Goods and Services Tax
Technical Paper

Issued by
The Honourable Michael H. Wilson
Minister of Finance

August 1989

Canada

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CHANGES TO CAPITAL COST ALLOWANCE RATE ANNOUNCED FOR ELECTRONIC POINT-OF-SALE EQUIPMENT

In conjunction with the release of the Technical Paper on the Goods and Services Tax today, the Honourable Michael Wilson, Minister of Finance, announced his intention to introduce amendments to the Income Tax Regulations to increase the rate of capital cost allowance for certain electronic point-of-sale equipment used in retail businesses. A 100-per-cent capital cost allowance rate (exempt from the half-year convention) will be introduced for the following types of equipment acquired by a taxpayer after today and before 1993, for use in a retail business carried on in Canada:

- electronic bar code scanning equipment designed to read product bar codes applied to goods held for sale in the ordinary course of the business;

- cash registers or similar sales recording devices designed with the capability to calculate and record sales tax imposed by more than one jurisdiction in respect of the same sale;

- equipment and computer software used to convert a cash register or similar sales recording device to one having the capability to calculate and record sales tax imposed by more than one jurisdiction in respect of the same sale; and

.../2

- equipment all or substantially all of which is used in conjunction with such property.

"These changes will assist retailers who wish to upgrade their equipment," the Minister said.

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Introduction

On January 1, 1991, the government will replace the existing federal sales tax with a new sales tax levied at a rate of 9 per cent on the vast majority of goods and services consumed in Canada. The new tax – the Goods and Services Tax (GST) – is an integral part of the government's plan to secure Canada's economic future. In particular, it will achieve three important goals.

- The GST will contribute to the deficit reduction effort and ensure we can continue to pay for programs and services Canadians value.
- The GST is an essential element of the government's plan to make the changes necessary to ensure that Canada can compete effectively in the world economy.
- The GST will improve the overall fairness of the tax system. Lower and modest income Canadians will be better off once the GST is in place.

Objectives

Reliable Tax

The federal government levies taxes in order to fund programs that are important to Canadians. Without a reliable tax system, the government's ability to maintain these programs and to manage the deficit is impaired.

The existing federal sales tax no longer meets this objective. The tax is levied on the sale of goods manufactured in Canada and on the duty-paid value of imports. Because it applies at an intermediate stage in the production chain, firms have an incentive to shift as many costs as possible beyond the tax point, thereby reducing the price upon which federal tax is charged. In addition, because the tax has numerous exemptions and multiple rates, it has increasingly been the target of pressure from businesses seeking more favourable tax treatment for their products. The boundaries between categories of taxable and tax-exempt goods have become very complex both to comply with and to administer. Indeed, no fewer than 22,000 special provisions and administrative arrangements have been required for a tax system that has only 75,000 taxpayers. With this complexity has come a sense of arbitrariness that has made the tax the subject of constant dispute and legal challenge. As a consequence, federal sales tax revenues are unpredictable and subject to significant erosion.

In contrast, the GST will be reliable. Because it will apply at a uniform rate to a very broad base, the number of borderlines subject to difficult interpretation will be greatly reduced. Moreover, because the GST will extend to the retail level, firms will not be able to avoid tax by rearranging their affairs to shift costs beyond the point at which the tax is levied. Finally, the GST's multi-stage structure will serve to minimize avoidance and evasion activity.

Economic Growth and Competitiveness

The existing federal sales tax is a serious impediment to economic growth and job creation in Canada. In particular, it is not an appropriate tax system for a highly industrialized economy that must meet the competitive challenges posed by the international marketplace. Indeed, no other industrialized country has retained a consumption tax of this kind.

Because it is levied at an intermediate point in the production chain, a substantial amount of tax is imposed on domestic production of all goods and services. This, in turn, increases the costs of Canadian exports, making our products less competitive in world markets. At the same time, it is the only tax in the industrialized world known to favour imports over domestically-produced goods. This occurs because Canadian manufacturers must charge tax on their full selling price which typically includes costs (e.g., marketing and distribution costs) which importers incur only after tax has been levied on imports. In short, the existing tax is constraining domestic output at the expense of real income and jobs for Canadians.

Since the GST fully removes sales tax from the production process in Canada, it will reduce the cost of investment and improve the ability of domestic producers to compete both in foreign markets and against imports from other countries. By increasing Canadian competitiveness and by removing other economic distortions, implementation of the GST will create a healthier economy and expand real domestic output by as much as 1.4 per cent annually – or some $9 billion in today's dollars.

Fairness

After sales tax reform, Canada's tax system will be fairer than it is today. This will be accomplished in three ways.

- First, the new GST will apply to a much broader base and at a lower rate than the existing FST. This will provide more equitable treatment of goods and services across sectors of the economy. It will also serve to reduce tax-based distortions of consumers' choices in the marketplace. Relative prices will reflect more accurately the underlying costs of goods and services, instead of the patchwork of policy, administrative and court decisions about the application of federal sales tax that has been stitched together over time.

- Second, the further integration of the federal sales and income tax systems will result in a more progressive tax system. Lower and modest income Canadians will be better off as a result of sales tax reform, while wealthier Canadians will pay their fair share of tax.

- Third, consumers will, for the first time, be informed in a clear and visible manner that they are paying federal sales tax. One of the great flaws of the existing FST is that consumers do not, for the most part, know they are paying it. Because the GST will extend to the retail level and will apply, with few exceptions, to a very broad base at the uniform rate of 9 per cent, consumers will know when they are paying federal tax.

The Need for a Consumption Tax

The federal sales tax is an important pillar of the government's fiscal structure. In 1989-90, for example, the tax is expected to generate about $17 billion, or 16 per cent of total tax revenues. These revenues are required to fund valuable programs and to ensure that Canada's deficit problem is managed responsibly.

Yet, at the same time, this important pillar is weakening. The existing federal sales tax is unreliable, economically destructive and unfair. Its failings have long been recognized, and a number of independent studies over the past five decades have called for fundamental changes to the federal sales tax structure. In short, it must be replaced.

Clearly, given the magnitude of the revenues it generates, any replacement tax would have to be levied on a very substantial base. Few taxes are of the scale that would make them realistic candidates for replacing the federal sales tax.

The income tax system might have been one option. But, close examination reveals that it is not attractive; the constraints on our freedom of action are severe. The government has already increased its reliance on corporate income taxes as a source of revenue. Additional tax increases of the magnitude required to replace the federal sales tax would be counterproductive. These would place the position of Canadian firms in jeopardy in world markets, thereby threatening economic growth and jobs in Canada. Moreover, any significant gap between Canadian and foreign tax rates could result in net revenue losses as multi-national corporations adjust their operations and financing to reduce their income in Canada.

To replace the federal sales tax, personal income taxes would have to increase by about 35 per cent. Increases of this order would require sharply higher marginal tax rates and threaten individual incentives to work and save in Canada.

Coupled with these constraints are the obviously intense fiscal pressures which make it impossible to forgo existing revenues. As a practical matter, therefore, the government has little choice but to continue to rely on some form of general consumption tax.

There are also important economic reasons for the federal government to retain a consumption tax as one of its major fiscal instruments. First, diversifying the government's fiscal structure across a number of tax bases at low rates is the best safeguard against extensive efforts to avoid and evade tax. More importantly, to the extent that reliance is placed on consumption taxes to raise revenues, the greater is the incentive for taxpayers to save for and invest in the future. This greater saving will tend to shift the growth path of the Canadian economy upward.

Finally, and perhaps most important, for a country like Canada which depends heavily on international trade for its economic prosperity, it is essential to have a domestic tax structure that allows us to compete effectively. Since income taxes become imbedded in domestic costs of production, excessive reliance on them can hurt our competitive position, especially if they are significantly out of line with those of our trading partners. This is not to say that any type of general consumption tax is appropriate. Indeed, it is clear that the existing federal sales tax is not. Canada needs a properly functioning destination-based tax levied on domestic consumption to ensure that imports receive the same tax treatment as domestic goods, and that our exports are not subject to tax. The GST is a tax of this kind. It will enhance Canada's international competitiveness – a key factor for a modern trading nation such as ours. As a result, the government will be able to continue to generate necessary revenues, but without impeding Canada's economic performance.

Linkage to the Income Tax System

One of the most pervasive arguments against the use of consumption taxes is that they are regressive. Because low-income groups tend to consume more as a percentage of income than high-income groups, the burden of sales taxation tends to rest disproportionately on precisely those people who can least afford to pay. In this regard, the government believes that Canada is in a unique position: our extensive experience with income tax credits, and especially refundable tax credits, ensures that we will be able to offset the inherent regressivity of a sales tax. Building on this experience, the package of measures that will accompany the introduction of the GST will ensure that the overall tax system is fairer after sales tax reform than it is today. In other words, by integrating more fully the sales and income tax systems through refundable credits we will be able to gain the economic benefits of an efficient tax on consumption while furthering the objective of greater tax fairness.

In jurisdictions that operate general sales tax systems, a common way to safeguard fairness is to provide extensive exemptions for products deemed to be basic necessities. By relieving these products of tax, the tax burden on lower income groups is theoretically reduced. However, this approach has some serious drawbacks.

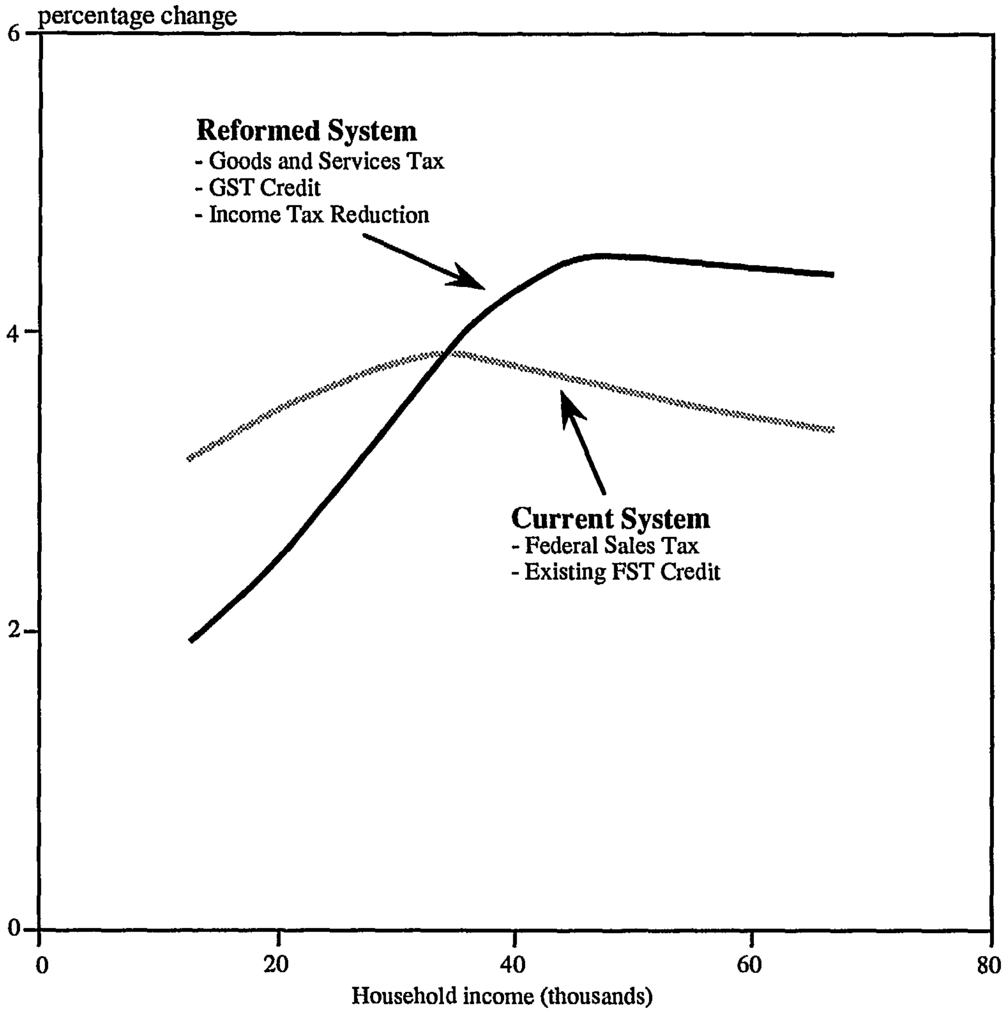
- The greatest beneficiaries of product exemptions are almost always those in high income categories who tend to consume more in absolute terms than those in lower income groups. As a result, exemptions are very costly and inefficient ways of helping those most disadvantaged by sales taxes.

- The narrower the tax base, the higher the tax rate. Lower income groups inevitably end up paying more tax on everything else they buy when basic necessities are not taxed. In this sense, exemptions are self-defeating.
- The more extensive the exemptions, the more complicated the tax system becomes to operate both for businesses and for government. These complications add to costs which, in turn, are passed on to consumers, including those of more limited means.

Chart 1

Fairer System

Families with Children



In order to ensure the fairness of their sales tax systems, many countries have had little choice but to rely on product exemptions with all of their accompanying drawbacks. In Canada, however, we have the opportunity to improve the fairness of the federal sales tax, while avoiding the difficulties posed by exemptions. This is because Canada has made extensive use of refundable tax credits within the income tax system to assist lower income households.

The government believes that the best way to make the new sales tax system fairer is by integrating it more fully with the income tax system through the sales tax credit mechanism. The sales tax credit is a much better instrument for targeting assistance directly to those who need it most. It is also more flexible in ensuring horizontal equity, for example, by recognizing that household needs may vary depending on the number and age of its members.

The key to the success of the sales tax credit in Canada is the very high rate of voluntary compliance with the income tax system in this country. Lower income Canadians do indeed benefit from the credit because the vast majority file income tax returns. In addition, the government will be working closely with the social services community to ensure that those Canadians who are most severely disadvantaged, and sometimes without a permanent home, will receive the benefits they are entitled to with a minimum of effort.

As a result of the new GST Credit and the other income tax and fairness measures set out in Part A, the overall sales tax system will be more progressive after the introduction of the GST than before. Indeed, families earning less than $30,000 per year – about the average industrial wage – will be better off than they are today.

Fiscal Implications

Central to the government's strategy to secure Canada's economic future is its commitment to put the country's fiscal house in order. The April 1989 budget introduced a number of expenditure cutting measures and tax increases designed to reduce the deficit. Among these, the government increased the existing federal sales tax rates, yielding additional revenues of about $2 billion per year.

Given its serious flaws, it was only possible to use the current federal sales tax to generate these incremental revenues because it will soon be replaced in its entirety by the GST. The GST represents a more stable, reliable source of revenues to pay for the programs Canadians value. Its introduction will, therefore, allow the government to secure the sales tax increases already announced in April. In that way, the new tax will contribute to deficit reduction.

At a 9-per-cent rate, based on the economic assumptions underlying the April budget and on a fully implemented basis, the GST would yield net revenues of about $24 billion in 1991 dollars. This amount would be sufficient to:

- replace, in 1991, revenues currently expected from the existing federal sales tax – about $18.5 billion or slightly more than 6.9 points of GST; and
- fund the new GST Credit, the other discretionary income tax changes, the automatic reductions in personal income taxes and increases in transfer payments due to indexing, and additional administrative costs – $5.4 billion, or just over 2.0 points of GST.

Details of these fiscal offsets are set out in Table B.1.

Process

It is important in undertaking a major tax change of this kind that the new system reflect the considered views of Canadians. It is also essential that businesses, which will be required to collect the GST on behalf of the federal government, are well-informed about the operation of the new system and have the time necessary to put the appropriate administrative systems in place. As an initial step, this paper sets out in some detail the key features of the GST. It will provide the basis for further discussion and technical refinement of the tax. In particular, the government will invite the House of Commons Standing Committee on Finance to examine this paper and to hold public hearings on the proposal.

The government also plans to release draft GST legislation in early fall. This draft legislation will form the basis for technical consultations with businesses, the tax professional community and other interested parties on the detailed design and operation of the new tax. It will also be a good starting point for businesses in planning and developing the systems required to collect the GST on behalf of the federal government.

On the basis of these consultations on the draft bill and following receipt of the report of the Standing Committee, the government will prepare final legislation for consideration by Parliament. It is expected that a bill will be introduced in the House of Commons in the fall session.

Well in advance of the start-up of the tax on January 1, 1991, Revenue Canada will be working closely with businesses to assist them in preparing for the new system. And most important, the government will act to ensure that the Canadian public is well-informed in advance about the GST.

Part A

Sales Tax Reform: Distributional Aspects

1. Introduction

The government shares with Canadians a commitment to ensuring the fairness of the overall tax system. Thus, one of the fundamental objectives of the government in replacing the current federal sales tax with the GST is to ensure that the burden of tax is distributed fairly, in accordance with income. In particular, lower and modest income households should be made better off – their overall tax burden actually reduced. A second fundamental goal is to ensure that the new system does not present a barrier to the affordability of housing in Canada. To meet these goals, a package of measures has been designed to accompany the introduction of the new tax.

Experience in Canada and abroad has shown that the best way to target assistance to those who need it is by using a combination of refundable credits and changes to the personal income tax structure. In this case, the existing refundable sales tax credit will be replaced by a significantly enhanced refundable GST Credit to assist lower and modest income households. In addition, to assist middle-income Canadians, the middle (26 per cent) tax rate will be reduced.

An initiative targeted directly at the purchasers of new homes will ensure that the GST does not pose a barrier to the affordability of housing. While the GST will not apply to residential rents or to the resale of existing houses, it will apply to the sale of newly constructed homes in the same way it will be applied to the vast majority of other commodities. However, the GST rate of 9 per cent will be about double the existing effective FST rate on newly constructed homes. To offset this tax increase, assistance will be provided in the form of a tax rebate at the time of purchase of a newly constructed house or condominium for use as a principal residence.

The package of initiatives has been designed to ensure that assistance is targeted to those who need it. Families with incomes less than $30,000 will be better off as a result of the combined impact of the new GST and the offsetting income and housing assistance initiatives. These measures include $3.6 billion for the new GST Credit, $0.7 billion for the reduction in the middle income tax rate and $0.9 billion for the housing rebate. The result is a fairer tax system.

2. Income Tax Changes

2.1 The GST Credit

Canada has extensive experience in the use of refundable tax credits. The child tax credit was first introduced in 1978, followed by the refundable sales tax credit in 1986. They have both proven to be effective means of targeting assistance to those Canadians who need it.

Since its introduction, the sales tax credit has been increased periodically. When introduced in 1986, maximum benefits were $50 per adult and $25 per child and these benefits were paid to families with net incomes of less than $15,000. The credit was enhanced in 1988 to $70 per adult and $35 per child and the threshold income level up to which maximum benefits were paid was increased to $16,000. In the recent budget, further enhancements to this credit were announced. For 1989, maximum benefits will be $100 per adult and $50 per child. These amounts will be further increased for 1990 to $140 per adult and $70 per child and the income threshold will rise to $18,000.

To ensure that the proposed GST system is fair, the existing FST credit will be replaced by a new GST Credit. Benefits will be $275 per adult and $100 per child and the threshold at which benefits begin to be reduced will be $24,800, the same as for the refundable child tax credit. In recognition of the extra costs incurred by single parents and single individuals, two additional features will be introduced. First, single parents will be entitled to claim a full adult credit for one dependent child. Second, single individuals, including single parents, will be able to claim an additional credit with a maximum value of $140.

The proposed increases in the amounts of the credit are substantial. For example:

- A family with two children and $20,000 of net income who received $10 in FST credit benefits in 1988 will receive a GST Credit of $750 in 1991.
- A single individual with net income of $20,000 who received no FST credit in 1988 will receive a GST Credit of $415 in 1991.

In total, 9.3 million families and unattached individuals will benefit. Of these: 3.0 million are families with children; 1.0 million are married couples without children; and 5.3 million are individuals.

2.2 Credit Benefits

As noted above, the GST Credit will be $275 per adult and $100 per child under 19. In recognition of the additional expenses incurred by single parents, they will be able to claim a full adult credit of $275 for one child under 19.

The threshold at which benefits begin to be reduced will be increased from the 1990 level of $18,000 to equal that for the refundable child tax credit (estimated to be $24,800 for 1991). For households with incomes above this level, the credit will be reduced by $5 for every $100 of net income in excess of the threshold; this is the same reduction rate that currently applies to the refundable FST credit.

Both the credit amounts and the threshold will be indexed to increases in the consumer price index (CPI) in excess of 3 per cent.

Under the increased and expanded credit, a family of two adults and two children with income less than $24,800 would receive $750 in credit benefits and those with incomes in excess of this threshold will receive some benefits up to an income level of about $40,000.

At low and modest income levels, single adults who maintain their own households face sales tax changes from replacing the FST with the GST similar to those faced by families. For example, at $15,000 of income the impact of replacing the FST system with the GST is an increase of $330 of sales tax for a single individual and of $355 of sales tax for a family of four.

In recognition of the costs of maintaining a separate household, adults who are not married, whether single or single parents, will be eligible for an additional credit. To ensure that this benefit is targeted at lower-income working or retired singles who maintain their own households and are not dependant on parents or other supporting persons, it will be paid at a rate of 2 per cent of net income in excess of $6,175 (the estimated value of the basic personal amount on the income tax return for 1990) and will reach its maximum value of $140 at an income level of $13,175. This maximum amount will be paid from $13,175 to the GST Credit threshold of $24,800. Above this threshold, it will be phased out along with the GST Credit. As with the GST Credit, both the amount and the thresholds will be indexed to increases in the CPI in excess of 3 per cent.

Both the equivalent-to-married and the additional $140 credit will be subject to restrictions analogous to those in the *Income Tax Act* so that, to the extent possible, married and common-law couples will receive the same credit benefits.

Credit amounts at different income levels for different family types are set out in Table A.1.

2.3 How Credits Are Calculated and Paid

The Credits will be calculated at tax time along with the regular income tax return. The amount of the Credits will be based on the previous year's income and family status. Income will be defined as it is now for the refundable sales tax credit and child tax credit; that is, net income as it appears on the income tax return plus social transfer benefits such as social assistance, workers' compensation and guaranteed income supplement. Family status for credit

Table A.1

Annual Sales Tax Credit

	Single			Family of four		
Income	1988	1990	1991	1988	1990	1991
		(in dollars)				
6,000	70	140	275	210	420	750
10,000	70	140	352	210	420	750
14,000	70	140	415	210	420	750
16,000	70	140	415	210	420	750
18,000	0	140	415	110	420	750
20,000	0	40	415	10	320	750
22,000	0	0	415	0	220	750
24,000	0	0	415	0	120	750
26,000	0	0	355	0	20	690
28,000	0	0	255	0	0	590
30,000	0	0	155	0	0	490
32,000	0	0	55	0	0	390
36,000	0	0	0	0	0	190
40,000	0	0	0	0	0	0

purposes will be that on December 31st of the base year. Credit benefits will be paid in four equal instalments in July, October, January and April.

Since the Credit is intended to offset the impact of the GST, it will be paid in advance of that tax being paid. The Credit received in January is in respect of sales tax which will be paid in the first quarter of the year, the April Credit in respect of the second quarter and so on.

To ensure that Credit benefits are received before the GST is introduced, the first Credits will be paid in advance of the introduction of the GST. The first Credit payment will be made in December 1990 and a second in April 1991. A one-page form to calculate these benefits will be included in the 1989 tax return package.

2.4 Middle Rate Reduction

To provide assistance to middle-income taxpayers, the middle marginal tax rate which in 1991 will apply to the income range $28,700 to $57,400 will be reduced from 26 per cent to 25 per cent. This reduction in the middle rate complements the enriched Credit since the benefit it provides increases over the income range where

Credit benefits are declining. The impact of this rate reduction on the tax liabilities of taxfilers at different income levels assuming the average provincial tax rate of 55 per cent is set out in Table A.2.

Table A.2

Middle Income Tax Reduction
Reduction in Federal Plus Typical Provincial Tax[1]

Income	Single	Family of four: One-earner	Family of four: Two-earner[2]
	(in dollars)		
25,000	0	0	0
30,000	21	21	0
35,000	101	101	0
40,000	181	181	0
45,000	261	261	0
50,000	341	341	23
60,000	459	459	119
75,000	468	459	263
100,000	468	468	576

[1] Assumes provincial tax rate of 55 per cent of federal tax.
[2] Assumes that 60 per cent of income is earned by one spouse and 40 per cent by the other.

3. Housing

3.1 Introduction

Although the existing federal sales tax (FST) does not apply directly to sales of new homes, a substantial amount of sales tax is hidden in house prices. Most of this tax burden comes from the 9 per cent FST applied to building materials such as lumber, bricks, doors and windows, and the 13.5 per cent tax applied to other items such as paint and wallpaper. In addition, some tax is collected at earlier stages in the production chain; that is, on items used to produce the building materials themselves and on certain capital goods used in the construction process.

For the nation as a whole, the current effective FST rate on a newly constructed house, including the sales tax increases announced in the 1989 budget, averages somewhat more than 4 per cent. This means that the cost of a typical house of $150,000 is really $144,000 with about $6,000 worth of tax.

This effective tax rate and, hence, the sales tax content in a new house is not uniform across the country. Indeed, it varies not only from one region to another, but also from one area of a city to another and from one type of house to another. The most important reason for this variation is differences in the relative importance of land costs in the prices of new houses. Because the existing tax applies only to the material inputs into a new house and not the final selling price, land is currently excluded from the tax base.

3.2 Operation of the GST

Unlike the existing system, under the GST no net tax will be collected on building materials, supplies and other inputs used to produce a house. Instead, sales tax will be applied directly to the sale of newly constructed houses. Residential rents will be tax exempt since GST will be collected when the developer/builder sells the rental dwelling to the landlord.

The resale of houses built before the introduction of the GST will be exempt from the new tax. It would be unfair and impractical to tax the sales of these houses under the GST since they already contain a substantial amount of tax under the existing system. Clearly, imposing an additional sales tax burden on these houses would be inappropriate.

By extending federal sales taxation to the retail level, the GST will subject the value added in the construction process itself to tax. In addition, the land component of new house prices will also become part of the tax base. As a result, the GST at 9 per cent would increase the sales tax burden on newly constructed houses relative to the existing tax system. Given that the current effective tax rate on a new house is a little more than 4 per cent on average, this increase would be just under 5 per cent. For instance, in Halifax, the price of a typical house would increase by about $4,400 from $95,000 to $99,400. The typical $190,000 new home in Vancouver would bear an additional $9,900 in tax, while the typical house price in Toronto would rise from $270,000 to $286,250 – an increase of over $16,000. In light of these potential impacts, the 1989 budget indicated that the GST would not be allowed to prejudice the reasonable opportunity for home ownership that Canadians would otherwise have enjoyed.

3.3 The GST and New Housing

In recognition of the importance of home ownership and the fact that it is the largest purchase made by most families, a substantial rebate of tax will be provided for most newly constructed residential dwellings purchased after January 1, 1991. All types of principal residences will be eligible for the rebate, including single-detached and semi-detached homes, row houses and condominiums. Moreover, because sales of substantially renovated houses will be taxed in the same way as sales of new houses under the GST, they will also be eligible for the tax rebate.

Through this system of tax rebates, the government will meet its commitment to ensure that the new system does not pose a barrier to the affordability of housing in Canada. Consistent with its approach to the refundable sales tax credit, the government believes that any special tax provisions for housing should be well-targeted. As a result, there will be a restriction on the price of houses eligible for assistance. This will prevent very wealthy households from benefiting from the rebate.

To qualify for the tax rebate, the purchaser must be a resident of Canada. The new home must also be the purchaser's principal residence.

The size of the tax rebate that will be provided on sales of new houses will depend on their price. For houses priced at $310,000 or less, the rebate will simply be one-half of any GST paid – in other words, 4.5 percentage points of tax. For houses priced between $310,000 and $350,000, the rebate will be $13,950 per home – i.e., the value of the 4.5 percentage point rebate on a $310,000 house. Beyond $350,000, the rebate will be calculated according to the following formula:

$$\text{Rebate} = 13{,}950 \times \frac{(400{,}000 - \text{house price})}{50{,}000}$$

As a result, all houses sold for $400,000 or more will not be eligible for any GST rebate. The total cost of these rebates will be approximately $900 million in 1991. The government will review these thresholds at least every two years and adjust them as necessary to ensure that they adequately reflect changes in economic conditions and housing markets.

The simplest possible way to provide the rebate is to calculate its value at the time the house is purchased and then merely charge a correspondingly lower tax on the sale[(1)]. This will ensure that purchasers who are entitled to benefits receive them immediately and with a minimal amount of administrative burden. Targeting the rebate according to the price of the house greatly simplifies administration since it eliminates the need for income testing and the associated verification process. At the same time, since the price of the house purchased is a reasonable indicator of the purchaser's income, the assistance will be well-targeted.

Table A.3 shows the distribution of the GST rebate for housing across income categories. As the table clearly indicates, this initiative will primarily assist middle-income Canadians. As a result, it serves to complement the new GST Credit which is targeted to lower and modest income households.

Table A.3

Distribution of the GST Rebates

Household Income	Distribution
(thousands of dollars)	(per cent)
0 - 40	14.0
40 - 60	36.5
60 - 80	35.4
80 - 100	13.9
100 +	0.2
Total	100.0

3.4 Results

The GST rebate for housing will substantially lower the impact of the tax on the price of a newly constructed house. To illustrate the effects of the rebate on typical house purchases, we have computed the effects of sales tax reform on the median-priced single-detached house in several centres across Canada. These are displayed in Table A.4.

In virtually every city in Canada, the change in typical house prices due to the GST will be 1 per cent or less. Indeed, in many parts of the country, the net

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(1) In instances where an individual has purchased land and then separately builds a house or contracts to have a house built on that land, the individual will be eligible to claim a rebate from Revenue Canada. The amount of the rebate will be based on the total GST paid on the land and the construction of the house.

increase will be less than one-half of one per cent. In many other centres, the amount of federal tax on a house will fall. The principal exception will be Toronto where, at present, land prices are extraordinarily high. Notwithstanding this, the GST rebate will limit typical house price increases in that city to about 1.6 per cent.

The rebate will substantially offset the impact of the tax on the vast majority of new houses purchased in Canada. Indeed, over 90 per cent of purchasers of owner-occupied new houses will be eligible for the maximum 4.5 percentage point rebate. An additional 5 per cent of new homes will receive some rebate of tax. In total, therefore, the housing rebate program will affect over 95 per cent of new house purchases. As a result, the GST will not pose a barrier to the affordability of new housing in Canada.

Table A.4

Effect of the GST on Typical House Purchases

City	Current house price	Existing FST[1]	Additional tax with 9 per cent GST	GST rebate	Additional tax after rebate	Price change	Net effect on monthly mortgage payments[2]
			(in dollars)			(per cent)	(dollars)
Halifax	95,000	3,850	4,400	4,100	300	0.3	2
Charlottetown	80,000	4,100	2,750	3,400	(650)	(0.9)	(5)
Trois-Rivières	70,000	3,400	2,600	3,000	(400)	(0.6)	(3)
Montréal	100,000	3,550	5,100	4,350	750	0.8	6
Toronto	270,000	7,400	16,250	11,800	4,450	1.6	35
North Bay	120,000	5,300	5,050	5,150	(100)	(0.1)	(1)
Regina	100,000	3,750	4,900	4,350	550	0.6	4
Edmonton	120,000	4,850	5,550	5,200	350	0.3	3
Vancouver	190,000	6,600	9,900	8,250	1,650	0.9	13

(1) Included in the current house price.
(2) Based on a 25-per-cent downpayment and a mortgage amortized over 25 years at a 12-per-cent interest rate. Brackets indicate a reduction.

4. Overall Impact

In undertaking reform of the sales tax system, a fundamental goal was to ensure that the overall impact of the new system would be fair and balanced. The package of income and housing assistance meets that goal. The GST Credit is significantly enhanced and broadened to provide assistance to lower and middle income taxpayers. Middle income taxpayers also receive income tax reductions as a result of the lower middle rate. Home buyers are assisted through the housing rebate.

The combined initial impact of the switch to the GST and the offsetting package of income and housing assistance is set out in Table A.5 for typical taxpayers at different levels of total family income. Column (2) of that table shows the burden of the GST relative to the federal sales tax it replaces. These figures take into account the impact of the Housing Rebate described in Section 3 above. This increased tax burden causes a one-time increase in the consumer price index of 2 1/4 per cent which in turn results in automatic increases in indexing for transfer programs such as family allowances and Old Age Security as well as in the personal tax system. Old Age Security benefits, the guaranteed income supplement and spouse's allowance are all fully indexed quarterly while family allowances and the personal income tax credits and brackets are indexed annually. Column (3) shows the consequences of this indexing.

Column (4) sets out the increased benefits from the GST Credit relative to the current sales tax credit. The impact of the reduction in the middle tax rate is shown in column (5). The final column then shows the overall combined distributional impact of the introduction of the GST, the housing rebate, automatic indexing and the discretionary changes to the credit and to the middle tax rate.

A single wage-earner under 65 with $20,000 of income will face an increase in sales tax of some $435 but this will be offset both by the increase in the GST Credit of $375 and partial indexing of the income tax system so that the net impact of the introduction of the GST is an increase in tax of $15. A typical one-earner couple with two children and $30,000 of income will face an increase in the sales tax of $550 but this will be more than offset by the higher credit, indexing of family allowances and the child tax credit and of the income tax system. As a result, this family will be some $214 better off as a result of reform. Finally, a typical single parent with two children and $20,000 of income would see sales taxes increase by about $425. However, this will be more than offset by the increase in the basic GST Credit and the introduction of the supplementary credit. In addition, this family also benefits from both the automatic indexing of transfers and of the tax system. Thus, the single parent with two children and $20,000 of income will be better off by about $235 as a result of the reform.

As is clear from Table A.5, singles with incomes less than about $12,500 gain from the reform and, for singles over 65, this is true for those with incomes up to about $25,000. Families with children and incomes up to $30,000 gain whether they are one-earner, two-earner or single-parent families.

Table A.5

1991 Impact of Sales Tax Reform on Typical Individuals and Families (Comparison with Post-1989 Budget)

Single Wage-Earner Under 65

(1) Income	(2) GST -FST	(3) Indexing	(4) GST -FST Credit	(5) Middle rate change[1]	(6) Aggregate change in tax
		(in dollars)			
12,500	275	−40	−262	0	−27
15,000	330	−45	−275	0	10
20,000	435	−45	−375	0	15
25,000	525	−45	−405	0	75
30,000	605	−151	−155	−21	278
35,000	685	−115	0	−101	469
40,000	750	−115	0	−181	454
45,000	830	−115	0	−261	454
50,000	915	−115	0	−341	459
60,000	1,100	−194	0	−459	447
75,000	1,435	−197	0	−468	770
100,000	1,950	−197	0	−468	1285

(1) Assumes provincial tax rate of 55 per cent of federal tax.

Single Over 65

(1) Income	(2) GST -FST	(3) Indexing	(4) GST -FST Credit	(5) Middle rate change	(6) Aggregate change in tax
		(in dollars)			
12,500	275	−227	−262	0	−214
15,000	310	−131	−275	0	−96
20,000	385	−131	−375	0	−121
25,000	470	−131	−405	0	−66
30,000	515	−220	−155	−21	119
35,000	550	−189	0	−101	260
40,000	705	−189	0	−181	335
45,000	810	−189	0	−261	360
50,000	900	−189	0	−341	370
60,000	985	−343	0	−459	183
75,000	1,020	−343	0	−459	218
100,000	1,635	−217	0	−468	950

Table A.5 Continued

One-Earner Couple With Two Children

(1) Income	(2) GST -FST	(3) Indexing	(4) GST -FST Credit	(5) Middle rate change	(6) Aggregate change in tax
		(in dollars)			
15,000	355	−125	−330	0	−100
20,000	410	−125	−430	0	−145
25,000	460	−125	−670	0	−335
30,000	550	−253	−490	−21	−214
35,000	600	−253	−240	−101	6
40,000	700	−253	0	−181	266
45,000	750	−211	0	−261	278
50,000	795	−211	0	−341	243
60,000	975	−229	0	−459	287
75,000	1,225	−229	0	−459	537
100,000	1,560	−233	0	−468	859

Two-Earner Couple With Two Children*

(1) Income	(2) GST -FST	(3) Indexing	(4) GST -FST Credit	(5) Middle rate change	(6) Aggregate change in tax
		(in dollars)			
15,000	340	−128	−330	0	−118
20,000	370	−95	−355	0	−80
25,000	485	−131	−580	0	−226
30,000	625	−183	−640	0	−198
35,000	635	−183	−390	0	62
40,000	665	−183	−190	0	292
45,000	770	−141	0	0	629
50,000	860	−217	0	−21	622
60,000	1,055	−166	0	−117	772
75,000	1,290	−166	0	−261	863
100,000	1,715	−313	0	−576	826

* Assumes that 60 per cent of income is earned by one spouse and 40 per cent by the other.

Table A.5 Continued

Single Parent With Two Children

(1) Income	(2) GST -FST	(3) Indexing	(4) GST -FST Credit	(5) Middle rate change	(6) Aggregate change in tax
		(in dollars)			
12,500	275	−125	−487	0	−337
15,000	325	−125	−510	0	−310
20,000	425	−125	−535	0	−235
25,000	540	−125	−760	0	−345
30,000	605	−177	−680	0	−252
35,000	655	−253	−430	−53	−81
40,000	755	−253	−230	−117	155
45,000	880	−250	0	−197	433
50,000	1,000	−210	0	−277	513
60,000	1,250	−256	0	−426	568
75,000	1,305	−227	0	−459	619
100,000	1,375	−231	0	−468	677

Part B

Sales Tax Reform: Economic Aspects

1. Introduction

The present federal sales tax (FST) limits economic growth and job creation in Canada by misallocating resources, lowering incentives to invest, and impeding the country's ability to compete internationally. It has become an increasingly unreliable and unpredictable source of federal revenue to fund programs that are important to Canadians.

Replacement of the FST with the broad-based Goods and Services Tax (GST) will reinforce other government initiatives to improve economic efficiency, raise productivity, and increase living standards. Among these initiatives are:

- the Canada-U.S. Free Trade Agreement which, by securing access to the large U.S. market, will permit Canadian firms to operate at a larger, more efficient scale;
- the personal and corporate income tax reforms of 1988, which have made the tax system more equitable and made economic rather than tax considerations the basis of resource allocation;
- deregulation in the energy and transportation sectors, thereby removing regulatory barriers to competition and the efficient use of resources; and
- the new labour market development strategy which will upgrade the skills of the work force.

These reforms increase Canada's potential output – its ability to supply goods and services – and make the Canadian economy more competitive. The Free Trade Agreement and sales tax reform will have particularly large economic benefits. Together they are estimated to raise the level of potential output over time by as much as 5 per cent, or more than $30 billion in today's dollars. Almost one-third of this gain, or $9 billion, would be the result of sales tax reform.

The benefits to the Canadian economy from sales tax reform will extend across all regions and sectors. They will be realized through a higher level of potential output, resulting from increases in productivity and competitiveness, and in the productive capital stock. Section 2 of this Part describes the channels through which these benefits will be achieved.

Sales tax reform, by lowering the cost of capital and improving the competitive position of domestic producers, will stimulate investment demand and net exports.

While consumption growth will slow initially, it will strengthen in due course because of rising employment and income. Thus, aggregate demand will expand over time toward the higher supply potential. The challenge that Canadians face is to achieve these benefits as quickly and as smoothly as possible. This can be done if there is no inflationary response to the one-time increase in the price level due to the introduction of the GST. Inflationary price and wage behaviour would, on the other hand, threaten sustained economic growth and delay the achievement of the economic benefits that the GST makes possible.

Section 3 of this Part describes the adjustment of the economy to the higher level of potential output. Section 4 describes the fiscal impact of replacing the FST with the GST.

2. The Benefits of Sales Tax Reform

Potential output is the maximum volume of goods and services an economy can produce when all its resources are fully utilized in the most efficient manner possible. Potential output is thus determined by the supply of labour and capital and by the efficiency (or total factor productivity) with which these resources are combined to produce the output of our economy.

Growth in the labour supply over a long period is primarily determined by the birth rate, net immigration, social factors, and how individuals value the choice between work and leisure. The influence of sales tax reform on these is expected to be small.

On the other hand, the positive influence of sales tax reform on factor productivity and competitiveness, and on the size of the capital stock, is expected to be large.

- First, the GST will reduce the FST-induced biases that affect consumption and production. It will eliminate the bias in favour of imports and eliminate the hidden tax on exports, thus improving the international competitiveness of Canadian producers. Improved competitiveness will lead Canadian business to expand operations and jobs. The GST will also ensure that the relative prices of competing goods and services better reflect underlying economic costs. This will result in decisions that use resources more efficiently, leading to significant increases in total productivity and potential output.

- Second, the GST, by fully refunding the tax on business inputs, will lower the cost of capital goods, thereby generating higher levels of investment, a larger capital stock, and greater potential output.

These effects are illustrated in Chart 2.

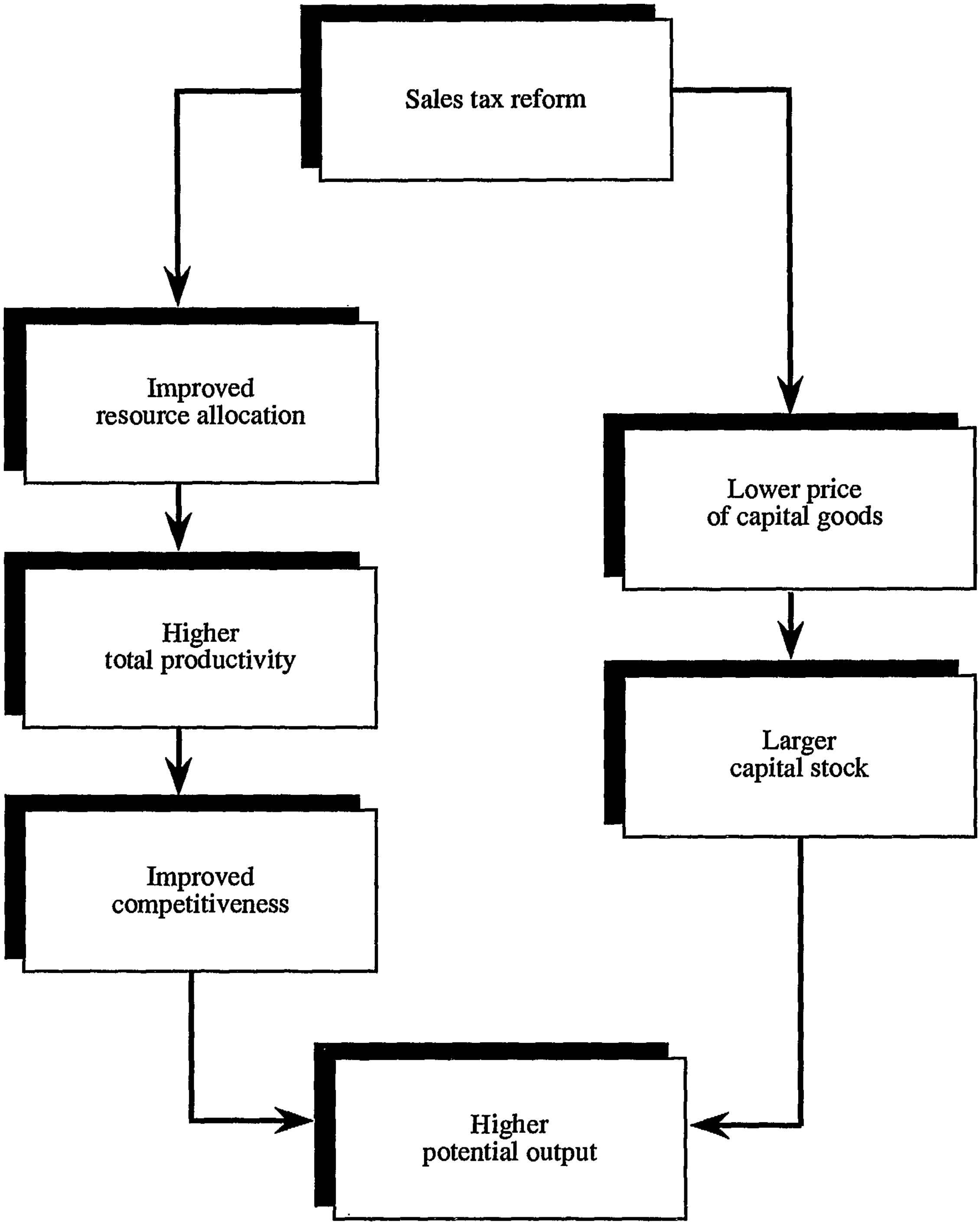
Higher Total Factor Productivity

The present federal sales tax leads to an inefficient allocation of resources in the economy because it distorts relative prices. These tax-induced distortions occur across both input costs and final selling prices for goods and services. The distortions to relative prices arise because of the four different FST rates, the widespread exemptions from the FST, and the early stage in the production and distribution chain at which the FST is levied.

As an example of the highly uneven burden of taxation on business inputs, most machinery and equipment purchased by the manufacturing sector is exempt from the FST, while a much greater proportion of the machinery and equipment purchases in other sectors of the economy is subject to tax. Even within categories of similar inputs the effective tax rates can vary widely. And the distortions to relative prices can become magnified as goods and services move beyond the manufacturing stage at which the tax is levied and toward the consumer. Distorted prices lead to distorted choices: the economy is not using its resources in the most

Chart 2

Impact of GST on Potential Output



efficient manner possible. This depresses potential output by reducing total factor productivity.

With the GST, the tax-induced distortion of relative prices will be reduced. The new tax has only one rate, is applied on a much broader base, and fully removes tax from the production process. It will ensure that the relative prices of competing goods and services for producers and consumers better reflect underlying economic costs, leading to decisions that result in more efficient use of the economy's available resources. Consequently, for the economy as a whole, there will be an increase in productivity and potential output.

To measure the gains in long-run efficiency, the Department of Finance has developed a general equilibrium model of the Canadian economy. A detailed description of this model will be available in a Departmental Working Paper – *The Goods and Services Tax: A General Equilibrium Analysis.*[2] The model incorporates the key aspects of the sectoral and regional structure of the economy and measures gains in efficiency achieved by reducing tax-induced price distortions.

The implementation of the GST is estimated to expand the supply capacity of the Canadian economy by 1.4 per cent. Of this, 0.9 per cent represents the increase in national income resulting from higher total factor productivity. The remainder of the 1.4-per-cent increase represents increased production stemming from a larger capital stock.

Higher Investment and a Larger Capital Stock

For many sectors of the Canadian economy, the current sales tax system penalizes investment in capital goods by taxing capital purchases. Indeed, roughly one-third of all investment expenditures in the Canadian economy is subject to the FST.

Under the GST, purchasers of capital goods will be able to claim a credit for taxes paid on such input purchases. This will be equivalent to reducing the price of capital goods by an average of 4 per cent. The actual reduction will vary significantly from industry to industry, depending on the extent to which purchases of capital goods are subject to the FST. In the services sector, for example, most capital purchases are subject to the FST; a relatively large decline in capital costs can thus be expected.

Lower capital costs will increase incentives to invest, resulting in a significant long-run increase in the economy's capital stock. For example, it is estimated that a 4-per-cent decline in the cost of capital could ultimately increase the Canadian economy's stock of capital goods by as much as 4 per cent.

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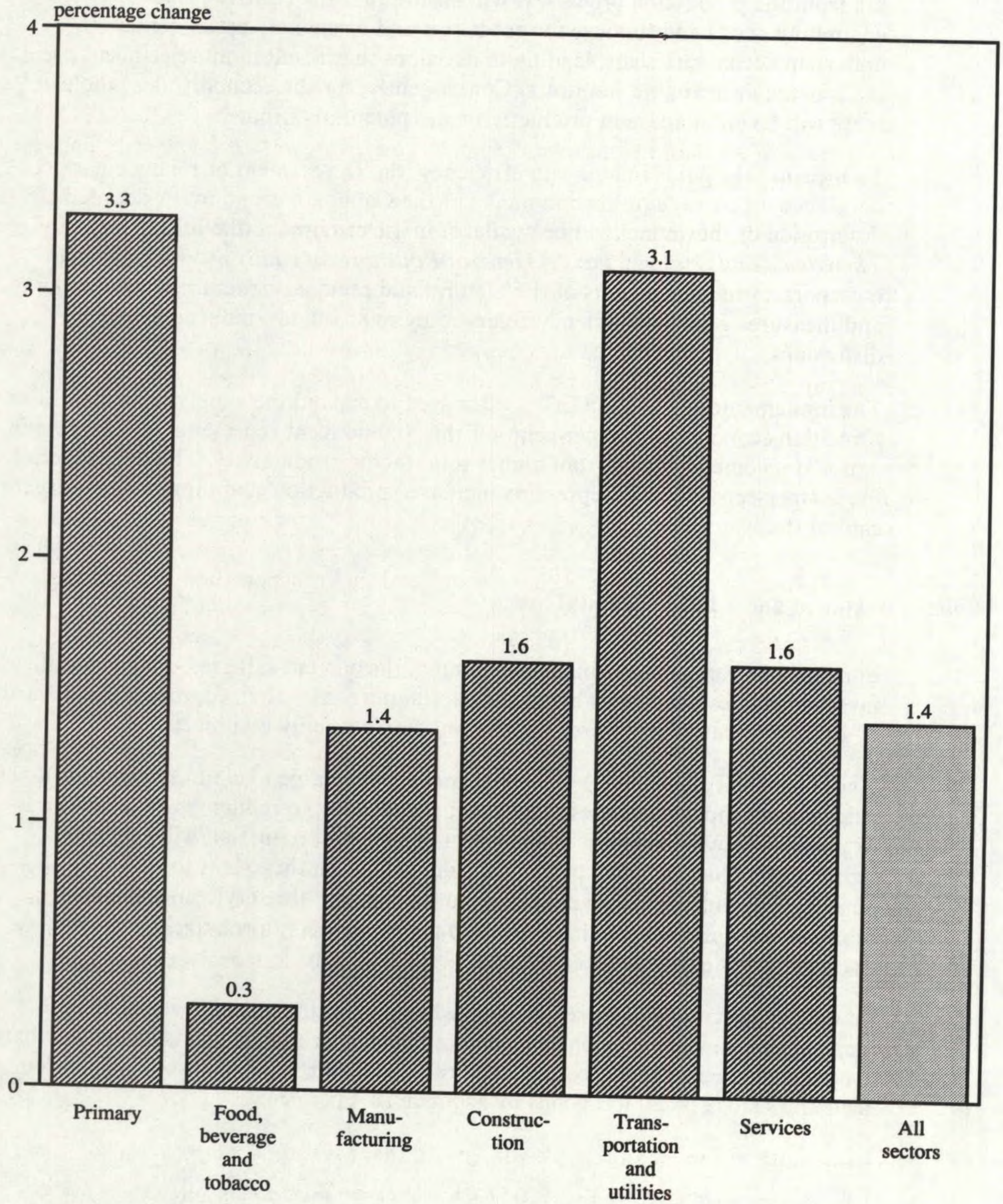
(2) See Department of Finance Working Paper 89-3. A similar model was used to estimate the gains from the Canada-U.S. Free Trade Agreement. See *The Canada-U.S. Free Trade Agreement: An Economic Assessment*, Department of Finance, 1988 and *A Guide to the GET Model*, Department of Finance Working Paper 88-10.

Chart 3

Long-Run Sectoral Output Gains From Sales Tax Reform



Source: Department of Finance, *The Goods and Services Tax*, April 1989 budget, p. 16.

Widespread Sectoral and Regional Benefits

The improvements in Canada's potential output through increases in productivity and competitiveness, and in the capital stock will be widely spread through the different economic sectors and regions.

Sectoral and regional effects will reflect the impact on both output prices and input costs of the replacement of the FST with the GST. For output prices, the GST lowers the effective tax rate on manufactured goods. This will tend to lower their prices relative to those of other goods and services. Conversely, the GST increases the tax burden on some other goods and most services. This will tend to increase their relative prices.

For input costs, however, the reverse occurs. The removal of the FST effectively eliminates the taxation of capital goods and other inputs currently paid by most sectors. The sector benefiting least from lower input costs will be manufacturing where, as noted above, a fairly large proportion of purchases is already exempt from the FST, particularly machinery and equipment used in production. For non-manufacturing sectors including the services sector, however, the removal of the FST will lower their costs, encouraging them to increase their output, either for the domestic market or for export.

The Department of Finance general equilibrium model captures the effects that sales tax reform will have on the major sectors of the economy through changes in both output prices and input costs. The analysis shows significant above-average potential output gains in the primary sector and the transportation and utilities sectors (see Chart 3). This is largely because these sectors are highly capital-intensive and many of their capital purchases are subject to the FST. As well, in the transportation sector in particular, the 13.5 per cent FST also applies to important non-capital inputs such as fuel.

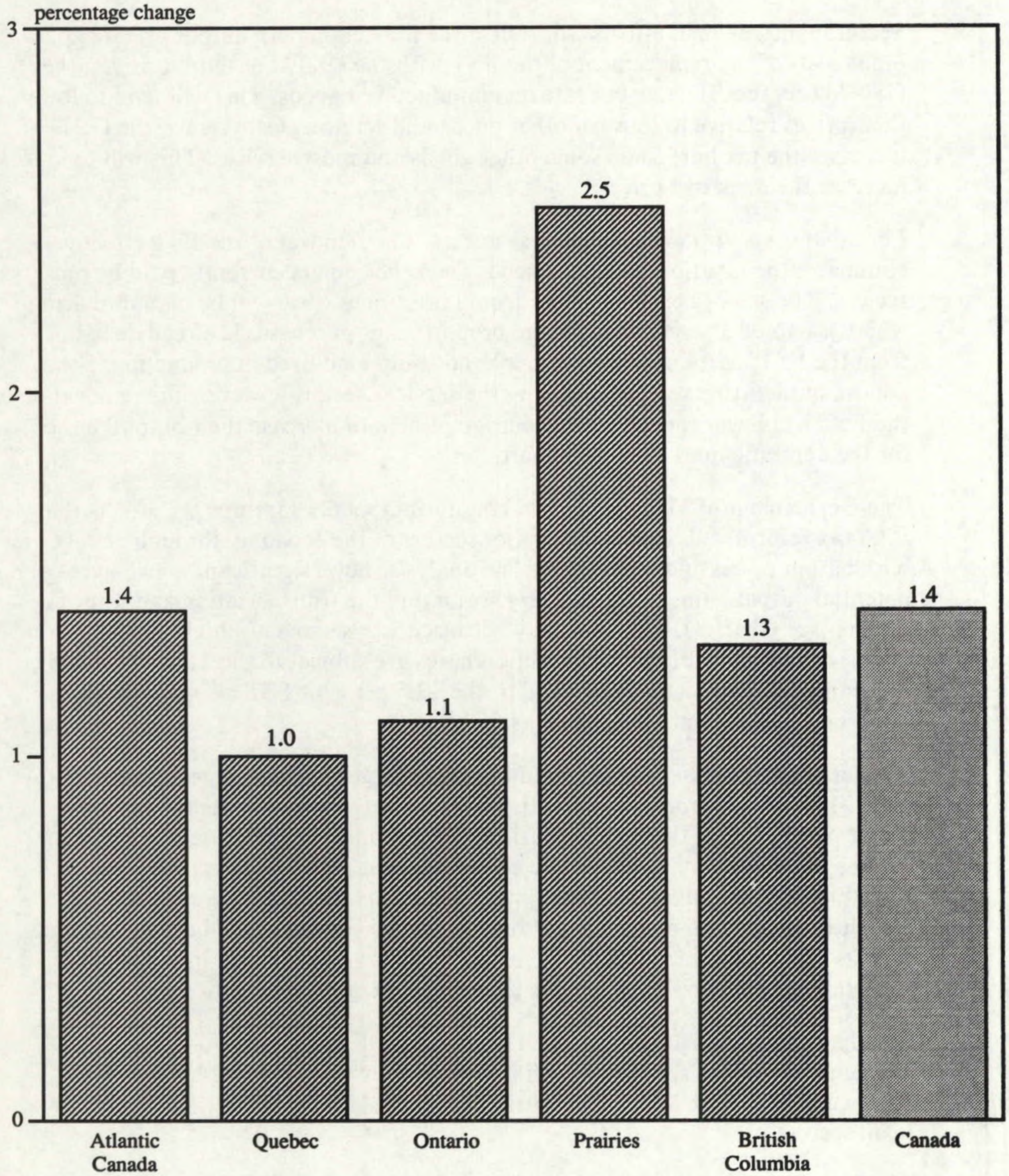
The services sector is also estimated to realize larger than average long-run output gains. This results from the high effective FST rate on the inputs the services sector purchases. In the case of tourism, for example, an FST rate of 9 per cent applies to building materials, while a 13.5 per cent FST applies to the fixtures, furniture and equipment for hotels and restaurants. For business services, there is currently a loss of competitiveness due to the 13.5 per cent FST burden on inputs such as office equipment. With the broad liberalization of trade internationally, it is particularly important to remove this impediment to competitiveness.

Finally, the removal of the current 11-per-cent federal sales tax on telecommunications services, which is largely an input tax borne by domestic producers, will be an additional source of stimulus to Canadian producers in all sectors.

The breadth of the sectoral gains will ensure that regional benefits are also widespread (see Chart 4). Western and Atlantic Canada will particularly benefit from sales tax reform because manufactured products, on which the GST will be

Chart 4

Long-Run Regional Output Gains From Sales Tax Reform



Source: Department of Finance, *The Goods and Services Tax*, April 1989 budget, p. 18.

rebated, are especially important as inputs into their capital-intensive, export-oriented industries. The benefits to the services sector are also important for ensuring widespread regional output gains, because services account for a large portion of total output in all regions.

3. Managing the Transition

From its first year of implementation, sales tax reform can put the economy onto a path of increased output and employment as it adjusts towards the higher level of potential output.

Direct Economic Impact on Aggregate Demand

As earlier sections have shown, sales tax reform will raise the level of Canada's potential output by lowering the cost of capital and by reducing tax-induced distortions in relative prices. Relative price changes resulting from sales tax reform will also have important direct effects on the major components of aggregate demand. Net exports and investment will be stimulated although these increases in aggregate demand will be partially offset initially by lower consumer expenditures. Lower personal income taxation, enhanced sales tax credits, and other aspects of the GST will also increase aggregate demand. The direct impacts of relative price and income taxation changes on aggregate demand are discussed below.

Improvement of Canada's International Trade Position

Because the FST is applied to inputs, it raises costs for domestic producers, putting them at a competitive disadvantage in both domestic and international markets. The replacement of the FST system with the GST would, on average, reduce exporters' costs by almost one per cent, thereby making Canadian producers more competitive in international markets and increasing job opportunities in export industries. The FST also favours imports because in many cases it is applied to these goods before marketing and distribution costs are incurred. Domestic producers of similar products often must pay the FST after their marketing and distribution costs are reflected in the price. Canadian goods therefore bear a higher tax burden than competing imported goods. For example, for domestic household furniture products, the current effective tax rate is 70 per cent higher than for foreign producers. For office machines and equipment, the margin is over 65 per cent. Canada is the only country in the industrial world to have a tax that favours imports over its own domestic production.

Replacement of the FST with the GST will correct these flaws. First, the introduction of the GST will eliminate the bias in favour of imports by applying a uniform tax on both imports and domestic goods and services, regardless of when costs are added to imports. The playing field will be levelled. This will raise the competitiveness of Canadian producers, leading to a substitution of domestic production for imports. Second, removal of the tax on inputs will strengthen the international competitiveness of Canadian products in both domestic and international markets. This will lead Canadian business to expand operations, increasing the demand for plant and equipment and for labour.

Increase in Plant and Equipment Investment

The GST will lower the price of capital goods because the tax will be rebated. Investment will rise. The incentive to increase investment will be largest for non-production machinery and equipment which is not exempt from FST, since they are taxed at a higher rate than buildings. Nevertheless, the demand for non-residential buildings will also rise. In addition, as producers adjust to the change in the composition of aggregate demand over time, further investment will be induced.

Positive Income and Consumption Effects Over Time

The GST will be paid by consumers at the final point of sale. At 9 per cent, the tax is estimated to result in a one-time increase in the consumer price index of about 2 1/4 per cent[3]. This initial one time increase in consumer prices arises in part because of the change in the structure of the tax and in part because of the additional sales tax revenues being raised to provide compensating measures to low- and middle-income Canadians, such as the enrichment of the sales tax credit and reduction in personal income taxes. The broadest price measure for the economy – the GDP deflator – will be affected less, since the impact of the rise in consumer prices will be partially offset by lower business input costs. As a result, the increase in the GDP deflator is estimated to be roughly half that of the CPI.

The 2 1/4 per cent direct impact of the GST on the consumer price index overstates the initial effect on the real purchasing power of consumers. The enrichment of the sales tax credit and the reduction in personal income taxes will reduce the direct impact on consumers' purchasing power. The effect on real disposable incomes will thus be considerably less than the initial 2 1/4 per cent rise in consumer prices.

Lower income Canadians, will actually experience a rise in their real disposable incomes. For example (see Table A.5), a one-earner family with two children and $25,000 in income will pay $460 more in sales taxes annually with the replacement of the FST with the GST. Automatic increases in indexation of transfer payments and the personal income tax combined with the enrichment of the sales tax credit will raise the family's real after-tax income by $795. The net effect will be an increase in real purchasing power of $335 annually.

Real personal disposable incomes of middle and upper income households will initially fall so that, in total, real disposable incomes are lower by about

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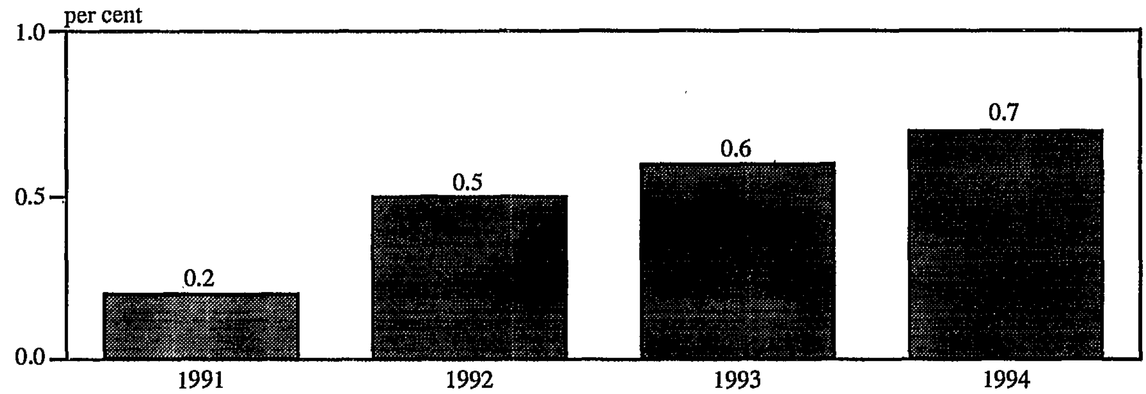
(3) In the April 1989 budget document *The Goods and Services Tax*, the consumer price impact was estimated to be between 2 1/2 and 3 per cent. The revised estimate of 2 1/4 per cent takes account of the effect of the special tax rebates at time of sale for purchases of new homes and refinements to the estimates of the applicable GST tax base.

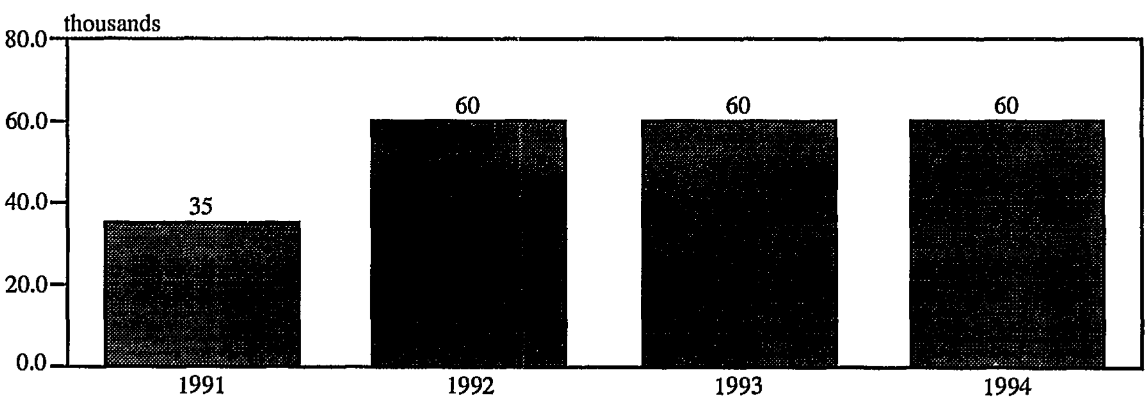
Chart 5

Economic Impact of Sales Tax Reform

Impact on the Level of Real GDP



Impact on the Level of Employment



one per cent. Over time, however, sales tax reform will result in higher real purchasing power for all Canadians.

- First, the estimated initial impact on real purchasing power does not include savings from the effective elimination of federal sales taxation of business capital inputs. Over time, these savings will be passed forward to consumers in the form of lower prices. Competitive forces will speed the process by which consumers will realize these benefits.

- Second, the improvements in productivity resulting from sales tax reform will, over time, lead to higher real incomes for Canadian households. This will be reflected in higher levels of consumer spending.

Avoiding an Inflationary Response

How quickly the benefits of sales tax reform are realized will depend crucially on the response of wages and prices to the price level effects of the GST. With restraint, the transition to the benefits will be smooth and relatively fast (Chart 5). In contrast, an unfavourable reaction which initiated an ongoing inflationary response would not only delay the achievement of the benefits, but would also make the transition more difficult.

If producers pass on through lower prices the savings resulting from the elimination of the FST, and if wage bargainers do not seek to pass the initial price impact through to labour costs, the price impact will be minimized and confined to a one-time adjustment in the price level. The Canadian economy would immediately be in a position to take advantage of the lower input costs, increased total productivity, and improved international competitiveness that the GST will bring. Real output would be higher through the entire transition to the longer-run gains in potential output.

It is estimated that in an environment of wage and price moderation, real GDP and employment would begin rising in the first year and, by the fourth year, half of the long-run real GDP gains, about 0.7 per cent or $4 1/2 billion in today's dollars, could be realized. This higher output would generate an increased demand for labour, leading to higher employment and a lower unemployment rate. Indeed sales tax reform could raise employment from the start and create 60,000 new jobs as early as 1992.

An inflationary price-wage response to the GST, on the other hand, would delay realization of the benefits and result in less favourable employment and output effects during the transition. Unit labour costs of Canadian firms would rise relative to those of foreign producers, offsetting the direct competitive advantages brought about by replacing the FST with the GST. Instead of a net export gain, net export losses could occur in the transition period. Rising inflation would also induce upward pressure on short-term interest rates, which would moderate aggregate demand.

An inflationary wage-price response to tax reform would not eliminate the benefits of replacing the FST with the GST. Total productivity, the capital stock, potential output, and Canada's international competitiveness would still ultimately be improved. The attainment of these benefits, however, would be delayed.

The price and wage responses to sales tax reform will have important implications for macroeconomic policy. With wage and price moderation, there would be no ongoing inflationary consequence of sales tax reform. In this environment, interest rates need not rise. In contrast, an inflationary response to sales tax reform would damage the prospects for sustained economic growth, and would require that macroeconomic policies be adjusted in order to counter inflationary pressures. Clearly, avoiding an inflationary response to the introduction of the GST serves the interest of all Canadians by ensuring that the benefits of sales tax reform are realized smoothly and quickly.

4. Fiscal Impact of Sales Tax Reform

Sales tax reform will encourage investment, enhance productivity and raise the economy's potential output. Achieving the benefits of sales tax reform will assist the government in reducing the deficit, controlling the debt, and ensuring a more stable and reliable source of tax revenues. The experience of the 1980s has emphasized that the existing sales tax system is highly unstable. Sales tax reform will establish a more solid basis for the government's fiscal planning.

Direct Fiscal Impact

Based on the economic assumptions underlying the 1989 budget, the GST, levied at 9 per cent on a broad base, and expressed in 1991 dollars for a fully implemented system, is estimated to yield about $24 billion in federal revenues. This figure is the net revenue available after providing GST rebates to provincial governments, charities, non-profit organizations, hospitals, school boards, municipalities, libraries, colleges and universities. Furthermore, this figure is also net of the housing rebate and the small business compensation fee, which in most cases, will be netted directly against tax liability by the vendor. The GST replaces the FST, which in 1991 would have yielded projected net revenues of about $18 1/2 billion. As a result, the replacement of the FST by the GST is estimated to result in higher sales tax revenues of about $5 1/2 billion.

This increase in sales tax revenues is primarily being used to increase the refundable sales tax credit, to reduce the middle income tax rate and to compensate for the one-time price adjustment on those components of budgetary revenues and expenditures that are indexed to the change in prices (see Table B.1).

The measures to protect lower and modest income Canadians are largely delivered through the personal income tax system. First, the refundable sales tax credit is being replaced by an enhanced Goods and Services Tax Credit. The total value of the GST Credit will amount to $3.6 billion in 1991, representing an increase of about $2.4 billion over the current refundable FST credit. Second, the middle income tax rate is being reduced from 26 to 25 per cent. As well, the one-time increase in prices will raise the indexation of personal income tax brackets and credits and of payments under various social programs, such as elderly benefits, family allowances and veterans pensions. In total, the measures designed to assist lower and middle income Canadians amount to about $5 billion in 1991.

The reduction in the middle income tax rate and the one-time price impact of sales tax reform will result in higher payments to the provinces, most notably under Established Programs Financing. There are also additional operating costs associated with administering the new tax system. The measures to assist low and modest income Canadians and the impact of sales tax reform on budgetary expenditures roughly offset the increase in indirect tax revenues. As a result, the overall fiscal situation is essentially unaffected by the direct impact of sales tax reform.

Table B.1

Sales Tax Reform: Fiscal Offsets

	Full year impact
	(billions of 1991 dollars)
Enhanced GST Credit	2.4
Middle income rate reduction	0.7
Price impact	
Indexation of personal income tax system	0.8
Transfers to persons (OAS, family allowances, – etc.)	0.9
Transfers to provinces	0.3
Administration costs	0.2
Total fiscal offsets	5.4

Details may not add due to rounding.

Fiscal Impact in the Medium Term

The net impact of sales tax reform on the government's medium-term fiscal strategy will be largely determined by how the transition to the long-run benefits of sales tax reform is managed. With price and wage moderation, the economic benefits of sales tax reform will accrue quickly and smoothly. The resulting increase in economic growth and employment would complement the government's strategy for deficit reduction and debt control.

In a situation of rising wage and price inflation, however, the economic benefits of sales tax reform would take more time to materialize. The adjustment path of the economy to these benefits would be more difficult.

5. Conclusions

The benefits to the Canadian economy from sales tax reform will be substantial. Because of the removal of tax-induced distortions, there will be an improved and more efficient allocation of resources in the economy leading to an improvement in competitiveness. Investment spending will be encouraged, and the capital stock raised. Canada's potential output – its ability to supply goods and services – will be increased by an estimated 1.4 per cent or $9 billion. As the gains in potential output are realized, the structure of the Canadian economy will change. The economy will become more investment oriented. Exporters will become more competitive internationally and our domestic producers will be on a level playing field with imports. The Canadian economy will be more productive. This will translate into higher incomes and a higher standard of living for all Canadians.

The challenge Canadians face is to achieve these benefits as smoothly and as quickly as possible. This will require moderation in wage and price behaviour as the GST is being implemented. If an inflationary response is avoided the Canadian economy and employment could grow more strongly beginning in the first year of implementation. Department of Finance estimates indicate that after four years the economy's output would be 0.7 per cent higher and 60,000 new jobs would be created. This increase in economic growth and employment would complement the government's strategy for deficit reduction and debt control.

Part C

The Design of the GST

1. Overview of the System

The Goods and Services Tax is a tax on the consumption of goods and services in Canada. From the perspective of final consumers, the tax will be very much like existing retail sales taxes operated by the provinces. GST will apply at the rate of 9 per cent to most retail sales.

The major difference between the GST and the provincial sales tax systems will be its operation at pre-retail levels. While businesses throughout the production and distribution chain, including retailers, will charge tax on their domestic sales, they also will be able to claim a full refundable credit – known as an input tax credit – for any tax paid on purchases of goods and services used in the course of doing business.

At the end of each reporting period, when a firm files its GST return, it will remit the difference between the tax charged on its sales and its input tax credits for the period. If these credits exceed the amount of tax collected on sales (for example, when a major capital purchase has been made), the difference will be refunded. The basic application of the tax from the perspective of an individual firm is illustrated in Chart 6.

Since the GST will be a tax on domestic consumer expenditures, it will apply to imports, but not to exports. Under the new system, sales tax will be fully removed from Canada's export sales – a significant advance over the existing system. This will be accomplished by charging no tax on export sales while, at the same time, allowing exporters to claim full input tax credits. On the other hand, imports will be fully taxable at the time of importation. Thereafter, they will be treated on the same basis as domestically produced goods.

Like a pure retail sales tax, the GST is a tax on final domestic consumption. They are equivalent taxes that differ only in the way the tax is collected. Effectively, the value added at each stage in the production-distribution process is taxed under the GST, rather than only at the point of final delivery of goods and services to consumers, as is the case under a single-stage retail tax. This is illustrated in Chart 7. The example considers the case of the GST levied at a 9-per-cent rate throughout the production and distribution chain for a household appliance such as a washing machine.

Chart 6

Goods and Services 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	$18,000
Purchases: $150,000	(13,500)
Tax Payable	**$ 4,500**

Tax Refundable
(if negative)

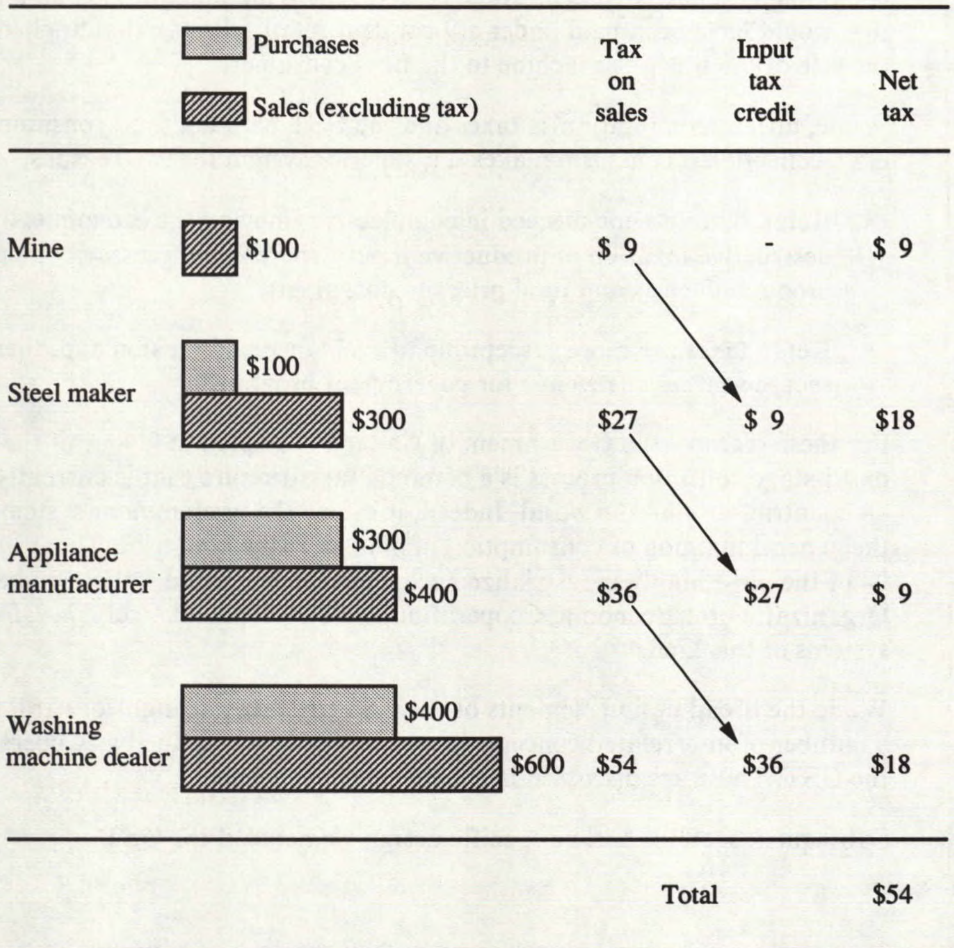
e.g.	Tax*
Sales: $180,000	$16,200
Purchases: $200,000	(18,000)
Tax Refund	**($1,800)**

*Tax rate of 9 per cent.

Chart 7

Goods and Services Tax

Basic Operation



In this example, the production of the washing machine begins with the mining of iron ore. To simplify the example, the mine is assumed to have no taxable purchases. It sells the ore to a steel maker for $100, plus $9 GST which is remitted to the government.

The steel maker has value-added of $200 and, therefore, sells steel to the appliance manufacturer for $300. The steel maker charges $27 tax on its sale but, because it claims a full input tax credit for the $9 of tax paid on its purchase of iron ore, it remits only the $18 difference. Similarly, the appliance manufacturer uses the steel to make a washing machine which it, in turn, sells to an appliance dealer for $400. Again, a 9-per-cent tax, or $36, is charged on the sale, an input tax credit of $27 is claimed, and the $9 difference is remitted to the government.

At the last stage, the appliance dealer sells the washing machine to a consumer after adding a $200 mark-up. Tax of $54 is levied on the $600 sale, while $18 is remitted after claiming a $36 input tax credit.

As the chart shows, the tax charged at each level is fully refunded at the next stage in the production chain until the sale to the final consumer. The total of the net amounts remitted at each stage is $54. This is identical to the amount of tax that would have been paid under a 9 per cent retail sales tax that applied only on the sale of the washing machine to the final consumer.

While, ultimately, retail sales taxes and the GST both tax final consumption, the GST collection mechanism makes it a superior system for two reasons.

- Retail taxes do not succeed in completely removing the economically destructive taxation of productive inputs, thereby unnecessarily increasing production costs and final prices to consumers.

- Retail taxes are more susceptible to avoidance and evasion and, therefore, less secure sources of revenue for government programs.

For these reasons, the Government of Canada has opted in favour of the GST. The multi-stage collection process is a common tax structure that is currently in use in 48 countries around the world. Indeed, it is now the predominant system used for the general taxation of consumption in industrialized countries. Today, 19 out of 24 of the most highly industrialized economies in the world – the members of the Organization for Economic Cooperation and Development – rely on sales tax systems of this kind.

While the broad design elements of the GST are fairly straightforward, there are a number of interrelated concepts involved in structuring the basic operation of the GST. These are discussed in the following section.

Subsequent sections outline specific design elements of the GST.

2. Basic Operation

2.1 Liability for Tax

Under the GST, the legal liability for payment of tax will rest with the purchaser. The vendor will act as an agent of the federal Crown in collecting the tax and remitting it to the government. This, in essence, is the same liability structure as exists under provincial retail sales taxes. In the case of imports, the legal liability for payment of GST will rest with the importer of record.

Purchasers will be required to pay GST at the rate of 9 per cent on the value of any consideration paid or payable for a taxable supply of a property or service made in Canada. The same rate of tax will apply to the excise- and duty-paid value of imports. Generally, tax will apply on supplies received from a **person** engaged in a **commercial activity**. Sales by persons qualifying for exemption under the **small traders' threshold** will not be taxable.

(a) Person

"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 required to account for GST collected at the partnership level rather than at the level of the individual partners.

(b) Commercial Activity

Every person engaged in a commercial activity, other than a small trader, will be required to collect GST in respect of all taxable supplies made in the course of that activity. In most cases, this will mean that the person is engaged in carrying on a business or otherwise engaged in an adventure or concern in the nature of trade before being required to collect tax. For these purposes, carrying on a business will have the same meaning as under the *Income Tax Act*.

Commercial activity also will include any supply of real property other than a supply of real property specifically exempted (see Section 7).

Since the GST will be a tax on consumption rather than profits, commercial activity will include certain activities of organizations established on a non-profit basis.

The definition of commercial activity specifically will exclude employment or any activity of a person to the extent that it relates to the supply of exempt goods or services by that person. Also excluded will be any activity carried on by an individual essentially as a recreational pursuit or hobby, or with no reasonable expectation of profit.

(c) Small Traders' Threshold

Sales made by a person in the ordinary course of a commercial activity which, in total, do not exceed $30,000 per annum will not be subject to GST. Persons qualifying under this small traders' threshold will not be required to collect GST on their sales or permitted to claim input tax credits for the tax paid on their purchases. The small traders' exemption will not apply to sales of real property. The rules for small traders are discussed in more detail in Section 4.1.

2.2 Supply

This Section discusses the treatment of domestic supplies. The application of GST to imported goods and services is discussed in Section 2.5.

Every person who acquires a taxable supply made in Canada will be liable to pay tax in respect of the supply calculated on the value of the consideration paid or payable for the supply.

The concept of "supply" is central to an understanding of the workings of the GST. In many instances, the term will be synonymous with the word "sale". However, in addition to sale, the definition of supply will include any 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 broad, generally there will be no GST consequences in respect of a supply made in the course of a commercial activity until payment is made or becomes due for the supply. For example, a supply would exist when a vendor accepts an order from a customer. Yet, there will be no GST implications until the vendor either invoices the customer or receives payment from the customer for the goods supplied or services rendered, whichever is earlier.

The following amounts will not be treated as consideration for a supply:

- revenues from supplies made outside Canada;
- most receipts in respect of a right to explore for and/or exploit a natural resource;
- revenues received from the sale of a business (i.e., a "transfer of a going concern");
- sports and gambling winnings; and
- government grants and subsidies.

(a) Taxable Supply

A taxable supply will be defined as any supply, other than a tax-exempt supply, made in the course of a commercial activity. Technically, this will include a supply to which a zero rate of tax applies. However, to simplify the presentation in this paper, taxable supply will mean only those supplies on which tax is payable; that is, it will include neither a tax-exempt nor a zero-rated supply. These two terms are described below.

(b) Tax-Exempt Supply

No liability for GST will arise on a tax-exempt supply. However, a person making tax-exempt supplies will not be able to claim input tax credits in respect of GST paid on purchases to the extent these are for use in making exempt supplies.

Tax-exempt supplies will include:

- long-term residential rents and sales of used housing;
- most health and dental services, including hospital and nursing home services;
- day-care services;
- legal aid services;
- most educational services;
- most supplies by charities;
- certain supplies by non-profit organizations, governments and other selected public sector organizations; and
- most domestic financial services.

These exemptions are discussed in detail in Sections 3, 7, 8, 9 and 11.

(c) Zero-Rated Supply

Zero-rated supplies are supplies to which a zero rate of tax applies. As the name implies, vendors will not be required to charge GST on zero-rated supplies. However, unlike the treatment of tax-exempt supplies, persons making zero-rated supplies will be able to claim input tax credits in respect of any tax paid on purchases relating to the making of zero-rated supplies. In other words, a zero-rated supply will be completely free of tax. In this paper, the terms zero-rated and tax-free are synonymous.

Consistent with the principle that the tax should only apply to consumption in Canada, exports of goods and services will be zero-rated (see Section 2.6). This will ensure that exports are completely relieved of GST.

Moreover, supplies of basic groceries, prescription drugs and medical devices also will be zero-rated. These are discussed in greater detail in Section 3.1.

(d) Supplies Made in Canada

As discussed earlier, GST will apply in respect of supplies made in Canada. In determining whether a supply is made in Canada, separate rules will apply depending on the nature of the supply.

A supply will be considered to be made in Canada if

- in the case of tangible personal property (i.e., a good), it is delivered or made available in Canada to the person to whom the supply is made;
- in the case of intangible personal property (such as intellectual property rights), the recipient of the supply is resident in Canada or resident outside Canada and registered to collect GST, and the property is for use or benefit in Canada;
- in the case of real property or a service in respect of real property (for example, architectural services), the property is situated in Canada;
- in the case of a supply of a telecommunications service, the bill for service applies in respect of a terminal or station situated in Canada; and
- in the case of any other supply of service, the service is performed in whole or in part in Canada.

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

(e) Timing of Liability for Tax

Liability for payment of GST on a taxable supply made in Canada will arise on the earlier of the day on which payment for the supply is made, or the day on which the payment for the supply becomes due. The application of the rules that will be used to determine when an amount becomes due for GST purposes is illustrated below. To facilitate compliance with the tax, these rules have been designed to ensure that the timing of liability for GST coincides with the time at which vendors normally record sales transactions in their books of account.

(i) Invoiced Supplies

For most supplies, the day on which payment becomes due will be deemed to be the date of the invoice issued by the supplier (or the day on which the invoice is issued if this precedes the date of the invoice). "Invoice" will be defined to mean a written notification of an obligation to make a payment, and will include a statement of account, a bill, cash register receipt and any other similar record issued by a vendor in respect of a supply. If there is an undue delay in issuing an invoice for a taxable supply ("undue delay" being determined with reference to the usual invoicing practices of the supplier), the date that the invoice would have been issued will be used to determine the time at which a liability for GST arises. This test will be similar to the one contained in paragraph 12(1)(b) of the *Income Tax Act*.

(ii) Leases and Other Agreements in Writing

For supplies made by way of lease, contract or other agreement in writing (excluding an invoice), the date on which payment becomes due will be the date on which the recipient is required to pay consideration for a supply to the vendor as specified in the written agreement.

(iii) Real Property

For sales of real property, liability for GST will be triggered on the earlier of the date on which ownership is transferred or the date on which the purchaser takes possession under the agreement of purchase and sale.

(iv) Continuous Supplies

The rules governing invoiced supplies generally will apply in the case of continuous supplies. In other words, goods or services supplied on a continuous basis, (or made available on a continuous basis) by way of wire, pipeline or other conduit (e.g., steam, electricity, natural gas, telecommunications services, etc.) generally will be taxed on the date the supplier issues an invoice or the date of the invoice, whichever is earlier.

(v) Progress Payments

Where consideration for a taxable supply becomes due on more than one day pursuant to an arrangement for progress payments in respect of construction-in-progress, tax will become payable on each progress payment as it is given or becomes due, whichever is earlier.

(vi) Deposits

No tax will become payable on a deposit in respect of a subsequent supply until the deposit is credited against the consideration due for the supply or the deposit is forfeited. Where a deposit with respect to a taxable supply is forfeited, the amount forfeited will be treated as a GST-included sum. Consequently, tax on a forfeited deposit will be equal to 9/109ths of the forfeiture.

(vii) Consignment Sales

Title to goods delivered on consignment, approval or other similar terms generally does not transfer to the consignee until the goods are resold by the consignee. Accordingly, under the general rule for invoiced supplies, liability for tax on the transfer to the consignee will not arise until the time the consignor invoices the consignee for the goods, or the consignee makes payment for them, whichever is the earlier. However, where an invoice is not issued or is long delayed, the override rule described in subsection (f) below would apply. In this case, the tax in respect of the transfer to the consignee will be payable at he end of the month following the month in which the consignee sold the goods.

(viii) Coin-Operated Machines

For purposes of calculating their net tax remittances/refunds, vending machine operators and other operators of coin-operated devices will be deemed to have collected GST on their sales on the day on which they remove money from the machine.

(f) Override Rule

In the vast majority of cases, the rules governing the timing of liability will coincide with the time at which the transaction normally would be recorded in the supplier's books of account.

However, instances will arise where the normal practice of the supplier is not to issue an invoice or to delay issuing an invoice for a lengthy period of time following completion of a supply. To cover off these eventualities, there will be a general override rule specifying that the time at which a GST liability arises in respect of a supply can never go beyond one month following the month in which the supply is completed. In other words, if a supply is completed, say, on the 15^{th} day of a month, and the recipient has not paid for the supply and the supplier has not invoiced the recipient for the supply, the liability for GST will occur approximately 45 days later: that is, on the last day of the month following the month in which the supply is made. This grace period is designed to accommodate those businesses which, for a variety of reasons, normally have lengthy delays in issuing invoices.

For purposes of determining when a supply is completed, the following rules will apply:

> **Ordinary Sale of Goods** – the earlier of the day on which the goods are delivered or title transfers to the purchaser.
>
> **Consignment or Approval Sales** – the day on which the consignee supplies them to another person or otherwise acquires ownership of the goods. If the goods go unsold, or are returned to the consignor, no GST liability will arise.
>
> **Services** – the day on which the service is substantially completed.
>
> **Construction Contracts** – the day on which the construction, renovation, alteration or repair specified in the contract is substantially completed. This provision also will apply in respect of a contract for the construction, renovation, alteration or repair to a ship or marine vessel where the work will require more than three months to complete.

Notwithstanding the general override rule for determining the time at which tax becomes payable, where part of the consideration for a supply is not ascertainable, GST will not become payable on that part until it becomes ascertainable.

2.3 Input Tax Credits

(a) Basic Approach

All persons (other than small traders), who are engaged in a commercial activity will be obliged to collect and remit GST on their taxable supplies. However, only those who have registered to collect the tax – referred to as "registrants" or "registered vendors" – will be entitled to recover the tax paid on their purchases. This will be accomplished by determining, for each registrant's reporting period, a refundable "input tax credit" entitlement. This entitlement will be the total of

- the tax paid or payable on purchases of taxed goods and services in Canada, and
- the tax paid or payable on goods imported into Canada,

to the extent such goods and services were acquired for use in a commercial activity.

Input tax credits claimed by a registrant for a reporting period will be subtracted from the tax collectible by the registered vendor on any taxable supplies made in that period in order to determine the registrant's net tax remittance or refund.

There will be no requirement to match purchase and sales records prior to claiming an input tax credit on a particular purchase. For example, inventory acquired in one reporting period may not be resold for many months. It will **not** be necessary for a business in these circumstances to wait until the inventory is resold in order to claim its input tax credit for the tax paid on the inventory. Rather, the credit will be claimable in the period in which the tax on the purchase has been paid or became payable.

Similarly, input tax credits will be allowed in full when the tax is paid or payable on purchases of capital property and other property such as office supplies. There will be no requirement to amortize the credit over the life of business assets, although special rules will apply in the case of certain passenger vehicles. These special rules are discussed below in subsection (f).

As a result, business assets and inventories held in the course of a commercial activity effectively will be free of GST. This will represent a significant improvement over the current federal sales tax which results in a substantial amount of non-recoverable tax on business inputs – an inappropriate outcome in the context of a tax on final consumer expenditures.

Since input tax credits will be claimed only for purchases that have borne tax, registrants will not be eligible for input tax credits on certain payments, including:

- payments in respect of wages and other remuneration (Contributions to pension plans, deferred profit-sharing plans and other deferred compensation plans, pension payments, group life insurance premiums, retiring allowances and other similar payments for the benefit of employees will be treated like wages. They will not be taxable and, therefore, will not give rise to any credit entitlement);

- payments in respect of interest and dividends;

- payments for tax-exempt and zero-rated supplies. (These supplies, by definition, will not be taxable when sold to the purchaser and, accordingly, will not entitle the purchaser to any input tax credit); and

- federal, provincial and municipal taxes, and most other licence fees, fines, penalties and other statutory levies.

(b) Tax Paid or Payable

Input tax credits will be claimable in respect of GST paid or payable on a taxable supply acquired by a registrant in the course of a commercial activity. Generally, registrants will become entitled to claim an input tax credit at the same time that the person supplying goods or services to the registrant incurs a liability to collect tax on the supply. However, there will be differences in two circumstances:

(i) Any tax invoiced to a purchaser will be creditable to the purchaser when invoiced. Consequently, where there is an undue delay in issuing an invoice to the purchaser, under the normal liability timing rules, the supplier will be under an obligation to remit tax before the purchaser obtains his or her invoice and is able to claim an input tax credit.

(ii) Similarly, the override rule for completed supplies, in some instances, will result in an obligation on the supplier to remit tax prior to issuing an invoice to the registrant-purchaser.

(c) Supporting Records

Registrants will be required to maintain adequate books and records to enable verification of GST paid on purchases and input tax credit entitlements. For the most part, meeting this requirement will involve little more than maintaining records already kept for income tax purposes.

As certain items will not be subject to GST, a registrant generally will not be able to claim an input tax credit for the tax on a purchase until a satisfactory invoice or other documentation of tax paid or payable has been obtained from the supplier. Information requirements on supporting documents are discussed below in Section 2.4.

While registrants will be required to maintain adequate books and records for audit verification purposes, these will **not** have to be filed with their GST returns. The retention period for books and records under the GST will be the same as for income tax purposes – six years.

(d) Imports

GST will be payable on the excise- and duty-paid value of goods at the time of importation. The GST paid or payable on imports will be included in determining the registrant's input tax credit entitlement in the normal manner.

(e) Apportionment Rule for Input Tax Credits

Where GST is paid or payable by a registrant on a purchase or importation, the registrant will be allowed to claim an input tax credit **to the extent the acquisition is for use in a commercial activity of the registrant.** Accordingly, if a good or service is for use exclusively in a commercial activity of a registrant, the tax paid will be fully creditable; conversely, if it is not to be used at all in a commercial activity, no credit will be permitted.

As a result, apportionment rules are needed only in those cases where registrants make exempt as well as taxable or zero-rated supplies or where they make personal use of business inputs. With certain exceptions, discussed below, a credit will be available only to the extent that the purchased input may reasonably be regarded as being for use in the commercial activity. For example, if the business use is 60 per cent, only 60 per cent of the tax on the purchase will be creditable.

The proportion of creditable input tax will vary, depending on what is reasonable in the circumstances. For example, in the case of a ten-story building with exempt apartment rentals on the second through tenth floors and a shopping concourse on the first floor generating commercial rents, square footage could serve as an appropriate basis for prorating input tax credits on the building.

Even though a purchase of goods or services may relate to a commercial activity, in certain circumstances the purchase may not generate an 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. These rules are described in subsections (f) and (g) below. Moreover, special simplified rules will apply in the case of capital goods. These provisions are discussed in subsection (h).

(f) Restrictions on Credits

(i) Club Memberships

No input tax credit will be allowed for GST paid on membership fees or dues in any club whose main purpose is to provide dining, recreational or sporting facilities. This provision will parallel the restrictions on club memberships under the *Income Tax Act.*

(ii) Personal or Living Expenses

No input tax credit will be allowed in respect of any personal or living expenses of a registrant. Travelling expenses incurred by a registrant while away from home on business will not be considered personal or living costs. Subject to the restriction on meals and entertainment expenses discussed below, GST paid on business travel expenses will be creditable in the normal manner.

(iii) Passenger Vehicles

For the most part, the rules for input tax credits in respect of the purchase or lease of passengers 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 the income tax threshold (i.e. $20,000) or that portion of the annual lease cost of the vehicle which relates to its value in excess of the threshold.

The definition of "passenger vehicle" for GST purposes will be the same as in the *Income Tax Act*. In other words, the definition will include any motor vehicle designed or adapted to carry not more than the driver and eight passengers. The following are excluded from the *Income Tax Act* definition and, hence, will not be subject to the GST rules for passenger vehicles:

- ambulances;

- motor vehicles acquired primarily for use as taxis or in connection with funerals;

- motor vehicles acquired for resale, leasing or rental purposes; and

- vans and pick-up trucks designed or adapted to carry not more than the driver and two passengers and used primarily for the transportation of goods or equipment in the course of a business.

Subject to the income tax threshold restriction, any GST paid or payable by a registrant on the purchase or lease of a passenger vehicle made available to an employee normally will be fully creditable, while any related employee benefit reported for income tax purposes will be subject to GST. Employee benefits are discussed in the following subsection.

A registered self-employed individual who acquires a passenger vehicle all or substantially all for use in a commercial activity will be entitled to claim a credit in the normal manner for the GST paid on acquisition of the vehicle. However, applying the normal rules where a passenger vehicle is acquired partly for commercial use and partly for non-commercial use would significantly complicate registrants' compliance with the tax in many instances. In particular, the application of change-of-use rules on a regular or recurring basis would be burdensome. Moreover, under the normal rules for capital goods (discussed in subsection (h) below), if the automobile were not primarily (i.e., at least 50 per cent) for use in a commercial activity, no input tax credit would be allowed.

To avoid these difficulties, where a registered self-employed individual purchases a passenger vehicle partly for non-commercial use, he or she will not be allowed to claim an input tax credit in respect of the vehicle in the reporting period in which the vehicle was acquired. Rather, a registered self-employed individual will be entitled to claim a credit equal to 9/109ths of the capital cost allowance in respect of the vehicle as reported for income tax purposes to the extent the vehicle is for use in a commercial activity. This credit will be claimed on the registrant's GST return covering the end of his or her fiscal year. GST paid on lease payments in respect of a passenger vehicle will be creditable in the normal manner.

In addition to simplifying the GST for self-employed individuals and allowing credit even where the commercial use is less than 50 per cent, under this approach, individuals will not be required to charge tax on any subsequent resale of the passenger vehicle.

The rules for passenger vehicles also will apply for aircraft acquired by self-employed individuals. It should be noted that there will be similar rules for expenses incurred by employees, partners and partnerships in respect of passenger vehicles and aircraft. The provisions relating to employee and partner expenses are discussed in Sections 13.1 and 13.2.

(iv) Meals and Entertainment Expenses

Paralleling the *Income Tax Act* restrictions on meals and entertainment expenses, input tax credits for these expenses will be limited to 80 per cent of the tax paid.

(g) Employee Benefits

As a general rule, the provision of employee benefits will be treated as a supply by the employer to the employee. In many instances, this will entail no GST consequences since the supplies that generate the benefit will be tax exempt. 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 for an exempt educational service; and
- interest-free and low-interest loans.

However, where the provision of an employee benefit by an employer is a taxable supply to an employee, the employer will be required to account for GST on the taxable employee benefit. The GST on the benefit will be equal to 9/109ths of the benefit as calculated for income tax purposes.

A special rule will apply where an employer acquires property or service all or substantially all of which is for the personal use or consumption of an employee (or any related individual). In this case, the employer will not be allowed to claim an input tax credit in respect of the GST paid or payable on the property or service acquired for resupply to the employee and GST will not apply to the employee benefit. For example, the GST paid on the lease by an employer of an automobile solely for the personal use of an employee will not give rise to any input tax credit to the employer. Nor will the employer be required to remit GST in respect of the benefit to the employee as reported for income tax purposes. On the other hand, if the automobile is partly for commercial use and partly for the personal use of the employee, a full input tax credit will be allowed on the acquisition of the vehicle and the benefit to the employee will be subject to GST.

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 GST taxable employee benefits as reported for income tax purposes for the previous calendar year.

The end of February was selected to simplify compliance; by that time, the employer will have calculated employee benefits for income tax purposes and prepared T4 slips. The first calculation of a taxable employee benefit will occur in February 1992 in respect of benefits provided in 1991.

(h) Capital Goods

For purposes of the GST, capital goods of a registrant will mean any good that would be capital property of the registrant within the meaning of the *Income Tax Act*, other than any property described in class 12 or 14 of the capital cost allowance classes. (Class 12 includes low value assets for which a 100 per cent write off is allowed, while class 14 includes patents, franchises, concessions, and licences for a limited period.) Capital goods will not include any inventory of the taxpayer or other property held for resale. The treatment of real property is discussed in the following subsection.

Registrants will be entitled to claim input tax credits for the tax paid on acquisitions of capital goods. Unlike the income tax deduction rules, the input tax credit for any GST paid on capital goods need not be amortized over the life of the asset, but will be claimed in full in the period in which it is acquired. If the capital good is later put to a non-commercial use, special change-of-use rules will apply.

Under the normal input tax credit rules, a credit for the GST paid on a capital good would be allowed to the extent that the asset is for use in a commercial activity. For example, if the asset was for use 60 per cent in a commercial activity, then 60 per cent of the GST would be creditable on acquisition. Adjustments would be required, however, every time the commercial usage of the asset changed. Given that the useful life of capital goods generally extends over a number of years, the frequent application of change-of-use rules would involve complex calculations and burdersome record-keeping in many cases.

Therefore, to simplify the operation of the GST, an exception to the normal input tax credit rules will apply in the case of capital goods. Unlike inventory and other business purchases which will be creditable to the extent they are for use in a commercial activity, a full input tax credit will be allowed in respect of a capital good if it is acquired for use **primarily** in a commercial activity. If this condition is not satisfied, then no part of the tax will be creditable. Similar rules will apply in determining any input tax credits in respect of improvements to capital goods.

Where the use of a capital asset for which an input tax credit has been claimed subsequently fails to satisfy the primarily commercial use test, the registrant will be deemed to have disposed of the asset and be required to account for GST on the asset's fair market value at that time.

Conversely, where GST has been paid on a capital good in respect of which no input tax credit previously has been claimed, the registrant will be entitled to claim a full input tax credit if and when the asset begins to be used primarily in a commercial activity. The credit in these circumstances will be based on the lesser of the tax paid on the acquisition of the asset (along with any improvements thereto) or the tax on the fair market value of the asset at the time the use of the asset changes.

These rules will simplify the application of GST in the area of capital goods. Registrants will not be required to deal with change-of-use rules except in those instances where the use of an asset changes from primarily commercial to primarily non-commercial, or *vice versa.*

Registrants will not be permitted to claim any input tax credit in respect of a capital good that has never borne GST, even if the asset's use increases to the point where it is used primarily in a commercial activity. For example, if a part-time cabinet-maker has a tablesaw acquired prior to start-up of the GST and uses it only 30 per cent of the time in a commercial activity, and then increases its use to 80 per cent in a commercial activity sometime after January 1, 1991, no input tax credit will be permitted, even though the asset's use is primarily in a commercial activity.

The sale or disposition of a capital asset will be subject to GST if, immediately prior to the sale or disposition, the asset was used primarily in a commercial activity. An exception to this rule will apply where a passenger vehicle is sold or disposed of by a self-employed individual, a partner or a partnership. In these cases, the vehicle will be subject to GST if, immediately prior to the sale or disposition, the vehicle was used exclusively in a commercial activity. Restrictions on input tax credits for passenger vehicles acquired by self-employed individuals are discussed above in subsection (f). Rules applying to partner and partnership expenses are described in Section 13.1.

While this general approach to capital goods is appropriate for the vast majority of businesses, in the case of financial institutions, special rules will apply. For the most part, capital goods acquired by financial service providers will be subject to the same rules as for real property, discussed below. The GST treatment of financial services is discussed in Section 11.

(i) Real Property

Unlike capital goods, an input tax credit will be allowed for GST paid on real property only to the extent that the real property is for use in a commercial activity. An input tax credit will be allowed even if the property is not primarily for use in a commercial activity, provided the property is not acquired primarily for the registrant's personal use and enjoyment (such as a residence). A parallel rule will apply for improvements to real property.

This approach to real property reflects the fact that, even though a building might be used primarily for making tax-exempt supplies (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 commercial use of an owner-occupied residential dwelling on which GST has been paid if the residential dwelling was acquired primarily for the owner's personal use and enjoyment.

Where there is a significant change in the commercial use of real property, change-of-use rules will apply. If the commercial usage decreases, a GST liability will arise on the extent to which the non-commercial usage increases based on the fair market value of the property at that time. This will ensure that land converted from commercial to non-commercial use by the owner is taxed on the same basis as land acquired in an arm's-length transaction. Conversely, if the commercial use increases, the registrant will be entitled to claim an input tax credit in respect of the increased commercial usage. The credit in this circumstance will be based on the lesser of the tax paid on acquisition of the property (plus tax paid on any subsequent improvements) or the tax on the fair market value of the property at the time there is a change-of-use. As a consequence, if the property has increased in value, the owner will not be able to recover any more tax than was actually paid when the property was first acquired.

Consistent with the treatment of capital goods, no input tax credit will be allowed in respect of real property to the extent the owner did not pay GST on the property when acquired or any subsequent improvements thereto, even where the commercial use of the property increases.

Real property acquired by charities, non-profit organizations, school boards, universities, colleges and governments will be treated in the same manner as capital goods acquired by these organizations. Accordingly, they will be entitled to claim full input tax credits only for the tax paid on real property acquired primarily for use in a commercial activity. On the other hand, no input tax credit will be allowed if the property is not primarily for use in a commercial activity. As a further consequence of treating real property acquired by these organizations in the same manner as capital goods, change-of-use rules will apply only when such an organization commences or ceases to use the real property primarily in a commercial activity.

2.4 Documentation Requirements

(a) General

Under the GST, vendors will be subject to certain documentation requirements. These requirements are necessary both to provide evidence to purchasers (i.e., those who bear the legal liability to pay the tax) that their GST liability has been discharged, and to ensure the smooth mechanical operation of the tax system itself. These documentation requirements will not interfere with vendors' actual pricing practices. This is a matter of contract law and is largely outside the scope of federal powers under the Constitution.

Vendors will be required to indicate to purchasers that their tax liabilities have been discharged in either of two ways:

i) separate indication on receipts of the actual amount of GST paid on taxable goods and services; or

ii) an indication on invoices/cash register receipts to the effect that prices include GST on taxable goods and services.

In addition, to facilitate the operation of the input tax credit mechanism at pre-retail levels, it will be important to ensure that registrants are able to determine quickly and easily whether GST was paid or payable on any particular purchase in order to calculate their input tax credits. In many jurisdictions with multi-stage sales taxes, this has meant the introduction of a "tax invoice" system, often involving significant additional paperwork for transactions between businesses. Under the GST, however, a more streamlined method will be adopted. This approach will rely on existing business records and invoicing practices. As a consequence, the GST will involve little, if any, change to existing billing practices.

Registrants will be required to maintain on file any contracts, invoices, or receipts issued or signed by their suppliers to support their input tax credit claims in respect of most purchases.

For the most part, documents used to support input tax credit claims will be the same receipts and invoices currently retained by businesses to support expense deductions under the *Income Tax Act*. The retention period for supporting documents under the GST will be the same as under the *Income Tax Act* – six years.

There will be no restrictions on the form or physical characteristics of documents used to support input tax credit claims under the GST so long as they meet certain basic information requirements. Documents may include invoices, cash register receipts, formal written contracts (including contracts for periodic lease payments), credit card receipts or any other document validly issued or signed by a registered vendor in respect of a purchase on which GST has been paid or is payable.

In order to minimize compliance requirements under the GST, the information that registrants will be required to obtain from their suppliers will vary depending upon the value of the supply.

Purchases Under $30

The only information required on supporting documents issued or signed by vendors for purchases under $30 will be:

- the vendor's name or trading name;
- sufficient information to identify when the GST in respect of the supply was paid or became payable. (For receipts, normally this will be the date on the receipt. For written contracts, it will be the time at which payment becomes due and payable under the terms of the contract); and
- the total consideration paid or payable for the supply.

These items generally are included in all invoices and receipts at present. As a result, no new information requirements will be required for low value receipts.

Purchases Between $30 and $150

Two additional pieces of information will be required for purchases of at least $30, and less than $150:

- the total amount of GST charged on the supply or, if prices are on a tax-included basis, a statement to this effect (Where a document such as a receipt or invoice is in respect of one or more taxable supplies and one or more supplies to which tax does not apply, the tax status of each will have to be shown if the document is to be used to support an input tax credit claim. A statement that "prices include GST where applicable" will not meet this requirement.); and
- the vendor's GST registration number.

Purchases of $150 or More

Further information will be required for purchases of $150 or more where a document issued or signed by a vendor is to be used to support an input tax credit claim:

- the purchaser's name, trading name or the name of his or her duly authorized agent or representative;
- sufficient information to ascertain the terms of sale (e.g., cash sale, discount for prompt payment, etc.); and
- a description sufficient to identify the supply.

This information generally is already provided on invoices, receipts and contracts for higher value purchases. These requirements, therefore, should involve little or no additional work for vendors.

(b) Non-Invoiced Purchases

Registrants will not be required to obtain supporting documentation from their suppliers in order to support input tax credit claims in certain circumstances. For example, no supporting documents from vendors will be required in respect of:

- purchases from coin-operated machines;
- reasonable *per diem* reimbursements made to employees to cover meals, automobile expenses and incidental costs incurred while on business trips within Canada; and
- certain other prescribed cases where the Minister of National Revenue is satisfied that:
  - it would be impractical to require vendors to issue appropriate invoices or receipts; or
  - other satisfactory documentary evidence of tax paid/payable on purchases is maintained by the registrant.

(c) Requirement to Issue Documents

Registered vendors will be required to issue an appropriate document (e.g., receipts, invoices, etc.) containing the requisite information if requested to do so by another registrant to whom a taxable supply is made.

2.5 Imports

Since the GST is a tax on domestic consumer expenditures, the tax will apply to imports of goods and services. This will also ensure that foreign suppliers do not have an advantage compared to their Canadian competitors.

(a) General Treatment

(i) Goods

The tax will be payable on the duty- and excise-paid value of goods imported into Canada. The GST on imported goods will be collected at the same time as customs duties are collected.

Registrants importing goods will include the amount of the GST paid or payable on imports in determining their input tax credit entitlements. 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.

(ii) Services and Intangible Property

Tax also will apply to services and intangible property (such as intellectual property rights) imported into Canada. However, these items do not flow across the border in the same manner as goods. Accordingly, it is difficult to identify and value services and intangible property at the time they are imported. Because of this, and to simplify the administration of the tax, GST will not be imposed **directly** on these items when imported by registrants for use in a commercial activity. However, since registrants will not be able to claim any input tax credit in respect of these imports (since no tax will have been paid), and since the value of these imports will be reflected in their taxable sales, GST will, in effect, apply to the value of the imported services and intangible property.

However, this approach is inappropriate in those cases where the imported service or intangible property is for use other than in a commercial activity. Therefore, tax will apply on any service (other than an exempt service) or intangible property supplied outside Canada to a person in Canada where the service or property may reasonably be regarded as having been received for use in Canada other than for use in a commercial activity. The tax will apply on a self-assessment basis and will be payable directly on the cost of imported taxable services or intangible property. This will ensure that there is no competitive disadvantage to domestic suppliers of similar items.

An example of the application of this rule would be where a Canadian bank hires an architect to design a building in Canada. If an architect operating in Canada is used, the architect will be required to charge GST on the services provided. However, if the services are rendered by a foreign architect who is not required to collect GST, the Canadian bank will be required to pay the tax on the service. In this way, the Canadian architect will not be placed at a competitive disadvantage.

(b) Direct Mail Imports

Currently, the Postal Imports Remission Order and the Courier Imports Remission Order provide duty and tax relief on importations through couriers and the post office if the value for duty does not exceed $40, or the aggregate of duties and taxes does not exceed $5.

These orders will be amended upon introduction of the GST to exclude books and periodicals in order to allow for the application of GST to imported book and periodical subscriptions. This will ensure that imports are placed on an equal GST footing with domestic books and periodicals.

Foreign publishers will account for the GST on their subscription sales in Canada.

(c) Non-Taxable Imports

GST will not apply to importations of zero-rated goods such as prescription drugs, medical devices and basic groceries.

As under the current federal sales tax, relief also will be provided for importations of a number of miscellaneous items, the major examples of which are:

- conveyances temporarily imported or re-imported while employed in the international transportation of passengers or freight;
- settlers' effects;
- goods imported by returning residents, subject of course to the normal threshold exemptions for returning tourists where applicable;
- conveyances and baggage temporarily imported by visitors to Canada;
- importations by representatives of foreign governments, NATO and other international organizations pursuant to Canada's obligations under various international treaties, conventions and agreements;
- goods imported by a charity in Canada that have been donated by persons not resident in Canada;
- medals, trophies and prizes (other than merchantable goods) bestowed or awarded by persons or organizations abroad or won in competitions abroad; and
- goods returned to Canada after having been exported for warranty repair work.

(d) Temporary Imports

There are, at present, a variety of special relieving provisions for temporary importations of certain classes of goods. These will be reviewed over the coming months and amended as appropriate to ensure consistency with the GST and the principles underlying the design of the tax.

2.6 Exports

Since the GST is meant to apply only to the consumption of goods and services in Canada, supplies made in Canada that are exports will be categorized as zero-rated supplies, and will not be subject to the tax. (Technically, there is no need to zero-rate exports that are supplies made outside Canada as these will be beyond the scope of the GST in any event.) To completely relieve exports of any sales tax content, exporters will be allowed to claim input tax credits in respect of any tax paid or payable on purchases of goods and services relating to their commercial activities. The net result will be a refund to exporters of the tax paid on their purchases.

Zero-rated exports will include exports of goods, intellectual property and services.

(a) Goods

Tax will not apply to any commercial export of goods. Where goods are delivered in Canada for direct shipment to a place outside Canada, they will be zero-rated. The transaction will have to meet prescribed rules to ensure that the goods are in fact exported to qualify as a zero-rated supply.

(b) Intellectual Property

Supplies of intellectual property rights, such as patents, trade secrets, industrial designs, trademarks, copyrights or know-how will be beyond the scope of the GST if the property is exclusively for use or benefit outside Canada.

(c) Services

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

- **International transportation services.** Generally, this will include all international passenger and freight transportation services, whether inbound or outbound. Excluded from this provision will be transborder passenger air transportation to the continental United States. The treatment of international freight and passenger transportation is discussed in Section 6.

- **Goods and services supplied to an unregistered non-resident operator of ships and aircraft for use in transporting passengers or goods to or from Canada.** This rule reflects the fact that these goods and services effectively will be consumed outside Canada. Zero-rated supplies under this provision will include, for example, repair and maintenance services, pilotage services, fuel sales and the provision by a domestic caterer of meals for an international flight.

- **Emergency repair services, including parts, supplied to an unregistered non-resident, where the service is performed in Canada in respect of railway rolling stock owned by the non-resident.**

- **Services supplied in Canada for use exclusively outside Canada.** For example, management fees charged by a Canadian parent company to a foreign subsidiary will be zero-rated under this provision, as will architectural fees charged by a Canadian resident in respect of real property situated in a foreign country.

- **Services supplied in Canada in respect of goods ordinarily situated outside Canada that are either situated outside Canada at the time of the supply or 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 zero-rated.

Provisions relating specifically to zero-rated exports of financial services are discussed in Section 11.

(d) Personal Exports

Foreign visitors to Canada will be able to claim a rebate of the GST on goods they purchase in Canada and take with them when they leave the country. The scope and conditions of the tourist rebate are discussed in greater detail in Section 6.4.

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

(e) Exports by Charities

Where they would not otherwise be permitted to recover the tax through input tax credits, charities will be entitled to a full rebate of the GST paid on goods acquired and exported for charitable purposes. The treatment of sales and purchases by charities is discussed in Section 8.

2.7 Non-Residents

(a) Basic Approach

Persons who are not resident in Canada will be required to charge and collect tax on the following supplies made in Canada:

- supplies of real property situated in Canada (other than a supply by way of sale – see Section 7.4);
- supplies made by a non-resident in the course of a business carried on in Canada; and
- certain performances by a non-resident in Canada.

Other non-residents may apply to be registered and collect the tax, even if they are not required to do so. This will ensure that they are not placed at a disadvantage relative to their domestic competitors in Canada. Registered non-residents will be entitled to claim input tax credits under the normal rules in calculating their net tax remittances/refunds.

(b) Non-Resident Performers

Where a non-resident performer provides his or her services directly to a GST-registered person, such as a promoter or a theatrical company, the non-resident will not be required to charge tax, provided he or she is not otherwise engaged in another commercial activity in Canada. 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, the value of the non-resident's services effectively will be taxed when the promoter or theatrical company charges admissions or attendance fees.

However, non-residents providing or staging a performance, exhibit, activity or event in Canada will be required to collect GST on any admissions or attendance fees they charge directly to spectators or attendees. An example of this would be ticket sales in Canada by a visiting foreign circus or a financial planning seminar given by a non-resident who charges a fee directly to each attendee/participant.

2.8 Operational Aspects

(a) Reporting Period

Registrants will calculate their net GST remittance or refund on a periodic basis – monthly, quarterly or annually, depending on sales volumes. Following each reporting period, a registrant will be required to file a GST return, and remit any tax due or claim a refund in respect of all of the registrant's commercial activities. For reporting purposes, every registrant will have a single fiscal year which will be divided into reporting periods in the case of monthly and quarterly filers. Registrants will have the option of selecting either the calendar year as their fiscal year or, if it is more convenient, their fiscal period for income tax purposes. An individual or trust with two or more fiscal periods for income tax purposes will be allowed to select any one of those fiscal periods as his or her fiscal year for GST purposes or, if the person so chooses, the calendar year.

The filing periods will be as follows:

- **Monthly** – registrants with annual revenue from taxable and zero-rated supplies greater than $6 million;
- **Quarterly** – registrants with annual revenue from taxable and zero-rated supplies of $6 million or less; and
- **Annual Filing with Quarterly Instalments** – registrants with annual revenue from taxable and zero-rated supplies not exceeding $500,000 will have the option of annual filing with quarterly instalments. This election will be made at the beginning of a registrant's fiscal year and will be binding on the registrant until the beginning of the following fiscal year. Quarterly instalments under this option will not be required where the net GST remittable for a year is less

than $1,000. The annual filing provisions are discussed in greater detail in Section 4.2.

Whether a registrant is required to file monthly will generally be determined by the registrant's total taxable and tax-free sales in the immediately preceding fiscal year. In other words, if this total exceeds $6 million, the registrant will be required to file monthly. However, if by the end of any quarter, the cumulative total of taxable and tax-free sales for the fiscal year exceed $6 million, the registrant will be required to switch to monthly filing as of the beginning of the following quarter.

Similarly, the determination of eligilibity for annual filing will be based on the registrant's sales in the immediately preceding fiscal year. However, where an annual filer's cumulative taxable and tax-free sales for the year exceed $500,000 by the end of either the first or second quarter of that year, the registrant will be required to revert to quarterly reporting periods in the next quarter. If a registrant who has elected to file annually exceeds the $500,000 threshold during the second half of the fiscal year, the registrant will be required to file quarterly only at the beginning of the following fiscal year.

Quarterly filers will have the option of filing monthly. This will be of benefit to those registrants making primarily zero-rated sales who are in a continual refund situation. An election to file monthly will be made at the beginning of the registrant's fiscal year and will be binding for the remainder of that fiscal year.

Both quarterly and monthly filers will be required to file returns within one month following their respective reporting periods. Vendors choosing the annual filing option with quarterly instalments will make their instalment payments on the last day of each fiscal quarter. An annual return reconciling the instalments to the registrant's actual tax remittable will be due at the end of the first fiscal quarter following the registrant's fiscal year.

(b) Reporting Entity

For GST reporting purposes, each corporation will be required to file one periodic return covering all of its commercial activities. However, it is common for corporations to divide their operations into divisions. If each division has a separate accounting system, and is identifiable by virtue of its activities or location, separate filing for each division will be allowed.

Notwithstanding an election for divisional reporting by a registrant, eligibility for the small traders' and filing thresholds will be determined on the basis of total taxable and zero-rated supplies by the registrant, not on a divisional basis. Moreover, each division will be required to adopt the same reporting periods for GST purposes. Special rules will apply in the case of a self-employed individual engaged in different commercial activities with different year ends.

Divisional reporting also will be allowed for charities, non-profit organizations, governments and selected public bodies.

(c) Remittances/Refunds

Remittances of any net GST due must accompany the registrant's return. Tax returns for monthly and quarterly filers will have to be filed within one month following the end of a registrant's reporting period. Penalty and interest at prescribed rates will be charged from the due date of the return on any tax remaining unpaid.

GST refund claims also will be made in the registrant's periodic return. Outstanding refund claims will be credited with refund interest beginning 21 days after the date the registrant's return is received by Revenue Canada.

3. Defining the Tax Base

The GST will apply to a very broad base covering the vast majority of goods and services consumed in Canada.

This section identifies the key tax-free and tax-exempt categories of goods and services under the GST. Certain additional exemptions for supplies made by the charitable, non-profit and public sectors, are described in Sections 8 and 9.

In the case of tax-free items, no tax will be charged on the supply of the good or service – that is, a zero rate of tax will be imposed on the supply. Nevertheless, vendors will be allowed to claim input tax credits for all tax paid on purchases relating to any tax-free supplies they make.

Tax-exempt supplies also will not be subject to tax at the time of sale. However, vendors will not be allowed to claim input tax credits for tax paid on purchases relating to these supplies.

3.1 Tax-Free Items

(a) Basic Groceries

(i) General

In December 1987, the government indicated that basic groceries would not be included in the base for the new sales tax. This decision reflected the widely held view of Canadians that, as a general principle, basic foodstuffs should not be taxed.

In keeping with this commitment, basic groceries – covering the overwhelming majority of sales of food for preparation and consumption at home – will be tax free under the GST. However, consistent with their treatment under the existing federal sales tax, soft drinks, candies and confections, and snack foods will continue to be taxable, thus requiring definitions to differentiate these categories from basic groceries.

Drawing borderlines of this kind is an inherently difficult exercise. No matter how the lines are drawn, the great variety of food products makes it virtually impossible to remove every possible anomaly.

Accordingly, for purposes of the GST, the definitions of soft drinks, candies and confections and snack foods will be virtually the same as those currently contained in the *Excise Tax Act*. These are summarized below.

Soft drinks and similar beverages:

- carbonated beverages;
- certain non-carbonated fruit juice beverages containing less than 25 per cent fruit juice by volume; and
- non-alcoholic malt beverages.

Candies and confections:

- chocolate bars;
- chewing gum;
- candy floss; and
- other types of candies.

Snack foods:

- potato chips, popcorn, cheese puffs and similar products;
- salted nuts and seeds;
- granola products (other than breakfast cereals);
- snack mixtures of seeds, nuts, dried fruit;
- flavoured ice and ice waters;
- pre-packaged individual servings of ice cream, sherbet, frozen yogurt, frozen pudding and similar products;
- fruit based snack foods such as fruit bars, drops, rolls; and
- pre-packaged individual servings of cake, cookies or pastry.

(ii) Restaurant Meals and Take-Out Prepared Foods

Restaurant meals and take-out prepared foods are not groceries. Accordingly, they will be included in the tax base for the GST. This is consistent with their treatment under the majority of provincial retail sales taxes.

As a result, just as with soft drinks, snack foods, candies and confections, definitions are required to differentiate this category of taxable items from basic groceries. And once again, some inevitably difficult definitional issues arise – especially given the variety of these products and the wide range of establishments selling them.

For example, is a fully prepared, heated and ready-to-eat meal purchased at a take-out establishment, but consumed at home a grocery? If the same establishment offers its patrons the opportunity of simply consuming the identical meal at tables on its premises without additional services, has the nature of the product changed? Given that there appears to be no significant difference between the two products, both should be treated in the same way for the purposes of the GST. In this instance, they should both be taxable.

Provinces confront many of the same choices in attempting to differentiate restaurant meals and take-out foods from basic groceries for purposes of their sales taxes. In this regard, a common feature of many provincial sales taxes is the use of *de minimis* thresholds for individual restaurant bills, below which no tax is charged. Provincial thresholds currently vary significantly – from one dollar in New Brunswick to six dollars in Manitoba.

Under the GST, however, the use of a *de minimis* threshold would pose substantial difficulties.

First, given that provincial *de minimis* thresholds vary by level and by application, as a general rule the federal and provincial thresholds differ. The existence of two separate and different thresholds would create considerable complexity for vendors, particularly for small businesses.

Second, a federal *de minimis* would not be compatible with streamlined accounting systems which, as a practical matter, are essential to reduce the compliance burden for small businesses such as convenience stores and grocery stores, which sell both tax-free basic groceries along with many taxable products. With these streamlined accounting procedures, small businesses selling both federally taxable and tax-free goods will not have to determine the federal as well as the provincial tax status of each sale at the cash register. Rather, they will be able to determine the federal tax on their sales based on their purchase records. (These rules are described in detail in Section 4.)

While streamlined accounting systems have the advantage of effectively removing the calculation of the GST from the cash register, they do require that the tax status of each item be known in advance of the time of sale. This is inconsistent with the use of a *de minimis* threshold which, by its nature, implies that the tax status of the item can only be determined at the time of sale, when the total bill is known.

For these reasons, a *de minimis* threshold for restaurant and other prepared meals under the GST appears to be an impractical option.

Two alternative approaches to incorporating restaurant meals and take-out prepared foods in the tax base for the GST are set out below. They differ primarily in the balance they strike between simplicity for vendors and consistency in the treatment of similar food products.

The first method relies primarily on the nature of the vendor – the establishment itself – to determine the tax status of the sale and, in that sense, is similar to the approach generally adopted under provincial sales taxes. In contrast, the second approach turns solely on the nature of the product sold to define its tax status. Under this method, a specific list of prepared food products would be taxed regardless of the type of establishment from which they are sold.

Although in different ways, both approaches achieve two critical objectives: first, while restaurant meals and take-out prepared foods are incorporated in the tax base, basic groceries remain tax free; and second, both maintain competitive equity between firms competing most directly with one another.

Before taking final decisions on which of these two approaches is the most practical means of applying the GST to restaurant meals and take-out prepared foods, the government will want the views of consumers, the restaurant industry and the grocery products sector.

Option 1: Tax Status Based on Nature of Establishment

Under this option, the treatment of restaurant meals and take-out prepared foods would fall under three categories, based on whether they were sold in an eating establishment, a combination grocery store/eating establishment or a grocery store itself. In turn, the definitions of these three categories of establishments depend upon the extent to which their sales consist of prepared foods. For the purposes of the GST, the latter would be defined to include:

- heated food;
- prepared salads;
- sandwiches;
- combination food platters such as cheese trays;
- ice cream cones, sundaes and similar single serving products dispensed on the premises;
- drinks dispensed on the premises; and
- sweetened baked goods.

Sales by Eating Establishments

Eating establishments would be defined to include any establishment **where all or substantially all sales were of prepared foods** or otherwise taxable food products (such as candies, soft drinks, or snack foods).

Any establishment falling under the definition of eating establishment **would be taxable on all their sales of food and drink.** The only exception would be food that is in a form clearly not suitable for immediate consumption – for example, a bag of coffee beans – which would be tax free even when sold by an eating establishment.

With this approach, establishments selling restaurant meals and/or take out prepared foods which compete most directly with each other would be treated in the same manner.

Typically included in this category of establishment would be eat-in restaurants, fast food restaurants, take-out establishments, cafeterias, pubs, convention centers, lunch counters, mobile canteens, snack bars, vending machines, catering services, or facilities from which food and beverages are dispensed at an exhibition, fair or sporting event.

Sales by Combination Retail Outlet/Eating Establishments

This category would be defined to include establishments which dispense beverages on the premises and where sales of prepared foods/beverages and other taxable food products constitute the majority of their total sales of food and beverages.

Unlike eating establishments, where all sales of food products would be taxable, establishments falling under this second category **would be taxable only on their sales of prepared foods** – that is, they would be taxable on:

- heated food;
- prepared salads;
- sandwiches;
- combination food platters such as cheese trays;
- ice cream cones, sundaes and similar single serving products dispensed on the premises;
- drinks dispensed on the premises; and
- sweetened baked goods.

By applying tax to these products, this treatment reflects the fact that businesses in this category compete with restaurants and other eating establishments. However, recognizing that they also compete with grocery stores and other retail outlets, their sales of other food products – i.e., basic groceries – would remain tax free.

Sales in Grocery Stores

Included in this category would be retail outlets which do not dispense beverages on the premises or whose sales of prepared foods and otherwise taxable food products account for less than 50 per cent of their total food sales. This would include, for example, most grocery stores and similar retail outlets. To reduce competitive inequities between these types of businesses and actual eating establishments, the former would be taxable on most of their sales of prepared foods, as defined above. However, unlike combination grocery store/eating establishments, these businesses would not be taxable on their sales of sweetened baked goods. Hence, purchases in grocery stores of muffins, doughnuts, cakes, pies and similar products would be tax free.

Option 2: Tax Status Based Solely on Nature of Product

The alternative to an approach based on the nature of the establishment is simply to identify a list of prepared food items which would be taxable regardless of the type of establishment selling them. Under this approach, the following would be subject to GST in all instances:

- prepared meals sold for a single price;
- heated food;
- prepared salads;
- sandwiches;
- combination food platters, such as cheese trays;
- ice cream cones, sundaes and similar single serving products dispensed on the premises;
- drinks dispensed on the premises; and
- single servings of cake, pie, or dessert pastries.

Summary of Two Approaches

The first option ensures that sales of all food products in a restaurant are treated consistently – they are all taxable. As a result, the operation of the tax would be very straightforward for these establishments and their patrons. Set against this is the disadvantage of minor differences in the treatment of similar products depending on the nature of the establishment in which they are sold.

The second approach would eliminate these minor anomalies because products defined as prepared foods, would always be taxable, notwithstanding the nature of the establishment in which they are sold. However, this approach would be somewhat less straightforward for consumers and would result in some complexities for eating establishments in complying with the tax, in that they would have to distinguish between their taxable and tax-free sales.

(iii) Exceptions Regarding Taxation of Prepared Meals

Notwithstanding which option is chosen for the treatment of prepared meals, the following foodservices will be **exempt** under the GST:

- **foodservices included as part of a basic fee for exempt accommodation.** Hence, tax will not be levied on foodservices provided to residents of nursing homes, university residences, or boarding homes;
- **meal plans providing all meals for a continuous period of one month or more.** Under this provision, for example, university students living off-campus will be provided with the same treatment as students living in university residences if they purchase a meal plan.
- **prepared meals served in a primary or secondary school,** other than meals supplied by a catering service at private parties, receptions, meetings or other similar occasions or events taking place at the school.
- **prepared meals supplied by Meals On Wheels or under a similar program** operated by a charity or non-profit organization to provide meals to aged, infirm or disabled individuals in their homes; and
- **food and drink supplied by a charity or non-profit organization in the course of relieving poverty, suffering or distress.**

(b) Agricultural and Fish Products

The simplest mechanism for removing basic groceries from the tax base is to zero rate them throughout the production-distribution chain. As a result, sales of agricultural products, farm livestock, fresh-caught fish and other seafood products will be tax free under the GST.

This will cover all but a few sales of produce by farmers and fishermen. Sales of agricultural and fish products which will be taxable include:

- cut flowers, foliage or trees;
- bedding plants, sod, living trees;
- soil and soil additives;
- seeds and natural fertilizer, except where sold in bulk;
- bait;

- wood;
- horses;
- wool, other than in an unprocessed state; and
- fur and animal hides.

(c) Prescription Drugs

The sale of prescription drugs is regulated by both the federal and provincial governments. In effect, the federal legislation sets out standards identifying drugs which must be sold on prescription throughout Canada. Provinces may, if they wish, require other drugs to be sold on prescription in their jurisdictions.

The following drugs, which must be sold under prescription under federal law, will be tax free under the GST.

- any drug containing a drug described in Schedule F to the Food and Drug Regulations made under the *Food and Drug Act*;
- any drug described in Schedule D and any drug or substance included in Schedule G to the *Food and Drug Act*; and
- with certain exceptions, any drug containing a substance described in the schedule to the *Narcotics Control Act*.

A number of drugs which do not require prescription under federal legislation, but which are used to treat life-threatening conditions, currently are exempted from federal sales tax. Even where they are not sold under prescription, these drugs will be tax-free under the GST. They are:

- Digoxin
- Digitoxin
- Deslanoside
- Erythrityl Tetranitrate
- Isosorbide Dinitrate
- Nitroglycerine
- Prenylamine
- Quinidine and its salts
- Aminophyline
- Oxtriphylline

- Theophylline
- Theophylline Calcium Aminoacetate
- Theophylline Sodium Aminoacetate
- Medical oxygen
- Epinephrine and its salts.

In addition to this list of drugs, drugs and medicaments for human use sold under the prescription of a medical practitioner authorized to write prescriptions will be tax free. As a result, all sales of prescription drugs for human use, not only those required to be prescribed by federal law, will be tax free when sold to a final consumer.

Drugs for animal use prescribed by veterinarians will be taxable under the GST.

Mechanism for Removing Prescription Drugs From Base

Drugs required under federal legislation to be sold under prescription, as well as those non-prescription drugs specified on the above list, will be tax free throughout the production-distribution chain. As a result, institutions such as public and private hospitals will be able to make bulk purchases of the prescription drugs on a tax-free basis. Other drugs will be taxable throughout the production-distribution chain, but when prescribed by a medical practitioner will be sold tax free at the retail level (with full input tax credits to eliminate tax paid at prior levels).

(d) Medical Devices

Tax-free medical devices under the GST will essentially include those which are currently exempted under the federal sales tax.

Hence, the major categories of tax-free medical devices will include:

- canes, crutches, wheelchairs, ramps and similar aids to the mobility of the disabled;
- artificial eyes, teeth, limbs, and orthopaedic braces;
- medical and surgical prostheses including surgical implants, and ileostomy, colostomy, and similar articles designed to be worn by an individual;
- hospital beds;
- artificial breathing apparatus for individuals afflicted with a respiratory disorder;
- hearing and speaking aids;

- prescription eyeglasses and contact lenses;
- various diabetic supplies;
- selected devices specially designed for the use of the blind and the hearing or speech impaired; and
- devices specially designed for use by the disabled to enable them to operate household or office equipment, and motor vehicles.

In addition, purchases of replacement parts designed exclusively to be used in a tax-free medical device and charges for installation or repairs to medical devices (including parts supplied together with the repair service) will be tax free.

3.2 Tax-Exempt Supplies

(a) Health Care Services

For all intents and purposes, health care services will be exempt from GST. These fall under two broad categories.

(i) Institutional Health Care Services

Health care services provided by a public or private hospital, nursing home, or a facility offering similar services for children or for the mentally disordered will all be tax exempt. The definitions for these services will be based on the definitions contained in the *Canada Health Act* and *Regulations* for hospital services, nursing home intermediate care and adult residential care services. In addition, private nursing services provided to these institutions or to individuals in their homes will be exempt.

The health services exemption will apply to fees charged by health care institutions to their patients or residents to cover accommodation, meals and health and personal care services. Also exempt will be supplies of medical equipment by health care institutions (e.g. the lease of kidney dialysis machines). Separate charges for other services provided by these institutions that are not health related (e.g., parking and meals served in a cafeteria to visitors) will be taxable in the normal manner under the GST.

(ii) Health Care Practitioners

Under the Canadian Constitution, health care in Canada falls under the jurisdiction of the provinces. Accordingly, provincial health insurance coverage was used as the basis for the exemption for health care practitioners proposed in the White Paper: to the extent that a health care practitioner's service was paid for under a provincial health insurance plan, it would be exempt under the new tax. This basic treatment will be maintained under the GST. However, the White Paper approach will be modified to make the exemption for services provided by health care practitioners more consistent across provinces and reduce compliance problems for those practitioners whose services are only partially covered by a provincial medicare plan (for example, where per visit or annual limits are applied to the insurance coverage).

Specifically, the health services provision will be expanded to exempt the following list of health care services in all jurisdictions in Canada, regardless of whether they are covered by a provincial medicare plan:

- physicians' services, except for purely elective cosmetic surgery;
- dental services, except for purely elective cosmetic dental services;
- optometric services;
- chiropractic services;
- osteopathic services;
- physiotherapy services; and
- chiropody and podiatry services.

All of these services are funded, in whole or in part, by health insurance plans in two or more provinces.

A health care practitioner generally will have to be licensed or otherwise certified to practice in the jurisdiction in order for his or her services to be exempt from GST. In the event that no such licensing or certification requirements exist for the profession in a particular province, to be eligible for the exemption, practitioners will have to demonstrate that they possess qualifications equivalent to that required in other provinces where such certification is necessary.

(b) Educational Services

The exemptions for educational services will fall under the following categories:

(i) Elementary and Secondary Schools

Elementary and secondary schools which fall within the jurisdiction of the various school boards or boards of education under provincial authority, as well as private, non-profit elementary and secondary schools which follow the approved curriculum of their province will not be required to charge tax on the instructional services which they supply to elementary and secondary school students. The supply of extra-curricular courses providing second language instruction in either of Canada's two official languages will also be exempt. These exemptions will apply to school-organized activities which are supplied for the benefit of elementary and secondary school students.

In addition, private tutoring which provides instruction in the required subject matter of an academic course forming part of a provincially approved elementary or secondary school curriculum will be exempt. This will include tutoring in a program of instruction leading to credit for courses in a provincial curriculum.

(ii) Publicly Funded Colleges and Universities

Publicly funded colleges and universities will be exempt with respect to their supplies of instruction in courses which can be taken for credit leading to diplomas and degrees, whether that instruction is supplied as part of their regular full-time programs or as part of their extension or adult education programs. In addition, these institutions will not be required to charge tax on courses providing second-language instruction in either of Canada's two official languages, whether or not such courses are provided as part of a degree program.

(iii) Courses for Entry into Regulated Professions or Occupations

Many professional organizations are statutorily empowered to regulate the practice of their profession or occupation. An exemption will be provided for instruction in courses, or examinations, supplied by or required by such organizations for the purpose of obtaining, maintaining or upgrading a professional accreditation required for the practice of those professions or occupations. As a result, bar admissions courses, for example, provided by a provincial law society will be exempt.

(iv) Training in Private Vocational or Language Schools

Instruction in courses which are part of a program to develop or enhance students' occupational skills will be exempt when supplied by establishments or organizations which are organized and operated primarily to supply those services. These include private secretarial schools and business colleges.

To be exempt, courses must be designed primarily to develop occupational skills and must be part of a program leading to a diploma or certification of competence similar to that provided by a community college or similar institution. Hence, as a general rule, instruction and training in sports, recreational or cultural activities such as dancing, skating, wine-tasting, cooking, sailing, or swimming will be taxable.

Establishments or organizations which are operated primarily to provide second-language instruction in one or both of Canada's two official languages will also be exempt.

The above exemptions are limited to supplies of instruction. Other supplies by educational institutions or establishments, such as bookstore sales or parking services, will be subject to the normal rules.

(c) Day-Care Services

Day-care services provided on a non-profit, commercial or public basis will be tax exempt. These will include services the primary purpose of which is to provide care and supervision to children under 14 years of age for periods normally less than 24 hours per day. This exemption will include services in private residences on an informal basis and those services provided in provincially licensed centres. It will also cover nursery school services, after-school programs offered by schools and community centres, and day camps.

(d) Legal Aid Services

Legal services provided under a provincially authorized legal aid program will be tax exempt. This will include payments by the client in respect of the legal aid services and payments by a legal aid society to a private lawyer for legal services.

4. The GST and Small Business

The basic operation of the GST incorporates a number of important features for all businesses which will reduce the compliance burden which might otherwise have been associated with the new tax. For example, the documentation requirements have been designed to minimize changes in existing business practices. For the most part, the documents used to support input tax credit claims will be virtually the same receipts and invoices currently retained by businesses to comply with the *Income Tax Act*.

As a result, for businesses making only taxable purchases and sales, compliance will be straightforward since they will largely be able to calculate the tax, using existing record-keeping systems.

Nevertheless, the government recognizes that small businesses may have more limited administrative resources at their disposal than their larger competitors. Moreover, the new tax has the potential to introduce a greater degree of complexity for certain small businesses – particularly those selling a combination of taxable goods and tax-free basic groceries at the retail level.

Consequently, a number of special measures will be adopted to reduce further the overall compliance burden for small business and to address specifically the problems which could otherwise be created for small retailers of groceries. These include:

- a $30,000 small traders' threshold below which vendors will not be required to register or collect and remit GST – thus allowing many small businesses to operate without having to administer the GST;
- optional annual reporting with quarterly instalments for registrants with annual sales below $500,000 – hence, reducing the frequency with which small businesses are required to calculate their tax remittable;
- streamlined methods of accounting for firms selling both taxable goods and zero-rated basic groceries at the retail level; and
- a small business administration fee to help offset compliance costs.

These special features will ensure that the compliance burden associated with operating the GST is kept to a minimum. The remainder of this chapter describes each measure in more detail.

4.1 Small Traders' Threshold

The $30,000 small traders' threshold will ensure that very small businesses will face no additional compliance burden as a result of the introduction of the GST.

A small trader will be any person with annual revenues of $30,000 or less from taxable and/or zero-rated supplies. Small traders will not be required to register with Revenue Canada, or collect and remit GST on their sales, nor will they be able to claim input tax credits for the GST paid on their purchases. In effect, they will be able to conduct their business outside the scope of the GST system.

The small traders' exemption will not apply to sales of real property. Receipts from the sale of capital property (whether it be real or personal property) will not be used in determining whether the vendor qualifies as a small trader.

Small businesses selling directly to final consumers will benefit from the small traders' threshold. However, some small traders selling primarily to registrants – i.e., to other businesses that are claiming input tax credits – may prefer to be registered. Otherwise, they would face a disadvantage in competing with larger firms because their own inability to claim input tax credits would result in the cascading of tax on their sales to their own business customers. In order to accommodate these vendors, persons qualifying for the small traders' threshold will have the option of applying to become a GST registrant. This application will be subject to the normal test that the person is actually engaged in a commercial activity.

A small trader who elects to become a GST registrant will be bound by that election for the balance of the fiscal year in which the election is made and for the subsequent fiscal year, or until the trader ceases to engage in a commercial activity, whichever is earlier.

The small traders' exemption will also apply to supplies made by charities, non-profit organizations, selected public sector organizations and governments. The application of the threshold to charities and non-profit organizations is described in more detail in Section 8.

4.2 Annual Reporting/Quarterly Instalments

In general, registrants with sales up to $6 million annually will file quarterly or, if they elect to do so, monthly tax returns. However, vendors with annual revenue from taxable and zero-rated supplies not exceeding $500,000 will have the option at the beginning of each fiscal year of electing to file annual returns and make four quarterly instalment payments of tax during the year.

The payment and reporting schedule for vendors choosing this option will be as follows:

- the quarterly instalments will be due by the last day of each quarter in the fiscal year; and
- the annual return reconciling the quarterly instalments with the registrant's actual tax payable for a fiscal year will be due within three months from the end of the fiscal year.

Registrants electing to file annually will be able to determine their quarterly instalment payments in one of two ways:

- First, registrants may simply base their instalments on the net tax payable in the previous year. This approach will provide certainty for vendors because, as is the case under the *Income Tax Act*, no penalties or interest will apply if each instalment is at least one quarter of the previous year's total net tax payable.

- Second, registrants will have the flexibility to make instalments based on their estimated sales for the year. As under the *Income Tax Act* penalties and interest will be charged on late or deficient instalments. Registrants will also earn interest on instalment overpayments, but this interest can only be used to offset any penalties and interest charged on late or deficient instalments for the year.

Registrants will also be able to reduce their instalments during the year if circumstances change and their net tax payable for the year is less than originally expected. This could occur if sales volumes fall, or an unanticipated capital purchase generates a large input tax credit.

Finally, registrants will not be required to make quarterly instalments during any year in which the sum of their instalments would be less than $1,000.

In the year of implementation, registrants choosing this option will, by necessity, have to base their instalments on an estimate. In order to make the transition to the tax as simple as possible, for the first year, vendors will be able to use a prescribed percentage of their total sales for the last fiscal period ending before 1991 as the base on which to calculate their instalments. No penalties and interest will be charged if each instalment payment equals at least one-quarter of this amount. However, registrants will be able to make lower instalment payments if they wish. In this case, penalties and interest will only apply if the instalment base they choose turns out to be less than 75 per cent of the net tax to be remitted for the first year under the new system.

This general approach to the transition period will be suitably modified for businesses whose fiscal periods do not coincide with the calendar year.

4.3 Streamlined Accounting

Compliance with the GST will be straightforward for registrants making only taxable purchases and taxable sales. These vendors will be able to calculate the GST collected on their sales directly from existing invoices or cash register tapes. Calculation of the GST on sales will also be relatively straightforward for businesses making both taxable and zero-rated sales if they have moderately sophisticated cash registers.

However, the interaction of the GST and the provincial sales taxes could increase complexity at the check-out counter for some small retailers – those selling a combination of taxable goods and zero-rated basic groceries who do not have sophisticated point-of-sale equipment.

For these businesses, in the absence of simplification measures, cashiers would need to identify both the federal and provincial tax status of each good sold. Moreover, cash registers would have to be modified to accommodate the operation of two sales tax systems at the point of sale.

To address this issue, two streamlined methods of accounting for the GST will be available to registrants selling a combination of taxable goods and zero-rated basic groceries at the retail level and with annual revenue from these sales not exceeding $2 million.

Vendors using either of these two methods will not need to distinguish between their sales of taxable goods and tax-free basic groceries at the check-out counter. Rather, they will determine the tax on their sales based on the tax status of their purchases of goods for resale.

As a result, it will be unnecessary for vendors using these methods to operate the GST at the cash register. That is, cashiers will not have to identify the federal tax status of each item at the check-out counter. Not only will this substantially simplify the operation of the tax for these retailers, but it will also not require vendors to modify their existing cash register systems. The government will provide vendors using these accounting practices with signs for posting in stores describing which categories of goods are subject to the tax.

Streamlined Accounting – Method 1

Under this method of streamlined accounting, retailers will determine the net tax owing for any period based on their **purchases** of taxable goods for resale during the period.

The value for tax will be computed using the retailer's regular selling price of the taxable goods purchased for resale. For example, in many instances, retailers simply adopt retail prices suggested by their suppliers. This easily identifiable list would then become the "regular selling prices" for the purposes of this accounting method. In other circumstances, where the retailer typically determines selling prices by applying a constant mark-up to purchase prices, the calculation of the GST using this streamlined method of accounting also would be straightforward.

Of course, if the retailer departs from the regular selling prices – for example, as a result of a sale – the actual selling price will be used.

Tax from sales of services, for example, video rentals, will have to be accounted for separately.

In calculating the net tax remittance for the period, the value of input tax credits, computed in the normal fashion, will be subtracted from the amount of tax on sales calculated using this method.

Given that, under this system, the tax on sales will be based solely on the purchases of taxable goods, those taxable goods held in inventory at the time a retailer elects to use this system will not automatically be subject to tax when they are eventually sold. In recognition of this, upon electing to use this system, a retailer will be required to remit GST on inventory of taxable goods for resale, valued at their regular selling prices. To facilitate this transition, the retailer will be permitted to remit this tax in four equal payments over the course of the first year that the vendor is on this system. If the retailer subsequently elects to opt out of this system, tax on the regular selling price of the retailer's inventory of taxable goods at the date of the changeover will be credited to the retailer at that time.

Many vendors may choose to adopt this streamlined accounting approach from the outset of the GST. As discussed in Section 12, with the introduction of the new tax, businesses will be eligible for a rebate of the federal manufacturers' sales tax contained in inventories held on January 1, 1991. As a further simplification measure, retailers using this method will be permitted to ignore the remittance of the GST on their inventories held on that date as long as they forego claiming the federal manufacturers' sales tax rebate on such inventories. Hence, these retailers will not need to undertake an inventory valuation upon the introduction of the GST. They will, nevertheless, be eligible to receive a credit for the GST on their taxable inventory if they later opt out of this method of streamlined accounting.

Streamlined Accounting – Method 2

In a manner similar to the streamlined accounting system described above, under Method 2, retailers will also estimate the tax on their sales based on their purchase records, thereby avoiding complexities at the check-out counter.

However, rather than using the retailer's actual selling prices of taxable goods for resale, this method will rely on a prescribed standard mark-up for basic groceries to compute the GST on the vendor's sales. Under this method, the vendor will follow the three-step calculation set out below.

- **First**, estimate sales of tax-free basic groceries by multiplying grocery purchases by a prescribed mark-up.
- **Second**, determine taxable sales by subtracting the above estimate of tax-free sales of basic groceries from the vendor's total sales for the period.
- **Third**, multiply this estimate of taxable sales by the tax fraction (9/109) to determine the tax on sales for the period.

Input tax credits will then be subtracted from the tax on sales in the normal manner and the balance remitted to Revenue Canada. (See Table C.1 for an illustrative example.)

Table C.1

Streamlined Accounting for Retailers – Method 2

	Purchases for resale (GST inclusive)	Sales (GST inclusive)
	(dollars)	
Actual		
Zero-rated basic groceries	50	
Taxable (detergent, etc.)	150	
Total	200	260

Simplified accounting

(1)	Groceries purchased for resale	50
(2)	Prescribed percentage mark-up for groceries (illustrative)	1.2
(3)	Equals: Estimated sales of groceries (1) × (2)	60
(4)	Total sales	260
(5)	Estimated taxable sales (4) – (3)	200
(6)	Tax on sales 9/109 × (5)	16.50

Registrants using this method to calculate their net tax remittable will be able to file quarterly or, if they are eligible, annually with quarterly instalments.

Given that this method relies on a prescribed mark-up for zero-rated basic groceries as the basis for calculating taxable sales, the estimate of taxable sales will be accurate as long as a registrant's average mark-up on groceries approximates the prescribed rate. If, however, a vendor's average mark-up on these groceries is significantly different from the prescribed mark-up, this method could over- or underestimate the tax which would otherwise have been remitted on the sales of taxable goods under the normal calculation of the tax. This potential inaccuracy is particularly important for vendors who sell a very high proportion of basic groceries. To safeguard against this, upper and lower limits will be placed on the amount of the tax payable on sales of taxable goods determined by this method.

Finally, unlike Method 1, the calculation of tax on sales using this system of streamlined accounting automatically ensures that all taxable goods held in inventory when the retailer begins to use this system are subject to tax when they are sold. As a result, under this system there is no need for the retailer to calculate separately and to remit GST on the regular selling price of the vendor's inventory. Similarly, where a vendor opts out of this method of streamlined accounting, no credit will be provided for tax on the vendor's inventory of taxable goods at that time.

As a consequence of this treatment, retailers choosing this method will be rebated the federal manufacturers' sales tax in their inventories held on January 1, 1991 in the normal fashion.

Summary of Two Approaches

Further refinements will be required to the methods of streamlined accounting described above. To this end, the government will consult with the small business community and, in particular, with small retailers of basic groceries, to finalize the operational details of the streamlined accounting systems. Among other areas, the government will want advice on:

- mechanisms by which the calculation of retailers' regular selling prices of taxable goods may be simplified;
- the value of the prescribed mark-up rate for basic groceries under Method 2, including whether more than one prescribed rate for groceries would be appropriate (e.g., based on the size of firm); and
- the application of streamlined accounting to vendors selling both basic groceries and taxable prepared foods.

However, in assessing possible modifications to the methods of streamlined accounting presented here, or indeed, whether additional methods may be appropriate, it will be important to balance carefully the advantages of each new refinement against any potential increases in complexity for small vendors that these modifications might entail.

Transition

Businesses with sales in excess of $2 million annually will as a general rule be expected to comply with the tax without the use of streamlined accounting. However, there are a number of medium-sized stores selling both taxable goods and zero-rated basic groceries which do not have sophisticated cash register systems such as electronic scanners. As a result, the introduction of the GST could entail some significant transitional costs for these businesses.

To address this issue, as a transitional measure until 1993, these methods of streamlined accounting will also be available on a **preapproval** basis to independent retailers with sales of taxable goods and basic groceries between $2 million and $6 million annually and to separate retail establishments of a registrant with sales of these items less than $2 million annually.

These retailers will be able to apply to use streamlined accounting at the time of registration. Where it is clear that they would otherwise have difficulty complying with the tax, they will be eligible to use either of the two methods during the first two years the GST is in place. However, for this category of vendors, should they choose the first method of streamlined accounting, they will not be permitted to ignore the GST payable on their inventories by foregoing the FST rebate. In the case of Method 2, the prescribed mark-up to be used by these firms will be determined following consultations with the industry.

This provision will smooth the transition to the new tax for medium-sized firms which have not yet acquired sophisticated cash registers.

As well, the government will also introduce temporary changes to the *Income Tax Act* to facilitate the acquisition of the technology necessary to operate both the GST and provincial taxes without the need for streamlined accounting. All retailers purchasing specified electronic point-of-sale equipment and related inventory control systems prior to 1993 will be eligible for a 100-per-cent capital cost allowance (CCA). This special class will not be subject to the half-year convention.

This measure will assist those medium-sized retailers who will have to acquire this technology during the period. Moreover, it will provide an incentive for vendors of all sizes to purchase systems which will allow separate identification of the amount of federal tax at the point of sale.

4.4 Small Business Administration Fee

The simplification measures described in this section will significantly reduce the burden of complying with the GST for many small businesses. Nevertheless, in recognition of the fact that there will be some increase in compliance costs, an administration fee will be paid to small businesses. The fee will be available to registrants who are carrying on a business and have revenue from taxable and zero-rated supplies of $2 million or less in a full fiscal period.

The administration fee will be equal to 0.4 per cent of total revenue from taxable and zero-rated sales to a maximum of $600 annually. Registrants will calculate and claim the administration fee on the last tax return in respect of each fiscal year. The fee will be refundable to the extent that it exceeds the net tax remittance of the registrant.

4.5 Summary

The special measures for small businesses are summarized in Table C.2. For purposes of qualifying for these measures, these thresholds will generally be based on the sales revenue of the registrant itself and other persons associated with the registrant.

Table C.2

Small Business Measures

Revenue from taxable and zero-rated supplies	Measures
0 – $30,000	– Small traders' threshold; no requirement to register or collect and remit GST – Optional registration for businesses selling to other firms
Under $500,000	– Optional annual filing/quarterly instalments – Streamlined accounting for retailers selling taxable goods and basic groceries – Administration fee
$500,000 – $2 million	– Quarterly filing – Streamlined accounting for retailers selling taxable goods and basic groceries – Administration fee
$2 million – $6 million	– Quarterly filing – Streamlined accounting on a preapproval basis for certain retailers selling taxable goods and basic groceries until December 31, 1992
All registrants	– 100-per-cent CCA for electronic point-of-sale equipment and related inventory control systems purchased before 1993

5. The GST and the Consumer

From the point of view of the consumer, the existing federal sales tax has some important failings. The vast majority of Canadians are not even aware that they are paying it, and those who are aware cannot calculate the actual amount of tax that is paid on any given purchase. This disservice to consumers stems from the structure of the tax itself.

- First, the tax is applied on sales by manufacturers to wholesalers and retailers. These businesses, in turn, pass the tax on to consumers in the form of higher prices. The fact that tax is included in these prices is not apparent to the consumer. Moreover, because there are four different tax rates and because wholesale and retail mark-ups vary widely both across sectors and across similar products within a sector, the amount of tax as a percentage of the final selling price is highly variable. This makes it virtually impossible for even the informed consumer to know how much federal tax is being paid when buying a commodity.

- Second, federal sales tax is also imbedded in the prices of goods and services that are not nominally subject to tax. This arises because the tax now applies to a broad range of inputs into the Canadian production process. As a result of the tax, costs of production in Canada increase, and these increases are often passed forward to consumers in the form of higher prices. Notwithstanding the fact that no consumer can calculate this indirect sales tax component of retail prices, it is there nonetheless, imposing a hidden tax burden on virtually every good or service purchased in Canada.

The GST will be a visible tax. The essence of visibility involves the application of tax at the retail level on a very broad base with a uniform rate. This ensures that Canadians will know when and at what rate they are paying federal sales tax.

The government believes that a model presentation of the GST by retailers has two key components.

- Identifying separately the amount of tax on cash register receipts. This ensures that consumers will have a tangible record of the amount of federal tax paid on purchases.

- Prominently displayed prices within the store (e.g., shelf prices) should incorporate the GST, thereby informing consumers of the total of the cost of the good and the federal tax. This will assist them in making budgeting decisions as they shop, before they go to the check-out counter. Where vendors choose to incorporate the GST in their shelf prices, this fact should be clearly indicated.

Vendors will be encouraged to adopt this model approach for the presentation of the GST. However, not all firms will be able to do so, at least in the near term, because of the technological constraints imposed by the cash register systems that are already in place in stores. These constraints will make it difficult for many retailers to identify two separate sales taxes – the provincial retail taxes and the GST – at the cash register simultaneously. Over time, as retailers upgrade their cash registers or introduce bar code scanning systems, it will become easier for them to identify the GST on register receipts in most stores. The federal government believes it is important to assist vendors to overcome these technological constraints on the model presentation of the tax. As a result, a 100-per-cent capital cost allowance will be provided for firms purchasing eligible electronic point-of-sale equipment and related inventory control systems prior to 1993.

Those vendors selling a mixture of taxable and tax-free items under both the GST and the provincial retail sales taxes (e.g., grocery stores) may face significant constraints in accounting for the federal tax at the cash register. As indicated in Section 4, small businesses in this situation will be able to adopt streamlined accounting procedures which will remove the need to keep track at the cash register of both categories of sales. As a consequence, however, these vendors will not be able to identify the amount of GST separately on cash register slips. This overall approach for small business reflects the government's commitment to ensuring that sales tax reform is practical. In this instance, it avoids forcing small businesses to make immediate and often costly changes in their cash register and accounting systems.

In all stores where the GST is included in the price, the government will provide retailers with the appropriate signs required to indicate this fact to consumers. The government will also be working with business associations and individual retailers to promote the model presentation of the tax. Moreover, the government will be consulting with business associations and advertising councils to promote consistent pricing and advertising practices.

Although the GST will be levied at a 9-per-cent rate, this does not mean that the prices of those goods and services subject to tax will increase by that amount. This is because the GST will be replacing an existing tax that is levied, directly and indirectly, at four different rates on a wide range of goods and services. The net effect of sales tax reform on the price of any good or service will be the combined result of removing the existing tax that is imbedded in prices now and then applying the new tax at a uniform rate of 9 per cent. Given that the GST will be charged at a uniform, lower rate on a much broader base than the current sales tax, there will be some shifts in the relative prices of goods and services as a result of reform. The price of previously untaxed items should increase, while the prices of many goods now taxed at the standard rate of 13 1/2 per cent (e.g., cars) should fall.

The government believes that there will be a number of forces operating to ensure that the savings from the removal of the existing FST will be passed on to consumers. First, and most important of these, will be the competitive pressures of the marketplace itself. With the elimination of the FST, each individual firm will have an incentive to reduce prices in order to gain an edge over its competitors. These competitors, in turn, will respond by matching price reductions in order to maintain their market shares, thereby setting in motion a chain reaction that will effectively flow FST savings through to consumers.

To reinforce further the ongoing competitive pressures in the economy, the government will be working with wholesalers and retailers to ensure that they are fully apprised of the fact that the 13 1/2-per-cent federal tax on manufacturers' selling prices will no longer be in effect as of January 1, 1991.

Market forces will also be strengthened if consumers are in a position to make their own judgements about the price consequences of implementing the GST. The alert consumer is the best safeguard against unfair pricing practices. To assist consumers in this regard during the initial period of the GST, the government will establish a special office to help keep them informed about the effect on prices of the removal of the FST and the introduction of the GST. The office will be an independent body that will report to Parliament through the Minister of Consumer and Corporate Affairs. It will:

- in advance of the start-up of the GST, provide information on what consumers might expect in terms of price increases and decreases for key goods and services;
- receive and investigate consumer complaints about pricing practices;
- table regular reports in Parliament; and
- undertake and publish independent research into the consumer aspects of sales tax reform.

6. Transportation and Travel

6.1 Passenger Transportation Services

(a) Domestic

Generally, GST will apply to fares charged for domestic passenger transportation services provided by any mode, including buses, trains, taxis, ships and aircraft.

However, passenger surface transportation services provided by local or municipal transit services will be tax exempt. The treatment of municipal transit is discussed in Section 9.1.

As well, since the use of Canada's highway systems and related infrastructure will not be subject to tax, bridge, road and ferry tolls will be exempt from GST.

(b) Transborder Air Travel

In light of the homogeneous nature of the Canada-U.S. air travel market, transborder air travel will be subject to GST. This will include any transborder air travel ticket to the continental United States or the islands of St. Pierre and Miquelon, either purchased in Canada or with first emplanement in Canada. However, transborder air travel tickets purchased outside Canada and with first emplanement in the U.S. (or the Islands of St. Pierre and Miquelon) will not be subject to tax. This approach will also facilitate the integration of the GST with the existing air transportation tax, discussed below in subsection (e).

(c) International

With the exception of transborder air travel services, international passenger transportation, whether inbound or outbound, will be zero-rated. This will include any passenger transportation service that begins or ends at a point outside Canada, including round-trip international transportation services (i.e., a stop-over outside Canada for other than connection, refueling or servicing purposes).

(d) Continuous Journey

It is not uncommon, particularly in the area of air transportation, for a traveller to have a single ticket in respect of two or more transportation services. For example, a traveller may purchase an airline ticket for two flights: one from Winnipeg to Toronto in order to connect with another flight from Toronto to an overseas destination.

Where multiple transportation services are provided on a single ticket, these will be treated as one continuous service and taxed as such. In other words, there will be no requirement to prorate ticket prices in order to segregate domestic (and transborder) from international services: as long as there is at least one international origin, destination or stop-over, the entire ticket will be treated as being in respect of a single international transportation service and zero-rated as such.

In those cases where a combination of domestic and international passenger transportation services are provided as part of a continuous journey, and separate tickets are issued to the traveller for each portion of the journey, the domestic ticket will be considered to be part of an international travel service whether or not the different tickets are in respect of the same mode of travel. Journeys of this type will be zero-rated. This rule will apply where all of the tickets are for the same traveller, purchased at the same time, and all intermediate stop-overs are for connection, refueling or servicing purposes only.

(e) Air Transportation Tax

The current air transportation tax (ATT) is a cost recovery measure designed to pay for airport facilities/services and in-flight navigation systems provided by Transport Canada. The ATT represents part of the cost of air travel services consumed. As such, where applicable, GST will be calculated on the ATT-included price of airline tickets.

The ATT will be modified to reduce the impact of the imposition of GST on domestic and transborder air travel. The present *ad valorem* rate of 10 per cent plus $4, to a maximum of $50 per ticket, on tickets purchased in Canada for air travel within the taxation area (Canada, the U.S. and the Islands of St-Pierre and Miquelon) will be reduced to 5 per cent plus $10, to a maximum of $40 per ticket. The flat tax of $19 on tickets for travel from Canada to overseas destinations will be increased to $40 per ticket. Specifically, the $40 tax will apply to all overseas tickets purchased in Canada or with first emplanement in Canada. The $19 flat tax will continue to apply to tickets purchased outside Canada for travel to Canada. As noted in subsection (b) above, GST will also apply to tickets purchased in Canada for domestic and transborder air travel, but not to tickets purchased in Canada for overseas air travel.

(f) Miscellaneous Charges

Excess baggage charges are incidental to the supply of passenger transportation services. Their GST status will be the same as the particular travel service provided to the traveller purchasing the passenger transportation service: if the travel service is taxable, related excess baggage charges also will be taxable.

In-transit charges for supplies to passengers of items such as food and drink will be taxable if the supply is made between two domestic stops. This rule will apply whether or not the passenger to whom the supply is made is holding a domestic or an international ticket. Where the supply is made between a domestic stop and a stop outside Canada, the supply will be zero-rated.

Ticket cancellation fees charged in Canada will be taxable whether or not the cancelled ticket is for an international or domestic service.

Ferry flight charges commonly are made by air carriers to charterers for the service of moving an empty aircraft from one place to another. While the object of a ferry flight may be to reposition an aircraft to provide passenger transportation services, the ferry flight itself is not a passenger transportation service. The charge for a ferry flight is more akin to a delivery or freight transportation charge and will be treated as such under the GST.

6.2 Freight Transportation Services

(a) Domestic

GST will apply to domestic freight transportation services provided by any mode. Taxable freight services will include services provided by common carriers, independent carriers and private carriers, as well as postal and courier services. Freight services provided partly outside Canada, where both the origin and destination are in Canada (e.g., coastal shipping or shipments routed through the United States) will be considered to be a domestic service and taxable as such. Registrants providing domestic freight services will charge tax on those services and, under the normal rules, will be allowed to claim input tax credits for any GST paid or payable on goods and services supplied to them in Canada. Tax paid or payable by a registrant purchasing domestic freight transportation services also will be creditable in the normal manner.

(b) International

Supplies of international freight transportation services – including both inbound and outbound services – generally will be zero-rated. However, given that it generally is not possible to ascertain whether postage stamps will be for domestic or international use at the time of sale, and the need to maintain equity in the treatment of postal and courier services, outbound international freight transportation services will be taxable if valued at less than $12.

An international freight transportation service will include any service provided for the movement of goods from a point inside Canada to a point outside Canada, or *vice versa*. For most carriers, this will be readily ascertainable from the origin and destination information currently provided on bills of lading.

In the case of an inbound international freight service, the service will be zero-rated if the origin specified on the covering bill of lading is a point outside Canada. However, where a bill of lading is issued for a transportation service commencing and ending in Canada, the service will be subject to GST, even if the service commences prior to the point at which goods are released from Canada Customs.

It is not uncommon for goods destined for export to be shipped under two or more bills of lading for sequential parts of the journey. A typical case is where an exporter contracts with a domestic carrier to have goods moved to a domestic port, at which point another bill of lading is cut for the ocean leg of the journey. In the absence of any special rules to the contrary, the first carrier in this example would be required to charge GST on the services supplied to the exporter. Provision will be made to allow fully domestic freight services to be zero-rated where the contracting shipper provides a declaration to the carrier that the movement is part of a continuous outbound international move. Such declaration will be permitted if:

- all of the goods being shipped under the bill of lading are for export; and

- the goods are not to be further processed, transformed, modified or any way altered in Canada prior to exportation, except to the extent necessary or incidental to the actual transportation of the goods. For example, any necessary packing or refrigeration services provided by the carrier would not be an impediment to treating the move as part of an international service. On the other hand, the domestic movement of ore to a refinery for processing will not qualify as part of a zero-rated international movement, even if the refined product subsequently is exported. However, the subsequent movement of the refined product to an international destination will be zero-rated.

The shipper will be liable for tax and penalty in the case of a false or misleading declaration. In this situation, the carrier will be held jointly and severally liable unless he accepted the declaration in good faith and exercised due care in so accepting it.

Shippers will be required to maintain satisfactory proof of export where they have made a declaration to have a domestic movement treated as part of a zero-rated continuous outbound movement. Where a domestic movement is treated as part of a zero-rated outbound movement and, for unforeseen reasons, the freight subsequently is diverted to a Canadian destination, the movement will be treated as a taxable service in the normal manner.

(c) Interline Settlements

Interline settlements between carriers will not attract GST. Only the carrier who settles the freight bill with a customer (i.e., the shipper in the case of a prepaid move, or the consignee in the case of a collect move) will be required to collect the GST on the services. However, since interlining will be considered to be a commercial activity, carriers will still be able to claim input tax credits in the normal manner for any purchases related to their interlining activities.

(d) Miscellaneous Charges

It is normal practice for carriers to charge for a variety of services to their clients in addition to basic freight transportation services. These can include:

- storage and warehousing fees;
- loading and unloading fees;
- excess weight charges;
- refrigeration charges;
- demurrage fees; and
- packing fees.

For purposes of the GST, freight transportation services will be considered to include any such fees that are necessary or incidental to the basic transportation service provided. Consequently, their GST status will hinge on the status of the basic freight charge to any particular customer. However, where these charges cannot be related specifically to any given transportation service(s), or are billed by anyone other than the carrier providing the freight service, they will be treated the same as any other service; that is, taxable if performed in Canada and not otherwise zero-rated under the service export provisions described in Section 2.6.

6.3 Travel Agents, Travel Wholesalers and Tour Operators

Travel agents typically sell on behalf of other travel service providers (e.g., airlines, hotels, and tour operators). The agent's services are paid for by other travel service providers through commissions. 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 zero-rated under the export rules where the commission is received from a non-resident such as a foreign hotel. Domestic travel service providers registered to collect GST, of course, will be able to claim input tax credits for any GST paid on agents' commissions like any other GST-paid purchase.

Tour operators and travel wholesalers are distinguished from travel agents by the fact that they purchase travel services for resale purposes. On occasion, travel agents also act as tour operators when they purchase travel services for resale purposes.

Typically, a tour operator will purchase blocks of airline seats, hotel rooms, sightseeing excursions, etc. These are then broken up and re-assembled into individual tour packages for sale to travellers at one all-inclusive price.

Because they effectively are functioning as retailers engaged in the business of buying items for resale purposes, the GST status of tour operator sales will be determined by the GST status of the individual travel services they purchase.

Tour operators selling entirely domestic tours simply will charge GST on their selling prices and claim input tax credits for the GST paid on any domestic travel services purchased.

If a tour operator sells an entirely foreign tour package (where all of the components of the package are non-taxable), the tour will be zero-rated.

Tour operators selling tours involving a combination of taxable and non-taxable travel services (e.g., a tour package to the U.S. – involving taxable transborder air fare and non-taxable accommodation in the U.S.) will be required to pro-rate their selling prices according to the value of taxable and non-taxable elements in the package. This proration will be based on the relative cost of each of the travel service elements to the tour operator. For example, after claiming input tax credits for the tax on transborder air travel services, the operator's average net travel service costs per package sold might break down as follows:

	(dollars)	(per cent)
Round-trip flight from Toronto to U.S. (taxable)	200	40
Accommodation and sightseeing in U.S.	300	60
Total	500	100

Assuming, say, a 20-per-cent margin, the operator's selling price would be $600. Because 40 per cent of the operator's input travel costs represent taxable services, GST at the rate of 9 per cent would be calculated on 40 per cent of the operator's selling price. In other words, the value-for-tax on the tour would be $240, on which $21.60 in GST would apply. Prorating will be required only once in respect of any given tour package – when it is first costed out. Thereafter, the operator will know that the value for tax on all such packages sold will be a fixed percentage of the selling price – 40 per cent in the above example. As long as the mixture of input travel costs does not change significantly, the operator will continue to use this percentage to determine the value for tax of all such packages sold. To illustrate, if, in the above example, the operator sold some packages for $550 (instead of $600), the GST on the lower-priced packages would apply to 40 per cent of $550, or $220.

6.4 Tourist Rebate

A common feature of consumption taxes around the world and in Canada is the provision of rebates to foreign tourists of the sales tax paid on selected purchases. Recognizing the importance of tourism to Canada, non-resident individuals visiting Canada will be entitled to claim a rebate of the GST paid on goods purchased by them while in Canada, provided that the goods subsequently are exported. In addition, they will be entitled to claim a rebate of the GST in respect of hotel, motel or similar short-term accommodation in Canada.

The foreign tourist rebate program will be administered as follows:

- claims must be for a minimum rebate of $25;
- no rebate will be allowed in respect of alcohol, tobacco or motive fuel purchases;
- claims will have to be submitted to the Department of National Revenue within one year from the date on which the goods were purchased or the accommodation service was provided;
- goods for which rebates are claimed must be exported within 60 days of purchase;
- any rebate in respect of accommodation will be limited to 30 nights' accommodation per visit; and
- claims will have to be supported by evidence of purchase and, in the case of goods, the Minister of National Revenue will be given authority to require satisfactory evidence of export.

Foreign visitors may be provided accommodation in Canada as part of a package of services for which they pay a single, all-inclusive price (e.g., in the case of a tour package or convention). To simplify administration of the rebate in these instances, the visitor will be entitled to claim either the actual tax paid on the accommodation, if this can be shown, or a specified flat amount per night.

7. Real Property

7.1 Basic Approach

The tax will apply to all sales or rentals of real property – land and buildings – unless the sale or rental is specifically exempt.

The following real property transactions will be exempt from the GST:

- long-term residential rents;
- sales of used residential housing, unless the sale takes place in the course of a business involving the purchase, substantial renovation and resale of such dwellings;
- sales of personal-use land by an individual or trust; and
- most sales and rentals of real property by charities, non-profit organizations and selected public sector organizations.

Where the tax applies to real property, the rules will generally parallel those for the sale or rental of other goods and services. Developers and construction firms will collect tax on their sales of land and new construction and will claim input tax credits in respect of any taxed purchases of land, equipment, materials and services used in the course of their commercial activities. Similarly, owners of office buildings will collect tax on their rental receipts and claim input tax credits in respect of the taxed goods and services they acquire. Registrants purchasing or renting real property to which the GST applies will claim input tax credits in the normal manner.

The exemption for small traders will not apply to sales of real property – in other words, the fact that the vendor is a small trader will not affect the tax status of sales of real property. At the same time, however, the receipts from such sales, other than in the course of a real estate business, will not be included in the revenue used to determine whether the vendor is under the small traders' threshold. However, rentals will be treated the same as any other supply for purposes of the threshold.

The remainder of this section describes in more detail the exemptions for real property and outlines certain special rules relating to real property transactions.

7.2 Tax-Exempt Supplies

The exemptions for residential rents and used residential housing will rely heavily on the definition of a residential complex. A residential complex will include owner-occupied single family homes, semi-detached homes, condominiums and multi-unit apartment buildings, together with the related land and common areas associated with such buildings.

An owner-occupied home will be treated as a residential complex where it is used primarily as such. Hence, even if it includes a room used as an office by a self-employed registrant, the entire home will still qualify as a used residential complex and therefore be exempt on resale.

The definition of residential complex will also include:

- summer cottages and other vacation homes;
- non-profit and private-for-profit nursing homes;
- facilities primarily used as a student residence at a university, college or school;
- group homes for the mentally or physically disabled; and
- residential accommodation supplied at a special work site or remote location as defined in Section 6(6) of the *Income Tax Act*.

However, the definition of residential complex will not include a hotel, motel or other similar establishment that provides all or substantially all of its accommodation for periods of less than 60 days.

(a) Residential Rents

All rentals of one month or more in a residential complex 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 complexes.

On the other hand, all supplies of room rentals will be taxable in a hotel or motel that does not qualify as a residential complex. This will include occasional rentals of one month or longer. As a result, the owner of a hotel or motel will be eligible to claim full input tax credits for any taxable purchases, including land and buildings.

These rules relating to residential rents will reduce the circumstances in which taxpayers have to apportion their costs for purposes of claiming input tax credits as a result of receiving both taxable and exempt rentals. Nevertheless, prorating will still be required in some cases – for example, where a landlord receives significant short-term rentals from an apartment building.

The provision of ancillary services, such as cleaning, heating and electricity, as part of the rental charge will be exempt where the rental is exempt.

(b) Sales of Used Housing

The sale of a used residential complex – such as an owner-occupied home, an apartment building or a summer cottage – will generally be exempt. A residential complex will be considered used from the time it is substantially complete and either has been sold, or any residential unit therein has been occupied as a place of residence.

The exception is that the resale by a registrant of a used residential complex will be fully taxable where a registrant has previously claimed an input tax credit for any part of the acquisition cost of, or any capital improvements to, the residential complex. For example, a landlord may claim a partial input tax credit for the purchase of a new apartment building with the expectation of making significant short-term rentals. In this case, the subsequent resale of the building by the landlord will be fully taxable.

On the other hand, since an input tax credit will not be allowed for real property that is used primarily for the personal use and enjoyment of the owner (see Section 2.3), owner-occupied housing will continue to qualify for exemption on resale even if part of the home is used for business purposes. Accordingly, the vast majority of resales of owner-occupied homes will be exempt.

Where an owner-occupied residential complex is not used primarily for residential purposes, then only the residential portion of the building will be exempt on resale; the remainder will be taxable.

As discussed below, the exemption for used residential housing will not apply to a sale which takes place in the course of a business involving the purchase, substantial renovation and resale of such dwellings.

To provide greater certainty to the purchaser in these transactions, vendors will be required to supply purchasers of used residential buildings with a certificate stating that the property qualifies as a used residential complex for GST purposes. The vendor will be liable for tax in the case of a false certification. In this situation, the purchaser will not be liable for tax on the property providing due care and diligence was exercised in accepting the certificate.

(c) Personal-Use Real Property

Sales of real property by individuals or trusts (all of the beneficiaries of which are individuals), other than real property which was used or rented by the vendor in the course of a taxable commercial activity, or real property which is sold in the course of a business will be exempt.

This means that in most cases, individuals selling country properties, non-commercial hobby farms and other non-business land will not have to collect tax on the sale. However, where an individual sells land that was used in the vendor's business, or sold in the course of a business, tax will apply.

As in the case of used residential complexes, to increase certainty for the purchaser, vendors of such land will be required to provide the purchaser with a certificate stating that the property meets the conditions of the exemption.

(d) Farmland

Sales of farmland will generally be subject to the normal GST rules. Farmland will not be taxed if it is sold as part of the sale of a going concern (see Section 13.28). Other sales or leases of farmland, such as the sale of a portion of a farm to a developer, will be taxable in the normal manner.

Transfers of farmland will be exempt where the transfer is between family members.

(e) Condominium Fees

The services provided by a condominium corporation to the owner of a residential unit in that condominium, or to any tenant of such an owner, will also be exempt where the services are related to the upkeep and maintenance of the condominium complex and associated land.

7.3 Supplies of Real Property by Charities, Non-Profit Organizations, Selected Public Sector Organizations and Governments

(a) Charities, Non-Profit Organizations and Selected Public Sector Organizations

In general, sales and rentals of real property by these organizations will be exempt to reflect the essentially non-commercial nature of the vast majority of their supplies.

However, certain exceptions will be made where the supplies are clearly in competition with the for-profit sector.

The following supplies of real property by charities, non-profit organizations and selected public sector organizations will be taxable.

- Sales to individuals of land or new residential housing. Neither the volunteers exemption nor the small traders' exemption will apply to such sales.
- Any sale or rental of real property for which an input tax credit has been claimed.
- Short-term rentals of facilities supplied for consideration in the ordinary course of a business, other than short-term residential accommodation.
- The provision of parking on a regular basis for consideration.

In addition, the provision by a non-profit organization of short-term accommodation for periods of less than one month will be taxable. However, an exemption will be provided for lodging, meals, and recreational services supplied at a recreational camp or similar place at such times as the lodging is primarily supplied to disabled, disadvantaged or underprivileged individuals.

Finally, the provision of short-term accommodation by a municipality, or in a student residence owned or operated by a university, college or school, will also be taxable. This will ensure that when these facilities are used essentially as hotels, they are treated as hotels.

(b) Federal and Provincial Governments

The treatment of sales and rentals of real property by the federal and provincial governments will be the same as the treatment of similar supplies made by a registrant. In other words, only those supplies of real property which are specifically exempt under the GST will be exempt when supplied by the federal and provincial governments.

7.4 Other Rules Related to Real Property

The exemptions for residential rents and used residential dwellings, combined with the special nature of many real property transactions, give rise to the need for the following additional rules related to supplies of real property.

(a) Self-Supply

Special rules are required where a developer/landlord constructs a residential complex such as an apartment building for subsequent lease to tenants. In these situations, a self-supply rule will apply. The developer will be able to claim input tax credits in the normal manner on purchases related to the construction of the residential complex. However, at the time the completed dwelling is put into rental use, the developer will be required to pay tax on the fair market value at that time. The complex will then qualify as a used residential dwelling and, hence, any subsequent resale will be exempt.

This rule will ensure that the developer/landlord receives the same treatment as any other person who purchases a new building for rental purposes, since they would be required to pay tax on the acquisition.

The self-supply rule will also apply to charities, non-profit organizations and selected public sector organizations where they develop and subsequently lease residential complexes, other than student residences constructed by or on behalf of a selected public sector organization.

In these situations, the organization will be treated as if it were a commercial developer. The organization will claim full input tax credits during the construction of the residential dwelling, but will be required to pay tax on the fair market value when the completed dwelling is first occupied.

Charities, substantially government funded non-profit organizations and selected public sector organizations will be eligible for partial rebates for the tax on their purchases (see Sections 8 and 9). However, in order to maintain competitive equity with private sector developers, these rebates will not be available for the tax paid on the purchase or on the self-supply of a residential complex to the extent the complex is used to provide residential rents at market rates. The organization will be eligible to claim the normal rebate for the tax paid on the self-supply to the extent the complex was built to provide:

- accommodation for students;
- subsidized rental housing; or
- accommodation for the mentally or physically disabled.

This approach will ensure that the provision of such accommodation is treated the same as any other exempt activity undertaken by these organizations.

The self-supply rule will also apply to a developer building a residential condominium complex where the units are occupied (i.e., leased) prior to the actual transfer of ownership due to delays in registering the condominium. In this circumstance, the self-supply rule will apply when each unit is first occupied and the developer will be required to remit tax on the fair market value of the condominium unit at that time. However, since the unit will then qualify as a used residential dwelling, no tax will apply to the subsequent transfer of ownership.

The self-supply rule will not apply to private individuals who, other than in the course of a business, construct a residential complex primarily for their own use. Hence, individuals building their own homes will not be eligible to claim input tax credits on their purchases, but there will be no tax consequences when they first occupy the dwelling.

It is also not appropriate for the self-supply rule to apply in the case of residential accommodation supplied at a special work site or remote location as defined in Section 6(6) of the *Income Tax Act*. Because the provision of such accommodation is not considered a taxable employee benefit to the recipients, for purposes of the GST, it will be viewed as simply an additional cost of doing business. Registrants purchasing or constructing residential accommodation for the use of their employees at a special work site or remote location will be eligible to claim full input tax credits related to the accommodation. Moreover, since the self-supply rule will not apply when the accommodation is first occupied, the registrant will hold the dwelling tax free in the same manner as any other business asset.

(b) Input Tax Credit at Time of Purchase/Change of Use

(i) Input Tax Credit

Input tax credits at the time of purchase will generally be allowed to the extent that the real property is for use in a commercial activity. There will be two exceptions to this general rule:

- No input tax credit will be allowed for the commercial use of any real property where it is primarily for the owner's personal use.
- The same rules as for capital property will apply to real property acquired by a charity, non-profit organization or selected public sector organization. A full input tax credit will be allowed if the real property is acquired primarily for use in a commercial activity; otherwise no input tax credit can be claimed.

(ii) Change of Use

Where the use of commercial real property changes significantly, change-of-use rules will apply. If the commercial usage increases, the registrant will be entitled to an input tax credit on the extent of the increased use, based on the lesser of the tax paid on acquisition of the property (plus tax paid on any subsequent improvements) or the tax on the fair market value of the property at the time the use changed. Conversely, where the commercial use decreases, a GST liability will arise in respect of the increased non-commercial use based on the fair market value at the time of the increase.

No input tax credit will be allowed in respect of real property on which the owner has never paid GST, even where the commercial use increases.

The capital property rules will also apply to changes in the use of real property owned by charities, non-profit organizations and selected public sector organizations. Thus, where GST has been paid on the acquisition of real property by one of these organizations and no input tax credit has been claimed, the organization will be entitled to a full input tax credit if the asset begins to be used primarily in a commercial activity. The credit will be based on the lesser of the tax paid on acquisition of the property (plus tax paid on any subsequent improvements) or the tax on the fair market value at the time the use of the property changed. Conversely, if a full input tax credit had been previously claimed by the organization and the use of the real property changes such that it is no longer primarily commercial, the organization will be required to pay GST on the fair market value at that time.

(c) Input Tax Credit at Time of Sale

In certain instances, a registrant will be required to collect tax on the sale of real property for which no input tax credit, or only a partial input tax credit has been claimed. For example, a medical practitioner who owns the commercial building in which he or she practices, may also rent out part of the space commercially. Because the medical services will be exempt, the practitioner will be able to claim only a partial input tax credit at the time of purchase, but the building will be fully taxable on resale.

To ensure that there is no tax cascading on the sale, the vendor will be able to recover any previously unclaimed input tax credits at the time of sale.

The input tax credit at the time of sale will be the lesser of:

- the unclaimed portion of the tax actually paid by the registrant on the original acquisition of and subsequent improvements to the building; and
- the proportion of the tax on the fair market value at the time the building is sold representing the extent it was used outside the commercial activity.

This rule will ensure that all the remaining tax is removed from the building, but will not allow the registrant to recover any more tax on appreciating real property than was actually paid.

(d) Renovations to Existing Homes

Special rules are not required for private individuals who improve or renovate their own residential dwellings primarily for their own personal use as a residence. The individual will pay tax on purchases related to the renovation, but will not be eligible to claim input tax credits in respect of those purchases. Moreover, the resale of the dwelling will continue to qualify for an exemption as a used residential complex.

However, the exemption for used residential housing does require modification where a renovated residential complex is sold in the course of a business involving the purchase, renovation and resupply of used housing. In the absence of special rules, substantial inequities could be created between the GST treatment of renovated used housing and the sale of new housing.

(i) Substantial Renovation

The sale of a **substantially renovated** residential dwelling in the course of a business involving the purchase, renovation and resupply of used homes will be taxable. In these circumstances, the resupply of the renovated dwelling will be treated the same as the sale of a new home.

For purposes of the GST, a residential dwelling will be considered substantially renovated if it incorporates no more of the original building than the supporting walls, roof, floors, staircases, foundation and other minor ancillary parts.

A registrant in the renovation business will claim input tax credits on all taxable purchases related to a substantial renovation. However, no input tax credit will be available in respect of the purchase of a used residential dwelling by the renovator since the purchase will be exempt. Accordingly, tax will apply to the full value of a substantially renovated dwelling, including the land, just as it will to a new home.

The time of supply rules for a substantially renovated dwelling will be the same as for the supply of a new home. If the dwelling is sold, tax will apply at the earlier of possession or closing of the sale. On the other hand, if the dwelling is leased, the normal self-supply rule will apply. The renovator will be liable for GST on the fair market value at the time the completed dwelling is first occupied.

(ii) Other Renovations

Different rules will apply where, in the course of a business involving the acquisition, renovation and resupply of used housing, a person purchases and renovates a home, but not to the degree that it qualifies as a substantial renovation.

In this circumstance, the dwelling will continue to qualify as a used residential complex and, hence, will be exempt on resale. However, a special self-supply rule will ensure that GST applies to the value added by the renovator. This will provide consistent treatment between renovations contracted for by a homeowner and those undertaken by a person in the renovation business.

(e) Clearance Certificates

Under the normal rules, a registrant purchasing real property will be allowed to claim an input tax credit at the time of purchase, notwithstanding that the vendor may not yet have remitted the tax to the government.

Given the large amounts of tax revenues at stake in commercial real estate transactions, there could be a strong incentive for the vendor not to remit the tax, particularly where the vendor is selling commercial property in the course of winding up a business, or is a non-resident with no other presence in Canada. Potentially, this could result in a substantial loss of revenue, since the purchaser will be entitled to claim an input tax credit for the commercial property acquired, even though no tax may have been remitted.

As a result, where there is a sale of real property to a registered vendor, and the value of the property exceeds $1 million, Revenue Canada will require evidence that the vendor remitted the tax on the sale before the purchaser will be able to claim an input tax credit on the purchase. To accomplish this, the vendor will obtain a certificate from Revenue Canada verifying that the tax has been paid. The purchaser will require a copy of this certificate before claiming an input tax credit.

In order to minimize the compliance costs associated with this provision, Revenue Canada will establish a streamlined procedure to allow the vendor to remit the tax and receive a certificate verifying that tax has been paid. As a result, in most cases, the purchaser will not experience any delays in claiming an input tax credit for the transaction.

Finally, as an additional safeguard, where the purchase is from a non-resident, the purchaser will be required to remit the GST directly to Revenue Canada. In this case the vendor will not be required to collect and remit the tax as an agent of the federal Crown.

7.5 Examples

The examples below illustrate how the GST will apply to real property transactions.

1. **Facts:** An individual purchases a piece of personal use real property and builds a cottage on on the property for the individual's own use as a residence.

   GST Implications: The purchase of the personal use property will be exempt. The individual will pay tax on purchases of materials and charges by subcontractors and will not be eligible to claim input tax credits. The self-supply rule will not apply when the individual moves into the cottage.

2. **Facts:** Individual A purchases a home from Developer X after the GST is introduced. Before moving in, A is transferred and sells the house.

   GST Implications: A will pay tax on the purchase of the home from Developer X. The resale of the home by A will be exempt since it will qualify as a used residential complex (i.e. the home became used when it was sold as a substantially completed residential complex, notwithstanding that it was not occupied).

3. **Facts:** Same as in Example 2, except that A, upon learning of the job transfer, rents out the home to B.

   GST Implications: The rent will be exempt and no tax will be payable under the change-of-use rules because the home will qualify as a used residential dwelling.

4. **Facts:** C purchases a new home after the implementation of the GST and converts one room into an office. The house is still used primarily as a residential dwelling.

GST Implications: The entire building will continue to qualify as a used residential dwelling since it is used primarily as such. In addition, since the building is used primarily for personal use, C will not be eligible for any input tax credits in respect of the purchase or subsequent improvements to the dwelling. The entire dwelling will be exempt on resale.

5. **Facts:** C purchases a new home and converts 60 per cent into an office for use in her dental practice. The balance of the home is used as a residence.

   GST Implications: The building will be treated as two separate parts. Forty per cent will continue to qualify as a residential building. The 60 per cent used as an office will be treated as a commercial building.

   C will not be eligible for an input tax credit at the time of acquisition since the commercial use is for providing exempt services (i.e., dentistry).

   On resale, the residential portion will be exempt providing no input tax has been claimed against it. The business part will be fully taxable. C will be eligible for an input tax credit at the time of sale for the lesser of the tax paid on acquisition or the tax on the sale price. The land associated with the building will have to be apportioned between the two parts of the building.

6. **Facts:** Landlord X purchases three buildings 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.

   GST Implications: 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 significantly.

   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.

7. **Facts**: Individual A purchases land on speculation and subsequently resells it. A is not in the business of buying and reselling land.

   GST Implications: The sale will be exempt.

8. **Facts**: Same as in Example 7, except that A is in the business of buying and reselling land.

   GST Implications: The subsequent sale will be taxable. An input tax credit may be claimed on the purchase of the land and on improvement costs. If A were not registered, these input tax credits may be claimed at the time of sale.

8. Charities and Non-Profit Organizations

Charities fulfill an important and distinct role in Canadian society. In large measure, they perform essentially a public service function, relying heavily on the financial support of governments and the voluntary efforts and contributions of the general public to pursue their objectives. In designing the rules governing the treatment of registered charities and non-profit organizations under the GST, special provisions have been incorporated, both with regard to their purchases and their sales, which reflect the important role that these organizations play.

8.1 Rebate of Tax on Purchases

Registered charities, and those non-profit organizations which are substantially funded by governments, will be eligible for a rebate of 50 per cent of the GST paid on their purchases. This rebate program will substantially reduce any additional taxes that the GST might have entailed for charitable and publicly supported non-profit activities undertaken in Canada. This section elaborates on the technical details of the operation of this rebate program.

(a) Eligibility for Rebates and Basic Filing Procedures

(i) Charities

For the purposes of the GST, a charity will be defined as a registered charity or a registered Canadian amateur athletic association within the meaning of the *Income Tax Act*.

All charities will be eligible for the rebate.

Non-profit nursing homes generally are already charities, or are eligible to become registered as such. Nevertheless, for greater certainty special provisions will be included to ensure that these organizations qualify for the rebate.

If the charity is a registrant for purposes of the GST, it will file its rebate claim with its regular GST return – i.e., either annually, quarterly or monthly as the case may be. Charities which are not registered to collect GST will be able to file for rebates on an annual or quarterly basis.

Rebate claims need not be accompanied by invoices, however, charities will be required to maintain adequate books and records, including original invoices, to substantiate rebate claims. There will be further consultations with the sector to determine the most efficient reporting system.

Where a charity is organized into multiple divisions, the central office of the charity will be able to claim the 50-per-cent rebate in respect of all of its divisions.

However, divisions of a charity which report GST separately will be required to file separate rebate claims.

(ii) Government-subsidized non-profit organizations

For purposes of the GST, non-profit organization (NPO) will have the same meaning as for purposes of the *Income Tax Act.*

Non-profit organizations which receive 50 per cent or more of their revenues in a year in the form of federal, provincial and/or municipal grants will also be eligible to receive the 50-per-cent rebate. For this purpose, revenues will include all receipts from sales and donations, as well as loans from persons with whom the NPO does not deal at arm's length.

For purposes of determining the eligibility of a non-profit organization for GST rebates, the definition of government funding will be limited to direct financial assistance to the organization. Given the difficulty in valuing indirect or non-financial forms of assistance, such as gifts in kind, low-interest loans, and loan guarantees, these types of assistance will not be considered as government funding for these purposes.

Given that the eligibility of NPOs for the rebate will be dependent on the degree of government funding during the year, qualifying NPOs will only be permitted to file for the rebate once annually, at the end of their fiscal year.

Each rebate claim by an NPO will have to be accompanied by an annual report, including financial statements, providing details on the nature and degree of government funding, its revenues from all sources for the year, and the taxable purchases made by the organization during the year.

The organization will not be required to submit invoices supporting its refund claim but will have to maintain adequate books and records including original invoices for verification purposes.

(b) Purchases Eligible for Rebate

The 50-per-cent rebate will apply to purchases of goods and services by qualifying organizations for their own use in pursuing their objectives.

Certain purchases, however, which are not for use by the organization – such as goods acquired solely for resale – will not be eligible for the rebate. The specific details of the operation of the rebate program will be finalized following consultations with the sector.

8.2 Supplies Made By Charities

(a) General Approach and Overriding Exemptions

Charities will not be required to collect GST on the vast majority of the services which they provide. This exemption will encompass a wide range of research, counselling, rehabilitative, educational and other social services. In addition, charities will be exempt on their sales of used and donated goods as well as new goods, under certain circumstances described below. Also, no tax will apply to any charitable donations received by the organizations. For charities, only specified supplies which are of a type generally made by commercial businesses will be taxable. This approach will ensure fair and uniform application of the tax to similar commercial activities, without impinging on the non-commercial pursuits of charities.

The following four **overriding** exemptions will apply to charities. Notwithstanding the nature of the sale, if a supply falls under any one of these four categories, it will not be taxable.

(i) Small traders' exemption

A charity will not be required to collect tax on any of its supplies (other than certain sales of real property) where its annual sales do not exceed the $30,000 small traders threshold (described in Section 4). Where a charity is organized into separate branches or divisions, the charity may apply to have any such branch or division treated as a separate entity for purposes of the small traders' exemption, provided that the branch maintains a separate system of accounts and can be separately identified by reference to the nature of its activities or its location.

(ii) Volunteer exemption

Any supply by a charity (other than sales of real property and certain gambling activities described below) will be exempt if made in the course of an activity, all or substantially all of the day-to-day administration and operation of which is undertaken by volunteers.

(iii) Nominal consideration exemption

Many charities supply goods or services for nominal amounts which do not cover the direct costs of making the supplies. Clearly, such supplies are not commercial in nature. Hence, any supply by a charity will be exempt if the consideration does not, or could not reasonably be expected to, exceed the direct costs of making the supply. For this purpose, direct costs exclude employee labour, capital and overhead expenses.

(iv) Supplies made for the relief of poverty, suffering or distress

Any supply of food, drink or accommodation will be exempt where made by a charity in the course of relieving poverty, suffering or distress.

(b) Taxable Supplies by Charities

Subject to the overriding exemptions described above, the following supplies by charities will be taxable:

(i) Sale of new goods and ancillary services

This provision will apply, for example, to university bookstores, museum souvenir/gift shops and similar stores, as well as mail-order operations. Street sales, door-to-door sales and supplies made from a temporary outlet (such as a booth erected on a fair ground) will also be taxable. However, in many cases, the latter types of sales will qualify for the volunteer or small traders' exemption. Sales of used or donated goods will be exempt.

(ii) The sale of prepared food or drink

Charities will be required to collect tax on taxable supplies of prepared food and beverages sold in any eating establishment, in the same way as will similar profit-making operations (see Section 3). This provision will ensure equity between food and beverage services supplied by charities and those provided by for-profit restaurants and similar establishments.

As well, the GST will apply to catering services supplied by a charity at an event sponsored or arranged by another person who contracts with the charity for catering. For example, subject to the overriding exemptions, a charity which provides catering at a private function, such as a wedding, will be required to collect tax on the service. However, tax will not apply where a charity supplies prepared meals to a hospital, nursing home, or an organization such as Meals On Wheels.

(iii) Admissions to places of amusement or recreation

This provision will apply wherever a fee is charged for admission to, or participation in, a place of amusement or recreation. This will include admissions to a professional theatrical, musical or other such performance, film presentation, slide show, exhibition, fair, horse race, or professional sporting event.

Similarly, admissions to museums, zoos, aquaria, historical sites, wildlife and other parks, and recreational facilities will be subject to GST.

However, admissions to **amateur** performances, presentations or events in all cases will be exempt from tax.

(iv) Adult recreational services

Charities, other non-profit organizations, and for-profit businesses provide many of the same types of adult recreational services, such as exercise classes and lessons in sporting activities. The tax will apply in a uniform manner to all such supplies, subject to the overriding exemptions. However, recreational programs established primarily for mentally or physically disabled or disadvantaged individuals will be exempt.

With respect to children's recreational services, it is recognized that charities play a key role in delivering a wide range of child development programs in the community. Accordingly, charities will be exempt on the supply of any program consisting of a series of supervised, instructional activities or classes in athletics, sports, outdoor recreation, music, dance, arts and crafts or similar activities, where the program is structured in a manner akin to programs providing child care services.

(v) Commercial gambling activities

As for non-profit organizations and governments, charities will be taxable on gambling activities operated on a commercial basis. The manner in which GST will apply to these activities is described in Section 13.6.

The general volunteer exemption will be modified in the area of gambling activities. Under this modification, an otherwise taxable gambling activity will be exempt if **both** of the following conditions are met:

- all or substantially all of the day-to-day administration and operation of the activity is undertaken by volunteers; and
- in the case of a bingo or casino event, the event is not held in a place used primarily for the purpose of that or similar gambling activities (e.g., a commercial bingo hall).

(vi) Short-term rental of commercial property

A charity will be required to collect tax on its short-term rentals of non-residential real property, where such supplies are made in the ordinary course of a business. This will include the regular rental of a hall for meetings, receptions or banquets.

(vii) Public parking

A supply of public parking by a charity will be taxable if the charity makes such supplies on a regular basis for consideration.

(viii) Sales to individuals of land or new residential housing

This provision will ensure that all new residential housing is taxed. Neither the volunteer exemption nor the $30,000 small traders' threshold will apply to such sales.

8.3 Supplies Made by Non-Profit Organizations

(a) General Approach

In contrast to registered charities, non-profit organizations need not be operated exclusively for charitable purposes. These organizations in fact may undertake a wide variety of activities, some of which involve the supply of goods or services of a type generally supplied by for-profit businesses. Given the diversity of non-profit organizations and their activities, the general rule is that their supplies made in the course of a commercial activity will be taxable in the normal manner unless specifically identified as exempt.

(b) Exemptions

Many non-profit bodies serve primarily public service functions or engage in activities which could not be considered genuinely commercial in nature. In recognition of this, the following exemptions will apply to all non-profit organizations:

(i) Overriding small traders' and nominal consideration exemptions

The small traders' and nominal consideration exemptions described above for charities will apply in an identical manner to supplies made by non-profit organizations. As in the case of charities, where a non-profit organization is organized into distinct branches or divisions, it may apply to have any such branch or division treated as a separate entity for purposes of the small traders' exemption, provided the branch maintains a separate system of accounts and is separately identifiable.

(ii) Supplies made for the relief of poverty, suffering or distress

This exemption will apply to non-profit organizations in the same manner as it applies to charities.

(iii) Volunteer, street and door-to-door sales of items under $5 each

Some non-profit organizations, such as youth clubs and student bodies, commonly engage volunteers to raise funds by selling small items, such as chocolate bars, on a door-to-door basis or otherwise than from a permanent retail establishment. Such activities could not be considered to be undertaken in competition with other suppliers. Accordingly, these sales will be exempt.

(iv) Admissions to amateur performances, presentations or events

The exemption described above in paragraph 8.2(b)(iii) for charities for amateur performances, presentations or events will apply in an identical manner to non-profit organizations as well.

(v) Children's recreational programs

The exemption described above for charities in the area of recreational programs established for children, disabled and disadvantaged individuals will likewise apply to non-profit organizations.

(vi) Subsidized homemaker/home-care services

Some non-profit organizations are involved in the delivery of homemaker/home-care programs that provide necessary services such as housekeeping, meal preparation, nursing, personal care and child care to aged, infirm or disabled individuals in their homes. The work of these agencies forms an important adjunct to publicly provided health care services, particularly in the area of post-natal and post-operative care. Such services are typically supplied to needy individuals on a means-tested basis. Clearly, these activities are not commercial in nature. Accordingly, subsidized homemaker/ home-care services will be exempt where provided by a provincially or territorially approved agency.

(vii) Meals On Wheels and similar programs

An exemption will be provided for meals supplied by Meals On Wheels or under a similar program operated by a non-profit organization. These programs are designed to assist needy individuals who due to age, an infirmity or a disability, have difficulty preparing adequate meals for themselves.

(viii) Memberships in organizations providing no significant benefit to members individually

Some non-profit organizations are established for the sole purpose of promoting the common objectives or ideals of all members of the organization. In such cases, the members individually often do not receive any benefit by reason of their membership, other than an indirect benefit that is intended to accrue to all members collectively, the right to vote at or participate in general meetings and perhaps an occasional newsletter or report on the financial status of the organization. Any fees charged for membership in such organizations will be exempt from tax. This exemption will not apply to memberships which entitle members to receive, for no additional charge or at a significant discount, books, periodicals, admissions or other goods or services for which a fee ordinarily would be charged.

An organization whose memberships are exempt under this provision may elect to have all such memberships treated as taxable supplies, thus enabling registered members to claim an input tax credit in respect of their membership fee.

(ix) Trade union and mandatory professional dues

The GST will not apply to annual dues which are required to be paid in order to maintain membership in a trade union, or are retained by an employer pursuant to the provisions of a collective agreement. The GST also will not apply to annual professional membership dues, the payment of which is necessary to maintain a professional status recognized by statute. However, in the latter case, the association may elect to have all such dues treated as taxable supplies, thus enabling members who are registered for GST purposes to claim an input tax credit in respect of their membership dues.

(x) Non-commercial gambling

As in the case of charities, non-profit organizations will not have to collect tax in respect of gambling activities, where all or substantially all of the day-to-day administration and operation of the activity is undertaken by volunteers and, in the case of bingos or casinos, the event is not held in a place primarily used for that or other gambling activities (e.g., a commercial bingo hall).

(xi) Supplies of non-residential real property

As discussed in Section 7, most supplies of real property by non-profit organizations will be exempt, with the exception of sales of land or new housing, public parking and short-term rentals of commercial facilities supplied in the ordinary course of a business.

(xii) Lodging supplied at recreational camps for the disabled or disadvantaged

An exemption will be provided for meals, lodging and other recreational services supplied by a non-profit organization at a recreational camp or similar place at such times as the lodging and services are supplied primarily to disabled, disadvantaged or underprivileged individuals.

8.4 Self-Supply Rules

The June 1987 White Paper indicated that to offset serious biases towards the self-supply of goods and services by public bodies, charities, and non-profit organizations, special rules would be provided which would impose tax on certain self-supplies by these entities.

However, with the new treatment proposed for governments and selected public sector organizations (as discussed in Section 9) and the 50-per-cent rebate discussed in this section for charities and government-funded non-profit organizations, the potential bias for self-supply has been substantially reduced. Hence, there will be no special self-supply rules for this sector under the GST.

9. The Public Sector

In Canada, the public sector is composed of the federal and provincial governments, and a variety of other public bodies – such as municipalities, schools, colleges, universities and hospitals – which are engaged in a wide range of activities. In the context of the GST, the public sector represents a unique challenge. On the one hand, consistent with the principle of a broad-based consumption tax, the federal government must ensure that the GST is applied in a fair and uniform manner to commercial supplies made by both the private and public sectors. This will ensure competitive equity and minimize tax-based distortions. At the same time, in designing the GST, the government recognizes the special role that public bodies play in our society and, therefore, will ensure that the tax system does not impede their non-commercial activities.

9.1 Public Sector Sales

(a) General Approach

To the extent that governments and their emanations engage in commercial activities, they should be subject to the same general rules as private sector organizations. As in the private sector, with the exception of those supplies that will be zero-rated (e.g., basic groceries) and tax-exempt (e.g., day care), supplies by governments will, in general, be subject to GST if they are made in the course of a commercial activity.

This approach will preserve competitive equity by ensuring that one type of supply receives the same tax treatment regardless of its origin within the private or public sector. In other words, it is the nature of the supply itself which will generally be the central determinant of tax status, not the nature of the organization that makes the supply.

The legal liability for the GST will rest with the purchaser. Therefore, in making taxable sales, public sector bodies, like registrants in the private sector, will act as the federal government's agents for the purposes of collecting and remitting federal tax.

Many government activities will clearly not be considered a supply for the purposes of the GST even though an exchange of money occurs. For example, transactions which arise out of the regulatory nature and functions of government will not, in general, be taxable. These will include drivers' licences, radio broadcasting licences, passport charges, construction permits, patent and trademark fees, as well as fines and penalties.

For public sector bodies which are registered charities, the exemptions set out in Section 8 for supplies made by charities will apply. Public sector bodies which are not charities will generally be exempt on the same supplies as non-profit organizations. For example, certain recreational programs for children and admissions to amateur performances will be tax-exempt when supplied by a public sector body. The nominal consideration and real property exemptions for supplies by non-profit organizations, however, will not apply to federal and provincial governments, but they will apply to selected public sector organizations – i.e., municipalities (including libraries), schools, universities, colleges, and hospitals.

For greater clarity, the precise treatment of certain types of sales by the public sector is set out in the rest of this section. This treatment will apply to supplies made by federal and provincial governments, as well as selected public sector organizations.

(b) Inspection Services

Governments often set standards for the quality of a good or service and require that the suppliers of these commodities submit to independent inspections. These include, among other things, safety/quality inspections for cars, electrical installations, buildings, elevators, meat and vegetables.

Sometimes these inspections are undertaken by government itself, but often they are provided by third parties as part of their commercial activity. In the interests of competitive equity, inspection fees will be taxable, regardless of the identity of the vendor.

To the extent that these activities occur at an intermediary stage in the production chain, registrants purchasing these services will, of course, be eligible to claim input tax credits for the tax paid in the normal manner. For example, tax on meat inspections will be paid by registrants who will, in turn, be able to claim full input tax credits. This, of course, remains consistent with the tax-free status of basic groceries.

(c) Quotas/Licences

Governments often regulate commercial and non-commercial activity alike through the issuance of quotas and licences. These can range from quotas issued to businesses to regulate access to a common property resource, to a driver's licence issued to an individual in order to maintain standards for public conduct on the roads. Access to the commercial fishery is often provided on a licencing basis, while quotas have been issued to dairy farmers by the Canadian Dairy Commission in order to regulate production. In a similar vein, municipalities often provide licences to taxi drivers through a quota system.

Although quotas and licences are sometimes issued by governments for a price, they typically merely reflect the exercise of a regulatory function. For the purposes of the GST, the initial issuance of quotas/licences under the authority of governments will not be considered supplies made in the course of a commercial activity and, hence, will not be taxable. However, in view of the significant service element in the provision of a right to hunt and fish for recreational purposes, these licences will be taxable.

After the initial issuance, quotas and licences are often traded in secondary markets at prices reflecting the economic rent associated with having a government protected exclusionary right. These subsequent sales of quotas and licences will be subject to the GST in the normal manner. In virtually all cases, however, these quotas and licences will be purchased by registrants who will be eligible to claim full input tax credits for any tax paid.

(d) Natural Resource Royalties

Given the extensive Crown ownership of natural resources in Canada, all transactions having to do with the granting of a right to explore for, or exploit a Crown-owned natural resource will not be considered a supply for the purposes of the GST. As a result, such things as Crown royalties, bonus bids, stumpage fees, and water use fees will not be taxed. This rule will not apply to payments for the use of, or right to use, real property of the Crown – e.g., grazing rights. In addition, where a right is supplied to an unregistered person to take a resource in a manner essentially equivalent to the sale of the property, the supply will be taxable in the normal manner. This will ensure that all sales to final consumers are taxed – e.g., the provision of a right to a consumer to cut and remove firewood.

For the sake of consistency and in order to simplify the operation of the tax in the natural resource production sector, freehold resources will receive the same tax treatment as Crown resources.

GST-registered resource exploration and development companies, of course, will not be able to claim any input tax credits in respect of their acquisitions of resource rights on which they have not paid GST.

Although the resource owner generally will not be required to collect tax on rights provided to explore for, or exploit a natural resource, this will be considered to be a commercial activity. As such, the owner will be permitted to register and claim input tax credits in the normal manner.

All domestic sales of production from a mine or of other natural resources, whether by the Crown or any other person, will be taxable in the normal manner. As with any other taxable supply, the tax will be on the purchaser, with the vendor collecting the GST on behalf of the federal government.

(e) Standard Municipal Services

Many services provided by municipalities to their residents have to do with the development and maintenance of municipal infrastructure and have become integral to the role of local governments. Included in this category are such things as garbage collection, water and sewerage, road building and clearing, and snow removal. In most municipalities, these services are financed from general revenues. In some cases, however, the municipality may identify the cost of the service separately on the tax bill, or arrange for the service to be provided on a direct fee-for-service basis.

Notwithstanding how the service is financed, standard residential services provided by, or on behalf of, municipalities will be tax-exempt. These residential services will be considered standard where a property owner has no option but to take the service. However, where the municipality provides an optional service to individual households on a fee-for-service basis, this will generally be a taxable supply. This will include, for example, charges for snow removal on private property, driveway paving, tree removal – in essence, commercial activities which are in competition with the private sector.

With the exception of water, utility services such as telecommunications, hydro electricity and natural gas will be taxable in all cases. Water supplies by municipalities, or by organizations performing municipal functions, will always be tax exempt.

As set out in the June 1987 White Paper, and consistent with the treatment of standard municipal services, municipal transit services provided on a not-for-profit basis will be exempt. Specifically, no tax will apply on fares charged by transit systems operated by, or on behalf of, a local authority or provincial government where all, or substantially all, of its service is to provide transportation within a municipality and surrounding areas.

(f) Postal Services

Canada Post Corporation provides a wide variety of services to the Canadian public, many of which are commercial activities in direct competition with the private sector. Consistent with the view that the Corporation should increasingly operate in a competitive manner similar to a private sector organization, GST will apply in the normal fashion to all goods and services supplied by Canada Post.

(g) Real Property

To the extent that federal or provincial governments sell or rent real property, they will be subject to the same tax treatment as any other supplier. However, real property supplies made by selected public sector organizations will generally be exempt. This exemption is addressed in detail in Section 7.

(h) Grants and Subsidies

Governments often provide grants and subsidies to private sector organizations, as well as to institutions within the public sector. Grants and subsidies made by public sector bodies will have no GST consequences for recipients – they will not be treated as consideration for a supply.

9.2 Public Sector Purchases

In establishing the GST treatment of purchases by the public sector in Canada, there are two key considerations.

First, under Section 125 of the *Constitution Act, 1867*, "no lands or property belonging to Canada or any province shall be liable to taxation". Given that the legal liability for the GST will rest on the purchaser, the provincial Crown will not be subject to federal tax on its purchases. The issue, therefore, is to ensure that provinces are relieved of any GST liability in a manner that is as simple as possible for the provincial governments and for vendors selling to them.

Second, in the normal operation of the GST, input tax credits may only be claimed to the extent that the purchases are for use in the course of a commercial activity. For the most part, however, the public sector will be making supplies which are either exempt or will not be considered a commercial activity. This means that those public sector organizations which do not have Crown immunity from taxation, e.g., municipalities, schools, hospitals, colleges and universities, would not be able to claim input tax credits on the major portion of their purchases. The federal government is of the view, however, that sales tax reform should impose no greater burden on this sector than the pre-reform system. Special rules discussed below are designed to achieve this objective.

(a) Provincial Government Purchases

(i) Definition of Eligible Entities

Provincial government will be defined to include provincial government departments, agencies and Crown corporations that are agents of her Majesty in right of a province.

(ii) Federal-Provincial Process

Notwithstanding the protection against taxation afforded governments under the Constitution, in 1977, the federal government and six provincial governments (i.e., Ontario, Quebec and the Atlantic provinces) agreed to replace a system of reciprocal exemption with one of reciprocal taxation. Manitoba and British Columbia entered into agreements in 1983. Under these Reciprocal Taxation Agreements, the participating provinces (i.e., excluding Saskatchewan and Alberta) agree not to claim refunds of federal tax to which they are otherwise entitled, and the federal government makes payments, as if it were taxable, of the sales and consumption taxes imposed by the participating provincial governments.

At present, these Agreements result in no major net transfer of funds between the two levels of government.

The Reciprocal Taxation Agreements will terminate automatically upon implementation of the GST. It will be important, therefore, for the federal government and all the provinces to begin negotiations on the appropriate treatment of both levels of government under the post-1990 sales tax regimes. A number of areas must be addressed, including:

- the mechanism for relieving provincial governments of their GST liabilities;
- how to provide parallel treatment for the federal government under the provincial retail sales tax systems;
- the collection of each others' taxes when sales are made by governments to third parties; and
- the status of other taxes and fees currently covered by the Reciprocal Taxation Agreements.

(iii) Relieving Mechanism

In general, two methods are available for relieving the provinces of any GST liability on their purchases:

- point of sale relief through the provision of exemption certificates; and
- payment of tax at time of purchase with a subsequent full rebate.

The federal government prefers the latter approach. In this way, the operation of the GST can be kept as simple as possible for businesses making sales to the provinces – they would not have to make special and, possibly, cumbersome provisions for relieving the provinces of tax at the time of sale.

(b) Federal Government Purchases

(i) Definition of Eligible Entities

Federal government will be defined to include federal government departments, agencies and Crown corporations that are agents of her Majesty in right of Canada.

(ii) Tax Treatment

There are clearly no net revenue implications for the federal government from the imposition of the GST on purchases made by its own departments and agencies.

However, in order to maintain simplicity for vendors, the federal government and its agents will pay tax on purchases just like any other organization.

(c) Purchases by Selected Public Sector Organizations

The public sector encompasses many organizations which perform key functions in the areas of health, education and local government. To the extent these organizations make taxable supplies in the course of a commercial activity, they will be required to charge tax just like any other vendor. However, as is the case with provincial governments, most of the supplies made by these public sector organizations will be tax exempt.

Again, without special provisions, these organizations would be subject to a substantial increase in federal taxation. However, as stated in the April 1989 federal budget, selected public sector organizations – hospitals, schools, municipalities, libraries, colleges and universities – will receive partial rebates of sales tax paid on their purchases to ensure that the reform of the federal sales tax imposes no greater burden than before reform.

The rebate will apply with respect to any GST paid on goods and services purchased by these organizations for their own use in pursuing their objectives. Consistent with the provisions set out in Section 8 regarding rebates for non-profit organizations and charities, some restrictions will be placed on the eligibility of rebate claims for certain purchases of goods and services which are not for use by the organization.

(i) Definition of Eligible Entities

Municipalities

In general, entities qualifying as municipalities under the *Excise Tax Act* will also qualify for the rebate accorded municipalities under the GST. This will mean that the rebate will be available to incorporated municipal bodies and related boards and commissions.

In addition, the Governor-in-Council will have the power to designate certain other, legally distinct local authorities to be municipalities for purposes of receiving the GST rebate. To qualify, the local authority will have to meet the following criteria. It must:

- perform a municipal service;
- be accepted as a local authority by the provincial government;
- operate in the public interest;
- be funded, in part, from taxes or by government grants; and
- be governed by elected representatives or by government appointed officers.

Overall, this treatment will ensure that all municipal libraries will qualify as municipalities even if they are legally distinct from the municipality. Moreover, many other legally distinct local authorities will also qualify including: police commissions; municipal transit systems; water distribution authorities and sewerage and irrigation authorities.

Universities and Colleges

Institutions will be eligible for the rebate accorded universities and colleges if they are a recognized publicly funded university, public college, or an affiliated research center.

A public college will be defined as a non-profit institution in receipt of direct government funding and whose primary purpose is to provide post-secondary educational services in one or more of the following areas:

- undergraduate university courses;
- technical courses leading to diplomas and certificates; and
- vocational programs.

Schools

Elementary and secondary schools which come within the jurisdiction of the various school boards or boards of education under provincial authority, as well as private, non-profit elementary and secondary schools which follow the approved curriculum of their province will also be eligible to claim the rebate.

Hospitals

Institutions which are *bona fide* public hospitals for the purposes of the *Excise Tax Act* will be eligible for the appropriate rebate. For example, this will include government and non-profit hospitals providing acute, rehabilitation, or chronic care services.

(ii) Rebate Mechanism

The rebates will be provided to these public sector organizations on a percentage basis, as follows:

$$\text{Rebate percentage} = \left[1 - \frac{\text{Estimated 1991 FST liability without reform}}{\text{Estimated 1991 GST}} \times 100 \right]$$

The rebate figures will be calculated using federal estimates of the FST and GST liabilities of these organizations. Four different rebate percentages will be established, i.e., one each for municipalities, universities/colleges, schools and hospitals.

These rebates will be paid directly to each organization. Registered organizations will be entitled to file claims with their regular GST return on an annual, quarterly or monthly basis as the case may be. Organizations that are not registered for GST purposes will be able to file on an annual or quarterly basis. Under this system, there will be no additional complexity for vendors since these selected public sector organizations will pay the full amount of tax at the point of purchase and subsequently file for rebates.

(iii) Process

The exact rebate figures have yet to be determined for each of the four categories of organization. The federal government will be discussing this issue with the appropriate representative associations prior to taking final decisions on the rebate percentages.

9.3 Self-Supply

The possibility of special self-supply rules for governments was raised in the June 1987 White Paper on Sales Tax Reform. Given that the provinces will not be liable for tax on their purchases and in view of the decision to provide selected public sector organizations with percentage rebates of tax, the potential bias towards self-supply has been greatly reduced. As a result, no special self-supply rules will be required for the public sector under the GST. However, any generally applicable self-supply rule, e.g., for residential real property, will apply to the public sector just as it applies to the private sector.

10. Indians and Indian Bands

Section 87 of the *Indian Act* exempts from taxation the personal property of an Indian or band situated on a reserve, as well as their interest in reserve or designated lands. This exemption applies notwithstanding any other Act of the Parliament of Canada.

The tax treatment of sales and purchases by Indians under the GST will be in full compliance with the requirements of the *Indian Act*. Given that the legal liability for the GST rests on the purchaser, at a minimum, Indian purchases of goods on reserve will not be taxed. This represents a substantial benefit to the Indian community relative to their treatment under the existing federal sales tax. At present, to the extent that the federal tax is embedded in the retail price of goods and services sold on reserve, Indian consumers pay the tax now in the same way as all other Canadian consumers. Moreover, Indians on reserve will be eligible for the substantially enriched GST Credit even though they will be receiving some relief from the GST directly.

The taxation of services under the GST raises issues of interpretation regarding Section 87 of the *Indian Act*. Further work is required in this area. In completing this assessment, the government will want the views of representatives of the Indian community and those groups involved in Indian taxation.

11. Financial Services

11.1 Introduction

In many respects, financial services are similar to the wide range of other services provided in the economy. Viewed from this perspective, the use of financial services represents consumption and ideally should be taxed within the context of a broad based sales tax like the GST.

However, financial transactions are often structured in a way that makes it difficult to apply a sales tax. The price for the service is often implicit, being reflected in, for example, the spread between interest received from borrowers and returns to depositors, policyholders and annuitants. While conceptually it is possible to identify these implicit prices, doing so in practice is extremely complex.

The June 1987 White Paper proposed a unique tax structure for the financial sector that attempted to identify the charges for financial services that are implicit in the margins earned by financial institutions. While some progress was made in translating this proposal into an operational tax structure, substantial technical problems remained. Given the magnitude of the remaining difficulties and the fact that no country in the world has successfully been able to apply sales tax to financial services, the 1989 budget document on the GST indicated that financial intermediation services will be exempt.

In accordance with this decision, the supply of financial services to domestic consumers and businesses will be tax-exempt under the GST. In other words, tax will not be charged on such consumer services as loans, deposits, mortgages and life and automobile insurance. However, the providers of financial services will pay tax on their own purchases.

As with all other goods and services, financial services provided to non-residents will be zero-rated. This will ensure that Canadian firms providing financial services remain competitive on world markets.

The rules for financial services will primarily affect a specific group of registrants – such as banks, trust companies, insurers, financial co-operatives and investment dealers – since the vast majority of financial services are provided by these institutions. In addition to exempt financial services, these institutions will normally make taxable and zero-rated supplies. Accordingly, under the general GST rules, they will have to allocate their inputs in order to determine their input tax credit entitlements. The tax paid on their purchases will be eligible for input tax credits to the extent they are for use in making a taxable or zero-rated supply. Registrants supplying exempt financial services only on an incidental basis will not be required to allocate inputs to financial services.

As a consequence of the decision to exempt financial services, it is necessary to categorize the exceptionally wide range of services provided by these institutions into taxable, zero-rated and tax-exempt supplies. This is a very fine-grained exercise which raises a number of complex technical issues regarding the treatment of the goods and services purchased by the providers of financial services.

In order to ensure that the approach is clear and practical, the government will be consulting with tax professionals and the industry itself in further refining the proposals outlined below.

11.2 Basic Approach

(a) Definition of a Financial Service

Financial services will be defined to include all supplies which are closely related to financial intermediation, market intermediation and risk pooling. Clearly this includes basic intermediation services such as lending and deposit-taking. However, there is also a range of service fees related to the intermediation process, such as cheque clearing fees and withdrawal charges, where the appropriate treatment is more difficult to determine.

The range of services to be exempted as financial services has been formulated by balancing the following competitive equity considerations:

- On the one hand, the range of exempted services should be narrow in order to preserve tax neutrality with other taxable goods and services.
- On the other hand, services which are closely related to the intermediation process should be exempt to minimize the incentive to combine these fees with interest charges in an effort to avoid the tax.

The definition of a financial service will hinge on the definition of a financial instrument. A financial instrument will include items such as currency, all forms of indebtedness, shares of capital stock, policies of insurance or reinsurance, cheques, other payment instruments, letters of credit, and options, futures contracts or guarantees in respect thereof.

Financial services will be defined to include the exchange of currency, the lending, advancing, borrowing or depositing of money and the issue, sale, underwriting, purchase, receipt, payment or transfer of ownership of a financial instrument. Leasing will not be considered a financial service, and therefore lease payments will be taxable as discussed in subsection 11.4(b).

Arranging for the purchase, sale or placement of a financial instrument will also be regarded as a financial service. Consequently, the services provided by insurance agents, mortgage brokers and investment dealers will be treated as tax-exempt supplies.

(b) Input Tax Credits

Subject to the *de minimis* rule discussed below, registrants providing financial services will be required to allocate inputs between their use in making taxable and zero-rated supplies and exempt supplies in order to determine their input tax credit entitlements. No input tax credits will be allowed to the extent that tax-paid purchases are for use in the provision of tax-exempt financial services in Canada.

Registrants will allocate inputs between their use in making taxable and zero-rated supplies and exempt supplies using a method suitable in the circumstances. As is the case in administration of the income tax, the method chosen will of course be subject to audit by Revenue Canada. The general rules for determining input tax credit entitlements under the GST are discussed in Section 2.3.

Prior to implementation, the government will be providing guidelines indicating illustrative methods for allocating inputs for the purpose of claiming input tax credits.

(i) De Minimis Rule

Virtually all businesses are engaged in financial activity to some extent, whether it be depositing of funds or the purchasing of term deposits, bonds or shares. However, for most firms these activities are only ancillary to their other activities. In the absence of any special rule, these firms would not be permitted to claim input tax credits for tax paid on purchases to the extent they are for use in the provision of financial services.

Registrants will not be required to allocate inputs to any supply of financial services where the annual revenue of an income nature received from these services, such as interest and dividends, is less than $10 million, and less than 10 per cent of the total annual revenue from all supplies. For example, if the revenue from exempt financial services of a large manufacturer of automobiles was 6 per cent of its total revenue, but exceeded $10 million, it would not meet the *de minimis* test and would be required to allocate inputs to the supply of financial services for input tax credit purposes. For any particular reporting period, the *de minimis* test will be based on results for the immediately preceding fiscal period.

While this approach does not require an explicit definition of a financial institution, virtually all firms considered to be financial institutions will not be excluded under the *de minimis* test. On the other hand, firms supplying financial services on an incidental basis will be excluded under the *de minimis* test, and will not have to allocate any inputs to their supplies of exempt financial services.

For the purpose of this document only, firms that are not excluded under the *de minimis* rule will be referred to as financial institutions.

(ii) Real Property and Capital Goods

The acquisition of capital goods and real property can involve large expenditures, and the extent of their use in an exempt supply can change over time. Unlike most other firms, financial institutions will have a significant and varying amount of exempt supplies. Because of this, it is important that the input tax credits obtained on purchases of capital goods and real property be calculated as accurately as possible.

The normal rules for determining input tax credits for purchases of real property will apply to financial institutions (see Section 2.3).

There will, however, be some modification to the rules for the treatment of capital goods in this area. Under the general rules, purchases of capital goods will be eligible for input tax credits only when they are for use primarily in the provision of a taxable or zero-rated supply. These rules are described in Section 2.3. Given the balance of taxable, zero-rated and exempt supplies provided by financial institutions, they would, in many cases, be denied input tax credits on the vast majority of their purchases of capital goods. This would clearly be inappropriate.

As a result, for these institutions, capital goods will be treated as if they were real property. In other words, input tax credits will be allowed to the extent capital goods are acquired for use in making taxable or zero-rated supplies. Given the potential complexity of applying the change-of-use rules to all capital goods purchased by financial institutions, possible means of simplifying these rules will be explored in consultation with the industry.

(iii) Exported Services

Financial services provided to non-residents for use outside Canada will be zero-rated, as is the case for all other exports of goods and services. As a result, providers of financial services will be eligible to claim input tax credits in respect of tax-paid purchases used in the provision of exported services. This will ensure that Canadian firms providing financial services remain competitive in global markets.

In the absence of special rules, there could be instances where firms would have an incentive to restructure transactions, through the use of foreign branches or affiliates, to inflate their input tax credits. Rules will be introduced, following discussion with the financial sector, to address this issue.

(iv) Imported Services

In the case of goods imported by financial institutions, GST will be paid at the border. Clearly, it is impractical to collect tax at the border on imported services. In the absence of special rules, financial institutions would have an incentive to import services in order to avoid the GST on these purchases. To ensure that domestic suppliers of these services are not placed at a competitive disadvantage, financial institutions, like other suppliers of exempt goods and services, will be required to self-assess the GST payable on all imported services, for instance data processing services (see Section 2.5). Input tax credits for the self-assessed tax will be recoverable in the normal manner; that is, registrants will not be able to recover the GST on the portion of imported services relating to an exempt supply.

11.3 Application to Specific Sectors

(a) Banks, Trust and Loan Companies and Financial Co-operatives

(i) Domestic Operations

Banks, trust and loan companies, and financial co-operatives (credit unions and caisses populaires) provide a wide range of services to domestic customers. The primary function of these institutions is the acceptance of deposits and the lending of funds – exempt activities in the context of the GST. These institutions also provide a number of services closely related to this intermediary function, such as cheque processing and the transfer of funds between accounts. The supply of these services to domestic customers will be exempt under the GST.

In addition, these institutions provide professional and administrative services, such as investment advice, management services, payroll administration and share registry. These services will not be included in the definition of financial services. Hence, the supply of these services will be taxable and will give rise to input tax credits in the normal manner.

Credit card fees include fees charged to both merchants and card users. Credit card user fees often cover a range of services, some of which, if charged separately, would be exempt (e.g., insurance) while others would be taxable (e.g., administrative charges). However, it is impractical to identify separately the individual charge for each service. Therefore, all credit card fees charged to domestic customers will be treated as a financial service – exempted from the GST.

There are a number of financial institutions which specialize in a particular aspect of the intermediation process. For example, the provision of credit by an acceptance company will be exempt as a financial service.

Premiums paid by financial institutions to the Canada Deposit Insurance Corporation and other stabilization funds will, like any other insurance premium, be tax exempt.

As noted previously, the transfer or placement of a financial instrument by an agent will be regarded as a financial service. Accordingly, the services provided by mortgage brokers and deposit-placing agents will be exempt.

Table C.3 sets out the proposed GST treatment of a number of services provided and fees charged by banks, trust and loan companies and financial co-operatives to domestic customers.

(ii) International Operations

Canadian financial institutions provide services to both residents and non-residents. Services provided to non-residents for use outside Canada will be zero-rated. As such, banks, trust and loan companies and financial co-operatives will be entitled to claim input tax credits to the extent that taxable purchases are for use in providing zero-rated goods or services to non-residents and foreign branches of Canadian financial institutions for use outside Canada. These inputs would normally include buildings, rents, computers, furniture and fixtures. In cases where inputs cannot be allocated to zero-rated supplies on a transaction-by-transaction basis, this allocation will be done in accordance with what is reasonable under the circumstances as set out above in Section 11.2.

Fees charged for various financial services will be considered to be a zero-rated supply to the extent the service is rendered to a non-resident for use outside Canada. The provision of a financial service to a Canadian branch of a foreign corporation will be considered to be a supply made in Canada and, therefore, will be exempt from the GST. Conversely, the provision of financial services to a foreign branch of a Canadian company will be considered as an export and, as such, zero-rated.

Table C.3

GST Treatment of Services Provided By Deposit-Taking Institutions to Domestic Customers

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Taxable supplies

- Professional and administration services
  - Administration fees
  - Appraisals
  - Debt counselling
  - Financial planning
  - Trustee
  - Safekeeping and custodian
  - Share registry
- Data processing services
  - Payroll
  - Record keeping and account reconciliation
- Sale or rental of goods
  - Cheques
  - Leasing property
  - Point of sale equipment rentals
  - Safety deposit box rentals

Table C.3 Continued

Exempt supplies
Deposit services
Account statements
Automatic transfer of funds
Automated teller machine charges
Cheque processing
Night depository
"Not Sufficient Fund" charges
Withdrawal charges
Credit services
Acceptance fees
Buy-down fees
Credit card user fees
Guarantee fees
Loan application fees
Loan maintenance fees
Merchant discount on credit card
Mortgage set-up fees
Overdraft charges
Other services
Canada saving bond commissions
Certified cheques
Currency products (swaps, options and forwards)
Deposit broker
Foreign currency
Interest rate products (swaps, options and forwards)
Mortgage broker
Travellers cheques

(b) Life and Property and Casualty Insurers

(i) Domestic Operations

The primary function of both life and property and casualty insurers is the pooling of risks. Life insurers provide life annuities and insurance against the risk of mortality, accident and sickness, whereas property and casualty insurers provide protection mainly against damage or loss of property and public liability claims.

The supply of insurance in respect of a Canadian risk will be tax exempt. Consequently, receipt of insurance premiums and the payment of insurance claims related thereto will both be tax exempt.

The investment return earned on financial instruments is also an integral part of an insurance operation. An insurer's investment revenue, such as interest on bonds and mortgages, and dividends on shares, will be tax exempt.

Insurers will not be eligible to claim input tax credits for the GST paid on purchases to the extent they relate to the supply of insurance in Canada or the income earned on Canadian investments. Taxed inputs typically used by insurers will include buildings, computers, furniture and fixtures, agents' expenses for travelling and entertainment, as well as outside professional fees.

Insurers supply other services to domestic customers which will be taxable if explicit fees are charged. For example, fees charged by a life insurer for administering a self-insurance fund will be taxable provided there is no insurance element involved. Similarly, insurance evaluation services provided by property and casualty insurers will also be taxable. To the extent that tax is charged on services rendered to a customer who is a registrant, and they are in respect of a commercial activity of the registrant, an input tax credit will be allowed in accordance with the normal rules.

Commissions earned by independent agents selling insurance policies will be considered to be in respect of an exempt financial service. Thus, purchases related to the agent's insurance commissions will not be eligible for input tax credits. This will ensure consistent treatment of independent insurance agents and employees of insurance companies.

Table C.4 sets out the proposed GST treatment of a number of services provided and fees charged to domestic customers in the insurance sector.

(ii) International Operations

The location of the supply of insurance services will be determined by the location of the risk. The insurance of foreign risks by a resident insurer will be considered to be an exported service, and as such, will be zero-rated. Accordingly, input tax credits will be allowed for purchases to the extent they are reasonably allocable to the supply of these zero-rated services.

A foreign branch of a Canadian insurer will be treated as a non-resident. Thus, services supplied to the foreign branch from the Canadian head office for use outside Canada will be zero-rated, in the same manner as if the foreign branch were a foreign subsidiary. Similarly, a Canadian branch of a foreign company will be treated as a resident. Where the Canadian branch imports services from abroad, it will be required to self-assess the GST on those imported services under the normal rules of the tax.

Table C.4

GST Treatment of Services Provided by Insurers to Domestic Customers

Taxable supplies

- Professional and administration services
  - Actuarial services
  - Estate planning advice
  - Fees for self-insurance schemes
  - Financial planning advice
  - Insurance evaluation
  - Investment advice
  - Segregated fund management
- Data processing services
  - Payroll
  - Record keeping

Exempt supplies

- Risk-pooling services
  - Insurance
  - Reinsurance
  - Sale of insurance policies by agents
- Saving services
  - Annuity fees
  - Universal plan fees
- Credit services
  - Buy-down fees
  - Guarantee fees
  - Loan application fees
  - Mortgage set-up fees

Reinsurance of foreign risks assumed by a resident insurer will be treated as a zero-rated export of services. Reinsurance of Canadian risks ceded to a non-resident insurer not licensed in Canada will be treated as an imported exempt service.

(c) Investment Dealers

(i) Domestic Operations

Market intermediation primarily involves the underwriting of securities on the primary market and the purchase or sale of securities on the secondary market –

either as an agent or as a principal. Market intermediation and directly associated services provided to domestic customers will be treated as tax-exempt supplies.

In addition to market intermediation, investment dealers provide financial intermediation services by advancing funds to customers, dealers and brokers for which they receive interest revenue and other fees. Investment dealers also hold accounts for customers, dealers and brokers. In essence, these are deposit accounts with interest paid on the cash balances. Financial intermediation services provided by investment dealers will be treated in the same manner as similar services provided by banks, trust and loan companies and financial co-operatives: all such services will be tax exempt.

Advice rendered in connection with mergers and acquisitions, financial counselling, or investments will be treated as taxable supplies. Thus, investment dealers will be put on an equal competitive footing with other businesses offering these or similar services. As is the case for other registrants, investment dealers will be eligible to claim input tax credits to the extent their purchases are attributable to their taxable or zero-rated supplies. Tax-paid purchases normally would include such things as rents, computers, office furnishings and fixtures.

Table C.5 sets out the proposed GST treatment of a number of services provided and fees charged by investment dealers to domestic customers.

Table C.5

GST Treatment of Services provided by Investment Dealers to Domestic Customers

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Taxable supplies

- Professional and administration services
  - Account administration
  - Financial planning
  - Investment advice
  - Management services
  - Merger and acquisition advice
  - Safekeeping and custodial

Exempt supplies

- Market intermediation services
  - Brokerage
  - Dealing in securities as principal
  - Underwriting or arranging for the placement of a securities issue
- Credit services
  - Credit management
  - Margin accounts

(ii) International Operations

The location of the supply of financial intermediation services provided by investment dealers will be determined on the basis of the residence of the customer – the same as for all other financial institutions. However, investment dealers will also be required to determine the location of supply of their market intermediation services.

Where a brokerage fee is paid by a buyer or seller of securities in the secondary market, the consumer of the service is the person paying the fee or commission. Therefore, brokerage services purchased by a Canadian resident will be tax exempt. Brokerage services purchased by non-residents will be zero-rated.

Where an investment dealer acts as a principal in marketing a newly issued financial instrument, the consumer of the service is the issuer of the financial instrument. The underwriting of securities for a Canadian issuer will be tax exempt, and zero-rated for non-resident issuers.

Where an investment dealer acts as a principal by trading securities in the secondary market on its own account, the consumer of the service is not readily identifiable. All such supplies will be treated as tax exempt.

11.4 Special Issues

(a) Tax Grouping

As is the case for the purposes of the *Income Tax Act*, each member of a related group of companies will be treated as a separate entity under the GST. As a result, goods and services provided to related members will be subject to GST where applicable and creditable to the extent they are acquired for use in making a taxable or zero-rated supply.

The government recognizes that in certain very limited circumstances, such as data processing services, special rules may need to be developed. The treatment of these circumstances will be the subject of discussions with the affected financial institutions.

(b) Leasing

The leasing of personal or real property will not be treated as a financial service. All lease payments will be subject to GST and creditable to the lessee to the extent the property is for use in making a taxable or zero-rated supply. Lessors, of course, will be able to claim input tax credits in the normal manner for the GST paid on goods they acquire for leasing purposes.

Under the general rules of the tax, property imported into Canada will be subject to GST at the border on its duty-paid value. Special rules will apply in cases where the importation is in respect of property leased from a non-resident by a person who is subject to the self-assessment rule for imported services. In these circumstances, the lessee, if he or she is the importer of record and has paid the tax on the importation, will be permitted to file for a refund of the GST paid at the border. The lessee will then account for GST on the lease payments in the normal manner under the self-assessment rule.

(c) Options

Generally, the tax status of the supply of an option will depend on the tax status of the good or service to which the option relates. For example, an option in respect of aluminum will be taxable, whereas an option in respect of a financial instrument will be tax-exempt.

Notwithstanding this general treatment, any option traded on a recognized exchange will be treated as a financial instrument and, therefore, tax-exempt.

(d) Precious Metals

Funds can be invested in a variety of financial instruments, including precious metals; that is, gold, silver, or platinum. An investment in precious metals may take the form of a precious metal certificate issued by the holder of the metal, or of the precious metal itself.

The initial supply of investment-quality precious metals by domestic refiners will be zero-rated. Similarly, the importation of investment-quality precious metals will not be subject to tax on importation. To qualify for this treatment, precious metals will have to be in the form of bars, coins or wafers with a purity level of at least:

- 99.5 per cent for gold and platinum; and
- 99.9 per cent for silver.

As is the case with other financial instruments, the supply of precious metals for investment purposes will be tax exempt. The supply of precious metals that do not satisfy the purity or form requirements will be subject to GST.

12. Transition

This section outlines the key provisions that will be put in place to ensure a smooth transition from the existing federal sales tax to the Goods and Services Tax. These include:

- rebates of federal sales tax already paid on inventories of new goods held for resale or lease, and on hand as of the start-up date;
- long-term fixed-price contracts;
- transactions straddling the start-up date;
- price adjustments in respect of supplies made prior to start-up; and
- other miscellaneous provisions such as restrictions on the GST used goods and change-of-use rules as well as instalment payment provisions under the current federal sales tax.

12.1 Federal Sales Tax Inventory Rebates

(a) General Provisions

On implementation of the GST, many firms will be holding inventories of new goods for resale on which federal sales tax previously will have been paid. In order to avoid double taxation of these goods, rebates of the existing federal sales tax will be provided in respect of these items to firms holding them on a tax-paid basis on implementation.

To qualify for rebate, inventory generally will have to be:

- in the hands of a GST registrant on implementation;
- in a new and unused condition;
- federal sales tax paid;
- in Canada on January 1, 1991;
- for sale or lease to customers in the ordinary course of the registrant's business; and
- acquired by the registrant prior to January 1, 1991.

Included in the definition of new and unused goods for resale will be rebuilt and remanufactured goods, as well as new and unused contractors' building materials. However, building materials that have been delivered to a job site will not qualify for rebate.

Under certain conditions discussed below in Section 12.4, rebates will be provided in respect of new and unused federal sales tax-paid goods sold by retailers to consumers prior to January 1, 1991 and returned afterwards for refund or credit.

Special rules will apply in respect of inventories of unsold new housing stock on hand at implementation. These are discussed below in subsection (b).

The current federal sales tax applies at an early trade level. As a result, the tax content on goods often is not apparent at subsequent trade levels. Revenue Canada – Excise currently has in place administrative mechanisms for calculating federal sales tax refunds where the amount of tax is not directly ascertainable from a business' purchase records. These will be suitably modified for use in the federal sales tax rebate program.

Additional details on the procedures and mechanisms for claiming rebates with respect to inventories will be provided in the coming months.

(b) New Housing

The price of newly constructed housing reflects a significant federal sales tax component as a result of the application of tax to construction materials. Under the GST, new housing will be taxable on the sale price to consumers. In the absence of any special provisions, a new house that is partially built or completed prior to start-up of the GST but the sale of which is not completed until after start-up effectively would be subject to a degree of double taxation.

To address this, rebates in respect of the FST embodied in newly constructed housing will be provided to purchasers of single, semi-detached and attached homes where the purchaser has entered into a written agreement of purchase and sale prior to January 1, 1991 and takes possession for occupancy prior to March 1, 1991. The rebate will be based on the estimated federal sales tax content per square foot in a comparable home completed prior to January 1, 1991. This estimate will be determined prior to start-up of the GST. The amount rebated will depend on the time at which the purchaser takes possession for purposes of occupancy. Where possession of a completed house occurs during January 1991, the rebate will be three-quarters of the estimated federal sales tax per square foot. The rebate will be one-half for purchasers taking possession in February 1991.

In the case of new condominium and rental apartment buildings under construction, the amount rebated will depend on the actual degree of completion on January 1, 1991. If the building is between 25 and 50 per cent completed, one-half of the estimated federal sales tax will be rebated. If the building is more than 50 per cent completed, a three-quarter rebate will be provided.

12.2 Fixed-Price Contracts

No special relieving rules will be provided for fixed-price contracts straddling the start-up date. Under the normal rules of the GST, the purchaser will be liable to pay tax on any taxable amounts paid or payable to the vendor as of January 1, 1991. For example, in the case of a long-term fixed-price commercial lease, the tenant will be required to pay GST on all lease payments on or after January 1, 1991; if the tenant is a registrant, the tax will be recoverable as an input tax credit in the normal manner. The vendor – in this example, the commercial landlord – will be required to collect and remit GST on any taxable payments received or receivable on or after January 1, 1991.

12.3 Transactions Straddling the Start-Up Date

In many cases, the normal rules governing application of the tax will determine the applicability of GST to transactions straddling the start-up date. The general GST timing rules are discussed in Section 2.2. However, four overriding exceptions will be made to the general rules:

Invoice Issued Prior to January 1, 1991

Mere issuance of an invoice prior to January 1, 1991 in respect of a supply occurring in 1991 will not be allowed to establish non-liability for GST purposes.

Goods and Services Currently Taxed

For sales of goods currently subject to federal sales tax (i.e., taxable goods sold by a licensed manufacturer or a licensed wholesaler), GST will not apply to the sale if delivery of the goods or transfer of title to the goods occurs before January 1, 1991. Where this does not occur, GST will apply. This rule will ensure that either the current federal sales tax or the GST, but not both, applies to all goods currently subject to federal sales tax.

Telecommunications services and telecommunications programming services are currently taxed at the rate of 11 per cent. To facilitate the transition to the new system, the current tax will apply on all billings to users covering periods commencing prior to 1991 and ending before February 1, 1991. All billings for these services in respect of periods either beginning in 1991 or ending after January 31, 1991 will be subject to GST.

Supplies Prior to Start-Up

Provisions will ensure that where goods, the sales of which are not currently subject to federal sales tax, are delivered or title is transferred to the purchaser prior to January 1, 1991, or services are performed prior to January 1, 1991, GST will not apply as long as the purchaser pays for the supply or the vendor issues an invoice for the supply prior to March 1, 1991. These provisions will not apply in the following circumstances:

- lease payments in respect of real or personal property;
- progress payments in respect of construction-in-progress; and
- telecommunications services and telecommunications programming services.

Prepaid Supplies

Special rules will apply in respect of payments made before January 1, 1991 for goods to be delivered or services to be performed after December 31, 1990.

Payments by corporations, partnerships and sole proprietors, made after August 31, 1989 and prior to April 1, 1990, for goods to be delivered or services to be performed after December 31, 1990, will be subject to GST. The tax will become payable by the purchaser on a self-assessment basis on January 1, 1991 on that portion of the payment reasonably allocable to the goods or services to be provided on or after that date. In the case of a person registered for GST purposes on January 1, 1991, the tax will be remitted with that registrant's first GST return. Of course, to the extent that the goods and services to which the payment relates are to be used in a commercial activity of the purchaser, they will give rise to an offsetting input tax credit.

For non-registrants, the tax will have to be remitted by April 1, 1991.

In the case of payments made by a person after March 31, 1990 and before January 1, 1991, the vendor will be required to collect tax on that portion of the payment relating to goods to be delivered or services to be performed on or after January 1, 1991. The vendor will be required to remit this tax with his or her first GST return.

With this treatment, GST will not be collected on supplies made prior to 1991. However, it will ensure that purchasers cannot avoid GST on supplies made after implementation simply by paying for them prior to January 1, 1991. This rule will not apply in the case of prepaid newspaper and periodical subscriptions.

Subject to these overriding rules, the following illustrates the application of the GST timing rules to transactions straddling the start-up date.

(i) Outright sale of goods to a purchaser

No GST will apply if delivery or passage of title to the purchaser occurs before January 1, 1991.

(ii) Importation of goods into Canada

No GST will be payable where "release" of the goods from Canada Customs takes place before January 1, 1991.

GST will apply where "release" occurs on or after this date.

(iii) Goods shipped by a supplier to a person on a consignment basis prior to January 1, 1991

GST will apply where the consignee sells the goods or takes them for his or her own use on or after January 1, 1991.

(iv) Where goods are supplied pursuant to a commercial construction contract under which progress payments are made

No GST will apply on those amounts that become due under the contract before January 1, 1991, provided such progress payments are reasonably related to the percentage completion of the construction project at the time the payment is made.

GST will be payable on amounts that become due on or after January 1, 1991.

(v) Where a supplier provides a taxable service to a person that has been paid for prior to January 1, 1991 (such as a building maintenance contract)

No GST will be payable if the service is substantially completed for the person before the start-up date.

Otherwise, GST will apply on a prorated basis over the period during which the service is provided.

(vi) Professional services (e.g., accountants, lawyers), where there is "work-in-progress" at the time the new tax takes effect

Prepayments for work to be done during 1991 will be subject to GST (on a prorated basis if the work is performed partially in both 1990 and 1991).

To the extent that the services are performed prior to January 1, 1991, GST will not apply as long as the services are paid for or the vendor invoices the client prior to March 1, 1991.

(vii) In the case of a taxable sale of real property

No GST will be payable if the date on which ownership or possession is transferred is before January 1, 1991.

Where, under written agreement, an amount becomes due before January 1, 1991, but the ownership of the real property is not transferred until January 1, 1991 or later, amounts due before that date (i.e., deposits) will be subject to GST as part of the consideration paid for the property.

12.4 Pricing Adjustments

Situations will arise where pricing adjustments are made following start-up of the GST in respect of supplies made prior to start-up. Examples include deferred quantity discounts, adjustments for goods less than quality or quantity ordered, and refunds or exchanges for defective goods.

For the most part, these adjustments will have no GST implications as long as they are reasonable in the circumstances. The exception will be for returned goods sold prior to January 1, 1991:

- Goods returned in straight exchange for other replacement goods will entail no GST consequences as long as the transaction does not involve the issuance of a credit note or refund to the customer. In these circumstances, there will be no adjustments in the vendor's federal sales tax inventory rebate claim.
- Where goods are returned and the customer is given a credit note, the credit note will be treated the same as money when it is redeemed. If the note is redeemed for a taxable supply, GST will be charged in the normal manner. Where the GST registered vendor issues a credit note for a returned good that was sold in a new and unused condition and subject to federal sales tax prior to January 1, 1991, the registrant will be permitted to apply for a federal sales tax rebate to the extent that a refund or credit note was provided to the customer (i.e., net of any re-stocking charges).

12.5 Miscellaneous Provisions

(a) Used Goods Rule

For the first three years of operation of the GST, the used goods rule (described in Section 13.9), which allows a notional input tax credit to registrants for purchases of used goods from non-registered persons, will be limited to registrants who, in the ordinary course of their business, acquire used goods for resale purposes. Hence, during the first three years of the GST, registrants who acquire used goods from a non-registrant for use as a capital property (for example, a used automobile) will not be entitled to claim a notional input tax credit in respect of the purchase.

(b) Limitation on Change of Use

As noted in Section 2.3, no input tax credits will be allowed under the change-of-use rules applying to capital property and real property in excess of the GST paid with respect to that property. Therefore, if the property was in the hands of a GST registrant prior to January 1, 1991, no input tax credit under the change-of-use rules will be available even if the commercial use of the property increases.

(c) Restriction on FST Instalment Rule

Under subsection 27(1) of the *Excise Tax Act*, manufacturers are permitted to account for the federal sales tax on instalment payments as the payments are received or become receivable. This provision will be suspended on November 30, 1990 for any instalment payment contract entered into on or after November 1, 1989. All federal sales tax on such contracts will become payable on December 31, 1990 for any goods that have been delivered by the manufacturer to the purchaser, or title to which has been transferred to the purchaser, as of that date.

13. Other Operational Aspects of the GST

This Section summarizes a number of miscellaneous provisions and operational aspects of the GST.

13.1 Partner Expenses

GST collected on supplies made by a partnership will be reported at the partnership level. For commercial reasons, it is common for some goods and services to be purchased by the individual partners directly (rather than by the partnership) for use in carrying on the business of the partnership. For example, an individual partner may incur travelling or vehicle leasing expenses for which he or she is not reimbursed. To the extent the partner is able to deduct such outside expenses for income tax purposes in calculating his or her partnership income, the partner will be able to recover the GST paid or payable on those purchases directly, to the extent that a credit for the purchases would have been available to the partnership if the partnership itself had acquired the goods or services. Refund claims for GST paid on a partner's expenses will be filed at the same time as the partner's income tax return.

Neither a partnership nor a partner will be permitted to claim an immediate input tax credit for the GST paid on the purchase of a passenger vehicle (as defined in the *Income Tax Act*) where the vehicle is partially for the personal use of one of the partners or any individual related thereto. However, either the partner or the partnership, as the case may be, will be allowed to claim a credit based on the capital cost allowance in respect of the vehicle as allowed for income tax purposes to the extent that the vehicle is for use in a commercial activity of the partnership. Individual partners will file for this amount on their annual GST refund claim for partner expenses. Where the partnership claims a CCA-based input tax credit under this rule, the credit will be claimed on the partnership's GST return for the reporting period that includes the fiscal year-end of the partnership.

These rules are designed to provide consistency in the treatment of passenger vehicles between partners and self-employed individuals. This treatment – also applicable in respect of an aircraft that has a personal use component – is discussed in greater detail in Section 2.3.

13.2 Employee Expenses

Many employees, such as commission salespeople, incur significant expenses in the course of carrying out their duties. These expenses often are not reimbursed by their employers except indirectly, through the salaries and commissions they are paid.

Since employees will not be considered to be carrying on a commercial activity, they will not be able to claim an input tax credit for the GST paid on these expenses. However, officers and employees will be refunded the GST paid on those employment expenses which are also deductible for income tax purposes. Where the income tax deduction is a capital cost allowance in respect of a passenger vehicle or aircraft, the credit will be based on 9/109ths of the CCA deduction allowed for income tax purposes.

The GST refund claim will be filed at the same time as the income tax return of the employee for the calendar year in which the expenses are incurred.

13.3 Bad Debts

If a registrant accounts for GST on a supply made to a person with whom the registrant is dealing at arm's-length and subsequently writes off a part or all of the consideration for that supply as a bad debt, the registrant will be allowed to claim an input tax credit for the tax component of the bad debt written off. GST will have to be remitted equal to 9/109ths of any part of the bad debt subsequently recovered.

13.4 Mixed and Combined Supplies

Where a vendor makes a mixture of discrete supplies, some of which are taxable and some of which are not, and invoices them for a single all-inclusive price, GST will be assessed on that part of the amount paid that is reasonably attributable to the taxable supply. For example, the price charged for a freezer (taxable) filled with basic groceries (zero-rated) will have to be prorated to isolate the value of the freezer for GST purposes.

As outlined in Section 2.2, the time at which a liability for GST arises will, in some cases, depend on whether the supply is of personal property, real property or service.

Instances will arise where a combination of these is supplied at one all-inclusive price. For example, an appliance dealer may deliver and install a dishwasher; this would be a combined supply of personal property (the dishwasher) and service (delivery and installation). Where these situations arise, the following rules will be used **to determine the time at which the liability for GST arises**:

- If one of the items supplied reasonably can be regarded as being of greatest value, then all of the items supplied will be treated as a supply of that item. In the dishwasher example above, the dishwasher clearly would be of greater value than the delivery and installation services. Hence, the supply of the dishwasher and the incidental services would be treated as a single supply of personal property.

- If the items supplied are of equal value:
  (i) where one of the items is real property, all of the items will be treated as a supply of real property; and
  (ii) in any other case, all of the items supplied will be treated as a supply of a service.

13.5 Diplomats and International Organizations

Consistent with Canada's international obligations under various international conventions, treaties and agreements, relief from GST will be provided to representatives of foreign governments and other international organizations. The mechanisms and procedures for providing such relief will be determined prior to the introduction of the GST.

13.6 Gambling, Lotteries and Pari-Mutuel Betting

In the case of pari-mutuel betting, gambling and lotteries operated on a commercial basis, payments received by the organizer for bets or raffle and lottery tickets will be subject to GST. Special provisions will allow the organizer to claim a notional input tax credit for cash prizes or winnings paid to a bettor. This notional credit will be equal to 9/109ths of the prize. However, where tax has been paid on prizes in-kind, an actual input tax credit will be allowed under the normal rules. The result will be that the tax applies only to the organizer's margin. There will be no credit to registrants for purchasing a lottery ticket or placing a bet.

In those cases where it is not practical for the operator to record the total amounts bet (for example, in casino betting), the operator will simply treat his or her gross margin as a GST-included amount and not claim any notional input tax credits in respect of cash prizes paid out. The operator will, of course, be able to claim input tax credits for the GST paid on any other expenses related to the gambling operation. The gross margin will be equal to total revenues, less any cash prize-winnings paid out to bettors; no deduction will be permitted for other operating and overhead expenses in determining the gross margin for these purposes.

GST will not apply to gambling or lottery winnings since these are not received as consideration for any supply.

In assessing the applicability of small traders' and filing period thresholds for gambling and lottery organizers, the gross margin will be used rather than total revenues.

13.7 Competition Prize-Winnings

Prize-winnings paid out to participants in a competitive event (such as a sporting competition with prizes paid to winning athletes) will not attract GST. However, input tax credits will not be available to the event organizer with respect to any prizes awarded to winning competitors. By the same token, registered competitors will not be required to remit tax on their prize-winnings. This will simplify the operation of the tax for event organizers, as they will not need to differentiate between registered and unregistered competitors, while, at the same time, ensuring that the value added by competitors as reflected in admissions and other supplies to consumers is effectively subject to tax.

13.8 Provincial Sales Taxes

Like the GST, provincial sales taxes also apply at the retail level. In instances where a sale is subject to the general provincial sales tax, as well as the GST, the GST will be levied on the price exclusive of the provincial tax.

Accordingly, where a business purchase by a registrant is subject to provincial retail sales tax as well as GST, the input tax credit will be calculated on the purchase price exclusive of provincial sales tax.

The appropriate GST treatment of provincial product taxes, mark-ups, and other similar levies, such as those on tobacco products, motive fuels and alcoholic beverages, is an issue which requires further discussion with the provinces.

13.9 Used Goods

With the exception of certain passenger vehicles (see Sections 2.3, 13.1 and 13.2), a sale of a used good in the course of a commercial activity by a registrant will be a taxable supply and, for a purchaser who is also a registrant, the normal input tax credit rules will apply.

Sales of used goods by private individuals who are not registrants, or by persons using such goods primarily in a non-commercial activity, will not be subject to tax as these transactions do not arise in the course of a commercial activity. Although goods sold by such persons will not be subject to tax on sale, if the purchaser is a registrant, and the goods are acquired for use in a commercial activity, subject to certain restrictions described below, the purchaser will be entitled to claim a notional input tax credit in respect of the used goods purchased. The notional credit will be equal to 9/109ths of the price paid by the registrant for used goods where the purchase was not subject to tax.

An exception to the general rule will be made in the case of appreciating used goods: no notional input tax credit will be allowed to a registrant who buys an appreciating used good from a non-registrant (i.e. a private individual or exempt organization). The definition of appreciating used goods will include listed personal property as defined in paragraph 54(e) of the *Income Tax Act* and other collectibles as may be prescribed. Listed personal property under the *Income Tax Act* includes:

- prints, etchings, drawings, paintings, sculptures or other similar works of art;

- jewelry;
- rare folios, rare manuscripts or rare books;
- stamps; and
- coins.

The used goods rule is intended to provide a mechanism to remove the GST embodied in used goods acquired by a registrant from a non-registrant. Special transitional rules will apply in recognition of the fact that most used goods will not have borne GST in the first few years of the GST:

- First, notional input tax credits will be allowed in respect of used goods acquired by a registrant during the first three years of the GST only if the goods are acquired in the ordinary course of a commercial activity of the registrant, and the goods are acquired for purpose of resale.

- Second, registrants in the business of purchasing and reselling used goods will be required to repay any notional or actual input tax credits claimed in respect of used goods sold in the export market during the first three years of the GST. However, recognizing that a registrant may have used the item in the course of his or her business before the export sale, the input tax recapture will be equal to the lesser of the input tax credit actually claimed or 9 per cent of the sale price of the exported used good.

13.10 Returnable Containers

Generally, the supply of returnable containers (such as soft drink bottles) will be taxable under the normal rules. Where such containers are returned by a consumer to a registrant for refund, the registrant will be entitled to claim a notional input tax credit equal to 9/109ths of the amount refunded to the consumer.

Instances will arise where returnable containers are supplied to consumers under zero-rated conditions. For example, a consumer may purchase a container of milk but pay no separate amount in respect of the returnable plastic container. Because the milk in this circumstance will be zero-rated, so will the container if there is no separate charge for it at the time of sale. As no tax will have been paid by the consumer for the container in this situation, the vendor will not be entitled to claim a notional input tax credit in respect of any refund given to the consumer when the container is returned.

13.11 Consignment Sales

Title to goods delivered on consignment, approval or other similar terms usually does not pass to the consignee until the time the goods are resold (or the consignee otherwise appropriates the goods for his or her own use). Under the normal rules, the consignee will be required to collect GST on the resale and, where the goods have been supplied by a registered consignor who has charged tax to the consignee, claim an input tax credit in the normal manner. The time at which liability arises for GST and input tax credit entitlement on consignment sales is discussed in Section 2.2.

Under the rule discussed immediately above, the consignee also will be able to claim a notional input tax credit on resale (or acquisition for own use) in respect of used goods supplied by an unregistered consignor.

13.12 Agents

In contrast to consignment sales, where title to goods passes from the consignor to the consignee, and then to the ultimate purchaser, in an agency sale, title transfers directly from the vendor to the purchaser, through the medium of an agent. In other words, the agent does not have title to the goods sold in these circumstances.

Subject to the special rule outlined below for property or services sold through an agent and invoiced in the agent's name, agents will be required to collect GST under the normal rules only on fees or commissions charged to their principals.

Where a registrant acquires a taxable supply through his or her own agent, an input tax credit will be allowed to the registrant in respect of GST paid or payable on both the supply and any fee payable by the registrant for the agent's services. Conversely, where a registrant makes a supply through his or her own agent, the registrant will be required to account for the tax collectible on the supply.

Of course, the registrant will be entitled to claim an input tax credit in respect of the GST paid or payable on the agent's fee.

Special rules will apply where an agent makes a taxable supply on behalf of a principal, and the agent prepares an invoice in his or her own name for the supply. In these circumstances, the agent will be treated for purposes of the GST as if he or she had purchased the property or service from the principal and resold it. As a consequence, the agent will be required to collect GST on the consideration payable by the customer and be permitted to claim an input tax credit in the normal manner in respect of the deemed supply from the principal.

13.13 Disbursements

It is not uncommon for a registrant to bill a client separately for certain disbursements made in the course of performing a particular service. For example, a lawyer may charge a client for payment of land transfer taxes and other out-of-pocket expenses for a real estate transaction in addition to his or her basic fee for service.

Depending on their type and how they are billed, disbursements will be treated differently under the GST. As a general rule, disbursements will be treated as being in respect of a supply to the client. Their GST status will depend on the tax status of the registrant's basic fee for service. Such disbursements might include, for example, travel, telephone and photocopying expenses. Where these disbursements are in respect of a taxable supply of a service to a client, the disbursements also will be taxable. Conversely, where the registrant's basic fee for service is zero-rated (for example, legal services provided to a non-resident outside Canada), the disbursements also will be zero-rated.

However, registrants will not be required to account for tax in respect of any disbursements made as an agent in the name of the client, provided the disbursement is separately itemized in the registrant's bill to his or her client. 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. Where such disbursements are not separately itemized to the client, or not made as an agent acting in the name of the client, they will be treated as part of the basic fee for service to the client.

13.14 Intellectual Property

Subject to the rules for imported intellectual property discussed in Section 2.5, the supply of intellectual property rights will be taxable in the normal manner. The GST paid by a registrant for the acquisition of any intellectual property rights (such as patents, trade secrets, industrial designs, trademarks, copyrights or know-how) also will qualify for input tax credits in the normal manner.

13.15 Non-Arm's-Length Transactions and Appropriation for Personal Use

Special rules will apply in the case of non-arm's-length transactions and where a registrant appropriates property or service for personal use. A few of these provisions have been referred to earlier – see the rules on capital property and change-of-use described in Section 2.3.

Special provisions also will apply where a person engaged in a commercial activity transfers goods and services for less than their fair market value to a non-arm's-length person who is a non-registrant or a person making tax-exempt supplies. The vendor will, in this case, be treated as having made a supply for consideration equal to the fair market value of the supply and be required to remit GST on that value. The definition of arm's-length for these purposes will be the same as in the *Income Tax Act.*

The same rules will apply where goods or services are appropriated for the personal use or benefit of a shareholder of a corporation, a member of a partnership, a beneficiary of a trust or any individual related to such shareholder, partner or beneficiary. In these cases, the appropriation will be treated as a taxable supply if it would have been taxable had the person obtaining the benefit acquired the property or service from the person providing it in the ordinary course of a commercial activity. Appropriation to personal use rules will not apply where the benefit consists of a property or service for which an input tax credit was denied on the basis that the property or service was for the exclusive personal benefit of the vendor, a related person or an employee of the vendor.

13.16 Gifts

There are different types of gifts and, under the normal rules, each will have particular GST consequences.

Promotional Gifts: The cost of "gifts" given by a business to customers in the course of a promotional campaign generally are reflected in the price of goods and services sold by the business. To tax those "gifts" would result in double taxation. Consequently, under the normal rules, "gifts", such as free samples given to customers as part of a business promotion scheme, will not be taxable as long as the "gifts" are reasonable in the circumstances. 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 commercial activity, will entitle the registrant to an input tax credit in the normal manner.

Gifts to Employees and Shareholders: Gifts to employees and persons related to employees will be treated as supplies made by the employer to the extent that the amount of the gift was included in the employee's income for purposes of the *Income Tax Act*. Accordingly, the employee benefit will be treated as a taxable supply if it would have been taxable had the employee acquired the benefit from another person in the ordinary course of that other person's commercial activity. The employee benefit rule will not apply where the input tax credit to the employer was denied on the basis that the property or services were acquired exclusively for the purpose of giving them to employees. Gifts to shareholders will be taxable at their fair market value as an appropriation for personal use.

Gifts to Charities: Where a registrant donates goods of its own manufacture or other goods or services normally traded by the registrant, the "donation" will be treated in the same way as a promotional gift.

13.17 Discount Coupons

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

Retailers' Coupons: These are issued by retail stores and provide 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 the GST, the issue of the coupon will have no tax implications and, on redemption, only the net consideration paid by the customer will be subject to tax.

Manufacturers' Coupons: These also provide a reduction in the selling price of specific goods. Usually, they are 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. However, the retailer will be required to collect tax on the reimbursement received from the manufacturer, with an offsetting input tax credit to the manufacturer. The reimbursement will be treated, in effect, as an after-the-fact 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 redeemed on subsequent purchases, only the net amount paid by the customer will be taxable.

13.18 Manufacturers' 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 registrants who operate rebate schemes to claim a notional input tax credit equal to 9/109ths of any rebate paid out in respect of a taxable supply. Where the person receiving the rebate is also a registrant, any rebate received by that person will be treated as a tax-included amount and the registrant will be required to remit tax equal to 9/109ths of that amount. 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 person obtaining the rebate will give rise to an input tax credit.

13.19 Co-operative Advertising

It is common practice for payments to be made between two businesses where one of them assumes responsibility for advertising the other's product. 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.

In effect, the manufacturer is purchasing a service from the retailer in this example. As such, under the GST, the retailer will be required to remit tax equal to 9/109ths of the rebate received from the manufacturer. The manufacturer, of course, will be able to claim a corresponding input tax credit for an amount equal to 9/109ths of the payment.

13.20 Gift Certificates

The sale by a business of a gift certificate will not be treated as a supply at the time of issuance. As a result, no GST liability will arise at that time. Rather, the gift certificate will be treated the same as money paid for a supply when it is redeemed and not as a reduction of the consideration payable.

13.21 Tickets and Tokens

The sale of tickets and tokens will be treated as a supply and will be taxable at the time of sale. If they are in respect of a zero-rated or an exempt supply (for example, a bus ticket for municipal transit), no tax will apply.

13.22 Returned Goods and Price Adjustments

A credit note issued by a registrant to a customer to reflect a price reduction (such as a volume discount) or on a return of goods will be treated as an adjustment to the original invoice. In these circumstances, the registrant will be permitted to make an offsetting adjustment in his or her tax collectible for the amount of tax credited to the customer. Similarly, the purchaser will make an offsetting adjustment to his or her GST return to ensure that any input tax credits claimed are the same as the amounts on which tax has been paid.

13.23 Cash Discounts

Goods and services may be supplied on terms which offer discounts for prompt payment or a penalty for late payment.

Where the amount charged on an invoice by a supplier to a customer is net of any discount, the supplier will charge tax only on that net amount. If the customer is a registrant, he or she will be entitled to an input tax credit in respect of the tax paid on the net amount. No further adjustments will be required by either person. Any additional amount payable if the customer incurs a penalty for late payment will not be treated as part of the value for tax.

Where the supplier invoices the customer for the full sale price and offers a discount for payment within a specified time, GST will be assessed on the invoiced price even where the customer reduces his or her payment by taking advantage of the discount offered. The discount will be recognized as a price adjustment in these circumstances only where a credit note is issued to the customer indicating the amount of tax credited on the discount.

13.24 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. Conceptually, patronage dividends should be treated in a manner similar to other price adjustments to individual customers. However, because patronage dividends often will be in respect of a mixture of both taxable and non-taxable supplies made to a variety of customers over the course of a year, it would be impractical to require co-operatives to treat their patronage dividends as individual price adjustments to each member.

Rather, co-operatives generally will treat their patronage dividend payments as aggregate price adjustments. Under this rule, each co-operative will be required to prorate its dividend payments to each member in any fiscal period according to the ratio of total taxable to non-taxable supplies made to all members in the co-operative's preceding fiscal period. This information will be provided to recipients of patronage dividends who, if they are registrants, will treat that portion of the dividend as including a tax adjustment. Members who claim a credit with respect to GST on their purchases from a co-operative or collect tax on their sales to a co-operative will include 9/109ths of the above-mentioned portion of the patronage dividend in their tax remittable when the dividend is received or receivable. The co-operative will be entitled to claim a corresponding input tax credit in respect of patronage dividends paid or payable to all members. For members who are not engaged in a commercial activity, there will be no further consequences as this treatment, in effect, results in a refund of a previous overpayment of GST.

If they elect to do so, co-operatives will be permitted to ignore patronage dividends altogether for GST purposes. Under this election, co-operatives will not treat patronage dividends as aggregate price adjustments and will not be permitted to claim any input tax credits in respect of dividends paid out to members. Similarly, members who are registrants will not be required to remit any GST on dividends received. This election may be attractive to co-operatives where all of their members are registrants as it will simplify compliance while leaving the co-operatives' and its members' combined net tax liabilities unaffected.

13.25 Telecommunications

Telecommunication services such as telephone, telegraph, telex and data transmission services will be taxable if billed in respect of a transmitting or receiving station or terminal normally located in Canada. Services billed in respect of a terminal or station outside Canada will be treated as an export and zero-rated. Registrants 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 entitlements.

13.26 Pay Telephone Charges

Pay telephone charges are regulated by a variety of federal and provincial bodies. So as not to interfere with regulated rates and rate-setting procedures, the GST on pay telephone calls paid in coin will be a specific amount designed to approximate a 9-per-cent *ad valorem* tax. The GST on a call worth 50¢ to $1.09 will be 5¢, and will increase by 5¢ for each additional 55¢ or part thereof charged on a call. This treatment will parallel the treatment of pay telephone charges under existing federal and provincial sales taxes.

Pay telephone calls charged on telephone calling cards will be subject to GST in the normal manner; that is, the 9-per-cent *ad valorem* tax will be collectible on the amount charged.

13.27 Holdbacks

The general timing rules will require a vendor engaged in a commercial activity to collect GST whenever consideration for a taxable supply is paid or becomes due. Similarly, a registrant will become eligible for an input tax credit whenever GST 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 by federal or provincial legislation, no liability for GST will arise on the amount held back until it is paid or the holdback period expires, whichever is earlier. In a situation where no holdback is specifically sanctioned by legislation, any amount held back will not defer the time at which GST becomes payable.

13.28 Transfer of a Business as a Going Concern

The sale or transfer of a business as a going concern, whether by way of outright sale, amalgamation, wind-up or other corporate reorganization, if both the vendor and the purchaser agree, will not be subject to GST. As a consequence, the vendor will not collect tax on the transfer of a going concern. Nor will the purchaser be entitled to claim any input tax credit in respect of the purchase. However, since the sale or purchase of a business as a going concern will not be excluded from the definition of commercial activity, both the purchaser and the vendor will be able to claim input tax credits for any GST paid on purchases related to the transfer (e.g., legal and accounting fees) to the extent that the going concern involves a commercial activity.

If either the vendor or the purchaser does not agree that the transfer should go untaxed, the transfer will be subject to GST in the normal manner. Taxing the transfer of a going concern will be advantageous in certain circumstances, particularly where the going concern involves certain non-commercial activities which prevented the vendor previously from recovering all of the GST paid on assets held in the going concern. For example, a doctor may sell his or her practice, along with the building and equipment used in the practice. If the purchaser in this example wanted to increase the commercial usage of the building (e.g., by leasing part of it out commercially to other businesses), the purchaser would be unable to recover the GST originally paid on the building unless he or she paid tax on it at the time the going concern was acquired.

Where GST applies on a transfer of a going concern, and the value-for-tax exceeds $1 million, Revenue Canada will require evidence that the vendor has remitted the tax on the transfer before the purchaser is entitled to claim an input tax credit on the transfer. This rule will parallel the tax clearance certificate provision for real property in excess of $1 million described in Section 7.4.

In all cases involving a transfer of a going concern by a registered vendor, the vendor will be required to notify Revenue Canada of the transfer.

13.29 Security Interests

The transfer or assignment of an interest in the assets of a registrant (where this amounts simply to a charge or lien on those assets as security for a debt or any other obligation) to another party will not give rise to any GST implications for either party. The same rule will apply when the security interest is discharged upon repayment of the debt or obligation by the debtor.

13.30 Repossessions and Seizures

A seizure or repossession will be treated as a supply for no consideration from the person from whom goods are seized (the "debtor") to the person who seizes the goods (the "creditor").

The resale by a creditor of a seized or repossessed property of a registrant will be treated as a taxable supply unless it otherwise is zero-rated or tax-exempt – for example, in the case of a supply of a used residential dwelling. In the case of a taxable supply, the creditor will be required to register and collect GST on the transaction. If the seized or repossessed property is appropriated for personal or exempt use by the creditor, the creditor will be treated as having sold the property at its fair market value at that time.

If the personal property is seized from an unregistered person or a registrant who has not claimed an input tax credit in respect of the property, and the creditor is registered to collect GST, the creditor will be entitled to claim a notional input tax credit equal to the GST collected on resale. This credit will be claimable at the same time as the tax becomes payable on resale. As a consequence, no net tax will be remittable by a registrant in respect of a seizure or repossession from a non-registrant. In effect, tax will be remittable only where the debtor was entitled to an input tax credit in respect of the property.

13.31 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 registrant, any GST obligations or liabilities that are incurred after that time will be determined as if the registrant were continuing to carry on the business. The personal representative will be held responsible for any liability incurred for remittance of tax during his or her 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 also will apply for the purposes of the GST.