both the making of blanks and the embossing services are requested and the appellant and the clients enter into a formal written contract, a single contract, which is divided into two parts, is drafted.

Further to a request from the Tribunal, counsel for the appellant entered a copy of an "Order Confirmation" form as an exhibit. Mr. Dalla Zuanna testified that an "Order Confirmation" form is sent to all clients, one for each operation, regardless of whether or not a formal written contract exists between the appellant and the clients. Mr. Dalla Zuanna stated that an invoice is sent to the clients at the conclusion of each operation in respect of each "Order Confirmation" form.

The second witness to appear on behalf of the appellant was Mr. Ali Hirji, Vice-President, Commodity Tax Operations, of Ninican Management Inc. (Ninican). Ninican is a management consulting firm that was engaged by the appellant to perform a review of its tax liability. Mr. Hirji referred to a list of the appellant's clients to which the refund application pertains and testified as to which clients on the list are licensed manufacturers and which ones are not.

After having heard all the evidence, the Tribunal requested the appellant to submit three samples of formal written contracts between it and its clients that meet the following descriptions: one for the making of blanks only, a second for embossing services only, and a third for both the making of blanks and embossing services. The Tribunal also requested submissions, if any, in a follow-up letter sent to the parties after the hearing, on the legal relationship between the appellant and the clients in view of the contracts.

In argument, counsel for the appellant submitted that the appellant performs two distinct operations: first, the making of blanks and, second, the provision of embossing services. He argued that the embossing services are completed pursuant to a contract for labour and that, therefore, section 45.1 of the Act is applicable. According to counsel, this section only subjects to tax contracts for labour with persons other than licensed manufacturers. Therefore, contracts with licensed manufacturers do not constitute a deemed sale as they otherwise would under section 45.1 of the Act. Consequently, contracts with licensed manufacturers are not taxable under subsection 50(1) of the Act.

Furthermore, with respect to the contracts with persons other than licensed manufacturers, counsel for the appellant argued that it is the appellant's position that its clients, as the persons contracting out the work to the appellant, are the legal manufacturers or producers for the purposes of taxation under subsection 50(1) of the Act, pursuant to paragraph (*b*) of the definition of "manufacturer or producer" under subsection 2(1) of the Act. In support of this position, counsel relied primarily on the decisions in *Rexair of*

Canada Limited v. The Queen, *Turnbull Elevator Co. of Canada Ltd. v. The Queen* and *The King v. Reuben Shore*.[2]

Counsel for the appellant submitted that not only do the clients have complete control over the goods through ownership of the patents, trademarks and tools used in the process through which the cards are made but they also exercise control through ownership of the raw materials, specifically the blanks, carriers, envelopes and insertions, as well as through restricting the ultimate delivery of the cards to either them or their customers. Counsel referred to certain terms and conditions included in the "Order Confirmation" form in support of this view.

Counsel for the appellant further submitted that policy statements of the Department of National Revenue, on which counsel for the respondent relied in his brief, should only be taken into account in considering the meaning of legislation where the legislation is unclear, which, counsel for the appellant submitted, is not the case in this appeal.

Furthermore, counsel for the appellant argued that the appellant's clients would also be considered the legal manufacturers under paragraph (*f*) of the definition of "manufacturer or producer" under subsection 2(1) of the Act, as the appellant is packaging or repackaging the cards for sale for its clients.

In response, counsel for the respondent argued that the process of making the blanks and performing the embossing services is one continuous process which cannot be separated for the purposes of taxation under section 50 of the Act, regardless of whether one company makes the blanks and another company performs the embossing services. Furthermore, the process constitutes not only production but also manufacture. Counsel argued that, if the process is divided, the blanks are useless and only become useful once they have undergone the embossing services. He argued, in relying on the decision in *Coca-Cola Ltd. v. The Deputy Minister of National Revenue for Customs and Excise*,[3] that the embossing and encoding activities are part of the overall production or manufacture of credit cards, in fact, the key operations, and, therefore, they cannot be separated from the manufacture or production of blanks. Accordingly, the appellant is the manufacturer or producer of the cards for the purposes of subsection 50(1) of the Act. As such, there is no need for the Tribunal to consider the application of section 45.1 of the Act.

With respect to whether paragraph (*b*) of the definition of "manufacturer or producer" under subsection 2(1) of the Act applies, counsel for the respondent submitted that, as a prerequisite, the Tribunal must find that the process constitutes manufacture and not merely production. Counsel further submitted that, in reference to the decision in *Gerrard-Ovalstrapping, Division of EII Limited v. The Minister of National Revenue*,[4] in order for the appellant's clients to be considered the legal manufacturers under paragraph (*b*), two conditions must be met. First, the clients must own or use certain proprietary, sales or other right to the goods being manufactured, and, second, a principal-agent relationship must be determined to exist between the appellant and the clients. In arguing that such a relationship does not exist in this case, counsel referred to departmental policy, as well as to the Tribunal's decision in *Palmer Jarvis Advertising v. The Minister of National Revenue*.[5] Specifically, in reference to the policy, counsel submitted that there is no

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2. 58 D.T.C. 1158 (S.C.); (1962), 63 D.T.C. 1001 (Ex. Ct.); and 49 D.T.C. 570 (Ex. Ct.), respectively.
3. [1984] 1 F.C. 447.
4. Canadian International Trade Tribunal, Appeal No. AP-93-289, September 26, 1994.
5. Appeal No. AP-92-375, May 17, 1994.

evidence of a principal-agent relationship, that the appellant and its clients are separate entities, that the clients have no financial or managerial control over the appellant and that the sales of the cards are made in accordance with usual commercial practices. In reference to *Palmer Jarvis*, counsel submitted that the appellant's clients only have creative control over the process, which is not sufficient control in order to establish a principal-agent relationship between the appellant and its clients.

In reply, counsel for the appellant submitted that the departmental policy to which counsel for the respondent referred in his argument was taken out of context and did not apply to the situation at issue. Furthermore, he argued that, if property in the blanks changes hands after their completion, this has an effect on taxation, contrary to counsel for the respondent's submission. Counsel for the appellant also reviewed the facts in support of his position that the clients have control over the appellant's process through which the cards are made, including dictating the specifications of the cards.

Specifically, the Tribunal must determine: (1) whether there is a single process of manufacture or production, including both the making of blanks and the embossing services performed on the blanks, or whether there are two distinct operations, first, the manufacture or production of blanks and, second, a contract for labour with respect to the embossing services; (2) if there are two distinct operations, whether the appellant is liable for FST pursuant to section 45.1 of the Act with respect to the embossing and encoding activities; (3) if there is a single process of manufacture or production, whether the clients can be considered the legal manufacturers or producers of the cards and, thus, liable for FST; and (4) whether the appellant is liable for FST pursuant to section 45.1 of the Act where the clients provide the appellant with blanks made by another firm for embossing and encoding activities.

Under subsection 50(1) of the Act, tax is imposed on all goods, produced or manufactured in Canada, payable at the time when the goods are delivered to the purchaser or at the time when the property in the goods passes, whichever is the earlier. Upon review of the evidence and the law, the Tribunal is not satisfied that the making of blanks and the embossing services constitute two distinct operations for purposes of determining tax liability. The Tribunal bases its view, in part, on the lack of evidence that property in the blanks passes to the clients upon completion of the blanks by the appellant. Accordingly, the Tribunal is of the view that the entire process of making cards is taxable under subsection 50(1) of the Act when the appellant performs both operations and that the embossing and encoding activities should not be viewed separately as a contract for labour, which would otherwise be governed by section 45.1 of the Act.

In support of its conclusion that property in the blanks does not pass upon their completion, the Tribunal relies, in part, on the three written contracts that it received in post-hearing submissions. While the Tribunal recognizes that these represent three sample contracts and that, in a number of cases, only "Order Confirmation" forms were used, the Tribunal takes the view that they provide a reasonable indication of the legal arrangement between the appellant and its clients where contracts existed for both the making of blanks and embossing services.[6]

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6. It should be noted that all three contracts submitted by the appellant set out terms governing both the making of blanks and performance of the embossing services.

The Tribunal points to a number of provisions in the contracts that suggest that title to the blanks does not pass once the blanks are made. Specifically, contract A[7] provides that "[t]itle and risk of loss of the plastic cards shall pass only on delivery of the processed cards to Canada Post Corporation," even though the contract contains other provisions which suggest that the appellant holds the inventory of blanks as bailee and that the client holds title to the inventory. Contract B provides that, where the contract has expired or been terminated, the blanks held by the appellant shall be offered for purchase to the client. Accordingly, title to the blanks belongs to the appellant once the blanks are completed and not to the clients as suggested by counsel for the appellant. Furthermore, contracts A and C provide that the appellant is to insure against risk of loss in relation to the blanks held by the appellant on its premises.

As already indicated, the Tribunal is of the view that the making of blanks and the embossing services when performed by the same manufacturer or producer constitute one continuous process, ultimately resulting in the making of credit cards. The Tribunal takes the position that the separation of the entire process into two distinct operations is artificial and considers the invoicing for the making of blanks to be a form of progress payment as opposed to consideration for the sale of the blanks.

The Tribunal must now determine who constitutes the manufacturer or producer for the purposes of paying the FST under subsection 50(1) of the Act.

The Tribunal is of the view that the making of credit cards constitutes manufacture in that "new forms, qualities and properties or combinations" are given to the materials used in the making of the cards.[8] Moreover, the appellant is clearly the physical manufacturer of the cards. There remains, however, to determine whether the appellant's clients constitute the legal manufacturers of the cards under paragraph (*b*) of the definition of "manufacturer or producer" under subsection 2(1) of the Act and are, therefore, liable for FST in respect of the cards.

In order for a person, firm or corporation to be considered a legal manufacturer under paragraph (*b*) of the definition of "manufacturer or producer" under subsection 2(1) of the Act, the Tribunal must be satisfied that the following two conditions are met: (1) a person, firm or corporation must own, hold, claim or use a patent, proprietary, sales or other right to goods being manufactured; and (2) the goods must be manufactured by them, in their name or for or on their behalf by others.

With regard to the first condition, the Tribunal is satisfied that the appellant's clients have a proprietary, sales and "other right" to the cards. In the Tribunal's view, the clients have a proprietary right to the cards in that they supply the appellant with the envelopes, carriers and customer information to be used in the manufacturing process. The Tribunal is further satisfied that the clients hold a sales right to the cards in that they are sold exclusively to the clients and cannot be sold to any other person. The Tribunal is also satisfied that the clients have an "other right" to the cards in that the clients own the trademarks used on the cards.

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7. To protect the confidentiality of information submitted to the Tribunal, the three samples of formal written contracts are referred to as contract A, contract B and contract C.
8. This applies the test for "manufacture" which was set out in *Minister of National Revenue v. Dominion Shuttle Company Limited* (1933), 72 Que. S.C. 15, and adopted by the Supreme Court of Canada in *The Queen v. York Marble, Tile and Terrazzo Limited,* [1968] S.C.R. 140.

However, the Tribunal is not satisfied that the second condition has been met in this appeal. The Tribunal is of the view that the second condition requires that the relationship between the appellant and the clients not simply be that of vendor and purchaser. For the clients to be deemed manufacturers under this provision requires something more than the clients merely being the purchasers of the cards from the appellant.[9] In effect, it requires that there be a principal-agent relationship between the parties. Whether or not such a relationship exists is largely a question of fact.

In reaching its conclusion on this issue, the Tribunal considered the nature and extent of control exercised by the clients over the appellant and its manufacturing process. Upon reviewing the facts of this case, the Tribunal determined that, in its view, the appellant's clients do not exercise sufficiently close supervision and control over the appellant's manufacturing process so as to meet the second condition under paragraph (*b*) of the definition of "manufacturer or producer" under subsection 2(1) of the Act. The Tribunal is of the view that the relationship between the appellant and its clients reflects that of vendor and purchaser and not principal and agent.

While the Tribunal recognizes that the clients are involved in dictating the specifications of the cards and supplying the appellant with certain materials, such as the design, carriers, envelopes and customer information, the Tribunal notes that the clients have no managerial control over the appellant. Furthermore, as confirmed by Mr. Dalla Zuanna, their right to inspect the goods being manufactured at any stage of the manufacturing process is very limited and does not include maintaining an employee of the clients on the appellant's premises for the purposes of inspecting the manufacturing process, as indicated by Mr. Dalla Zuanna.

The Tribunal's conclusion is given further support by the terms of the written contracts submitted by the appellant. For example, contract A refers to the appellant as an independent contractor in relation to its client and that the appellant's personnel are agents or employees of the appellant and not servants or agents of the client. In contract B, the appellant is referred to as the "Contractor." Moreover, contract B provides that "[t]he Contractor is an independent contractor and not the servant, employee, partner or agent of the [client]." As well, it provides that, "[n]o partnership, joint venture or agency will be created or will be deemed to be created by this [contract] or any action of the parties under this [contract]."

Having found that the appellant is liable for FST on both the making of blanks and the embossing services, where the appellant was under contract to perform both of these operations, the Tribunal believes that a distinction must be made where the blanks are made by a person other than the appellant and subsequently brought to the appellant for embossing services only.

At the time that the blanks are provided to the appellant, they are owned by the clients. In the Tribunal's view, the subsequent embossing services are performed by the appellant pursuant to a contract for labour. Accordingly, the provisions of section 45.1 of the Act are invoked. Pursuant to section 45.1 of the Act, where a person manufactures or produces goods from any material supplied by another person, other than a licensed manufacturer, there is a deemed sale at the time the goods are delivered to the other person. Consequently, the manufacturer or producer is liable for FST on the amount charged under the contract in respect of the goods under subsection 50(1) of the Act.

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9. *Supra*, note 4.

In the Tribunal's opinion, the operations performed by the appellant under such contracts constitute production, in that the cards, once embossed and encoded, are something new; they can perform a different function than previously.[10] Given that the operations constitute production as opposed to manufacture, paragraph (*b*) of the definition of "manufacturer or producer" under subsection 2(1) of the Act does not apply. With respect to the application of paragraph (*f*), the Tribunal is of the view that the appellant's clients are not engaged in any of the activities described in that paragraph through the appellant performing the embossing services.

Therefore, where the appellant entered into contracts for embossing services with persons other than licensed manufacturers, it is liable for FST on the amount charged under those contracts. However, where such contracts exist with licensed manufacturers, the appellant is not liable for FST on the amount charged under the contracts and is, therefore, entitled to a refund of any amounts paid as such, as these were paid in error.

As it is unclear from the evidence which, if any, licensed manufacturers on the appellant's list of clients only contracted for embossing services and not the making of blanks, the Tribunal directs the appellant to provide such information to the Department of National Revenue in order that it may calculate the amount of refund, if any, to which the appellant is entitled.

Accordingly, the appeal is allowed in part.

Charles A. Gracey
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Presiding Member

Raynald Guay
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10. *The Minister of National Revenue v. Enseignes Imperial Signs Ltée* (1990), 116 N.R. 235, Federal Court of Appeal, File No. A-264-89, February 28, 1990.