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# Goods and Services Tax

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Tabled in the House of Commons  
by the Honourable Michael H. Wilson  
Minister of Finance

December 19, 1989

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## Preface

The Goods and Services Tax (GST) is a key part of the government's broad economic plan for Canada. It will help improve our competitiveness and help get the federal deficit under control. It will also make the overall tax system fairer than it is today. These are important goals.

In August of this year, the government set out the details of the GST in a Technical Paper. Since then, Canadians have been engaged in an important national debate – one that has ranged beyond the GST itself to address broader questions about the demands of economic change and the need for government to control the deficit and restrain spending.

The government recognizes that change is never easy – especially when it is on the scale of the GST. However, Canadians accept the need for government to levy taxes so long as revenues are used to fund programs that they value and to reduce the deficit. They want the assurance that their tax dollars are not wasted – that they are used effectively and prudently by government. The measures recently announced to improve efficiency and to eliminate waste are a further demonstration of this government's continuing commitment to responsible stewardship of taxpayers' dollars.

An important contribution to the national debate on the GST has been made by the House of Commons Standing Committee on Finance. The Committee provided a forum for the exchange of views and for a review of the design of the GST. All of this has played an important part in the government's own decisions regarding the final shape of the GST package. These decisions are set out in the Summary and Technical Notes that follow.

In the course of the government's consultations on the GST, two key points emerged. First, there is widespread recognition that the existing federal sales tax is irreparably flawed and must be replaced. The Goods and Services Tax is the most appropriate replacement for a sophisticated industrial economy like Canada.

Second, Canadians have expressed concern about the short-term inflation risks involved in the transition to the GST at a 9-per-cent rate. In response, the government is acting to lower the GST rate to 7 per cent. Although this has involved some tough choices, the resulting package of measures is balanced. Lower and modest income Canadians remain fully protected, while other income groups, the business sector and government itself, through restrained spending, all contribute to achieving the 7-per-cent GST. The deficit is not increased and the risk of an inflationary response is substantially reduced.

An important objective in implementing the GST is to keep the system as straightforward as possible to operate for those businesses and other organizations that must collect the tax. Since the release of the Technical Paper, the government has consulted widely on the operational aspects of the GST. As a result, the government will make adjustments in a number of areas to ensure that the GST is more equitable and straightforward in operation. These are set out in detail in the Technical Notes. The government will continue to explore avenues to lower compliance costs in the weeks and months ahead.

The final step in the national debate on the GST is the tabling of legislation for consideration by Parliament. The government plans to introduce this legislation as soon as the House resumes in the new year. With the approval of Parliament, the GST will be put in place on January 1, 1991. At that time, Canada will have a modern sales tax system that is fairer and more reliable, and that will allow us to better meet the competitive challenges of the 1990s and beyond.

A handwritten signature in cursive script, reading "Michael H. Wilson".

The Honourable Michael H. Wilson

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# Summary

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## Introduction

In June 1987, the government announced its intention to replace the existing federal sales tax (FST) with a comprehensive tax on the consumption of goods and services in Canada. The new sales tax system – the Goods and Services Tax (GST) – is scheduled to come into effect on January 1, 1991. The GST will help achieve three important goals.

- *First*, it will contribute to the government's deficit reduction effort and ensure we can continue to pay for programs and services Canadians value.
- *Second*, it is an essential element of the government's plan to make the changes necessary to ensure Canada can compete effectively in the world economy.
- *Third*, it will improve the overall fairness of the tax system. The refundable GST Credit will provide lower and modest income Canadians with more disposable income than they had before reform.

The Goods and Services Tax represents a further step in the implementation of the Agenda for Economic Renewal – the government's broad economic plan for Canada set out in November 1984. That plan is directed at creating productive jobs and higher living standards through sustained, non-inflationary economic growth. These goals are being realized: first, by introducing the major reforms required to sustain economic growth and enhance Canadian innovation and competitiveness; and, second, by exercising greater fiscal responsibility in order to get the federal deficit under control and to reverse the build-up in public debt.

Significant progress has been made in implementing the structural changes needed to improve productivity and to keep Canada competitive. The energy and transportation sectors of the economy have been deregulated. The corporate and personal income tax systems have been reformed and a free trade agreement with the United States is now in place. Crown corporations have been privatized, and important steps have been taken to improve the flexibility and skills of Canada's labour force.

Substantial progress has also been made in reducing the federal deficit. In 1984-85, the deficit was \$38.3 billion. This fiscal year, the deficit will be \$30.5 billion. Building on this progress, in the April budget the government set out a plan to reduce it further to \$15 billion by 1993-94 – the last year that the federal government will have any net borrowing requirements in financial markets and, thereafter, we will be in a position to begin repaying outstanding marketable debt.

The government's economic plan is working. The Canadian economy is now completing its seventh consecutive year of expansion since the recession of the early 1980s. Indeed, since 1984, with the exception of Japan, Canada has had the fastest economic growth among the major industrialized countries.

As Canada's economic expansion has matured, demand has outstripped the country's capacity to supply goods and services and inflation pressures have increased rapidly. Monetary policy has remained firm and interest rates have risen. The government will continue its efforts to reduce both inflation pressures and the federal deficit so that the economy can be put on a path to sustained growth. At the same time, consistent with its economic plan, the government is continuing to implement structural initiatives to increase the economy's capacity to supply goods and services so as to lay the foundation for greater economic prosperity. Sales tax reform, which will replace the existing distortionary federal sales tax with the GST, is an essential part of that plan.

## **1. Economic Benefits of the GST**

The world economy has become increasingly integrated and international competition is intensifying. It is incumbent upon governments to position their countries to meet the challenges and opportunities of growing global competition, and to stave off the protectionist pressures that inevitably arise in the face of those challenges. The demands of a competitive international economy have made sales tax reform in Canada all the more important.

In the 1980s, the tax systems of virtually all industrial countries have undergone or are undergoing major reform. This reflects the almost universal recognition of the distortions and inequities caused by high tax rates and years of ineffective and costly tax preferences. If there has been one theme to worldwide tax reform, it is "broaden the base and lower the rate". This was the theme that guided our reform of the income tax system in 1987, just as it guides our plans for the GST.

Clearly, as tax reform has become more widespread, it imposes its own constraints and opportunities on individual countries. In a highly integrated world economy, countries cannot allow their tax systems to get out of line in a way that damages competitiveness. Canada is not immune from this imperative. We do not have the luxury to be complacent about the economic damage that is caused by the existing federal sales tax.

It is widely recognized that the existing sales tax is fundamentally flawed. Because it is applied to sales of manufactured goods, a significant amount of tax – in fact, some \$8 billion – is derived from the taxation of inputs into the production of all other goods and services. This raises the cost of capital to domestic producers, discouraging investment and more efficient production techniques.

Every bit as important, these taxes on productive inputs do not apply to foreign producers. Therefore, they impair the ability of Canadian exporters to compete in

global markets. In effect, they are forced to compete with one hand tied behind their backs.

At the same time, the existing system taxes domestic products more heavily than imported products. On average, federal sales tax on domestic products is about one-third higher than for comparable imported goods. So, in addition to hampering our exports, the tax actually favours imports over domestically produced goods. It is the only consumption tax in the industrialized world known to do so.

Finally, the tax distorts the relative prices of goods and services in Canada, thereby interfering with the choices of consumers and producers in the marketplace. As a result, our national economic resources are used less efficiently.

Consistent with the government's other structural initiatives, replacing the existing federal sales tax with the GST will pay very large economic dividends. For example, the GST and the Free Trade Agreement together will raise the level of Canada's potential economic 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, will be the result of sales tax reform.<sup>(1)</sup>

In combination, the range of structural reforms undertaken by the government since 1984 significantly improve Canada's economic prospects. Prior to these changes, productivity growth was weak and investment had been stagnant. It was generally thought that the Canadian economy would at best be able to sustain an average annual growth rate of about 2 3/4 per cent over the first half of the 1990s without incurring rising inflation. With these reforms in place, the economy's capacity to grow will be raised to a range of 3 1/4 to 3 1/2 per cent, thereby providing opportunities to increase substantially Canadians' standard of living.

As shown in Charts 1 and 2, the substantial benefits of sales tax reform will be shared widely across the economic sectors and regions of Canada. Under the GST, sales tax on business inputs will be fully refunded. This will have the effect of reducing the price of capital goods by 4 per cent on average. Lower capital costs will lead to new investment, an enhancement in the stock of productive capital, and significant output gains in most sectors. In the primary, transportation and utilities sectors, these gains will be well above the all-industry average. These sectors are highly capital intensive and, therefore, tend to bear a relatively heavy tax burden under the existing federal sales tax.

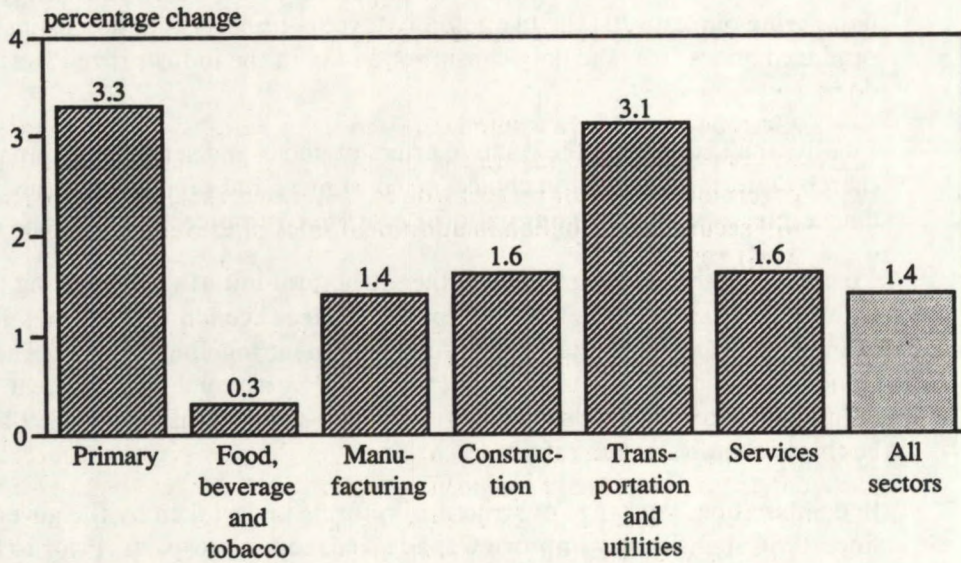
Across regions, the output gains in Atlantic and Western Canada will exceed the national average. This occurs because industries in those regions tend to be capital intensive and export-oriented – industries that benefit disproportionately from the rebate of GST on business inputs.

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<sup>(1)</sup> See Hamilton, Robert and Chun-Yan Kuo, *The Goods and Services Tax: A General Equilibrium Analysis*, Department of Finance Working Paper 89-3.

Chart 1

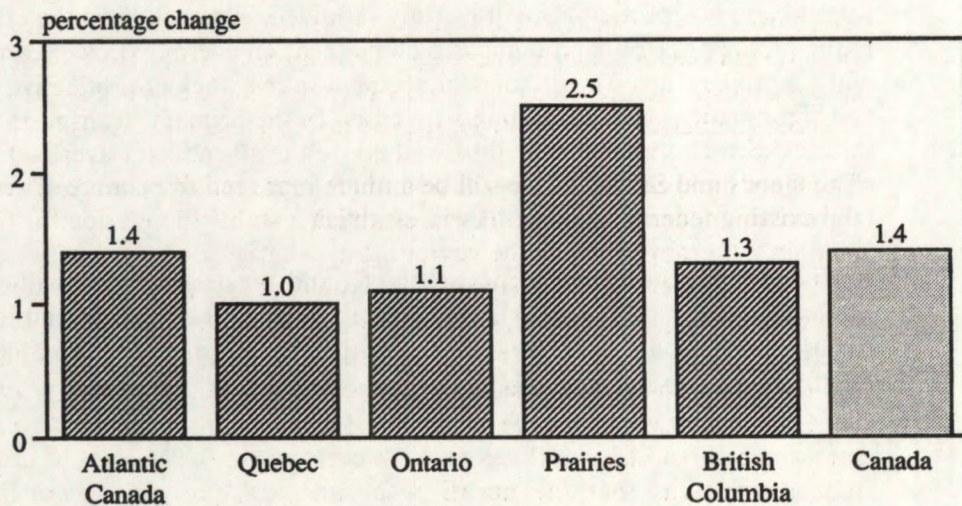
### Long-Run Sectoral Output Gains From Sales Tax Reform



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

Chart 2

### Long-Run Regional Output Gains From Sales Tax Reform



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

## 2. Fiscal Benefits of the GST

The existing federal sales tax is an increasingly unreliable source of federal revenues. As such, the tax is an impediment to sound fiscal planning and a threat to the government's strategy for getting the deficit under control.

The GST will contribute to the federal government's deficit reduction effort in two ways:

- *First*, because it will minimize tax avoidance and evasion activities, the GST will provide greater assurance that the revenues required to meet the government's deficit targets will, in fact, be forthcoming. In particular, it will secure the \$2 billion in additional sales tax revenues announced in the April 1989 budget.
- *Second*, by improving Canadian economic performance, the GST will lead to a lower deficit than would have been the case in the absence of reform.

One reason that the existing tax is so unstable is that it applies at such an early point in the production and distribution chain. Manufacturers can reduce the amount of tax they charge by pushing as many costs as possible beyond the point at which tax is charged. There are a variety of creative ways that have been found to do this. Indeed, because of the poor structure of the tax, it is sometimes necessary for Canadian manufacturers to do so simply to stay in business in the face of competition from importers who pay less tax. One consequence, however, has been a serious erosion of federal revenues.

At the same time, the antiquated structure of the tax requires a patchwork of no fewer than 22,000 special deals simply to keep the system functioning. This means that, on average, a special deal is struck for about one out of every three taxpayers. This is no way to do business. Yet, in today's highly competitive environment, taxpayers have strong incentives to exploit every opportunity to avoid tax that is afforded by this frail and arbitrary structure. Indeed, the number of new court cases has been increasing dramatically, from 108 in 1987-88 to 215 in the first six months alone of this fiscal year. The extent to which these efforts succeed further undermines federal sales tax revenues.

The Goods and Services Tax will be a much more reliable source of revenue than the existing federal sales tax. It will establish a stable foundation for fiscal planning, thereby allowing the government to better maintain programs that Canadians value and to manage effectively the deficit problem. Because the GST will extend to the retail level, the inherent incentives in the existing tax for businesses to restructure their operations to reduce tax liabilities will be removed. In addition, high-income consumers cannot organize their affairs to avoid paying the GST. Moreover, since the GST will be levied on a broad base at a uniform rate, the number of borderlines between categories of goods will be greatly reduced and, with that, the incentives for tax avoidance and court challenges. Finally, the multi-stage nature of the tax will enhance self-enforcement and accurate reporting – key factors in preventing base erosion and in maintaining tax fairness.

The GST can also be expected to pay important fiscal dividends over time. As potential economic output expands as a result of sales tax reform, Canada's national income will rise. This means, in turn, that the federal government's tax revenues will be higher than they would have been in the absence of reform. These additional revenues will support the government's effort to reduce the deficit.

### **3. The GST: A Fair Tax**

The implementation of the GST will also make the overall sales tax system fairer to individuals both as taxpayers and consumers.

An important objective of sales tax reform is to ensure that families earning under \$30,000 per year will have a higher after-tax income once the GST is in place. The key to accomplishing this goal is the new GST Credit which will be paid by cheque to all eligible Canadians. Eligibility will be based on income as reported on income tax returns.

The new GST Credit builds on the government's experience with the existing federal sales tax credit which it first introduced in 1986. The credit system provides for the much closer integration of Canada's sales tax and income tax systems – a major tax policy innovation. It allows the federal government to continue to have a consumption tax as an important source of revenue, but without the regressive features generally associated with consumption taxation. Indeed, by using the credit mechanism, assistance can be targeted to those who need it most. As a result, we can have a sales tax that strengthens our competitiveness and acts as a reliable source of revenues while, at the same time, actually improving the overall fairness of the tax system.

GST Credit cheques will be paid quarterly to all eligible Canadians, even if they pay no income tax. The first payment is planned to be delivered to recipients in December 1990, prior to the scheduled implementation of the GST in January 1991.

The GST will also be fairer to consumers. Since the existing federal tax is levied at an intermediate stage in the production process, it is invisible to final consumers. While individual Canadians are paying the tax, they are generally unaware of that fact. Even the informed consumer – one who knows of the existence of the current federal sales tax – cannot calculate the amount of tax paid on any given purchase. In contrast, 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 Consultative Process**

Reform on the scale of the introduction of the GST is a massive undertaking. The fact that the GST involves new principles and operations has dictated the manner in which the government has proceeded in implementing it. Self-assessment by

taxpayers is basic to the Canadian tax system. Therefore, to ensure a smooth transition to the new system, individual Canadians and businesses who must comply with it should have an opportunity to become familiar with the GST and to gain an understanding of its operation before it is implemented. At the same time, it has been important for individuals, tax professionals and the representatives of key social and economic sectors to have the opportunity to work with government to finalize the details of the application of the GST.

The consultative process has had many stages.

- In November 1984, the government indicated that it had begun to study the possibility of replacing the current federal sales tax with a value-added sales tax system.
- In October 1986, the federal government set out the basic guidelines for its approach to comprehensive tax reform in Canada.
- In June 1987, as an integral part of its White Paper on tax reform, the government announced its intention to proceed with the replacement of the existing sales tax.
- From the summer of 1987 until the spring of 1989, the federal government undertook detailed discussions with the provinces about the feasibility of an integrated National Sales Tax (NST) – one of the three options presented in the June 1987 White Paper on tax reform. While it did not prove possible to reach agreement on an NST in time for implementation in 1991, these discussions contributed substantially to the federal government's elaboration and design of the GST itself.
- In the April 1989 budget, the government announced its plans to introduce the new GST at a 9-per-cent rate on a very broad range of goods and services starting in January 1991.
- In August 1989, the Minister of Finance released the GST Technical Paper which provided detailed information on most aspects of the new system.
- In October 1989, the government issued draft GST legislation and accompanying explanatory notes. The draft provided the tax professional community and other interested parties with an opportunity to comment on the precise legal design of the new tax.

Since the release of the Technical Paper, the government has canvassed a wide range of views on virtually every aspect of the GST – from consumers and provincial governments to the business community, tax professionals and other interest groups. In addition, the House of Commons Standing Committee on Finance examined the Technical Paper and held public hearings on the proposal. These hearings were an important forum for public debate, and the Committee's report on the GST, tabled in Parliament on November 27, 1989, represented a major contribution to the government's decisions on the final design of the new system.



Through these consultations and during the course of the national debate on the GST, a number of important points have emerged.

- There is widespread recognition that the existing federal sales tax is fundamentally flawed and must be replaced, and that a destination-based value-added tax like the GST is the most appropriate system for a sophisticated, modern industrial economy like Canada's – a conclusion that was endorsed by the House of Commons Standing Committee on Finance.
- Among tax professionals, there is general agreement that the technical design of the GST is fundamentally sound.
- Canadians are prepared to accept the major changes entailed by the GST in order to improve the country's economic performance, but only if the federal government itself is prepared to continue to control spending, to use taxpayers' dollars wisely, and to reduce the deficit.
- Some commentators have expressed concern about the economic risks posed by a 9-per-cent GST during the transition to the new system.
- A number of businesses and institutions which will be required to administer the tax have called for measures to simplify its operation.

These observations are important. Public recognition of the need for reform and the technical soundness of the GST reaffirm the government's resolve to proceed with implementation of the GST, as scheduled, on January 1, 1991. But in moving ahead, it is clear that the government must address the basic concerns of Canadians about spending and the deficit, about the economic risks of a 9-per-cent rate for the GST, and about the inevitable changes required for businesses to operate the new system.

This paper represents the government's response to these concerns. It sets out in detail the necessary refinements to the GST – changes that will be reflected in legislation which the government will table in the House of Commons as soon as the House resumes in the new year.

## **Expenditure Control, the Deficit and the GST**

Throughout the national debate on the GST, Canadians consistently emphasized that the government must continue to restrain spending, operate more efficiently, and intensify efforts to eliminate the federal deficit.

Canadians understand the need for the federal government to raise the revenues necessary to fund the programs they value. While no one likes taxes, everyone recognizes that they serve an important purpose.

The people of Canada have been asked to make sacrifices in order to deal with the federal deficit. Getting rid of the albatross of rapidly escalating public debt is a

difficult problem. But it is essential if we are to safeguard the economic prosperity of future generations.

In response to this challenge, the government has acted. From 1984-85 to 1988-89:

- The federal deficit as a proportion of the economy declined from 8.6 per cent to 4.8 per cent of GDP.
- The growth of government debt has been reduced from an average of about 25 per cent per year in the 1980-84 period, which was about three times the growth rate of national income, to about 12 per cent per annum over the past four years. Last year, the debt grew by 9.9 per cent, just slightly above the growth rate of national income – the first time in 15 years that growth in the debt was below 10 per cent.
- Strict control over government spending has been an indispensable part of this progress. The growth of government spending on programs has been held to an average of only 3.5 per cent over this period – less than the rate of inflation for the period.
- The size of the federal public service has been reduced by about 12,000 person-years, and is now at the level it was in 1973.
- In 1988-89, the government spent \$1.7 billion less on operations – wages, salaries, travel, telephones – than it did in 1984-85. This amounts to a 10-per-cent reduction during this period.
- Major Crown corporations have been privatized and chronic money losers like the Post Office have been made profitable. Employment in Crown corporations has been reduced by more than 60,000. While over half of this reflects privatization, a substantial portion stems from productivity improvements and increased efficiencies.

The last federal budget included major reductions in program spending, including lower expenditures on defence, official development assistance, and subsidies to businesses and Crown corporations. These changes will yield savings of \$2.5 billion per year when fully implemented.

Canadians believe, and the government agrees, that controlling spending must be an ongoing process. Government must be managed with an eye to eliminating waste and to improving efficiency. The tax dollars of Canadians must be respected. The government recognizes that Canadians are calling for even greater efforts to control and reduce spending. As a result, on December 15, 1989, a number of measures were announced that will make the federal government more efficient and businesslike and will reduce federal spending by \$1.4 billion over the next three years and yield ongoing expenditure savings of \$700 million annually when fully implemented. These measures include:

- fewer executive jets for Cabinet Ministers, less international travel by government employees, and less money for official residences in Ottawa;

- reducing expenditures of Parliament, including a 20-per-cent cut in foreign travel by Parliamentarians and fewer support services and dining facilities for MPs;
- continuing to cap overall increases in operating and maintenance budgets of all government departments at 2 per cent per year – well below the expected rate of price increase;
- deferring spending on almost \$1/2 billion worth of construction in the National Capital Region; and
- a number of cost-recovery initiatives, including increased processing fees for immigration services and student loans.

The government recognizes that if Canadians are to be called upon to make sacrifices in order to reduce the deficit, they have a right to demand sound stewardship of taxpayers' dollars. This stewardship will continue.

## The GST Rate

Virtually all independent economic observers agree that sales tax reform will substantially increase Canada's capacity to produce goods and services. Very few other initiatives available to the government have the same potential to spur structural adjustment and to strengthen economic growth in Canada. The GST will remove the burden of federal sales tax from the domestic production of goods and services, thereby encouraging investment. It will eliminate the inherent biases in the existing system in favour of imports and against Canadian exports. And, because it will apply at a lower uniform rate to a much broader range of goods and services than the current tax, the GST will significantly reduce the influence of the tax system on the decisions of both consumers and producers. All of this means that our national wealth will increase.

That said, in the course of the debate on the GST, concerns have been expressed about the short-term economic impacts of a 9-per-cent GST rate during the transition to the new system. These concerns are two-fold:

- *first*, the higher the tax rate, the greater is the inflationary risk posed in the transition period; and
- *second*, while the GST has the effect of spreading the burden of federal sales taxation more evenly across sectors of the economy, the higher the rate, the greater are the transitional adjustment problems in those sectors that are now relatively lightly taxed under the existing FST.

In the Technical Paper on the GST, the government estimated that the 9 per cent GST package would result in a one-time price increase of about 2 1/4 per cent. However, because of the income tax and transfer elements of the package, the initial effect on real purchasing power of Canadians would be much less. Indeed,

families earning less than \$30,000 would be better off. For higher-income families, real incomes would fall initially, but increase fairly quickly as the economy strengthened as a result of sales tax reform. On average, real disposable income would experience a temporary decline of only about 1 per cent from the level it would otherwise have reached.

The extent of the macroeconomic risks during the transition period has been the object of controversy. Given the modest effect on real disposable incomes for workers at or about the average industrial wage, and the potential gains for workers in the absence of an inflationary response, the government believes there would be no need for an inflationary wage-price response to the introduction of the GST at 9 per cent. Interest rates need not rise and the Canadian economy could begin to realize the economic benefits of the GST from the first year of implementation.

Others have argued that the government has underestimated the transitional risks posed by a 9-per-cent GST with respect to inflation and, hence, interest rates. Consequently, many have called for a reduction in the GST rate to minimize those risks and, on that basis, a consensus appears to have developed that it would be prudent to lower the rate. That was also the recommendation of the House of Commons Standing Committee on Finance.

The GST rate will, therefore, be reduced to 7 per cent.

## 1. Principles of Rate Reduction

In discussing the possibility of a lower rate over the past few months, the government has consistently emphasized that this would require some very hard choices. In making these tough choices, the government has been guided by four basic principles.

- *First*, lower- and modest-income Canadians must continue to be fully protected under sales tax reform – in particular, families earning less than \$30,000 per year must still be better off once the GST is in place.
- *Second*, while sacrifices are necessary to achieve rate reduction, these must be balanced across sectors and across income groups. The government must also contribute its share by cutting expenditures and by reducing waste and inefficiency.
- *Third*, a critical goal in lowering the rate to 7 per cent is to reduce substantially the one-time impact on the price level associated with the introduction of the GST.
- *Fourth*, the rate reduction must be fully funded. The two percentage point reduction in the rate lowers federal revenues by \$5.9 billion. If the federal deficit is not to increase, the measures must close this revenue gap.

## 2. Scope of the Challenge

At a 9-per-cent rate on a fully implemented basis, the GST would have yielded net revenues of about \$24 billion in 1991 dollars. This amount would have been sufficient:

- to replace, in 1991, revenues expected from the existing federal sales tax – about \$18.5 billion; and
- to fund the other elements of the GST package, including 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 – totalling \$5.4 billion.

Two key consequences flow from the decision to reduce the GST rate to 7 per cent.

- *First*, there is a significant reduction in the incremental sales tax burden on families and individuals. In other words, relative to the burden today under the existing federal sales tax, the additional sales tax paid under a 7-per-cent GST will be much lower than at 9 per cent. For example, for a typical one-earner couple with two children with net income of \$20,000, the incremental sales tax burden at a 7-per-cent GST rate will be about \$150 per year in 1991 dollars. By contrast, that incremental burden would have been about \$410 under a 9-per-cent GST.
- *Second*, there is a much smaller one-time increase in the price level. At a 7-per-cent GST rate, the CPI is expected to increase by just under 1 1/4 per cent, compared to the 2 1/4-per-cent increase forecast under the 9 per cent GST.

As a result of these factors, a number of consequential changes can be made to the GST package which serve to lower its overall cost without diminishing the fairness of the new system. These changes include a reduction in the size of the GST Credit, a lower housing rebate percentage, and automatic adjustments in federal income tax revenues and transfer payments due to indexing.

Having made these consequential changes, lowering the GST rate from 9 per cent to 7 per cent leaves a gap of \$3.2 billion that must be filled to ensure that there is no adverse impact on the deficit. Effectively, then, the challenge of rate reduction is one of filling that \$3.2 billion gap through a series of expenditure and revenue measures.

## 3. Steps to a 7-Per-Cent GST

Table 1 summarizes the measures required to achieve a fiscally balanced GST at a 7-per-cent rate. Panel B provides the revenue implications of the consequential adjustments in the GST package, while Panel C sets out the fiscal actions the government will take to reduce the GST rate.

Table 1

**Sales Tax Reform: Lowering the GST Rate**

	Full-year impact*
	(billions of 1991 dollars)
A. Revenue loss from rate reduction	- 5.9
B. Consequential adjustments:	
GST Credit	1.2
Housing rebate	0.4
Indexation effects	1.1
Total consequential adjustments	<u>2.7</u>
C. Fiscal actions:	
a) Expenditure reductions	0.7
b) Additional actions	
Eliminate middle income tax rate reduction	0.7
High-income surtax	0.2
Large corporations tax	0.2
Small business administration fee	0.6
Adjustments in product and excise taxes	0.7
Adjustment in tax base	0.1
Total fiscal actions	<u>3.2</u>
Total Offsets	<u><u>5.9</u></u>

\*This is the full fiscal year impact of the GST on a mature system basis, excluding the transitional impacts of moving from one system to the other.

**Consequential Adjustments**

Because of the reduction of the GST rate to 7 per cent, the incremental sales tax burden on lower- and modest-income Canadians is greatly reduced. It is possible, therefore, to increase the amount of the Credit by less than it would have been under the 9-per-cent GST package without in any way diminishing the protection it provides. The new GST Credit will be set at \$190 per adult and \$100 per child. Single parents will be able to claim an adult credit in respect of one dependent child. Single adults, including single parents, who maintain their own households

will be able to claim an additional credit of up to \$100. In total, the value of the GST Credit will be about \$2.4 billion or some \$1.2 billion less than under the 9-per-cent GST package, but without any adverse impact on the fairness of the new system for lower and modest income families. (See Section 1 of the Technical Notes for a full description of the GST Credit and its impact on typical families and individuals.)

With a reduction of the GST rate to 7 per cent, the GST housing rebate can correspondingly be reduced while still ensuring that the tax will not pose a barrier to housing affordability. The government is also taking the opportunity to simplify the structure of the housing rebate in order to minimize tax distortions and to reduce incentives for tax avoidance. As a result, the rebate will be set at 2.5 percentage points of tax on newly-constructed residential dwellings up to \$350,000 – yielding the same 4.5 per cent effective tax rate that had been available to homes up to \$310,000 under the 9-per-cent GST system. The rebate will be phased out on a downward sliding scale for houses priced beyond \$350,000 until it is completely eliminated for \$450,000 houses. At the 7-per-cent rate, the total cost of the housing rebate program can be lowered by about \$400 million per year, while keeping the increase in typical house prices in virtually every city in Canada at 1 per cent or less.

Under the 7-per-cent package, the one-time price effect of introducing the GST is greatly reduced – from 2 1/4 per cent to just under 1 1/4 per cent. Because the price effect is lower, federal payments and revenue receipts that are tied to the CPI will automatically be adjusted. As a result, there will be reduced costs to the federal government from the indexation of personal income tax brackets and credits, and lower indexed payments under various programs, such as elderly benefits, family allowances and veterans pensions. Total automatic savings from lower indexing costs will amount to about \$1.1 billion.

## **Fiscal Actions**

Throughout the national debate on the GST, the importance of spending restraint on the part of government was emphasized time and again. Canadians are looking for better management and more effective use of their tax dollars. To that end, the government has recently announced a package of measures to promote greater efficiency in government operations. These measures, while reducing waste and inefficiency, will provide an ongoing contribution to rate reduction of about \$700 million per year. They reconfirm the government's determination to restrain spending and to provide Canadians with the stewardship their tax dollars deserve.

As part of the 9-per-cent GST package, the government indicated that the middle income tax rate would be reduced from 26 to 25 per cent in order to assist middle-income taxpayers. With the reduction in the sales tax burden implied by the GST at 7 per cent, this income tax assistance is no longer required. Even without this assistance, middle-income taxpayers will generally be better off under the revised GST package than they would have been at the 9-per-cent rate originally proposed.

Reducing the GST rate from 9 to 7 per cent would have yielded the greatest benefit in dollar terms to high-income Canadians – they tend to consume more and, therefore, pay more on average in sales tax. In the interest of lowering the rate, it is not possible to provide high income individuals with this tax advantage. As a result, the federal surtax currently applied to high-income individuals will be increased from 3 to 5 per cent. The threshold for paying this high-income surtax will also be lowered from \$15,000 of basic federal tax annually to \$12,500 of tax. These changes mean that high-income Canadians will generally pay about the same amount of tax as under the 9-per-cent GST.

Not only will individual Canadians assist in reducing the GST rate, the business community will also contribute.

Effective January 1, 1991, the Large Corporations Tax will be raised from .175 per cent to .2 per cent on corporate capital employed in Canada in excess of \$10 million – a 15-per-cent increase in the tax rate.

The proposed small business administration fee of 0.4 per cent of total revenue from taxable and zero-rated sales up to \$600 annually will be eliminated. In recognition of the transitional costs associated with the implementation of the new system, however, a one-time credit of \$1,000 will be provided to small businesses at the start-up of the GST. In addition, effective December 19, 1989, the existing federal sales tax will be removed from electronic point-of-sale equipment. This will assist those small businesses who wish to upgrade their cash register systems to better accommodate the GST. As such, it complements the 100-per-cent capital cost allowance on such equipment that was announced in August.

The existing federal sales tax is levied on manufacturers' sales of alcohol and tobacco at a rate of 19 per cent and on motive fuels at a rate of 13.5 per cent. The replacement of the existing federal sales tax with a GST of 7 per cent at the retail level would result in a substantial reduction in federal revenue from these products. Sustaining this loss would make achievement of the 7-per-cent rate very difficult.

In considering the overall tax treatment of these commodities, the government wants to ensure that the operation of the GST is as straightforward as possible and that the competitiveness of Canadian industry is maintained. In order to achieve these goals while helping to preserve federal revenues, the special product taxes, mark-ups and similar levies imposed by the provinces on tobacco, motive fuels and alcoholic beverages will be incorporated in the GST tax base.

Even with the inclusion of provincial product taxes in the GST base, federal revenues from alcoholic beverages and tobacco would decline somewhat. Federal excise taxes on these commodities will be adjusted so that the federal tax burden on final consumers does not change as a result of sales tax reform.

As a result of these measures, the average price to final consumers of alcohol, tobacco and motive fuels will not rise. Existing federal revenues from the final consumption of these products will remain the same as under the current sales and excise tax regime. This, however, yields a saving to the federal government of



\$700 million relative to the package of measures set out in the August Technical Paper.

In making these changes, the government recognizes the fiscal importance of revenues from these products to the provinces. Given the treatment of provincial product taxes under the GST, the government expects that the provinces will make consequential adjustments in these taxes to maintain their own revenues. However, in view of the fact that the combined federal and provincial tax burden will remain the same, on average the price of these products to final consumers need not rise. At the same time, because the GST on motive fuels will be fully recovered by business users, the benefits of sales tax reform for such economically key and regionally important industries as mining, forestry and transportation will be preserved.

Finally, modest adjustments will be made in the GST tax base in the area of prepared food. These changes are designed primarily to achieve a more equitable and straightforward operation of the GST in this area. In the context of efforts to lower the rate, a subsidiary benefit is an increase in GST revenues of about \$100 million.

#### **4. A Balanced Package**

As a result of the fiscal actions and the consequential adjustments set out above, the federal government is able to reduce the GST rate to 7 per cent without increasing the deficit.

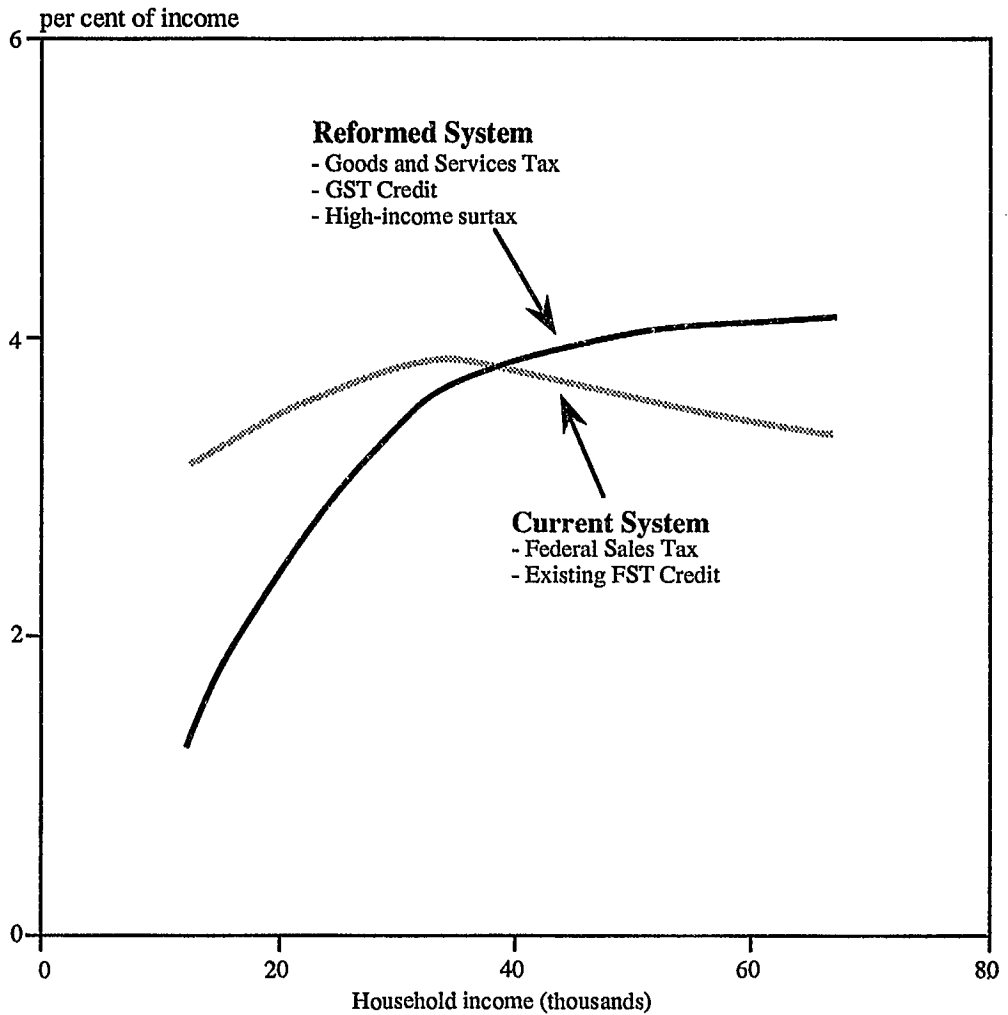
In addition, the mix of actions the government has taken to lower the rate also succeeds in ensuring a substantially reduced impact on the Consumer Price Index from the implementation of the GST – a key principle of rate reduction. In contrast, many have advocated significant broadening of the GST base in the interest of lowering the rate. However, the government believes that such action would be an inappropriate, indeed a self-defeating, route to a lower rate, since base broadening measures do nothing to reduce the impact on the CPI.

While reflecting very difficult choices, the government believes that the package of measures to reduce the rate is well balanced across sectors and across income groups.

From the outset, one of the fundamental goals of sales tax reform was to achieve a fairer tax system overall. The government believes that the 7-per-cent GST package continues to meet this test of fairness – the federal sales tax system will be more progressive once the GST is in place. This is shown in Chart 3.

The government's commitment to ensure that families earning less than \$30,000 are better off as a result of sales tax reform is fully met. Indeed, under the 7-per-cent GST package, lower- and modest-income Canadians are better off not only relative to the status quo system, but in comparison with the 9-per-cent package.

Chart 3  
**Fairer System**  
**Families with Children**



In general, middle income families are also better off at the 7-per-cent rate, while upper-income Canadians will pay approximately the same amount of tax overall.

While middle- and upper-income Canadians have been asked to forgo some of the income tax benefits they would have received under the 9-per-cent GST in the interest of lowering the rate, the business community will also contribute to realizing this important objective. For this reason, the large corporations tax has been increased and the small business administration fee replaced with a one-time transitional credit.

Individual Canadians and the business community cannot be expected to accept the tough actions required to reduce the GST rate unless they can be assured that

the government itself remains committed to expenditure control and deficit reduction. It is for this reason that a number of spending restraint measures have been announced that will make government more businesslike and efficient.

All of these have been hard choices, but they are balanced choices.

## **5. Economic Impacts of the 7-Per-Cent GST**

### **A. Sales Tax Reform Will Raise the Economy's Potential Output**

Analysts agree that the economic gains from sales tax reform come from eliminating the distortionary FST. The FST causes an inefficient allocation of resources, restricts the size of the capital stock and impairs the ability of domestic producers to compete in international markets. Elimination of the FST will raise the economy's capacity to produce goods and services and improve Canada's competitiveness. Potential output – the volume of goods and services an economy can produce when its resources are fully utilized – will rise by 1.4 per cent. The gains in potential output will be broadly based, both sectorally and regionally.

The longer-run benefits arise because elimination of the FST removes tax-induced distortions in the prices of goods and services, and lowers the cost of capital. As the GST has a single rate and a broad base, the benefit of much less relative price distortion will be realized regardless of the level of the GST rate. As well, as the GST on input purchases will be rebated, the reduction in the cost of capital stems solely from FST elimination and is independent of the level of the GST rate. Consequently, the longer run benefits of sales tax reform will be very similar whether the GST rate is 9 or 7 per cent.

### **B. Transitional Economic Impacts of the GST**

Economic performance will improve as the economy moves toward these long-run benefits. The response of prices and wages to the GST implementation will influence the path of adjustment over the transition period. In the August Technical Paper it was pointed out that an inflationary response would delay the realization of the longer-run benefits of sales tax reform.

In the present environment of strong inflation pressures, concerns have been raised about the risk of an inflationary response to a 9-per-cent GST. The lower GST rate will reduce this risk. Indeed, lowering the actual price impact and reducing the risk of an inflationary response are the main advantages of the 7-per-cent GST.

The reduction of the GST rate from 9 to 7 per cent will not increase the deficit. The foregone revenues from the lower rate have been compensated by automatic reductions in the costs of some of the offsets, by other revenue measures and by expenditure reductions. Therefore, in the absence of an inflationary response in

wages and prices – as assumed for the economic responses shown in the August Technical Paper – it is expected that the impacts of the GST on output and employment would be similar at 9- and 7-per-cent rates.

In the environment of strong inflation pressures, however, the lowering of the rate will help ensure that the long-run benefits of sales tax reform will be achieved quickly and smoothly. Overall economic performance will improve from the first year of implementation as the economy moves toward the long-run gains. The economic effects of sales tax reform over the transition period are discussed below.

**(i) Canada's International Trade Position Will Improve**

The replacement of the FST with the GST will, on average, reduce exporters' costs by almost 1 per cent, thereby making Canadian producers more competitive in international markets and increasing job opportunities in export industries.

The FST 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.

The removal of the import bias inherent in the FST will further improve Canada's competitiveness by putting domestic producers on a level playing field with imports in the domestic market.

**(ii) Investment in Plant and Equipment Will Rise**

The GST will lower the price of capital goods because the tax paid on capital purchases will be rebated, whereas many capital goods are presently taxed under the FST. This decline in the cost of capital goods will increase investment over time.

**(iii) Price Impact and Inflation Risks Will Be Reduced**

Reduction of the GST rate from 9 to 7 per cent will lower the one-time increase in the Consumer Price Index from 2 1/4 per cent to just below 1 1/4 per cent. The impact on the GDP deflator, the broadest price measure for the economy, is roughly half that on the CPI; the fall in the price of investment goods offsets part of the rise in consumption prices.

The price impacts are measured under the assumption that all the savings from the FST elimination, with the exception of the FST paid on capital goods, will be quickly passed on to consumers. The savings from the FST on capital goods are assumed to be reflected in consumer prices over time.

Given the compensating measures proposed in the 7-per-cent package and the prospects for increased income and employment, a 1 1/4-per-cent increase in the

price level is unlikely to lead to a pass-through to wages. The lower GST rate and associated lower price impact will complement the government's overall macroeconomic strategy of reducing inflation pressures and help create scope for lower interest rates.

**(iv) Income and Consumption Will Rise Over Time**

The impact on real after-tax incomes of Canadians will be less than the initial rise in consumer prices because of the enrichment of the sales tax credit. The changes to the sales tax credit are designed to ensure that families earning less than \$30,000 are better off under the GST.

Real after-tax incomes of middle and upper income households will initially fall. In total, real after-tax income on average will be lower initially by somewhat less than 1 per cent. This is similar to the impact estimated for the 9 per cent GST proposal as the lower price effect and the consequential reduction in the GST Credit and the other income tax changes are essentially offsetting. This reduction in real after-tax income will be temporary. Over time, sales tax reform will result in greater real purchasing power for all Canadians as the savings from the elimination of the FST on business capital inputs are passed forward to consumers, and as employment growth and GST-related improvements in productivity raise real incomes of Canadian households. As the real purchasing power of consumers rises over time, so too will consumption.

**(v) Economic Performance Will Improve From the First Year of Implementation**

Table 2 shows that with wage and price moderation, the 7-per-cent GST will raise real GDP from the first year of implementation and by 0.7 per cent by 1994, equivalent to \$4 1/2 billion in today's dollars. By 1994, one half of the estimated

Table 2

**Economic Impacts of the GST, 1991 to 1994**  
(Per Cent Differences in Constant Dollar Levels)

	1991	1992	1993	1994
Gross domestic product	0.2	0.5	0.6	0.7
Final domestic demand	-0.3	0.2	0.5	0.7
Business non-residential investment	0.4	2.0	3.4	4.0
Net exports (billions of dollars)	1.5	1.0	0.4	0.2
Employment (thousands)	35	60	60	60

long-run output gain from sales tax reform will be realized. Increases in output over the transition period are led by investment, as businesses respond to the 4 per cent decline in the cost of capital. An improvement in the balance between exports and imports also contributes to higher output in the first few years as elimination of the FST improves exporters' profitability and puts domestic producers on a level playing field with imports. The increases in investment raise imports of machinery and equipment so that the contribution from the net export balance declines over time.

As the economy expands, employment grows and by 1992, 60,000 new jobs will have been created. The unemployment rate falls by 0.3 percentage points by 1992.

## **Operational Aspects of the Tax**

The GST involves a fundamental change in the manner in which the federal government collects its sales tax revenue. It is a multi-stage sales tax and although this is a common tax structure currently in use in 48 countries around the world, it is a new concept in Canada. The government realizes that replacement of the existing sales tax with such a different system is a substantial undertaking and one that will require some adjustment by businesses and consumers.

One of the government's key objectives in sales tax reform has been to keep the GST as straightforward as possible for businesses to operate. The important lesson from the experience of other countries is that one of the best ways to achieve this goal is to maintain a very broad base and a single rate. The GST meets this criterion. It will be levied at a 7-per-cent rate on one of the broadest sales tax bases in the industrial world, covering the vast majority of goods and services sold in Canada. As a result, for most businesses the operation of the GST will simply amount to subtracting the tax paid on all their purchases from the tax charged on their sales. If the tax collected on their sales is greater than the tax paid on their purchases, the difference will be remitted to the government. If it is less, the difference will be refunded to the business. To claim a refund or to remit tax owing, most registrants will only have to complete a single page tax return. The information required by the government to support returns will essentially be the same as that already required for income tax purposes. Business invoices and receipts will remain much as they are today.

The operation of the GST is somewhat less straightforward for those businesses whose sales fall into more than one category, for example, stores selling a combination of taxable and tax-free goods, or registrants providing a combination of taxable and exempt goods and services.

In the former case, while full input tax credits are available on all purchases, vendors must be able to identify easily those sales on which they must charge tax. For most businesses in this situation, this is also reasonably straightforward. For stores selling basic groceries, however, the fact that the provinces have their own borderlines between taxable and tax-free grocery products presents an additional

complication. As a result, special procedures for operating the GST in this area were set out in the August Technical Paper.

For organizations providing a combination of taxable and tax-exempt sales, the compliance with the GST is complicated to some extent by the requirement to allocate inputs between the two types of activities. Most suppliers have sufficient administrative resources to accomplish this task without an undue compliance burden. Certain institutions in this situation – namely, charities and non-profit organizations (NPOs) – may, however, be less equipped to comply with the apportionment rules.

## **1. Basic Groceries**

Basic groceries will be tax-free under the GST, while restaurant meals and take-out prepared foods will be taxable. This gives rise to two potential difficulties. The first involves accommodating tax-free basic groceries in situations where vendors have to deal with provincial sales taxes in addition to the GST. The second is the inherently difficult exercise of drawing borderlines between categories of food products.

In response to the problems posed by the simultaneous operation of two separate sales taxes, the government outlined two methods of streamlined accounting in the Technical Paper. These alternative accounting methods will be available for retailers selling a combination of taxable goods and zero-rated basic groceries. The proposed methods will simplify compliance with the GST for these retailers by obviating the need to identify the federal tax status of each item at the cash register. The government will continue to consult with industry representatives on further refinements to these accounting methods.

Recognizing that drawing borderlines between tax-free groceries and taxable restaurant meals and take-out prepared foods will inevitably give rise to some anomalies, the government set out two options in the Technical Paper. These options were the subject of extensive consultations with representatives of the restaurant, food services and grocery products industries. The government's objective of establishing workable borderlines in this area, while ensuring that firms in direct competition are treated equally, has resulted in the following approach: sweetened baked goods and single servings of a limited number of products will be included in a list of food products which will be taxable regardless of where they are sold.

This will help make the operation of the GST in the food sector more straightforward and achieve a greater degree of competitive equity between establishments selling similar products. In essence, there will only be two types of establishments: restaurants, where all food and drink is taxable, and non-restaurants, where tax is charged only on a list of prepared foods. This issue is discussed in greater detail in Section 3.

## 2. Alternative Accounting Methods for Charities and Non-Profit Organizations

To the extent that charities and NPOs make taxable or tax-free supplies, they will be eligible for full input tax credits on purchases related to these sales. However, the vast majority of sales by charities and a great many sales made by NPOs will be exempt. Under the standard rules, no input tax credits are provided for inputs used in the provision of exempt supplies. In recognition of the important public service functions performed by these institutions, charities and substantially government-funded non-profit organizations will be eligible for a 50-per-cent rebate of any GST paid on purchases used in exempt activities.

The provision of extensive exemptions and special rebates for these organizations inevitably engenders some additional complexity in a tax system such as the GST. In the course of consultations, charities and NPOs raised concerns about the administrative burden involved in accounting for exempt and taxable activities, combined with the claiming of rebates.

In recognition of the limited administrative resources available to many charities and government funded NPOs, and consistent with the recommendation of the House of Commons Standing Committee on Finance, the government will provide an alternative accounting option for these institutions. This is set out in detail in Section 7. In essence, these institutions will be given the option of bypassing the normal rules for input allocation by making use of significantly less complicated accounting techniques.

The advantage of this alternative method is that charities and eligible NPOs will not be required to track the amount of GST paid on materials used in making taxable versus exempt supplies. The government believes that the provision of this option will ensure that the operation of the GST is straightforward and the administrative burden is minimized. Nevertheless, charities and NPOs will, of course, have the option of claiming input tax credits and rebates in the normal manner.

## 3. Other Modifications in the Design of the GST

A number of other refinements of the GST have emerged through consultation with industry and other groups who will be affected by the tax. These design changes, which will contribute to the overall equity and simplicity of the GST, are set out in detail in the Technical Notes. Some of these changes are highlighted below.

- *Farmers and fishermen* will be provided with a prescribed list of selected major items which they will be able to purchase tax-free. This will address concerns raised during consultations regarding the cash flow implications of paying GST on large purchases of farm and fishing equipment.
- Adjustments have been made in the area of *meals and entertainment expenses* to allow 100-per-cent input tax credits throughout the year with a



once-a-year reconciliation to pay back the 20 per cent of the input tax credit on expenses which are actually ineligible for this credit. This will simplify the accounting for this type of expense throughout the year.

- Optional rules have been developed with regard to *joint ventures* in the natural resource sector to provide greater flexibility in the operation of the tax in this area.
- *Intra-group sales* will be zero-rated subject to an ownership/commercial activity test. This will address concerns about incentives to amalgamate into one entity to avoid having to charge GST and claim input tax credits on business-to-business sales within a group.
- *Inventory rebates* will generally be calculated as a fixed percentage of acquisition costs. This will simplify the process of claiming rebates, given that verification of the actual federal sales tax paid on inventories at the retail and wholesale levels would have involved an undue compliance burden.

#### **4. Federal-Provincial Co-operation**

While the basic design of the GST ensures that the operation of the new tax system is not complex in and of itself, some concern has been expressed that the existence of federal and provincial sales taxes operating at the retail level will involve an increased compliance burden for some vendors. Clearly, this is an issue primarily for retailers since most businesses at intermediate points in the production and distribution chain do not have to deal with provincial retail sales taxes.

Furthermore, it is important to distinguish between the actual operation of collecting two separate retail-level taxes and the complications involved in dealing with not one, but two distinct tax administrations. From an operational point of view, the breadth of the GST base will ensure that in most retail stores, federal tax will always apply. The only decision for vendors at the checkout counter will be whether provincial retail sales tax also applies. However, a potential problem does arise for those retailers making a combination of taxable and tax-free sales under both the federal and provincial tax systems. The primary case is that of basic groceries. It was in response to concerns about complexity in the latter area that the government developed systems of streamlined accounting for retailers.

Clearly, retailers will still have to comply with two separate sales tax administrations. For this reason, the federal and provincial governments recently agreed to explore ways of coordinating some aspects of the administration of their sales tax systems in an effort to reduce compliance costs for businesses. In addition, the federal government will explore with the provinces and with the affected institutions themselves possible avenues for simplifying the operation of the GST for municipalities, universities and colleges, school boards and hospitals.

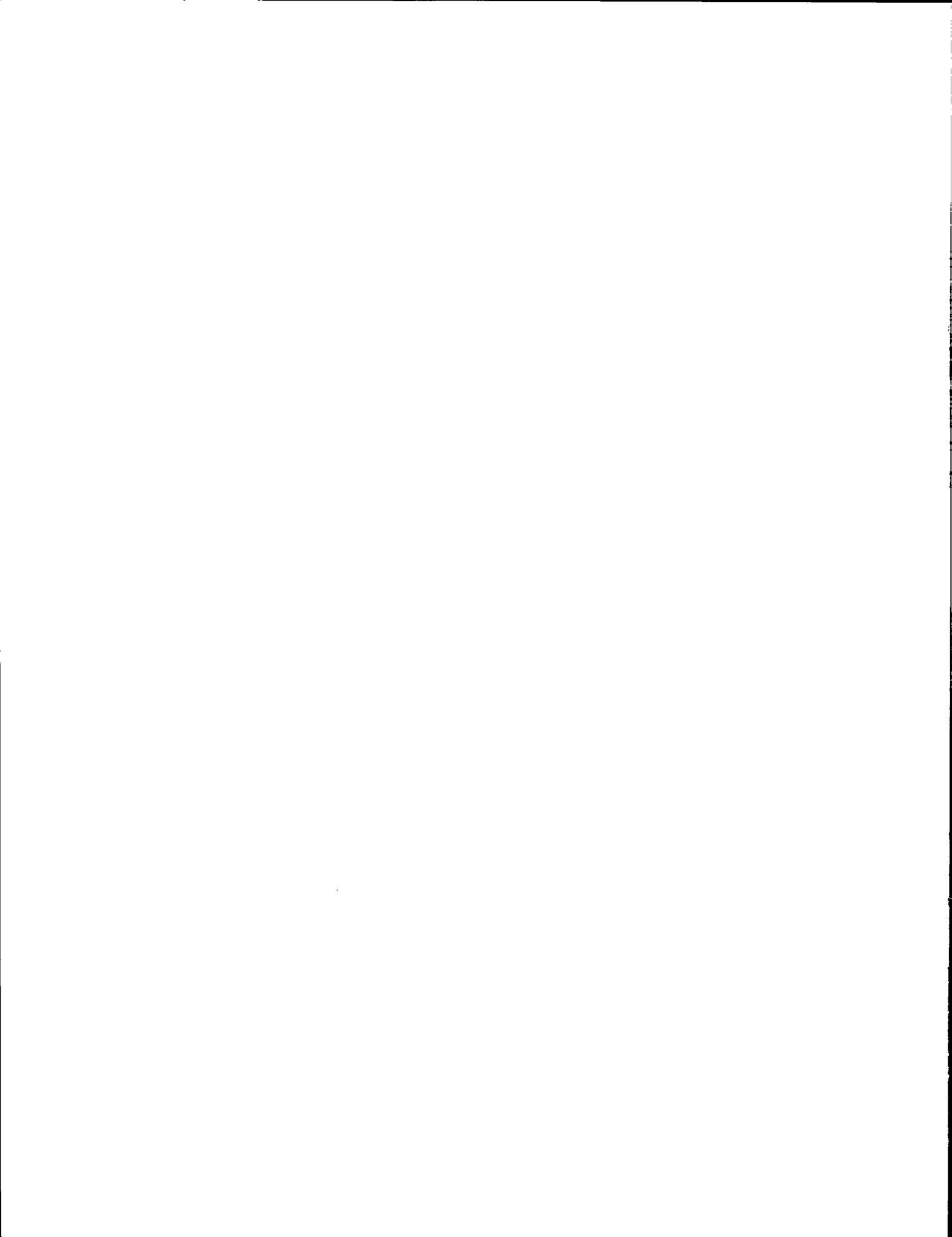
Beyond this, the basic structure of the GST can accommodate the provinces should they choose to participate in an integrated tax at some future time.

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# Technical Notes

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Further to the Goods and Services Tax  
Technical Paper issued by the  
Minister of Finance on August 8, 1989.



## Section 1: Distributional Aspects

### A. Summary

The government has consistently maintained that sales tax reform should be accomplished in a way which contributes to a fair and progressive tax system. The proposals contained in the Technical Paper were targeted to ensure that assistance was directed to those most in need. They ensured that lower- and modest-income families would be made better off in the new regime. In reviewing the trade-offs necessary to secure a lower rate for the GST, the government has ensured that equitable treatment across income groups remains a fundamental element of the reform.

An important benchmark established in the Technical Paper was that families with income below \$30,000 should benefit under the new regime. That will remain the case. First, the lower GST rate itself will reduce the burden on all Canadians, including, of course, those in lower income groups. Second, a refundable tax credit will continue to be an essential component of the GST package and its rates will be set so that, overall, lower income families will be in the same net tax position as was contemplated in the Technical Paper. In total, the GST Credit will involve expenditures of about \$2.4 billion annually and will provide benefits to 8.7 million families and individuals.

The reduction in the GST rate to 7 per cent brings about a substantial reduction in sales tax for all taxpayers including those with higher levels of income. The extent of the tax reduction increases as incomes rise and, in the absence of offsetting action, the reduction in the rate would make the GST package at 7 per cent less progressive than what was proposed in the Technical Paper. In order to ensure that the overall burden is fairly shared, the reduction from 26 to 25 per cent in the middle marginal income tax rate, which had been part of the 9-per-cent GST package, will not be implemented. As well, the existing 3-per-cent surtax on high-income Canadians will be increased to 5 per cent effective January 1, 1991, and the threshold at which it begins to apply will be reduced from \$15,000 of basic federal tax to \$12,500 (or approximately \$62,000 of income).

Together, these changes ensure that families with incomes below \$30,000 will be better off as a result of reform and that the overall distribution of the net impact on incomes is much the same as proposed in the Technical Paper.

## **B. Details of Credit and Income Tax Changes**

### **(i) The GST Credit**

To ensure that the net impact on incomes of lower-income families remain approximately the same as in the Technical Paper, the new GST Credit will be set at \$190 per adult and \$100 per child. These credits reflect the lower tax burden of the GST at 7 per cent.

Single parents will be able to claim an adult credit in respect of one dependent child. In addition, single adults, including single parents, who maintain their own households will be able to claim an additional credit of up to \$100. The credit will be phased in at a rate of 2 per cent of net income in excess of \$6,169 and will reach its maximum value at an income level of \$11,169.

As set out in the Technical Paper, the income threshold at which benefits begin to be reduced will be increased to about \$24,800 in 1991 from its 1990 level of \$18,000. Above this level, benefits will be reduced by \$5 for every \$100 of net income in excess of the threshold. Both the credit amounts and this threshold will be indexed to increases in the Consumer Price Index (CPI) in excess of 3 per cent. The threshold and credit levels will be reviewed periodically and adjusted as appropriate.

As a result, families and individuals will receive substantially increased credits. These increased benefits are set out in Table 1. As that table shows:

- 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 \$580 in 1991;
- a single individual with net income of \$20,000 who received no FST Credit in 1988 will receive a GST Credit of \$290 in 1991.

### **(ii) How Credits Are Calculated and Paid**

The Credit will be calculated at tax time along with the regular income tax return. The amount of the Credit 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 on the income tax return plus social transfer benefits such as social assistance, workers' compensation and guaranteed income supplement. Family status for credit purposes will be identical to that for income tax purposes in the previous year and will not be changed during the year in which the credit is paid. Credit benefits will be paid by cheque, in advance, in four equal instalments in July, October, January and April.

To ensure that Credit benefits are received before the GST is introduced, application forms to enable Revenue Canada to calculate the Credit will be mailed by Revenue Canada as part of the 1989 tax return package. On the basis of this application, the first GST Credit benefits will be paid in December 1990, in advance of the introduction of the GST, and a second payment will be made in April 1991.

Table 1

**Annual Sales Tax Credit**

Net income	Single			Family of four		
	1988	1990	1991	1988	1990	1991
	(in dollars)					
6,000	70	140	190	210	420	580
10,000	70	140	267	210	420	580
14,000	70	140	290	210	420	580
16,000	70	140	290	210	420	580
18,000	0	140	290	100	420	580
20,000	0	40	290	10	320	580
22,000	0	0	290	0	220	580
24,000	0	0	290	0	120	580
26,000	0	0	228	0	20	518
28,000	0	0	128	0	0	418
30,000	0	0	28	0	0	318
32,000	0	0	0	0	0	218
36,000	0	0	0	0	0	18
40,000	0	0	0	0	0	0

**(iii) Middle Rate Reduction**

In the Technical Paper the government proposed to reduce the middle marginal tax rate by one point, from 26 to 25 per cent. In order to provide part of the revenue necessary to allow the GST rate to be reduced, the government will not proceed with this reduction. However, with GST at 7 per cent, the sales tax burden on middle income Canadians is substantially reduced so that the net sales and income tax burden on most middle income taxpayers will be lower than it would have been under the Technical Paper proposals.

**(iv) High-Income Surtax**

The lower GST rate also reduces the impact of sales tax reform on higher-income Canadians. To ensure that the overall reform is progressive and to replace some of the revenues forgone by the reduction in the GST rate, the existing high-income surtax will be increased by 2 percentage points and the threshold lowered from \$15,000 of Basic Federal Tax to \$12,500. This will affect only those taxpayers with incomes in excess of about \$62,000.

## C. Overall Impact

As is clear from Table 2 below, the result of these changes is to ensure that families with incomes below \$30,000 are better off after reform and that the distribution of benefits is very similar to that in the Technical Paper.

In Table 2, Column (2) shows the burden of the GST relative to the federal sales tax it replaces. As in the Technical Paper, these figures take account of the housing rebate described in Section 6. This increased tax burden causes a one-time increase in the consumer price index of just under 1 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. 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 high-income surtax is shown in Column (5). Column (6) then shows the overall combined distributional impact of the introduction of the GST, the housing rebate, automatic indexing the increased GST Credit and the high-income surtax. For reference, the combined distributional impact as it would have been under the 9-per-cent GST is shown in Column (7).

For example, a single wage-earner under 65 with \$20,000 of income will face an increase in sales tax of some \$210 but this will be offset both by the increase in the GST Credit of \$250 and partial indexing of the income tax system so that the net impact of the introduction of the GST is an annual reduction in tax of \$63. About 53 per cent of single taxpayers under 65 years of age have incomes of \$20,000 or less. A typical one-earner couple with two children and \$30,000 of income will face an increase in the sales tax of \$215 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 \$245 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 \$205. 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 the automatic indexing of both transfers and the tax system. Thus, the single parent with two children and \$20,000 of income will be better off by about \$186 as a result of the reform.

In aggregate, the proposed reform reduces the sales tax burden for about 4.3 million households, about 37 per cent of the total. Because households headed by persons over 65 or by single parents tend to have somewhat lower incomes, a much higher proportion of these households will be better off as a result of sales tax reform. About 75 per cent of households headed by persons over 65 will be better off as a result of sales tax reform. About 78 per cent of single parent families will have their net tax burden reduced.

Table 2

**Direct Distributional Impact of Mature GST System on  
Typical Individuals and Families in 1991 Dollars\***

Single Wage-Earner Under 65						
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Income	GST - FST	Indexing	GST-FST Credit	High- income surtax	Revised system: total change in tax	Technical Paper: total change
(in dollars)						
12,500	130	-23	-150	0	-43	-27
15,000	160	-23	-150	0	-13	10
20,000	210	-23	-250	0	-63	15
25,000	255	-35	-278	0	-58	75
30,000	295	-86	-28	0	181	278
35,000	330	-68	0	0	262	469
40,000	350	-68	0	0	282	454
45,000	405	-68	0	0	337	454
50,000	440	-68	0	0	372	459
60,000	560	-101	0	0	459	447
75,000	770	-104	0	148	814	770
100,000	1,045	-104	0	293	1,234	1,285

\*Note: In these tables, a negative figure indicates a reduction in tax or an increase in credits. A positive figure indicates an increase in tax.

Single Individual Over 65						
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Income	GST - FST	Indexing	GST-FST Credit	High- income surtax	Revised system: total change in tax	Technical Paper: total change
(in dollars)						
12,500	130	-128	-150	0	-148	-214
15,000	140	-70	-150	0	-80	-96
20,000	175	-70	-250	0	-145	-121
25,000	220	-81	-278	0	-139	-66
30,000	230	-124	-28	0	78	119
35,000	235	-109	0	0	126	260
40,000	325	-109	0	0	216	335
45,000	380	-109	0	0	271	360
50,000	450	-109	0	0	341	370
60,000	485	-182	0	0	303	183
75,000	560	-186	0	106	480	218
100,000	780	-115	0	258	923	950



Table 2 Continued

One-Earner Couple With Two Children						
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Income	GST - FST	Indexing	GST-FST Credit	High- income surtax	Revised system: total change in tax	Technical Paper: total change
(in dollars)						
15,000	140	-66	-160	0	-86	-100
20,000	150	-66	-260	0	-176	-145
25,000	180	-77	-498	0	-395	-335
30,000	215	-142	-318	0	-245	-214
35,000	240	-142	-68	0	30	6
40,000	280	-121	0	0	159	266
45,000	310	-121	0	0	189	278
50,000	315	-121	0	0	194	243
60,000	400	-120	0	0	280	287
75,000	570	-123	0	119	566	537
100,000	680	-123	0	268	825	859

Two-Earner Couple With Two Children*						
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Income	GST - FST	Indexing	GST-FST Credit	High- income surtax	Revised system: total change in tax	Technical Paper: total change
(in dollars)						
15,000	140	-68	-160	0	-88	-118
20,000	150	-50	-185	0	-85	-80
25,000	190	-70	-410	0	-290	-226
30,000	265	-98	-468	0	-301	-198
35,000	260	-98	-218	0	-56	62
40,000	265	-98	-18	0	149	292
45,000	310	-77	0	0	233	629
50,000	365	-124	0	0	241	622
60,000	460	-96	0	0	364	772
75,000	600	-96	0	0	504	863
100,000	770	-171	0	0	599	826

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

Table 2 Continued

Single Parent With Two Children						
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Income	GST - FST	Indexing	GST-FST Credit	High- income surtax	Revised system: total change in tax	Technical Paper: total change
(in dollars)						
12,500	130	-28	-300	0	-198	-337
15,000	155	-66	-300	0	-211	-310
20,000	205	-66	-325	0	-186	-235
25,000	270	-66	-550	0	-346	-345
30,000	295	-94	-468	0	-267	-252
35,000	285	-141	-218	0	-74	-81
40,000	335	-141	-18	0	176	155
45,000	415	-120	0	0	295	433
50,000	460	-120	0	0	340	513
60,000	690	-145	0	0	545	568
75,000	700	-122	0	65	643	619
100,000	715	-122	0	246	839	677



## Section 2: Basic Operation

The key concepts and basic structure of the GST will be essentially as outlined in Section 2 of Part C of the Technical Paper on the Goods and Services Tax. Every person engaged in a commercial activity (other than a small supplier with less than \$30,000 in taxable sales per year) will be required to collect GST at the rate of 7 per cent in respect of taxable supplies made in the course of that activity. Registrants will be entitled to recover GST on their purchases through the input tax credit mechanism to the extent that such purchases are for use in a commercial activity.

Consultations with a wide range of industry groups and tax practitioners have confirmed that the technical design of the GST is sound. That said, however, a number of constructive suggestions were made for simplifying the day-to-day operation of the tax and clarifying the application of certain key provisions. The more important changes are elaborated below.

### A. Meals and Entertainment Expenses

Consistent with the *Income Tax Act*, the Technical Paper proposed to restrict input tax credits for meals and entertainment expenses to 80 per cent of the credit that otherwise would be allowed in recognition of the personal consumption element in such expenses.

In consultations with the Department of Finance, and in testimony before the House of Commons Standing Committee on Finance, a number of groups indicated that the application of the 80-per-cent restriction for meals and entertainment expenses would create substantial accounting complexities for many GST registrants.

In response to these concerns, the rules will be simplified to allow input tax credits for meal and entertainment expenses to be claimed in full for the reporting period in which they are incurred. However, at the end of the registrant's fiscal year, there will be a 20-per-cent recapture of input tax credits claimed for these expenses during the year. For registrants reporting on a monthly or quarterly basis, the amount recaptured will be included in the GST return for the first reporting period in the next fiscal year. This will enable registrants to calculate the input tax credit recapture at essentially the same time they would normally calculate their meal and entertainment expense deductions for income tax purposes.

These modifications will significantly simplify the claiming of input tax credits for meal and entertainment expenses while preserving the principle that private consumption should be taxed under the GST.

## **B. Intra-Group Supplies**

As a general rule, GST registrants will collect tax on all of their taxable supplies. Their clients, if they are engaged in a commercial activity, will claim input tax credits to recover any tax paid on their purchases.

While this is entirely appropriate where registrants are not related to each other, a number of organizations identified sales between closely related corporations as an inappropriate area to apply GST. In particular, it was noted that taxing transactions between a parent corporation and its fully owned subsidiary, or between a corporation and a closely related special-purpose corporation, could have different implications than if the separate corporations had been divisions of a single corporate entity.

To address these concerns, provisions will be made to zero-rate intra-group supplies between two or more closely related corporations resident in Canada if the corporations are engaged exclusively in commercial activities (and, therefore, would be entitled to fully recover any GST paid on purchases from other members in any event).

For these purposes, a corporation will be considered to be "closely related" to a second corporation if at least 90 per cent of the value and number of full voting right shares of the capital stock of the second corporation are owned by:

- the first corporation;
- a subsidiary of the first corporation if 90 per cent of the value and number of full voting right shares in the subsidiary are owned by the first corporation; or
- a person or group of up to five persons who own more than 90 per cent of the value and number of full voting right shares in the first corporation.

To qualify for zero-rating of intra-group supplies between closely related corporations, the members to be included in the group will be required to file a joint election to this effect.

Intra-group transactions between financial institutions are described in greater detail in Section 8.

## **C. Joint Ventures**

Under the general rules outlined in the Technical Paper, depending on the terms of a joint venture arrangement (other than a partnership), each of the participants in the joint venture could be required to account separately for GST to the extent

of their participation in the joint venture. A number of representatives of the resource sector (where joint ventures are especially common) expressed concern that this would be a cumbersome approach, particularly where there is a single operator and the remaining participants are not directly involved in the day-to-day operation of the joint venture.

To provide greater flexibility in the operation of the GST in this area, joint venture participants and the operator will be able to elect to have the operator act as the participants' agent and be responsible for accounting for GST on all purchases and sales by participants through the operator. As a consequence, GST will apply neither to any revenues subsequently distributed to participants by the operator nor to reimbursements by the participants to the operator for expenses incurred on their behalf. Legally, however, the operator and the participants will remain jointly and severally liable for the collection and remittance of GST on those supplies. Participants, of course, will still be permitted to claim input tax credits for tax paid on joint venture-related expenses incurred by them directly (and not through the operator) to the extent that they would be entitled to claim input tax credits if the election had not been made.

The election will be available to joint ventures involving the exploration and development of mineral, petroleum and gas deposits. This will permit greater flexibility in the operation of the GST in this sector. Provision will also be made for this election to be available to joint ventures in other prescribed cases. These will be determined following consultations with other industry groups.

## **D. Incidental Supplies**

Some concerns were expressed in the course of consultations about the uncertain tax status of supplies that are merely incidental to otherwise exempt or zero-rated supplies. For example, if a residential landlord includes electricity in the rents charged to tenants, would the landlord be required to collect GST on the portion relating to the supply of the electricity? Similarly, it was asked whether tax would have to be collected on some portion of the price of a box of cereal (a zero-rated grocery) if the manufacturer includes a small toy in the box.

To clarify the application of GST in circumstances such as these, the legislation will contain a general rule to confirm that any supply that is incidental to another supply will be treated as part of that other supply. This rule will apply where the primary and incidental supplies are provided together for a single consideration but not where a separately identifiable charge is made for the incidental supply.

This provision will remove doubt about the need to prorate consideration received for a supply where the potential tax status of an incidental supply differs from the primary supply to which it relates.

Special provision will be made to exempt a mixture of items supplied for a single consideration where the supply is primarily of exempt financial services. This rule is described in greater detail in Section 8.

## **E. Supply Made in Canada by Non-Residents**

Under the general rules of the GST, persons engaged in commercial activities will be required to collect and remit tax on any taxable supplies they make in Canada. Non-resident suppliers will be bound by these rules to the extent that they:

- carry on a business in Canada;
- supply admissions to a place of amusement, seminar, activity or event in Canada; or
- maintain a permanent establishment in Canada.

The Technical Paper also indicated that foreign publishers would be required to account for GST on their subscription sales in Canada. Moreover, it noted that non-resident importers who subsequently make supplies in Canada would be considered to be engaged in business in Canada and, therefore, be permitted to recover the tax paid on importations like any other person engaged in a commercial activity in Canada.

The rules must be sufficiently broad, both to require foreign publishers to collect tax on their subscription sales in Canada and to enable non-resident importers to claim input tax credits where appropriate. Consequently, provision will be made in the final legislation to deem non-resident vendors to be engaged in business in Canada for GST purposes where they solicit orders for or offer tangible personal property, for supply in Canada, whether or not through an agent in Canada.

While this will ensure that such persons are permitted to claim input tax credits in respect of their tax-paid purchases in Canada, non-residents will only collect GST on supplies they make in Canada. For this purpose, the regulations will provide that books and periodicals sent by mail to someone in Canada will be treated as supplies made in Canada.

Combined, these provisions will ensure that foreign publishers are placed on an equal footing with domestic publishers with whom they compete, and that non-resident importers are accorded the same right to claim input tax credits as resident importers.

## **F. Timing of Liability – Modification to Override Rule**

Liability for payment of GST on a taxable supply will arise on the earlier of the day on which the supply is paid for, or the day on which the payment for the supply becomes due.

The Technical Paper outlined a series of rules to determine when the payment for a supply becomes due. In the vast majority of cases, these rules will coincide with the time at which suppliers normally would record transactions in their books of account (e.g., invoice date, due dates specified in agreements in writing, etc.).

The Technical Paper also proposed an override rule to ensure that the liability for GST could never go beyond one month following the month in which the supply is completed. While the practical operation of this rule will be straightforward in the case of construction contracts and supplies of goods, a number of groups indicated that the application of the rule to services would be ambiguous. The time when services are completed is sometimes unclear, particularly in the case of ongoing legal and other professional services.

Recognizing these concerns, the override rule for timing of GST liability will not apply in the case of services. This will provide greater certainty of timing of liability for GST in the case of services and, therefore, simplify compliance with the tax.

## **G. Timing of Liability – Agreements in Writing**

For most supplies, the invoice date will be the time at which liability for GST is triggered. A special rule was set out in the Technical Paper for supplies made by way of lease, contract or other agreement in writing. Under this rule, liability for GST will arise on the date specified in the agreement on which the recipient is required to pay consideration for the supply.

In consultations on the timing of liability rules, a potential conflict was identified between the invoice and agreement in writing provisions. Uncertainty about the timing of liability would arise in the case where, for example, a leasing company sends a notice of payment – an invoice – as a courtesy to a customer in advance of the due date specified in the leasing contract.

To address this ambiguity, the GST legislation will provide that the invoice rule is superceded in the case of leases by an agreement in writing.

## **H. Apportionment Rule for Input Tax Credits**

Subject to the special provisions described in the Technical Paper for simplifying the claiming of input tax credits on capital goods, a general rule under the GST is that registrants will be allowed to claim an input tax credit for the tax paid on an acquisition *to the extent it is for use in a commercial activity of the registrant*. Accordingly, if a good or service is exclusively for use in a registrant's commercial activity, the GST paid will be fully creditable; conversely, if it is not to be used at all in a commercial activity, no credit will be permitted. However, in those limited instances where registrants make exempt as well as taxable or zero-rated supplies, or where they make personal use of business inputs, they will be required to apportion their purchases for input tax credit purposes.

In the course of consultations with various groups, concerns were expressed about the allocation methods to be used for input tax credit purposes. A number of groups suggested legislating the methods to be used in any given circumstance. While this would provide greater certainty, such certainty would be achieved at



the expense of tax equity and flexibility in the legislation to respond to new circumstances as they arise. For example, it would be possible to legislate that operating costs in an apartment tower with a shopping concourse on the bottom floors be prorated on a square footage basis. However, where these costs (e.g., electricity, snow removal in parking lot, maintenance/renovation) relate disproportionately to the taxable commercial rentals in the building (and not to the exempt residential rentals), the result would be a denial of input tax credits in respect of the commercial rentals. Clearly, this would be unfair.

The legislation will not, therefore, prescribe specific allocation methods to be used in each circumstance. Registrants will be permitted to use methods of their own design as long as the methods are reasonable in the circumstances. There will be no requirement for registrants to seek the prior approval of Revenue Canada for the use of particular allocation methods. However, Revenue Canada will be consulting with industry groups and will issue guidelines on the use of various methods.

While the legislation will provide flexibility in the choice of methods for allocating inputs, it will require that any apportionment methods adopted by a registrant be applied on a consistent basis.

## **I. Exports**

The Technical Paper proposed to zero-rate the supply of goods to a recipient if the recipient exports the goods and the supplier maintains satisfactory evidence of exportation.

Several groups indicated that this rule could put exporters in a difficult position. In many cases, the supplier could be held liable for GST if, in good faith, goods are sold on a zero-rated basis and the recipient subsequently fails to provide the supplier with evidence of export to satisfy the conditions for zero-rating the supply in the first place. Two principal areas where this could occur are on sales to non-resident individuals and where the recipient takes delivery of goods in Canada for export using the recipient's own truck.

To address this problem, supplies to individuals will not qualify for zero-rated treatment as exports unless the goods are delivered outside Canada by the supplier, or delivered by the supplier to a common carrier for delivery outside Canada by the carrier. In the case of goods exported by truck, zero-rating will not be permitted where recipients use their own vehicles to move the goods outside Canada. In each of these cases, however, the recipient of the supply will be entitled to claim a rebate of any GST paid on goods exported, subject to the requirement that the purchaser provides the Minister of National Revenue with satisfactory evidence of export.

## Section 3: Defining the Tax Base

### A. Introduction

A key principle of sales tax reform is that the GST apply to a very broad base, covering the vast majority of goods and services consumed in Canada.

The House of Commons Standing Committee on Finance endorsed strongly the principle of establishing a broad tax base. Indeed, its importance was frequently emphasized in witnesses' testimony before the Committee.

The advantages of having a broad base with a single rate are widely recognized:

- A broad tax base ensures that the application of the tax does not distort production and consumption decisions. This promotes the more efficient operation of the economy.
- A broad base provides a fairer and more even application of tax across the range of consumer expenditures.
- A broad base simplifies the operation of the tax.
- Finally, of course, maintaining a broad base for the GST is fundamental to the effort to lower the overall rate of tax.

An argument frequently advanced in favour of providing numerous exemptions and/or multiple tax rates is that, by selectively removing items from the base that make up a greater proportion of expenditures by lower-income families, a fairer system can be achieved. However, exemptions require a higher rate of tax on other goods and services also purchased by lower-income Canadians to raise the same amount of revenue. Moreover, exemptions typically provide higher-income consumers with a greater tax benefit in absolute terms than lower-income earners.

A much more efficient way of targeting assistance to those who need it most is the use of refundable tax credits, provided directly to lower- and modest-income families. The GST Credit will permit the simultaneous achievement of the twin objectives of a fair and broad based tax.

Limited exclusions from the GST tax base were set out in the Technical Paper. The appropriateness of this approach was reaffirmed in the Report of the Standing Committee on Finance. Nevertheless, in the course of consultations on the GST, several areas emerged where technical changes could be made to improve the operation of the tax.

In the following sections, the key changes to the tax-free and tax-exempt categories arising from these consultations are elaborated.

## **B. Basic Groceries**

As indicated in the Technical Paper, basic groceries – covering the vast majority of foods purchased for preparation and consumption at home – will be zero-rated. GST will apply to soft drinks, candies and confections, and snack foods. The definitions of these categories of goods were set out in the Draft Legislation and are virtually identical to those currently contained in the *Excise Tax Act*.

### **Restaurant Meals and Take-Out Prepared Foods**

Restaurant meals and take-out prepared food are not basic groceries. Consistent with their treatment under the majority of provincial sales taxes, they will be taxable under the GST.

Incorporating these into the tax base, while excluding basic groceries, inevitably entails a difficult tradeoff between the goals of simplicity on the one hand, and competitive equity, on the other.

For example, it could be argued that the system would be simpler if grocery stores and similar outlets were not taxed on any of their sales of food even though restaurants and take-out establishments were taxable on all their sales.

Although simple, this approach would create an unacceptable degree of competitive distortion, given the range of prepared food products sold by grocery and convenience stores.

In defining the tax base in this area, then, the task is to strike a balance between the goals of simplicity and competitive equity.

#### **Technical Paper Options**

Recognizing that there are no simple solutions, the Technical Paper set out two options for the application of the tax in this area and proposed consultations with the foodservice and grocery distribution sectors on this important issue.

Under the first option, businesses were classified into the following three groups depending on the proportion of their sales of prepared food to total food sales:

- *Eating establishments*, with sales of prepared food accounting for all or substantially all of their total food sales, would be taxable on all their sales of food and drink;

- *Combination establishments*, with sales of prepared food accounting for over 50 per cent of their total food sales, would be taxable on a specific list of prepared foods and beverages; and
- *Grocery stores*, with less than 50 per cent sales of prepared foods, would be taxable on a shorter list of prepared foods.

It is important to note that the principal difference between the latter two categories was that grocery stores would not be taxable on their sales of sweetened baked goods, whereas combination establishments would be taxed on their sales of these goods to avoid creating a significant competitive advantage over eating establishments.

In contrast, the second option outlined in the Technical Paper focused solely on the nature of the product to determine its tax status. Under this method, a specific list of prepared food products was identified which would be taxed regardless of the type of establishment in which they were sold.

The Technical Paper acknowledged that each approach had advantages and disadvantages. Under Option 1, businesses competing most directly with each other – i.e., those in the same category – would be treated equally. In addition, for businesses classified as eating establishments, this approach presented a relatively straightforward system. Because virtually all their sales of food and drink would be taxable, they would not need to keep separate track of their taxable and tax-free sales.

However, Option 1 gave rise to two major shortcomings.

- *First*, given that it provides different tax treatment depending on the type of establishment, it creates potential competitive inequities where different types of establishments compete directly with each other.
- *Second*, this option would create ongoing compliance problems for businesses to determine in which category they fell. It would be particularly problematic for businesses such as small convenience stores or bakeries to determine whether they were combination establishments or grocery stores based on potentially shifting sales patterns.

Option 2 would have avoided these difficulties by not differentiating by types of establishments. However, despite its intuitive appeal, this option would produce certain anomalous results and create serious complexities for businesses.

Although most prepared foods would be taxed under this option, certain items sold as part of a prepared meal served in an eating establishment would be tax free. For example, a muffin served with breakfast in a restaurant would be tax free, but an order of toast would be taxable.

Apart from these apparent anomalies, this method would also entail significant compliance difficulties for eating establishments as they would have to separately account for their taxable and tax-free sales.

The objective in pursuing consultations on this issue was to develop an approach which would, as far as possible, reduce the competitive inequities inherent in Option 1, while at the same time avoid the anomalies and complexities inherent in Option 2. Two key areas were identified where changes could substantially improve the operation of the tax.

#### *Single-Serving Containers of Yogurt, Pudding and Beverages*

These are typically purchased in convenience stores for immediate consumption and compete directly with identical products sold in fast food outlets and cafeterias.

Under Option 1, the taxation of these items in eating establishments but not when sold by other outlets was identified as a particular source of competitive inequity. Similarly, under Option 2, not taxing these items in eating establishments would create complexities for them in accounting for the tax.

#### *Sweetened Baked Goods*

The differential tax treatment of sweetened baked goods between combination establishments and grocery stores is clearly the most problematic feature of Option 1. Indeed, the sole difference in the treatment of combination establishments and grocery stores is the taxation of sweetened baked goods.

In addition, as noted above, the non-taxation of sweetened baked goods in restaurants under Option 2, gives rise to particularly anomalous results and compliance costs.

#### **Revised Approach**

To resolve these potential competitive inequities and to improve the operation of the tax, the following two changes will be incorporated into the final GST legislation:

- *First*, single-serving containers of yogurt, pudding and beverages, other than unflavoured milk, will be taxable. However, where these items are sold in a package containing several single servings, they are more akin to basic groceries, and hence, will continue to be tax free.
- *Second*, sales of doughnuts, cookies, muffins, pies, cakes, (including ice cream cakes and pies), dessert croissants (i.e., with sweetened topping or fillings), pastries, and other sweetened baked goods will be taxable. However, tax will not apply to items such as raisin bread, bagels, unsweetened crackers or similar products.

These two changes, in effect, permit the development of a hybrid approach for the tax treatment of restaurant meals and take-out prepared foods, drawing together elements from both Option 1 and Option 2.

Under this revised approach, like Option 2, tax will apply to the following list of prepared foods, sold in all establishments:

- heated food and drink;
- fresh prepared salads;
- sandwiches;
- arrangements of prepared foods, such as cheese trays;
- ice cream cones, sundaes and similar single serving products dispensed on the premises;
- drinks dispensed on the premises;
- sweetened baked goods; and
- single-serving containers of yogurt, pudding, and beverages other than unflavoured milk.

As under Option 1, however, businesses where the above items account for all or substantially all sales of food will be classified as eating establishments and will be taxable on all their sales of food and drink, other than food not sold in a form suitable for immediate consumption – such as a bag of coffee. This will virtually eliminate their need to separately account for taxable and zero-rated sales.

In summary, this revised approach to the treatment of restaurant meals and take-out prepared foods accomplishes three objectives:

- *First*, it will ensure that the operation of tax is relatively straightforward for eating establishments.
- *Second*, items sold in grocery stores which compete most directly with eating establishments – such as heated food and drink, sandwiches, fresh salads, single-serving containers, and sweetened baked goods – will be treated the same as when they are sold by eating establishments. This, coupled with the reduction in the tax rate to 7 per cent, will substantially reduce potential competitive inequities in this area.
- *Finally*, it will continue to ensure that the vast majority of food sold for preparation and consumption at home – that is, basic groceries – remains tax free.

### **C. Agriculture and Fishing**

Since the release of the Technical Paper, the Department of Finance has had extensive consultations on the GST with the agricultural and fishing sectors.

In these consultations, farmers and fishermen commonly expressed the concern that they would continually be faced with increased cash flow requirements under

the GST because they would be paying tax on purchases, but not collecting tax on their sales. It was noted that although farmers and fishermen could file monthly GST returns to reduce these cash flow problems, this would entail an additional compliance burden for these businesses, many of which are relatively small. The higher volume of GST returns would also increase administrative costs for Revenue Canada.

To facilitate the operation of the tax in this area, the GST legislation will provide for a prescribed list of selected major farm and fishing purchases to be unconditionally zero-rated. The list will be developed in consultation with the Departments of Agriculture, Fisheries and Oceans, and National Revenue, and with representatives of the farming and fishing sectors.

This list will be limited to major items of a type purchased exclusively by farmers and fishermen – for example, combines, large tractors, fishing boats and commercial fishing nets.

By restricting the list to major items, the objective is to simplify compliance for farmers and fishermen while, at the same time, ensuring that no additional compliance burden is created for general retailers – such as hardware stores – which will continue to collect tax on all their sales. Of course, farmers and fishermen will still be able to claim input tax credits in the normal manner for any business purchases of items not included in the prescribed list.

With this change, potential cash flow problems faced by farmers and fishermen will be significantly alleviated. This will reduce the need for these small businesses to file monthly and, in turn, result in an overall lowering of compliance and administrative costs.

Another issue which arose in the course of the government's consultations was the treatment of sharecropping arrangements, where farmland is leased in exchange for a portion of the tenant farmer's crop production. Typically, exchanging of taxable properties between registrants in the course of commercial activities will not give rise to any net tax liability for either party. However, because sharecropping involves the exchange of a taxable supply (the rental of land) for a zero-rated commodity (farm produce), the application of the normal rules would entail unintended complexities.

To avoid these unnecessary complexities, the legislation will provide for the rental of farmland under a sharecropping contract between registrants to be zero-rated. This will simplify the operation of the tax for these arrangements.

## **D. Educational Services**

Following consultations, minor changes will be made in the legislation to clarify that private elementary and secondary schools will be exempt on their supplies of instruction to elementary and secondary school students. This will include private-for-profit elementary and secondary schools.

The Technical Paper and Draft Legislation proposed that tutoring in the required subject matter of an academic elementary or secondary school course be exempt from GST. The legislation will clarify that the exemption will also include tutoring which is part of a program of instruction (or a prescribed program offering equivalent instruction) that must be taken as a prerequisite for the credit course.

As a result of this provision, music lessons, for example, which follow the program of the Royal Conservatory of Music, will be exempt.

## **E. Legal Aid**

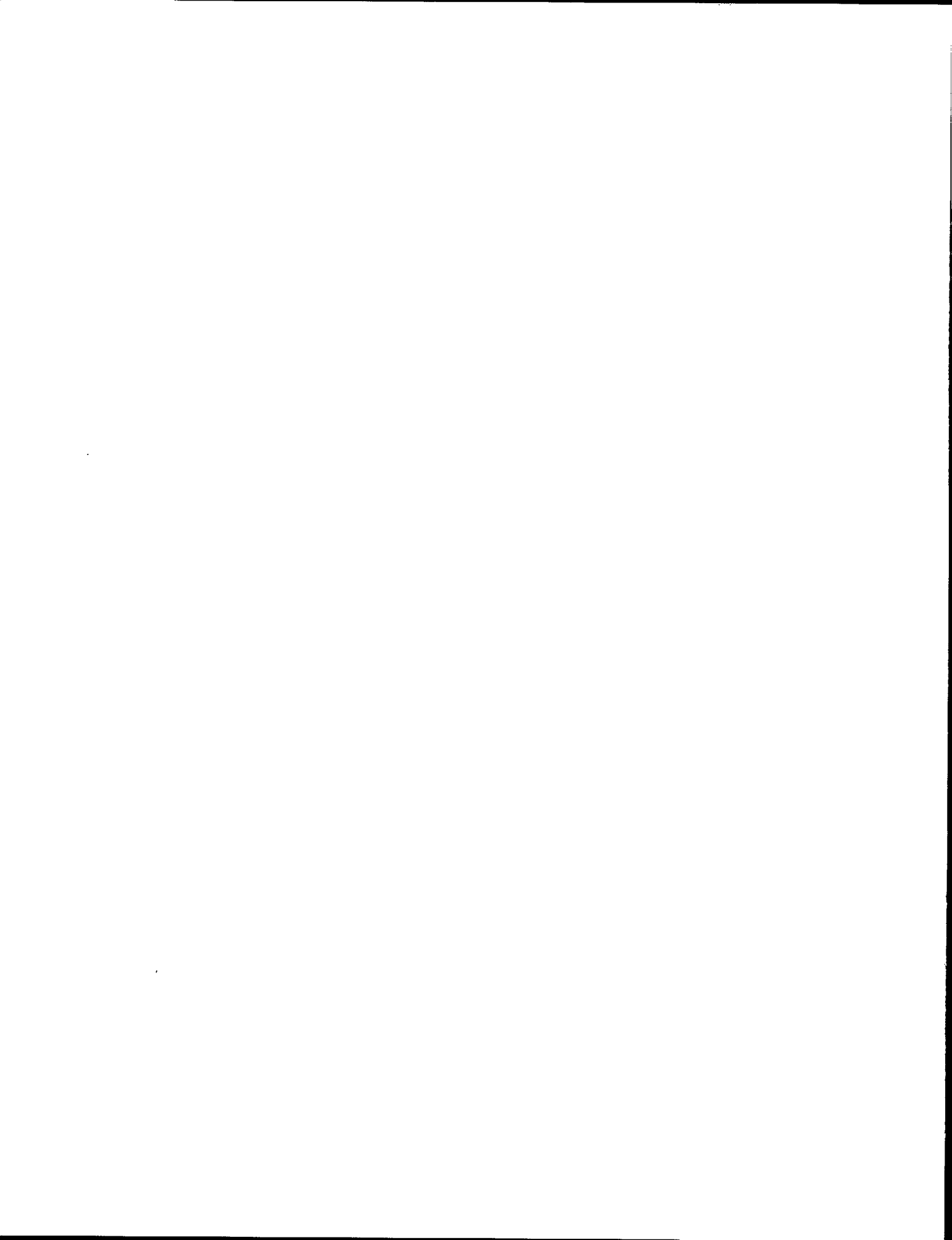
The Technical Paper indicated that legal aid services would be exempt from GST. In consultations with the legal community, concerns were expressed that complications would be created for lawyers providing exempt legal aid services because of the resulting need to prorate their inputs. This problem was also acknowledged by the House of Commons Standing Committee on Finance in its Report on the GST.

To address this problem, provision will be made to allow legal aid societies to elect to be taxable on their contracts with private lawyers supplying legal aid services. However, under this election, they will be able to claim a rebate of a prescribed proportion of the tax on the legal aid bill.

The prescribed rebate proportion will be determined following further consultations with the sector and will be set to provide a benefit equivalent to exempting the legal service.

As a result, legal aid societies will be able to obtain the same net benefit intended by the exemption for legal aid services, but with less compliance burden for private lawyers contracting with them. However, in the event that the legal aid society chooses not to make this election, the normal rules will apply – i.e., the legal aid service will be exempt. In this circumstance, lawyers will, of course, be able to make use of the various provisions designed to limit the compliance burden for businesses making a combination of taxable and exempt supplies.





## Section 4: Compliance Costs

During the government's consultations, a number of business groups – particularly those representing the small business community – indicated concern about the potential increase in compliance burden associated with the GST. Concerns have been raised in three major areas:

- the compliance burden inherent in the basic operation of a value-added tax such as GST;
- the additional costs to retailers of having to comply with both the GST and the provincial sales taxes; and
- the higher one-time adjustment costs in the transition from the existing federal sales tax to the GST.

### A. Basic Operation

A fundamental objective in the design of the GST has been to make the basic operation of the tax as straightforward as possible. In accomplishing this objective, there are valuable lessons to be learned from the experience of other countries with value-added taxes, particularly in terms of defining the key elements necessary to ensure a simple tax system. These include:

- a broadly based tax with a single rate;
- documentation requirements which are consistent with standard business practices; and
- filing frequency based on the size of the firm.

#### (i) Broad Base/Single Rate

Studies on value-added taxes in other jurisdictions have shown that perhaps the single most important factor in minimizing complexity is a single-rate tax applying on a very broad base of goods and services<sup>(1)</sup>.

As classes of goods and services are excluded from the base, or multiple tax rates are introduced, complex borderlines are created. This inevitably complicates the

<sup>(1)</sup> For example, see Henry J. Aaron, ed. *The Value-Added Tax: Lessons from Europe*, Washington, D.C., The Brookings Institute, 1981.

accounting procedures required to comply with the tax and increases complexity at the point of sale since vendors must differentiate between taxable and non-taxable categories of goods and services.

For this reason, a key principle in the design of the GST has been that it would apply at a single rate to an extremely broad range of goods and services. Indeed, the GST will have one of the broadest bases of any consumption tax in the world.

## **(ii) Documentation Requirements**

Another important factor in reducing the administrative burden is the degree to which the tax requires additional bookkeeping and specialized invoices and receipts. For example, in some VAT jurisdictions vendors are required to issue special tax invoices and are subject to specific bookkeeping requirements<sup>(2)</sup>.

In contrast, under the GST only minimal changes will be required to existing business practices. The retention period for books and records will be the same as for income tax. Moreover, the invoices and receipts required to verify input tax credits will typically be the same as those currently required for income tax purposes, with only minor modifications. As described in the Technical Paper, the information that registrants will be required to obtain from suppliers will depend 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.

### **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 charges on the supply or, if prices are on a tax-included basis, a statement to this effect (Where a document such as a receipt

<sup>(2)</sup> Alan A. Tait, *Value-Added Tax: International Practice and Problems*, Washington D.C., International Monetary Fund, 1988.

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.

Much of this information is already provided on invoices, receipts and contracts for higher value purchases.

### **(iii) Filing Frequency**

The frequency with which vendors are required to calculate tax owing and file tax returns also has a significant impact on the overall compliance burden. Obviously the paper work involved in filing returns imposes a greater burden on small businesses, since they generally have more limited access to administrative resources.

As a result, the government has attached considerable importance to limiting the costs associated with calculating tax owing and remitting GST returns. First, for the vast majority of businesses filing their GST return will involve no more than completing a one-page form. Second, more than one million registrants representing about 75 per cent of taxfilers, will be eligible to file one return annually and remit quarterly instalments. Given that the fiscal year for GST and income tax purposes will typically coincide, these registrants will realize additional administrative savings since many of the calculations for the GST will also be useful in completing their income tax returns. Most other businesses will be able to file on a quarterly basis. Only some 30,000 registrants – those with annual sales exceeding \$6 million – will be required to file on a monthly basis.

#### **(iv) Cash Flow**

In assessing the overall impact on business, it is important to recognize that, by its nature, a value-added tax offers some cash flow advantages for businesses complying with the tax. This arises primarily because registrants are generally able to hold the tax collected on their sales for a period of time before it has to be remitted to government. In fact, studies have indicated that the cash flow benefits of a VAT typically offset a substantial portion of the costs incurred by registrants in complying with the tax<sup>(3)</sup>.

Obviously, the cash flow implications of the GST will vary considerably between individual registrants depending on the nature of their business. The impact will depend on the registrant's mix of taxable and zero-rated supplies and how frequently the firm is required to file a GST return. Moreover, cash flow will also be affected by the registrant's credit arrangements with its suppliers and the terms of payment for its sales.

The cash flow issue is of particular significance to businesses which currently hold tax-paid inventory under the existing federal sales tax. Since the FST is built into their cost of inventory, these firms require additional working capital in order to finance the FST. In contrast, they will generally realize a cash flow advantage under the GST since they will be collecting more tax on their sales than they pay on purchases.

### **B. GST and Provincial Sales Taxes**

Although the design of the GST itself ensures that the basic operation of the tax is straightforward, a significant difference from the situation in other VAT jurisdictions is the interaction of the GST and provincial sales taxes. Clearly this is an issue primarily for retailers, since the application of the provincial sales taxes at earlier trade levels is generally quite limited.

Furthermore, it is important to distinguish between the day-to-day costs involved in operating two retail-level taxes simultaneously and the process involved in dealing with two distinct tax administration systems.

From an operational perspective, the interaction of two sales tax systems should not pose significant problems for retailers whose sales are all subject to the GST. For these firms, the problem of identifying both the federal and provincial tax status at the check-out counter should not arise. Since all their sales will be federally taxable, the only decision to be made at the check-out counter is the treatment of the goods being sold under the provincial sales tax – the same identification task that retailers face today. Due to the breadth of the GST base, many retailers will fall into this category and, hence, should not experience significant difficulties in the actual collection of the federal and provincial taxes. Calculation of the GST on sales will also be relatively straightforward for business making both taxable and tax-free sales if they have sophisticated cash registers.

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<sup>(3)</sup> Ibid.

However, the interaction of the GST with the provincial sales taxes could increase complexity for those selling a combination of taxable goods and tax-free basic groceries, who do not have sophisticated point-of-sale equipment. To address this issue, the government proposed two methods of streamlined accounting for retailers. These methods were designed to address the identification problem by removing the need to determine the federal tax status of goods at the check-out counter.

In short, the broad GST base and the availability of streamlined accounting should substantially reduce the potential operational difficulties associated with the interaction of the GST and the provincial sales taxes.

Nevertheless, retailers will have to comply with two separate administrative systems. For this reason, the federal and provincial governments recently agreed to explore ways of co-ordinating aspects of the administration of the two sales tax systems. For business, co-ordination of this type may simplify the requirements of dealing with two separate sales tax administrations.

Indeed, beyond these co-operative measures, it is important to recognize that the basic structure of the GST has been designed so that it can accommodate provincial participation at a later date.

### C. Adjustment Costs in the Transition

Based on international experience, it is generally agreed that the initial start-up costs associated with the introduction of a new tax are substantially higher than the ongoing costs of compliance<sup>(4)</sup>. Small business, in particular, has expressed concern about the costs of acquiring new technology and associated software and the time and expense involved in learning how the GST will operate.

In recognition of the costs involved in preparing for the introduction of the GST, the government will provide two new measures designed to ease the transition to the new system.

- *First*, an exemption from the existing FST will be introduced for electronic point-of-sale and related inventory control equipment. The exemption will be effective December 19, 1989 and will complement the 100-per-cent CCA for this equipment announced in the Technical Paper. Taken together, these two provisions will reduce the after-tax cost of acquiring the technology required to accommodate the GST at the retail level by approximately 20 per cent.
- *Second*, in light of the government's decision not to proceed with an ongoing administration fee a one-time transitional credit of up to \$1,000 will be provided to small businesses which are required to become GST registrants (this credit is described in detail in the following section).

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<sup>(4)</sup> Ibid.

In combination, this credit and the incentives for purchasing point-of-sale equipment should ensure a relatively smooth transition to the new system for the vast majority of small businesses.

### **Transitional Credit for Small Business**

The transitional credit will be available to businesses which are required to become GST registrants and which have annual sales of \$2 million or less. The credit will equal \$300 for registrants with annual revenue from taxable and tax-free sales of \$60,000 or less. For registrants with annual revenue from such sales exceeding \$60,000, the credit will equal 0.5 per cent of sales to a maximum of \$1,000.

For this purpose, annual sales will be determined by reference to total taxable and zero-rated sales made in the registrant's first fiscal quarter commencing after 1990. For monthly and quarterly filers, the credit will be deductible from their GST remittance on their first return following that quarter. Any outstanding balance will be refundable. In the case of registrants filing annually and making quarterly instalments, Revenue Canada will issue a cheque to the registrant upon receipt of their first quarterly instalment payment.

For the purposes of calculating this credit, the members of an associated group of companies will be treated as a single entity. In effect, the group will be eligible for a single credit calculated on the combined revenue of all the members.

The transitional credit will not be available to listed financial institutions as described in Section 8.

## **Section 5: Transportation and Travel**

### **A. Passenger Transportation Services**

As indicated in the Technical Paper, GST will apply to all domestic passenger transportation services, other than municipal transit services. In light of the homogeneous nature of the Canada-U.S. travel market, transborder air travel also will be subject to GST. Finally, it was indicated that other international passenger transportation services (including domestic services that are part of a continuous international journey) would be zero-rated.

Two issues arose in the course of consultations on the design of the GST as it relates to passenger transportation services where changes to the original proposals will be made:

- the treatment of international day trips; and
- the treatment of in-flight charges.

As a consequence of the reduction in the GST rate from 9 to 7 per cent, adjustments will also be made to the Air Transportation Tax.

These changes are outlined below.

#### **(i) International Day Trips**

Under the Technical Paper proposals, a passenger transportation service (other than a transborder air travel service) would be zero-rated if the service commenced or terminated at a point outside Canada. In addition, if it began and ended in Canada, the service would still be zero-rated as an international service if there was any stop-over outside Canada. For these purposes, "stop-over" was defined to be a place where passengers are permitted to embark or disembark a conveyance for any reason other than connection, refuelling or servicing purposes.

In the course of consultations on the GST treatment of international passenger transportation services, it was pointed out that the stop-over rule would produce anomalous results in a significant number of cases. For example, an otherwise all-Canadian bus tour would be zero-rated if the bus merely stopped for lunch at a U.S. border town. Similarly, tour boats along the Great Lakes that stop on the U.S. side would be able to sell tickets on a zero-rated basis, while those that cannot or do not stop on the U.S. side would be required to collect tax on their ticket sales. Clearly, these would be inappropriate results.



To correct these and other similar anomalies, international day trips will be excluded from the zero-rating provisions for international passenger transportation services. Under this rule, the supply of a passenger transportation service to an individual or group will be taxable if the service commences and terminates in Canada and the individual or group does not go outside Canada for more than 24 hours. As transborder air travel will be subject to GST under a separate provision, this rule will not apply to passenger air transportation services.

## **(ii) In-Flight Charges**

The draft legislation for the GST contained a provision to zero-rate in-flight supplies of goods and services where the supply is made between a domestic and foreign airport. Given that international flights are not permitted to transport passengers from one domestic point to another domestic point, the provision will be broadened to zero-rate supplies on international flights, whether or not the aircraft is between domestic and foreign airports. This will simplify the operation of the tax for passenger air carriers engaged in international service without compromising the basic principles of the GST.

## **(iii) 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. Presently, the tax on tickets purchased in Canada for air travel within the taxation area (Canada, the U.S. and the Islands of St. Pierre and Miquelon) is 10 per cent, plus \$4, to a maximum of \$50 per ticket.

The Technical Paper indicated that the ATT would be modified to reduce the impact of the imposition of GST on domestic and transborder air travel. At a 9-per-cent rate, the ATT would have been reduced to 5 per cent, plus \$10, to a maximum of \$40 per ticket. With a GST rate of 7 per cent, the ATT will be adjusted from its current level to 7 per cent, plus \$10, to a maximum of \$40 per ticket.

As tickets from Canada to overseas destinations will still be zero-rated under the GST, the flat-rate ATT on overseas tickets either purchased in Canada or with first emplanement in Canada will, as indicated in the Technical Paper, increase to \$40.

## **B. Freight Transportation**

The Technical Paper indicated that domestic freight transportation services will be subject to GST, while international services will be zero-rated. In this regard, a number of proposals were set out for distinguishing between domestic and international freight transportation services. For the most part, consultations with

the transportation sector focused on the appropriateness of the proposed borderlines between domestic and international services. As a result of these discussions, modifications to the original proposals will be made in the following areas:

- the scope of the provisions for inbound international freight;
- the threshold for zero-rating outbound freight; and
- the treatment of international freight forwarding services.

In addition, the rules relating to interline settlements will be simplified.

Each of these modifications is described in greater detail below.

### **(i) Inbound Freight**

The Technical Paper proposed to zero-rate freight transportation services from a place outside Canada to a place inside Canada. However, where a bill of lading is issued for a freight service commencing and ending in Canada, the service would be taxable, even if the service commenced before the point at which goods are released from Canada Customs.

In discussions with the Department of Finance, as well as testimony before the House of Commons Standing Committee on Finance, transportation industry representatives pointed out that the proposed treatment could lead to a significant diversion of business away from Canadian ports and carriers. This would be particularly evident in the case of prepaid inbound movements: as foreign shippers generally would not be GST registrants, they would not be able to recover any GST paid on the domestic portion of an inbound movement and, therefore, would seek ways to minimize their potential GST costs – to the detriment of domestic ports and carriers.

In response to these concerns, inbound freight transportation services will be zero-rated up to and including any service straddling the point of Customs release of goods being transported. In addition, a fully domestic service (beyond the point of Customs release) will be zero-rated if the carrier maintains documentary evidence satisfactory to the Minister of National Revenue that the service is part of an inbound movement to the destination specified by the foreign shipper of the goods.

These changes to the inbound freight rules will ensure that domestic carriers and ports are not adversely affected by the introduction of the GST. Indeed, the elimination of the existing federal sales tax costs on inputs to the transportation sector upon introduction of the GST will contribute towards a strengthening of the international competitive position of domestic carriers and ports.

### **(ii) Outbound Freight**

The Technical Paper proposed to zero-rate international outbound freight transportation services valued at \$12 or more – this, in recognition of the fact that

it is not possible to ascertain whether, in the case of postal services, postage stamps will be for domestic or international use at the time of sale.

During the course of consultations on the treatment of outbound freight, it was determined that the threshold could be lowered without adding significant complexity to the operation of the GST. Consequently, outbound freight transportation services will be zero-rated if valued at more than \$5.

### **(iii) International Freight Forwarders**

Freight forwarders who present themselves as carriers and assume liability as carriers will be subject to the same rules as all other carriers: their supplies of domestic freight transportation services will be taxable, while their international services will be zero-rated. Under the Technical Paper proposals, forwarders acting as purchasing agents of freight services for shippers would be required to collect GST on their commissions in the same manner as any other agent. The tax collected would, of course, be creditable in the normal manner to their business customers engaged in commercial activities.

A potential problem identified in the course of consultations with international freight forwarders on the GST was that their foreign clients would be unable to recover the GST collected on commissions paid to forwarders in Canada (unless, of course, they are GST registrants). Clearly, this would be inappropriate in the context of the GST as it would result in a hidden tax on exports in the case of outbound freight transportation services purchased through an international freight forwarder, and cascading on imports in the case of inbound freight services purchased by a non-resident through a freight forwarder. To correct these anomalies, freight forwarding agents' services to unregistered non-residents will be zero-rated to the extent that they are in respect of purchasing zero-rated international freight transportation services.

### **(iv) Interline Settlements**

Recognizing the substantial complexity that would be involved in applying GST to interline settlements between freight carriers, the Technical Paper proposed to zero-rate interline freight settlements. As a result, only the carrier who settles the freight bill with a customer (i.e., the shipper in the case of a prepaid move, or consignee in the case of a collect move) would be required to collect GST on the services.

A number of representatives of the freight transportation sector expressed concern about the practical implications of the interline settlements provision following release of the draft GST legislation. Concerns focused on two particular features of the draft provisions:

- *First*, the definition of "carrier", implicitly excluded any person who did not physically perform a freight transportation service, even though the person

may assume liability as a carrier in the supply of a freight transportation service. This was of particular concern to representatives of the trucking industry. They pointed out that the vast majority of transactions between a truck carriage company and an independent owner-operator would be subject to GST: in these circumstances, typically, the company will not physically perform any of the freight services, even though it assumes liability as a carrier of the goods being transported. The resulting compliance burden on small owner-operators would, therefore, be substantial.

- *Second*, a concern was raised about the effectiveness of the draft interline provision given that the contractual relationships between carriers in respect of any given freight transportation service are often ambiguous, and can vary from case to case. Where one carrier subcontracts for the services of another carrier, the provisions would operate as intended. However, where an interline carrier has an implied contract with the shipper or consignee of the goods being transported (and not with another carrier, even though the interline carrier receives payment from another carrier), the draft provisions would not function properly since there would be no "supply" from one carrier to the other to zero-rate.

In response to these concerns, the definition of "carrier" will be expanded to include anyone who supplies a freight transportation service (i.e., assumes liability as a carrier), whether or not the person physically performs any portion of the service. As a result, where a carrier enters into a contract of carriage to move goods, and subcontracts the move to another carrier (say to an owner-operator of a truck), the transaction between the contracting carrier and the second carrier will not be subject to GST.

In addition, provision will be made to deem transactions between carriers for any particular freight movement to be in respect of a supply between the carriers, notwithstanding any other contractual arrangements governing the transaction. Where one carrier acts as an agent in collecting payment for a freight movement from a shipper or consignee on behalf of other interline carriers involved in the movement, only the transaction between the carrier and the supplier or consignee will be subject to GST. All subsequent disbursements of revenues between the various carriers involved in the movement will be treated as being in respect of zero-rated supplies between the carriers under the interline settlements provision.

The combined effect of these provisions will be to simplify the operation of the GST for freight carriers and provide greater certainty of liability with respect to interline settlements between freight carriers.

## **C. Tourist Rebates**

The government recognizes the importance of the tourism industry in Canada. The proposed 9-per-cent rate was a principal focus of concern for many representatives of the tourism industry. This concern was expressed in consultations on the GST with the Department of Finance, as well as in

submissions to the House of Commons Standing Committee on Finance. The reduction in the rate to 7 per cent will be beneficial to the tourism industry.

As indicated in the Technical Paper, rebates will be available to visiting foreign tourists for GST paid on short-term accommodation in Canada, as well as for tax paid on goods purchased in Canada and subsequently exported. Recognizing the importance of maintaining the attractiveness of Canada as a destination for foreign tourists, every effort will be made to maximize the accessibility of the tourist rebate program for visitors to Canada. In this regard, the rebates will be given prominence in government-sponsored tourism promotional material, and at all border crossings and other points of arrival and departure. In addition, the Technical Paper provision that limited visitors to two rebate claims per year will be modified to permit four claims annually.

One particularly interesting proposal made during the course of consultations on the administration of the foreign tourist rebates was to allow visitors the option of being paid their rebates at points of departure from Canada. The government believes that this proposal warrants further consideration and will be assessing its administrative feasibility.

## Section 6: Housing and Real Property

### A. Introduction

The Technical Paper proposed that GST would apply to the following supplies of real property:

- sales and leases of commercial properties such as office buildings, shopping malls and hotels;
- the sale of new residential housing, including owner-occupied homes and rental properties; and
- sales and leases of land made in the course of a business (including sales of land which had been used in a commercial activity of the vendor).

A number of exemptions from the GST were also proposed, including:

- sales of used residential housing (e.g., single family homes, condominiums and apartment buildings);
- long-term residential rents;
- sales of personal-use real property; and
- transfers of farmland between related individuals.

To meet the government's commitment that the GST not pose a barrier to the affordability of housing, the Technical Paper proposed a substantial rebate of tax for newly constructed homes. At the same time, a restriction on the price of houses eligible for the rebate ensured that the assistance would have been well targeted.

At the 9-per-cent tax rate, the Technical Paper proposed a rebate of 4.5 percentage points of tax for homes priced at \$310,000 or less. For homes priced between \$310,000 and \$350,000 the rebate would have been equal to the value of 4.5 percentage points of tax on a \$310,000 home, or \$13,950. Beyond \$350,000, the rebate would have been phased-out based on the following formula:

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

This structure ensured that approximately 90 per cent of all new homes would have been eligible for a full rebate; reducing the tax rate on the purchase of these homes to 4.5 per cent – much the same as the burden under the existing sales tax

system. Homes priced at \$400,000 or more would have been taxed at the full rate of 9 per cent – reflecting the government’s view that purchasers of these very high priced homes do not face an affordability problem.

Since the publication of the Technical Paper, the government has engaged in extensive consultations with a wide range of groups spanning the real estate and housing market. In addition, the treatment of real property was a major focus of the work undertaken by the House of Commons Standing Committee on Finance.

During the course of the consultation process, one principal alternative has emerged to the Technical Paper approach. This alternative – the so called “trade-up” approach to the taxation of housing – was reflected in the recommendations contained in the Report of the Standing Committee.

## **B. The Trade-Up Approach**

The Finance Committee recommended that GST be applied to all real property transactions – commercial and residential – at a reduced rate of 5 per cent. In the area of housing, they recommended a trade-up approach which had the following key elements:

- GST would apply to purchases of both new and used homes, but only on the incremental value. In other words, an individual selling a home for \$100,000 and purchasing another for \$250,000 would pay tax of 5 per cent on the difference of \$150,000.
- This basic approach would apply to sales of rental properties on the same basis as for owner-occupied housing.
- The operation of the tax would rely on a system of credits. Vendors selling a residential complex would obtain a credit equal to the tax on the sale. The credit could then be applied against the GST incurred on a subsequent purchase of a residential complex. This would result in tax being collected only on the incremental value of the purchase.
- The credit would not be refundable where an individual traded down to a lower-priced home or left the housing market. The non-refundability of the credit is the principal source of additional revenues resulting from this tax design and, therefore, is a critical feature of the proposal.

The Finance Committee estimated that adopting this treatment would generate up to \$1.6 billion in additional revenue, over and above the Technical Paper proposal. Indeed, this represented the single largest component of the package of measures proposed by the Committee to lower the overall GST rate.

Despite the magnitude of the potential revenue available, and its value in achieving a lower rate, broadening the tax base to include resale housing raises a number of very difficult issues; in particular, the non-refundability of the credit in situations where individuals leave the housing market.

## **(i) Tax Avoidance**

A substantial portion of the additional revenue generated by the trade-up approach would arise where elderly individuals sold their existing home in order to trade down to a lower priced unit or leave the owner-occupied market. In these instances, the tax on the sale of the home would exceed the tax on a subsequent purchase and, therefore, the vendor would not be able to use the full value of the credit.

Given the magnitude of these credits – the credit on a \$200,000 house would be \$10,000 – this system would create incentives to find ways of transferring properties to children. Where this occurred, the child would be able to use the credit from a future sale of the property against a subsequent purchase of another property – in effect, allowing the credit to be passed on from one generation to the next.

While conceptually this result might be appropriate, it would significantly erode revenues. Securing these revenues would require intrusive and heavy-handed anti-avoidance measures.

## **(ii) Distortion of Investment Choices**

In the rental market, the fact that the credit would be non-refundable could distort investment choices by creating a lock-in effect for investors. The Finance Committee's recommendation partially addresses this concern by allowing credits from the sale of rental properties to be used on any subsequent purchase during the investor's lifetime. That said, however, a significant lock-in effect would remain, since over time the value of these credits would be eroded by inflation and escalating real property values. To the extent this occurred, the proposal would generate less additional revenue and lead to an inefficient allocation of resources due to the distortions in investment activity.

At the same time, investors in real property would obviously try to arrange their affairs to ensure transfers of property did not attract tax. One relatively straight-forward approach would be to transfer property into a corporation – subsequent transfers of the property would then involve the sale of shares rather than the property itself.

## **(iii) Fairness**

The trade-up approach also raises a basic issue of fairness. At the same time that the tax rate on expensive homes would be reduced to 5 per cent, purchasers of moderately priced homes would be asked to pay somewhat more tax on their purchase. To the extent the burden of the tax fell on first-time home buyers, it would be inconsistent with the government's commitment that the GST not pose a barrier to the affordability of housing.



In contrast, under the approach proposed in the Technical Paper, purchasers of very expensive new homes would pay tax at the full GST rate since they would not be eligible for the rebate. Moreover, the structure of the rebate would protect modest-income home buyers by limiting the change in typical house prices in virtually every city in Canada to less than 1 per cent.

Finally, it is important to recognize that the trade-up approach would also impose a substantial new compliance burden on purchasers and vendors of used housing – representing about 350,000 transactions yearly. Ultimately, as the housing stock turned over, this could involve virtually all homeowners in remitting tax and keeping track of credits from previous sales.

As a result of these difficulties, the government has decided to maintain the basic treatment outlined in the Technical Paper.

## **C. Housing Rebate**

### **(i) General Approach**

The government remains committed to ensuring that the GST not pose a barrier to affordable housing. As a result, the housing rebate will remain a key element of the GST proposal. As a consequence of the reduction in the GST rate to 7 per cent, there will be an arithmetic adjustment in the size of the rebate to ensure that the vast majority of new homes will be taxed at a rate of 4.5 per cent.

In response to the rebate structure outlined in the Technical Paper, a number of housing analysts have suggested that the structure of the rebate, with three different threshold levels, is unnecessarily complex. More importantly, they argued that the phase-out of the rebate was too rapid, leading to distortions in housing markets and creating the potential for significant avoidance activity.

As a result, the government has decided that, although the underlying objectives of the rebate remain the same, the precise structure will be modified to simplify its operation and to reduce market distortions. The revised structure is outlined below.

- For homes priced at or below \$350,000 the rebate will equal 2.5 percentage points of tax; and
- For homes priced between \$350,000 and \$450,000 the rebate will be calculated on the basis of the following formula:

$$\text{Rebate} = \$8,750 \times \frac{(450,000 - \text{house price})}{100,000}$$

Purchasers of homes priced in excess of \$450,000 will not receive a rebate. The impacts on typical house prices are displayed in Table 3. In light of the reduction to the GST rate, the cost of the rebate program will fall from approximately \$900 million to approximately \$500 million.

Table 3

**Effect of the GST on Typical House Purchases**

City	Current house price <sup>(1)</sup>	Existing FST <sup>(2)</sup>	Additional tax with 7 per cent GST	GST rebate	Additional tax after rebate	Price change	Net effect on monthly mortgage payments <sup>(3)</sup>
			(dollars)			(per cent)	(dollars)
Halifax	100,000	4,050	2,700	2,400	300	0.3	2
Charlottetown	95,000	4,850	1,450	2,250	(800)	(0.9)	(5)
Trois-Rivières	75,000	3,650	1,350	1,800	(450)	(0.6)	(3)
Montreal	105,000	3,750	3,350	2,550	800	0.8	6
Toronto	290,000	7,900	11,850	7,050	4,800	1.6	37
North Bay	160,000	7,050	3,650	3,800	(150)	(0.1)	(1)
Regina	110,000	4,150	3,300	2,650	650	0.6	5
Edmonton	130,000	5,250	3,500	3,100	400	0.3	3
Vancouver	210,000	7,300	6,900	5,050	1,850	0.9	14

<sup>(1)</sup> Based on CMHC price data for the period January 1989 to October 1989.

<sup>(2)</sup> Included in the current house price.

<sup>(3)</sup> Based on a 25-per-cent downpayment and a mortgage amortized over 25 years at a 12-per-cent interest rate.

This rebate will substantially offset the impact of the tax on the vast majority of newly constructed houses purchased in Canada. Specifically, over 90 per cent of new house purchases will be eligible for the full rebate. In total, more than 95 per cent of new house purchases will receive some assistance. As a result, the impact on typical house prices will be less than 1 per cent in most cities – and even in the Toronto area, the increase will be only about 1.6 per cent.

## (ii) Owner-Built Homes

The rebate for newly constructed homes described above will apply in cases where the house is purchased from a builder who supplies both the land and house as part of a single transaction. Although this is the most common method of acquiring a new home, it is by no means the only method. There are many cases where purchasers acquire the land separately from the house and may undertake all or part of the construction themselves. The Technical Paper indicated that the housing rebate would apply in these circumstances.

Consistent with the structure of the general rebate, the value of the rebate for owner-built homes will depend on the total value of the property (house and land). In addition, for owner-built homes, the rebate will depend on whether GST was paid on the acquisition of the land.

For properties valued at or below \$350,000 and where GST was paid on the land, the purchaser will be entitled to a rebate equal to the lesser of \$8,750 or 36 per cent – roughly equivalent to 2.5/7ths – of the total tax paid. If tax was not paid on the land, the rebate will be equal to 10 per cent of the tax paid.

As under the general rebate, the assistance will be phased out between \$350,000 and \$450,000. Table 4 summarizes the rebate.

Table 4

### Rebate for Owner-Built Houses

Value of property (\$'000)	Value of rebate	
	GST paid on land purchase	No GST paid land purchase
0 – 350	the lesser of 36% of GST paid or \$8,750	the lesser of 10% of GST paid or \$1,720
350 – 450	the lesser of 36% of GST paid or $\$8,750 \times A^{(1)}$	the lesser of 10% of GST paid or $\$1,720 \times A^{(1)}$
450 +	no rebate	no rebate

<sup>(1)</sup> A is equal to  $\frac{(450,000 - \text{property value})}{100,000}$

Where the value of the completed dwelling is clearly less than \$350,000, the purchaser will not be required to obtain a formal appraisal. As a result, the vast majority of owner-built homes will not require an appraisal and the rebate will be calculated simply as a percentage of tax actually paid. Only where the value of the property is close to or exceeds \$350,000 will the purchaser be required to obtain a formal appraisal. For properties appraised at greater than \$350,000 the rebate will be calculated on the basis of this appraisal.

## **D. Other Issues**

### **(i) Short-Term Accommodation**

The Technical Paper provided a specific exemption for long-term accommodation – in other words, accommodation in a residential unit for a period of one month or longer.

During consultations since the release of the Technical Paper, concerns were expressed that this approach did not adequately address situations where individuals without permanent homes live in low-cost accommodation on an intermittent basis. The Technical Paper included a specific exemption for supplies of short-term accommodation by charities and non-profit organizations for the relief of poverty, suffering or distress. However, it was argued that relief should also be extended to low-cost temporary accommodation offered by the private sector.

Indeed, in response to these concerns, the Finance Committee recommended an exemption for short-term accommodation supplied for less than \$20 per day.

The government believes that this idea has merit and would be consistent with the exemptions for non-profit organizations and charities in this area. As a result, an exemption will be provided for all short-term accommodation in a residential unit supplied for less than \$20 per day or \$140 per week.

### **(ii) Clearance Certificates**

The Technical Paper proposed that in transactions of real property exceeding \$1 million the vendor would be required to obtain a certificate from Revenue Canada verifying that tax had been paid. The purchaser would be required to obtain a copy of this certificate in order to be eligible for an input tax credit on the transaction.

A number of groups have argued that difficulties could arise where the vendor did not remit the tax and obtain a certificate. In this circumstance, the purchaser would be unable to claim an input tax credit.

In response, the Finance Committee recommended that the purchaser be allowed to remit tax directly in these circumstances. The vendor would only be required to notify Revenue Canada of the sale.

On balance, the government believes that the Finance Committee proposal will simplify the administration of the tax in this area while providing certainty for purchasers of expensive properties.

Hence, vendors will not be required to obtain clearance certificates for sales to registrants of real property. Such purchasers will be required to account for the tax directly on these transactions. This will allow the tax to be recorded and an offsetting input tax credit claimed on the same GST return.

### **(iii) Long-Term Rentals of Land**

Although the Technical Paper included an exemption for long-term residential rents, representatives of the real estate industry have pointed out the lack of a specific reference to the situation where an individual owns a residential unit, but rents the land on which it is located. The most common example is the rental of a mobile home pad. However, it is also becoming increasingly common – particularly in retirement communities – for individuals to purchase a home without the associated land and then pay a monthly fee which covers the lease of the land and a share of maintenance and upkeep of the common areas.

The government's view is that it would be inconsistent to tax such land rentals, since they are an integral part of the cost of long-term accommodation. Accordingly, an exemption will be provided for the long-term rental of land on which a residential unit is located. This will include mobile home pads and the rental of land on which a permanent home is located. However, it will not extend to campgrounds or the rental of space for motor homes and trailers since they do not qualify as residential units.

## **Section 7: Charities, Non-Profit Organizations and Selected Public Sector Bodies**

### **A. Introduction**

The rules governing the operation of the GST in the charitable and non-profit sector are designed to strike a balance that recognizes the important role of charities and non-profit organizations in Canadian society, while ensuring that competitive equity is maintained for private businesses offering very similar services. Accordingly, although most activities of charities will be exempt, tax will apply on a specified list of supplies which are of a type generally made by commercial businesses. Similarly, the GST will include several exemptions for sales by non-profit organizations, although these are more limited in scope given the diversity of this group and their greater involvement in commercial activities.

Charities and non-profit organizations as a whole are not given special status under the existing federal sales tax, although some relief is provided for specified institutions, particularly in the area of health and education, and for specific goods commonly purchased by these organizations. As a consequence, all charities currently bear an element of sales tax on their purchases. Nevertheless, given the broader GST base, these organizations would generally incur additional costs under the new tax. In recognition of this, two important features which are of substantial benefit to charities and non-profit organizations have been incorporated into the GST system – the treatment of grants and subsidies and the special 50-per-cent rebate for purchases by charities and substantially government-funded non-profit organizations.

In other jurisdictions with value added taxes, the treatment of grants and subsidies received by charitable and non-profit organizations varies significantly. In New Zealand, for example, the grant is directly subject to tax. In many other countries, these grants are treated as exempt supplies. In these instances, although no tax is payable on grants received, they nevertheless have the effect of limiting the recipient organizations' ability to claim input tax credits where they are making taxable supplies which are partially funded by the grants and subsidies.

A different approach has been taken toward the treatment of grants and subsidies under the GST. Under this approach, the grants are neither taxed nor do they limit the claiming of input tax credits available to the organization – in effect, they are ignored for GST purposes. The result is that where an organization makes taxable supplies at a subsidized price, it nevertheless will be entitled to a full refund of the tax on purchases relating to the taxable activity. This is a

significant benefit for charities and non-profit organizations which make taxable supplies; in many cases they will claim more tax back than they collect on their sales.

Many charitable and non-profit organizations will also be paying GST on purchases for which they will not be able to claim input tax credits. To assist these groups, the Technical Paper indicated that charities and substantially government-funded non-profit organizations would be eligible for a rebate of 50 per cent of the GST paid on their purchases for non-commercial use. This rebate will substantially reduce any additional costs that the GST might have entailed for charitable and publicly supported non-profit activities. Indeed, it is important to recognize that the lower rate of GST coupled with the 50-per-cent rebate will mean that the net tax on the purchases of charities and non-profit organizations will be significantly less than would have been the case under the initial Technical Paper proposals.

On the basis of extensive consultations with representatives of the charitable and non-profit sector, the government is confident that the overall approach to the treatment of this sector is appropriate. Nevertheless, certain areas were identified where further refinement and clarification of the specific proposals set out in the Technical Paper are required.

## **B. Alternative Accounting Method**

The provision of special exemptions and other relieving measures inevitably gives rise to some additional complexity in a tax system such as the GST. A key concern expressed by representatives of the charitable and non-profit sectors, in the course of consultations with the Department of Finance and in submissions to the House of Commons Standing Committee on Finance, was the additional bookkeeping requirements that the GST might entail. This is of particular concern to small organizations which typically do not have sophisticated accounting systems.

Given the breadth of the exemptions for sales by charities and non-profit organizations, in many cases, the only paperwork the GST will entail will be in completing a periodic application for a rebate equal to 50 per cent of the total tax paid on their purchases. Additional accounting would be required in the case of an organization which is engaged in non-commercial activities but which also has taxable sales in excess of the small trader's threshold. Like other registrants, such an organization will have to account for tax on its taxable sales, file GST returns and will be eligible to claim input tax credits.

Under the normal rules for claiming input tax credits and rebates, an organization making both taxable and exempt supplies would have to separate its purchases into two categories – those for use in taxable activities and those for non-commercial use. The organization would then be entitled to claim full input tax credits in respect of the first category and the 50-per-cent rebate on the remainder. Under this system, the organization would have to keep track of the

end use of its purchases. In addition, prorating would be required where a single expense, such as commercial rent, was incurred for both taxable and exempt purposes.

Certain purchases, namely inventory acquired solely for resale, large capital items and real property, do not pose a major difficulty for the calculation of input tax credits and the 50-per-cent rebate. The end use of the inventory is quite clear. If the resale is taxable, a full input tax credit is allowed. Similarly, if capital or real property is acquired primarily for use in taxable activities, a full input tax credit may be claimed on the property; otherwise, the 50-per-cent rebate applies. However, it is more difficult to track the use of such items as general office supplies, or to allocate common overhead expenses to specific activities. To avoid this complexity, an optional simplified method of calculating input credits and the 50-per-cent rebate on such purchases will be provided for charities and substantially government-funded non-profit organizations.

Under the simplified method, an organization would claim input tax credits in the normal manner for inventories and for purchases of capital goods and real property over \$10,000. However, in lieu of determining the actual input tax credits allowable on its remaining purchases, the organization would be permitted to claim a rebate equal to a prescribed percentage of its taxable sales – a proxy for the portion of its purchases relating to taxable activities. The organization would then claim a rebate of 50 per cent of the remainder of the actual tax paid on its purchases. The following example shows how the input tax credit and rebate of tax on purchases would be calculated under this method using, for illustrative purposes, a prescribed percentage of 20 per cent.

	(in dollars)
Total purchases of inventory	1,000
GST paid on inventory	70
Other taxable purchases	3,500
GST paid on other purchases	245
Revenue from taxable sales	2,000
GST collected on taxable sales	140
 <b>Calculation of Input Credit and GST Rebate:</b>	
Input tax credit for GST paid on inventory	70
Rebate of estimated GST on other purchases related to taxable supplies	
20% of \$2,000 × 7%	28
50% rebate of remaining tax paid	
50% of (\$245 – \$28)	109
	207
Combined input credit and rebate	
GST remittable on taxable sales	140
	67
Net tax refund	



The alternative method of calculation described above will significantly simplify the accounting of charities and non-profit organizations. It will eliminate the need for these organizations to track purchases and pro-rate costs. Further consultations will be held with representatives of the charitable and non-profit sector to refine the details of this option and ensure that it results in a reasonable approximation of the refund to which the organization would otherwise be entitled.

### **C. Rebate to Non-Profit Organizations**

Substantially government-funded non-profit organizations will be entitled to the same rebate of tax paid on purchases as charities. The Technical Paper proposed that, in order to qualify for this rebate, a non-profit organization would have to receive 50 per cent or more of its revenues in a year in the form of federal, provincial and/or municipal grants.

The Department of Finance, as well as the House of Commons Standing Committee on Finance, received representations from several charities and non-profit groups that expressed the view that the 50-per-cent funding threshold is too high and in fact inconsistent with the objective of many of these organizations to reduce their reliance on grant funding to less than 50 per cent.

In response to this concern, the funding threshold will be lowered to 40 per cent. This level strikes a balance between maintaining consistency with the self-funding objectives of these organizations and ensuring that the rebate is targeted to publicly supported organizations.

In the course of consultations, non-profit organizations also expressed a concern that under the Technical Paper proposal, they would be entitled to file for the 50-per-cent rebate only once annually, at the end of their fiscal year. Apart from cash flow costs, this delay in filing the rebate claim would result in significant uncertainty for these organizations when making budgetary decisions throughout the year. The proposed restriction on filing was in recognition of the fact that the eligibility of these organizations for the rebate will be dependent on the degree of government funding they receive for the year. However, it was pointed out that there are many organizations whose long-standing funding arrangements or firm commitments from governments would make it possible to ascertain their eligibility for the rebate before their year-end.

Accordingly, the rebate program will be designed so that non-profit organizations will be eligible to claim the rebate during the year on a quarterly basis or, where they are registrants, with their GST returns, providing they can satisfactorily show that they will meet the funding threshold for the year. For this purpose, the degree of government funding over prior periods will be a major consideration.

### **D. Purchases Eligible for Rebate**

The Technical Paper indicated that certain goods acquired solely for resale purposes would not be eligible for the 50-per-cent rebate. This has led to some

uncertainty regarding goods purchased for sale or distribution in the course of special fund-raising campaigns, such as the sale of peanuts by the Kidney Foundation or daffodils by the Cancer Society. To clarify, the rebate will be allowed in respect of goods acquired specifically for the purpose of re-supply in the course of special fund-raising events. However, no rebates will be provided for GST paid on alcoholic beverages and tobacco products acquired for re-supply on an exempt basis, even if such goods are supplied in the course of a fund-raising event. Consistent with this restriction, the specific exemption for volunteer sales by non-profit organizations of items under \$5 each will not apply to sales of alcoholic beverages or tobacco.

## **E. Interest on Outstanding Rebate Claims**

The draft GST legislation provided that outstanding rebate claims by charities, non-profit organizations and selected public sector organizations would be credited with interest beginning 60 days after the day the application for the rebate was received by Revenue Canada. However, interest on outstanding net tax refunds owing to other GST registrants would be credited as of 21 days from the day of filing the GST return. In response to concerns over this timing difference, and in the interest of simplifying the administration of the system, the 21-day rule will apply in both cases.

## **F. Scope of Specific Exemptions**

A number of concerns raised in discussions with representatives of the charitable and non-profit sector revealed a need for clarification in the following areas:

### **(i) Volunteer Activities of Charities**

The Technical Paper outlined an overriding exemption for supplies made by charities where all or substantially all of the direct day-to-day administration and operation of an activity is undertaken by volunteers. A concern was raised that, if this requirement were narrowly interpreted as referring only to persons who oversee an activity (as opposed to those who actually carry out the operations), many volunteer activities would not qualify for the exemption.

To clarify the scope of the volunteer exemption, an activity will be considered to be volunteer-run if the combined administrative and other functions performed in carrying on the activity are substantially all performed by volunteers. This means, for example, that if the co-ordination of a fund-raising drive is solely undertaken by a few paid staff, while the door-to-door selling is carried out by several volunteers, the sales will be exempt under the volunteer provision. On the other hand, if a few volunteers plan an activity but the various functions (such as managing the event, soliciting orders, catering or entertaining) are carried out substantially by paid staff or contract workers, the activity will not qualify for the volunteer exemption.

## **(ii) Children's Recreational Programs**

The Technical Paper proposed a special exemption for non-profit children's recreational programs. A number of organizations expressed concern that there are numerous programs ordinarily provided for children 14 years of age or under that could inadvertently fall outside the scope of the proposed exemption if a small number of older children are also permitted entry into the programs. Clearly, it is not the intention to exclude such programs. To ensure that the intended policy is realized, the legislation will provide that, where it may reasonably be expected, given the nature of the activities or the skill level required to participate in those activities, that a program will be provided **primarily** to children 14 years of age or under, the program will qualify for the exemption.

## **(iii) Sponsorships and Gifts**

The Technical Paper indicated that gifts or donations given to a charity or non-profit organization will not be taxable. As well, where the donor is a registrant, input tax credits will be allowed in respect of non-monetary gifts that are reasonable in the circumstances and either relate to a promotional campaign of the donor or are goods manufactured or normally traded by the donor. Furthermore, any amounts for which a charitable or political donation receipt is issued for income tax purposes will not be included in the taxable value of a supply, even if the amount is required to be paid in order to receive the supply (e.g., the portion of the admission fee to a fund-raising dinner for which the individual attending the event may receive a receipt for income tax purposes).

The Technical Paper, however, did not specifically address the situation where a commercial sponsor pays an amount, in cash or in kind, to a charity or non-profit organization in return for promotional services provided, or the right to use the recipient organization's logo. Several non-profit organizations, particularly amateur sports associations, expressed concern over the uncertain GST status of such sponsorships.

To address these concerns, the legislation will provide that these sponsorships will be treated the same as the receipt of a grant or subsidy. In other words, they will not be treated as consideration for a supply and, accordingly, will not be taxed.

## **(iv) Memberships in Non-Profit Organizations**

The Technical Paper proposed to exempt the supply of memberships in a non-profit organization if the only direct benefit received by members individually was the right to vote at or participate in meetings and the right to receive newsletters or reports on the activities or status of the organization. Specifically excluded from the exemption were memberships which entitle members to receive goods or services, including publications, for which a fee ordinarily would be charged.

A number of non-profit associations indicated in the course of consultations that there are instances where additional services are provided to members. However, the services involve no significant monetary benefit. For example, it is not uncommon for non-profit associations to supply their members publications which are also sold on a cost recovery basis to non-members. The value of the publications is often insignificant in relation to the price of the membership. As well, some non-profit associations, particularly professional or trade associations, assist their members by investigating complaints and acting as conciliator in disputes involving members. Although such assistance obviously directly benefits those individual members involved in a dispute, for most members the availability of these services provides only an indirect benefit. Finally, although some associations provide their members with the exclusive right to purchase services which only the association offers, often the members nevertheless are required to pay the full price for such services.

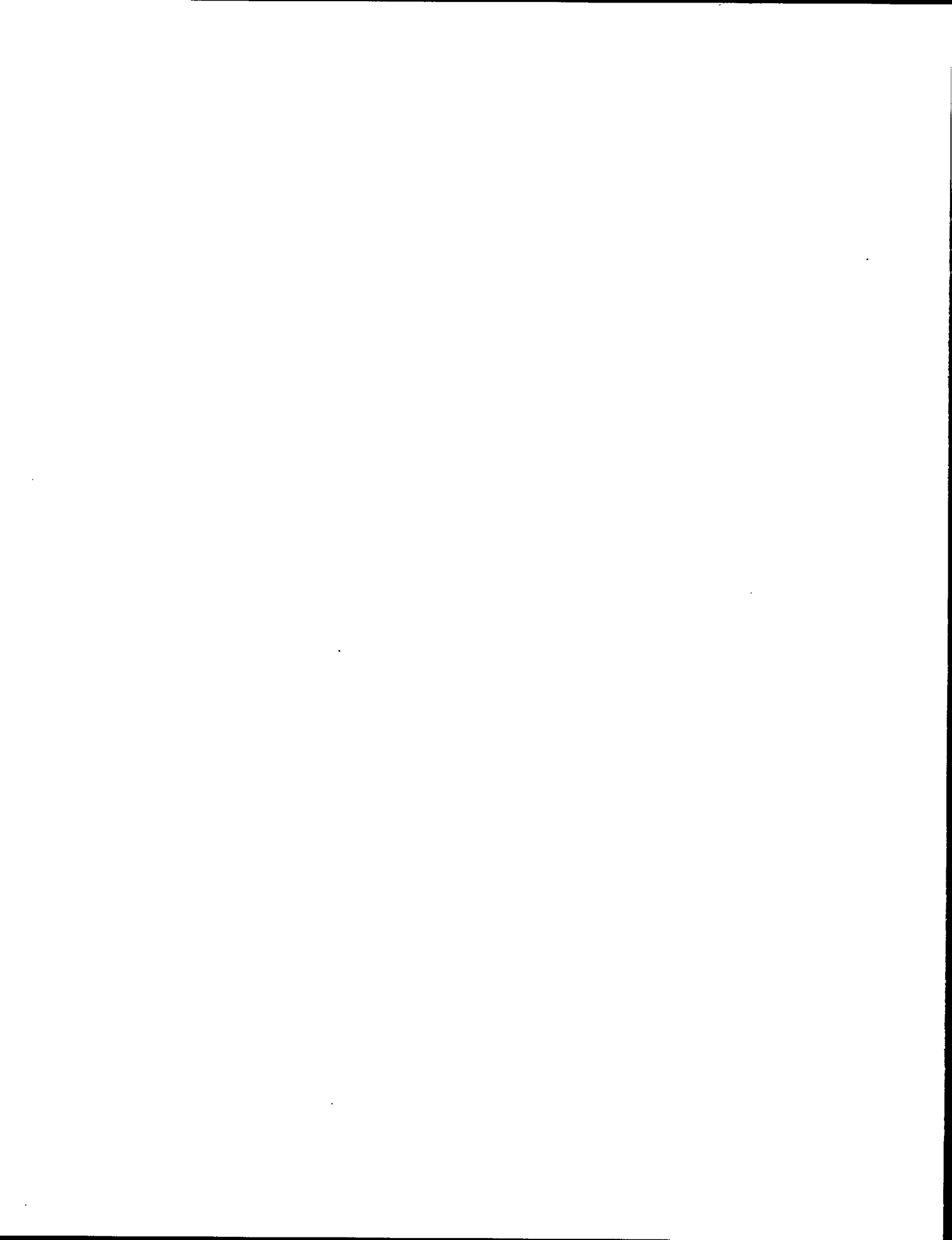
The government agrees that the rules regarding membership fees should be modified to accommodate these circumstances. In particular, the rules will ensure that the provision of goods or services in the manner described above will not alter the exempt status of a membership.

#### **(v) Election to be Taxable on Real Property Supplies**

As indicated in the Technical Paper, charities, non-profit organizations and selected public sector organizations will be exempt on most of their supplies of real property. This exemption will greatly simplify compliance in many instances and, indeed, will be particularly beneficial where these organizations supply real property to each other. For example, school boards frequently swap land and buildings. As well, charities often lease available premises on a long-term basis to other charities.

However, in the course of consultations, some organizations expressed a preference to be taxable on certain supplies of real property. In particular, it was noted that, where an organization supplies long-term leases of commercial property to businesses, it would be preferable to charge tax and claim input tax credits for purchases related to the maintenance of, or improvements to, the property. The businesses could, in turn, claim input tax credits for tax on the lease payments. Such treatment would avoid tax cascading and allow the organization to compete on an equal footing with other commercial landlords.

Accordingly, charities, non-profit organizations and selected public sector organizations will be allowed to elect, on a property-by-property basis, to have all supplies of a particular property treated as taxable supplies. Thereafter, the organization's entitlement to input tax credits and the tax consequences of a change in the use or a sale of the property would follow the normal rules that apply to commercial owners of real property.



## **Section 8: Financial Services**

### **A. Introduction**

In concept, financial services should be taxed under a broadly based sales tax like the GST. They represent consumption on the part of the purchaser – even though they are often purchased in conjunction with savings or investment activities.

However, applying a sales tax to financial services is exceptionally difficult because of the fact that many of these services are priced in an implicit manner. For instance, the price charged by a bank for accepting deposits and lending money is often implicit in the difference between the interest rates charged to borrowers and the rates paid to depositors – that is, the margin or spread. Because of these complexities and the fact that no other country has been able to successfully include financial services in their sales tax base, the Technical Paper indicated that financial services will be exempt under the GST. As with all other goods and services, exported financial services will be zero-rated. This approach has been endorsed by the House of Commons Standing Committee on Finance in its report on the GST.

While the Technical Paper outlined the basic design of the tax, a number of issues required further consultation:

- the definition of a financial service;
- the definition of a financial institution;
- the treatment of intra-group transactions; and
- methods for allocating inputs in determining input tax credits.

On the basis of recommendations from the House of Commons Standing Committee on Finance and the government's consultations with representatives from the financial industry, this chapter describes further refinements to the government's proposed treatment of financial services under the GST.

### **B. The Definition of a Financial Service**

As outlined in the Technical Paper, the definition of a financial service will include financial intermediation, market intermediation, risk pooling and all services closely related to these activities.

### **(i) Mixed Supplies**

Financial institutions often bundle several different services together and provide them as a package for a single fee – e.g., bank service charge packages. The application of the tax is straightforward as long as the component services are either all taxable or all exempt.

However, in some cases, a single fee or charge can cover a mix of taxable and exempt financial services. In determining the tax status in these circumstances, vendors will not generally be required to break these supplies into their component parts. Instead, where a supply includes more than one service and one of these is a financial service, the supply will be exempt if it *primarily* involves financial services. For instance, if a bank offers personalized cheques (taxable) as part of a package where all other components are exempt, the entire charge will be exempt.

### **(ii) Non-Registered Insurers**

The Technical Paper proposed that services related to insurance policies sold by licensed insurers would be exempt from GST. In contrast, warranties and other forms of insurance provided by firms not licenced to sell insurance would be taxable since these services are largely non-financial. For example, insurance that is typically supplied in conjunction with another good or service, such as car rental insurance, would be taxable.

However, under this approach, medical and dental plans provided by non-registered insurers would have been taxable, even though they compete directly with licensed insurers who will sell these products on an exempt basis. In order to ensure equitable treatment, the definition of an exempt insurance service has been extended to include health and dental insurance plans, whether provided by a licensed insurer or by another person.

### **(iii) Property and Casualty Insurance**

The Technical Paper proposed including property and casualty insurance services as financial services and, therefore, treat them as exempt. In response, the industry has suggested that these services are not financial in nature and therefore should be taxable.

On balance, the government believes that treating property and casualty insurance as a financial service is the most appropriate approach and is consistent with the general treatment of financial services. It has been recommended by the Standing Committee on Finance and is similar to the treatment of property and casualty insurance in virtually every other country with a tax of this kind.

The government will continue to work with the industry to explore methods of minimizing the consequences of the GST for claims costs relating to commercial activities.

The services provided by insurance adjusters will be taxable.

## C. The Definition of a Financial Institution (*De Minimis* Rule)

As a result of exempting financial services, providers of financial services will be required to apportion inputs between their use in financial and other activities for the purpose of claiming input tax credits.

To simplify the operation of the tax for firms whose financial activities are only ancillary to their main activities, there will be, as proposed in the Technical Paper, a *de minimis* rule to determine which firms will be treated as financial institutions. Registrants who fall below the *de minimis* threshold will not be defined as financial institutions and will not have to allocate any inputs to the provision of financial services where those services are related to their commercial activities.

For GST purposes, there will be two types of financial institutions:

- **listed financial institutions**, which will include banks, trust companies, financial co-operatives, insurers, investment dealers, and investment funds, all of whom clearly provide predominantly financial services and to whom the *de minimis* rule will not apply; and
- **other financial institutions**, which will include other firms who, on the basis of the *de minimis* rule, are considered to be providing a significant amount of financial services.

The *de minimis* rule involves a straightforward calculation so that firms can easily determine whether or not they are affected by the financial institution rules. Basically, firms whose annual revenue of an income nature from interest, dividends and separate fees for financial services accounts for more than 10 per cent of their total revenue or more than \$10 million, will be defined as financial institutions. For the purpose of this rule, firms will not be required to include interest and dividends received from a related non-financial company, as long as that income is not income from a business for income tax purposes. For any particular reporting period, the *de minimis* rule will be based on results for the immediately preceding fiscal period.

Firms defined as financial institutions on the basis of the *de minimis* rule will not typically be providing predominantly financial services, but they will be providing a significant amount of financial services and, in many cases, will be in competition with listed financial institutions. Therefore, they should be treated on the same basis as listed financial institutions.

During consultations, concern was expressed that the *de minimis* rule could result in a firm being categorized as a financial institution simply on the basis of large interest or dividend receipts, even though it may not be providing significant financial services. While the government recognizes these concerns, the basic structure of the *de minimis* rule will be maintained. For many companies, the concerns are addressed by the exclusion of interest and dividends from related companies. In addition, given the fact that inputs will be allocated on a reasonable basis rather than necessarily on an arbitrary revenue-based approach, the affected firms should not face an inappropriate tax burden or significant compliance costs.



## **D. Treatment of Intra-Group Transactions**

### **(i) Background**

For both regulatory and business reasons, financial institutions often carry out activities such as data processing or management through related companies. The exemption of financial services means that taxable services purchased by financial institutions from related companies and used in the provision of financial services would be subject to GST. As a result, these services would become more costly to the institution than if it performed them in-house.

In the absence of special rules, the GST could produce anomalous and inequitable results, forcing financial institutions to restructure their operations and penalizing firms that are forced by regulation to carry out certain activities in separate entities.

In addition, the unique corporate structure of financial co-operatives – credit unions and caisses populaires – would, in the absence of special rules, give rise to serious inequities and would place financial co-operatives at a competitive disadvantage relative to other deposit-taking institutions.

The structure of a financial co-operative network is, in many respects, analogous to a large bank, with the central co-operatives carrying out activities similar to the head office of the bank. Under the GST, taxable services provided by the head office to a branch (such as training) would be within the same entity and, therefore, would not be subject to tax. However, those same services provided by a central co-operative to a local co-operative would be taxed since the central and the local are two separate entities. This would clearly be inequitable.

These problems were acknowledged in the Technical Paper and subsequently were the subject of consultations with representatives of the financial sector.

### **(ii) Approach**

The key considerations in developing rules for intra-group transactions were:

- the range of services eligible for intra-group treatment;
- the appropriate criteria for determining the membership of a related group; and
- ensuring that the rules adequately accommodate the unique structure of financial co-operatives.

The Technical Paper proposed that special rules be developed only for a selected list of services, such as data processing. During consultations on this issue, it became clear that to address adequately the issue, the list would have to include a broader range of services such as management and administration assistance and advice. Given that these services represent the vast majority of intra-group

charges, and that it would be very difficult to establish an equitable borderline around a specified list of services, it was decided that all services, including leases, will be eligible for the intra-group rules.

For the purposes of these rules, registrants will be closely related where the degree of common ownership is at least 90 per cent. Restricting the application of these rules to a high level of common ownership will eliminate the most serious inequities for services purchased from a closely related corporation. At the same time, these rules should provide a level playing field for all institutions by restricting their application to only situations where the companies are closely related.

Registrants who are residents in Canada and members of a group that includes a listed financial institution will, on an election basis, be allowed to exempt service charges between themselves. Where two firms jointly elect for this exemption, all supplies between them will be exempted and both firms will be treated as listed financial institutions.

Once two companies have elected to exempt supplies between themselves, the election will stand for at least one year, or until they are no longer closely related, whichever is earlier. After one year, the companies will be able to revoke the election, and all supplies would then become taxable. Once an election has been revoked, the permission of the Minister will be required in order for the firms to re-qualify for exemption on intra-group supplies.

Because of their unique ownership structure, financial co-operatives would not qualify under the closely related test. The rules will be extended to include all services from one financial co-operative to another – including transactions between a financial co-operative and its stabilization fund.

In addition, where a group of financial co-operatives jointly own a separate company (e.g., a data processing company), each one will be considered closely related to the company if together they own at least 90 per cent of the company.

The GST legislation will provide some flexibility to permit an exception to the 90-per-cent ownership rule in very limited circumstances.

## **E. Apportionment of Inputs for Input Tax Credits**

### **(i) General Approach**

Since financial institutions typically will have a mixture of taxable, zero-rated and exempt supplies, they will be required to apportion their inputs between these various activities for the purpose of claiming input tax credits.

The government remains committed to ensuring that an accurate allocation process is adopted. Therefore, the legislation will require that the allocation method be reasonable in the circumstances.

Experience in other countries clearly shows that methods which attribute inputs directly to activities yield the most accurate and equitable results. In contrast, revenue-based approaches, while somewhat simpler, have proven to be inequitable and prone to manipulation. As a result, the use of revenue-based formulae will be kept to a minimum and, to the maximum possible degree, input tax credits will be based upon the specific use of the input.

The government recognizes that this allocation process may impose an additional compliance burden on some institutions. As a result, in the period leading up to the implementation of the tax, Revenue Canada will consult with the industry in an effort to develop appropriate methods of apportioning inputs.

For persons other than financial institutions, purchases (other than capital goods) which are used 90 per cent or more in a commercial activity will be fully creditable. Similarly, where these inputs are used at least 90 per cent in exempt activities, they will not be eligible for any input tax credits. These rules would not be appropriate for financial institutions since there may be many instances where an input is used less than 10 per cent in commercial activities. As a result, these rules will not apply to financial institutions.

## **(ii) Change-in-Use Rules**

Financial institutions will be allowed to claim input tax credits on capital goods to the extent that these purchases are used in making taxable or zero-rated supplies. Since the use of capital goods can change significantly over time, input tax credits will be adjusted where the extent of the use of these capital goods in commercial activities has changed.

In order to simplify the computation of input tax credits, adjustments will only be made where the cumulative change in use exceeds 10 per cent. In addition, financial institutions will only track the change in use of capital goods where its purchase price exceeds \$50,000. This \$50,000 threshold will not apply to changes in use arising from an election to provide exempt supplies to a closely related person as described in Section D.

## **F. Other Issues**

### **(i) The Treatment of Investment Funds**

Investment funds, such as mutual funds and investment corporations, are essentially conduits through which individuals carry out investment activities. These funds will be defined as listed financial institutions.

Management services provided to these funds – for instance, the daily supervision, administration and management of the fund's portfolio – will be a taxable supply, whereas charges by the fund to investors will be exempt. As a result, the services

provided through the fund will be treated on the same basis as if the investors had purchased them directly.

## **(ii) Income Tax Discounting Services**

Tax discounters prepare income tax returns for individuals and provide these individuals with their refund immediately. For this service, the discounter charges an amount which is equal to a percentage of the refund.

Services provided by tax discounters will be taxable and, therefore, treated on the same basis as the preparation of an income tax return. Consequently, income tax discounters will be considered to have collected GST equal to  $\frac{7}{107}$ ths of the amount charged to a client, as determined under the *Tax Rebate Discounting Act*.

## **(iii) International Insurance Services**

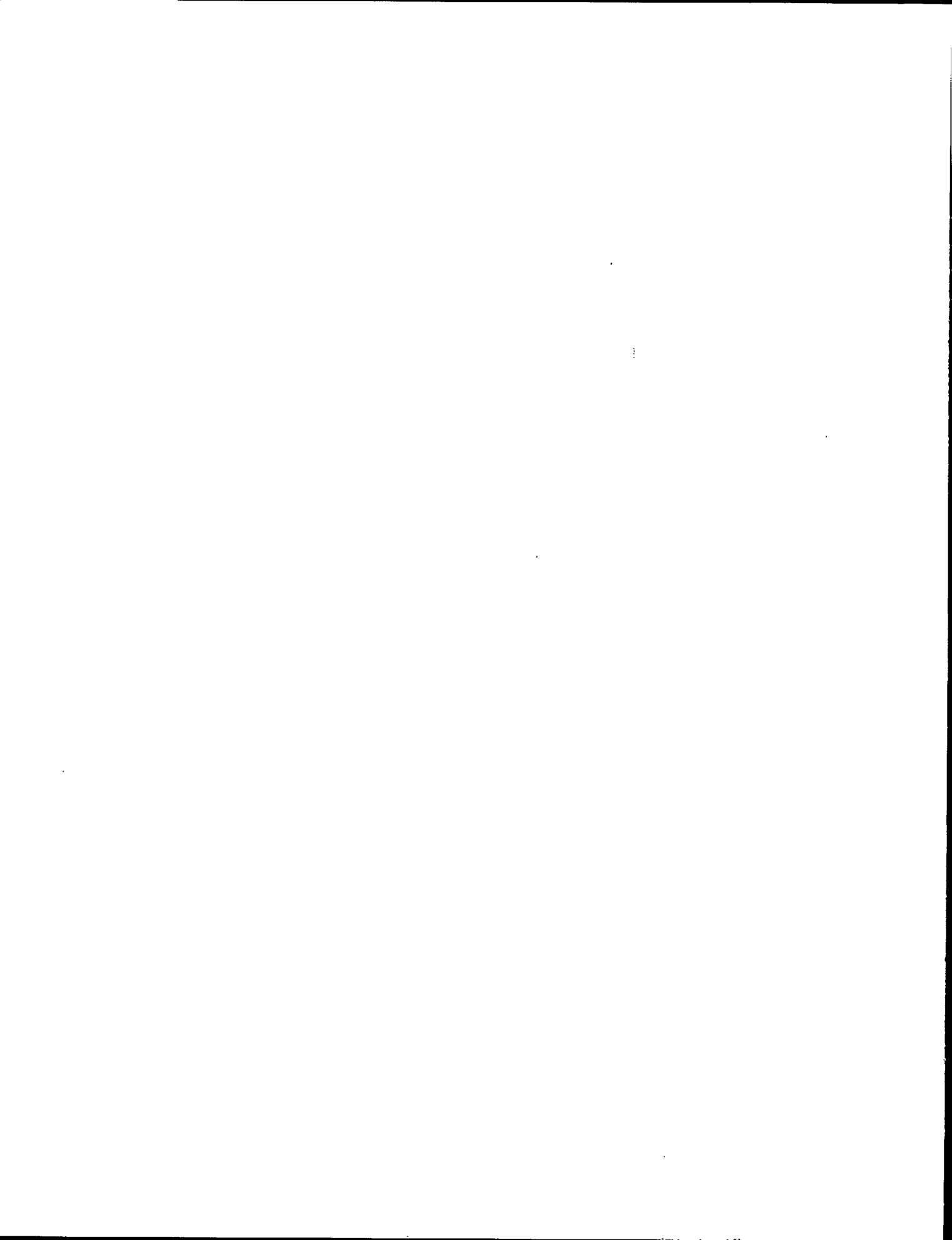
Generally, the location of the supply of insurance services will be determined by the location of the risk. As such, where the risks covered by an insurance policy are located outside Canada, the services supplied by the insurance company in respect of that policy will be considered to be exports and will be zero-rated.

In the case of an individual life or accident and sickness insurance policy, the insurer's services will be zero-rated when the policy is issued in respect of a non-resident. For all other policies (e.g., group life, product liability), the insurance services will be treated as zero-rated supplies to the extent that non-resident risks are insured under the policy. Consequently, insurers will be eligible for credits on inputs associated with these policies in accordance with the non-resident risks covered by the policy.

## **(iv) Thresholds for Reporting Periods**

Financial institutions will determine their reporting periods on the same basis as all other registrants. Under these rules, as outlined in the Technical Paper, a registrant's reporting period will be determined on the basis of its annual revenue from taxable and zero-rated supplies. Registrants with taxable and zero-rated supplies greater than \$6 million will be required to file monthly. Otherwise, registrants will file quarterly with an option to file monthly. Where taxable and zero-rated supplies do not exceed \$500,000, registrants will have the option of filing annually with quarterly instalments.

For the purpose of this calculation, revenue from exported financial services will not be included, since valuing these services would be either extremely complex or very arbitrary.



## Section 9: Transition

### A. Federal Sales Tax Inventory Rebates

On implementation of the GST, many firms will be holding inventories of new goods for re-supply on which federal sales tax previously will have been paid. As indicated in the Technical Paper, in order to avoid double taxation of these goods, rebates will be provided to firms holding inventories of new and unused goods on an FST-paid basis on 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 that have not been delivered to a job site.

In designing the inventory rebate program, the objective is to balance equity with simplicity. The current federal sales tax applies at an early trade level. As a result, the tax content on goods is not generally ascertainable at subsequent trade levels.<sup>(1)</sup> Consequently, the calculation of inventory rebates will be based on prescribed rebate percentages in all cases. Claimants will simply apply the prescribed percentages to the value of their tax-paid inventories on January 1, 1991. To determine the value of their inventories, claimants will employ the same methods used to value inventories for income tax purposes. There will be one general rebate percentage applied to the vast majority of FST-paid goods. Separate rebate percentages will be prescribed for construction materials currently subject to the lower 9-per-cent rate and for motor vehicles. Rebates in respect of gasoline and diesel fuels will be a specific amount per litre, based on the per litre FST rate on these items on December 31, 1990. Given the practical difficulty of differentiating firms by trade level, the inventory rebate percentages will be the same for all businesses with FST-paid inventories.

Relying exclusively on prescribed rebate percentages will greatly simplify the claiming and administration of the FST inventory rebate program. As a further simplification measure, firms will be permitted to estimate their FST-paid inventories on hand as of January 1, 1991 without the need for a physical inventory count at that time. The estimated inventory in these circumstances will be based on an inventory count taken before or after January 1, 1991 where the Minister of National Revenue is satisfied that the registrant's inventory control system will permit a reasonably accurate estimate of the person's inventory on January 1, 1991.

<sup>(1)</sup> In this regard, it should be noted that it is the practice of some licenced manufacturers to show an "FST allowance" on their invoices. However, the amount shown is often an inaccurate portrayal of the actual tax paid. Generally, it does not reflect the various adjustments and deductions available to licenced manufacturers – amounts which, in many instances, cannot even be ascertained by licenced manufacturers until after sales have been made (e.g. subsequent volume discount adjustments, transportation cost deductions, etc.).

Claimants will be required to submit their rebate claims to the Minister of National Revenue no later than December 31, 1991.

## **B. Capital Goods and Equipment Leases**

A focus of a number of submissions to both the Department of Finance and the House of Commons Standing Committee on Finance was the absence of any special transitional relief for capital goods acquired or equipment leases entered into before the start-up of the GST. In both cases, two basic arguments were made:

- the application of the existing FST to capital goods purchased or leased prior to the introduction of the GST will result in an element of double taxation under the new system to the extent that the FST-included cost of these items will continue to be reflected in prices after 1990; and
- the knowledge that businesses will be able to recover any tax paid on their purchases after 1990 will create an incentive to defer acquiring capital goods currently subject to FST until 1991 or, in the case of leases, to close out existing leases before 1991.

The government recognizes these as valid concerns. However, they must be weighed against the fiscal implications that would be involved in providing special transitional relief in this area. In its Report on the GST, the House of Commons Standing Committee on Finance noted that the cost of a sliding scale FST rebate on capital goods purchased in 1990 alone would be about \$1.5 billion.

Clearly, this would be an unacceptable addition to the existing federal deficit. Consequently, there will be no special transitional relief provisions for capital goods.

Nonetheless, the government recognizes that, in many cases, leasing is an alternative to financing equipment acquisitions. Persons who entered into equipment lease agreements before the release of the GST Technical Paper chose this method of financing without knowledge of the potential GST consequences. Since the acquisition of this equipment under a debt financing arrangement would not have had GST consequences, lease payments for equipment made after December 31, 1990 under an agreement in writing entered into before August 8, 1989 also will not be subject to GST.

## **C. Condominiums**

The draft GST legislation indicated that the liability for GST on new condominiums generally will arise on the date title transfers to the purchaser. Typically, this will be on or shortly after the date of registration of the condominium corporation. However, in no event will the timing of GST liability on the purchase of a new condominium unit be permitted to extend beyond 60 days of registration if, prior to that time, possession for the purpose of occupancy has transferred to a purchaser.

No GST will apply on the purchase of a condominium unit if possession for the purpose of occupancy transfers to the purchaser before January 1, 1991 (even if title does not transfer until 1991).

An important concern raised in the course of consultations on the transitional rules relating to condominiums focussed on the fact that a number of condominium units not scheduled for completion after 1990 were pre-sold to individuals prior to release of the draft GST legislation. Similarly, a number of limited partnerships entered into contracts with developers for the construction of condominium complexes. It was pointed out in both cases that firm purchase and sale agreements had been entered into with no prior knowledge of the potential GST implications by either vendors or purchasers. Clearly, it would be unfair in these circumstances to allow the normal GST rules to apply and require payment of an additional tax over and above the already agreed upon price (part of which reflected anticipated FST costs to be incurred during construction).

In response to these concerns, condominium units sold to individuals and complexes sold to limited partnerships under a purchase and sale agreement signed by the purchaser(s) on or before October 13, 1989 (that is, the date of release of the draft GST legislation) will not be subject to GST.

So as not to unduly complicate the GST for builders, they will still be permitted to claim the FST rebate on all unfinished and unoccupied units – including grandfathered sales – on January 1, 1991 in the normal manner. Moreover, they will be permitted to claim input tax credits in the normal manner in respect of any GST paid on inputs relating to grandfathered sales.

However, builders will be required to pay a special tax equal to 4 per cent of the selling price of any grandfathered sales. In the case of units sold to individuals, the tax will apply at the time when possession of the unit transfers to the purchaser. In the case of complexes sold to a partnership, the tax will apply at the time when ownership transfers to the partnership or 60 days after the complex is registered as a condominium complex, whichever is earlier. This will ensure that the effective tax content on grandfathered condominium sales is approximately the same as it would have been if the existing federal sales tax had continued in place.

Under the normal rules of the GST, a builder who, prior to registration of a condominium corporation, leases a unit to someone other than the purchaser of the unit would be required to self-assess the GST on the unit. To ensure that the intended result is achieved for grandfathered sales of condominium complexes to limited partnerships, the self-assessment rule for new residential construction will not apply to the lease of condominium units in these cases.

#### **D. Transactions Straddling Start-Up Date**

The Technical Paper proposed a series of rules to determine the tax status of transactions straddling the start-up date. In the course of consultations with



various industry groups, five areas were identified where changes to those transitional rules are required:

- uninvoiced supplies;
- telecommunications and telecommunication programming services;
- continuous supplies of goods;
- transportation; and
- prepaid supplies.

These are described in greater detail below.

### **(i) Uninvoiced Supplies**

The Technical Paper proposed not to apply GST to supplies of services performed or FST-exempt goods delivered prior to January 1, 1991 as long as the purchaser pays for the supply or the vendor issues an invoice for the supply prior to March 1, 1991. A number of groups pointed out that the March 1 cut-off date would give rise to significant transitional difficulties, particularly in the case of professional service providers (e.g., lawyers, accountants, etc.) who gear their billings towards March 31.

To ease these difficulties, the cut-off date will be changed to April 30, 1991. Any amounts paid or invoiced prior to that date will not be subject to GST to the extent that the amount relates to goods delivered or services performed prior to 1991. Any amount for a supply that is neither paid nor invoiced until after the end of April 1991 will be subject to GST, whether or not the amount is in respect of a supply made prior to 1991.

To further simplify the application of this rule, there will be no differentiation between FST-taxable and FST-exempt goods delivered prior to 1991. Amounts in respect of all such goods will be subject to GST if the amounts are both unpaid and uninvoiced after April 30, 1991.

### **(ii) Telecommunication and Telecommunication Programming Services**

Telecommunication services and telecommunication programming services are currently taxed at the rate of 11 per cent. To facilitate the transition to the new system, the Technical Paper proposed to allow the current tax to apply to all billings for periods beginning prior to 1991 and ending before February 1, 1991.

Representatives of the telecommunication and telecommunication programming service industries indicated in the course of consultations with the Department of Finance that it would be a relatively simple matter for them to prorate billings for services between 1990 and 1991. Moreover, they suggested that prorating their

bills would be a fairer approach in that the tax status of services to users would not depend on the user's billing period as it would under the approach proposed in the Technical Paper.

Consequently, telecommunication and telecommunication programming services will be subject to the general prorating rule for services straddling the GST start-up date: the existing tax will apply to all such services supplied to users up to December 31, 1991, while GST will apply to all services supplied after that date. Of course, incidental equipment rental charges (e.g., telephone and pay-TV descrambler rentals) also will be prorated on the same basis.

### **(iii) Continuous Supplies of Goods**

Under the transitional rules laid out in the Technical Paper, billings for continuous supplies of goods (e.g., electricity, gas, etc.) are to be prorated so that only goods delivered on or after January 1, 1991 are subject to GST.

A question arose in the course of consultations regarding the application of this rule in cases where consumers pay for continuous supplies under a "budget payment" or "equal billing" plan. In these instances, GST will apply to all amounts invoiced in 1991. However, there will be a year-end reconciliation so that GST, in effect, applies only to goods actually supplied in 1991. The scheduling of the reconciliation will be left up to the supplier of the goods, but must occur before January 1, 1992.

### **(iv) Transportation**

Under the rules proposed in the Technical Paper, amounts paid for any transportation service straddling the start-up date would be prorated so that GST applies to that portion of the service performed on or after January 1, 1991. Clearly, this would be a very complicated procedure in the case of, say, a freight service commencing in December 1990 and ending in January 1991, or an airline ticket for several flights, some of which are in the very latter part of 1990, with the remainder in 1991.

As a general rule, therefore, transportation services will not be subject to GST if they commence prior to January 1, 1991. However, any passenger transportation service extending beyond January 31, 1991 will be subject to GST on 50 per cent of the consideration for the service. In addition, bus, rail and air passes will be excluded from the special transitional rule for transportation services and will be prorated over the period for which the passes are valid.

The net effect of these rules will be to significantly simplify the transition to the new system for transportation service providers. Generally, there will be no need to prorate services that straddle the GST start-up date except where there is substantial consumption of passenger services in 1991.

### **(v) Prepaid Supplies**

The Technical Paper indicated that any supply of goods to be delivered or services to be performed after December 31, 1990 will not be subject to GST if paid for by an individual prior to April 1, 1990. A number of questions were subsequently raised about the GST status of "prepaid" funerals. Technically, "prepaid" funerals often are not prepaid. Rather, in many provinces, a person who prepays for a funeral legally only deposits money into a trust account. When the services are provided, the supplier draws upon the trust account: technically, it is only at the time that monies are drawn from the trust that payment is made for the supply. To provide greater certainty of the application of the prepaid supplies rule, specific provision will be made in the legislation to ensure that the supply of a funeral service after start-up of the GST and pursuant to a contract entered into prior to April 1, 1990 (under which any monies are deposited in trust for future payment of the service) will not be subject to GST.

## **Section 10: Other Operational Aspects**

### **A. Used Goods**

#### **(i) General**

The Technical Paper set out the general rules for the treatment of sales of used goods.

Sales of used goods by registrants will be taxable. Where they are sold from one registrant to another registrant for use in the course of a commercial activity, the normal rules for the claiming of input tax credits will apply.

Sales of used goods by private individuals will not be subject to GST. As a general rule, where they are sold to a registrant, the registrant will be able to claim a *notional input tax credit* as if tax had been charged and included in the purchase price paid to the individual. However, the Technical Paper indicated that notional input tax credits in respect of used goods would be limited to dealers in used goods in the first three years of operation of the GST. Thereafter, notional credits for used goods will be available to registrants generally.

As a result of the notional input tax credit, when dealers subsequently resell used goods and charge tax, the net effect is that tax will be remitted only on the dealer's margin – that is, the difference between the dealer's purchase cost and sale price.

#### **(ii) Appreciating Used Goods**

An exception to the general approach to used goods was proposed for the treatment of appreciating used goods, such as works of art, jewellery, and collectibles such as rare books, coins and stamps.

Given their appreciating nature, providing notional input tax credits for purchases of these goods from individuals means that more tax would be refunded to registrants purchasing such goods than had been collected from the individual in the first instance. In particular, applying the general used goods rules to these items would create an incentive for individuals who are registrants to transfer appreciating goods to their businesses in order to generate artificially large notional input tax credits. Moreover, providing notional input tax credits for appreciating used goods which were subsequently exported would entail an unwarranted revenue loss resulting from the notional input tax credit for tax that had never been paid. For these reasons, the Technical Paper proposed that no notional input tax credits be provided in respect of appreciating used goods.

In consultations with art dealers, auctioneers, and other businesses selling appreciating used goods, the concern was expressed that this treatment would result in substantial cascading of tax each time an appreciating good was sold to a final consumer and then resold through a dealer or auctioneer.

### **(iii) Revised Treatment of Appreciating Used Goods**

In response to these concerns, the treatment of appreciating used goods will be modified.

Under the revised approach, business acquisitions of appreciating used goods valued at less than a specified threshold amount (say \$2,000) will be subject to the normal used goods rules. That is, businesses will be able to claim either actual or (subject to the three year transitional limitation for dealers) notional input tax credits on the purchase of these items. GST will, of course apply on any subsequent resale.

For appreciating used goods in excess of the specified threshold value, the normal used goods rules will also apply to dealers acquiring the goods as inventory for resupply. Hence, if a dealer acquires such a good from a private individual and then resells it, in effect, tax will be remitted only on the dealer's margin.

Where an appreciating used good is exported or otherwise sold on a zero-rated basis by a dealer for consideration in excess of the threshold, any notional or actual input tax credits claimed in respect of the property will be recaptured. The amount recaptured will be the input tax credit claimed in respect of the item sold or the tax that would have been collected if GST applied to the sale, whichever is less. The amount recaptured will be included in the supplier's GST return for the period in which the zero-rated sale was made. Consistent with this recapture rule, any GST paid on the purchase of appreciating used goods over the prescribed threshold amount will not qualify for the foreign tourist rebate.

Under this revised approach, acquisitions of new or used appreciating goods by a registrant, other than for purposes of resupply, will be deemed to be acquired otherwise than in the course of a commercial activity if they are in excess of the specified threshold value. Accordingly, any tax paid on these goods will not qualify for either an actual or a notional input tax credit. By the same token, however, no tax will be charged if the business subsequently resells the good.

In the absence of any provision to the contrary, the application of the revised appreciating used goods rule would mean that establishments such as art galleries or museums (which are in the business of charging admissions on a commercial basis to patrons to view exhibits of appreciating used goods) would be denied input tax credits on their acquisitions of these goods. This could have adverse implications for these entities.

Accordingly, exhibitors of appreciating used goods will be able to elect to be treated as dealers of these goods for purposes of the GST. Establishments making this election will be able to claim input tax credits on their purchases of

appreciating used goods even though they are acquired as capital properties rather than as inventory for resale. However, any subsequent sales of appreciating used goods by these entities will be taxable in the normal manner.

The threshold amounts for purposes of the revised appreciating used goods rule will be prescribed in regulations following consultations with affected industries.

## **B. 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 Technical Paper indicated that the GST on pay telephone calls paid in coin will be a specific amount designed to approximate the general *ad valorem* rate. At a 7-per-cent GST rate, the tax will be 5¢ on each 70¢ charged for a pay telephone call. As such, 5¢ tax will apply to calls worth 70¢ to \$1.39, 10¢ on calls from \$1.40 to \$2.09, and so on.

As noted in the Technical Paper, pay telephone calls not paid in coin (e.g., charged to a calling card) will be subject to GST in the normal manner; that is, the 7-per-cent *ad valorem* tax will be collectible on the amount charged.

## **C. Patronage Dividends**

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 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 under the GST 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, the Technical Paper indicated that it would probably be impractical to require co-operatives to treat their patronage dividends as individual price adjustments to each member. Therefore, it was proposed that co-operatives treat their patronage dividends as aggregate price adjustments. Under this rule, each co-operative would be required to prorate its dividend payments to each member in any given fiscal period according to the ratio of total taxable to non-taxable supplies made to members in the co-operative's preceding fiscal period. This information would then be provided to recipients of patronage dividends who, if they are registrants, would treat that portion as including a GST adjustment. The co-operative would be entitled to claim a corresponding input tax credit in respect of patronage dividends paid to all members. For members not engaged in a commercial activity, this treatment would result, on average, in a refund of any previous overpayment of GST.

In the course of consultations on the treatment of patronage dividends, some co-operatives indicated that they had sufficiently sophisticated record-keeping systems to enable them to treat their patronage dividends as individual price

adjustments to each member in respect of each member's particular purchases throughout the year. As this would yield a more accurate result than the approach set out in the Technical Paper, the final GST legislation will provide flexibility for co-operatives to rely on this more sophisticated method if they so choose.

Of course, as indicated in the Technical Paper, co-operatives will be permitted to elect to ignore patronage dividends altogether for GST purposes. This election may be attractive to a co-operative where all of its members are registrants as it will simplify compliance while leaving both the co-operative's and its members' combined net tax liabilities unaffected.

## **D. Cash Discounts**

Goods and services may be supplied on terms which offer discounts for prompt payment.

Where the amount charged on an invoice by a supplier is net of any discount offered, the supplier will charge tax only on that net amount. However, where the supplier invoices a customer for the full sale price and offers a discount for payment within a specified time, the Technical Paper proposed to apply GST to the invoiced amount and, where the discount is subsequently taken, adjust the GST by way of a credit note from the supplier to the customer.

Recognizing that the issuance of credit notes for GST adjustments arising from cash discounts could place a significant compliance burden on some businesses, the draft GST legislation proposed an alternative approach. Under this approach, tax would still be calculated on the invoiced amount. However, there would be no adjustments or credit notes in respect of discounts subsequently taken.

In the course of consultations on the GST treatment of cash discounts, a clear consensus emerged among various industry representatives and tax practitioners in favour of the alternative approach outlined in the draft legislation. Therefore, there will be no adjustments or credit notes in respect of cash discounts. This will simplify the operation of the tax for both vendors and buyers. Vendors will collect and remit tax on the invoiced price, irrespective of any cash discounts subsequently taken by their customers. Their customers, if they are registrants, will simply claim an input tax credit equal to the tax on the invoiced amount without any need for a subsequent adjustment if a cash discount is realized.

## **E. Discount Coupons**

As indicated in the Technical Paper, GST will apply on the value of the consideration paid by a consumer for a good or service purchased, net of any discounts taken by the consumer, including any discounts in respect of a retailer's, manufacturer's or money coupon. The Technical Paper also proposed that any reimbursement subsequently paid to a retailer for accepting a manufacturer's coupon or a money coupon would be subject to GST in the normal manner. The

person who reimburses the retailer would be entitled to claim an offsetting input tax credit for any GST paid to the retailer. Consistent with the principle that the reimbursement for a manufacturer's coupon should, in effect, be treated as an after-the-fact reduction in the manufacturer's selling price to the retailer, the draft legislation indicated that the GST status of the reimbursement for a coupon would hinge on the GST status of the goods purchased by a consumer and for which the coupon was redeemed.

A number of industry groups in the course of consultations on the operation of the GST indicated that the proposed treatment of reimbursements for manufacturer's and money coupons would be quite cumbersome in practice. The system would be particularly difficult for small grocery stores which would be forced to segregate zero-rated coupons (i.e., for basic groceries) from taxable coupons, for no net revenue gain to the federal treasury. Paralleling the treatment of cash discounts, it was suggested that a simpler approach would be to ignore coupon reimbursements altogether in the context of GST. Finally, it was pointed out that the treatment proposed in the Technical Paper and draft legislation would result in inconsistent treatment of the handling fee earned by both retailers and coupon clearance houses from coupon sponsors: these fees would be taxable or zero-rated depending on the tax status of the coupons to which they relate.

In order to simplify the operation of the GST, particularly for small grocery stores, coupon reimbursements (including any associated handling fees) will not be subject to tax.

## **F. Pari-Mutuel Betting**

The Technical Paper indicated that, in the case of commercial gambling activities, the GST would apply to amounts wagered, net of any applicable provincial taxes. However, because the operator would be permitted to claim a notional input tax credit for amounts paid out to bettors as winnings, the tax, in effect, would apply only to the operator's gross margin. In the case of pari-mutuel betting, applying a 7-per-cent GST would, on average, translate into a tax of approximately one to one and a half cents on each dollar bet.

In consultations with racetrack operators, it was noted that, because of the unusual nature of their business, the application of the tax would have a disproportionately large impact on the "churn", that is, the number of times the same dollar is turned over and bet in subsequent races.

It was suggested that, to address this problem, consideration be given to removing pari-mutuel bets from the GST base. In response to these concerns, the House of Commons Standing Committee on Finance recommended that pari-mutuel betting be zero-rated.

However, the government believes strongly that it would be inappropriate in the context of a broad-based GST to remove pari-mutuel betting – clearly a discretionary, recreational expenditure – from the tax base.



Nevertheless, the government recognizes that the operation of the GST in this area, in combination with other levies on pari-mutuel betting, could lead to inappropriate results. For this reason, the existing 0.8 per cent federal agricultural levy on pari-mutuel betting will be eliminated, effective January 1, 1991 with the introduction of the GST.

## **G. Holdbacks**

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. The Technical Paper proposed that amounts held back, if specifically sanctioned in legislation, not be subject to GST until the amount is paid or the holdback period expires, whichever is earlier.

The point was made in the course of consultations on this provision that legislation governing holdbacks varies between provinces. Moreover, it was noted that many construction contracts contain explicit holdback provisions not required by statute but which, nonetheless, govern the payment arrangements between the contracting parties.

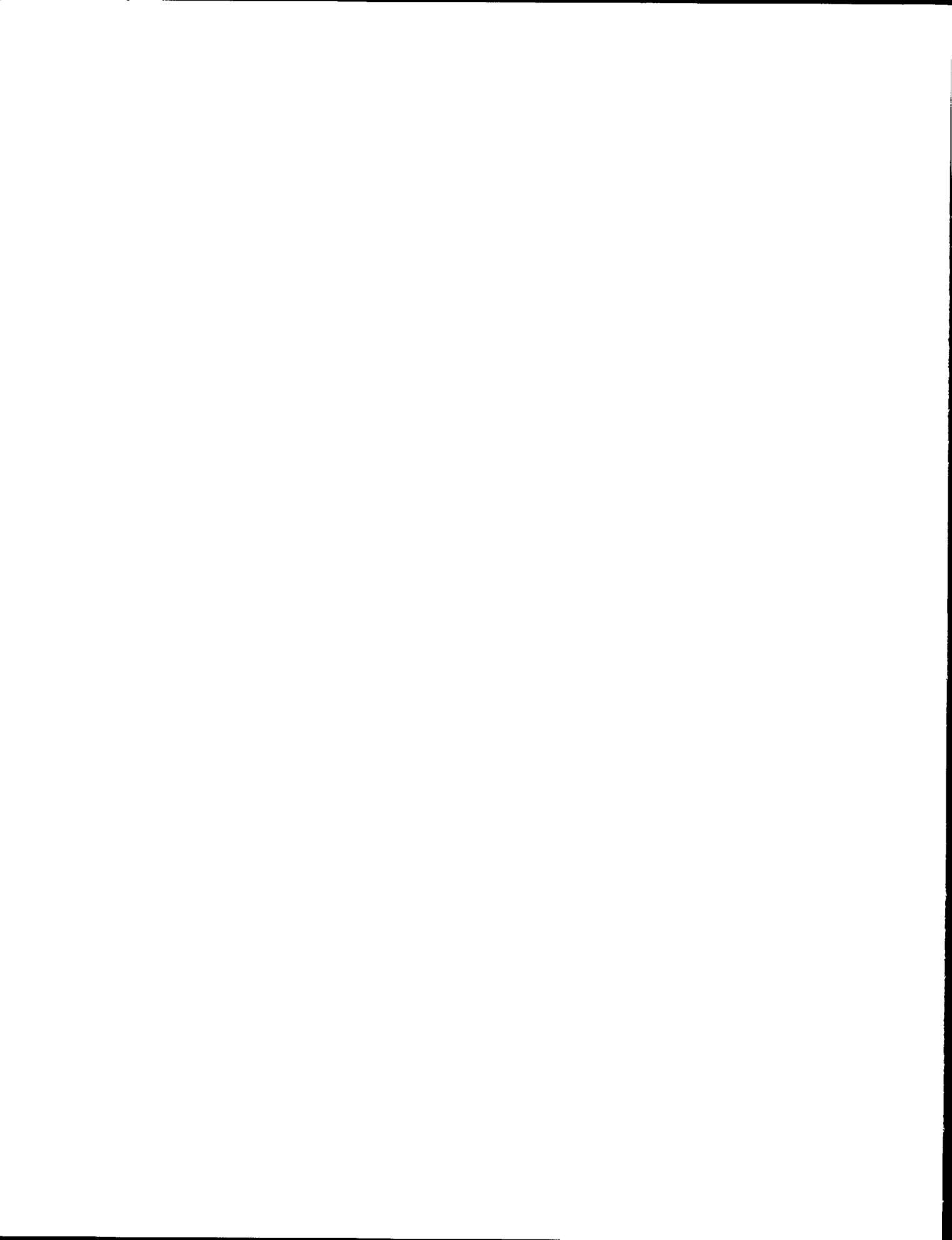
In response to concerns raised about the provision outlined in the Technical Paper, the holdback rule will be broadened to include reference to both legislatively sanctioned holdbacks and holdbacks explicitly provided for in written contracts in respect of the construction or renovation of real property. Also included will be holdbacks explicitly provided in written contracts for the construction or renovation of a ship where the construction or renovation work to be done under the contract may reasonably be expected to take more than three months. In all of these instances, therefore, a liability for GST will not arise in respect of an amount held back until either the amount is paid or the holdback period expires, whichever is earlier.

## **H. Share Acquisition and Ownership Costs**

The Technical Paper indicated that the transfer of a business as a going concern between two registrants would not be subject to GST if both the vendor and the purchaser so agree. Since the transfer 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 relating to the transfer (e.g., legal and accounting fees) to the extent that the going concern involves a commercial activity.

It was noted in the course of consultations on the GST that the treatment of tax paid on professional fees and other costs incurred in acquiring the shares of a company would not parallel the rules that would apply in acquiring the assets of the company. To address this concern, the GST paid by registrants on costs relating to the acquisition of all or substantially all (i.e., 90 per cent or more) of the voting shares of a corporation engaged exclusively in commercial activities will qualify for input tax credits in the normal manner.

In addition, where one company has an investment in shares or indebtedness of a related company engaged exclusively in commercial activities, that investment will be treated as property used by the first company in a commercial activity. As a result, an input tax credit will be available for the GST on any stewardship and other costs relating to such investment.



## Section 11: Product and Excise Taxes

### A. Introduction

In addition to the federal sales tax, the federal commodity tax system also includes excise duties and excise taxes which are imposed on a selected range of products. Excise duties are applied under the *Excise Act* to domestically produced tobacco products and alcoholic beverages, other than wines. Equivalent duties are imposed under the *Customs Tariff* on imported spirits, beer and tobacco products. These levies apply at the point of production or upon importation and are included in the base for purposes of calculating the federal sales tax. Excise taxes are imposed under the *Excise Tax Act* on such products as motive fuels, tobacco products, automobile air conditioners, jewellery, wine, playing cards, and smokers' accessories. Like the federal sales tax, these levies apply at the time of sale of excisable goods by the manufacturer.

Provincial governments also apply a variety of special levies on many of these same products, often in addition to the standard provincial retail sales taxes which are applied at the time of sale to consumers. These include product taxes on tobacco products and motive fuels, liquor board markups, health taxes on alcohol and production licence fees. Generally, these levies apply after application of all federal levies.

Federal excise levies, the manufacturers' sales tax, provincial product taxes and markups, and provincial retail sales taxes combine with the manufacturer's price and wholesale and retail markups in a fixed ordering to determine the retail price of the product. This ordering in which the elements comprising the retail price are arranged gives rise to a complex system of interaction between the various components. Importantly, because they are applied early in the chain, a change in the federal excise levies or the manufacturers' sales tax affects the base on which provincial markups and *ad valorem* taxes are calculated.

The removal of the federal sales tax at the manufacturer's level and its replacement by the GST at the retail level obviously has significant implications for the way in which federal and provincial taxes on these products interact.

In addition, it raises key questions about the impact on federal revenues from these products. The substantial reduction in the federal sales tax rate – from 13.5 per cent to 7 per cent in the case of gasoline and diesel fuel and from 19 per cent to 7 per cent for tobacco products and alcoholic beverages – is only partially offset by shifting the imposition of the tax from the manufacturer's trade level to the retail level. Thus, in the absence of some adjustments, federal revenues

from excisable goods would decline significantly. Sustaining this loss in existing revenues would make the achievement of a 7-per-cent rate for the GST much more difficult.

## **B. Objectives in the Treatment of Federal Excise Levies and Provincial Taxes**

In addressing the complex issue of the interaction of these levies, the government has four main objectives:

1. To develop a straightforward approach to the operation of the GST, while ensuring that in the critical area of motor vehicle fuels, the competitive position of Canadian businesses is not eroded;
2. To maintain revenues at current levels from alcohol and tobacco products and from consumer purchases of motor vehicle fuels;
3. To ensure that provinces have the flexibility to adjust their levies on these products to maintain their current levels of revenue; and
4. To achieve these objectives without increasing consumer prices, on average, for motor vehicle fuels, alcohol or tobacco products.

In developing an approach to achieve the above objectives, a key element is the treatment of provincial product taxes and markups.

## **C. Treatment of Provincial Levies**

The application of the GST at the retail level on these products is consistent with the general principle that it extend to the retail level. In addition, incorporating provincial product taxes and markups in the GST base has a number of operational advantages.

**First**, inclusion of provincial product taxes simplifies the calculation of the input tax credit on motor vehicle fuels purchased by business users. If provincial product taxes are excluded from the base, businesses would have to deduct the provincial levies on these products from their purchase cost before calculating their input tax credit. This would be particularly complex for businesses purchasing fuels in several provinces with different tax rates. Inclusion of provincial product taxes in the GST base simplifies the input tax credit by eliminating this extra step.

**Secondly**, inclusion of provincial product taxes fully protects current revenues from consumer purchases of motor vehicle fuels and hence avoids the need to increase excise levies on these products. While minor adjustments in retail prices will occur in some provinces, on average, retail prices of motor vehicle fuels will not be affected by the shift from the manufacturers' sales tax to the GST. Maintaining current revenues from these products by broadening the GST base rather than by

increasing excise levies protects the competitive position of Canadian businesses that are heavy users of vehicle fuels, such as the logging, mining and transportation sectors. These users and other businesses will receive a full input tax credit for the GST on their fuels, but would not be so protected from an increase in the excise taxes.

**Thirdly**, in the case of alcoholic beverages, inclusion of all provincial levies avoids a complex problem of separating the fiscal and commercial components of provincial levies on these products. Most provinces are extensively involved in the commercial functions of marketing and distributing alcoholic beverages. In many cases, provincial markups on these products are composed of two elements – a commercial component, to cover the costs and normal profits of the business activities of selling and distributing the products, and a fiscal component, or tax, imposed by the province to raise revenue. Equity between different product categories, and between provinces with different mixes of private and public distribution systems, requires that at least the commercial component of such levies be included in the GST base. However, if provincial product taxes are not included in the GST base, the fiscal component of such levies should also be excluded. Clearly, separating the commercial and fiscal components of these levies would not be an easy task. Inclusion of provincial product taxes in the GST base, and hence the full amount of provincial markups, simplifies the operation of the GST in this area.

Of course, including provincial product taxes in the GST base in no way precludes the provinces from adjusting their levies to maintain provincial revenues. While the federal sales tax at the manufacturer's trade level will be replaced by the GST at the retail level along with some adjustments in excise levies, total federal revenues will not increase. Thus, provinces can make whatever adjustments are necessary in their rates to compensate for the reduction in the provincial base that arises from removing the federal sales tax from their base, without increasing average prices of these products to consumers.

For all of these reasons, provincial product taxes, markups and other similar levies will be included in the GST base. The general provincial retail sales taxes imposed on consumers and collected by vendors in nine provinces will not form part of the federal sales tax base. In addition, where a special provincial retail tax is levied on consumers in place of the general retail sales tax, and the rate does not exceed the greater of 12 per cent or the general retail sales tax in that province plus 4 percentage points, the special retail tax will also be excluded from the GST base. All other provincial levies, including selective product taxes imposed on producers, distributors or consumers, liquor board markups, licence fees, commissions, and retail sales taxes imposed at rates above the threshold, will be included in the GST base.

#### **D. Treatment of Federal Excise Levies**

With the introduction of the Goods and Services Tax, certain modifications will be made to the current system of excise levies. Adjustments in the rates of some of

the excise levies will be necessary to protect current federal revenues and to ensure that unintended shifts do not occur in the relative tax burden on different but competing product categories. As well, while most excise levies will be retained, some excise taxes will be eliminated.

Under the manufacturer's sales tax, only excise duties and the excise tax on wine are included in the tax base. However, under the GST, all federal excise levies will be included in the sales tax base. This is a natural result of moving the federal sales tax from the manufacturer's level to the retail level.

### **(i) Alcoholic Beverages**

The excise duties on spirits and beer and the excise tax on wine will be maintained at the manufacturer's trade level.

Introduction of the GST will significantly alter the way federal sales taxes are calculated on alcoholic beverages. The current system, under which a 19-per-cent tax is imposed on the manufacturer's sale price, inclusive of excise duties, will be replaced by a GST of 7 per cent on the retail price of products to consumers, including federal excise levies and provincial markups and product taxes. The substantial reduction in the sales tax rate is thus partially offset by the broader base on which the GST applies. However, in the absence of compensating adjustments in excise levies, a substantial reduction in federal revenues from alcoholic beverages would occur upon implementation of the GST. In addition, because of variations in markups and provincial taxes in the various product categories, a substantial shift in the relative tax burdens on beer, spirits and wine would also occur.

Therefore, federal excise levies on beer, spirits and wine will be increased to maintain total federal revenues from each product category at approximately current levels. For regular beer, the excise duty per case of 24 bottles will be increased from \$1.58 to \$2.29. The excise duty on spirits will be increased from \$3.22 to \$3.32 per 750 ml bottle and the excise tax on wine from \$0.34 to \$0.39 for a 750 ml bottle. While minor adjustments in prices may occur in some provinces because of differences in provincial treatment of these products, *on average*, federal revenues and consumer prices for each of the product categories will not change upon implementation of the GST.

### **(ii) Tobacco Products**

Implementation of the GST will also have an impact on federal taxes and revenues from tobacco products. The replacement of the federal sales tax of 19 per cent on the manufacturer's sale price plus excise duties, with a GST of 7 per cent on the retail price, inclusive of all federal levies, distributional costs, and provincial taxes other than the general retail sales tax, would result in a small reduction in federal revenues from tobacco products. As in the case of alcoholic beverages, federal excise levies will be increased to maintain total federal revenues at current levels.

Thus, federal excise taxes and duties on cigarettes will rise from \$9.78 to \$9.94 per carton. Similar increases will be implemented in the excise levies on other tobacco products. Both the excise duties and excise taxes on tobacco products will continue to be applied at the manufacturer's trade level.

### **(iii) Motive Fuels**

Federal excise taxes on gasoline, diesel fuel and aviation fuel will be retained at the manufacturer's trade level. With the inclusion in the GST base of provincial levies on fuels as well as federal excise taxes, distribution costs and retail mark-ups, federal sales tax rates and revenues will not be affected significantly by implementation of the GST. On average, prices for these products will remain at current levels. Under the GST, business users will receive an input tax credit for the full amount of the federal sales tax paid in respect of gasoline, diesel fuel and aviation fuels.

Concurrently with implementation of the GST, the 1.5 cent per litre gasoline excise tax rebate to commercial users will be eliminated. This rebate will continue to be available to the physically disabled, registered charities and registered amateur athletic associations.

### **(iv) Jewellery and Related Products**

Currently, an excise tax is imposed on jewellery, clocks and watches valued at over \$50, articles made in whole or in part of precious stones, and goldsmiths' and silversmiths' products other than plated products for serving food or beverages. This excise tax will continue to be imposed at the manufacturer's level at the current rate, following implementation of the GST. Thus, manufacturers of jewellery will continue to apply the excise tax on the sale price of their products and the tax will be included in the base for GST purposes. Manufacturers may continue to use the determined values established by Revenue Canada to determine the value of their products for excise tax purposes.

### **(v) Automobile Air Conditioners and Automobile Weight Taxes**

The excise taxes on automobile air conditioners and heavy automobiles will be maintained. These taxes will continue to be levied at the wholesale trade level. As with other excise levies, they will be included in the GST base.

### **(vi) Other Excisable Goods**

Excise taxes are currently imposed on a number of miscellaneous items. These excise taxes raise very small amounts of revenue which no longer justify the administrative and compliance costs they entail, particularly under a reformed commodity tax system. Consequently, the excise taxes on lighters, matches, smokers' accessories, coin-operated games and playing cards will be repealed, effective January 1, 1991.





## **Section 12: Administrative Provisions**

### **A. General Description**

The administrative provisions of the GST will parallel those currently contained in the *Excise Tax Act* and the *Income Tax Act*. Thus, there will be provisions dealing with books and records, audits, civil penalties and penal infractions and rules for compliance, assessments, collection, objections and appeals. Powers will be granted to the Minister to permit the effective enforcement of the legislation.

Provisions relating to search warrants, directors' liability, solicitor/client privilege and the like will also be included, based largely on the *Income Tax Act*. Information furnished for GST purposes will, like information furnished under the *Income Tax Act*, be protected under confidentiality provisions. However, to ensure the efficient administration of Canada's tax system, Revenue Canada – Taxation and Revenue Canada – Customs and Excise will be able to share information.

The GST legislation will also contain a general anti-avoidance provision similar to that contained in section 245 of the *Income Tax Act*.

### **B. Penalties and Infractions**

Like the *Income Tax Act* and the existing *Excise Tax Act*, the GST legislation will provide for civil penalties where returns are not filed and other provisions of the law are not complied with. In addition, penalties paralleling those in subsection 163(2) of the *Income Tax Act* will be provided where a person has been grossly negligent in performing a duty under the GST or has participated in the making of a false statement or an omission in a GST return or form.

Penal offences, punishable upon conviction, will also be provided for in the GST legislation. These will substantially parallel the corresponding provisions in the *Income Tax Act*.

The following offences will be included in the legislation – evasion, failing to file a return as and when required and willfully failing to pay, collect or remit any tax.

### **C. Assessments**

The system of assessments under the GST will be similar to that under the existing *Excise Tax Act*. The Minister will be empowered to assess or reassess for

a given reporting period up to four years after the later of the day of filing of a return and the day on which the return should have been filed. The Minister will also have the power to reassess rebate applications within four years after the day on which the application for rebate was filed.

## **D. Objections and Appeals**

The provisions for objections and appeals will be closely modelled on those contained in the *Income Tax Act*. A person disputing an assessment will be permitted to file a notice of objection within 90 days of the sending of the assessment. The Minister will then reconsider the assessment and may confirm or modify it. If the person still disputes the decision of the Minister, the person may appeal within 90 days to the Tax Court of Canada. There will also be provisions permitting the Minister or the Tax Court to extend the time for objecting or appealing.

Provision will be made for both formal and informal procedures in appeals taken to the Tax Court.

The Canadian International Trade Tribunal (CITT) will have exclusive jurisdiction to determine issues relating to the value for tax of imported goods. Where valuation is the only question in dispute, a direct appeal to the CITT will be available. Where the appeal also involves other issues, the appeal will be to the Tax Court, although the Tax Court will be required to refer the valuation question to the CITT for determination. The CITT will continue to have jurisdiction to determine all issues related to the FST, including inventory rebates to be provided on transition to the new system.