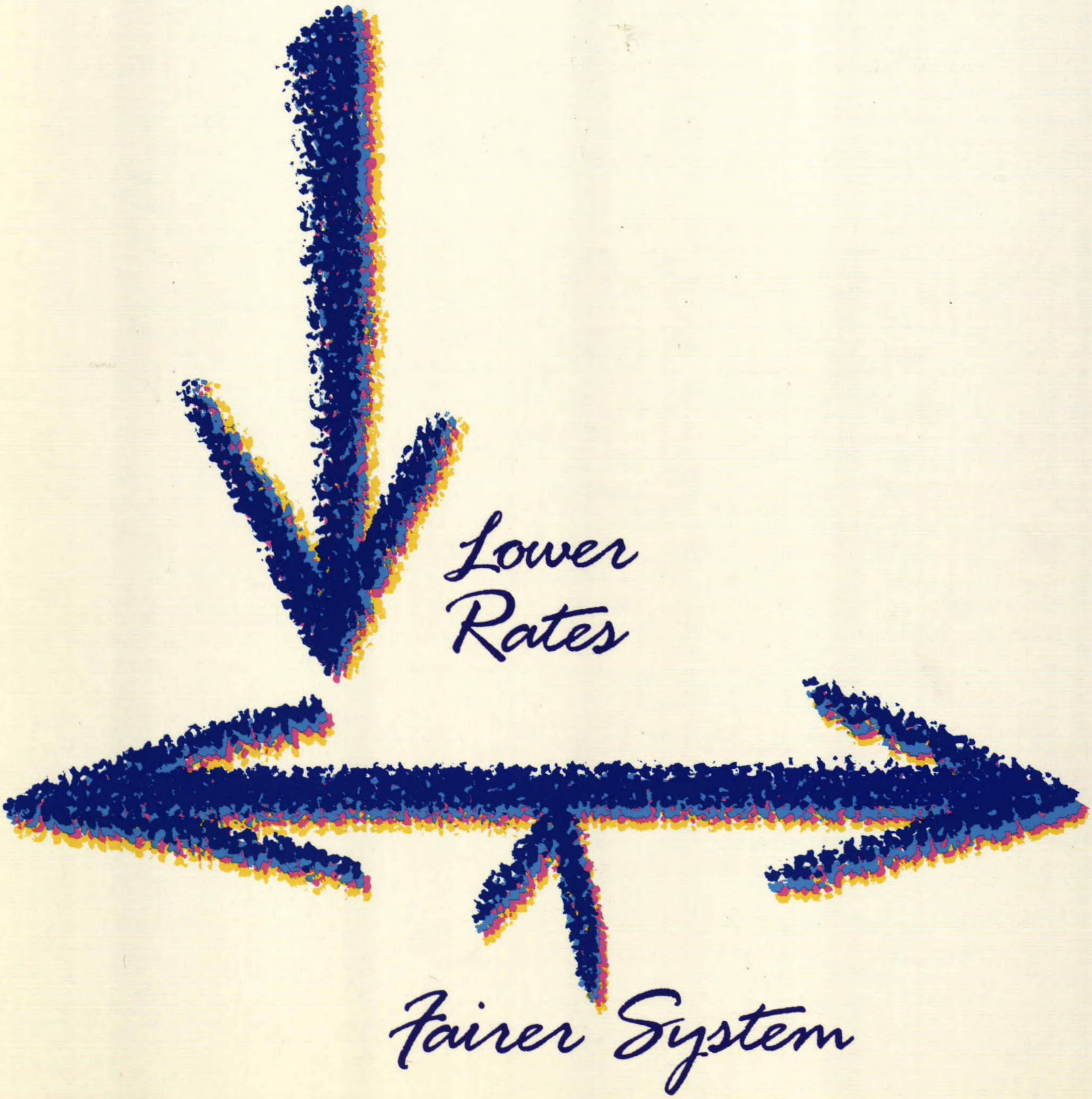
x Reform 1987

Sales Tax Reform

June 18, 1987

The Honourable
Michael H. Wilson
Minister of Finance



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Introduction

Major reform of the federal sales tax system is an integral part of the government's plan for comprehensive tax reform. Together with reform of the personal and corporate income tax systems, sales tax reform is an opportunity to strengthen economic growth in Canada and to improve tax fairness. It is an opportunity to build a tax system that is well suited to the demands of a competitive international marketplace: first, because it will strengthen the ability of our industries to compete in foreign and domestic markets; and second, because a fair and effective sales tax system will provide the necessary balance among revenue sources that is essential to a competitive personal and corporate tax structure with lower marginal rates. In turn, this will help to encourage savings and promote investment in Canada.

The federal sales tax is a major source of revenue, helping to fund such distinctive Canadian priorities as our national system of health care, affordable higher education, regional development and support for those in need. Reform of the current system will help to maintain and enhance these programs that are of fundamental importance to all Canadians. Over all, it will provide new flexibility in managing the economy and expand opportunities for social progress.

The current federal sales tax is seriously flawed. It is too narrowly based. Many areas of economic activity are not currently taxed, with the result that many manufactured goods are treated in a clearly discriminatory way. The federal sales tax is biased against our exports and in favour of imports. It is becoming increasingly complicated, making compliance more difficult. It taxes goods capriciously, scattering and compounding its impacts through the distribution chain in a frequently unpredictable manner. It distorts consumer prices and is unfair to those in need. It creates barriers to economic growth and the creation of jobs and opportunities for Canadians.

These problems are well known and the need for change is widely recognized by those who are affected. The government believes that the time has come to move the debate forward and to begin to build a new sales tax system.

In that context, Part A of this paper proposes a direction for change: to replace the current sales tax at the manufacturer's level with a broad-based multi-stage sales tax extending to the retail level. The paper outlines alternative mechanisms for implementing the new tax either at the federal level or on a national basis.

An integrated national sales tax system would be a major national achievement. It could amalgamate the existing sales tax systems of the federal and provincial governments into one, reducing complexity, lowering administrative costs and greatly enhancing economic efficiency.

Building a new sales tax system is a national undertaking involving fundamental change. It will require wide consultations with interested Canadians and extensive federal-provincial discussions. The federal government proposes to explore the opportunity of a national system fully with the provinces before implementing sales tax reform.

To allow time to pursue these discussions, a new sales tax system will be implemented as a second stage of the government's comprehensive reform of the tax system. In the interim, changes are proposed in the current sales and excise tax system to address some competitive distortions, prevent revenue leakage and broaden the tax base. Along with increased revenues from corporate income tax, these and other interim sales tax measures detailed in Part B of this paper provide additional revenues to finance the reduction in personal tax rates to be undertaken in stage one of tax reform.

Part A: The Multi-Stage Sales Tax

Chapter 1: Principles of a Good Sales Tax

A reformed sales tax system – a system that will better serve all Canadians – should be based on three fundamental principles.

- It should support the **growth** and **efficiency** of the economy.
- It should be **fair**, both to individuals and families and in its application to sectors and firms across the economy.
- It should **minimize compliance costs** for businesses and **administrative costs** for government.

These principles have guided the government in its review of the current federal sales tax and in the development of the framework for a new system. This chapter discusses the importance of these principles for sales tax reform.

1. Growth and Efficiency of the Economy

A good sales tax system should be neutral. That means it should not lead businesses to alter their production or distribution systems nor should it distort their competitive position in the market. It also should not distort consumer choices.

Business decisions should be based on growth potential and economic merit, not tax considerations. To help ensure this, the amount of sales tax on a commodity should be a constant percentage of its price regardless of the production methods and distribution networks used.

The tax should not prompt businesses to restructure their operations in order to reduce their tax liability, basically by shifting functions and costs that add value to a product beyond the point where it is taxed. While this kind of activity may reduce a firm's tax liability, it may also involve a less efficient use of resources and thereby constrain economic growth. To avoid this kind of distortion, the tax should extend to the final point of consumption – the retail level.

A neutral sales tax should be borne by consumer goods and not by goods to be used for further production – in other words, not by business inputs. Taxing these inputs leads to tax "cascading", with tax imposed on a product after other taxes have already been paid on the goods used to produce it at earlier stages in the production-distribution network. This form of double taxation results in hidden and significant costs, frequently confronting consumers with higher prices. If taxation makes some methods of production more costly than others, businesses are forced to adopt different and less efficient methods off production. This forces costs up, reduces competitiveness and impedes economic growth.

Taxing business inputs increases the cost of producing Candian goods. This is particularly serious for our exports, which are sold in increasingly competitive world markets. But it also creates a bias in Canada in favour of imports, because domestic producers must carry a hidden tax burden which their foreign competitors do not incur.

A system which taxes business inputs increases the cost of capital goods used by business and discourages investment. Over the long term, it weakens prospects for economic growth and job creation. Put simply, a bad sales tax makes the economy poorer.

A neutral sales tax should treat consumer expenditures on competing goods and services equally, to avoid distorting prices and thus interfering with the choices and preferences of consumers. This is accomplished most effectively by a tax that is levied at a uniform rate on a broad base. Such a tax will eliminate tax-induced distortions in the relative positions of firms producing competing products.

In summary: efficiency and growth require a sales tax that is neutral – a tax that is applied at a uniform rate on a broad base and that extends to the retail level. The broader the base, the lower the rate necessary to generate required revenues.

2. Fairness

A fair sales tax system should address two broad concerns. It should not impose an unfair burden on lower-income individuals and families. And it should not favour particular business firms or products over their competitors in the marketplace.

Sales taxes are generally considered to be regressive because they are not levied in accordance with the ability to pay. They are judged to weigh unfairly on lower-income individuals and families, who consume a much larger share of their income than those who are generally better off.

The need for fairness can be addressed through a variety of methods.

Governments have traditionally attempted to compensate for the regressive nature of sales taxes either by exempting such basic commodities as food and clothing or by implementing multiple-rate systems designed to lower the tax burden borne by these commodities. This approach has economic costs in terms of greater complexity and lost efficiency, but these have been accepted as an unavoidable price of fairness.

However, exemptions may not be the most effective way to protect the purchasing power of those most in need. While low-income earners benefit from exemptions, so do higher-income earners who also buy tax-exempt products and services. Indeed, higher-income people usually benefit more because they tend to buy more consumer goods and services over all, including tax-exempt products like food and clothing. In addition, when some goods are exempted, the rate on other goods must be higher to raise the same amount of revenue.

An alternative way to offset the impact of the sales tax on lower-income individuals and families directly is by integrating the sales tax with the personal income tax system. With such an approach, the distributional impact of the sales tax could be made fairer through mechanisms such as refundable tax credits. Credits are flexible and efficient. They can be adjusted to accommodate the requirements of households facing different conditions and demands. For the same revenue cost, refundable income tax credits can do more to provide benefits to those in need than a system of sales tax exemptions. This is so because credits can be targeted to provide assistance where it is needed without losing the tax revenue that would be forgone from higher-income consumers if particular items were exempted.

The federal government currently provides a refundable sales tax credit of $50 for adults and $25 for children to individuals and families earning up to $15,000. The credit is reduced by five cents for every dollar of income exceeding this amount. In the first stage of tax reform the credit will be increased by $20 for adults and $10 for each child. At the same time, the threshold will be increased to $16,000. Enhancing this credit significantly in the context of comprehensive sales tax reform would be a means of furthering tax fairness.

A key challenge in designing a good sales tax system is to strike a balance between the exemption and credit approaches described above to produce a sales tax that is fair and is seen to be fair.

Another dimension of sales tax fairness is its impact on competing businesses. An important part of the overall tax burden can be unevenly distributed across the economy if the sales tax treats products differently and if different rates of tax apply to various goods and services.

If the sales tax base is too narrow, a relatively small proportion of goods will carry a disproportionately heavy tax load while a wide range of goods and services will carry almost none.

3. Low-Cost Compliance and Administration

A good sales tax system should not impose heavy compliance costs on businesses or create undue administrative costs for government. There are three principal ways to keep these costs down.

The first is to ensure that the tax is neutral and that the rate is low. If it is neutral, businesses have no need or incentive to undertake costly reorganizations of their production and distribution systems to reduce their tax liability. Similarly, because a neutral tax requires a broad base, it achieves any given revenue objective with a lower tax rate. Lower rates encourage compliance and simplify government administration by reducing the incentive for tax avoidance and encouraging public acceptance of and respect for the system.

The second way the tax system can keep compliance costs down is by maintaining a reasonably stable and predictable environment in which to conduct business, not just in the short term but over the period of years required for long-term investment planning. To maintain such an environment, the tax system should not have to undergo significant revisions on a regular basis. Frequent revisions to the system and ambiguities in law and practice that require a steady stream of administrative rulings and ad hoc arrangements create new anomalies and problems which, in turn, produce pressure for further adjustments. Individuals and businesses should not be left in doubt about their tax obligations under the system, nor should the system place on them the burden of making judgements about what is a taxable or non-taxable sale.

Third, the sales tax system should minimize the paperburden on businesses. This is important to all businesses, but particularly to the small business sector. Reducing paperburden through more straightforward tax policies and simpler tax forms would make an important contribution to easier, low-cost compliance.

If businesses do not need to maintain a complicated system of records, for example segregating taxable from non-taxable commodities, compliance can be achieved more easily and at relatively low cost. Accordingly, the principle of self-assessment on which the tax system is based is strengthened, reducing administrative costs.

Conclusion

The objective of the government is to design and implement a system that reflects each of these principles to the fullest extent possible and creates the best possible balance among them. In many respects the principles are complementary. A tax applied at a uniform rate on a broad base supports economic growth and efficiency, minimizes compliance and administrative costs and, together with refundable sales tax credits, can increase the equity of the system.

Canada's current federal sales tax clearly falls far short of these principles on all counts. The next chapter outlines in detail the many problems with the existing federal sales tax.

Chapter 2: The Current Federal Sales Tax System

Canada's federal sales tax is also known as the manufacturers' sales tax. It is applied to a manufacturer's sale price of goods produced in Canada and to the customs value of imported goods, including any applicable duty.

The standard rate of tax for most manufactured products is currently 12 per cent, with construction materials taxed at 8 per cent and alcohol and tobacco products at 15 per cent. Many items, such as food, clothing and footwear, are exempt from federal sales tax, although some items within these categories would normally be classified as luxury items, rather than necessities.

1. The Problems of the Federal Sales Tax

Canada was the first industrial nation to adopt a manufacturers' tax. Six decades later, it is the last to be still using it.

When the manufacturers' sales tax was put in place in 1924, it seemed adequate in the context of the Canadian economy of the time. The structure of trade was simpler. Manufacturers, wholesalers and retailers typically operated as independent organizations. Transactions between them were relatively easy to identify and tax because they occurred through sales in the marketplace, rather than through transfers between levels of an integrated corporation.

Since the 1920s, the trading system has become more complex and patterns of trade more varied. Dramatic changes in methods of production, commodity distribution networks and world trade patterns have exposed major flaws and shortcomings in the tax.

The faults of the federal sales tax have been identified and documented in numerous studies over the past five decades, beginning with the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission) in 1940, continuing in 1966 with the Royal Commission on Taxation (the Carter Commission), and most recently with the Federal Sales Tax Review Committee (the Goodman Committee) in 1983. These and other reviews have expressed serious concerns about the structure of the federal sales tax and have recommended substantial change.

While piecemeal changes to address the most pressing concerns have been made over the years, with varying degrees of success, the fundamental inadequacies of the tax remain. They are widely recognized.

(a) The Federal Sales Tax is Too Narrowly Based.

The tax base for the federal sales tax is extremely narrow. Only about one-third of all the goods and services Canadians purchase are subject to federal sales tax. Just how narrow this tax base is can be illustrated by the fact that tobacco, alcohol, automobiles, automobile parts and motive fuels together account for about 40 per cent of federal sales tax revenues, yet they represent only about 15 per cent of all consumer expenditures.

A wide range of expenditures are not directly touched by federal sales tax. The tax base is composed largely of manufacturers' sales. The value added by many wholesalers and retailers is not taxed and virtually all services are excluded from the tax base. Items that are exempt from federal sales tax include food products, heating fuels, clothing and footwear, to name a few. By contrast, sales tax in most other industrialized countries applies to a significantly broader base of consumer expenditures.

Because federal sales tax is collected on such a narrow range of items, the tax rates on these items must be high in order to yield the budgetary revenues the government requires.

The combination of a narrow tax base and high tax rates is unfair and distorts the natural and efficient operation of the economy. By imposing a tax burden on the products of certain sectors while giving a tax advantage to other competing products and sectors, the federal sales tax encourages the consumption of tax-exempt items while discouraging the consumption and production of taxable products.

(b) The Federal Sales Tax Distorts Production and Distribution Decisions.

Manufacturers can reduce their federal sales tax liability by shifting certain aspects of their operations beyond the point where products are taxed. Separating marketing activities from manufacturing activities is a case in point. It is not uncommon for manufacturers to have their private brand products made by other companies. The federal sales tax then applies to the manufacturing cost of the products and does not include advertising and marketing costs incurred later in the production and distribution network. Similarly, a firm can reduce the tax burden on a product by contracting out its production to a manufacturer whose price will not include the initial product development costs. In this and a variety of other ways, costs can be kept outside the tax base for taxable products. This means that certain firms can sell at lower prices, since they pay proportionately less tax.

As a result, the effective tax rate (the percentage that tax represents of the final selling price of a good) may differ for the same products, depending on the nature of the production and distribution system. These results are clearly not fair to competing producers who do not have the opportunity to structure their activities in a comparable way. Together with increasing competitive pressure in the market, the high rates of tax required by the narrow base of the current federal sales tax serve to provide increasingly strong incentives for firms to adopt strategies of this kind. As they do, the competitive distortions and inequities increase. They represent an important obstacle to the growth and development of some Canadian businesses – an obstacle that is due solely to the structure of the tax system.

(c) The Federal Sales Tax Has Widely Different Effects on Prices.

There are almost as many effective tax rates under the present federal sales tax as there are products in the market.

The absence of any uniformity in effective tax rates stems from the fact that federal sales tax applies to only a portion of the final selling price – the manufacturer's selling price. Subsequent mark-ups at the wholesale and retail levels vary from product to product and result in a wide diversity in effective tax rates.

Table 2.1 presents the findings of a 1984 survey of 660 different commodities ranging from kitchen utensils to canoes to cosmetics. No two products bore the same effective rate of tax. Perhaps the most astonishing finding of the survey was that the effective tax rate was different not only for different industries but also for similar products made by different manufacturers in the same industry.

The survey found that the effective tax rate for a class of products could vary dramatically – by as much as two to three times (see Chart 2.1). For example, the effective tax rate on cosmetics (adjusted for increases in the statutory rates since the survey) ran as high as 17.08 per cent and as low as 5.15 per cent. Similarly, the highest effective tax rate on auto parts was found to be 13.26 per cent while the lowest was 4.28 per cent.

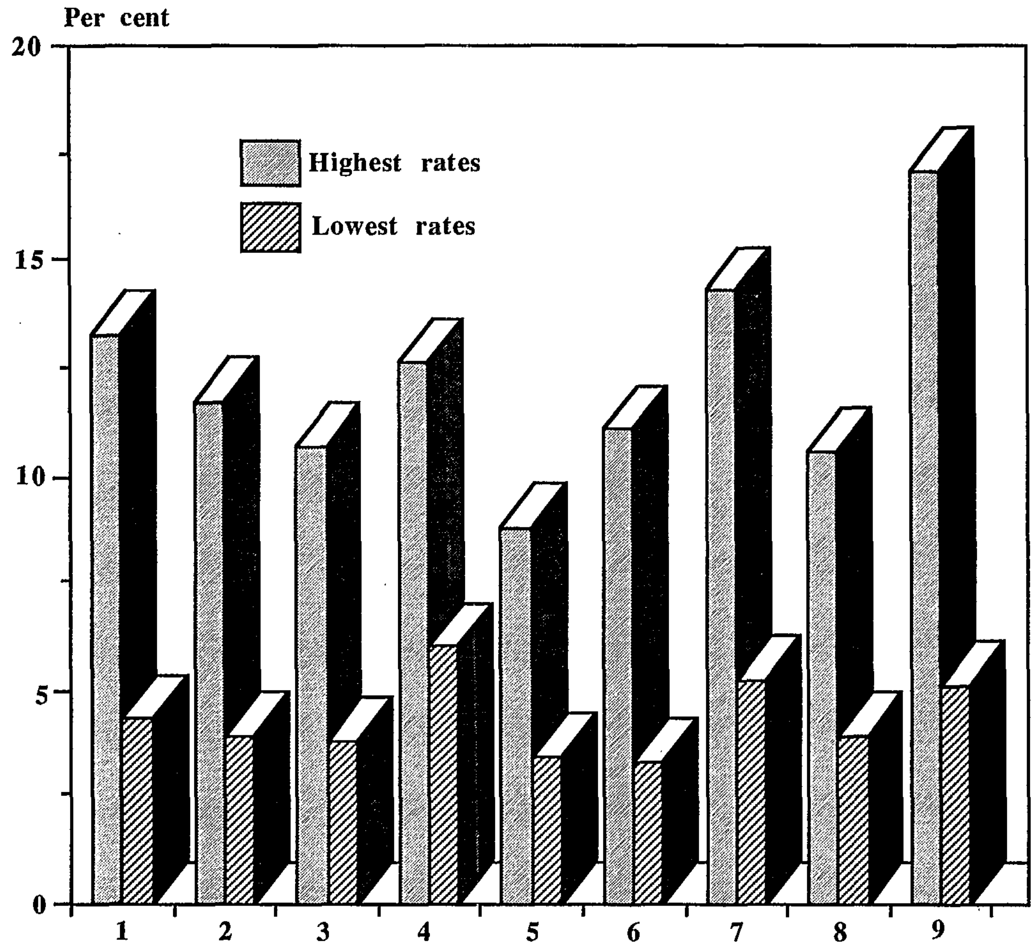
Widely different effective tax rates are harmful to the economy. Two manufacturers may pay different effective tax rates on comparable products without being aware of it. The resulting variation in final prices for comparable products distorts the consumer's perception of the relative value of different products or different brands of the same product, and therefore impairs the ability of certain products and firms to compete in the marketplace.

(d) The Federal Sales Tax Impedes Exports and Increases the Cost of Investment.

The current federal sales tax applies not only to manufactured goods destined for sale to consumers, but also to business inputs such as office supplies and building materials used to produce other goods or to construct business facilities. About half of the total federal sales tax collected is derived from business inputs (see Chart 2.2).

Chart 2.1

Effective Federal Sales Tax Rates on Selected Domestically Produced Commodities



1- Auto parts
2- Household textiles
3- Kitchen utensils
4- Household appliances
5- Electric light bulbs, lamps
6- Office and stationery supplies
7- Sporting equipment
8- Blankets, bedsheets and towels
9- Cosmetics

Table 2.1

Variation in Effective Federal Tax Rates on a Sample of Domestically Produced Commodities

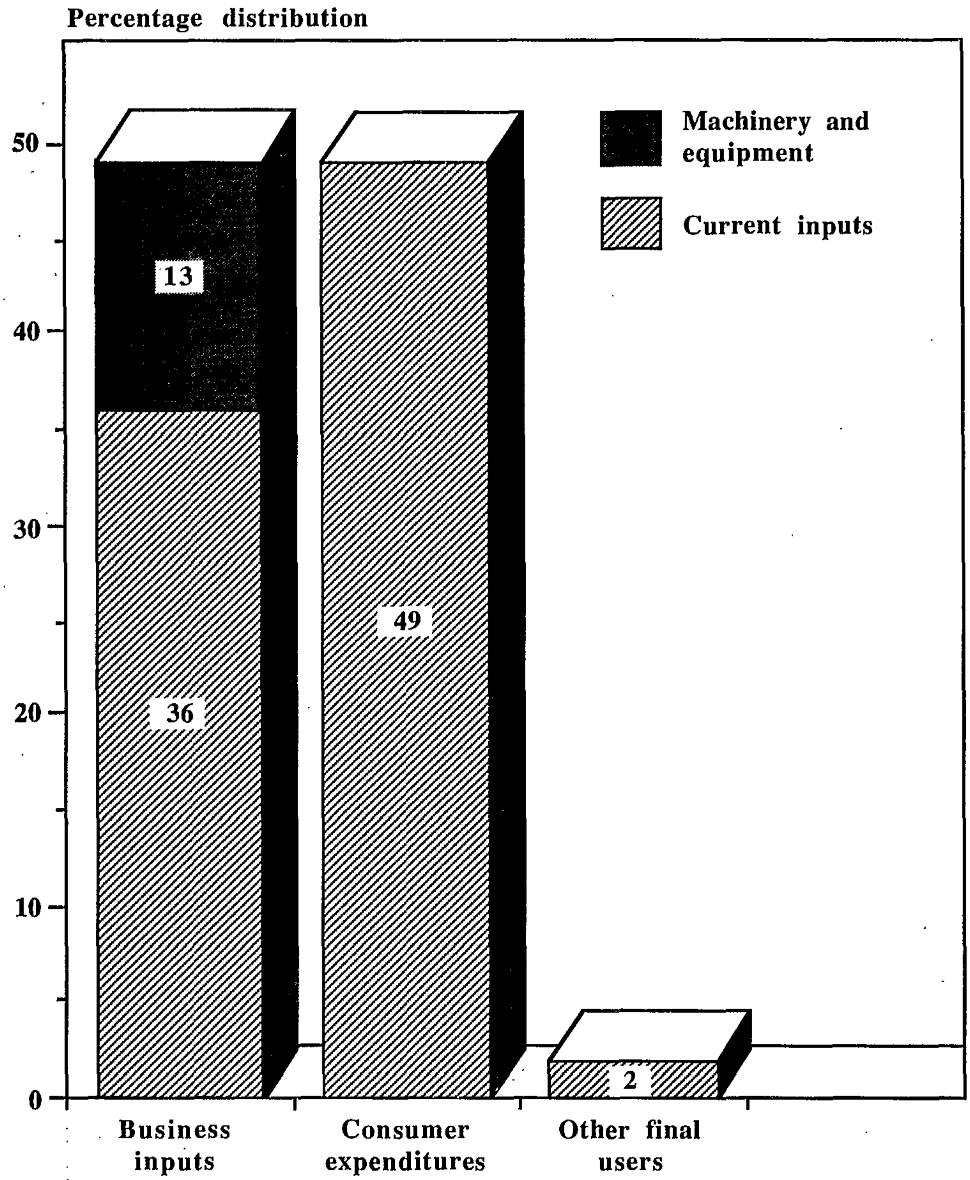
	Average rate	Highest rate	Lowest rate	Ratio of highest to lowest
		(per cent)		(ratio)
Commodities with 12% statutory rate				
Luggage, purses and wallets	5.48	8.34	4.08	2.04
Blankets, bed sheets and towels	5.13	10.51	3.94	2.67
Carpets, rugs and mats	7.50	9.24	5.67	1.63
Household textiles	6.29	11.70	3.95	2.96
Household furniture	6.70	9.32	4.38	2.13
Small appliances	9.03	12.38	4.88	2.54
Kitchen utensils	6.14	10.72	3.82	2.81
Household air cleaning machinery	7.43	10.05	4.99	2.02
Household appliances	8.09	12.67	6.05	2.09
Hand tools	5.17	6.21	4.73	1.32
Power tools	7.62	8.82	7.02	1.26
Builder's hardware	8.10	10.29	6.70	1.54
Brooms and brushes	6.29	9.91	4.75	2.09
Smokers' accessories	4.51	7.77	3.25	2.39
Glassware and glass products	5.45	5.76	5.28	1.09
Garbage bags, paper plates	9.31	12.09	5.55	2.18
TV, radios, stereos	8.35	9.24	6.20	1.49
Electric light bulbs, lamps	5.23	8.79	3.43	2.56
Office furniture	9.20	10.77	7.32	1.47
Office and stationery supplies	5.92	11.08	3.27	3.39
Office machines and equipment	11.20	11.60	10.80	1.07
Household cleaning components	7.78	9.88	7.02	1.41
Tires	8.31	10.40	5.84	1.78
Auto parts	5.91	13.26	4.28	3.10
Recreation vehicles	8.62	8.62	8.62	1.00
Batteries	5.23	6.76	3.44	1.96
Lubricating oil and grease	8.02	11.88	4.44	2.67
Canoes, sail boats	10.35	11.97	8.78	1.36
Watches and clocks	6.29	9.35	5.55	1.69
Photographic equipment	9.70	10.48	8.84	1.18
Jewellery	4.69	10.61	3.94	2.70
Sporting equipment	7.55	14.24	5.28	2.70
Toys and game sets	8.54	11.44	5.83	1.96
Cosmetics	7.75	17.08	5.15	3.32
Average	7.26	10.39	5.51	1.89
Commodities with 8% statutory rate				
Builder's hardware	5.71	6.59	1.89	3.49
Paint, varnish, wallpaper	6.05	8.90	3.71	2.40
Average	5.89	7.74	2.80	2.77

Note: The effective sales tax rate is the percentage that tax represents in the final sale price of a product. The data presented in this table were obtained by multiplying the 1984 survey estimates by 1.67 for construction materials and 1.33 for other goods to adjust for the increases in the corresponding statutory rates from 5 to 8 per cent for construction materials and 9 to 12 per cent for other goods.

Data based on *Federal Sales Tax Survey* (1985) conducted by Woods Gordon on behalf of the Department of Finance.

Chart 2.2

Federal Sales Tax Revenues from Business Inputs and Consumer Expenditures *



* Based on Statistics Canada input-output data for 1980.

Although manufacturing machinery and equipment and raw materials purchased by manufacturers are generally exempt from tax, business inputs are for the most part taxable for all firms beyond the manufacturer's level. The tax on business inputs can result in a form of double taxation because the inputs may be used for the production of other goods which are themselves subject to tax. These unseen tax costs on business inputs are passed on through the trade chain and are ultimately reflected in the final price paid by consumers.

It is worth noting that the survey estimates of effective tax rates provided in Tables 2.1 and 2.2 reflect only the direct tax payable on the sale of finished goods. The tax on business inputs is estimated to represent an additional 0.35 to 1.7 per cent of the final selling price of various consumer products.

As a trading nation Canada must be competitive, but the tax on business inputs puts our exports at a disadvantage. While there is no direct sales tax charge on exported goods, the federal sales tax on business inputs represents an indirect charge, estimated at about 0.9 per cent of the sales value of exports. This amount may seem small, but it represents a very substantial fraction – well in excess of 10 per cent – of the profit margins of many Canadian exporters operating in today's extremely competitive international market. Thus in a very real way the federal sales tax on inputs is an impediment to Canada's export performance and competitiveness.

The tax on business inputs also increases the cost of investment in Canada and to that extent inhibits economic growth and the creation of jobs.

Because of the inadequacies of the federal sales tax, Canadian investors and exporters are paying hidden taxes that are not imposed in other countries with more efficient sales tax systems. Canadian business is therefore placed at a competitive disadvantage in both international and domestic markets.

(e) The Federal Sales Tax Gives Preferential Treatment to Imports.

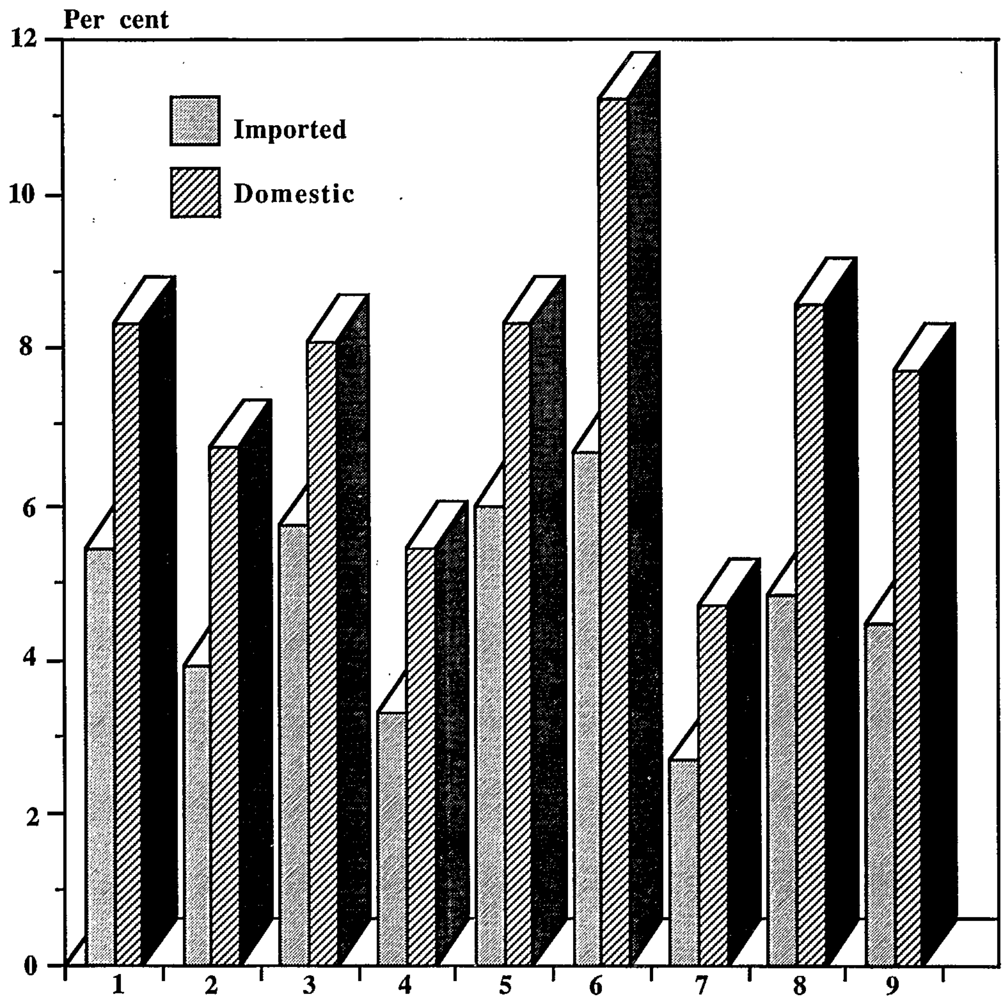
Canada's federal sales tax has the dubious distinction of being the only national sales tax in the world known to favour imports over domestically manufactured products.

The extent of this preferential treatment is considerable. The 1984 survey previously cited showed that on average the effective rate of tax was about one-third higher on domestic products than on competing imports. In several cases, the effective tax rate on domestic products was as much as 70 to 80 per cent higher than on competing imports (see Table 2.2 and Chart 2.3).

This situation exists because of a fundamental fault in the current federal sales tax. Imported goods are taxed on their value declared for customs plus the amount of duty, if any. This means that, for imported goods, many costs that are frequently included in a domestic manufacturer's sale price – for example, distribution and marketing costs – are assumed by importer-distributors after the tax is levied. These costs are not included in the tax base for imports as they usually are for domestic products. This bias in the current federal sales tax in favour of imports is illustrated in Table 2.3.

Chart 2.3

Effective Federal Sales Tax Rates on Selected Domestic and Imported Goods



1- Tires
2- Household furniture
3- Household appliances
4- Glassware and glass products
5- Televisions, radios, stereos
6- Office machines and equipment
7- Jewellery
8- Toys and game sets
9- Cosmetics

Table 2.2

Effective Federal Sales Tax Rates on a Sample of Domestic and Imported Goods

	Domestic	Imported	Ratio of tax on domestic products to tax on imports
	(per cent)		(ratio)
Commodities with 12% statutory rate			
Luggage, purses and wallets	5.48	5.11	1.07
Blankets, bed sheets and towels	5.13	7.05	.73
Carpets, rugs and mats	7.50	5.48	1.37
Household textiles	6.29	6.28	1.00
Household furniture	6.70	3.91	1.71
Small appliances	9.03	6.58	1.37
Kitchen utensils	6.14	4.59	1.34
Household air cleaning machinery	7.43	5.16	1.44
Household appliances	8.09	5.75	1.41
Hand tools	5.17	4.43	1.17
Power tools	7.62	7.95	.96
Builder's hardware	8.10	—	—
Brooms and brushes	6.29	3.63	1.73
Smokers' accessories	4.51	2.39	1.88
Glassware and glass products	5.45	3.31	1.65
Garbage bags, paper plates	9.31	—	—
TV, radios, stereos	8.35	5.97	1.40
Electric light bulbs, lamps	5.23	3.99	1.31
Office furniture	9.20	9.68	.95
Office and stationery supplies	5.92	5.24	1.13
Office machines and equipment	11.20	6.64	1.69
Household cleaning components	7.78	—	—
Tires	8.31	5.43	1.53
Auto parts	5.91	5.55	1.06
Recreation vehicles	8.62	5.35	1.61
Batteries	5.23	3.63	1.55
Lubricating oil and grease	8.02	6.61	1.21
Canoes, sail boats	10.35	9.02	1.15
Watches and clocks	6.29	5.05	1.24
Photographic equipment	9.70	9.62	1.01
Jewellery	4.69	2.65	1.77
Sporting equipment	7.55	4.40	1.72
Toys and game sets	8.54	4.84	1.76
Cosmetics	7.75	4.40	1.76
Average	7.26	5.48	1.33
Commodities with 8% statutory rate			
Builder's hardware	5.71	3.33	1.72
Paint, varnish, wallpaper	6.05	3.25	1.86
Average	5.89	3.29	1.79

See footnote to Table 2.1.

Table 2.3

Illustration of Federal Sales Tax Impact on Prices of Domestic and Imported Goods

Domestic good		Imported good	
Cost to produce	$1.00	Cost to produce (assumed equal to duty-paid value)	$1.00
Marketing costs	$1.00	Tax at 12%	$0.12
Final manufacturer's price	$2.00	Marketing costs by Canadian distributor	$1.00
Tax at 12%	$0.24		
Retailer mark-up	$1.00	Retailer mark-up	$1.00
Final price	$3.24	Final price	$3.12

The bias in favour of imports over domestic products can seriously hamper the ability of Canada's manufactured goods to compete with imported products. It hurts our manufacturing sector and ultimately contributes to limiting Canada's potential for economic growth and employment by making it economically attractive for manufacturers to move or keep their production operations abroad to take advantage of the more favourable tax treatment enjoyed by imports.

(f) The Federal Sales Tax is Unfair to Low-Income Canadians.

Lower-income earners must spend a larger proportion of their incomes on goods and services than do higher-income earners, who generally have funds left over to save or invest. In 1982, the last year for which data are available, Canadians whose earnings placed them in the top 20 per cent of income earners spent on average only 57 per cent of their earnings on goods and services. In contrast, individuals and families in the bottom 20 per cent spent 100 per cent of their incomes while those in the next income bracket, who are marginally better off, still spent more than 85 per cent of their incomes. Consumption patterns of this kind mean that low-income households inevitably pay a larger proportion of their incomes in sales tax than do high-income households.

Previous governments have tried to compensate for this inequity by excluding from tax such necessities as food, clothing, heating fuel and electricity.

Not only lower-income earners, but higher-income consumers as well benefit from exemptions when they purchase tax-exempt products and services. And the fact is that higher-income people, who buy more of everything, including tax-exempt products like expensive food and luxury clothing, tend to be the greater beneficiaries. In 1982, a family earning $15,000 spent approximately $2,200 on food and more than $900 on clothing. A family with income of $60,000 or above spent almost twice as much on food and almost four times as much on clothing. Table 2.4 indicates that while households with incomes below $25,000 accounted for 48 per cent of all Canadian households, they purchased about 36 per cent of Canada's total food consumption. This means that the 52 per cent of households with incomes greater than $25,000 received 64 per cent of the benefit of the tax exemption for food. Similarly, Canadians with incomes above $25,000 received almost 75 per cent of the tax savings from an exemption for clothing.

That exemptions of this kind are less than efficient in improving the fairness of the federal sales tax is illustrated by Line A in Chart 2.5. Notwithstanding exemptions, lower-income households bear a disproportionate burden. Line B indicates that the refundable sales tax credit introduced in the February 1986 budget has achieved a somewhat fairer, more even, distribution of the tax burden by targeting assistance directly to those in need.

(g) The Federal Sales Tax is Too Complex.

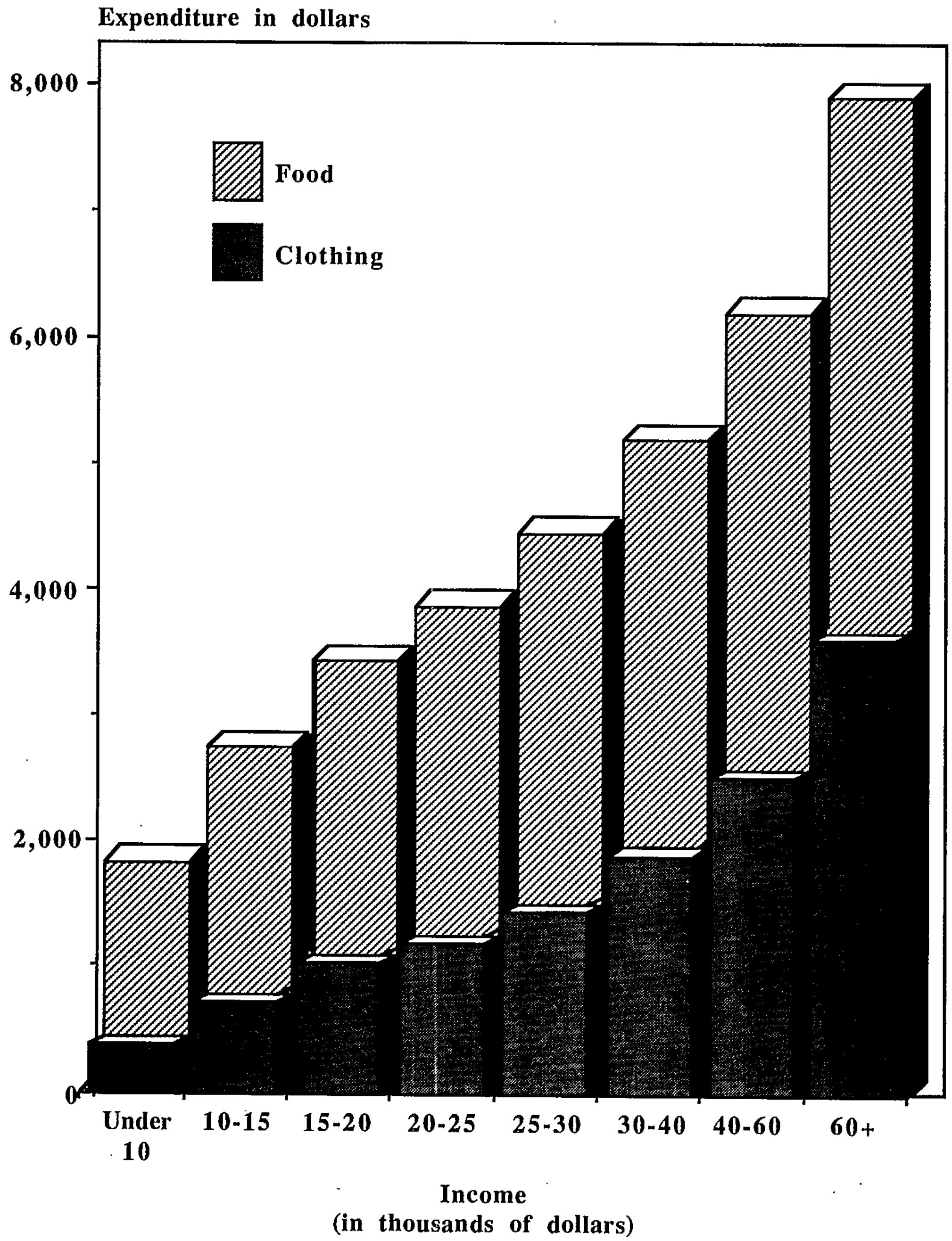
The manufacturers' sales tax is one of the most complex of sales tax systems. It causes compliance difficulties, expense for taxpayers and costly administrative problems for Revenue Canada.

Complexity arises because the tax is not applied on all products, and because the distinction between taxable and exempt items is often difficult to define and to sustain. For example, directories, catalogues and children's colouring books are taxable while other books and magazines are not. Regular footwear and tennis shoes are exempt but ski-boots and bowling shoes are taxable. Major disputes have gone before the courts to resolve boundaries between taxable and exempt goods: "Is fluoridated toothpaste exempt as a health product because it claims therapeutic properties or is it taxable as a cosmetic?" If electricity is not taxed, should flashlight batteries be exempted because they are "containers for electricity"? Such disputes raise issues of economic fairness, and millions of dollars of tax revenue are at stake in their outcome.

Complexity is aggravated by the fact that where the federal sales tax does apply, it is currently applied not at one, but at three different rates: 8, 12 and 15 per cent. Multiple rates have led to disagreements over what is taxable at what rate. For example, even though the list of construction materials eligible for the 8-per-cent rate runs on for several pages, there are frequent disputes over whether certain types of flooring materials and built-in furniture are eligible for the 8-per-cent rate or are taxable at 12 per cent as regular household supplies.

Chart 2.4

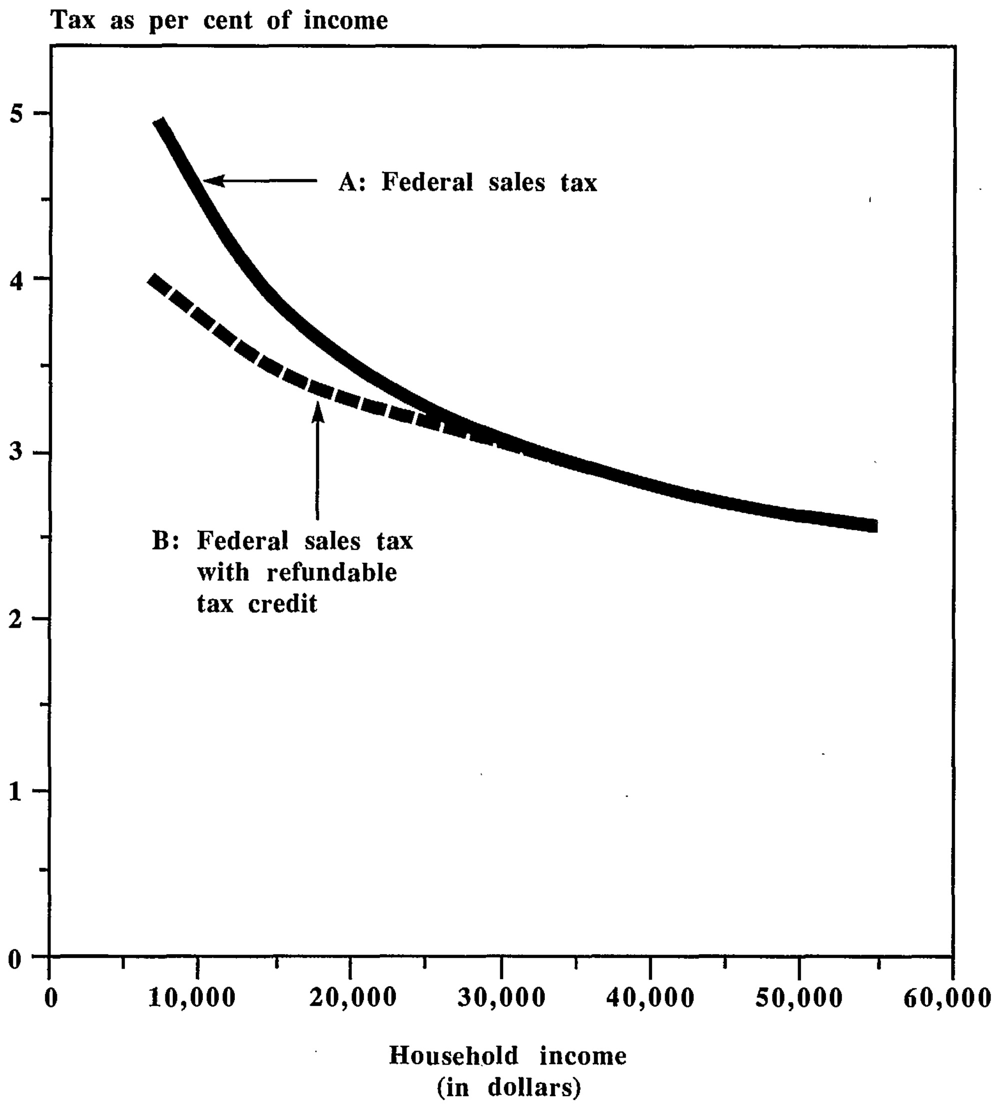
Average Family Expenditure on Food and Clothing



Source: 1982 Family Expenditure Survey.

Chart 2.5

Distributional Impact of the Current Federal Sales Tax With and Without Refundable Sales Tax Credit



Note: The current sales tax credit is $50 per adult and $25 per child, reduced by 5 cents for every dollar of income in excess of $15,000.

Table 2.4

Consumption by Canadian Households by Income and Type of Purchase, 1982

Gross household income brackets ($000)	Percentage of all households		Per cent of total consumption by income brackets: Food consumed at home		Alcohol and tobacco		Clothing		Shelter and utilities		Vehicles and fuel		All items	
0-5	2.7		1.0		.8		.4		1.1		.1		.7	
5-10	11.4		6.2		4.6		3.2		6.4		2.5		4.5	
10-15	11.6	48.2	8.4	36.0	7.1	33.1	5.5	25.6	8.2	34.8	5.0	27.3	6.7	30.4
15-20	11.1		9.5		9.4		7.6		8.9		8.5		8.4	
20-25	11.4		10.9		11.2		8.9		10.2		11.2		10.1	
25-30	11.0		11.7		12.2		10.4		11.2		11.4		11.2	
30-40	17.9		20.9		21.4		22.2		20.7		21.9		21.4	
40-60	16.9		22.3		23.3		27.7		23.7		26.5		25.2	
60+	6.0		9.1		10.0		14.1		9.6		12.9		11.8	
TOTAL	100.0		100.0		100.0		100.0		100.0		100.0		100.0	

Source: Statistics Canada, *Family Expenditure in Canada, 1982*, Survey Data Tape

Equally important, the existence of three rates adds significantly to business compliance costs. A recent study of selected businesses undertaken for the government by a private consulting firm indicates that firms producing goods taxed at two different rates sustained compliance costs about 50 per cent higher than if only one rate were applicable. In light of the fact that more than half of all the firms subject to the federal sales tax produce goods taxed at more than one rate, the dimensions of these added compliance costs are significant.

Another cause of complexity has been the piecemeal nature of past attempts to correct various problems with the tax. For example, in an effort to ensure that the sales tax provides a uniform impact on competing goods marketed at different trade levels, a system of "notional values" for tax was introduced to reduce disparities.(1) While the intention had merit, notional values led to considerable administrative complexity. Today these values are difficult to monitor and in many cases are outdated and arbitrary, often failing to address even in part the inequities for which they were originally developed.

In much the same vein, no fewer than 22,000 special provisions and administrative interpretations of the *Excise Tax Act* have been provided in an effort to achieve a reasonable degree of fairness and equity in the application of the tax. While equally well intentioned, these efforts have met with equally little success. More often than not the results have been increased complexity and a greater sense of arbitrariness.

While the complexity of the tax increases compliance costs generally, the burden on small business is disproportionately large. Studies indicate that compliance costs, as a percentage of sales, increase from 0.1 per cent for firms with sales exceeding $5 million to over 1 per cent for firms with sales of $100,000 or less. For small firms these costs represent approximately 8.5 per cent of taxes paid, while declining to less than 0.5 per cent for larger firms. Accordingly, lowering compliance costs through sales tax reform would provide proportionately greater benefits to small businesses.

(h) The Federal Sales Tax is an Unstable Tax.

Because of its complexity and archaic legal structure the federal sales tax has become subject to an increasing number of court challenges by taxpayers. Frequently, individual court cases can have far-reaching consequences for the application of tax to various sectors of the economy, raising new questions about tax fairness and efficiency. These court cases can also affect government revenues in unforeseen and unpredictable ways, requiring ad hoc adjustments to maintain the tax base.

Recent court cases concerning the application of tax on sales by a manufacturer to an associated corporation illustrate these problems. The federal sales tax

(1) Notional values are the values arrived at after administratively excluding wholesale and retail mark-ups included in the manufacturer's price.

legislation contains a provision by which the Minister of National Revenue can specify a "fair" price for the calculation of tax on non-arm's-length sales by a manufacturer to an associated firm. This provision is designed to deter tax avoidance through the use of artificially low transfer prices on such sales. Recent court decisions may severely limit the application of this provision. Should this occur, in the absence of further legislative amendments, manufacturers could more readily limit their tax liability by making sales at artificially lower values to related marketing companies. Such actions would represent a substantial erosion of the tax base and would further detract from the uniform application of the tax.

2. Conclusion

The major problems with the current federal sales tax stem from the narrow base of the tax and its application at the manufacturer's level. In an advanced economy with highly sophisticated and varying networks of production and distribution, applying the tax at the manufacturer's stage or any other intermediate point along the trade chain gives rise to major distortions and biases – problems which are compounded by the narrowness of the base itself. The narrower the base, the higher the rates required to meet revenue needs. In turn, these higher rates compound the inherent biases and inefficiencies of the tax.

The current system results in the frequently arbitrary application of tax between products and between business sectors. It leads to ad hoc measures and special provisions for different industries, often creating a sense of unfair treatment and always leading to greater administrative complexity. It affects businesses unevenly, placing many at a competitive disadvantage at home and in international markets. Over all, the tax encourages economic inefficiency and retards growth and job creation.

Individual Canadians are directly and adversely affected. The tax distorts consumers' perceptions of the value of many of the goods they buy and biases their choices in the marketplace. Even more important, the tax fails to address the priority of helping those in need. While the existing refundable sales tax credit is a helpful step, in the context of the current system, it cannot be a solution.

In short, the current federal sales tax fails to meet any of the basic principles of a good sales tax. The government is proposing to replace it with a new, more broadly-based tax system extending to the retail level.

Chapter 3: The Direction for Change: The Multi-Stage Sales Tax

1. Introduction

The government proposes to replace the federal sales tax with a broadly-based multi-stage sales tax that extends to the retail level. This multi-stage tax would be a form of value-added tax. It would be levied on and collected from all businesses, in stages, as goods move from primary producers and processors to wholesalers, retailers, and finally to consumers.

Under this multi-stage tax, businesses will pay tax on their sales and claim a credit for any tax paid on their purchases. A tax of this kind has a number of advantages. It will:

- eliminate tax on business inputs, thereby ensuring there are no hidden taxes on consumer products;
- treat all business firms uniformly, regardless of how they manufacture and distribute their products;
- apply tax in a fair way to consumers purchasing different goods and services and, by broadening the base of the tax, make possible a lower rate of tax for consumers;
- ensure uniform effective rates of tax on the final sale price of products and, in the process, remove difficult and administratively cumbersome valuation problems;
- treat imports in the same manner as domestically produced goods;
- remove completely the hidden taxes from Canadian exports.

2. The Multi-Stage Tax and the Retail Sales Tax

A multi-stage sales tax is similar in concept to the single-stage retail sales taxes imposed by most provinces, in that both are meant to apply to the final consumption of goods and services in Canada. However, there are important operational differences between the two systems, with significant economic and administrative consequences.

A single-stage retail sales tax is familiar to most Canadians. It is levied on final sales to consumers and is collected at one point – at the time of purchase. Because the retail sales tax is intended to apply only to consumers, businesses acquire goods and services on a tax-free basis through a system of exemption certificates and registration numbers. In practice either a certificate or a registration number is presented to the vendor at the time of purchase as authorization for exemption from tax.

In contrast, under a multi-stage system, tax is collected from all vendors of goods and services in the production and distribution network on all their sales. As a result, there is no need under such a system to determine if the sale is to a consumer. Tax is levied and collected as goods move from primary producers to manufacturers and processors, to wholesalers, retailers and, finally, to consumers. Each business will charge tax on its sales but receive credit for any tax paid on its purchases. In essence, this system is effectively equivalent to applying the tax to the value added by each business. Value added by a business is defined as its total sales minus its purchases of goods and services from other businesses. If all goods and services were to be subject to a uniform rate of tax, a tax on sales, with an offsetting credit for tax paid on purchases, would be equal to the tax applied to the difference between total sales and total purchases.

In its simplest form, a multi-stage sales tax is calculated by taking taxable sales made by a business during a given period, multiplying them by the tax rate, and then subtracting any tax paid by the firm on its business purchases.

To give a simple illustration, a manufacturer sells a household appliance to a retail dealer for $900 and the retail dealer sells it to the consumer for $1,000. The manufacturer will charge tax on $900. The retailer will charge tax on its sales of $1,000 and claim a credit for the tax it paid on the purchase from the manufacturer. If the tax rate were 8 per cent, for example, the manufacturer would charge tax of $72 and the retailer, $8 (which is tax of $80 on sales less a credit of $72). The two firms remit total tax of $80, which is also 8 per cent of the final sale price of the appliance to the consumer – an amount equivalent to the revenue from a retail sales tax levied at the same rate.

Thus, in concept, a multi-stage sales tax and a retail tax are similar. Both apply to the sale of goods and services to consumers. With the same coverage and rate, both yield equivalent amounts of revenue.

Both taxes achieve an important goal of sales tax reform – extending the tax to the final consumption point. In this context, the retail sales tax offers the advantages of simplicity and familiarity. The concept of the tax is straightforward. Currently, nine provinces impose retail taxes. Both businesses and consumers have long experience with the system and understand its basic features. A federal retail sales tax would represent a substantial improvement over the current federal system. Nonetheless, the retail sales tax has two disadvantages.

- It does not permit complete removal of tax on business inputs. Therefore tax cascading would still occur.

- In comparison to a multi-stage tax, it may be more difficult to achieve tax fairness through a retail sales tax because of its greater susceptibility to non-compliance. As a result, it is also a less secure source of revenue.

There is no country in the world in which a retail sales tax system has successfully removed all tax on business inputs. Under this tax system, some of the tax burden from business inputs can be removed by means of a system of licenses and exemption certificates which authorize designated businesses to purchase certain goods and services on a tax-free basis. However, this is administratively cumbersome for both buyer and seller. The seller is required to segregate sales to business customers from those to consumers and is responsible for verifying the status of business buyers. The buyer must be able to determine the use to be made of the goods and services at the time of purchase. This is often uncertain, particularly in the case of goods which can be used for both private consumption and business purposes such as office supplies and furniture, many tools, fuels, electricity, and a range of other services. Furthermore, it is difficult for tax administrators to verify subsequently that tax-free sales were made in appropriate circumstances.

For these reasons, exemptions for business inputs under a retail sales tax are generally limited to inventory for resale and major production machinery, leaving a wide range of other business inputs still bearing tax. Examples include shelving used by wholesalers and retailers, computers and cash registers, transportation vehicles and fuel, electrical fixtures, and a range of office supplies. Such business inputs account for approximately one-third of provincial retail sales tax revenues in Canada. As a result, tax cascading and the imposition of hidden taxes on businesses can be significant.

In contrast, one of the key advantages of a multi-stage tax is its effectiveness and simplicity in relieving business inputs from tax. For this reason, many countries have moved from the retail sales tax to a multi-stage system. Under this system, inputs are taxed when sold but the buyer is allowed to claim a credit for the tax. The multi-stage tax relieves the vendor of any responsibility for verifying the status of the buyer and the buyer's intended use of the purchased goods and services. It is the buyer's responsibility to determine the use of the goods and services for business purposes and claim a credit on that basis. In this sense, the operation of a multi-stage sales tax is consistent with the principle of self-assessment which underlies our income tax system. Under both the income tax and multi-stage sales tax systems, firms determine the use made of goods and services for business purposes and claim a deduction or credit.

Self-assessment is an important principle in Canada. It works well because individuals and businesses have a long tradition of voluntary compliance with the country's tax law. Key considerations in designing a new sales tax system are to maintain the integrity of self-assessment and to ensure that the tax is, and is seen to be, applied in a fair manner to all. The structure and operation of the tax should not permit the few to avoid paying their fair share of tax, thereby increasing the burden on the many.

Clearly all sales tax systems will require some degree of audit, and enforcement action by government will always be required. The objective is to minimize it.

On this score the difference between the retail and multi-stage taxes is one of degree. The multi-stage system, by dispersing the collection of tax over a number of points, reduces both the incentive to misreport and the revenue consequences of misreporting. In addition, the availability of input tax credits on business purchases encourages accurate reporting. In contrast, the retail tax may be more vulnerable to errors because it relies on a single point of tax collection. On balance, most industrialized countries have found the multi-stage tax to be superior in this regard.

In a simpler economy, where retailing networks were more clearly segregated from the rest of the production and distribution chain and where manufacturers and wholesalers made virtually no sales to consumers, a retail sales tax would be a more attractive option. In today's economy, however, many more enterprises serve both consumers and other businesses, making it difficult to identify purely retail operations. While evident throughout the economy, this difficulty is most apparent in the fast-growing service sector where services are commonly supplied to both household and business users. In many instances, the supplier is unable to distinguish these uses at the time of sale. Marketing patterns are already highly complex, and current trends suggest that they will be even more intricate in the future, making a retail sales tax even less suitable.

This increasing complexity in production and distribution networks calls into question a commonly perceived advantage of the retail sales tax – that a smaller number of business firms is required to register for a tax collected only at the retail level. In practice today, many wholesalers or manufacturers also make some retail sales and thus would need to be registered. In addition, even firms that make no retail sales would need to be registered in order to acquire their business inputs exempt from tax. Thus, with the same coverage and a complete removal of tax on business inputs, the number of registered firms for the two tax systems would be much the same.

These factors have been the primary motivations behind the decision of many advanced industrialized countries to adopt the multi-stage sales tax over the retail sales tax. It is now generally recognized that a multi-stage tax is a more practical and certain way of removing tax from all business inputs and gaining the advantages of an efficient sales tax. This view is also reflected in the recommendation by the Goodman Committee[(2)]

> "that special attention be given to studying the merit of introducing a federal value-added tax up to the level at which taxable goods and selected services are sold to final consumers and that the provinces be encouraged to join in the administration of such a tax".

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(2) The Federal Sales Tax Review Committee chaired by Mr. Wolfe Goodman was appointed in 1983 to review the manufacturer's sales tax and to recommend options for reform. It was composed of tax practitioners and representatives of business and consumer groups.

3. Description and Operation of the Multi-Stage Tax

The Tax Rate

The rate of tax to be applied under the multi-stage tax will be determined by the need to generate sufficient net revenues to

- replace the revenues from the existing federal sales tax;
- remove the personal and corporate income surtaxes;
- fund further income tax reductions for middle-income families; and
- provide a significantly enriched refundable tax credit which will ensure a greater degree of tax fairness for low-income Canadians than currently exists.

Until final decisions are taken about the comprehensiveness of the base, it is not possible to specify the actual rate. For the purpose of the examples in this paper, a rate of 8 per cent is used.

Calculation for Tax Payable and Refunds

Chart 3.1 shows the basic method of calculating a multi-stage sales tax: businesses add up the tax payable on all taxable sales for a given reporting period and receive a credit for any tax paid on their purchases.

Taxable sales will include sales of most goods and services in Canada. They will not include any export sales. A firm making sales exclusively in the export market will have taxable sales of zero but nevertheless will be eligible for a refund arising from the credit for tax paid on purchases.

Firms will be entitled to claim input tax credits on the purchase of any taxed goods or services that are used in business. If a firm's credits for taxed purchases exceed its tax payable on taxable sales – which could result from inventory build-up, large capital outlays or a large volume of export sales – it would be entitled to a refund. This refund feature will ensure that the sales tax does not penalize companies for building inventories and, by removing the tax from business inputs without delay, it acts in favour of business investment, expansion and export sales.

Imports will be taxable at the time of importation. In the case of households importing goods, the tax paid at the border will be the final tax. In the case of importation by firms, they will be liable for tax on any resale of these imports in Canada but will be able to claim an input credit for tax they have paid at the border.

Application at Each Stage in the Production-Marketing Chain

Chart 3.2 illustrates how the multi-stage sales tax is applied to the value added over the course of the production and marketing chain for a piece of furniture such as a table.

Chart 3.1

Multi-Stage Sales Tax

Basic Calculation

Taxable Sales

times

Tax Rate

equals

Tax Charged on Sales

minus

Tax Paid on Purchases
(Input Tax Credit)

equals

Tax Payable (if positive)

e.g.	Tax*
Sales: $200,000	$16,000
Purchases: $150,000	(12,000)
Tax payable	$ 4,000

Tax Refundable (if negative)

e.g.	Tax*
Sales: $180,000	$14,400
Purchases: $200,000	(16,000)
Tax refund	($1,600)

* Assumes a tax rate of 8 per cent.

Chart 3.2

Multi-Stage Sales Tax

An Illustration of Furniture Manufacture and Distribution

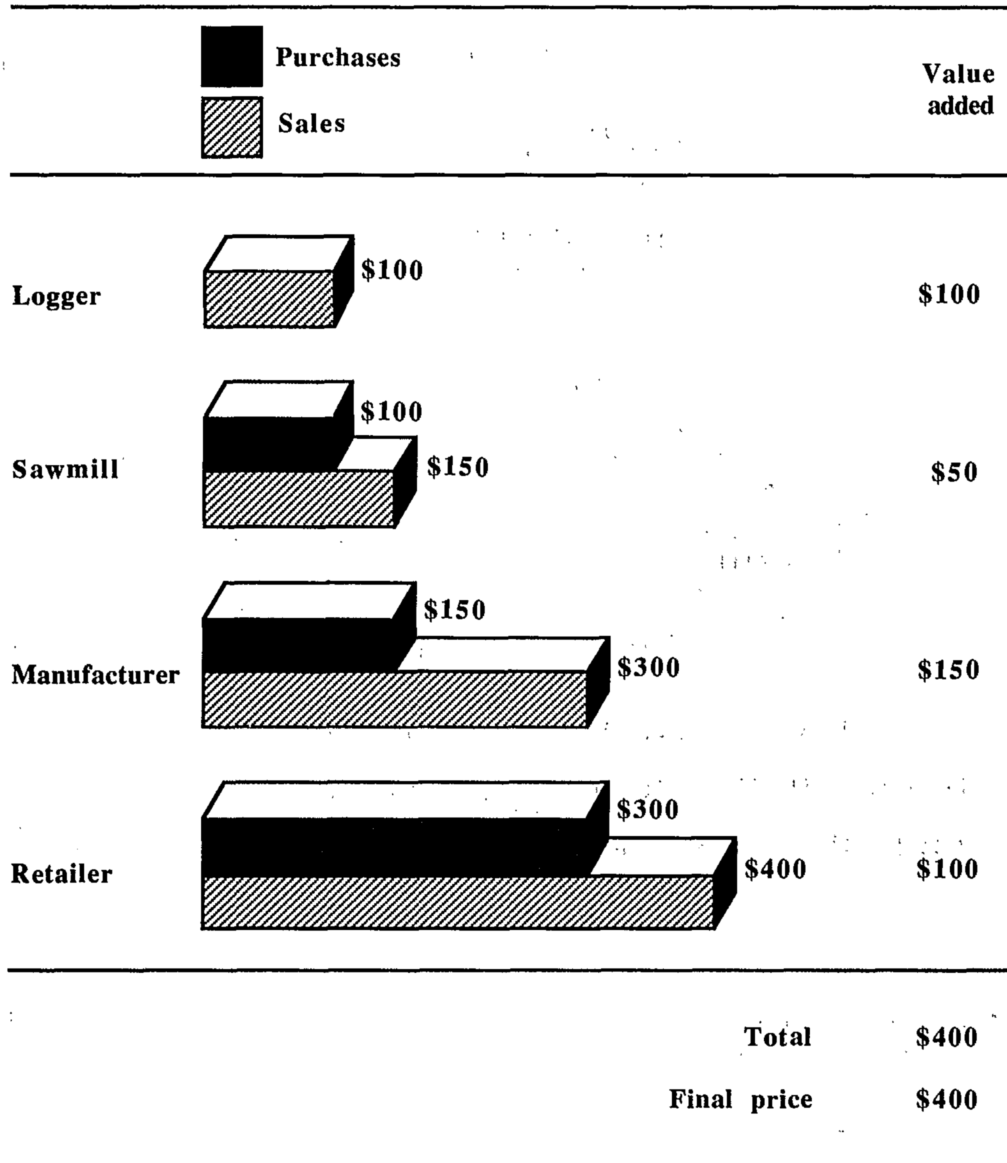
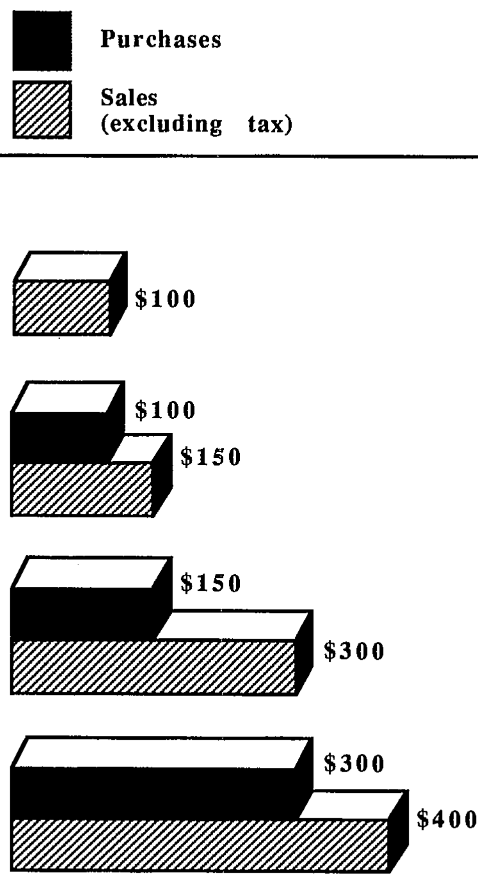


Chart 3.3

Multi-Stage Sales Tax

An Illustration of Furniture Manufacture and Distribution



	Purchases	Sales (excluding tax)	Tax on sales	Input tax credit	Net Tax
Logger		$100	$ 8		$ 8
Sawmill	$100	$150	$12	$ 8	$ 4
Manufacturer	$150	$300	$24	$12	$12
Retailer	$300	$400	$32	$24	$ 8
			Total		$32

Note: Purchase and sale amounts shown in the chart do not include tax. In order to pass on the tax, each vendor would charge tax in addition to the amounts shown. Thus, for example, the logger would charge the sawmill $108.

The production of the table begins with the cutting of logs by a logger. To simplify the example, the logger is assumed to have no business costs, so that the logger's value added is equal to its sales to the sawmill, $100. The sawmill has sales of $150 and purchases of $100, leaving a value added of $50. The furniture manufacturer purchases the sawmill's lumber for $150 and uses the lumber to make the table which is sold to the retailer for $300. Thus, the table manufacturer's value added is $150. The process ends at the retail level where the table is sold to the consumer for $400. The retailer has sales of $400 and a value added of $100.

Adding the value added of all businesses in the production-marketing chain gives a total of $400, which is also the final price to the consumer. This illustrates a basic principle of the multi-stage sales tax: that for any good or service produced and sold, the sum of values on which businesses pay tax equals the final price of the good or service to the consumer.

Chart 3.3 demonstrates the way the tax would be calculated over the course of the same production-marketing chain shown in the preceding example, using a specific rate of 8 per cent.

Assuming that the tax is ultimately passed on to the consumer, each business will increase its overall price by 8 per cent as a result of the tax. Thus the logger will sell the logs for $100 and charge a tax of $8. The sawmill will have sales of $150 on which it would charge $12 in tax. After deducting $8 paid in tax on its purchase of logs, it would have a net tax liability of $4. The manufacturer and the retailer calculate their net tax liability in the same way as the logger and the sawmill. The total tax collected on the production and marketing of the table is $32, which is equal to 8 per cent of the pre-tax retail price of $400. Under a single-stage retail sales tax levied at the same rate, the total amount of tax paid would also be $32.

The two systems yield equivalent amounts of tax because any tax on sales by the logger, the sawmill, and the manufacturer under the multi-stage tax is fully credited or refunded at the next stage in the production and marketing chain. The only tax that is not refunded is the one collected by the retailer on final sales to consumers. In this way, a multi-stage tax, while collected in stages along the production and distribution chain, is a tax on final consumption. By effectively removing tax on all business inputs, it pays important economic dividends. These are outlined in Section 4 of this chapter: Meeting Sales Tax Reform Goals.

Under the current 12-per-cent manufacturers' sales tax, the manufacturer would pay a tax of $36 on its pre-tax selling price of $300. In addition, all of the businesses in the production-distribution chain would not recover the tax they currently pay on a variety of their business inputs such as motor fuels, building materials and office supplies. Furthermore, if the table were exported, these hidden taxes would clearly weaken the manufacturer's competitive position in the market.

Reporting Period

To remit the multi-stage tax, businesses will calculate their overall liability once in a given period on the basis of their taxable sales, with a credit for the tax paid on their purchases. The reporting period would vary, depending on the size of the firm and its volume of sales. For example, unincorporated small businesses might report annually, most other businesses quarterly, and very large firms with taxable sales exceeding a given threshold, monthly.

A detailed discussion of the operation of the multi-stage tax and its application to a number of major sectors of the economy is set out in Annex I.

4. Meeting Sales Tax Reform Goals

(i) Economic Benefits

A multi-stage sales tax offers several key economic advantages over the present federal sales tax:

- It ensures uniform application of tax to goods moving through different production and marketing channels.
- It allows for a complete removal of tax on business inputs.
- It does not favour imports over domestic products.
- It allows for the complete removal of tax on exports.

Uniform Application of Tax

A multi-stage tax is neutral. Unlike the current federal sales tax, it does not provide incentives to businesses to alter their production and distribution systems, nor does it affect their competitive position in the market. Because the multi-stage tax extends to the retail level, the final tax liability on a product is independent of the production-distribution chain. It depends only upon the final price to consumers.

Consider once again the example set out in Chart 3.3. If the manufacturer, instead of making a direct sale to the retailer, were to sell to a wholesaler for $250 and the wholesaler in turn resold the table to the retailer for $300, the final amount of tax collected would remain unchanged. The manufacturer would charge tax of $20, leaving a net liability of $8, or $4 less than in the case of the direct sale. The wholesaler would charge tax of $24 and receive a credit of $20 for a net liability of $4. The tax paid by the wholesaler completely offsets any reduction in tax paid by the manufacturer.

Consider another example in which the manufacturer and the retailer are associated and the manufacturer sells the table to the retailer at the artificially low price of $250. While the manufacturer would charge less tax on its sale ($20 rather than $24), the retailer would be entitled to a correspondingly smaller tax credit. Thus, use of artificially low values at intermediate points does not yield any net tax advantage to firms. The tax remains a constant percentage of the final price to consumers.

Complete Removal of Tax on Business Inputs

The primary purpose of input tax credits in a multi-stage tax is to relieve business of any tax that has already been paid on its purchases. Tax will have been paid only on the purchases of taxable goods and services from other businesses. Therefore, expenses such as interest, wages, taxes and license fees, which are not taxable goods and services, do not give rise to any credit entitlement.

Full and immediate credit is allowed for the tax paid on all business purchases of capital goods as well as purchases for inventory. As a result, unlike the income tax, a multi-stage sales tax does not require computations for depreciation of capital property and valuation of inventories. Any tax paid by a firm on its purchases will be creditable only to the extent the purchase is for use in the course of a taxable activity. Where a purchase is not solely for use in a taxable activity, the tax would be prorated on a reasonable basis.

No Bias Favouring Imports

Because the multi-stage sales tax extends to the retail level, it would ensure a uniform tax on both imports and domestic goods and services, regardless of when costs are added to imports. In contrast, under the current federal sales tax, marketing costs can be added to the price of imported products after the tax has been imposed. In most cases this results in a lower effective rate of tax on imports than on Canadian goods.

Consider, for example, a foreign-made household appliance that is imported by a Canadian distributor at a cost of $700, sold to a dealer for $900 and then sold to a consumer for $1,000 (Table 3.1). Under a multi-stage sales tax of 8 per cent, the distributor would charge tax of $72 on the sale price of $900 with a credit for taxes paid on importation. The dealer would charge tax of $80 on the sale of $1,000, the price to consumers, with a credit for the taxes charged by the Canadian distributor. The total price on which the imported appliance attracts tax in Canada is $1,000, the same as the final retail price of the appliance to consumers.

A Canadian-made appliance sold for the same price to consumers would bear exactly the same tax. If the Canadian manufacturer were to sell the appliance for $900 to a dealer who in turn sells it to the consumer for $1,000, the dealer would charge tax on $1,000 and get a credit for tax charged by the Canadian manufacturer on its sale price of $900. The total amount taxed would be $1,000, the same as for the imported appliance.

Table 3.1

Illustrative Calculation of Tax Under a Multi-Stage Sales Tax of 8 per cent for Canadian-made and Imported Household Appliances

	Canadian-made appliance			Imported appliance		
	Tax on sale	Input tax credit	Net tax	Tax on sale	Input tax credit	Net tax
			(dollars)			
Sale by manufacturer						
domestic[1] ($900)	72	–	72	–	–	–
foreign ($700)	–	–	–	56	–	56
Sale by importer-distributor ($900)	–	–	–	72	56[2]	16
Sale by dealer ($1,000)	80	72	8	80	72	8
Total			80			80

[1] The domestic manufacturer's price is assumed to be higher than that of the foreign manufacturer because the domestic manufacturer incurs marketing costs which, in the case of imported goods, are incurred by the importer-distributor.

[2] The importer-distributor is credited for tax paid at the border.

By contrast, under the current system the imported appliance attracts a tax of 12 per cent, or $84 on the importer's cost of $700, while the Canadian manufacturer pays tax of $108 on the sale price of $900.

Removal of Hidden Tax on Canadian Exports

One of the main purposes of the multi-stage sales tax is to relieve exports of all sales taxes. To do this, the tax will not apply to export sales, and exporters will be allowed to claim a full credit for any tax already paid on purchases of goods and services. Where the exporter does not make any domestic sales or where the tax on domestic sales is less than the tax on purchases in a given period, the exporter would be entitled to a tax refund.

To illustrate how this feature of the tax works in practice, consider a small mining company which buys equipment, diesel fuel, gasoline and other supplies, all for $1 million, incurring tax of $80,000, and which sells the entire year's production in the export market for $2 million. Under the multi-stage tax, the company would not charge any tax on the $2 million export sale, and would be entitled to a full refund of the $80,000 tax paid on the purchases of equipment, fuel and other inputs. In contrast, under the current federal sales tax in which exports are exempt, the firm would pay almost $18,000 of tax indirectly on its inputs – a hidden burden for which there would be no credit or other relief.

In freeing exporters from tax liability on their exported products, the multi-stage tax acts in a manner consistent with Canada's international rights and obligations under the General Agreement on Tariffs and Trade.

(ii) Compliance and Administration

Compliance costs under the multi-stage tax depend critically on two factors: the breadth of the tax base and the structure of tax rates. Complexity can increase if the base is selective or if different rates are applied to different products. Alternatively, the tax can be simpler if the base is broader and the rate uniform. The multi-stage sales tax need not involve substantial compliance costs for individual firms. With a broad base and uniform rate, there would be no need to keep separate track of taxable and non-taxable goods or of goods bearing different tax rates. Because the tax calculation itself is simple, the reporting forms could be kept short and straightforward, requiring basically little more information than total taxable sales and total taxed purchases.

The actual calculation of tax could be done in one of two ways, depending on whether tax is shown on all sales invoices or is simply included in the sales price. If the tax is shown on invoices, then businesses would add up the tax they charge on their sales and subtract from it the sum of taxes they paid on their purchases.

If the tax applies to virtually all goods and services at a uniform rate, however, there would be no need for a separate calculation of tax on every invoice. Businesses could include the tax in their prices. In this case, they would calculate their tax liability by multiplying their total sales by the rate of tax and then subtracting an input credit equal to their total purchases multiplied by the rate of tax. Because the tax is included in the selling price, the tax and the credits would be calculated by taking a fraction of the total sales and purchases rather than a percentage. A tax at 8 per cent would thus be calculated by taking 8/108ths of the tax-inclusive sales revenues.

To illustrate, consider a business with sales of $1,000 and purchases of $800. Under the first approach, where tax appears explicitly on invoices, a business would charge a tax of $80 on sales and receive a credit of $64 for the taxes appearing on its purchase invoices. Under the second approach, where tax is included in the price, the tax-inclusive sales would be $1,080 and purchases $864. The tax and credits would be calculated by taking 8/108ths of these amounts respectively.

To reduce compliance costs of the multi-stage tax for the small business sector, reporting by small firms would be limited to quarterly statements or, for very small unincorporated businesses, annual statements filed at the same time as their income tax returns. This type of filing schedule will minimize the paperwork and maximize the cash flow advantages for small enterprises. Recognizing their more limited administrative resources, the government proposes to pay a collection fee to small businesses. This could be done in a manner similar to the compensation provided by provinces under their retail tax systems.

While compliance costs for the multi-stage tax will be lower for any firm currently subject to the federal sales tax, the total number of firms paying tax would increase substantially. This is the natural consequence of applying a sales tax through to the retail level – the only point where economic efficiencies can be fully realized. By virtue of these increased numbers the costs of administering the system will necessarily increase, although it is possible to design a reporting and monitoring system that will keep average auditing and processing costs reasonably low. Based on the experience of other countries with similar tax systems, overall administration costs are approximately $1 for every $1,000 of tax collected.

The largely self-enforcing nature of a multi-stage tax – one of its key advantages – helps to constrain these costs. Because one firm's output tax is another firm's input credit, there is a strong incentive for voluntary compliance and for reducing the administrative complexity of the tax.

(iii) Fairness

Fairness in the multi-stage tax has two dimensions:

- the treatment of sectors and firms so that the tax system does not confer any unfair competitive advantage or disadvantage; and
- the treatment of individuals and families so that the effective burden of the tax is distributed fairly.

Both these aspects of fairness are among the most important issues addressed by comprehensive sales tax reform. Treating sectors and firms fairly is critical in maintaining efficiency and avoiding undue complexity. And of course, achieving fairness in the impact of the tax on individuals and families is a basic commitment.

(a) Tax-Exempt and Tax-Free Sales

Traditionally, governments in Canada have provided exemptions from sales tax for particular business sectors and products in order to improve overall tax fairness. Under a multi-stage tax, exemption can be achieved in two very different ways:

- **tax-exempt sales**: a business does not charge tax on its sales and cannot claim an input tax credit for its purchases;
- **tax-free sales**: a business does not charge tax on its sales but can still claim an input tax credit on its purchases.

In countries operating multi-stage taxes, the tax-exempt sales mechanism is sometimes used to assist small businesses and the non-profit sector. It has the effect of completely removing any administrative burden. Businesses and organizations making tax-exempt sales charge no tax and claim no credits. They are not registered taxpayers. In effect, like a household, they are outside the administration of the tax system.

In contrast, the tax-free sales mechanism is used to ensure that exports bear no tax burden. It can also be used to relieve the tax on domestic consumption of particular goods. Businesses making tax-free sales are registered because they claim credits on their inputs.

Tax-free sales completely remove the tax. Tax-exempt sales provide only partial relief from tax. In fact, for firms operating at intermediate levels in the trade chain, tax-exempt sales may increase rather than reduce costs. This may be counterproductive not only for the firm itself, but for its customers and for the economy as a whole.

Consider the example of an exempt sawmill operator. Chart 3.4 illustrates how this exemption at an intermediate point in the production-marketing system distorts the operation of the tax, increases the tax paid, potentially increases the consumer price and, ironically, may work to the competitive disadvantage of the sawmill operator. In this example we assume that the sawmill operator sells lumber exempt from the tax. The logger charges tax of $8 on a sale of $100. The sawmill, now exempt, charges no tax on sales, but also cannot claim credit for the tax paid on its purchases. The furniture manufacturer charges tax of $24 on its sales, but is not able to claim a credit for exempt purchases from the sawmill. As a result, the manufacturer's net tax liability increases from $12 to $24. There is no change to the retailer's tax.

The sum of taxable amounts in this example has increased to $40 from the $32 shown in Chart 3.3 because of the exemption allowed the sawmill. The tax paid increases even though the tax rate has not changed. This additional tax of $8 will be reflected either in higher prices to consumers or in reduced profit margins for business, depending upon market conditions.

From this example, a number of important conclusions can be drawn:

- Tax-exempt sales lead to tax cascading – some elements of the total value of a product are taxed twice. In the example, the manufacturer pays tax on the value already taxed in the hands of the logger. This is unfair and inefficient.

- Tax-exempt sales lead to a discrepancy in the effective tax rate between a particular product and its competition by disrupting the uniform application of the multi-stage tax. Variable effective rates cause prices of comparable products to differ, distorting consumer perceptions of their respective values and giving some products and producers an unfair, tax-induced advantage.

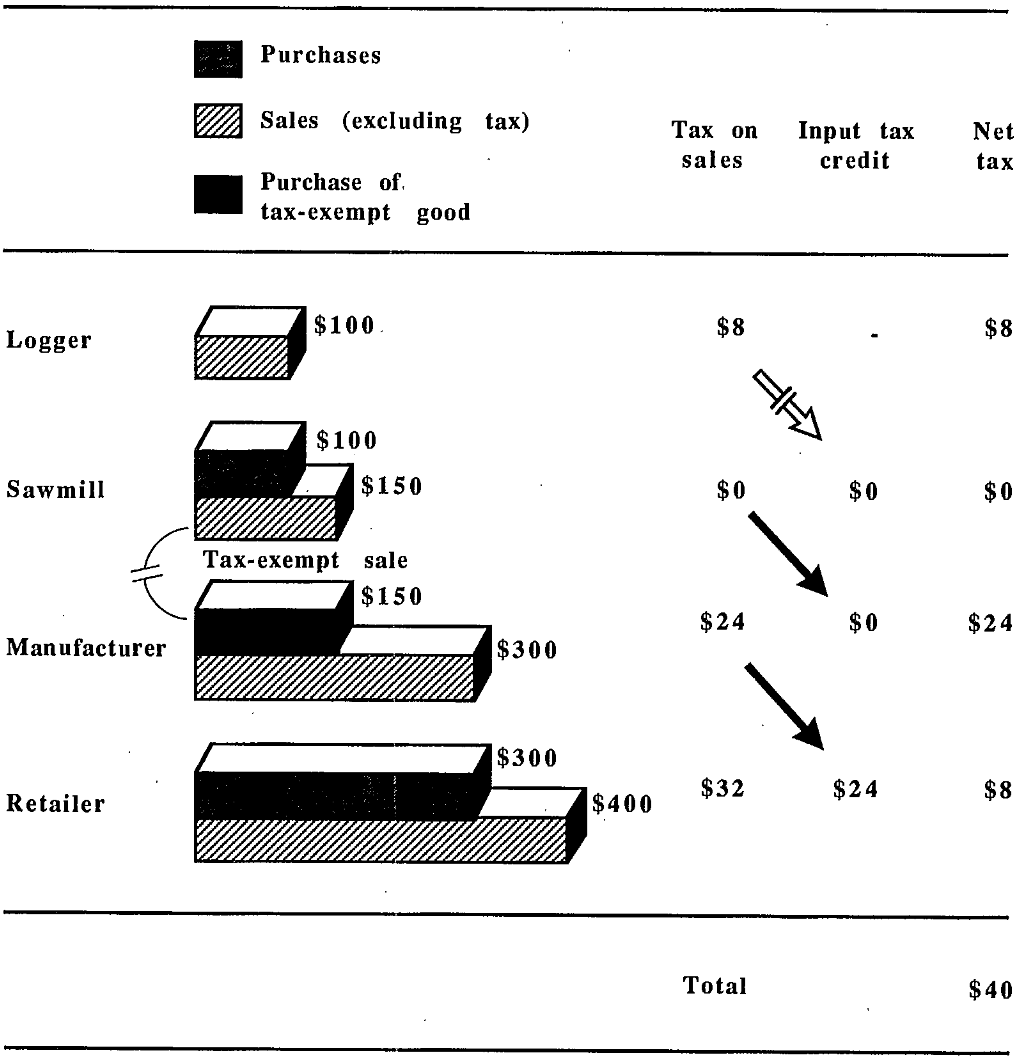
- Tax-exempt sales create more complex record keeping. In the example, lumber must be segregated and tracked separately in the manufacturer's accounts, while other inputs will be taxed and will be eligible for a credit. In effect, the manufacturer now requires a more complex system of record keeping.

- Tax-exempt sales create a strong incentive to minimize purchases from an exempt firm. Thus, in the example, the exemption may work to the sawmill operator's competitive disadvantage.

Chart 3.4

Multi-Stage Sales Tax

An Illustration of Cascading With Tax-Exempt Sales Furniture Manufacture and Distribution



In this example, it has been assumed that, in spite of tax cascading, the manufacturer and the retailer charge the same prices as in the example with no exemptions shown in Chart 3.3. Competition from foreign suppliers who are not affected by tax cascading may prevent the manufacturer and retailer from increasing their prices.

Note: In addition to sale amounts shown, vendors other than the sawmill would charge tax at 8 per cent.

In addition to these consequences, tax-exempt sales would also lead to an increase in the cost of exports and create a bias in favour of imports. In the example, the cost of exports would go up because a manufacturer who exported the table would not be able to claim any credit for the tax-exempt purchases from the sawmill. While there is no tax directly on the sawmill, the sales by the sawmill do include the $8 in tax charged by the logger. The bias in favour of imports is created because an imported finished table that is sold in Canada for a net-of-tax price of $400 would still attract a total tax of $32, as opposed to $40 in the case of the domestically manufactured table.

There are, therefore, convincing reasons for limiting the number of exemptions through tax-exempt sales under a multi-stage sales tax. The harm they cause, in terms of tax cascading, discriminatory treatment of competing products, added compliance problems and distorting effects on the economy result not in increased fairness, but in less.

However, tax-exempt sales can be both fair and efficient in the case of activities that are quite separate from the commercial production and marketing networks of other goods and services. Therefore, the multi-stage tax will not apply to residential rents or the resale of residential homes. Similarly, sales of a non-commercial nature by non-profit organizations and health services and education provided by these institutions will be exempt. Relatively isolated from other marketing and production chains, these exemptions do not give rise to significant complexities or economic distortions. In fact, they simplify administration and compliance.

Some of the adverse consequences of tax-exempt sales illustrated in Chart 3.4 are mitigated if tax relief is provided instead through the mechanism of a tax-free sale. In this event, the sawmill operator, while still not liable for tax on sales, would be able to claim a credit for the tax paid on its purchases. It would be entitled to a net refund of $8. The net tax payable by other businesses in the chain would remain the same, as shown in the chart. The total tax collected would be $32, the same amount collected under a system of no exemptions.

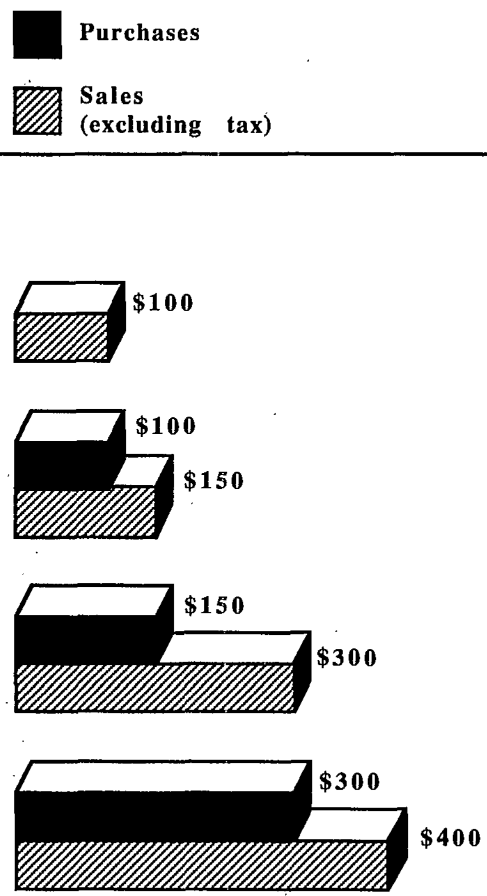
While avoiding the adverse consequences of tax-exempt sales, tax-free sales are of no advantage for an intermediary producer or distributor. The net revenues of the sawmill are the same whether or not its sales are tax-free. If taxable, the sawmill operator would charge $12 in tax on its sale of $150 and the manufacturer would claim an input tax credit for this amount. If tax-free, the sawmill operator would charge no tax and the manufacturer would receive no credit. There is no net difference. However, the sawmill is no better off with a tax-free sale because it forfeits the cash flow advantages of collecting tax at the time of sale and remitting it only at the end of the tax period. In addition, both the sawmill and the manufacturer face the added accounting complexity of tracking separately their tax-free sales and purchases.

In contrast, when sales to final consumers are tax-free, this mechanism results in a tangible tax benefit. As illustrated in Chart 3.5, if the sale by the retailer is tax-free, the net tax collected in the system is reduced to zero. While the retailer charges no tax, full credit is claimed for all the tax collected at earlier points in the chain.

Chart 3.5

Multi-Stage Sales Tax

An Illustration of Tax-Free Sales
Furniture Manufacture and Distribution



	Tax on sales	Input tax credit	Net tax
Logger	$8	-	$8
Sawmill	$12	$8	$4
Manufacturer	$24	$12	$12
Retailer	$0	$24	-$24
	Total		$0

Note: In addition to sale amounts shown, the logger, sawmill and manufacturer would charge tax at 8 per cent.

(b) Competitive Fairness and Efficiency

Tax-exempt and tax-free sales for businesses in the production and distribution chain contribute little to competitive fairness and efficiency. Tax-exempt sales lead to cascading and recreate many of the same biases that exist within the current federal sales tax. Tax-free sales overcome these disadvantages. However, purely from the perspective of individual businesses, they are of little benefit. If provided at intermediary points in the production network, they result in no net tax savings. However, if extended to the retail level, they result in the complete removal of tax and provide a benefit to consumers.

This analysis of the impact of tax-exempt and tax-free sales suggests that exemptions do not contribute to competitive fairness and efficiency between firms. The structure of the multi-stage tax and its application on a broad base are the key mechanisms for safeguarding this aspect of fairness.

Set against this argument in favour of a very broad base is the benefit that tax-free sales provide to consumers. When provided for particular goods, they may be a means of achieving greater fairness among individuals.

(c) Fairness to Individuals and Families

The fundamental argument against the use of general sales taxes as a major revenue instrument has always been their disproportionate burden on lower-income consumers. Two options are available to offset this impact in the context of the multi-stage sales tax: to permit the tax-free sale of certain categories of goods or lower the rates of tax applied to them; or to provide refundable tax credits for those in need.

Tax-free sales and multiple rates attempt to reduce the regressive nature of sales taxes by relieving the tax burden on commodities which are regarded as essential and comprise a large part of the expenditures of lower-income people. This approach adapts the structure and application of the tax itself to make it less regressive. In contrast, the tax credit approach addresses regressivity more directly by compensating lower-income earners for the direct impact of the tax.

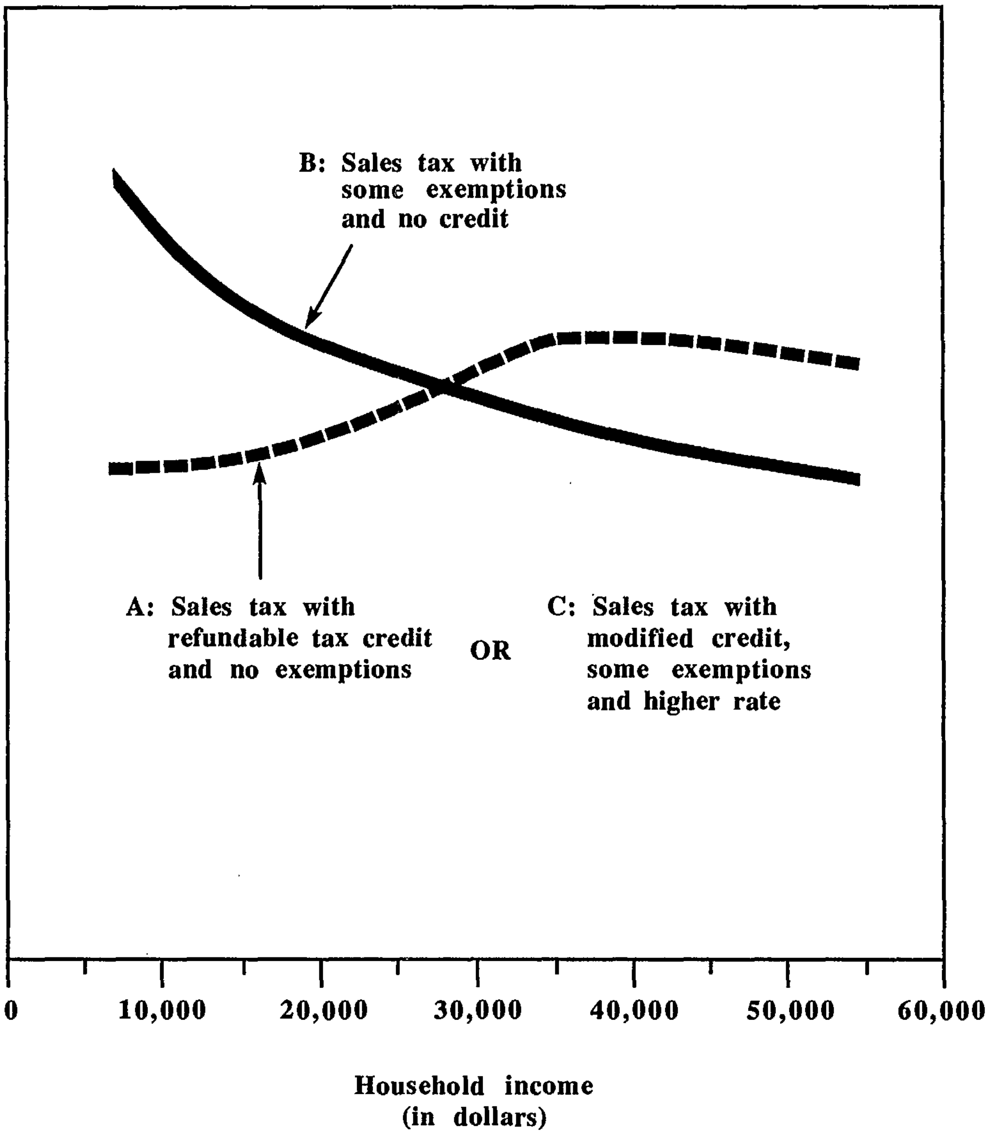
In weighing the relative merits of these two approaches a number of factors must be considered.

Evaluating Exemptions and Credits

Tax-free sales succeed in lessening the burden of sales tax on lower-income individuals and families. By simply removing tax from those goods and services which constitute a relatively much larger part of the expenditures of lower-income groups, exemptions of this kind can provide greater proportionate benefits to those in need than to those in higher-income brackets. However, simply because they spend more on everything, higher-income earners gain more in absolute terms. For

Chart 3.6

Illustration of Refundable Sales Tax Credit and Exemptions



Note: Lines A, B and C are all drawn to yield the same revenues, net of the credit.

example, assuming a tax rate of 8 per cent, tax-free sales for food and clothing would provide a tax saving of $250 for a family earning $20,000, but a reduction of $625 for a family earning $80,000. Exempting food and clothing from sales tax gives higher-income people a greater absolute tax benefit than those at lower-income levels. This is because higher-income people spend more on food and clothing, in particular, more on expensive foods and clothing. Thus, tax is not collected from higher-income Canadians, resulting in substantial forgone revenue. This puts upward pressure on the overall tax rate paid by all.

Credits overcome this problem. They are flexible. They can be targeted directly to those in need and adjusted for family size. They can be paid regularly and in advance of expenditures by households. Chart 3.6 illustrates the comparative effectiveness of exemptions and credits as means of assisting lower-income households. It is clear from the chart that while exemptions assist lower-income households, they are less effective in reducing the overall regressivity of a sales tax. The broken line A shows the impact by household income of a sales tax imposed on a comprehensive base and supplemented by a refundable tax credit. In contrast, line B shows the impact of a sales tax system with exemptions, rather than a credit. It requires a higher rate of tax to raise the same total revenue. The distributional impact of the tax shown in line A can also be achieved by combining these exemptions with a modified credit – in effect, this would become line C. In this event, the resulting rate of tax on all other goods and services would be even higher than in either of the other approaches.

From the perspective of consumers, one of the great advantages of a tax-free sale is its simplicity and familiarity. No special action or initiative is required to benefit from the exemption. The commodity is simply made available on a tax-free basis. This simplicity of access helps to explain the use of exemptions and multiple tax rates in other countries where income tax filing is limited to a relatively small portion of the population.

A further advantage of exemption through tax-free sales is that it provides a way of recognizing horizontal variations in need for certain categories of goods for families with similar incomes. For example, family needs may vary depending on the age of children.

In contrast to most other countries, Canada already operates a sophisticated system of refundable credits as part of the personal income tax. As a result of the introduction of the child tax credit in 1978, a portion of which is now prepaid, and the refundable sales tax credit in 1986, most low-income Canadians already file income tax returns. This provides a channel and the infrastructure needed for the further development of this option within the reformed sales tax system. An enriched sales tax credit, prepaid on a quarterly basis, could be delivered to lower- and middle-income Canadians without additional complexity for them and little or no additional administrative cost. An enriched tax credit could be an important building block for broader efforts in the future to strengthen Canada's income security system.

Finally, while not imposing any additional burden on households, credits simplify compliance for business. They help to avoid the need for additional record keeping required under exemptions to segregate sales into their appropriate tax classifications. Exemptions and multiple rates sometimes involve arbitrary choices and may require vendors to make difficult judgements, potentially creating uncertainty about overall tax liability.

Chapter 4: Options for Implementing the Multi-Stage Sales Tax

The multi-stage sales tax outlined in Chapter 3 could be implemented in the form of a National Sales Tax system, replacing both the current federal sales tax and the existing provincial retail sales taxes. Alternatively, it could be designed to operate only at the federal level, with provinces continuing to collect their own sales taxes separately.

Within the federal-only option, the tax could operate either with or without an explicit tax calculation on each sale invoice. If the tax is to apply to a less than comprehensive base, invoices would be needed to help businesses keep track of taxable and non-taxable sales and calculate their input tax credits by separating taxed from non-taxed purchases.

1. National Sales Tax

Tax reform provides an opportunity for the federal government and those provinces choosing to participate to integrate their sales tax systems into a single national system. A national system would:

- maximize the economic benefits of reform by fully removing the tax on business inputs at both levels of government, thereby strengthening the competitiveness of Canadian industries;
- simplify compliance for taxpayers;
- eliminate duplication of tax administration;
- provide fairer tax treatment of firms, sectors and households.

The National Sales Tax, as a joint federal-provincial tax, would have a number of important design elements:

- a common tax base;
- a uniform federal rate and variable provincial rates;
- invoicing to facilitate the calculation of tax liability and input credits;
- provision for non-participating provinces;
- a single tax administration; and
- refundable federal-provincial credits for low- and middle-income Canadians.

In many respects, the operation of the National Sales Tax would be similar to current arrangements for the personal and corporate income tax system. It would be legislated separately by the provinces and the federal government. The tax would apply to a common range of goods and services agreed upon by the two levels of government. There would be a uniform federal rate across Canada, with flexibility for individual provinces to determine their own rates independently. Under the National Sales Tax, the federal rate would be determined by the same factors outlined in Chapter 3 for the multi-stage tax.

Common Base

To simplify administration and compliance, the National Sales Tax would apply on a common federal and provincial base in all participating provinces.

Without a common base, little tax simplification would be possible. In many ways, the system could become more complex than it is today. The base for application of the federal rate would be uniform across Canada. If a province were to impose tax on a different base, then businesses operating in that province would need to do two separate tax calculations, one for each level of government. The segregation of taxable and exempt sales would be different for each level of government. This layer of complexity would be compounded and spread across the country, to the extent that businesses in any province had sales to and purchases from businesses in other provinces.

If all governments were to have different tax bases, the system would be a national tax in name only. Effectively, it would be unworkable.

Uniform Federal Rate/Variable Provincial Rates

Under the National Sales Tax system, within each province there would be one tax rate. In addition to the federal component of the rate which would be uniform across the country, the National Sales Tax rate applicable in a province would incorporate the rate set independently by the provincial government. Because provinces would naturally retain the right to determine their own rates, the National Sales Tax rate would vary between provinces.

For a business that makes all its sales and purchases within one province, the calculation of the tax would be straightforward. The tax charged on its sales and the credits claimed for its inputs would both be calculated on the basis of the national tax rate applicable in that province.

To illustrate, consider the production-distribution chain from the logger to the furniture retailer operating exclusively within a province which has established a provincial tax rate of 7 per cent in addition to a federal levy of 8 per cent. The tax calculation under the national system is shown in Chart 4.1. As the example shows, the total tax collected is $60, or 15 per cent of the final price to consumers. Replacing the revenues from both the current federal sales tax and the provincial retail tax, $32 – or 8 per cent of the final price – accrues to the federal government and $28 to the province.

Chart 4.1

National Sales Tax

An Illustration of Furniture Manufacture and Distribution Within One Province

	Purchases	Sales (excluding tax)	Tax rate	Tax on sales	Input tax credit	Net tax
Logger		$100	15%	$15.00		$15.00
Sawmill	$100	$150	15%	$22.50	$15.00	$7.50
Manufacturer	$150	$300	15%	$45.00	$22.50	$22.50
Retailer	$300	$400	15%	$60.00	$45.00	$15.00
					Total	$60.00

Notes:
- In addition to sale amounts shown, vendors would charge and invoice tax of 15 per cent. Federal rate assumed to be 8 per cent; provincial rate assumed to be 7 per cent.
- The tax on sales and input tax credits shown above are comprised of federal and provincial elements. For example: the sawmill's input tax credit of $15 includes a federal element of $8 (8 per cent of $100) and a provincial share of $7 (7 per cent of $100). The tax on the sales of the sawmill is composed of a federal portion of $12 (8 per cent of $150) and a provincial element of $10.50 (7 per cent of $150).

Where businesses engage in interprovincial trade, the tax would operate on the basis of a destination principle. The National Sales Tax rate applicable on any sale would be the rate that applies in the province to which the goods are shipped.

For example, consider again the previous example in which the logger, sawmill and manufacturer operate in Province A, and the retailer in Province B. Assuming that these provinces levy tax at 7 per cent and 5 per cent respectively, the calculation of the national tax is presented in Chart 4.2. All of the calculations are the same as in the one-province example, except that the manufacturer and the retailer now charge the National Sales Tax at the rate of 13 per cent – the rate applicable in the province to which the goods are shipped and sold. Over all, the tax collected is $52 or 13 per cent of the final price to the consumer.

It should be noted that even though different businesses at different trade levels may have collected taxes at different rates, the national system ensures that the final tax collected on a product is the same as it would be under a combined retail sales tax of 13 per cent in the province in which the goods are consumed. This maintains the important principle that, whatever the flow of goods through intermediaries and provinces, the tax on the product is a constant percentage of the final price to consumers.

Invoicing

To accommodate variable provincial rates, tax would be calculated separately on sales invoices. Without invoicing, it would not be possible for businesses to separate their sales to and purchases from provinces with different tax rates, making it virtually impossible for them to calculate accurately their input credits and overall tax liability. Invoicing for the national system would be similar to that of the current provincial retail taxes.

As a consolidated federal-provincial rate, the National Sales Tax would apply directly to the sale price of a good. This avoids the pyramiding that results when the taxes of one level of government are applied to prices which already include the taxes of the other.

Provision for Non-Participating Provinces

The national system would provide the flexibility needed to accommodate provinces which might decide not to participate. Under the National Sales Tax this could be accomplished quite simply by designating the provincial rate as zero in any such province. However, in non-participating provinces with their own sales tax systems, taxpayers would be required to comply separately with both a federal multi-stage tax and the provincial retail taxes. Where this is the case, opportunities for consolidation and greater efficiency in tax administration would be lost and the compliance burden on retailers would increase.

Tax Administration and Legislation

The National Sales Tax would allow consolidation of 10 federal and provincial tax administrations into one. The tax could be administered through a set of federal-provincial tax collection agreements similar to those for income tax or through some other mechanism. This would allow considerable savings in administrative costs to both levels of government. Uniform guidelines for administration of sales tax across Canada would simplify compliance for businesses.

The tax would be imposed by both the federal and provincial legislatures in a harmonized fashion, along the lines of the income tax system. The provincial component for a national tax to be legislated by the province would be a direct tax, thereby respecting constitutional powers with respect to taxation.

Refundable Sales Tax Credits

Refundable sales tax credits would be provided to offset the relatively heavier impact of the tax on lower- and middle-income Canadians. There is considerable flexibility in the manner in which such credits could be delivered. Provinces would have the option of providing their own credits separately from federal credits, or of developing a joint system. Provinces might also wish to provide compensation to low-income Canadians through means other than the income tax system.

Assessment of the National Sales Tax

The harmonization of the federal and provincial sales taxes into a single National Sales Tax would have the following advantages:

a. All Tax Removed on Business Inputs

Unlike the current federal and provincial sales taxes, a National Sales Tax would remove all tax on business inputs. It is estimated that approximately one-half of current federal sales tax revenues and one-third of provincial sales tax revenues are collected on business inputs.

The National Sales Tax, by removing all such taxes, would significantly strengthen the competitive position of Canadian exporters and remove the bias in favour of imports. It would enhance the overall efficiency of the Canadian economy by eliminating the tax distortions that exist under the current systems at both levels of government.

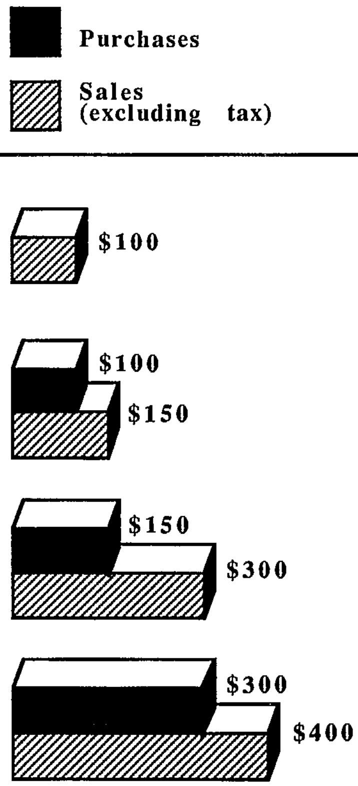
b. Simplicity for Taxpayers – Only One Sales Tax System

A National Sales Tax would be the simplest possible option for taxpayers. Under a national system there would be one tax base, one tax return to file each period,

Chart 4.2

National Sales Tax

An Illustration of Furniture Manufacture and Distribution Between Provinces



	Tax rate	Tax on sales	Input tax credit	Net tax
Logger Province A	15%	$15.00	-	$15.00
Sawmill Province A	15%	$22.50	$15.00	$7.50
Manufacturer Province A	13%	$39.00	$22.50	$16.50
Retailer Province B	13%	$52.00	$39.00	$13.00

Tax Rates:		
Federal	8%	
Province A	7%	
Province B	5%	Total $52.00

Notes:
- In addition to sale amounts shown, vendors in or selling into Province A would charge and invoice tax of 15 per cent. Those in or selling into Province B would charge and invoice tax of 13 per cent.
- The tax on sales and input tax credits shown above are comprised of federal and provincial elements. For example: the sawmill's input tax credit of $15 includes a federal element of $8 (8 per cent of $100) and a provincial share of $7 (7 per cent of $100). The tax on the sales of the sawmill is composed of a federal portion of $12 (8 per cent of $150) and a provincial element of $10.50 (7 per cent of $150).
- The manufacturer charges the rate of tax applicable in the province to which the good is to be shipped. In this example, the tax charged is the rate in Province B, 13 per cent (comprised of 8 per cent federal rate + 5 per cent provincial rate).

and one tax administration to deal with. Since provincial sales taxes apply at the retail level and since the reformed federal sales tax will also extend to the retail level, it makes considerable sense to integrate the two systems. With one system, compliance costs would be significantly lower.

c. Savings in Administrative Costs

Under a National Sales Tax the federal and provincial administrations would be consolidated. This is a major advantage in itself, and an important opportunity to achieve lower-cost government. One of the reasons to pursue a joint national system at the outset is that it would allow a smooth and orderly integration of the tax administrations at the two levels of government.

d. Improved Tax Fairness

A National Sales Tax provides an opportunity to achieve greater fairness in the treatment of firms, sectors and lower- and middle-income Canadians.

For businesses, a uniform application of one tax on a broader base would ensure more consistent treatment and fairer competition. The broader base would permit lower rates at both levels of government, enhancing efficiency and simplifying compliance. For consumers, there would be no pyramiding of taxes on the goods they buy. For lower- and middle-income individuals and families, enriched tax credits would help to offset the impact of the tax, thereby enhancing the fairness of the sales tax system.

Other Considerations

While the National Sales Tax provides substantial advantages and opportunities, it also poses significant challenges to the federal and provincial governments. Many of these relate to the transition to the new system rather than to ongoing operations once the system is established.

a. Effect on Previously Untaxed Goods and Services

For obvious reasons, the shift from a narrowly based federal sales tax to a broadly-based multi-stage sales tax will have some impact on the prices of previously untaxed goods and services. This impact would be more substantial if existing provincial retail sales taxes were replaced by a national system at the same time. This one-time increase in the prices of goods and services which are not now subject to tax will be offset, to a certain degree, by price reductions resulting from the lowering of the rate on currently taxable commodities. After a brief period, price trends would return to normal.

b. Single National Tax Base

Under a National Sales Tax, the federal and participating provincial governments would have to agree to a uniform base; all items exempt from tax in the base for one jurisdiction would be exempt for all other participating jurisdictions. While each jurisdiction would retain flexibility to adjust unilaterally its own rate of tax, it would not be possible to make unilateral changes in the tax base. If a government wanted to provide targeted assistance for purchases of particular goods and services, it would have to be through a mechanism other than changes to the National Sales Tax base.

c. Allocation of Tax Between Provinces

For proper allocation of revenues among provinces, vendors will be required to separate their sales and purchases by province and to report tax on that basis. Rules will also have to be developed to determine allocation of tax on cross-border flows of services such as transportation and telecommunications.

2. Federal Sales Tax Reform

Should a consensus with the provinces on a national system not be achievable, the government will replace the current federal sales tax with a federal-only multi-stage tax. Tax reform that is limited to one level of government cannot, of necessity, fully achieve all the benefits offered by truly national reform. However, a new sales tax at the federal level would meet many of the goals of tax reform. It would represent an important step forward in tax simplification, tax fairness and in improving Canada's industrial competitiveness.

The government will consider two alternative mechanisms for a federal-only multi-stage tax.

- A federal Goods and Services Tax which would be levied at a single rate on virtually all goods and services in Canada, with minimal exemptions. This system could operate without invoices.

- A federal Value-Added Tax (VAT) which would allow greater flexibility in deciding which goods and services would be taxed but at the cost of additional paperburden to separate taxable from exempt transactions. Invoices would be required.

These mechanisms are both variants of the multi-stage sales tax discussed in Chapter 3, and have many common elements. The discussion that follows outlines the distinctive features of each approach.

(i) Federal Goods and Services Tax

A federal Goods and Services Tax, applied at a uniform rate to virtually all goods and services in Canada, would not require a separate tax calculation on each invoice. Since the tax base would be comprehensive, businesses could either include the tax in their prices or identify it separately and apply it at the time of purchase. In either event, to calculate their tax liability, businesses could take their total taxable sales multiplied by the tax rate and subtract from it an input tax credit equal to their total taxed purchases multiplied by the tax rate.

As outlined in Chapter 3, when prices are tax-inclusive, the tax is calculated by taking a fraction of sales and purchases rather than a percentage. The calculation on this basis is illustrated in Chart 4.3. The tax collected from any one business and the total tax are the same as they would be were tax charged separately on each invoice.

Since virtually all domestic sales and purchases would be subject to tax, a business's tax liability for a period could be calculated using information from the books of account already maintained by firms. This would simplify compliance and keep business costs down.

A federal tax structured in this way can operate in parallel with provincial retail sales tax systems. Retailers would be likely to include the federal tax in their prices and the provincial tax would be applied on that price at the time of sale. In this event, as the federal tax would not be shown separately on the sales invoice, there would be no need for any changes to cash registers. From the perspective of the vendor, the relationship between the operation of the federal and provincial tax systems would remain much the same as it is today.

A federal Goods and Services Tax would be applied on a comprehensive base. It would include a substantially enriched refundable sales tax credit for lower- and middle-income Canadians. The tax credit would be structured along the lines of the current sales tax credit. It would vary by family size and would be gradually phased out through the middle-income ranges.

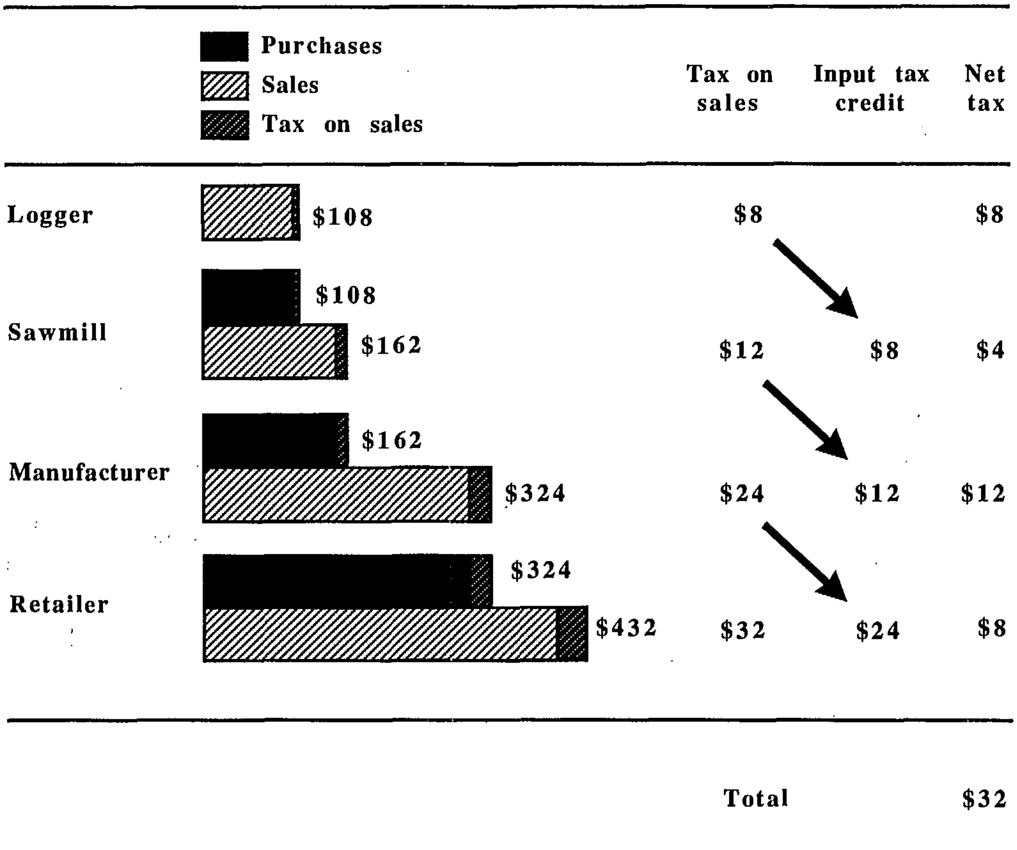
In addition, this tax would include a tax collection fee to small businesses to compensate them, in part, for the costs of compliance. The fee to small businesses could be in the form of a credit against their sales tax payable for each return filed.

A broadly-based federal Goods and Services Tax would achieve many of the goals of federal sales tax reform. It would promote economic efficiency and competitiveness and remove all the distortions of the existing federal sales tax. By minimizing exemptions and utilizing a single rate, it would be the simplest approach from the perspective of both tax administration and taxpayer compliance. This simplicity is especially important in light of the fact that taxpayers at the retail level would be dealing with two different sales tax systems – the federal Goods and Services Tax and the provincial retail sales tax. Finally, the

Chart 4.3

Federal Goods and Services Tax

An Illustration of Furniture Manufacture and Distribution



Note: For the purpose of this example, the tax rate is assumed to be 8 per cent. Because the tax is included in the selling price, unlike the retail sales tax which is added to the selling price, the tax rate is expressed as a fraction rather than a percentage. Therefore, a tax of 8 per cent would be calculated by taking 8/108ths of the tax-inclusive selling price. If the tax-inclusive selling price is $432, the tax would be 8/108 x $432 = $32.

inherent regressivity in a broadly-based sales tax would be eliminated through the enhancement and prepayment of the refundable sales tax credit.

The major disadvantage of a federal Goods and Services Tax is that it does not provide the flexibility to exempt particular products or sectors of the economy. This is feasible only under a system with tax invoicing.

(ii) Federal Value-Added Tax

The federal Value-Added Tax would also be a broad-based tax. However, the explicit invoicing of tax would allow the government the flexibility to exempt selected goods and services or selected classes of business operators. This system would be similar to those operating in European countries and several other countries around the world.

Businesses would charge the tax on their taxable sales and would be allowed to claim an input credit for any taxes paid on their purchases. However, given that some of the purchases may not have borne tax at all, businesses would need to substantiate their input credit claims by invoices showing the tax charged.

In general, businesses would not include the federal tax in their prices but would add it on separately at the time of sale. This would be particularly the case for businesses that make taxable as well as exempt sales or those making sales to other businesses. In the former case, invoicing of tax would facilitate segregation of taxable from exempt sales. In the latter case, the business purchasers would need invoices showing tax charged in order to be able to claim their input credits.

How much the existing refundable sales tax credit would be enhanced under this option would clearly depend on how far the tax base is broadened. To the extent that essential items of consumption were not taxed, the credit would not have to be increased as much. Similarly, to the extent small businesses were exempted from tax, there would be no need to provide a collection fee.

A federal VAT applied to a less-than-comprehensive base would require a higher rate of tax to achieve given revenue objectives. For example, food and clothing represent 17.6 per cent of a fully comprehensive base for a federal VAT. To relieve these items from tax and yet generate the same revenues would require an increase in the overall rate from 8 per cent to 9.7 per cent.

The federal VAT would also remove the inefficiencies of the current federal sales tax. First, because the federal VAT would extend to the retail level, it would apply uniformly to taxable goods and services that flow through different production-distribution channels. Second, it would permit removal of virtually all tax on business inputs and thus strengthen the competitive position of Canadian firms. Third, it would eliminate the bias in favour of imports. In addition, there would be gains in economic efficiency, though not to the same extent as under a tax applied on a comprehensive base.

The main disadvantage of this option is the additional paperburden and compliance costs it imposes on businesses. In fact, if the exemptions were numerous, the tax could become extremely difficult for retailers to comply with. Retailers would have to cope with two sales tax systems – a federal VAT and a provincial retail sales tax – each with different tax rates and tax bases. Retailers would have to keep track of their sales in four categories: sales subject to both federal and provincial taxes; sales subject to federal tax only; sales subject to provincial tax only; and sales exempt from both taxes.

Cash registers are currently designed to segregate taxable and exempt sales under only one tax. Many may not be able to keep track of sales in four categories, requiring retailers to replace them with more highly sophisticated machines.

3. Summary

The options for a multi-stage sales tax being considered by the government are a National Sales Tax, integrating the federal and provincial sales tax systems, or a federal-only system in the form of either a Goods and Services Tax or a Value-Added Tax. The National Sales Tax would apply on a common federal and provincial base. The tax rate would combine a uniform federal rate and a provincial rate determined by each province. Tax would be calculated separately on each invoice. Refundable sales tax credits would be provided under the system. The administration of current federal and provincial systems would be consolidated into one.

A federal-only tax would adequately meet the key requirements of a sound and beneficial sales tax, although not as fully as a national system. A federal Goods and Services Tax offers an option that is relatively simple to comply with, requiring no separate tax calculation on each invoice, but lacking the flexibility to provide exemptions. That flexibility could be met by a federal Value-Added Tax, but at a cost in terms of complexity and paperburden.

Each option is far better than the current federal sales tax and would be a major improvement in Canada's tax system.

Chapter 5: Conclusion

The existing federal sales tax system is out of date and must be reformed. Its consequences for the Canadian economy are growing more serious in the face of an increasingly competitive trading environment. There have been wide-ranging discussions about reform over the years and many views expressed. The time has come to move the debate forward.

The government will implement a broad-based multi-stage sales tax. Its implementation is an essential element of comprehensive tax reform. Its design by legislators will be based upon one of the alternatives set out in this document. Regarding the choice between alternative mechanisms for such a tax, the government proposes to examine the option of the National Sales Tax with the provinces who have expressed initial interest in building a joint system along these lines. The National Sales Tax offers important advantages for economic efficiency and tax simplification. It is an opportunity to improve tax fairness.

Clearly, reform of this kind, involving this option or others, could be sweeping, involving the implementation of an entirely new tax and the replacement of 10 existing systems. There are a number of major issues to be addressed. To provide an opportunity to explore these issues with the provinces, the government has adopted a two-stage approach to comprehensive tax reform. Federal and provincial Finance Ministers will meet in the fall of this year to continue their discussions on sales tax reform. In preparation, a working group of officials from the provinces and the federal government will begin work this summer.

The new multi-stage tax will affect individual Canadians and groups, organizations and businesses across Canada. Their views on the implementation of the new sales tax are essential. Ongoing consultations between the Minister of Finance and representatives of business, labour and the non-profit sector will provide an important opportunity for discussion. As the preparatory work for implementing sales tax reform proceeds, officials of the Department of Finance will place a high priority on providing opportunities for consultation with interested groups and organizations. These discussions will help to clarify important technical issues regarding the application of the sales tax to individual sectors. The Standing Committee on Trade, Finance and Economic Affairs will also wish to examine the question of sales tax reform. Its hearings will serve as an important forum for public discussion.

On the basis of these discussions and those with the provinces, the government will move ahead in stage two of its plans for comprehensive tax reform to put in place a new sales tax – on either a national or a purely federal basis. Coincident with the introduction of the new system, a substantially enriched refundable sales tax credit will be implemented. At the same time, there will be further changes to the personal income tax system, including the elimination of the surtaxes and adjustments to the rate structure.

A new sales tax will strengthen the national economy. It will enhance competitiveness and growth. It will help to provide jobs. The system will simplify compliance for business and it will be fair to individual Canadians and their families.

A new sales tax and major reforms in the corporate and personal income tax system represent a comprehensive plan to provide Canadians with a tax system that is more efficient and more easily understood. The tax system will provide a more reliable foundation on which the government can build new efforts to pursue the other priorities of Canadians. And most important, the tax system will be fair.

Annex I

The Multi-Stage Sales Tax
Details of the Proposal

Table of Contents

Introduction

Chapter 3 of this paper describes in general terms the structure and operation of a broad-based multi-stage sales tax. Chapter 4 outlines three different mechanisms for implementing this type of tax: first, an integrated federal and provincial sales tax system referred to as the National Sales Tax; second, a federal Goods and Services Tax ("federal GST"); and third, a federal Value-Added Tax ("federal VAT").

Regardless of which variant is chosen, there are many common elements. This Annex provides a technical elaboration of the common elements of a multi-stage sales tax, including who will be subject to the tax, how it will be calculated and when it will be payable. It discusses concepts and terms essential to a detailed understanding of a multi-stage sales tax.

The information in this technical Annex is intended to assist Canadians in understanding how a multi-stage sales tax will operate, with a view to facilitating consultations on the detailed design of the new sales tax system.

Section 1: Basic System

As outlined in Chapter 3 of this paper, a multi-stage sales tax is in concept equivalent to a single-stage retail tax – it is a tax on final domestic consumption of goods and services. However, a multi-stage sales tax is more effective in ensuring that tax applies only on final consumer sales and that all business inputs are thus relieved from tax.

Under a multi-stage sales tax each taxpayer in the production, processing and distribution chain pays tax on his or her taxable sales but receives an input tax credit for any tax paid on purchases. Effectively, only the value added by each taxpayer is subject to tax, and this amount is taxed at each stage in the production-distribution process rather than only at the point of final delivery of goods and services to consumers as under a single-stage retail tax. Any tax collected by one taxpayer on a sale to another taxpayer is, however, refunded or credited to the second taxpayer. Since a multi-stage sales tax is a tax on domestic consumer expenditures, the tax would apply to imports but not to exports.

These are the broad elements of a multi-stage sales tax. To apply these elements in a complex economy like Canada's, with its great variety of ways in which business is conducted, will require detailed rules to ensure the smooth and effective working of the system. This Annex provides a description of these rules and how they would apply.

Invoice Requirement

Before proceeding with the detailed commentary, it is important to review the key technical difference between the different variants for implementing sales tax reform – that is, the invoice requirement.

No special invoice requirement would be needed under a federal GST to substantiate input tax credit claims. Under such a system, almost all of a taxpayer's domestic purchases of goods and services would bear tax. With such a broadly-based system, the taxpayer would automatically become entitled to an input tax credit on the purchase price of most goods and services acquired in Canada even though the taxpayer would not have direct evidence in the form of an invoice that his supplier in fact was liable for tax on the transaction.

While a federal GST would not have an invoice requirement, taxpayers nevertheless would be expected to maintain proper records of their purchases and sales. To verify input tax credit claims, taxpayers would be required to maintain evidence of amounts paid or payable, which could be in the form of invoices, bills of account, written contracts, cancelled cheques, receipts or other similar documents.

A multi-stage sales tax with significant producer or product exemptions, or more than one rate of tax, such as a National Sales Tax or a federal VAT, would require a different record-keeping structure since taxpayers would not know, in the absence of appropriate invoices, whether any particular purchase bore tax or the rate of tax, if any, that did apply. Consequently, any such tax would require that taxpayers obtain invoices from their suppliers to substantiate their input tax credit claims. These invoices would indicate the amount of tax charged or, in some cases, only the tax rate if the amount is tax-inclusive and all items covered by the invoice are taxable at the same rate. Invoices would also show the taxpayer's registration or account number. This number would indicate whether or not the supplier is actually a taxpayer, for purposes of auditing input tax credit claims.

Section 2: Liability for Tax

There are a number of inter-related concepts involved in computing a person's net tax liability under a multi-stage sales tax.

Under such a tax, every **person** will be liable to pay tax on all **amounts received or receivable** by the person for **taxable supplies** made in Canada in the course of a **taxable activity**. Tax will be remitted on a **taxation period** basis. A taxpayer will be able to claim a credit for any tax paid or payable on the purchase of taxed goods and services (referred to as an **input tax credit**) in determining his or her net tax liability or refund. The concepts of supply, taxable supplies, supplies made in Canada and amounts receivable for supplies are discussed in Section 3. Section 4 deals with the input tax credit. The other terms underlined above are described below.

2.1 Person

The term "person" will be very broadly defined to include any individual, partnership, corporation, trust, estate, society, union, club, association, organization or other body of any kind, including the federal and provincial governments. The key difference from the corresponding definition in the *Income Tax Act* is that a partnership will be taxable at the partnership level rather than at the level of individual partners.

2.2 Taxable Activity

To be subject to tax, a person must be engaged in a "taxable activity". In most cases, this will mean that a person must be carrying on a business before he or she is subject to tax and, for these purposes, carrying on business will have the same meaning as in the *Income Tax Act*. However, since the tax is on consumption rather than profits, it will also apply to commercial sales by persons who may be exempt from taxation under the *Income Tax Act*, such as charities, non-profit organizations and government bodies. The term taxable activity will also include any activity that involves the sale or rental of commercial real property or sale of new housing, but not most other sales or rentals of residential property.

The definition of taxable activity will specifically exclude any activity to the extent that it relates to the supply of tax-exempt goods and services. These are the goods and services that will not be subject to tax. Tax-exempt supplies are discussed in Sections 10 and 11 and include certain goods and services provided by non-profit organizations such as charities and educational institutions. The supply of certain health services, most residential rentals and sales of used residential dwellings will also be exempt.

Under a multi-stage sales tax, persons engaged in a taxable activity will be taxpayers.

2.3 Taxation Period

A taxpayer will calculate his or her net tax liability or refund due on a periodic basis. Following each taxation period, a taxpayer will be required to file a tax return, and remit any tax due or claim a refund.

Except for individuals with small amounts of sales, taxation periods will be either a month or a quarter. Most taxpayers will file quarterly. Their quarterly periods will be based on their fiscal year for income tax purposes, as opposed to the calendar year. Taxpayers whose annual taxable sales exceed an annual threshold ($6 million, for example) will file monthly. Where an associated group's annual sales exceed this threshold, all members of the group will file monthly. Both quarterly and monthly filers will be required to file returns within one month following their respective taxation periods.

Taxpayers who are individuals with small amounts of sales will be able to file their returns and remit the tax annually. To take advantage of annual filing, an individual will be required to choose a common fiscal year-end for all of his or her taxable activities. Annual filing will be allowed if, for either the current or previous year (or, in start-up situations, the current year), the individual has taxable sales of less than $50,000 and net tax payable of less than $1,000. The individual's annual tax return will be due within 120 days of the end of his or her fiscal year. For individuals with calendar fiscal years, this time will correspond with the due date for income tax returns.

Taxpayers who qualify for annual or quarterly filing will be allowed to elect to file monthly. This option will benefit taxpayers who are regularly in a refund position, especially exporters. The election will take effect in the first month of a fiscal period and the taxpayer will be required to continue filing on that basis for the rest of that fiscal period.

Section 3: Taxable Supplies

3.1 Basic Approach

Sales of goods or services are referred to as "supplies" under a multi-stage sales tax. The tax will apply to the amounts received or receivable for taxable supplies made in Canada by a taxpayer in the course of a taxable activity. In computing net tax liability or refund, the taxpayer will be able to claim a credit for any tax paid or payable on the purchase or importation of taxed goods and services.

The net tax liability of a taxpayer for a taxation period will be the difference between the following two amounts:

A. The tax charged on all amounts received or that became receivable by the taxpayer in the taxation period in respect of taxable supplies made in Canada by the taxpayer in the course of any taxable activity.

B. The tax paid or payable on purchased goods or services to the extent they were acquired for use in a taxable activity. (This includes the tax element in all amounts paid or that became payable by the taxpayer in the taxation period in respect of taxable supplies made in Canada to the taxpayer, and also the tax paid on all goods imported into Canada by the taxpayer.)

Broadly speaking, then, the net tax liability of a taxpayer is the difference between tax on taxable sales and tax included in taxed purchases; that is, the tax effectively applies to the value added by the taxpayer in the course of a taxable activity.

A general principle in determining the tax liability of taxpayers will be that, as far as possible, there should be a matching (in terms of both the timing and the amount) of tax charged and credits claimed for transactions between taxpayers.

An amount will become taxable at the earlier of either the time the amount is received or the time the amount becomes receivable. Conversely, in determining a taxpayer's input tax credit, tax in respect of an amount will become creditable at the earlier of either the time of payment or the time the amount becomes payable. Also, a vendor will be taxable on the full sale price without any deduction for reserves (e.g., for proceeds of sale not yet received), since the purchaser will be able to claim an input tax credit in respect of the full purchase price.

3.2 Key Concepts

(a) Supply

The concept of supply is central to an understanding of a multi-stage sales tax system. The term covers a broad range of transactions involving the provision of property or services. Its definition will include any sale, transfer, lease or disposition of property, any provision of service, and any agreement to provide any property or service.

Although the definition of supply will be very broad, there will be no tax consequences to making a supply in the course of a taxable activity until an amount is received or becomes receivable for that supply. For example, where a taxpayer delivers property for sale on a consignment basis, no amount will be considered as receivable by the taxpayer until the property is sold by the consignee. Similarly, while a vendor's acknowledgement of the receipt of a purchase order will be a supply, as it is an agreement to provide property or service, no amount will be taxable to the vendor until an amount is received or becomes receivable in respect of that supply.

(b) Taxable Supply

Tax will be payable only on taxable supplies. A taxable supply will include any supply other than a tax-exempt supply or a tax-free supply. These two terms are described below.

(c) Tax-Exempt Supply

Vendors will not be required to pay tax on tax-exempt supplies. However, a person making tax-exempt supplies of goods and services will not be able to claim any input tax credits in respect of taxed purchases acquired for use in making such supplies.

Tax-exempt supplies will include the provision of certain goods and services by non-profit organizations such as charities, educational institutions and certain government bodies, and the provision of certain health services (see Section 10). Also exempt will be most residential rentals and sales of used residential dwellings (see Section 11). Consideration could be given to treating other supplies as tax-exempt although this would be very difficult to administer under a federal GST.

For taxpayers that are not financial institutions, the receipt of interest or dividends and gains realized on the disposition of financial instruments will also be tax-exempt and thus will not be subject to the sales tax. These aspects are discussed in more detail in Section 12.

However, the supply of financial services by financial institutions will be subject to tax. The application of tax to financial institutions is discussed in Section 13.

(d) Tax-Free Supply

Vendors will also not be required to pay tax on tax-free supplies. However, unlike the treatment of tax-exempt supplies, a person making tax-free supplies of goods and services will be able to claim input tax credits in respect of any taxed purchases to the extent that they are for use in making such supplies.

Exports of goods and services will be tax-free (see Section 6). This will ensure that the tax applies only to goods and services consumed in Canada and that exports are completely relieved of the tax.

Consideration could be given to treating other supplies as tax-free, although this would be very difficult to administer under a federal Goods and Services Tax.

(e) Supplies Made in Canada

Tax will apply only where a taxable supply is made in Canada. In determining whether a transaction takes place in Canada, separate rules will apply depending on whether the supply involves personal property, services or real property. For these purposes, personal property will mean any property other than real property. A supply will be deemed to be made in Canada if:

(a) in the case of personal property, it is delivered or made available in Canada;

(b) in the case of a service, it is performed in Canada; and

(c) in the case of real property, it is situated in Canada.

Importations of goods into Canada will be subject to tax at the border on their duty-paid value. Certain importations of services will also be subject to tax, as discussed in Section 7.

The definition of Canada for purposes of the tax will be generally identical to the definition in the *Income Tax Act*. However, for imported goods, the *Customs Act* definition will be used so that the tax and any customs duty will be collected at the same time.

(f) Amounts Receivable

The tax liability for a supply will arise in the taxation period in which an amount is received or becomes receivable for the supply. Several provisions will specify when an amount becomes receivable by a taxpayer. These timing rules will be the same whether or not there is any special invoicing requirement. An amount will be considered to have become receivable at the earliest of the following times:

(1) Invoiced Supplies

For supplies covered by an invoice, the date on which the invoice is issued. Where the date appearing on the invoice precedes the actual date of issuance, the date of the invoice will be used. If there is an undue delay in issuing an invoice for a taxable supply of services, the date the invoice would have been issued but for the undue delay will be used. This test will be similar to the one contained in paragraph 12(1)(b) of the *Income Tax Act*.

(2) Agreements in Writing

For supplies made under a lease, contract or other agreement in writing, the date on which the amount becomes due and payable to the taxpayer pursuant to the written agreement.

(3) Delivery

For sales of personal property, the date of delivery. Consequently, if this date precedes the date of an invoice or the date stipulated under a written agreement, the date of delivery will be treated as the time of sale.

(4) Real Property

For sales of real property, the earlier of the date on which ownership is transferred or the date on which the purchaser takes possession of the real property.

In most cases the time for including an amount in calculating a tax liability under the above rules will coincide with the time at which the transaction is normally recorded in the taxpayer's books of account.

The following example illustrates these rules. Assume a manufacturer sells goods to a wholesaler. An amount would become receivable with respect to the sale on the earliest of:

(a) if an invoice was issued, the earlier of the date of the invoice or the date on which the invoice was issued;

(b) the date of delivery; or

(c) if the sale was governed by an agreement in writing, the date on which an amount becomes due and payable to the taxpayer under the agreement.

To facilitate taxpayer compliance, consideration will be given to allowing the rule described in paragraph (1) – i.e., the date on which an invoice is issued – to override the rules described in paragraphs (2) and (3) where the taxpayer issues an invoice within a specified number of calendar days (say, for example, 14) of the date on which the amount would otherwise become receivable. As a result, the date of delivery would not be relevant in the above example if an invoice were issued within 14 calendar days of that date.

There will be several exceptions to the above rules to deal with specific circumstances. First, for construction contracts, an amount will become receivable when it is due and payable to the contractor under the terms of the contract. (Otherwise, the delivery by the contractor of construction materials to the customer's job site could trigger a tax liability to the contractor at the time of delivery.) Second, in the case of supplies such as sales of metered gas where goods are delivered more or less continuously throughout a billing period, the tax will apply only as the charges are invoiced to the customers. Third, in the case of sales made through a coin-operated machine, the date on which the operator removes any money from the machine will be the date an amount becomes receivable.

Section 4: Input Tax Credit

4.1 Basic Approach

Businesses, in determining their net tax liability, will be able to recover any tax paid or payable on their business inputs. This will be accomplished by determining, for each taxation period, an "input tax credit". This input tax credit will be the total of:

(a) the tax paid or payable on purchases of taxed goods and services in Canada; and

(b) the tax paid at the border on goods imported into Canada, to the extent such goods and services were acquired for use in a taxable activity.

The input tax credit will be subtracted from the tax payable by the business on its taxable sales for that period in order to determine the business's net tax liability or refund.

Since an input tax credit would be claimed only with respect to a purchase which has borne tax, the following payments would not be included in determining a taxpayer's input tax credit:

- payments in respect of wages and other remuneration. Contributions to pension plans, deferred profit-sharing plans and other deferred compensation plans, pension payments, retiring allowances and other similar payments for the benefit of employees will be treated like wages, and thus will not give rise to any credit entitlement.
- payments in respect of interest and dividends.
- tax-exempt and tax-free supplies made to a taxpayer. These supplies, by definition, will not be taxable to the vendor and, accordingly, would not entitle the purchaser to any input tax credit.
- federal, provincial and municipal taxes, licence fees, fines, penalties and other statutory levies.

4.2 Amounts Payable

Input tax credits will be claimable in respect of amounts paid or payable for taxable supplies made in Canada to a taxpayer.

Under a system that does not rely on invoices, such as a federal GST, the rules that determine the amount payable for a taxable supply made in Canada to a taxpayer, and therefore the time at which an input tax credit could be claimed, would generally parallel the rules for determining amounts receivable, as discussed in Section 3. Thus, the supply of a taxable good or service generally will entitle the buyer to an input tax credit at the same time the supply becomes taxable to the seller. However, there will be differences in treatment in the following circumstances:

(a) Any tax on an invoiced service rendered to a purchaser will be creditable to the purchaser when invoiced. The supplier who performs the service could, however, become taxable at an earlier time if there is an undue delay in issuing an invoice for the performance of the service.

(b) For purchases of personal property, the purchaser could not claim an input tax credit at the date of delivery where this date precedes both the date of the invoice and the date on which an amount becomes due and payable by the purchaser under any written agreement. The vendor, however, would become liable for tax on the date of delivery in these circumstances.

Under an invoice-based system, such as a National Sales Tax or federal VAT, a taxpayer generally would not be able to claim an input tax credit in respect of an amount paid or payable unless the taxpayer has an invoice to support the claim. As discussed in Section 1, invoices would show the registration or account number of the supplier and the tax charged on the goods or services supplied.

For transactions where invoices are not normally given, such as real estate rentals, the taxpayer would be required to obtain satisfactory evidence that his or her supplier was liable for tax on the transaction to support any claim for an input tax credit. For example, a written lease agreement, contract or certificate from the supplier containing the same basic information required for invoices would be satisfactory evidence.

4.3 Imports

Tax will be paid on the duty-paid value of imported goods at the border, and the tax paid on imports will be included in determining a taxpayer's input tax credit in the normal manner. Section 7 discusses the application of the tax to imported goods and services.

4.4 Apportionment Rule for Input Costs

Any tax paid by a taxpayer on the purchase of taxed goods and services in Canada or on imported goods will be included in determining the taxpayer's input tax credit only to the extent such inputs are for use in a taxable activity of the taxpayer. Accordingly, if a good or service is for use exclusively in a taxable activity, the tax paid will be fully creditable; conversely, if it is not to be used at all in a taxable activity, no credit will be permitted. The application of the tax on a comprehensive basis to virtually all supplies of goods and services in Canada would mean that businesses are able to claim an input tax credit in respect of virtually all purchases that are acquired for business purposes.

In addition, input tax credit claims for inventory and capital goods will be allowed in full upon acquisition. There will be no requirement to amortize the credit over the life of the capital goods or to delay credit claims until goods held in inventory are sold.

As a result, apportionment rules would be needed only in those few cases where taxpayers make exempt as well as taxable supplies or where they make personal use of business inputs. In these cases, a credit would be available only to the extent that the purchased input may reasonably be regarded as being for use in the taxable activity – that is, if the business use were 60 per cent, only 60 per cent of the input tax would be creditable.

The proportion of input tax that would be creditable in these cases could be determined in a number of ways – for example, according to the mix of taxable and exempt sales, the amount of time that an asset is to be used in the taxable activity or, in the case of a building, the square footage or value of the parts of the building devoted to the taxable activity.

Even though a purchase of goods or services may relate to a taxable activity it still may not generate any input tax credit entitlement for several reasons. For example, certain input costs may have a significant personal consumption element or may be in respect of supplies made available to employees for personal consumption. To simplify the administration of the tax, a number of special rules will be implemented to deal with these situations and capital property. These provisions are discussed below.

4.5 Non-Creditable Supplies

(a) Recreational Equipment or Facilities

No input tax credit will be allowed in respect of membership fees or dues in any club whose main purpose is to provide dining, recreational or sporting facilities for its members. Similarly, no input tax credit will be allowed for amounts paid or payable by a taxpayer for the purchase or rental of any recreational or sporting equipment or facilities, or any amount paid or payable that relates to the construction, operation or maintenance of such property. This rule will not apply to taxpayers who use the property in a sporting or recreational business or who are in the business of selling or leasing such property.

(b) Personal or Living Expenses

No input tax credit will be allowed in respect of any personal or living expenses of a taxpayer. Travelling expenses incurred by a taxpayer while away from home on business will not be considered personal or living costs. As well, no input tax credit will be allowed in respect of any amount paid or payable for the lease of property that is primarily for the personal use and enjoyment of the taxpayer or relatives of the taxpayer. A similar provision will apply to acquisitions of capital property as discussed below (subsection 4.7).

(c) Passenger Vehicles

The rules for input tax credits in respect of the purchase or lease of passenger vehicles will parallel those for deductibility under the *Income Tax Act*. Thus, no input tax credit will be allowed in respect of that portion of the purchase price of a passenger vehicle which is in excess of $20,000 or that portion of the annual lease cost of a vehicle which relates to its value in excess of $20,000. The definition of "passenger vehicle" for sales tax purposes will be the same as in the *Income Tax Act*.

Subject to the above restriction, any amount paid or payable by a business in respect of tax on the purchase or lease of a passenger vehicle made available to an employee will normally be fully creditable, while any related employee benefit reported for income tax purposes will be subject to the multi-stage sales tax in the hands of the employer (see the following discussion on employee benefits). A self-employed individual who acquires a passenger vehicle for use in a taxable activity will, however, not be subject to the employee benefit rule. In this case, no input tax credit would be allowed in respect of the purchase or lease of a passenger vehicle unless all or substantially all of the use of the vehicle is in the course of a taxable activity.

An input tax credit will be allowed in respect of the operating expenses of a passenger vehicle to the extent such expenses are also deductible for income tax purposes. These rules will simplify compliance and administration and reflect the personal use component of the vehicle.

4.6 Employee Benefits

No input tax credit will be allowed in respect of payments by taxpayers on account of salaries, wages and related items such as contributions to pension and other deferred income plans. Similarly, an employer will not be able to claim an input tax credit for any payments for taxable supplies that are provided to employees essentially in lieu of salaries and wages.

No special rule will be required for a number of employee benefits, since the supplies that generate the benefit will be tax-exempt and therefore will not generate any input tax credit in the hands of the employer. Examples include the following:

- rent-free or low-rent housing provided to employees;
- the payment of premiums under provincial hospitalization and medical care insurance plans and certain other government plans;

- the payment of an employee's tuition fees at a non-profit educational institution; and

- interest-free and low-interest loans (except in the case of financial institutions as discussed in Section 13).

Where an employer is otherwise able to claim an input tax credit in respect of taxed purchases that give rise to an employee benefit, special rules will apply. Employee benefits arising in these circumstances will be dealt with in one of two ways.

> First, no input tax credit will be allowed in respect of goods and services acquired for use exclusively for the personal benefit of the taxpayer's employees or any individual related to an employee. For example, any tax on premium payments under group life and health insurance plans or the purchase by an employer of an award, such as a holiday trip for an employee, will not be creditable.
>
> Second, where the good or service is not exclusively for the personal benefit of an employee or any individual related to him or her, the employer will be able to claim an input tax credit for the tax on such good or service in the normal manner. The employer will then be required to pay tax on the value of the employee benefit element of these costs as calculated for income tax purposes. That is, the employer would be treated as if it had made a taxable supply equal to the value of the employee benefit.

Any taxable supply in respect of employee benefits will be determined once a year at the end of February and will be taxable at that time. The value of the supply will be an amount equal to the aggregate of the employee benefits as reported for income tax purposes for the previous calendar year. The choice of the end of February is to simplify compliance; by that time, the employer's calculation of any benefit will have been done for income tax purposes and the preparation of T4 slips.

An example of this second approach would be the provision of an automobile by an employer to an employee. The employer will be able to claim an immediate input tax credit for the tax on the automobile and, each February, will pay tax on the amount of any taxable benefit to the employee. Note, however, that the rule would not apply where the employer does not make any taxable supplies – a company receiving only residential rents, for example – since the employer in that case would not be entitled to claim any input tax credits. Therefore, if a residential landlord provides an automobile to an employee, the landlord will not claim any input tax credit for any amount with respect to the lease or purchase of the car, and would not pay any sales tax on the employee's automobile benefit.

4.7 Capital Property

In the absence of any special rules, expenditures for capital property would give rise to input tax credits in the taxation period in which the expenditures are incurred to the extent they are for use in a taxable activity. Thus, where capital property is acquired for use exclusively in a taxable activity, the tax component in its cost will be immediately creditable. Unlike the income tax deduction rules, the input tax credit for any tax on capital property need not be amortized over the life of the property, but will be claimed in full in the period in which it is acquired. If the property is later put to a non-taxable use, special change-of-use rules, similar to those in the *Income Tax Act*, will apply. However, it is expected that these change-of-use rules will apply in only a very narrow range of circumstances provided the tax applies in a comprehensive manner.

For the purposes of the multi-stage tax, capital property of a taxpayer will mean any property that is capital property of the taxpayer within the meaning of the *Income Tax Act* other than any property described in class 12 or 14 of the capital cost allowance classes. It therefore will not include any inventory of the taxpayer or other property held for resale.

(a) Charities, Non-Profit Organizations and Governments

To simplify administration and compliance, special rules will apply to charities, non-profit organizations and government bodies as defined in Section 10.

For such organizations, a full input tax credit will be allowed in respect of a capital property if the property is acquired for use **primarily** in a taxable activity. If that condition is not satisfied, then no part of the tax will be creditable. A similar rule will apply in determining any input tax credit in respect of improvements to capital property.

The normal change-of-use rules will not apply to these organizations even where the degree of use in making taxable and tax-exempt supplies changes.

Where an input tax credit has been claimed in respect of capital property, its resale will be taxable.

(b) Other Taxpayers

For all other taxpayers the rules applicable to capital property will be similar to the rules for non-capital property: any input tax credit will be based on the extent to which the capital property will be used in a taxable activity. In addition, the property must meet one other test before an input tax credit can be claimed. This test will depend on whether the property is personal property or real property.

- For personal property acquired for use in a taxable activity, an input tax credit will be allowed only if the property is **primarily** for use in a taxable activity. A similar rule will apply for improvements to personal property.

- For real property acquired for use in a taxable activity, an input tax credit will be allowed even if the property is not primarily for use in a taxable activity, provided the property is not acquired primarily for the taxpayer's personal use and enjoyment (such as a residence). A similar rule will also apply for improvements to real property.

The purpose of the first rule will be to ensure that the taxable use of personal property is significant before any credit can be claimed. The second rule will reflect the fact that, even though a building's primary use may be the provision of tax-exempt services (such as long-term residential rents), the taxable use of the property may be significant – for example, commercial rents on the first few floors of an apartment tower. However, no input tax credit will be allowed for the business use of an owner-occupied dwelling unless the business use is the primary use of the building.

After a capital asset is purchased, and an input tax credit is claimed based on the degree of use of that asset in a taxable activity, the use of the asset may change. In these circumstances, the normal change-of-use rules will apply.

Resales of capital property will be subject to tax where an input tax credit was previously claimed in respect of the property.

Section 5: Non-Residents

5.1 Basic Approach

Under a multi-stage sales tax, all taxable goods and services supplied in Canada in the course of a taxable activity will be subject to tax. Taxpayers who are not resident in Canada will, however, be taxable only on the following transactions in Canada:

(a) supplies of real property situated in Canada;

(b) supplies made by a non-resident who has a permanent establishment in Canada; and

(c) certain performances by a non-resident at a place of entertainment in Canada.

Generally, this approach will ensure that non-residents are subject to tax only where they have a significant presence in Canada. All other non-residents will be considered not to be taxpayers and supplies by them will be treated as supplies made outside Canada and, therefore, outside the scope of the tax. Non-residents who are taxpayers will be entitled to claim input tax credits under the normal rules in calculating their tax liability. No input tax credit will be allowed in respect of payments to a non-resident unless the non-resident is a taxpayer.

5.2 Non-Resident Performers

Non-resident performers will be subject to tax on performances at a place of entertainment in Canada where the non-resident is paid directly by the customers – for example, through ticket sales in Canada by a visiting foreign circus. Where non-resident performers provide their services to a taxpayer, such as a promoter or a theatrical company, the non-resident will not be taxable. However, since the payment to the visiting performer by the promoter or theatrical company will not entitle the promoter or theatrical company to any input tax credit, while they will still be subject to tax on their charges to customers, the tax, in effect, will apply to the value of the non-resident's services.

5.3 Residence

To apply the above rules, it will be necessary to determine whether or not a taxpayer is resident in Canada. For the purposes of the tax, "residence" will have its usual legal meaning. Accordingly, the determination of a taxpayer's residence will generally be a question of fact. For greater certainty, the following will be treated as residents in all circumstances:

(a) any corporation incorporated in Canada;

(b) any partnership where all of the partners (other than limited partners) are resident in Canada;

(c) any trust or estate where the trustee, administrator, heir or other legal representative managing and controlling the trust or estate is resident in Canada; and

(d) any unincorporated society, club, association, organization or branch thereof where a majority of the members having management and control are resident in Canada.

Section 6: Exports

Since any multi-stage sales tax is meant to apply only to the consumption of goods and services in Canada, amounts received from export sales will not be subject to the tax. Exports that would otherwise be subject to the tax will be categorized as "tax-free supplies". To completely relieve exports of any sales tax content, exporters will be allowed to claim a full input tax credit in respect of any taxed purchases of goods and services that relate to their export activities. The net result will be a refund to exporters of the tax paid on their purchases.

Tax-free exports would include exports of goods, intellectual property or services.

6.1 Goods

Tax will not apply to any export of goods. Where goods are delivered in Canada for export, the transaction will have to meet prescribed rules to ensure that the goods are in fact exported to qualify as a tax-free supply.

6.2 Intellectual Property

Supplies of intellectual property rights, such as patents, trade secrets, industrial designs, trademarks, copyrights or know-how will be tax-free if made in Canada to non-residents who are not taxpayers.

6.3 Services

A number of services that relate to the export of goods or that are not for consumption in Canada will be tax-free. These include the following:

(i) **International transportation services** except outbound freight transportation billed to taxpayers in Canada (whether resident or non-resident) and the purchase in Canada of trans-border air passenger transportation to the continental United States. The taxation of international freight and passenger transportation is discussed in Section 8.

(ii) **Services performed in Canada for non-resident operators of ships and aircraft for use in transporting passengers or goods to or from Canada.** Goods sold to these operators who are not taxpayers for use in this business will also be tax-free. This rule reflects the fact that these goods and services will effectively be consumed outside of Canada. Tax-free supplies under this provision would include, for example, repair and maintenance services, fuel sales and the provision by a domestic caterer of meals for an international flight.

(iii) **Services supplied in Canada to a non-resident who is not a taxpayer for use exclusively outside of Canada.** For example, management fees charged by a Canadian parent company to a foreign subsidiary will be tax-free.

(iv) **Services supplied to a non-resident who is not a taxpayer in respect of goods for export from Canada.** For example, export packaging services performed for such non-residents will be tax-free.

(v) **Services supplied in Canada to a non-resident who is not a taxpayer in respect of goods, ordinarily situated outside Canada, that are either situated outside Canada at the time of the supply or are temporarily imported for the sole purpose of having the services performed on them and exported thereafter.** For example, repair or custom work on goods sent to the Canadian manufacturer of the goods from abroad will be tax-free.

(vi) **Services in respect of real property located outside Canada.** For example, legal or architectural fees charged by a Canadian resident in respect of real property in the United States will be tax-free.

6.4 Personal Exports

Foreign visitors to Canada will also be allowed to claim a refund of the tax on goods they purchase for export. To qualify for the refund, the goods will have to be exported within a specified period (for example, 90 days from purchase). There will be a dollar threshold on refund claims to minimize administrative costs.

The sale of goods at duty free shops will not be subject to tax.

Section 7: Imports

Since a multi-stage sales tax is a tax on domestic consumer expenditures, the tax will apply to imports of goods and services. This will also ensure that foreign supplies do not have a competitive advantage compared to their Canadian-made counterparts.

7.1 Goods

The tax will be payable when goods are imported into Canada, except where the import qualifies under the existing exemptions for tourists, immigrants and returning residents. The tax will be levied on the aggregate of the value of the goods for duty purposes plus any duties or excise levies payable. The tax on imported goods will be collected at ports of entry.

A business importing goods will include the amount of the tax paid at the time of importation in determining its input tax credit. The ability to claim a credit for the tax paid on imported goods will be subject to the same provisions that apply to purchases of goods and services from Canadian sources. As a consequence, for the purposes of recovering the tax paid on business inputs, domestic and imported goods will be treated equally.

7.2 Services

Tax will also apply to services imported into Canada. However, imported services do not flow across the border in the same manner as goods. Accordingly, it is difficult to identify and value services at the time they are imported. Because of this, and to simplify the administration of the tax, tax will not be imposed **directly** on services imported by taxpayers. However, since taxpayers will not be able to claim any input tax credit in respect of an imported service (since no tax will have been paid on the service), and since the value of the service will be reflected in their taxable sales, tax will, in effect, apply to the value of the imported service.

This approach would be ineffective if the imported service is for use in non-taxable activities. Therefore, the import of services for use in Canada other than in the course of a taxable activity will be subject to tax. The tax will apply on a self-assessment basis and will be payable directly on the cost of the imported service. This will ensure that there is no competitive disadvantage to domestic suppliers of services. An example would be a Canadian university hiring an architect situated abroad to design a building in Canada. If an architect operating in Canada had been used, the services would be subject to tax. Accordingly, if an architect situated abroad who is not subject to tax performs the service, the Canadian university would be required to pay the tax on the service so that the Canadian architect is not placed at a competitive disadvantage.

Section 8: Transportation and Travel

8.1 Passengers

The tax will apply to commercial domestic passenger transportation services. These will include services provided by commercial operators of buses, trains, ferries, taxis, ships and aircraft. Tax will not apply to local transit services provided on a not-for-profit basis. Firms providing taxable domestic passenger transportation services will be taxable on amounts received for services provided and will claim an input tax credit for taxed goods and services supplied to them in Canada for use in their taxable activities.

The tax will also apply to trans-border air passenger travel to the continental United States when the passenger air transportation services are purchased in Canada. This extension of the tax recognizes the homogeneous nature of the Canada-U.S. air travel market and will facilitate integration of the new tax with the existing air transportation tax (as described in subsection 8.1(a) below).

All other international passenger transportation services will be tax-free. These will include trips both to and from Canada. A firm providing such services will be allowed to claim an input tax credit in respect of all its purchases of taxed goods and services supplied to it in Canada.

Where a combination of domestic and international passenger transportation services is provided as part of a continuous journey, the domestic portion of the travel will be considered to be part of the international travel and will be tax-free, provided there is no destination or stop-over in Canada other than for connection between various parts of the transportation service. In other cases, where the journey includes travel between two Canadian points, the domestic portion will be subject to tax.

Amounts paid by a business for domestic travel (and trans-border air travel purchased in Canada) will be included in the calculation of its input tax credit. International travel, being tax-free, will not give rise to any input tax credit claims.

(a) Air Transportation Tax

The current air transportation tax will be amended on the introduction of a multi-stage sales tax. The present *ad valorem* tax of 10 per cent plus $4 to a maximum of $50 per ticket on passenger transportation within the taxation area (Canada and the U.S.) will be modified to reduce the impact of the imposition of the new tax on domestic and trans-border air travel.

8.2 Freight

The tax will apply to all domestic freight transportation services. These will include services provided by all common carriers. Also included will be transportation provided partly outside Canada where the transportation is between two domestic points, such as coastal shipping or shipments routed through the United States. Firms providing domestic freight services will be taxable on amounts received or receivable and will be allowed to claim an input tax credit in respect of amounts paid or payable for taxed goods and services supplied to them in Canada. Tax paid or payable by a business purchasing domestic freight transportation services will be included in the calculation of its input tax credit for purposes of calculating its tax liability in the normal manner.

International freight transportation services to a foreign destination supplied in Canada will also be taxable if they are billed to someone in Canada. A firm providing such services will be taxable on them and will be allowed to claim an input tax credit in respect of all amounts paid or payable for taxed goods and services supplied to it in Canada in the same manner as for domestic freight transportation services.

An exporter purchasing outbound international freight transportation services in Canada will be allowed to claim an input tax credit in respect of the amount paid or payable for such services for purposes of calculating its tax liability in the same manner as for other taxed goods and services purchased in Canada. This will ensure that no tax element in respect of transportation services will be included in the cost of goods exported from Canada. A supply of outbound international transportation services by a Canadian carrier directly to a non-resident who is not a taxpayer (billed outside Canada) will be tax-free as an export supply. An input tax credit will be available to the supplier in respect of all taxed goods and services supplied to it in Canada, thus ensuring that its international services supplied outside Canada will be entirely free of tax.

The cost of inbound international freight transportation services will be tax-free. However, since no input tax credit will be allowed to a Canadian business in respect of purchases of these services, tax will be collected indirectly on inbound freight costs at the next stage when the Canadian business sells its goods or services.

Where a combination of domestic and inbound international freight transportation services is provided as part of a single contract for services, the terms of the contract will determine whether all or only part of the service is tax-free. For example, where the domestic service is provided as part of the total inbound international freight transportation service contract, and the charge for the domestic portion of the service is not separately itemized, the entire service will be treated as an international service and will be tax-free. In this case, no input tax credit will be allowed to the purchaser. Alternatively, where the domestic and international parts of the service are charged separately, only the inbound international portion will be tax-free. The carrier providing the domestic portion will be taxable on amounts received or receivable, while the purchasing firm will be allowed to claim an input tax credit in respect of those amounts in calculating its tax liability.

In the case of a combination of domestic and outbound international freight transportation services billed in Canada, no special rules will be required as both parts of the service will be fully taxable (and entitle the purchaser to an input tax credit) regardless of whether they are separately itemized.

Even under a federal GST, an invoicing requirement may be needed to substantiate input tax credit claims for freight services. The reason for this is that otherwise there would be administrative problems in ensuring that input tax credits were allowed only where tax had been paid.

8.3 Travel Agents, Travel Wholesalers and Tour Operators

In the case of travel agents, travel wholesalers and other tour operators, special rules will be needed so that tax is not collected in respect of foreign travel and accommodation which the tour operator purchases directly from a foreign vendor for its domestic customers. Travel and accommodation in foreign countries is not consumed in Canada and thus should not be subject to a domestic consumption tax. However, the agent's, wholesaler's or operator's services are provided in Canada and should be subject to tax.

The need for special rules is best illustrated by way of example. If an individual arranged a foreign travel package directly, the purchase would not be subject to the domestic tax. If, instead, the individual purchased the foreign travel package through a Canadian tour operator, the general sales tax rules would lead to an inappropriate result: the Canadian tour operator would be subject to tax on the full price charged to the individual but would not be able to claim any input tax credits for amounts paid to foreign suppliers (such as amounts paid for foreign hotel services included in the package), since no tax would have been paid on these purchases.

Accordingly, travel agents, travel wholesalers and tour operators, in computing their sales tax liability, will be allowed to claim a notional input tax credit with respect to purchases of goods and services directly from foreigners for customers (for example, the purchase by a tour operator of hotel accommodation abroad). In addition, input tax credits in respect of tax-free supplies to the tour operator (such as the cost of a foreign airline ticket) will be allowed. No special rules will be needed where a travel agent does not purchase travel services but merely acts as an agent; the agent's commissions will be taxable under the general rules or tax-free under the export rules where the commission is received from a non-resident such as a foreign hotel.

Section 9: Other Provisions and Operational Aspects of a Multi-Stage Sales Tax

This section summarizes a number of miscellaneous provisions and operational aspects of a multi-stage sales tax. The transitional measures that would have to be considered in moving to a new sales tax system are also discussed.

9.1 Other Provisions

(a) Exemption for Small Vendors

Under a federal Goods and Services Tax, exemptions, including any for small businesses, have to be limited and confined to those situations where sales are made exclusively to final consumers. In other situations, exemptions require segregation of taxable and exempt purchases by businesses for purposes of determining their input tax credit claims. This is not feasible in the absence of an invoice requirement and, accordingly, the exemption would be limited to individuals who supply goods or services in limited amounts directly to consumers. To be eligible, the individual would have to meet the following conditions:

- the individual does not have a fixed place of business other than his or her residence;
- the individual makes all, or substantially all, of his or her sales to final consumers; and
- total sales by the individual do not exceed $5,000 in the calendar year.

Under either a National Sales Tax or federal VAT, the dollar threshold for the exemption could be higher and it could be extended to incorporated businesses, partnerships and other business entities.

(b) Partner Expenses

Tax will be payable by a partnership as if it were a separate entity, rather than by the individual partners. For commercial reasons, it is common for some goods and services to be acquired by the partners directly (rather than by the partnership) for use in carrying on the business of the partnership. In such cases partners will be able to recover the tax on their taxed purchases provided that a credit for these purchases would have been available to the partnership if the partnership itself had acquired the goods or services. To simplify administration, refund claims for tax on partner expenses will be permitted on an annual basis only and will be filed with each partner's income tax return.

(c) Employee Expenses

Many employees such as commission salesmen incur significant expenses in the course of carrying on their duties. These expenses are often not reimbursed by their employers except through the salaries and commissions that are paid. As salaries and commissions are not included in determining the input tax credit of the employer, and since the employee will be treated as not carrying on a taxable activity, no credit would be permitted for these expenses in the absence of special rules. As a consequence, officers and employees will be refunded the tax paid on those employment expenses which are also deductible for income tax purposes. The refund will be claimed with the income tax return of the employee for the calendar year in which the expenses are incurred.

(d) Bad Debts

If a taxpayer accounts for tax on a supply that it has made, and subsequently writes off a part or all of the consideration for that supply as a bad debt, the taxpayer will be allowed to claim an input tax credit for any tax on the bad debt in computing his or her tax liability in the period in which the debt is written off. Any part of the bad debt subsequently recovered will be included in taxable receipts.

(e) Gambling and Lotteries

In the case of gambling and lotteries operated on a commercial basis, payments received by the organizer for bets or raffle and lottery tickets will be subject to tax. Special provisions will allow the organizer to claim a credit for prizes paid out. This will ensure that the tax will apply only to the organizer's margin. There will be no credit for purchasing the ticket or placing the bet as this represents private consumption. Tax will not apply to gambling or lottery winnings since these are not received as consideration for any supply to the organizer.

(f) Real Property and Intellectual Property Rights

The tax borne by a taxpayer for the acquisition of real property or in respect of any intellectual property right such as a patent, trade secret, industrial design, trademark, copyright or know-how, will only be creditable where the person supplying the property is a taxpayer. Under a federal GST, this means that an input tax credit could be claimed by the purchaser only where the supplier certifies in the prescribed manner that he or she is taxable on the supply. No special rule is required under a system with an invoice requirement. The rules that apply to real property are described more fully in Section 11.

(g) Provincial Sales Taxes

Provincial retail sales taxes are imposed on consumers but are collected by vendors in the nine provinces that impose such levies. Where a business collects a provincial sales tax on behalf of the province on its sales, that tax will not form part of its taxable receipts for purposes of the federal multi-stage sales tax. That is, the multi-stage tax will apply on amounts excluding the retail sales tax. As a consequence, a business which has paid the provincial retail sales tax on some of its business inputs such as office furniture and supplies should be allowed to claim an input tax credit only in respect of the purchase price excluding the provincial retail sales tax component. However, compliance with this approach would require considerable change to the accounting systems of taxpayers under a federal GST. Accordingly, in this case, taxpayers would be allowed to base their input tax credits on the provincial tax-included purchase price notwithstanding the fact that the federal tax would not have been paid on the provincial sales tax component. No special rules would be required to accommodate provincial sales taxes under a multi-stage tax that relies on invoices.

Provincial tobacco and gasoline taxes are often collected by retailers but are subsequently paid to wholesalers who remit the tax to the provincial governments. As is the case for provincial retail sales taxes, such taxes will, for purposes of the federal tax, be excluded from the taxable sales of wholesalers in these circumstances. For other businesses, as an administrative convenience, the amount of these provincial taxes would be included in both their taxed inputs and taxable sales under a federal GST. Thus, a retailer selling tobacco products would include the provincial tobacco tax in both its purchases and sales that are subject to the federal tax. This yields the same result as would be obtained if the retail business excluded the provincial tax from both its sales and purchases, but is simpler to administer and comply with. For business purchasers of these products, input tax credits would be calculated based on the full cost of the product notwithstanding the fact that the cost includes a provincial tax component on which federal tax has not been paid.

(h) Used Goods

A sale of a used good in the course of a taxable activity by a taxpayer will be a taxable supply and, for a purchaser who is also a taxpayer, the normal input tax credit rules will apply.

Sales of used goods by private individuals who are not taxpayers, or by persons making only tax-exempt supplies, will not be subject to tax as these transactions do not arise in the course of a taxable activity. Although goods sold by such persons will not be subject to tax on sale, if the purchaser is a taxpayer, and the goods are acquired for use in a taxable activity, the purchaser will be entitled to claim a notional input tax credit in respect of the used goods purchased. This treatment will recognize that the sale of used goods by households does not represent new value added. It will also ensure that, where used goods are purchased for use in a taxable activity, tax will apply only to the additional value added to the used goods by the firms acquiring them.

Under an invoice-based system, a notional input tax credit would be allowed to a taxpayer who purchased a used good from a private individual, even though there may not be an invoice relating to the purchase.

Used goods that tend to appreciate in value pose certain problems. When held in the hands of private individuals, value is added to them on which no tax is ever paid. Under a multi-stage sales tax, no input tax credit will be allowed to a taxpayer who buys an appreciating used good unless the good is bought from another taxpayer with a certificate or invoice certifying that tax has been paid on the transaction. This means that no credit will be allowed in respect of appreciating used goods bought from a private individual. The definition of appreciating used goods would include listed personal property identified in paragraph 54(e) of the *Income Tax Act*, namely:

- prints, etchings, drawings, paintings, sculptures or other similar works of art;
- jewellery;
- rare folios, rare manuscripts or rare books;
- stamps; and
- coins.

(i) Non-Arm's-Length Transactions and Appropriation for Personal Use

There will be special rules for application of tax on non-arm's-length transactions and where a taxpayer appropriates property or service for personal use. A few of these provisions have been referred to above – see the rules on capital property and change of use in Section 4.7. These provisions will apply where a business transfers goods and services for inadequate consideration to a non-arm's-length person who is a consumer or a person making tax-exempt supplies. The taxpayer will, in this case, be taxable on the fair market value of the supply notwithstanding that the actual consideration received may be less. The definition of arm's length for these purposes will be the same as in the *Income Tax Act*. Similar rules will apply in determining the input tax credit of a business when it acquires goods and services for consideration in excess of the fair market value from a non-arm's-length person who is not engaged in a taxable activity. Special rules will also be required where goods or services are appropriated for use by a shareholder of a corporation, a member of a partnership, a beneficiary of a trust or any person related to such shareholder, partner or beneficiary.

(j) Gifts

There are different types of gifts and each will have particular sales tax consequences.

Promotional Gifts: The cost of "gifts" given by a business to customers in the course of a promotional campaign are generally reflected in the price of goods and services sold by the business. To tax those "gifts" would effectively result in double taxation. Consequently, "gifts" given to customers as part of a business promotion scheme will not be taxable as long as the "gift" is reasonable in the circumstances and the recipient is not related to the taxpayer. Similarly, input tax credits will be allowed in respect of purchases reasonably related to a promotional campaign involving "gifts" to customers.

Personal Gifts to Clients: These are similar to promotional gifts and, as long as they are expenses reasonably related to a taxable activity, will entitle the taxpayer to an input tax credit in the normal manner.

Gifts to Employees and Shareholders: Gifts to employees will be taxable under the employee benefit rule where input tax credits have previously been claimed in respect of the goods or services subsequently given to employees. No input tax credit will be allowed in respect of property or services acquired with the specific intent of giving them to employees. Gifts to shareholders will be taxable at their fair market value as an appropriation for personal use.

Donations to Charities and Non-Profit Organizations: Where a taxpayer donates goods of its own manufacture or other goods or services normally traded by the taxpayer, the "donation" will be treated as a promotional gift. Cash donations will not give rise to any input tax credits. Similarily, to ensure neutrality between cash donations and donations in kind, where a taxpayer acquires a good or service other than in the course of a taxable activity, and donates it to a charity or non-profit organization, the taxpayer will not be entitled to any input tax credit in respect of the purchase.

(k) Discount Coupons

In general, coupons or similar discounts can be grouped into three categories:

Retailers' Coupons: These are issued by retail stores and offer a discount on the purchase of specific products or services. The value of the coupon is deducted from the selling price of the merchandise or service when the coupon is redeemed. Under a multi-stage sales tax, the issue of the coupon will have no tax implications and, on redemption, only the net amount paid by the customer will be subject to tax.

Manufacturers' Coupons: These are also offered to provide a reduction in the selling price of specific goods. They are usually redeemable at any retail store selling the specified products, with the manufacturer reimbursing the retailer for the amount of coupons accepted. Like retailer coupons, only the net amount paid by the customer to the retailer will be taxable under a multi-stage tax. However, the reimbursement received by the retailer from the manufacturer will be included in the retailer's taxable receipts, with an offsetting input tax credit to the manufacturer in computing his tax liability. The reimbursement will be treated, in effect, as a reduction in the manufacturer's sale price to the retailer.

Money Coupons: These are given at the time of sale, usually on the basis of a percentage of the dollar value of goods purchased. Money coupons are used by customers much like retailers' or manufacturers' coupons to reduce the purchase price of goods or services on redemption. Therefore, the original purchase on which the coupons were granted will be subject to tax on the full sale price. However, when the coupons are eventually used on subsequent purchases only the net amount paid by the customer will be taxable.

(l) Manufacturer's Rebates

Some manufacturers offer cash rebates to consumers of their products. Rebates are like manufacturers' coupons and, when paid out, effectively result in a reduction of the value added by the manufacturer. As such, special provisions will allow manufacturers and other taxpayers who operate rebate schemes to claim an input tax credit in respect of any rebate paid out. Conversely, provisions will ensure that, if the person receiving the rebate is also a taxpayer, any rebate received by that person will be taxable. This will ensure that only the net value added by the rebate sponsor is actually subject to tax. Similarly, only the net amount paid by the rebate beneficiary, if also a taxpayer, will give rise to an input tax credit.

(m) Co-operative Advertising

It is common business practice for price adjustments to be made between two taxpayers where one of them assumes responsibility for some advertising. For example, a manufacturer may give a retailer a rebate once the retailer provides evidence that the manufacturer's goods were displayed in "prime space" or that the retailer has paid for local advertising.

Under a multi-stage sales tax, where such a rebate is paid, the retailer will be required to treat the amount of the rebate as a taxable receipt. The manufacturer will be able to claim a corresponding input tax credit once it has obtained written evidence of the rebate claim from the retailer.

(n) Gift Certificates and Tickets

The sale by a business of a gift certificate will not be treated as a supply at the time of issuance; rather, the amount received or receivable for issuing the certificate will be subject to tax at the time the certificate is exchanged for goods or services. The sale of tickets will be subject to tax at the time of issuance.

(o) Credit and Debit Notes

Credit and debit notes may be issued for a number of reasons. Where a taxpayer issues a credit note because goods previously sold are returned or because the sale price is reduced, the taxpayer will be entitled to claim an input tax credit equal to the tax on the amount of the note in computing its tax liability. This treatment will ensure that tax is collected only on the net consideration received by the vendor. Conversely, tax will apply to any debit notes issued (for example, if the vendor issues notes to reflect an increase in the sale price of goods previously sold). In such cases, the purchasers will be required to make offsetting adjustments in computing their tax liability so that the amounts for which they obtain input tax credits are the same as the amounts on which the vendor pays the tax.

(p) Returned Goods

Goods returned to a vendor for refund will entitle the vendor to an input tax credit in respect of the amount refunded. Where the goods are returned by another taxpayer, the other taxpayer will become taxable on the refund.

(q) Cash and Volume Discounts

Goods and services may be provided on terms which offer discounts for prompt payment or volume purchases. In these situations, adjustments may be required to ensure that only the net amount of the consideration received is actually subject to tax.

Where the amount invoiced by a supplier to a customer is recorded net of any discount taken, the supplier will pay tax only on that net amount. If the customer is a taxpayer, he or she will claim an input tax credit only in respect of the net amount. No further adjustments will be required by either person to obtain the correct result. However, where the supplier invoices the customer for the full sale price, the supplier will be allowed to claim an input tax credit in respect of any discounts subsequently granted and, if the customer is a taxpayer, he or she will be required to account for tax on discounts earned.

(r) Co-operatives

Members of a co-operative often receive patronage dividends, usually after the end of the co-operative's fiscal year, based on the volume of the members' purchases from or sales to the co-operative and results of the operations of the co-operative. Patronage dividends will be treated in a manner similar to discounts. Members who claim a credit with respect to their purchases from a co-operative or pay tax on their sales to a co-operative will include the patronage dividend in their amounts subject to tax when the dividend is received or receivable. The co-operative will be entitled to claim an input tax credit in respect of patronage dividends paid or payable to all members.

(s) Telecommunications

Telecommunication services such as telephone, telegraph, telex and data transmission services will be taxable if billed in Canada (that is, if billed in respect of a transmitting or receiving station or terminal located in Canada). Services billed outside Canada will be treated as a tax-free export. Accordingly, businesses will include the tax paid or payable in respect of both domestic and international services billed in Canada to them in determining their input tax credit claims. Suppliers of telecommunication services will pay tax on all amounts billed to users in Canada but not on payments from abroad.

(t) Agents

Agents will generally be taxable under the normal rules only on fees or commissions charged to their principals.

Where a taxpayer acquires a taxable supply through an agent, an input tax credit will be allowed to the taxpayer in respect of amounts paid or payable for both the supply and the fee for the agent's services. Conversely, where a taxpayer makes a supply through an agent, the supply will be taxable to the taxpayer and an input tax credit will be claimed by the taxpayer in respect of the agent's service fee. If the customer is also a taxpayer, the customer will be entitled to an input tax credit in respect of any amounts paid or payable to the principal if the principal is known, or to the agent if the principal is undisclosed.

Special rules will be required where an agent acts on behalf of an undisclosed non-resident principal who is not a taxpayer. If an agent makes a supply on behalf of such a principal, no tax would ever be collected under the normal agency rules. Conversely, where the agent acquires goods for export to the non-resident principal, neither the agent nor the principal would be able to recover any tax paid on the goods. To address this situation, where an agent acts on behalf of an undisclosed non-resident principal who is not a taxpayer, the agent will be deemed to be the taxpayer in respect of all supplies made or received in his own name on behalf of that principal.

(u) Disbursements

As outlined immediately above, an agent generally will be taxable on any fees or commissions charged to clients. It is not uncommon for an agent such as a lawyer or an accountant to bill a client for certain disbursements made in the course of performing a particular service.

Depending on their type and how they are billed to principals, disbursements will be treated differently under a multi-stage sales tax. As a general rule, agents will not be required to account for tax in respect of any disbursements made in the name of a principal, provided the disbursement is separately itemized in the agent's bill to the principal. Such disbursements would include, for example, any taxes or registration fees paid by a lawyer on behalf of a principal in respect of a real estate transaction. However, where such disbursements are not separately itemized to the principal, the disbursement will be treated as a taxable supply by the agent to the principal.

Agents will be required to account for tax on disbursements relating to expenses incurred in their name in the performance of any service even if those expenses are separately identified to a principal. Such disbursements might include, for example, travel, telephone and photocopying expenses. Where an agent bills a principal for the actual amount of expenses, the agent will incur no net tax liability in respect thereof since the agent will be entitled to offsetting input tax credits for those expenses.

(v) Holdbacks

The general timing rules will impose a tax liability on a vendor whenever an amount for a taxable supply is received or becomes receivable. Similarly, a taxpayer will become eligible for an input tax credit whenever an amount is paid or payable in respect of a taxable supply. It is common practice in certain types of transactions, for example in the construction industry, for a purchaser to hold back an amount otherwise payable as security against liens. Where a holdback is clearly provided for in a written agreement, the holdback will not be payable by the purchaser or receivable to the vendor until the holdback period expires. The same rule will apply to holdbacks allowed or required by federal or provincial legislation. In any situation where no holdback is specifically provided for or legislatively sanctioned, any amount held back will not defer the time at which an amount becomes payable or receivable for sales tax purposes.

(w) Transfer of a Business as a Going Concern

The sale of a business as a going concern will not be subject to tax. The purchaser, therefore, will not be entitled to claim any input tax credit in respect of the purchase.

(x) Security Interests

The transfer or assignment of an interest in the assets of a taxpayer, where this amounts simply to a charge or lien on those assets as security for a debt or any other obligation, will be disregarded in calculating the tax liability of both parties. The same rule will apply when the security interest is discharged upon repayment of the debt or obligation by the debtor.

(y) Personal Representatives

Where a receiver, receiver-manager, liquidator, trustee in bankruptcy, executor, administrator or other person acting in a representative capacity assumes the care and management of the business of an insolvent, deceased or incapacitated taxpayer, any tax liability that is incurred after that time will be calculated as though the taxpayer were continuing to carry on the business. The personal representative will be held responsible for any tax liability incurred during such administration.

Sections 51 of the *Excise Tax Act* and 159 of the *Income Tax Act* require personal representatives, other than trustees in bankruptcy, to obtain a tax clearance certificate before distributing any assets to persons beneficially entitled to the residue of a business or estate. Failure to obtain the certificate places a personal liability on the personal representative for any taxes remaining unpaid, to the extent of the value of the assets so distributed. Similar rules will apply for the purposes of the multi-stage sales tax.

9.2. Operational Aspects of a Multi-Stage Sales Tax

(a) Reporting Entity

For tax reporting purposes, a consolidated return for a group of companies will not be provided for; each corporation generally will be required to file one periodic return covering all of its taxable activities. However, it is common for corporations to divide their operations into divisions. If each division has an independent accounting system, separate management, and is separately identifiable by its activities or location, separate filing for each division may be considered.

(b) Payments/Refunds

Payments of any tax due will have to accompany the taxpayer's return. Except for individuals who qualify for annual filing, tax returns must be filed within one month following the end of a taxpayer's taxation period. Interest at a prescribed rate will accrue from the due date of the return on any tax remaining unpaid.

Tax refund claims will be made in the taxpayer's return. Refunds will be paid after review and approval by the tax authorities. Refund claims outstanding after the due date of the return or the date the return is filed, whichever is later, will be credited with refund interest to the date of payment.

(c) Interaction with Income Tax Act

In the calculation of a business's taxable income for income tax purposes, purchases and sales will be recorded net of any sales tax content. Similarly, acquisitions of depreciable property will be recorded net of tax, and capital cost allowance will be calculated on this tax-excluded cost.

The only exception to these rules will be if the tax on a business input is not creditable. For example, a landlord receiving only long-term residential rents would be unable to claim any input tax credit. In such cases, deductible expenditures for income tax purposes would include a sales tax component and capital cost allowance would be calculated on the tax-included cost of assets.

Refunds of federal sales tax on inventory held for resale as of the implementation date will, for income tax purposes, either be included in the recipient's income or reduce the recipient's cost of inventory. As a result, taxpayers will be able to deduct only the net cost of inventory for income tax purposes.

9.3 Transitional Provisions

Transitional provisions would cover three major aspects of the changeover to either a federal GST or VAT:

- rebates of federal sales tax already paid on inventories of new goods on hand as of the start-up date;
- contracts entered into before release of the implementing legislation; and
- transactions straddling the start-up date.

Additional provisions may have to be considered in changing to a National Sales Tax. These would be developed in the course of consultations with provincial governments.

(a) Rebates of Federal Sales Tax

On implementation of a multi-stage tax, many firms such as wholesalers and retailers will be holding inventories of new goods for sale on which federal sales tax will have previously been paid and such taxpayers will be entitled to recover this tax.

(b) Existing Contracts

Federal sales tax changes have traditionally been effective as of certain specified dates without any special relieving provisions for contracts entered into prior to that date. This practice reflects the fact that there is no simple and equitable way of relieving existing contracts from the impact of a tax change. Accordingly, many businesses make explicit arrangements in their contracts for future tax changes.

A similar practice will be followed with respect to a multi-stage sales tax and, therefore, no general exemption will be provided for existing contracts entered into prior to release of the implementing legislation. Given the considerable time that will elapse between the release of the legislation and the implementation date, most taxpayers should be able to arrange their affairs to take the new tax system into account.

Nonetheless, there may be circumstances where it may be appropriate to provide transitional relief. The details of any such transitional relief will be made available at a later date.

(c) Transactions Straddling the Start-up Date

Special rules will be required to ensure fair treatment of transactions which straddle the implementation date. For example, payment may be received prior to the implementation date but delivery of the goods or services may occur after that date. On the other hand, payment may be received on or after implementation but the delivery may be before. Rules will be developed to define clearly the application of the new tax to such transactions.

Section 10: Charities, Non-Profit Organizations and Government Bodies

10.1 Basic Approach

The application of a multi-stage sales tax to charities, non-profit organizations and government bodies depends on which variant of the proposal (that is, a National Sales Tax, federal GST or federal VAT) is adopted. The purpose of this section is to set out one approach to the taxation of this sector in order to facilitate discussion.

Because a multi-stage sales tax will apply to sales of a commercial nature, most of the activities of charities, non-profit organizations and government bodies would be exempt. These organizations would be taxable on supplies of a commercial nature. This would ensure fair and uniform application of tax to commercial supplies made by the profit-making and non-profit sectors and minimize competitive distortions.

Although certain supplies made by charities, non-profit organizations and government bodies would be taxable, there would be two over-riding exemptions for such supplies. The first is an exemption for volunteer organizations. Under this rule any supply (other than a supply of land) that would otherwise be subject to tax would be exempt when made in the course of an activity where all or substantially all of the staff involved in the management and operation of the activity are unpaid volunteers. The second is an exemption for otherwise taxable supplies (other than a supply of land) made by a charity, non-profit organization or government body if the revenue from all such supplies made by such an organization does not exceed $5,000 per annum. This exemption would parallel the $5,000 threshold for individuals selling directly to final consumers.

10.2 Charities

For the purposes of the multi-stage sales tax, a "charity" would include a registered charity or registered Canadian amateur athletic association within the meaning of the *Income Tax Act*.

Subject to the volunteer exemption and the $5,000 threshold described above, charities would be taxable only on the following:

(i) **The sale of goods in a retail store.** This provision would apply to university bookstores, museum souvenir/gift shops and other similar retail stores.

Street sales, door-to-door sales and mail order sales (which are not made from a retail store) would not be taxable under this rule. Sales in retail stores run by volunteers and sales of used or donated goods, where such sales constitute all or substantially all of the sales in the course of that activity, would also be exempt from tax.

(ii) **The sale of food or drink in a restaurant, cafeteria or pub.** This would ensure that sales from restaurant operations run by charities are placed on the same footing as similar sales by profit-making restaurant operations for sales tax purposes. The tax would apply to sales by both eat-in and take-out operations.

(iii) **Admissions to a professional theatrical, musical or other such performance, film presentation, slide show, horse race or professional athletic event.** Admissions to such events would be taxable only when the events are staged in a place designed, built or used primarily for the staging of such events. Admissions to museums, parks, zoos, aquariums and recreational complexes would be exempt, as would admissions to amateur theatrical, cultural and sporting events.

(iv) **Any sale of land to a private individual for purposes of residential construction or personal use.** This provision would ensure that all land acquired for residential construction or personal use is tax-paid. Neither the volunteer exemption nor the $5,000 threshold would apply to the sale of such land.

10.3 Non-Profit Organizations and Government

Under a multi-stage sales tax, "non-profit organizations" would include any organization established and operated for any purpose other than profit, provided no part of the organization's income is available for the benefit of any member of the organization. Specifically excluded from this definition would be organizations established or operated primarily to provide dining, recreational or sporting facilities for their members. As a result, clubs providing such facilities would be subject to tax on their members' fees and any other goods and services which they provide.

"Government" would include government departments, agencies, Crown corporations that are agents of the Crown, and municipalities.

Non-profit organizations and governments would be taxable on any commercial activity involving the supply of property or service of a type that is generally supplied by a commercial business. Thus, non-profit organizations and governments would be taxable on the same supplies as charities plus any supplies made in other types of commercial activities. For greater certainty, a number of commercial supplies of government organizations could be explicitly identified as taxable so as to reduce competitive inequities, minimize the compliance burden for business users (i.e., to reduce the need to segregate taxed and untaxed inputs), and reduce the incidence of tax cascading on supplies to final consumers (which would occur where non-profit organizations or governments make sales to other taxpayers).

Non-profit organizations and governments would be exempt on all supplies of real property with the exception of any sale of land to a private individual for purposes of residential construction or personal use. In addition, admissions would be taxable only if they are admissions to a professional performance, film presentation, slide show, horse race or professional athletic event. Thus, the taxation of real property transactions and admissions would be identical for charities, non-profit organizations and governments.

10.4 Health Sector Exemptions

The vast majority of publicly funded and non-profit health services provided in Canada would be exempt from tax under the general exemption for charities, non-profit organizations and government bodies. This would include a broad range of health services provided through non-profit and government organizations and institutions, including hospital services, nursing home services, home care, and services provided by medical, dental, and other recognized health care practitioners employed by these organizations.

Health services provided by the private sector – private hospitals and clinics, medical, dental and health care practitioners and commercially-operated homes for the aged and infirm – would also be exempt to the extent that such services are paid for pursuant to the Canada Health Act or under government-funded social welfare programs or certain other prescribed federal or provincial statutes or programs. Included in this latter group would be health services provided to members of the armed forces, the RCMP, inmates of penitentiaries, and health services paid for under provincial workers' compensation plans.

Private hospitals and individual practitioners would thus be exempt on the provision of government-insured or otherwise government-funded services, but would be taxable on amounts received in respect of services that are not insured under public plans.

The exemption for health services would extend to goods supplied in the course of providing those exempt services. For example, drugs administered in a hospital are an integral part of the provision of health services by the hospital and thus would be exempt from tax.

10.5 Educational Services Exemption

Most educational services provided by non-profit educational institutions would be exempt from tax under the general exemption for charities, non-profit organizations and government bodies. However, for greater certainty, there would be a general exemption for the supply of educational services by such organizations. This would include specific reference to the supply of education at the primary, secondary and post-secondary levels as well as extension courses and nursery schools.

Non-profit educational institutions and organizations, however, would be taxable on such supplies as bookstore, pub and cafeteria sales.

10.6 Self-Supply Rules

Under a multi-stage sales tax, persons exempt from tax would not be eligible to claim an input tax credit in respect of their purchases. In some circumstances, this could give rise to a bias for such exempt persons to self-supply certain goods and services which they otherwise would obtain from outside taxable suppliers. For example, the tax on the cost of road construction by an independent contractor could be sufficiently large to act as an incentive for a municipality to do its own road construction. By using its own employees and equipment, the municipality would be able to avoid tax on the independent contractor's value-added.

While there is an inherent bias towards self-supply in any multi-stage sales tax with exemptions, there are legitimate concerns that any such bias should not be overly significant. Provisions would therefore be required to impose tax on certain goods and services when self-supplied by exempt entities. A comprehensive self-supply rule would, however, be administratively burdensome. It is therefore expected that the range of goods or services eventually subject to any self-supply rule would be relatively limited. These would be identified in the course of consultations with the business and non-profit sectors.

10.7 Invoicing of Tax-Exempt Supplies

In a federal GST, charities and non-profit organizations would be required to indicate explicitly to their business buyers that certain supplies are exempt from tax. Otherwise, taxpayers purchasing goods or services from a charity or non-profit organization would assume that the supply was taxable and that they were entitled to claim an input tax credit in respect of those purchases. Accordingly, where such organizations make significant sales to business taxpayers, they would be required to identify the tax-exempt status of the sale on an invoice.

Section 11: Real Estate

11.1 Basic Approach

The multi-stage sales tax will apply to the sale or rental of real estate – land and buildings – for commercial use and to the sale of new residential dwellings. However, residential rentals and the resale of used residential dwellings will be exempt from the tax unless the resale takes place in the course of a business that involves the purchase, renovation and resale of used residential dwellings.

Where the tax applies to real estate, the rules will parallel those for the sale or rental of other goods and services. Developers and construction firms will thus pay the tax on their receipts from sales of land and construction and will claim input tax credits in respect of any related taxed purchases of equipment, materials and services. Similarly, owners of office buildings will pay tax on rental receipts and will claim input tax credits in respect of the taxed goods and services they acquire. Purchases of real property and rents paid by a business will generally constitute taxed purchases and therefore the tax thereon will be creditable by a business in computing its tax liability.

The special rules which set out the exemptions for residential rentals and sales of used dwellings are described below, together with other rules which relate to real estate transactions.

11.2 Tax-Exempt Supplies

The tax will not apply to long-term residential rents and sales of most used residential dwellings. Sales by individuals of other personal-use real estate will also be exempt. In addition, as outined in the approach to charities, non-profit organizations and governments outlined in the previous section, all rentals and most sales of real property by this sector would be exempt.

The definition of a residential dwelling will cover owner-occupied homes and apartment buildings, together with the related land associated with such buildings. In the case of an owner-occupied home, the entire home will be treated as a residential dwelling where it is used primarily as such. Therefore, even if it includes a room used as an office by a self-employed taxpayer, the entire home would still qualify for the exemption.

The definition of residential dwelling will not include a hotel, motel or other similar dwelling that provides all or substantially all of its accommodation on a short-term basis – that is, for periods of less than 60 days.

(a) Tax-Exempt Supplies – Residential Rents

All rentals of 30 days or more in a residential dwelling will be tax-exempt. Thus, most apartment and house rentals will not be subject to tax. As a consequence, residential landlords will not be entitled to recover any tax paid on the purchase, repair or improvement of residential dwellings.

On the other hand, all amounts received or receivable for room rentals in most hotels and motels will be taxable. Owners of hotels or motels will be able to recover the tax paid on their taxed input costs, including the purchase of the buildings, in computing their tax liability.

This approach will reduce the number of situations where taxpayers have to apportion their tax credit for input costs as a result of receiving both taxable and exempt rentals. Prorating may still be required in some cases – for example, where it is clear that part of a building is used as a hotel while another part is used for long-term apartment rentals. In these situations, the taxpayer will treat the building as two discrete parts (one as a residential apartment building and the other as a hotel) and apportion input costs accordingly. Prorating will also be necessary where a landlord receives significant short-term rentals in an apartment building.

The provision of ancillary services such as cleaning, heating and electricity (but not meals), as part of the rental charge, will also be exempt where the rental is exempt.

(b) Tax-Exempt Supplies – Sales of Used Residential Dwellings

The sale of a used residential dwelling such as an apartment building will be exempt unless the taxpayer previously claimed an input tax credit in respect of any part of the acquisition cost of, or any capital improvements to, the residential dwelling. For example, an input tax credit may have been claimed by a landlord of apartment buildings with significant short-term residential rentals. Where an input tax credit has been claimed, any proceeds on the resale of the dwelling will be subject to tax.

Resales of owner-occupied homes will also generally be exempt. Since no input tax credit will be allowed for real property that is primarily for the taxpayer's personal use and enjoyment, an input tax credit will not be allowed for any part of the cost of an owner-occupied home even if a part of the home is used for business purposes. Accordingly, resales of such homes will qualify for full exemption.

However, as noted above, an owner-occupied building will be treated entirely as a residential dwelling only where it is used primarily as such. Accordingly, where an owner-occupied building is used primarily in a taxable activity, the part so used will not qualify as a residential dwelling. In this case, the taxpayer will be allowed to claim an input tax credit in respect of the non-residential part of the building used for business purposes and, on resale, that part will be taxable. The resale of the residential part of the building will be exempt.

The resale of a used residential dwelling in the course of a business that involves the purchase, substantial renovation and resale of such dwellings will also be taxable. In this case the taxpayer will, under the normal rules, be able to recover any tax paid on taxed inputs acquired for use in the renovating business. In addition, the taxpayer will be allowed to claim a notional input tax credit in respect of the acquisition of the dwelling to be renovated even though tax may not have been paid on this purchase. This treatment will ensure that the taxpayer who is in the business of renovating and reselling homes will be taxable only on the value added to renovated homes. This will equate the resale of substantially renovated homes with the sale of new homes.

(c) Tax-Exempt Supplies – Personal-Use Real Property

The sale by an individual of personal-use real property will also be exempt. Personal-use real property is real property owned by a taxpayer that is used primarily for the personal use and enjoyment of the taxpayer or one or more related individuals. It would include, for example, country properties and hobby farms that are for the taxpayer's personal use and enjoyment.

Personal-use real property will not, however, include any part of such property that is subdivided for the purpose of sale. In addition, personal-use real property will not include any real property in respect of which a taxpayer has claimed an input tax credit.

(d) Tax-Exempt Supplies – Sales and Rentals of Real Property by Charities, Non-Profit Organizations and Governments

Under the approach to taxing charities, non-profit organizations and governments outlined in Section 10, all rentals of real property by this sector would be exempt.

In addition, all sales of real property by these organizations would be exempt except for the sale of land to individuals for the purpose of constructing a home or for other personal use purposes.

11.3 Other General Rules

The following additional rules will be implemented as part of the sales tax framework as it relates to real property.

(a) Supplies in Canada

A basic rule is that the tax should apply only to taxable supplies made in Canada. In the case of sales or rentals of real property, the transaction will be considered to be made in Canada only if the real property is situated in Canada.

(b) Definition of Real Property

Real property will be defined very broadly and will include leasehold interests and other similar interests in real property. However, security interests in real property created by virtue of a mortgage or other similar obligation will not be considered to be real property.

(c) Timing of Amount Receivable

A business's tax liability for a given reporting period will be determined by reference to amounts received or receivable by it in that period. In the case of a sale of real property, the date when the amounts would be receivable will generally be the earliest of the date of transfer of ownership ("closing"), possession, or the date on which an amount becomes due and payable to the vendor under a written agreement covering the sale. Where real property is leased, the date on which payment is due and payable under the lease will be the date on which an amount becomes receivable.

(d) Certification Requirement

In computing their tax liabilities, businesses will be able to claim an input tax credit only for those purchases of goods and services on which tax has been paid by the vendor. Since certain sales of land and buildings will not be subject to tax, it will be necessary to distinguish them from taxable sales of real property. To facilitate this under a federal GST, purchasers would be allowed to claim an input tax credit in respect of the purchase price of land and buildings only where the vendors certify that they are taxable on the sale and have paid the tax. The certification requirement would apply to all sales of real property. This approach would facilitate proper computation of the tax liability by ensuring that taxpayers are aware of the tax status of the real property acquired by them.

(e) Other Rules

- When real property is sold in a taxable transaction, an input tax credit will be allowed at the time of sale for any tax credits not previously claimed. Any unclaimed tax credits in respect of improvement costs incurred after the implementation date will also be creditable when the property is sold in a taxable transaction.

- A self-supply rule will apply where a developer constructs a residential dwelling and subsequently leases it to tenants. The developer will be treated as if the dwelling were sold at its fair market value when it is put into rental use. This rule will ensure that the developer receives the same treatment as a landlord who purchases a new building for rental purposes on which tax would have been levied. Any subsequent resale of the dwelling will not be taxed, as the dwelling will qualify as a used residential dwelling.

- The general change-of-use and apportionment rules will apply to real property.

11.4 Examples

The following examples illustrate the rules that will apply to real property.

1. Individual A purchases a new home from Developer X after the implementation date of the tax. Shortly after moving in, A is transferred and sells the house.

   The tax will apply to the sale by Developer X of the new home. A will not be entitled to claim any input credit in respect of the purchase price. The resale of the home by A will not be subject to tax.

2. As in Example 1, except that A, upon learning of the job transfer, rents out the home to B.

   The residential rental income will be exempt. No tax will be payable under the change-of-use rules as the home will qualify as a used residential dwelling.

3. As in Example 1, except that A is self-employed and used one of the rooms in the house as an office. The house is still primarily used as a residential dwelling.

   Since the building is primarily used as a residential dwelling, the entire building would so qualify. In addition, since the dwelling is used primarily for personal use, A will not be able to recover any tax relating to the purchase price or any capital improvements. Therefore, A's resale of the entire used dwelling will be exempt.

4. As in Example 1, except that A uses a large part of the building, say, 60 per cent, to conduct a business and the balance as a home.

   Only 40 per cent of the building will qualify as a residential dwelling. In accounting for the tax, A will have to separate the business component of the building from the residential component. The sale of the residential component will be exempt, provided that A, in computing his tax liability, had not claimed any input tax credit for that part of the building. The sale of the business part of the building will be taxable. If A had not claimed an input tax credit in respect of the tax paid on this part of the building on acquisition, it would be creditable on sale. The land associated with the building would have to be apportioned between the two parts of the building.

5. Landlord X purchases three buildings intending to operate them as follows: Building A as an apartment building with long-term rentals, Building B as an apartment building with some short-term and long-term rentals, and Building C as a hotel with only short-term rentals.

   No input tax credit will be permitted with respect to Building A and all of the residential rentals in the building will be exempt. The resale of Building A will be exempt as well.

For Building B, the residential rentals of 30 days or more will be exempt. An input tax credit could be claimed at the time of purchase in respect of part of the acquisition cost of the building based on the expected taxable use, but if this course of action were taken,

(a) the subsequent sale of the building would be taxable and the landlord could claim, at the time of sale, an input tax credit with respect to any tax paid in respect of the acquisition cost or any improvements to the extent not previously claimed; and

(b) the change-of-use rules could result in a tax liability if the mix of taxable and exempt uses should change.

If the landlord does not claim an input tax credit in respect of any part of the acquisition cost of Building B or the cost of any improvements in computing his or her input tax credit, the resale of Building B will be exempt.

Tax paid on the acquisition cost of Building C will be creditable. All rentals from Building C will be taxable, and its resale will be taxable.

6. A purchases land on speculation and subsequently resells it. The land is not personal-use real property.

The subsequent sale will be taxable. An input tax credit may be claimed at the time of sale in respect of any tax paid on the acquisition of the land and on improvement costs provided the tax credit was not previously claimed.

Section 12: Financial Services

12.1 Basic Approach

Many businesses are engaged in financial transactions, whether it be issuing cheques or notes, selling shares, borrowing or lending funds, or purchasing bonds or shares. However, financial transactions of most businesses are only ancillary to their main activities of supplying other services or property, or are of an investment nature.

Under the multi-stage sales tax only financial institutions will be subject to tax on the supply of financial services. Thus, taxpayers that are not financial institutions will not pay tax on the receipt of interest or dividends or on the realization of gains on financial instruments. Conversely, these taxpayers will not be able to claim input tax credits in respect of interest or dividend payments, the realization of losses on financial instruments, or other costs incurred in respect of financial instruments.

Financial services provided by financial institutions are similar to services provided by other sectors of the economy. They require the use of labour and capital resources and are charged to users in a variety of ways. They include intermediation services provided by a bank in serving as a link between borrowers and lenders, or the service provided by an investment dealer in assisting its clients in buying and selling securities. In the case of non-financial businesses, however, dealings in financial instruments represent their savings and investment activities rather than financial intermediation. Since a multi-stage sales tax is a tax on consumption and not on savings, these financial and investment activities of non-financial businesses should not be taxed.

To apply these rules will require a number of definitions, including what is a "financial service" and a "financial instrument" and who is a "financial institution". These are discussed below along with other aspects of the rules as they will apply to the financial activities of non-financial businesses. The taxation of the financial activities of financial institutions is discussed in the next section.

12.2 Definitions

(a) Financial Services

The definition of financial services will include all forms of activities with respect to financial instruments including the paying, lending, advancing, borrowing, depositing or receiving of money and the issue, sale, purchase, receipt, payment, collection or transfer of a financial instrument. Also included will be the underwriting of a financial instrument and the lending or borrowing of commodities.

(b) Financial Instruments

The definition of financial instruments will include items such as currency, all forms of indebtedness, shares of capital stock, policies of insurance or reinsurance, cheques or letters of credit, and options, futures contracts or guarantees in respect thereof. The definition of financial instruments will be very broad to ensure that non-financial businesses will be exempt on all of their financial activities.

(c) Financial Institutions

The definition of financial institutions will include persons whose principal business is the lending of money, or accepting deposit liabilities such as banks, trust companies, credit unions, and loan and acceptance companies. As well, the definition will include traders or dealers in securities and insurers. To ensure that most holding companies in a corporate group will not be regarded as financial institutions for purposes of the multi-stage sales tax, a financial institution will include only those entities whose principal business is the supply of financial services primarily to persons with whom those entities deal at arm's length. Also, a venture capitalist will not be treated as a financial institution. An investment intermediary, such as a mutual fund trust, will be excluded from the financial institution rules if the intermediary has no employees (see Section 13.8 for a more detailed discussion of investment intermediaries).

Finally, deferred income plans such as registered pension plans will not be treated as financial institutions although they will be taxable on their non-financial activities such as commercial real estate sales and rentals. This category will include pension corporations and any trust governed by:

- a registered pension fund or plan;
- an employee profit sharing plan;
- a deferred profit sharing plan;
- a registered supplementary unemployment benefit plan;
- a registered retirement savings plan;
- a registered education savings plan;
- a registered retirement income fund;
- an employee benefit plan; or

- an employee trust,

as defined under the *Income Tax Act*.

12.3 Financial Activities of Non-Financial Businesses

(a) Deferred Payment Arrangements

As noted above, a non-financial business will not be taxable on interest receipts. Similarly, interest costs will not give rise to any input tax credit for non-financial businesses. Accordingly, interest and other carrying charges on conditional sales contracts and contracts that provide for deferred payment of the sale price will not be taxable to the vendor where they are billed separately to the purchaser or segregated on the bill of sale or invoice. Conversely, these charges will not entitle the purchaser to any input tax credit in these circumstances.

However, where interest or carrying charges are not separately invoiced but, instead, are rolled into the sale price of any other property or service supplied by the taxpayer, the taxpayer will be required to pay tax on the full sale price. Conversely, the taxpayer's customer, if he or she is a taxpayer, will be entitled to an input tax credit in respect of the full sale price where interest or carrying charges are not explicitly identified as such.

(b) Insurance Agents' Commissions

From the standpoint of an insurance agent, arranging the purchase or sale of a financial instrument will not be regarded as a financial service. Consequently, such taxpayers will be taxable on commissions received or receivable for those services under the general rules.

(c) Payments for Financial Services

Amounts paid or payable by a taxpayer who is not a financial institution in respect of financial services supplied by a financial institution will not entitle the taxpayer to any input tax credit. The one exception to this rule will be property and casualty insurance premiums (see 12.3(f) below).

There are several reasons why an input tax credit will not be allowed in respect of interest and other similar financing costs charged to a taxpayer who is not a financial institution.

> First, a financial institution will only be taxed on its net margin. As discussed in Section 13, the net financial margin represents interest income and other revenue from financial services less interest expense and other deductible outlays and expenses of a financial nature. Thus, the net margin of a financial institution in most cases represents a very small fraction of the

interest charged to its customers. The remainder represents the untaxed return on savings of depositors and the risk premium for doubtful loans. To allow an input tax credit to business borrowers in respect of gross interest and other similar financing costs would be inappropriate since only a small fraction of those costs would have borne tax.

Second, financial intermediation services performed by financial institutions involve, in essence, the bringing together of borrowers and lenders. Lenders provide funds which, in turn, are lent out to borrowers by financial institutions. The service performed by financial institutions – intermediation – is supplied to both borrowers and lenders, not just borrowers. Consequently, it would be inappropriate to allow a full input tax credit in respect of tax paid by financial institutions to borrowers alone, since the tax accrues on a service provided to both borrowers and lenders. To allow a credit to either borrowers or lenders would result in over-compensation to some and under-compensation to others because the relative value of services provided to each would vary over time, between different transactions, and according to market conditions.

Third, it is not possible to calculate the taxable margin of a financial institution on a transaction-by-transaction basis. The margin will vary as rates vary over time, between different borrowers and lenders and according to market conditions. Thus, it would be very difficult to allow an appropriate credit to a business customer in respect of individual financial transactions.

Fourth, it would be inappropriate to allow a credit if the funds were used other than in the course of a taxable activity. To trace the actual use of the funds would be complex to administer and any arbitrary rule would not provide an appropriate credit in all circumstances.

Finally, any cascading of tax resulting from the denial of a credit should not cause significant economic distortions. For example, assuming a financial margin of 2 percentage points, and a tax rate of 8 per cent on that margin, the tax on a $30,000 loan paid in one lump sum at the end of one year would be $48. Assuming financial intermediation services are of equal value to both depositors and borrowers, the $48 in tax would represent a tax of $24 on the services provided to each.

Thus, no input tax credit will be allowed in respect of interest expense on funds borrowed by a non-financial firm for use in its business. This restriction will also apply to fees and commissions akin to interest.

The cost of brokerage fees and commissions incurred by a non-financial business with respect to the acquisition or disposition of financial instruments will also not be included in determining the business's input tax credit. This is partly because gains and losses arising from the acquisition and disposition of such instruments will be exempt (and thus any tax paid on inputs for use in an exempt activity should not be creditable) and partly because the tax would not be identifiable for many such transactions (e.g. in the case of underwriting securities).

(d) Financial Service Fees Paid to Non-Residents

To ensure that Canadian financial institutions are not placed at a competitive disadvantage, the payment to a non-resident investment firm that is not a taxpayer of a fee or commission for the purchase or sale of publicly listed financial instruments will be subject to tax. As will be the case for other imports of services which are discussed in Section 7, the tax will be levied on the person importing the service on a self-assessment basis. Thus, if a pension fund purchases publicly listed securities from a non-resident broker and pays a fee or commission, the pension fund would be required to pay tax on the amount of the fee or commission. Where an explicit fee or commission is not charged, the tax will be calculated on the basis of a prescribed fee schedule to determine the appropriate amount as a tax base. The government will be discussing the nature of this rule with representatives of the investment community to ensure that appropriate results are obtained.

(e) Non-Financial Services Supplied by Financial Institutions

With the exception of property and casualty insurance, no input tax credits will be allowed in respect of financial services supplied by a financial institution to taxpayers who are not financial institutions. However, where financial institutions make explicit charges for non-financial services such as safekeeping, trusteeship or cheque supplies, taxpayers will be allowed to claim input tax credits in respect of such charges.

(f) Property and Casualty Premiums

Business customers will be able to claim input tax credits in respect of property and casualty insurance premiums. This will be possible because of the way in which this financial service is rendered. The premium will be fully creditable as a taxed input cost of the business customer, and fully taxable to the insurer. When a claim arises, the reverse will take place: the insurer will claim a credit in respect of the claim paid out and the business customer will pay tax on the recovery of the claim. If the claim is paid to a third party (for example, a repair garage) to restore the loss, the third party would pay tax on the amount received.

Examples of this treatment include:

- insurance proceeds on the theft of business goods from a taxpayer;
- insurance proceeds for fire or other damage to a taxpayer's commercial property;
- the receipt of proceeds under a business interruption insurance policy.

If insurance proceeds are used to pay for a taxed business input, an input tax credit will be allowed in respect of the amount paid in the normal manner. Accordingly, the offsetting of insurance proceeds by the cost of outlays to replace lost or damaged goods will generally result in no net tax liability arising on insurance claims.

(g) Leasing

The leasing of personal or real property will not be treated as a financial service. All leases will be treated as operating leases with the lease payments taxable to the lessor and fully creditable to the lessee where the property is used in a taxable activity. This will ensure a neutral treatment of purchases and leases of property as a full input tax credit will be allowed in respect of all purchase and lease costs.

(h) Options

Options for the supply of goods, services or financial instruments will generally be treated as financial instruments. Accordingly, the trading of options will generally be a tax-exempt activity for non-financial businesses.

The one exception to this rule will be where a vendor grants an option to purchase non-financial goods or services that are supplied by the vendor in the course of a taxable activity. In this case, the vendor will be taxable on any amount received as consideration for the granting of the option provided the goods or services covered by the option are delivered by the vendor. This amount will be taxable at the time of delivery. The purchaser of the goods or services will be allowed to claim an input tax credit in respect of any amount paid for the goods or services to the extent the goods or services are for use in a taxable activity. The purchaser will be allowed to claim an input tax credit in respect of amounts paid to the vendor for the acquisition of the option. Any amount paid to anyone other than the vendor for the acquisition of the option would not qualify for input tax credit.

Section 13: Financial Institutions

13.1 Introduction

Financial institutions provide services to businesses and individual consumers in a variety of ways. It may be through the raising of debt or equity capital and the lending of money, commonly known as financial intermediation. It may be the purchase or sale of shares or debt securities, or underwriting of such securities, often referred to as market intermediation. Protection against risk may be provided by the pooling of insurance premiums in a capital fund. The value of the intermediation services provided by financial institutions to their customers in the course of their dealing in money or other financial instruments adds value to the economy and, thus, the domestic consumption of these services should be subject to tax.

The charge for these financial services can sometimes be explicit. For example, a broker may charge a fee for selling a new issue of shares and the fee would measure the value of the brokerage services. More often, however, the value of the service is implicit in the margin of the financial institution – that is to say, the difference between the return it obtains on funds made available to its customers and the cost of the funds it raises. Thus the value of the service which a bank provides to its borrowers and depositors is represented by the spread between interest charged to the borrowers and the cost of its depositors' funds or equity capital.

The only practical way to apply the tax to a financial institution is to apply the tax to the **net** financial flows of a financial institution. This portion of the value added by a financial institution will be calculated periodically based on the financial income and financial expense of the institution for the period concerned. This amount will then be combined with the taxable receipts and taxed inputs of non-financial transactions of the financial institution under the general rules. This method of applying the tax to the financial activities of financial institutions will be the same regardless of whether or not the multi-stage tax contains an invoice requirement.

The following financial institutions will be subject to tax in respect of their financial services:

(1) banks, credit unions or caisses populaires, trust companies, loan companies and acceptance companies;

(2) investment dealers;

(3) life insurers and property and casualty insurers;

(4) any person whose principal business is the lending of money, accepting deposit liabilities, or the purchasing or selling of debt securities; and

(5) investment intermediaries such as mutual fund corporations, mutual fund trusts, pooled fund trusts, and segregated funds, where they have incurred salaries and wages.

As explained in Section 12, the definition of certain financial institutions will depend on a principal business test. Holding companies, venture capital companies and pension funds generally will not be treated as financial institutions.

13.2 General Concepts

(a) Sales Tax Base of a Financial Institution

The general rules described earlier in this Annex for calculating the sales tax liability of a non-financial business will apply to a financial institution's sales and inputs of a non-financial nature. For example, a financial institution's receipts from cheque supplies or commercial real estate rentals will be taxable under the general rules. Similarly, input tax credits will be allowed in respect of amounts paid for taxable supplies acquired in Canada such as stationery, equipment or buildings.

However, special rules will be needed to include in the sales tax base the margin on the financial services of a financial institution, and also any explicit charges for financial services. Before describing these rules in more detail, it is useful to explain the general concepts which have been followed in designing them.

The objective has been to include in the tax base the value added in the provision of financial services by financial institutions, as measured by margin calculations appropriate for the particular institution.

Banks, trust and loan companies, and financial co-operatives carry on financial intermediation between owners, depositors and borrowers and other users of funds to economize on transaction costs and to pool risks of default by borrowers. In its simplest form, the difference of 2 percentage points between, say, lending at 10 per cent and raising funds at 8 per cent measures the value of these intermediation services. It is this margin of financial revenues less financial costs that will be added to the sales tax base of such an institution. Given that the margin includes a premium for default risks, a credit will be allowed for bad debts.

For insurance companies which are providing financial protection against risks, inflows will be represented by premiums received, and outflows by claims paid. Where an insurance premium contains a savings element, these companies are also undertaking activities similar to other financial intermediaries. They invest the savings of policyholders and owners, and return investment income to them in the form of lower premiums, an increase in cash surrender values or in policy dividends. Investment income is also used to finance part of the cost of policy claims. Thus, the margin for an insurance company will be, basically, premiums plus investment income, less claims, policy dividends and the increase in the policy reserves.

No margin calculation will be necessary where a commission is explicitly charged by an investment dealer for its services. However, where the investment dealer acts as a principal in buying and selling securities, the margin will be represented by the profit on sale of the securities less the costs of financing such transactions. In addition, an investment dealer may act as a financial intermediary in raising and lending funds in a manner similar to a bank or trust company.

Mutual fund corporations, mutual fund trusts, and other investment intermediaries perform a different type of financial service – the management of investment portfolios, where the results are passed on to groups of individual investors. Where the portfolio is managed by another entity for a fee, and the portfolio consists entirely of financial instruments, there is no value added in the portfolio itself, and tax will be payable by the managing entity only on the fee charged. In other cases where the intermediary has salaried employees or holds non-financial investments, such as real estate, there is value added in the intermediary which will be included in the sales tax base.

(b) Adjustment for the Cost of Financial Capital

Savings and investments will not form part of the base under a comprehensive sales tax. For any person that is not a financial institution, this is achieved by providing a full and immediate credit in respect of any tax paid on non-financial assets used in a taxable activity and also by excluding any return on investment in financial assets, such as bonds or shares, from the tax base. Similarly, where such a person borrows money or raises equity capital to make the investments, no input tax credit will be allowed in respect of the interest costs of the borrowed money or dividends paid to shareholders.

In the case of a financial institution, however, financial inflows and outflows must be included to calculate the margin that will be subject to tax. In the course of doing this, further steps will be taken to ensure that this margin is not overstated.

To the extent a financial institution raises funds by borrowing, a deduction for the interest expense will ensure that the financial institution's margin will be properly determined. If this deduction were not allowed, the financial institution would be taxed on more than its margin and, thus, on more than its value added.

Financial institutions, however, also use equity funds in their provision of financial services, such funds being derived from share issues, retained earnings or other surplus. If such equity funds were used to purchase only non-financial assets, and if all non-financial assets were financed with equity funds, then no problem would arise, as any input tax credit in respect of non-financial assets would be claimed fully and immediately and the cost of these equity funds would not have to be taken into account in determining the financial institution's margin from its financial activities. However, an examination of the balance sheets of financial institutions demonstrates that there is substantial variation in the sources and uses of funds, both within a particular type of institution and among different types. Equity funds may be used to purchase financial assets and borrowed funds may be used to purchase non-financial assets. It is therefore essential that further steps be taken to ensure neutrality in the treatment of debt and equity capital under a comprehensive sales tax. This neutrality will be achieved by allowing a deduction not only for the interest cost of debt capital but also for an allowance for the use of equity capital in the business of a financial institution (see the discussion under Special Rules in 13.7(b) below).

Since the cost of all funds employed by a financial institution will thus be deductible in determining the margin that will be subject to tax, further rules will be needed to ensure that a financial institution will not have an advantage compared with a non-financial business. These rules are also discussed in detail below under Special Rules in subsections 13.7(c) to (f).

(c) International Aspect

The sales tax will apply only to financial services of financial institutions which are supplied in Canada to residents. The concept of residence is discussed in Section 5. In addition, for these purposes, where financial services are supplied to a branch, residence will be governed by the location of the branch rather than by the residence of the company.

Because of the international nature of finance and insurance, special considerations will be necessary in determining whether the service is provided to residents in Canada, and the amount of the tax relating thereto. Where a financial institution operates both inside and outside Canada, formulas will be required for segregating domestic and foreign financial services, as it would be impractical to spell out rules on a transaction-by-transaction basis as to which transactions are consumed in Canada as compared to outside of Canada. These formulas would effectively ensure that services supplied outside Canada will be tax-free, in the same way as exports of other goods and services. Furthermore, input tax credits will be allowed in respect of tax paid by institutions on non-financial purchases in Canada, such as buildings, equipment or office supplies, whether they relate to domestic or foreign operations and, consequently, the tax thereon will be fully relieved.

(d) Provincial Allocation

If the provinces join in a multi-stage national sales tax, special consideration will be given to the way in which the national sales tax would apply to financial institutions. This is necessary because the sales tax base of a financial institution will include the margin from its financial services, and special rules will be needed to determine where those services are consumed. This is a matter which will be discussed further with the provinces.

13.3 General Rules for all Financial Institutions

The supply and the purchase of non-financial goods and services by financial institutions will be treated in the same manner as for non-financial businesses. Fees and commissions explicitly charged by financial institutions for various services including pension, trust and investment management services, stock transfer services, bond trustee services, and estate, trust and agency management services will also be included in the financial institution's sales tax base under the rules for non-financial services. The special rules for financial institutions will add to this sales tax base the difference between the revenues from and costs of its supply of financial services. Revenues will include fees and commissions received for supplying financial services.

Certain general rules are appropriate for all financial institutions in measuring the sales tax base that will be derived from their financial services. For example, interest income or expense flows will be accounted for on an accrual basis. Similarly, a discount or premium on a debt security, or a fee or commission relating to a financial instrument, will be amortized to produce an accurate measure of the margin.

Certain amounts received as fees and commissions will also be included in the margin on the same basis as interest since the two types of revenue may be interchangeable. For instance, a financial institution may charge a fee for servicing a loan or setting up a loan instead of combining this fee with the interest rate charged, or it may agree to accept a fee instead of instituting an upward adjustment in the interest rate attached to a loan.

Since the interest charged by a financial institution includes a premium for default risks which should not be subject to sales tax, an input tax credit will be allowed in respect of provisions for doubtful debts. Details of this provision are discussed below (subsection 13.7(a)).

Subject to the amortization of debt securities and the provision for doubtful debts, a gain or loss on a financial instrument will be included when realized upon disposition. This gain or loss will normally be calculated by comparing the sale proceeds with the cost or amortized cost. Where a financial instrument is included in the financial institution's inventory, the gain or loss can be calculated for purposes of the sales tax with minimal adjustment from the amount calculated for financial statement purposes. However, for simplicity, and so that the rollover rules of the income tax legislation can be automatically incorporated in the sales tax rules, the gain or loss on a financial instrument that is a capital property for income tax purposes will be the capital gain or loss as computed for income tax purposes, without reduction by one-half and without deduction for a reserve.

Dividend income will be included when received.

In addition to a deduction for interest expense on borrowed funds, there will be a deduction for the cost of equity funds in determining the financial institution's margin. This deduction could be either in the form of a deduction for dividends paid or a prescribed allowance on equity. Where a financial institution invests in non-financial assets, a prescribed rate of return thereon will be included to offset the deduction for the cost of funds and to preserve neutrality in treatment between financial and non-financial institutions. For similar reasons, where a financial institution invests in a connected corporation there will be a deemed inclusion in the sales tax base. Details of these provisions are discussed below under Special Rules (subsections 13.7(b) to (f)).

13.4 Banks, Trust and Loan Companies and Financial Co-operatives

Banks, trust and loan companies and financial co-operatives (credit unions and caisses populaires) accumulate funds by taking deposits from businesses, consumers and governments who may be resident in Canada or abroad and by raising equity capital. With these funds the financial institutions engage in short- and long-term lending activities and invest in securities a portion of which may be marketable.

The revenue from financial services received by these financial institutions may take many forms. Interest and dividend revenue is received from the borrowers of the funds and the issuers of the securities. Gains or losses arise from dealing in foreign currencies and marketable securities.

The total revenue received is used to pay interest to depositors, dividends to owners, to provide for losses on bad debts, and to finance future investments. The remainder of the revenue is used to pay overhead costs and salaries to employees.

(a) Intermediation

Banks, trust and loan companies and financial co-operatives will be required to include in the calculation of their sales tax base the amount of interest income derived from loans and mortgages, amortization of issue premiums or purchase discounts on debt obligations, dividends received on equity securities, foreign exchange gains, and gains or income arising from the disposition of financial instruments.

In computing the margin for this activity they will be permitted to deduct the costs involved in attracting funds – mainly interest expense and the return to shareholders, either deemed or actual – together with losses on the sale of securities, amortization of purchase premiums or issue discounts on debt securities and foreign exchange losses. Patronage dividends will also be deductible in determining credit unions' and caisses populaires' margins as a measure of the cost of equity.

For banks, trust and loan companies and financial co-operatives that supply services entirely within Canada, no other rules will be necessary.

(b) International Operations

As in the export of non-financial goods and services, sales tax will not apply to financial services provided to persons not resident in Canada.

The amount of this export which should not be subject to tax is the margin attributable to foreign operations. However, this margin cannot be determined on a transaction-by-transaction basis. Thus, it will be necessary to employ a formula to determine what portion of the intermediation margin is from a foreign source and should not be subject to tax. The allocation of the intermediation margin between Canada and abroad will be based on the residence of the person paying the interest, dividend or similar type of income and fees or commissions for security transactions.

Therefore, in determining the margin, an additional deduction will be allowed for an amount determined as:

$$\frac{\text{foreign-source revenue}}{\text{total revenue}} \quad \text{times} \quad \begin{bmatrix} \text{total financial revenue} & \text{less} & \text{total financial costs} \end{bmatrix}$$

Total and foreign-source revenue in the above formula refer to revenue from interest, dividends or similar types of income and fees. Total financial revenues, on the other hand, refer to revenues from all financial services including gains on the disposition of securities and foreign exchange gains. Conversely, total financial costs refer to all financial costs including losses on the disposition of securities and foreign exchange losses. This formula provides a way of removing the foreign proportion of the margin from the worldwide margin calculation of the financial institution.

13.5 Traders and Dealers in Securities

(a) Market Intermediation

Investment houses provide market intermediation. This intermediation generally involves brokerage, dealing and underwriting. Such firms act as brokers when they act as agents for clients who are buying or selling securities. For bringing buyers and sellers of securities together, they receive a fee or commission normally based on the value of the transaction.

Alternatively, investment houses may act as dealers or principals by becoming a party to a market transaction. They hold an inventory of securities and buy and sell them with a view to profit. Where a dealer purchases and sells a new issue of securities, an underwriting activity is being undertaken.

Both the amount of fees and commissions received and the profit or loss from security transactions are a measure of the value of services such intermediaries provide. Such amounts received by investment houses and other financial institutions performing similar services will therefore be included in the tax base for a multi-stage sales tax.

Borrowings and equity capital provide the base to allow a trader or dealer in securities to finance its operations. To determine the value of the services provided, interest expense and the cost of equity capital will be recognized as an input for purposes of the multi-stage sales tax.

In addition to the above activities, investment dealers perform financial intermediation by advancing funds to clients. Interest, dividend and other revenue from such services by an investment dealer will be included in the calculation of the dealer's margin in the same manner as for banks, trust and loan companies and financial co-operatives. An investment dealer also holds customer accounts, which are essentially treated as deposit accounts with interest paid on the cash balance, and these interest costs will similarly be deductible in determining the margin from its financial intermediation activities. In addition, the cost of equity capital, again either actual or deemed, will be deductible in determining this margin.

(b) International Operations

Rules will be required to allocate the gain or loss from market intermediation between taxable services supplied to Canadian residents and tax-free services supplied to non-residents.

Where the revenue is from a brokerage fee paid by a buyer or seller of securities, either in a secondary market such as a stock market or for marketing a new securities issue, the fee or commission is paid by the consumer of the services. Therefore, it will be appropriate to base the allocation on the country of residence of the buyer or seller from whom the fee is received.

If an investment dealer acts as a principal by marketing a new financial instrument issue, the consumer of the service is the issuer of the financial instrument. Therefore, it will be appropriate to base the allocation of the resulting profit or loss on the country of residence of the issuer of the financial instrument.

Where an investment dealer acts as principal through trading in the secondary market in outstanding securities on its own account, the consumer of the service is not easily identifiable. By trading in the market the financial institution is aiding in the creation of an efficient market for the security. This is of benefit to purchasers, sellers and holders of securities and assists businesses in issuing additional securities in the market. Therefore, the consumers of the service would not be readily identifiable. The resulting profit or loss could be allocated, based on the proportion that fee and commission revenue, underwriting gains and interest and dividend receipts from Canadian residents is of the total of such revenue of the institution. The government recognizes that this allocation system may not yield appropriate results in all circumstances and will be discussing suitable alternatives with the financial institutions affected.

Interest revenue from debt securities and costs associated with deposit accounts with investment dealers will be treated in a manner similar to that proposed for banks and other types of deposit-taking institutions. The margin from such intermediation will be allocated based on the proportion that fee and commission revenue, underwriting gains and interest and dividend receipts from foreign residents is of the total of such revenue of the institution. This formula provides a way of recognizing the foreign proportion of the worldwide margin so that it will not be taxed.

13.6 Insurance Companies

(a) General Rules

The insurance industry may be divided into two broad categories: life insurers, and property and casualty insurers. The financial services provided by life insurers include financial protection against the risks of mortality and accident and sickness, and annuities based on life contingency. Property and casualty insurers provide protection against damage or loss of property, public liability claims and other forms of peril. A common feature of both is the pooling of risk, with inflows into a capital pool in the form of premiums, and outflows in the form of claims.

An investment return on financial instruments is an integral part of an insurance operation. In the case of property and casualty insurance or term life insurance, the investment funds are derived from the receipt of premiums and the holding of funds pending payment of claims. In the case of annuities or the savings element in whole life insurance, the insurer is acting more directly as a financial intermediary in its investment of policyholder funds. A portion of the return is added to the amount which the policyholder can claim as cash surrender value, as well as being used to provide risk coverage. Good experience of the insurer may also be shared with the policyholder in the form of refunds of premiums, policy dividends, or experience-rating refunds, and, in the case of a stock insurer, with the shareholders.

All of these factors must be taken into account in determining the sales tax base of an insurer. In addition to the financial intermediation rules already described, premiums will be included in the sales tax base, and a deduction provided for the amounts needed to meet the various policy benefits payable to policyholders in respect of risk coverage and investment experience.

The general provisions for determining the insurer's sales tax liability will permit input tax credits to be claimed for taxed purchases such as buildings, equipment and stationery. Similarly, any rentals from non-residential real estate investments of insurers will be taxable under the general provisions.

(b) Pooling of Risk Capital

The unique feature of an insurance operation is the pooling of capital for the coverage of risks. Only a small portion of the premium is needed to cover the services of the insurer in managing this pooling. Most of the premium is actually a contribution of capital into the pool for later payment to claimants. This reallocation of capital does not represent the value of insurance services and will not be subject to sales tax. Since premiums received under insurance policies will be fully included in the insurer's sales tax base, there will therefore be a deduction for claims.

(c) Provision for Claims – Life Insurers

Where long-term life insurance is written for a level premium, the premium in the early years exceeds that needed to cover the mortality risk. This excess creates a savings element available to meet the higher risk in later years. Premiums received by a life insurer for deferred annuities are even more akin to savings deposits. Since such premiums will be fully included in determining the financial margin, the life insurer will need a reserve for the savings element of these premiums to put them on the same footing as a deposit-taking institution. This need will be met by permitting reserves for life insurance policies and accident and sickness insurance policies equal to the maximum allowed for income tax purposes, except for the extra reserve in respect of qualified annuities. The deduction of these reserves will offset the inclusion of the return on the related investments, and effectively prevent sales tax from being imposed on savings of policyholders.

For each taxation year under the new system, the increase or decrease in the reserves will be deducted from or added to the sales tax base of the life insurer, by adding in the opening reserves and deducting the closing reserves. Transitionally, in the first year of the system, there will be included the amount which these reserves would have been at the end of the immediately preceding taxation period. Claims paid after the commencement of the system, and subsequent increases in reserves, will then be deductible.

(d) Provision for Claims – Property and Casualty Insurers

Reserve provisions will also be needed for property and casualty insurers. To arrive at a proper measure of the sales tax base in a given period, property and casualty insurers will be allowed a reserve in respect of unearned premiums, i.e., premium receipts that relate to future insurance coverage. There will also be a provision for claims that remain unsettled at the end of the year, similar to that allowed for income tax purposes. As proposed under the corporate income tax reform, this provision will be limited to the present discounted value of such claims.

Where a business taxpayer pays a premium for property and casualty insurance, the full amount of the premium will be creditable immediately. Claim settlements paid directly to an insured business will be taxable. Proceeds then used to pay a third party performing a repair or replacement will be creditable to the insured and taxable to the third party. A similar end result will be obtained where the insurer pays the third party directly for the repair or replacement.

Thus, the insurer will be taxed only on its margin, which measures the value of its services; the capital which is pooled to meet risks and which is redistributed to policyholders produces no net sales tax, which is appropriate as no net value has been added to the economy.

(e) Policy Dividends and Rebates

Under participating life insurance policies, policy dividends are paid to the policyholders. These are derived from favourable results of the insurer from investments and mortality and expense experience, and may be viewed partly as a return of premiums and partly a sharing by participating policyholders in the business income. Refunds of premiums or experience-rating refunds may be made on other types of policies such as group term policies or certain types of casualty policies.

These policy dividends and rebates will be deductible in determining the margin of the insurer. However, since the deductible policy dividends contain an element of return on equity, no further deduction for the cost of equity capital will be provided to a mutual insurer or in respect of the participating fund of a stock life insurer.

(f) Supply in Canada of Insurance and Other Financial Services

The location of the supply of insurance services is indicated by the location of the risk. Thus, premiums and claims counted in the sales tax base of an insurer will include only those arising from Canadian risks.

In the course of its operations an insurer also provides other financial services by investing policyholder funds in bonds, shares and other non-insurance financial instruments, as well as in real estate. Further investments are needed to cover a solvency margin, that is, the excess of assets over liabilities required by supervisory authorities to protect the policyholders. The revenue from all these investments will be included in calculating the overall margin of the insurer, to the extent such revenue relates to the provision of insurance services in Canada.

Where an insurer operates only in Canada and covers only Canadian risks, all its investment revenue will be taxable. However, special considerations apply to an insurer operating both inside and outside Canada. While any revenue from real estate will be taxable under the ordinary rules according to its location in Canada, special rules will be needed to determine the portion of the sales tax base from financial instruments which will be regarded as arising from financial services provided in Canada.

Under the income tax system, a similar objective has been met by a set of rules for determining the total amount of investments that should be attributed to the Canadian insurance coverage – the so-called "Canadian Investment Fund". This fund is determined by multiplying worldwide investments by the ratio of Canadian policy reserve liabilities to total policy reserve liabilities. Since the effect of the formula is to allocate a portion of overall surplus to Canada, it gives equivalent treatment to resident companies operating only domestically and to companies that operate internationally.

Since the provision of insurance coverage is the primary focus of insurers, the location of the risk provides a meaningful basis for allocating an insurer's financial services between Canada and the rest of the world. Accordingly, the allocation for a resident insurer will be the proportion of the insurer's worldwide margin from financial instruments other than insurance policies that its Canadian policy reserve liabilities bear to its total policy reserve liabilities.

For non-resident insurers operating in Canada it is not practical to apply a worldwide ratio in determining the supply of financial services in Canada. However, a modified version of the income tax concept of the Canadian Investment Fund, which will exclude real property in Canada and which will be referred to as the Canadian Financial Investment Fund, will be used to achieve a result similar to that for resident insurers. For the non-resident insurer, the financial investment revenue allocated to the supply of insurance services in Canada will be the proportion of its investment revenue from Canadian financial investments that its Canadian Financial Investment Fund for the year is of its Canadian financial investments for the year. If its Canadian financial investments exceed its Canadian Financial Investment Fund, only a portion of financial investment revenue will be included. On the other hand, if its Canadian Financial Investment Fund exceeds its Canadian financial investments, the formula will effectively attribute further investment revenue to Canada at the same average rate of return as earned on Canadian financial investments.

(g) Reinsurance

Where insurance of Canadian risks by a Canadian-licensed insurer is reinsured with another Canadian-licensed insurer, the reinsurance will not be included in the margin of the initial insurer, but will be included in that of the reinsurer. However, different considerations arise where reinsurance of foreign risks is involved or where reinsurance of Canadian risks is ceded abroad to an unlicensed insurer.

If a Canadian resident insurer assumes reinsurance of foreign risks, it will be regarded as an export of insurance services, and the net proceeds will not be included in its sales tax base. However, if a Canadian insurer reinsures Canadian risks with a foreign insurer, the reinsurance premium will be deducted from the Canadian insurer's margin (and related claims excluded) only where the foreign insurer is licensed to carry on insurance business in Canada and is liable for the sales tax.

(h) Provincial Premium Taxes

All provinces levy taxes at various rates on insurance premiums. Like other taxes levied on insurers and other businesses, they will not be deducted in determining an insurer's margin.

(i) Segregated Funds

Life insurers, on behalf of policyholders, manage segregated funds that operate in a manner similar to open-ended mutual fund trusts. For purposes of the sales tax, the segregated fund will be treated as a separate trust which is an investment intermediary or a deferred income plan. The insurer will be taxable on any fees or commissions received from managing the segregated fund, and any income from seed money in the fund.

13.7 Special Rules

A number of additional rules will be applicable to all of the financial institutions discussed previously.

(a) Bad and Doubtful Debts

When a financial institution lends funds it incorporates a premium in its interest rate representing an amount to reflect the expected loss to the financial institution upon a default of a debt obligation. Since the financial institution is taxed on the receipt of interest earned on loans, which includes a premium for default risks, it is therefore necessary to provide a deduction representing the value of any loss.

Financial institutions including banks, trust and loan companies, insurance companies, and financial co-operatives will be allowed to claim an input credit in respect of provisions for bad and doubtful debts that may be claimed for income tax purposes. Since the provision of financial services to non-residents will not be subject to the multi-stage sales tax, the rules for bad and doubtful debts will be limited to loans made to Canadian residents. In the determination of residence for this purpose, where loans are made to a branch, residence will be governed by the location of the branch rather than by the residence of the company.

Where a financial intermediary has recovered part or all of a bad debt that was previously written off, or where a specific loss provision has been reversed, the amount of the recovery or reversal will be taxable in the year it occurs. This will recapture amounts previously deducted from the tax base.

For each taxation period under the new system, the allowable increase or decrease in the provision for doubtful debts will be deducted from or added to the tax base of the financial institution, by adding in the opening provision and deducting the closing provision. Thus, in the first year of the tax, the amount of the provision for doubtful debts allowable for income tax purposes at the end of the immediately preceding year will be included in the sales tax base. Bad debts arising after the commencement of the system, and subsequent allowable increases in provisions, will then reduce the sales tax base.

(b) Allowance for Equity Funds

As explained above under General Concepts, there will be a deduction with respect to the cost of equity funds to ensure that a financial institution's margin is properly calculated.

A natural way to provide such an allowance would be to give a deduction for dividends actually paid. This would reflect the actual cost of equity in many situations, and in that way would be preferable to some imputed cost. For a class of shares that is widely held, say where at least 35 per cent is held by arm's-length parties, or where the share is publicly traded, such a rule may be satisfactory since the rate of dividends paid would reflect the interplay of market forces. However, in specific circumstances, limits would have to be placed on the level of dividends which would be deductible in determining the margin of the financial institution. For example, where a class of shares is held primarily by connected non-financial corporations there may be little constraint either for income tax or sales tax purposes on the level of dividends which could be paid. A high-level dividend could then seriously erode the sales tax base of the financial institution.

Thus there would be need for some limitation on dividend deductibility in defined circumstances. A limit related to some measure such as paid-up capital could be applied. The main difficulties with this approach are that it would provide limited offset for equity in the form of retained earnings, and that any such limit would produce the ancillary need for a cumulative limit of some sort because of the irregularity of dividend payouts.

As an alternative to a deduction based on dividends, the allowance for equity funds for a financial institution could be determined by applying a prescribed rate to the institution's equity. Actual dividends paid would be ignored in such an approach, and the allowance would be a steady periodic deduction. The calculation of equity would be based primarily on equity as reported for financial statement purposes. This would be adjusted for major differences between book and tax calculations such as the difference between net book value and tax value of financial instruments and for differences between book reserves and tax reserves. Since the allowance would be based on equity as a whole, there would be no need to apportion it between different classes of shares. In technical terms the approach appears to be workable, but it could suffer from flaws because it would allow a deduction based on an assumed cost of equity.

It is evident, therefore, that the method of determining an appropriate allowance for equity funds is not a simple matter. The government will be consulting with the financial industry to determine the best method to adopt.

(c) Connected Corporations

The rules discussed above for calculating the sales tax base of financial institutions have related to portfolio investments. Special rules will apply where direct investments are made in connected corporations. For this purpose, consistent with the government's proposals for self-dealing measures in the regulation of financial institutions, one corporation will be considered to be connected with another for sales tax purposes if it owns more than 10 per cent of the share capital of the other.

(d) Funds Invested in a Connected Corporation

Where a financial institution makes a loan to, or invests funds in, a connected corporation, a prescribed market rate of return will be deemed to have been earned thereon and will be included in determining the institution's margin. This will serve as an offset to the deduction allowed to the financial institution for the cost of debt or equity capital. Thus, if the connected corporation is resident and is not a financial institution, this treatment would parallel that of any other non-financial corporation which raises its own debt financing and cannot deduct the interest expense. If the connected corporation is a resident financial institution, or is non-resident, the rules for a prescribed minimum deemed return will be necessary to ensure an appropriate domestic and international allocation of the financial margin.

The minimum deemed return on funds invested by the financial institution in debt of a connected corporation, and included in the institution's sales tax base, will be reduced to reflect any interest actually paid by the connected corporation to the financial institution.

The rules for a prescribed deemed return will also apply to investment by a financial institution in equity capital of a connected corporation. However, dividends and gains or losses on the shares of a connected corporation generally will be excluded from the sales tax base of the financial institution. As a result, the inclusion in the sales tax base of the institution in respect of equity investments in connected corporations will be limited to the prescribed deemed return.

(e) Other Transactions with Connected Corporations

A non-financial business will not be required to include in its sales tax base any gain or loss from the sale of a financial asset. However, since a financial institution is in the business of buying and selling financial instruments, any gain or loss will properly be included in its sales tax base. To ensure appropriate results, any sale of a financial instrument by a financial institution to a connected corporation will be deemed to have occurred at no less than fair market value.

Similarly, where a financial institution receives a deposit from a connected business, the deduction to the financial institution for interest paid on such deposits will be limited to a reasonable amount.

(f) Investment in Non-Financial Assets

Capital Property: Where a financial institution purchases capital property for use in its financial services business or in a non-financial taxable activity such as renting or leasing, it will be entitled to claim an input tax credit in respect of the cost of the property in computing its sales tax base, in the same manner as a non-financial business. However, a non-financial business will not be able to claim an input tax credit in respect of the cost of funds used for such a purchase. To give equivalent tax treatment, a financial institution will be required to include in its sales tax base an amount approximating an interest charge on the funds invested in such capital property. This amount will be equal to a prescribed rate times the net book value of the property.

Leasing Activities: A financial institution which carries on both a leasing and a loan business in the same corporation will be taxed under the general rules on lease payments received and under the financial institution rules on the interest income received. Since a leasing business is not defined to be a financial activity, the interest costs and the cost of capital associated with funding a leasing activity should not be deductible in computing the sales tax base. Accordingly, the rules described immediately above for capital property will also apply to a financial institution's investment in lease receivables, so that no deduction will effectively be allowed for the amount of interest which is reasonably attributable to its leasing activities. This will place the leasing activities carried on by a financial institution on the same basis as leasing activities of a non-financial business.

Low-Interest Loans to Employees: Where loans are made to employees without interest or at preferred rates of interest, the financial institution will include in its sales tax base the amount by which interest at a prescribed rate exceeds the interest actually charged.

13.8 Investment Intermediaries

An investment intermediary can be an investment corporation, a mortgage investment corporation, a mutual fund corporation, a mutual fund trust, a related segregated fund trust, a real estate investment trust or a pooled fund trust. Investment intermediaries largely confine themselves to investment activities, flowing investment income and gains through to the investors on an annual basis, with the investment risk being borne ultimately by the investors.

Investment intermediaries also offer investors the opportunity to utilize the services of a professional manager to make investment decisions. The value added by an investment advisor may be measured by the explicit fee charged for these services. Where the investment advisor is not an employee of the intermediary, the fee for these services is taxable to the advisor. The value added is contributed primarily by the advisor rather than by the financial intermediary which is, in effect, an extension of the investment activities of the individual investors. In such circumstances the intermediary will be effectively exempt from tax as it will be deemed not to be a financial institution.

However, instances may arise where investment intermediaries employ individuals to act as investment advisors or to serve other functions. To isolate the tax base for these investment intermediaries, they will include investment income such as interest and dividends in the sales tax base but they will also be permitted to deduct amounts distributed to investors. These distributions may take the form of a taxable dividend, a capital gains dividend or allocations to the investors under the terms of the various trust agreements. The allocation of these various amounts will generally follow the provisions of the *Income Tax Act* for the flow-through of income received by these investment intermediaries. As a deduction will be allowed for amounts distributed to investors, the need for an equity deduction will not arise for these institutions.

Where the investment intermediary has receipts from other than financial instruments, for example, commercial rents, the intermediary will be subject to tax with respect to such supplies under the normal rules. In this way the individual investor will be indirectly subject to the same amount of tax as if he or she had held the property directly.

13.9 Administrative Considerations

Financial institutions usually determine various amounts, such as insurance reserves and loan loss reserves, only on an annual basis. To reflect these operating practices, financial institutions will be required to make an annual reporting of their tax liability for both financial and non-financial activities based on the fiscal period they use for income tax purposes.

To ensure that financial institutions pay tax on a regular basis, they will be required to remit instalments of estimated tax on a monthly basis, with the final balance being paid after the end of the fiscal period. These rules will be similar to those in the *Income Tax Act*, with certain modifications where the tax for a previous period has been reduced by purchases of certain capital assets.

13.10 Transitional Provisions

Application of tax to fixed-term financial contracts in existence before the commencement of the system could impose an inappropriate burden. However, there are variations in the mix of shorter- and longer-term contracts among financial institutions, and there could be difficulties in defining the type of contracts entitled to relief, the amount of such relief, and its duration. To ensure uniform and fair application of the tax to all financial institutions during the transition period, the government will be discussing the need for and nature of suitable transitional provisions with affected institutions.

Annex II

The Multi-Stage Sales Tax
Calculating The Tax

Calculating the Tax – Examples

The following examples illustrate how a hypothetical taxpayer (ABC Inc.) would compute its sales tax liability – first, under a system where sales and purchases are recorded tax-inclusive and, second, under a system where amounts are recorded net of tax, as would likely occur if there were an invoice requirement. The examples assume an 8-per-cent rate of tax on tax-excluded amounts which is equivalent to a rate of 8/108 on tax-included amounts.

To simplify the examples, it is assumed that ABC Inc. has only two books of account – a cash receipts book and a cash disbursements journal – and that the company has no receivables or payables at the end of a taxation period. Thus, although adjustments would normally be required at the end of each period to put the accounts on a receivable/payable basis (that is, to calculate the tax owing on sales not yet collected and to claim input tax credits for taxed purchases not yet paid) these are not reflected in these examples.

Assuming all amounts are shown tax-inclusive as in Example 1, in preparing for the new tax, ABC Inc. would create two new columns in its cash disbursements journal (Figure 1). The new columns would identify those purchases of goods and services on which tax has been paid (referred to as "input tax creditable amounts"), and tax paid on imports, respectively. In its cash receipts book (Figure 2), a new column – taxable sales – would be added. ABC Inc.'s net tax liability would be $1,016, the difference between its tax liability of $4,200 on sales (8/108ths of taxable sales) minus input tax credits totalling $3,184 on taxed purchases. This calculation is shown in Figure 3.

Example 2, which is based on the same information used in Example 1, shows how ABC Inc. would calculate its net liability under a system where all amounts are shown tax-exclusive. Under such a system, only one new column to keep track of the tax paid on both domestic purchases and imports (referred to as "creditable input tax") would be added to its cash disbursements journal (Figure 4). ABC Inc.'s cash receipts book would have at least one new column ("taxable sales") if the amount of the sales and the separately identified tax thereon are not separately recorded in the books. Alternatively, ABC Inc. would add two columns, "taxable sales" and "tax liability" to its cash receipts book and record the tax on each sale separately in its books. The latter approach has been taken in this example to differentiate it from Example 1 (see Figure 5).

ABC Inc.'s periodic net tax liability would be calculated as shown in the sales tax worksheet in Figure 6 under a system where all amounts are shown net of tax. As in Example 1, the company's net tax liability would be $1,016.

Example 1

(Purchase Prices Recorded Tax-Inclusive)

Figure 1: ABC Inc. Cash Disbursements Journal Summary

Description	Amount	Input tax creditable amounts (Memo account)	Tax on imports	Inventory purchases	Capital equipment	Wages	Other
Inventory – domestic supplier	$11,340	$11,340		$11,340			
Capital equipment	7,560	7,560			7,560		
Inventory – imports	5,778		$ 428	5,350			
Wages	15,120					$15,120	
Receiver General	3,240						$ 3,240
Personal drawing	3,160						3,160
Rent	1,620	1,620					1,620
Repairs and maintenance	216	216					216
Property tax	3,024						3,024
Advertising	486	486					486
Telephone	162	162					162
Bank loan repayment	3,240						3,240
Hydro	540	540					540
Stereo – private	1,080						1,080
Cleaning	216	216					216
Insurance premium – property	756	756					756
Import capital equipment	11,556		856		10,700		
Truck lease payments	1,296	1,296					1,296
Professional services	1,080	1,080					1,080
Outbound freight	216	216					216
Postage	162	162					162
Employee pension plan	432						432
	$72,280	$25,650	$1,284	$16,690	$18,260	$15,120	$20,926

Example 1 (cont'd)

(Receipts Recorded Tax-Inclusive)

Figure 2: ABC Inc. Cash Receipts Book Summary

Description	Bank deposits	Taxable sales	Other receipts
Domestic sales	$45,900	$45,900	
Export sales	4,000		$ 4,000
Sale of used equipment	8,640	8,640	
Bank loan	15,000		15,000
Loan from friend	1,500		1,500
Interest on short-term deposits	450		450
Rental of excess warehouse space	2,160	2,160	
Totals	$77,650	$56,700	$20,950

Figure 3: ABC Inc. Sales Tax Worksheet

Tax Liability Calculation	
Total taxable sales for the period per cash receipts book	$56,700
Tax liability (8/108ths of total taxable sales)	$ 4,200
Input Tax Credit Calculation	
Total domestic tax creditable purchases per cash disbursements journal	$25,650
8/108ths of total domestic tax creditable purchases	$ 1,900
Add – tax on imports per cash disbursements journal	1,284
Input tax credit	$ 3,184
Net Liability (Tax liability minus input tax credit)	$ 1,016

Example 2

(Tax Shown Separately on Purchase Invoices)

Figure 4: ABC Inc. Cash Disbursements Journal Summary

Description	Amount	Creditable input tax	Inventory purchases	Capital equipment	Wages	Other
Inventory – domestic supplier	$11,340	$ 840	$10,500			
Capital equipment	7,560	560		$ 7,000		
Inventory – imports	5,778	428	5,350			
Wages	15,120				$15,120	
Receiver General	3,240					$ 3,240
Personal drawing	3,160					3,160
Rent	1,620	120				1,500
Repairs and maintenance	216	16				200
Property tax	3,024					3,024
Advertising	486	36				450
Telephone	162	12				150
Bank loan repayment	3,240					3,240
Hydro	540	40				500
Stereo – private	1,080					1,080
Cleaning	216	16				200
Insurance premium – property	756	56				700
Import capital equipment	11,556	856		10,700		
Truck lease payments	1,296	96				1,200
Professional services	1,080	80				1,000
Outbound freight	216	16				200
Postage	162	12				150
Employee pension plan	432					432
	$72,280	$3,184	$15,850	$17,700	$15,120	$20,426

Example 2 (cont'd)

(Receipts Recorded Tax-Exclusive)

Figure 5: ABC Inc. Cash Receipts Book Summary

Description	Bank deposits	Taxable sales	Tax liability	Other receipts
Domestic sales	$45,900	$42,500	$3,400	
Export sales	4,000			$ 4,000
Sale of used equipment	8,640	8,000	640	
Bank loan	15,000			15,000
Loan from friend	1,500			1,500
Interest on short-term deposits	450			450
Rental of excess warehouse space	2,160	2,000	160	
Totals	$77,650	$52,500	$4,200	$20,950

Figure 6: ABC Inc. Sales Tax Worksheet

Tax Liability Calculation	
Tax liability per cash receipts book	$4,200
Input tax credit (Creditable input tax per cash disbursements journal)	$3,184
Net Liability (Tax liability minus input tax credit)	$1,016

Part B – Changes to Sales and Excise Taxes

The government is committed to comprehensive sales tax reform as outlined in Part A of this background paper. Discussions will proceed with the provinces and others to assess the feasibility of a National Sales Tax. Pending the conclusion of these discussions and the replacement of the existing sales tax with a multi-stage tax, either national or federal, changes to the existing system are required. This is necessary to correct some of the most serious inequities in the existing system and to stem the erosion of the tax base through the use of tax avoidance mechanisms.

The government is also proposing other sales tax measures which, together with the corporate tax changes, will provide the additional revenues required to proceed with personal income tax reform.

The following changes will be made in the sales and excise tax system:

1. The federal sales tax will apply to sales by marketing companies related to a manufacturer.

2. For a range of products, the federal sales tax will be shifted from the manufacturers' level to the wholesale level.

3. Sales tax at a rate of 10 per cent will apply to telecommunication services, such as telephone and telex services, but not including charges for local residential telephone lines. The sales tax on cable and pay television services will be increased to 10 per cent from the present 8 per cent.

4. Paint and wallpaper will be deleted from the list of construction materials that are taxable at the lower sales tax rate of 8 per cent.

5. The refundable federal sales tax credit will be increased by $20 per adult and $10 per child.

6. Federal sales and excise tax remittances will be accelerated, effective April 1, 1988.

Except for the proposal relating to accelerated remittances, these changes will be effective January 1, 1988.

1. Application of Tax to Marketing Companies Related to Manufacturer

In the case of transactions between related companies, existing legislation authorizes the Minister of National Revenue to specify a fair price for purposes of sales tax calculation. On these transactions, in the past, the Minister's fair price valuation has been based on the price at which such goods were or would have been sold to independent persons. However, recent judicial consideration of the fair price provision has identified deficiencies in the legislation in this regard.

This has created considerable uncertainty in the determination of an appropriate value for tax in non-arm's-length transactions. Such a determination can only be made in a fair and objective way by reference to prices charged to independent persons. The alternative of basing the tax on the physical manufacturing costs is neither practical nor fair. Costs such as fixed capital expenditures and management and administration cannot be readily allocated to specific products. Thus, competing manufacturers may be faced with widely varying values for tax which bear little relationship to the prices at which the products are actually sold.

The legislative deficiencies in the fair price provisions have compounded the competitive distortions that arise under the federal sales tax. Some manufacturers have set up marketing companies and are now accounting for tax on lower values than their competitors. Manufacturers who make direct sales to independent distributors are finding it difficult to maintain their market position given that the tax advantage achieved by their competitors through the use of marketing companies may exceed their entire profit margin.

The use of lower values for calculation of tax in non-arm's-length sales is also resulting in a significant revenue loss which has to be made up by higher taxes on others.

To address these problems, the government is proposing that where a manufacturer sells goods primarily through a related person, that person will be deemed to be the manufacturer of all such goods sold by him and will be liable for tax on his sale price. This will remove the incentive for manufacturers to establish marketing companies to reduce tax otherwise payable on their sales. The tax on sales through related marketing companies would be the same as on direct sales by manufacturers to independent distributors. This measure will apply to both domestic and imported goods. It will thus ensure greater fairness in the application of tax between domestic and imported goods.

The new marketing company rules will apply where:

- a domestic manufacturer makes sales of a product in Canada primarily (generally defined to be more than half of total sales) to one or more distributors related to the manufacturer;

- a product is imported into Canada primarily by one or more distributors related to the foreign manufacturer of that product; or

- a product is imported into Canada primarily by one or more distributors related to the foreign exporter (other than the manufacturer) and the product bears the brand or trade name of that exporter or any other person related to the exporter, or is produced under a patent, copyright or industrial design of, or used by, such person.

If one of these tests is met in a given month or in any of the preceding 11 months, each related distributor will be deemed to be the manufacturer of such goods acquired for resale in Canada and be required to pay tax on his or her sale price.

For purposes of these rules, "distributor" includes the foreign manufacturer or exporter itself if it is the importer of the goods into Canada. The term "product" refers to goods that are identical in all respects.

Where a distributor deemed to be a manufacturer in the above circumstances in turn resells the goods primarily to other related distributors in Canada, the other distributors will also be subject to the same rules.

The current fair price provisions in the *Excise Tax Act* will also be modified so that in other cases of non-arm's-length sales where the manufacturer is making substantial sales to independent persons, the tax will apply to the fair market value of the goods. Fair market value will be readily determinable in such cases by reference to prices charged to independent persons. This will obviate the need for Ministerial determination of value for tax.

The primary purpose of this measure is to deter tax avoidance. The legislation will, therefore, provide the Minister of National Revenue with the discretion to relieve a business from the deemed manufacturer status created by this provision if there is satisfactory evidence that no tax avoidance or reduction is resulting from sales through the related marketing company.

This discretion will be available:

- where the manufacturer makes sales of identical goods in reasonable quantities to independent persons at the same price as charged to its related distributors; or

- where the distributor resells the goods at the same price as the price at which it acquires the goods from the manufacturer.

In these cases, clearly no tax avoidance is occurring and it is unnecessary to deem the marketing company to be the manufacturer.

Ministerial discretion may also be exercised where sales by the manufacturer in a month are not representative of its normal sales pattern. It is not the government's intention to deem a related marketing company to be the manufacturer of a product line where, under normal circumstances, the manufacturer makes most of its sales to independent persons, but because of unusual circumstances, the majority of its sales in a particular month are made to related persons.

A person deemed to be a manufacturer under this measure will be subject to all of the normal rules applicable to other manufacturers under the Act. For example, tax paid at the time of purchase on goods held in inventory will be refunded where the deemed manufacturer has a liability to pay tax on his sale price. A deemed manufacturer may also elect to be considered to be the taxpayer on sales of goods similar to or of the same class as goods on which he is liable for tax. This provision enables businesses to minimize compliance costs associated with holding mixed inventories of tax-free goods for which they are deemed to be the manufacturer and tax-paid goods which they sell as a distributor.

For purposes of this measure, marketing companies will be deemed to be related to the manufacturer, exporter or foreign distributor if they are related persons within the meaning of that term under subsections 251(2) to (6) of the *Income Tax Act*. Generally, these relationships exist in the case of individuals where they are connected by blood, marriage or adoption, and, in the case of corporations, through ownership or control. Further information in this regard is contained in Revenue Canada Interpretation Bulletin IT-419.

These changes will be effective from January 1, 1988.

2. Changes in Trade Level for Imposition of Federal Sales Tax

Changes are proposed in the level of imposition of the sales tax on certain products to address disparities and anomalies in the application of tax and the bias in favour of imports. The government proposes to shift the application of the existing tax to the wholesale trade level, effective January 1, 1988, for the following products:

- household chemicals such as soap, laundry detergents, cleaning materials, bleaches, air fresheners, waxes and polishes;
- pet litter;
- games, toys and sporting goods and equipment such as board games, playing cards, puzzles, mechanical and stuffed toys, golf clubs and supplies, racquet sport equipment, recreational fishing equipment and playground equipment;
- records, prerecorded and blank audio and video tapes, compact discs, video discs and related accessories.

It is estimated that the application of federal sales tax to sales by related marketing companies and the shift in the level of tax to the wholesale trade level for the products indicated will prevent further erosion of the sales tax base and yield additional annual revenues of approximately $300 million.

3. Tax on Telecommunication Services

A 10-per-cent sales tax is proposed on telecommunication services. The basic line charge for local residential telephone service will not be subject to tax.

The tax will apply to charges for local and long distance telephone service to businesses, long distance telephone service to individuals, cellular telephone service, the transmission or reception of telegrams, cablegrams and radiograms, teleprinter services, rentals of dedicated lines and other telecommunication services. Service charges relating to the commencement or termination of a taxable telecommunication service will also be subject to tax.

Internal communication systems that are bought for the purchaser's own use will not be taxable unless offered to the general public. However, public carriers that supply telephone or other telecommunication services for their own use, where the same services are offered to the public, will be required to self-assess the tax on those services.

The tax will not apply to sales and rentals of terminal equipment (such as telephone sets and private branch exchanges) or to charges for internal wiring, unless the supplier requires subscribers to acquire the equipment or wiring exclusively from it or a related person. If terminal equipment that is freely available in the marketplace may be legally used for transmitting and receiving messages through the public carrier's telecommunication system, then charges by the carrier for terminal equipment will be exempt from tax. The exemption for charges for telephone sets, private branch exchanges and other terminal equipment is designed to ensure fairness between taxable carriers and other persons supplying similar equipment. Service charges relating to the installation, maintenance, repair or replacement of exempt equipment will not be subject to tax.

Payments made between public carriers for interline services will generally be exempt from the tax to ensure that the tax is limited to the final user of the service.

The tax will not apply to any provincial retail taxes that may be payable in respect of the service.

The tax will be imposed on users and consumers of telecommunication services. It will be collected by businesses providing telecommunication services at the time the charge for the service is paid.

Telecommunication carriers who provide taxable services in Canada will collect the tax as licensed agents of the Minister of National Revenue. The rules generally applicable to taxpayers under the *Excise Tax Act* will apply to suppliers licensed as agents for purposes of the telecommunication services tax.

The tax will apply to charges for telecommunication services provided on or after January 1, 1988. However, any charge for services after that date that were billed before June 19, 1987 will not be subject to the tax.

Effective January 1, 1988, the rate of tax applicable to cable and pay television services will also be increased from 8 to 10 per cent.

Additional revenue from these measures is estimated to be $870 million in a full year.

4. Deletion of Paint and Wallpaper From the List of Construction Materials

Paint, varnish, wallpaper and similar materials will be deleted from the list of construction materials taxable at the rate of 8 per cent. As a result, they will be subject to the general rate of sales tax of 12 per cent. This measure will be effective on January 1, 1988, and will yield additional revenues of $60 million in the 1988-89 fiscal year.

5. Federal Sales Tax Credit

Commencing in the 1988 taxation year, the federal sales tax credit will be increased by $20 per adult and $10 per child from the current levels. The new credit amounts, which will be available in full to recipients with family net income of up to $16,000, will be $70 per adult and $35 per child. The amount of the credit payable to an individual or family is reduced by 5 per cent of family net income in excess of $16,000. The credit is refundable so that families who pay no federal income tax receive the benefits of this measure.

The increase in the amount of the refundable sales tax credit is designed to fully protect low-income families and individuals from the impact of the proposed increases in these sales taxes. This measure will reduce annual revenues by $150 million.

6. Accelerated Payment of Sales and Excise Taxes

Although the obligation to pay sales and excise taxes arises when a sale is made, such taxes are generally not payable until the end of the month following the month in which the goods are sold. On average, this represents a delay of 45 days in payment of tax. The government is proposing two changes to accelerate the remittance of these taxes.

Taxpayers with average monthly taxes payable of $1 million or less, paying on a monthly basis, will be required to have their payments in the hands of the Receiver General or the Minister's fiscal agent by the 21st day of the month following the month in which the goods were sold. On average, the delay in payment of the tax will be reduced to 36 days. This measure will take effect commencing with the payment in May 1988, in respect of sales made in April 1988. Those taxpayers making payments on a quarterly or semi-annual basis will also be required to make the remittance by the 21st day of the month following the quarter or the six-month period in which the goods were sold.

Taxpayers whose average monthly liability for sales and excise taxes is in excess of $1 million will be required to make payments on a semi-monthly basis commencing with their liability for the first 15 days of April 1988. This will affect fewer than 1 per cent of taxpayers.

For 1988, the new semi-monthly remittance system will apply to taxpayers whose aggregate monthly remittances of sales and excise taxes for the calendar year 1987 exceeded $12 million. For subsequent years, the annual threshold will be based on the taxpayer's total remittances in the immediately preceding calendar year.

Some taxpayers may have separate divisions or affiliated, associated or related firms and the overall organization may hold several sales and excise tax licences. In these circumstances, the aggregate of the monthly liabilities of all divisions, affiliates, associates and related firms is used for purposes of the $1 million threshold.

For those taxpayers, taxes due on transactions during the first 15 days of each month must be in the hands of the Receiver General or the Minister's fiscal agent by close of business on the last business day of the month. Taxes due on transactions during the remainder of each month must be in the hands of the Receiver General or the Minister's fiscal agent by close of business on the 15th day of the month following.

Where a taxpayer cannot conveniently close his or her accounting records to determine the precise liability for sales and excise taxes for the first 15 days of each month, the taxpayer may make the payment of an estimated amount equal to one-half the total tax payable in respect of sales made in the previous calendar month. The taxpayer will be required to adjust the payment for the tax liability of the remainder of the month to reflect the over- or under-payment made for the first half of the month.

Similar rules will apply for taxpayers now authorized to calculate and remit their tax liability based on accounting periods rather than on calendar months.

The one-time revenue gain to the treasury from these accelerated payment provisions is estimated to be $1.6 billion.