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Report of the Federal Sales Tax Review Committee

Submitted to
The Honourable Marc Lalonde
Minister of Finance

May 1983

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Summary

This Committee, appointed by Finance Minister Marc Lalonde on February 10, 1983, was asked to review options for correcting certain structural problems in the manufacturer's sales tax. It was also asked to recommend alternative solutions to this sytem and, as well, to review the wholesale draft legislation as a possible option to correct these structural problems. The Committee has completed its study and investigations and wishes to make the following recommendations to the Minister of Finance.

The Proposed Shift to the Wholesale Trade Level

It is the opinion of the Committee that the marginal improvements which shifting the tax to the wholesale trade level would produce do not justify the disruption which it would cause in an already functioning system.

Modifications to the Existing Manufacturer's Sales Tax System

The Committee recommends a number of modifications to the existing system to mitigate some of its structural defects. These recommendations are that:

(a) Certain importers be deemed to be manufacturers for sales tax purposes;

(b) Manufacturers be entitled to account for sales tax on all sales of like goods at their lowest selling prices to independent customers;

(c) Established and determined values be given a statutory basis, subject to appeal;

(d) The concept of "marginal manufacturing" be modified to reduce its impact;

(e) Paragraph 2(1)(b) be clarified with regard to the treatment of certain agency arrangements;

(f) A full and proper system of assessment, objection and appeal be enacted; and

(g) Certain other technical and administrative deficiencies in the Excise Tax Act be corrected.

Tax Reform Process

The Committee strongly recommends to the Minister of Finance that he immediately undertake intensive and serious study, in consultation with the provinces, with regard to shifting the federal sales tax to the level at which consumers purchase goods in Canada.

I. Introduction

After some years of study which included publication of the Discussion Paper on Federal Sales and Excise Taxation (Green Paper) in 1975 and the Report of the Commodity Tax Review Group (Brown Paper) in 1977, the Honourable Allan J. MacEachen announced in 1981 that legislation would be introduced repealing the general manufacturer's sales tax and replacing it with a wholesale tax, that is, a tax on the purchase price of goods acquired by retailers. Draft legislation to implement a wholesale tax was tabled in Parliament in April 1982, to correct a number of perceived defects in the manufacturer's sales tax system. In response to a large number of submissions from the business community, in his Economic Statement of October, 1982 the Minister delayed the implementation of the wholesale tax to allow a further review of alternative proposals. On February 10, 1983 the Honourable Marc Lalonde, Minister of Finance, announced the appointment of a committee of tax practitioners and business and consumer representatives, known as the Federal Sales Tax Review Committee, to review options for the reform of the federal sales tax system. This Committee was given certain terms of reference and was asked to report back to the Minister in May 1983 on the most efficient options for resolving the difficulties of the current system.

1. Committee Members

The members of the Committee are listed below and are in agreement with the Report except as noted. The names of the organizations with which the members are affiliated have been inserted for the purpose of identification; they do not necessarily imply approval of this Report by these organizations.

Wolfe D. Goodman, Q.C., S.J.D.
Chairman
Goodman and Carr
Toronto

Joseph R. Brown, R.I.A., C.A.
Vice Chairman
Arthur Andersen & Co.
Toronto

Helen R. Anderson
Member
Consumers Association of Canada
Islington

Raymond C. Bertrand
Member
Canadian Grocery Distributors Institute
Montreal

Gerald W. Childerhose
Member
Ford Motor Company of Canada Limited
Oakville

Jack Cooper
Member
Cooper Canada Limited
Toronto

James S. Draffin
Member
Northern Telecom Limited
Mississauga

Harold Empey
Member
Federated Cooperatives Limited
Saskatoon

David Fulton, R.I.A.
Member
Thorne Riddell Associates
Toronto

Normand Guerin, C.A.[1]
Member
Samson Belair
Montreal

Eric H. Haynes
Member
Canadian Toy Manufacturers Association
Kleinburg

Ray W. Huddlestone
Member
Shell Canada Limited
Toronto

Patricia C. Johnston
Member
Canadian Federation of Independent Business
Willowdale

Daniel Knechtel, C.A.
Member
Eaton's of Canada Limited
Toronto

Eric G. Owne, C.G.A., F.C.I.S.
Member
Canadian Manufacturers Association
Toronto

Roger Rougier[2]
Member
Roger Rougier Limitée
Montreal

Keith V. Sandford
Member
Foster Tax and Tariff
on behalf of Canadian Construction Association
Ottawa

2. Terms of Reference

The terms of reference of the Committee are as follows:

"1. To review options for correcting structural problems in the manufacturer's tax system, including disparities of tax burden between

(a) domestic goods and imported goods, and

(b) domestic goods sold at different trade levels.

2. To recommend alternative solutions that:

(a) yield approximately the same revenue as the present system;

(b) minimize the use of notional values in the calculation of the amount of tax payable;

(c) simplify administration and do not impose an excessive compliance burden upon taxpayers; and

---

[1] Mr. Guerin rendered a minority report to the Minister of Finance, a copy of which appears as Appendix I.

[2] Mr. Rougier attended a number of meetings of the Committee but had to resign prior to the rendering of the Report for personal reasons.

(d) do not contravene Canada's obligation under GATT and will not cause retaliation by its international trading partners.

3. *To review the wholesale tax draft legislation as an option and to recommend modifications where appropriate to respond to public concerns.*

4. *To report to the Minister of Finance by May 15, 1983."*

3. Committee Meetings

The Federal Sales Tax Review Committee met on a number of occasions in Toronto, Ottawa and Montreal to discuss the issues involved. These meetings were attended by the appointed members of the Committee as well as a number of invited officials from the Department of Finance and the Department of National Revenue. Our Committee wishes to record its appreciation for the help and courtesy which it has received from these officials.

We have also been greatly assisted by our Special Consultant, Andy Friedman, C.A. of Peat, Marwick, Mitchell & Co. On occasion we were assisted by experts from certain industry groups and government departments. A number of individuals who had prepared written submissions also made oral submissions to the Committee, or in some cases to sub-committees.The Committee held meetings on the following dates:

February 14, 1983
February 21, 1983
February 22, 1983
March 7, 1983
March 8, 1983
March 16, 1983
March 17, 1983
March 30, 1983
March 31, 1983
April 14, 1983
April 15, 1983
April 24, 1983
April 25, 1983
April 26, 1983
May 9, 1983
May 10, 1983
May 16, 1983
May 17, 1983
May 26, 1983

4. Submissions

The Department of Finance made available to the Committee all public submissions received in response to its requests in 1978 and 1982 as well as its analyses of and responses to such submissions.

To ensure that all interested parties had an opportunity to air their views on the issues referred to the Committee, advertisements were placed in the Business Section of *The Globe and Mail*, *The Financial Post*, *La Presse* and *Le Journal des Affaires*. Those making new submissions to the Committee included the following:

A and W Distributors Eastern Canada Limited
Alcan Canada Products Limited
Alliance of National Distribution Associations (Canada)
Association of Canadian Distillers
Association Nationale des Distributeurs de Tabac et de la Confiserie
Automobile Importers of Canada
Automotive Industries Association of Canada
Avon Canada Inc.
A.W. Brown, R.I.A.
BMW Distributors Eastern Canada Limited
Calego Inc.
Canada Safeway Limited
Canadian Appliance Manufacturers Association
Canadian Business Equipment Manufacturers Association
Canadian Conference of the Arts
Canadian Construction Association
Canadian Corporate Management Company Limited
Canadian Cosmetic, Toiletry and Fragrance Association
Canadian Grocery Distributors Institute
Canadian Electrical Distributors Association
Canadian Federation of Independent Petroleum Marketers
Canadian Hardware and Housewares Manufacturers Association
Canadian Importers Association
Canadian Industrial Traffic League (The)
Canadian Institute of Steel Construction
Canadian Motion Picture Distributors Association
Canadian Steel Service Centre Institute
Canadian Television Association
Canadian Tire Corporation, Limited
Canadian Toy Manufacturers Association
Canadian Trucking Association
Carol-Wabush Distributing Co. Ltd.
Chesebrough-Pond's (Canada) Inc.
Professor Robert M. Clark, University of British Columbia
Clay Brick Association of Canada
Coleco Canada Ltée.
Consolidated Parts Distributors of Canada Ltd.
Cooper Canada Limited
Datafile Limited
Direct Sellers Association
Drug Trading Company Limited
Equipment World Inc.
Educational Media Producers and Distributors Association of Canada
Fasken & Calvin
Favorite Products Company
Federated Co-operatives Limited
Federation of Automobile Dealer Associations of Canada
Gulf Canada Limited
Heating, Refrigerating and Air Conditioning Institute of Canada
Honda Canada Inc.
Home Hardware Stores Ltd.
J. Hutchinson and Eric G. Owen

Interior Designers of Ontario
Kelly, Douglas & Company, Limited
Karku-Titan Canada Ltd.
Montreal Copy Centre Limited
Motorcycle and Moped Industry Council
Motor Vehicle Manufacturers' Association
Northern Telecom Limited
Revelstoke Companies Limited
Roger Rougier Limitée
Shell Canada Limited
Shipping Federation of Canada (The)
Simpsons-Sears Limited
Society of Management Accountants of Canada
Southland Agencies
C. E. Springer & Company Ltd.
Budd Sugarman Interior Design Limited
Sunoco Inc.
Thor-Weld Industries
United Auto Parts
Volkswagen Canada Inc.
Woodward Stores Limited

During one of the sessions the Committee arranged to have the theoretical implications of different tax bases discussed by four academic authorities on fiscal policy who have a special interest in commodity taxation. These gentlemen were:

Professor Richard M. Bird
University of Toronto

Professor John F. Due
University of Illinois

Professor James Johnson
McMaster University

Professor Francois Vaillancourt
Université de Montréal

II. The Current Manufacturer's Sales Tax System

In its present form, the federal manufacturer's sales tax dates from 1923. In general, federal sales taxes are currently applicable on the sale price of goods manufactured or produced in Canada and on the duty paid value of goods imported into Canada. The tax is a single incidence tax which is imposed at the rate of 9% on taxable goods, with the exception of construction materials and equipment for buildings, for which the rate is 5% and alcoholic beverages and tobacco products for which the rate is 12%.

Certain goods such as food and clothing are unconditionally exempt from the tax, while other goods may be exempt depending upon their end use or upon the status of the purchaser. Raw materials and partly manufactured goods are exempt when purchased or imported by a manufacturer for further manufacture or for incorporation into his finished product. The manufacturer may also acquire most types of production equipment exempt from tax.

Effective January 1, 1981 the federal sales tax base was extended significantly when the definition of manufacturers or producers was broadened. As of that date a range of activities, collectively described as marginal manufacturing, were deemed to be taxable operations. These operations included such activities as assembling, blending, mixing, cutting to size, bottling and packaging. Persons engaged in such activities are now considered to be manufacturers and are therefore obliged to account for tax upon the sale price of the goods so produced.

There are some significant exceptions to the general application of this tax. Since 1980, taxes on cosmetics and motive fuels have been imposed on the last party selling to the retailer. Sellers of cosmetics and motive fuels have had over two years of experience with a wholesale tax.

It was recognized at an early date that under the manufacturer's sales tax system some inequities would occur, in that certain manufacturers might sell to wholesalers, retailers and end users and would be forced to pay tax on their selling price, no matter what the trade level of the sale involved. For this reason, such manufacturers are allowed to establish a lower base on which to pay federal sales tax. Where a manufacturer does not sell to wholesalers but its competitors do, Revenue Canada in many cases determines a discounted "notional" value on which such parties can pay federal sales tax. Unfortunately, such procedures are not provided for in the statute, and they have proven to be arbitrary, selectively used and are not subject to judicial review.

III. History of the Tax Reform Process

Over the years a number of groups have studied the tax, including the Rowell-Sirois Commission in 1940, the Carter Sales Tax Committee in 1956, the Royal Commission on Taxation in 1966, the Department of Finance in the Green Paper of 1975 and the Brown Paper of 1977.

The 1956 Carter Committee Report recommended a move to a wholesale tax to help neutralize the tax advantage enjoyed by some imported goods over domestic goods. As well, such a move in tax level was seen as solving problems of notional valuation, where manufacturers sell goods to customers at different trade levels.

The 1966 Royal Commission on Taxation agreed that the manufacturer's sales tax lacked neutrality and tended to favour imported goods over domestic goods. While it considered that the wholesale tax offered improvement over the manufacturer's sales tax, it considered that the greatest degree of neutrality would be achieved if the tax were imposed at the retail level. Imposition of the tax at the retail level would also allow government to tax services in the future if it so desired.

The federal government's 1975 Green Paper outlines the inadequacies identified by previous reviews of the manufacturer's sales tax as follows:

- *"serious valuation problems arise due to the various trade levels at which goods are marketed. In many instances, no provision exists for taxpayers to appeal rulings in respect of the value for tax;*

- *imported goods gain a potential tax advantage over domestically produced goods because advertising, warranty, and other marketing values added in Canada, which typically are included in the taxable value of domestic goods, may not be included in the taxable value of imported goods;*

- *the present system favours goods bearing the private brand of a person other than the manufacturer because these may escape tax on many values that are included in the taxable value of goods bearing the brand name of the actual manufacturer; and*

- *the treatment of transportation costs tends to favour goods of manufacturers located closer to supply sources over goods of local manufacturers and thus may encourage the establishment of manufacturers close to their source of materials."*

The Green Paper then went on to discuss three basic alternatives to the manufacturer's sales tax:

(1) to improve the current tax at the manufacturer's level;

(2) to move the tax to the wholesale level; or

(3) to move the tax to the retail level.

The Green Paper indicated a strong preference for moving the federal sales tax to the wholesale level. It stated that the marginal advantages of a retail sales tax over a tax imposed at the wholesale level, in terms of reducing major competitive distortions inherent in the existing system, did not appear sufficient to warrant serious consideration of a federal sales tax at the retail level. Although the Paper indicated a preference for a wholesale tax, it requested representations from the public on all alternative proposals.

In mid-1977 the Brown Paper Report of the Commodity Tax Review Group (consisting of officers from both the Department of Finance and the Department of National Revenue) was issued. The Report analysed approximately 200 submissions in response to the 1975 Green Paper. Of the 200 briefs received, approximately one-third favoured retention of the manufacturer's tax, about one-quarter favoured a retail tax and only 10% favoured a wholesale tax. The remainder either expressed no opinion on the question or suggested other options. Some of those who supported retention of the manufacturer's tax recommended that importers be licensed so that they became liable for tax on their sales in Canada, that the definition of "manufacturer" be expanded to include those persons who deal in private brand goods or who perform marginal manufacturing operations, provision of legal authority for current valuation measures, and provision for an effective appeals mechanism.

The Brown Paper did not disagree with the view that a retail sales tax would be the most neutral of the three types of commodity taxes. However, it believed that the increase in the degree of neutrality attainable by a retail tax was not sufficient to offset the problems of integrating such a tax with provincial retail sales taxes existing in nine provinces, and the additional administrative burden which would be imposed upon retailers. The Commodity Tax Review Group concluded that the most practicable and effective solution to the problems of the manufacturer's tax structure was a move to the wholesale level. Such a move would be the least disruptive of all the alternatives, in that the "substantial benefits it would yield may be achieved by relatively minor adjustments to the current system".

The November 1981 Budget announced the introduction of a wholesale tax; the Budget was followed by the April 1982 White Paper issued by the Minister of Finance on the "*Proposal to Shift the Federal Sales Tax to the Wholesale Trade Level*". The contents of this White Paper and accompanying draft legislation are discussed elsewhere in our Committee's Report. The Minister requested submissions from interested parties by the summer of 1982. As a result of over 125 submissions received, implementation of the wholesale tax was first postponed until January 1, 1983, and, subsequently, until at least mid-1984. In February 1983, the Federal Sales Tax Review Committee was appointed to study the wholesale tax proposal and to suggest alternatives.

IV The Wholesale Tax Proposal

1. November 12, 1981 Budget

The federal Budget of November 12, 1981 proposed major reforms of the federal sales tax. The tax, which in the past was levied on the sale of domestic goods by a manufacturer or on the importation into Canada of finished goods, was now to be imposed on the Canadian wholesaler or the last entity to sell to the retailer. In order to provide time to evaluate and understand the proposed changes, it was originally proposed that the wholesale tax not be implemented until July 1, 1982. The Finance Minister stated that the move to the wholesale level was not intended to raise additional revenues and, accordingly, the general federal sales tax rate would be reduced from 9% to 8%, effective January 1, 1983. The six month delay in the rate reduction was designed to offset a one time revenue loss resulting from refunds of the federal sales tax content of wholesaler's inventories at the transition date.

It was also announced that to ensure what was perceived to be a fairer application of federal sales taxes in the future, "large chain retailers" acquiring inventory directly from manufacturers would be subject to an additional tax in recognition of the wholesaling functions which many of them perform. The rate and manner of calculation of this tax was not announced at that time.

2. Proposed Legislation

On April 30, 1982 the Honourable Allan J. MacEachen, then Minister of Finance, tabled a paper in the House of Commons giving more details of the proposed federal sales tax reform. At the same time he postponed the effective date of implementation six months to January 1, 1983 and requested that interested parties make their views known by the end of June 1982. Draft legislation implementing portions of the proposed reform was tabled at the same time.

3. General Scheme

The draft legislation set out in greater detail the proposal in the November 12, 1981 Budget to shift the incidence of federal sales tax from the manufacturer to the wholesaler or the last trade level to sell to the retailer. The surtax on large retailers was also clarified: a "Large Retailer Tax" would be imposed upon all retailers whose purchases attracted more than $250,000 of sales and excise taxes in a year.

Excise tax on "luxury" items such as jewellery, watches and smokers' accessories would also be reduced from 10% to 8%. Other features not included in the draft legislation but proposed in the discussion paper included:

(a) interest would be paid on refund claims outstanding for more than 60 days after all necessary documentation had been filed;

(b) refund of the federal sales tax content of bad debts;

(c) formalization of assessment and appeals procedures in the same manner as presently applicable for income tax purposes; and

(d) transitional provisions for the refund of federal sales taxes on tax-paid inventory which is converted into tax-free inventory.

4. Liability for Tax

Generally, federal sales tax would be paid by the last person who sells goods to retailers. The term "wholesaler" was broadened to include a producer or a manufacturer, ensuring that their direct sales to retailers would also attract tax. All wholesalers would be required to be licensed, and current manufacturer's licences would be converted to wholesaler's licences. The $50,000 small manufacturer's exemption would be extended to wholesalers whose annual sales by wholesale did not exceed $50,000.

The legislation proposed deeming certain other parties to be wholesalers subject to licensing, even though they are really retailers. These deemed wholesalers were to include:

(a) duty-free sales outlets;

(b) suppliers to contractors, where such contractors acquired goods for supply and install contracts; and

(c) importers who sold certain prescribed goods such as large ships, aircraft, large computers and certain specialized equipment, which are generally sold directly by Canadian manufacturers to users.

5. Exemptions

Generally, the wholesaler would be required to pay tax on all sales to retailers, but some sales by wholesalers would not be taxable:

(a) sales to manufacturers for further production;

(b) sales of unconditionally exempt goods;

(c) sales to other wholesalers;

(d) sales of used goods previously taxed;

(e) export sales; and

(f) sales to exempt customers (such as hospitals).

6. Tax Base

Normally, the wholesale tax would be based on the price charged by the wholesaler. As under the existing manufacturer's sales tax system, certain other elements would also be included in the tax base, such as cost of packaging, charges for advertising, short term financing, servicing, storage, warranty and commissions (if such were not already included in the price charged for the product). The deductions from the sale price in arriving at the tax base, which were allowed administratively in the past and hence could not be appealed, would be formalized to a considerable extent in the proposed legislation.

The draft legislation provided for a deduction from the tax base for discounts or rebates, erection or installation costs and transportation costs.

The legislation proposed to correct a perceived inequality in the manner in which freight formed a part of the sales tax base. Importers of finished goods who were not wholesalers would pay federal sales tax on duty paid value plus freight costs to the first Canada Customs reporting point. On the other hand, domestic freight on the movement of finished goods in Canada (whether from the Canada Customs reporting point to the wholesaler, from the manufacturer to the wholesaler, or from the wholesaler to the retailer) would be deductible from the federal sales tax base.

However, a deduction would not be allowed with respect to domestic freight costs involved in bringing raw materials and work-in-process to the manufacturer. The determination of the freight deduction was expected to be complex for most wholesalers and would likely involve the use of formulae. It was suggested that Revenue Canada would promptly develop guidelines for use in this area.

7. Notional Values

Provided a wholesaler made at least 15% of his sales to retailers in representative quantities to two or more arm's-length customers, he could use a lower value in calculating tax on sales to end users. These notional values were similar in principle to the "established values" under the existing manufacturer's sales tax system. While in the past such notional valuation was allowed only by administrative practice and not provided for by statute, the rather complex mechanics of the proposed valuation scheme are included in the draft legislation.

8. Tax Rates

The general rate of federal sales tax would remain at 9% for six months after the implementation date of the shift of the sales tax to the wholesale level. At the end of this six month period, it was proposed that the general rate would drop to 8%. The tax rate on construction materials would remain at 5%, even though the incidence of sales tax on such goods would also shift to the wholesale level and the total amount of the tax collected would increase substantially.[3]

9. Timing of Payment

(a) Producers

Producers including "marginal manufacturers" would continue to carry inventory of raw materials, work-in-process and finished goods free of tax. If they sold taxable goods to retailers or end users, they would pay sales tax at the time of sale.

(b) Wholesalers

Wholesalers who sold goods by wholesale would be allowed to carry inventory either tax-paid or tax-free, depending upon the circumstances. The draft legislation provided guidelines for the determination of this question. The guidelines can be described as the "50/30" rules:

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[3] The Department of Finance has estimated the tax increase on building materials at $60 million on a total of $600 million. On the other hand, it has estimated that reduction of the general rate from 9% to 8% would involve an offsetting overall revenue loss of $60 million.

(i) If a wholesaler sold more than 50% of its total sales to retailers, it must acquire resale merchandise free from sales tax and account for tax at the time of sale. The wholesaler could apply this rule to its total business, any of its divisions or branches or any of its distinct product lines, based on the preceding calendar year.

(ii) Where sales to retailers were less than 30% of total sales, the wholesaler would still be licensed but goods would be acquired tax-paid. On sales to retailers, the wholesaler would be required to pay tax on the difference between its selling price to these customers and its cost.

(iii) Wholesalers who made between 30% and 50% of their sales to retailers would be allowed the option to carry inventory either tax-paid or tax-free and to account for taxes as discussed in (i) or (ii).

(c) Retailers

Retailers would normally purchase inventory tax-paid and arrange for a refund of taxes in situations where sales were made to exempt customers. However, under the draft legislation, retailers who made more than 50% of their sales of taxable goods under exempt conditions in the prior three month period could apply to be licensed and authorized to acquire inventory on a tax-free basis. It was proposed that the licence and authorization would be cancelled automatically if the retailer failed to meet the "more than 50%" requirement for three consecutive years.

This licensing arrangement whereby a retailer could carry inventory tax-free was provided for at a cost. Licensed retailers would be required to account for tax on sales to end users on not less than 105% of their cost price or duty paid value.

10. Certificates and Authorizations

Under the draft legislation the existing system of licensing by way of manufacturer's "S" licences, wholesaler's "W" licences and cosmetics "C" licences has been altered. As previously described, all manufacturers and wholesalers and some retailers would be required to be licensed. However, having a licence would not be sufficient to enable the licensee to acquire goods from a supplier tax-free. In order to do so, the licensee would apply to Revenue Canada for an "authorization". An authorization number would be required where goods were acquired for further production as well as for resale by the licensee.

Authorizations would be granted in respect of a corporation as a whole, or restricted to its wholesale business, or the wholesale business of a division or branch, or the wholesale business in a distinct line or class of goods.

The draft legislation provided for cancellation of such authorizations by Revenue Canada for any reason, including a decline below the 30% level of sales by a wholesaler to retailers in each of the three preceding tax years.

Entities holding "W" wholesaler's licences under the existing manufacturer's sales tax system would be required to requalify under the new system. Should such organizations fail to meet the new guidelines they would not receive an authorization and would be required to convert tax-exempt inventory into tax-paid inventory at the implementation date of the new legislation.

11. Deemed Sales

The draft legislation also ensured that certain events, which were not in themselves sales, would be treated as such for federal sales tax purposes, resulting in the payment of sales tax at the time the specified activity occurred. These taxable events included:

(a) cessation of business by a wholesaler with tax-free inventory;

(b) commencement of the lease of goods on which no tax had been previously paid;

(c) production of goods from articles or materials supplied by another person; for delivery to that person;

(d) transfer by a wholesaler to a non-arm's-length retailer;

(e) transfer by a wholesaler of goods on consignment to any retailer;

(f) appropriation of goods for the wholesaler's own use; and

(g) giving away of free goods by a wholesaler except for replacement goods supplied under a written warranty and samples of goods that he usually sells in Canada.

12. Sales to Contractors and Repair Shops

The treatment of sales to contractors and repair shops required special consideration. Their treatment would depend on whether the vendor selling to them held inventories on a tax-paid or tax-free basis. If the vendor was primarily a wholesaler he would usually acquire inventories free from tax and all sales, including sales to contractors, would be subject to tax on the sale price. However, if the vendor was primarily a retailer, inventories would normally be acquired on a tax-paid basis and sales to contractors or repair shops from such tax-paid inventories would be exempt from further tax, as long as the contractor certified that he was buying the goods for installation under a supply and install contract rather than for resale.

13. Large Retailer Tax (LRT)

It was proposed that LRT would be imposed on any retailer or group of associated retailers whose annual sales and excise taxes payable ("Annual Tax Content") on goods acquired for resale exceeded $250,000. Associated retail groups would be treated as a single entity for the purposes of this tax. "Association" would be determined using rules which were very similar to those in use currently for income tax purposes.

(a) Calculation of Tax

Where the Annual Tax Content of a retailer or an associated group of retailers exceeded $750,000 LRT would be calculated as 15% of Annual Tax Content. This equates to an increase of 1.35% on sales tax at 9%, 1.2% on sales tax at 8% and 0.75% on sales tax at 5%.

Where the Annual Tax Content of a retailer or an associated group of retailers was between $250,000 and $750,000 a graduated tax liability was proposed in order to avoid a gross disparity between those retailers just above and those just below the

$250,000 threshold. For every $2 that the Annual Tax Content was below $750,000 a deduction of $1 would be allowed from the tax base up to a maximum of $250,000.

Associated retailer groups would be considered as single entities for LRT purposes so that the $250,000 threshold would be allocated among the individual members of the group in order to determine the annual deduction.

(b) Exemptions

Certain classes of goods would be exempted from LRT. While such exemptions were not clearly identified in the draft legislation, they were enumerated in the proposal paper and are listed below:

(i) "big ticket items" that do not normally flow through wholesalers, including automobiles, trucks and aircraft;

(ii) purchases of goods produced off-site in competition with on-site construction;

(iii) tobacco products and alcoholic beverages (which would still be taxed at the manufacturer's level);

(iv) contractors' purchases for real property contracts only;

(v) purchases of goods subsequently resold on a tax-exempt basis;

(vi) purchases of goods sold to another retailer; and

(vii) purchases by retailers who have elected to be licensed as wholesalers.

(c) Remittance

Remittance of LRT would be required by way of monthly instalments. The provisions for calculating these instalments would closely parallel those applying currently to corporation income tax instalments. Any balance owing would be due not later than three months after the end of the taxation year. Special rules would be provided for short taxation years and for associated groups of retailers.

V. Analysis of the Proposed Wholesale Tax

1. Advantages

The Department of Finance's White Paper of April 1982 stated that an ideal sales tax is one that provides fiscal flexibility to the taxing authority while achieving the highest degree of neutrality and certainty with the least administrative burden. This means that a good sales tax should:

(i) be neutral in its impact on competing taxable goods and between imported goods and domestically produced goods;

(ii) be imposed under a clear and concise statute which requires only simple administrative procedures and includes a minimum number of exceptions so that taxpayers may determine their tax liability with certainty;

(iii) impose the least possible compliance burden on both taxpayers and Revenue Canada; and

(iv) be capable of, and quickly responsive to, change to achieve desired fiscal and other economic policies.

The 1982 White Paper indicated that when the present sales tax system was implemented about 60 years ago it met most of these criteria. At that time both imported and domestically produced goods generally flowed through wholesalers and thus were taxed at a common point which was on acquisition by wholesalers. Over time, however, major changes have occurred in the marketing of manufactured goods in Canada. For example, the White Paper stated that while imported goods continue in most cases to flow through wholesalers and are taxed on the wholesaler's acquisition costs, Canadian manufacturers now sell a large proportion of their goods directly to retailers and users and those goods are often taxed on their sale price to retailers and users. The paper went on to state that marketing costs incurred by wholesalers are generally not taxed, although similar costs incurred by manufacturers who sell directly to retailers are taxed. Imported goods may enjoy a tax advantage over domestically produced goods because advertising, warranty and other marketing costs incurred in Canada, which are typically included in the taxable value of domestic goods, may not be reflected in the taxable value of imports. Freight costs incurred by domestic manufacturers on their raw materials are an element of the manufacturer's sale price and thus are taxed, whereas freight costs incurred in delivering imported, fully manufactured goods to Canada are generally not included in the value on which the tax on imported goods is calculated.

According to the Department of Finance the advantages of the wholesale tax are that it would:

"(i) remove the present bias against domestically produced goods;

(ii) achieve a more uniform tax burden on competing domestic manufacturers marketing their goods in different ways in Canada;

(iii) cause the tax to be calculated on the actual sale price in most instances, thereby obviating many of the discretionary adjustments and taxable values now made by Revenue Canada;

(iv) permit the introduction of an effective appeal mechanism;

(v) facilitate administration by eliminating many refund claims from wholesalers and retailers who have made sales of tax-paid goods to customers entitled to an exemption;

(vi) allow wholesalers to obtain their inventories exempt of tax and thus reduce their costs of inventories by an estimated $400 million; and

(vii) permit lowering the general rate from 9% to 8%" [since temporarily increased by 1% from 1984 to 1988 in the Spring 1983 Budget]."

In the Committee's view, the most important benefit to be derived from a wholesale tax would be an improvement in tax neutrality as between domestically manufactured goods and finished goods imported by a wholesaler and as regards wholesaler's private branded goods.

2. Disadvantages

(a) Untaxed Functions

When one examines the criteria by which a good sales tax is judged, on the whole a wholesale tax appears to be more neutral in its impact on competing taxable goods than a manufacturer's tax. However, a wholesale tax is far from being completely neutral in its impact. Particularly as regards direct imports by retailers and retailers' private branded goods, certain wholesaling functions may escape taxation. As well, in certain other industries such as direct selling enterprises (door-to-door businesses) and some franchised operations, certain retailing functions are included in the wholesaler's price and therefore the tax base appears to be too high.

(b) LRT Deficiencies

The Department of Finance has indicated one reason for the Large Retailer Tax was to deal with the problems of private branded goods and direct imports by retailers. However, the Large Retailer Tax is a blunt instrument which is unable to discriminate between the type and significance of wholesaling functions undertaken by different retailing firms. For example, two retailing firms with roughly the same size operations would bear the same amount of Large Retailer Tax even though one had no wholesaling operations whatever and the other undertook significant wholesaling operations.

Franchise operations and retailer buying groups probably largely avoid the application of LRT. Thus, the proposal would induce distortions in commercial arrangements. It would also involve costly procedures for implementation of the tax and for preparing annual returns.

(c) Retailer Margins

Not only does the wholesale tax not address functions which should be included in the base but which are performed after the point at which tax is levied but it also

ignores the disparity in the tax content of consumer purchases of taxable goods arising from differences in retail margins. Such retail margins are probably far greater than wholesale margins for most goods. Therefore, the goal of neutrality is not achieved because the tax content of the consumer's dollar spent on products having a high retail markup will be much less than that of the same dollar spent on products having a low retail markup.

(d) Notional Values

The Department of Finance has stated that a good sales tax should be imposed under a clear and concise statute and impose the least possible compliance burden on both taxpayers and Revenue Canada and has suggested that one of the advantages of a wholesale tax is that it will "cause the tax to be collected on the actual sale price in most instances thereby obviating many of the discretionary adjustments and taxable values now made by Revenue Canada".

However, as previously described, a wholesaler, under the government proposal, would be able to elect to use an alternative "notional" value in situations where it sells at more than one trade level or where it has certain"deemed" sales. The taxpayer is given the opportunity to use four different methods which involve calculating average sale prices (or average discounts from list) for a previous month or three months for each of the taxpayer's products, with an option to refine this method by doing such calculations by marketing region. As well, a fifth alternative allows Revenue Canada to prescribe notional values.

The legislation understandably is long, complex and difficult to understand. Calculation of averages for notional valuation must be done monthly. A company with hundreds or thousands of products might require long and complex analysis by computer to come up with such values. It is unclear how the calculation of such notional values would be adjusted for or normalized for such items as volume discounts granted quarterly or annually, late transportation deductions and other similar items.

The calculation of these values might be cumbersome, misleading and difficult where it is unclear who the customer is. This is especially a problem in the auto parts industry where complex transactions may occur and products may flow through a number of wholesalers each of whom may mark up the goods.

In summary, as a result of the introduction of the deemed sale provisions and a number of multi-tiered sales situations, it appears that in a large number of situations tax will instead be collected on a notional value. However, in some situations, tax will be collected on actual sale price because it is too complicated, cumbersome, confusing, time-consuming and expensive to calculate notional values continuously each month.

(e) Transportation Deductions

The manner in which the Department of Finance allows for deductions for transportation from the tax base discriminates against situations in which goods move from one wholesaler to another or between different wholesale outlets of the same wholesaler. Where goods are shipped from a manufacturer directly to retailers, none of the freight is taxed. However, where goods move from a producer to retailers through two or more wholesalers, some of the freight attracts tax. Analogous problems may arise in respect of imports of goods.

(f) Buying Groups

A wholesale tax might encourage retailers to form buying groups that do not take title to the goods, bypass the traditional wholesaler, purchase directly from the manufacturer and thereby reduce the tax base. It may even be feasible for a similar reduction to be achieved by having a wholesaler act as the agent of one or more retailers. One might question whether this type of move will not weaken the role of the wholesaler in today's economy. Since one criterion of a good tax is that it does not induce tax motivated changes in business practices, this is a serious criticism.

(g) Deemed Sales

As previously mentioned, it has been proposed that federal sales tax be paid, *inter alia*, upon cessation of a business, transfers to a wholesaler's own retail stores, and consignments of goods.

In theory, a sales tax should be imposed only at the time goods are sold. However, in the deemed sale situations tax is payable before the sale of the goods and before any monies have been received by the vendor with which to pay the tax. For example, oriental carpets are frequently delivered for consignment by importers to retailers, who may hold them for long periods before they are sold. Transfers by a wholesaler to its own retail stores also require payment of tax on an imputed wholesale markup. Serious administrative difficulties arise in establishing taxable values in such situations and in keeping track of such values in order to be able to adjust taxes payable if goods are transferred or returned at a price which varies from the deemed value on which tax was initially paid.

(h) Contractors and Repair Shops

Admittedly, treatment of sales to real property contractors and sales to repair shops is a complex problem for which no easy solution is possible. However, treating these purchasers as retailers for the purposes of the wholesale tax would be both cumbersome and unworkable in some situations. Contractors would be encouraged to search out suppliers with tax-paid inventories in order to obtain price reductions since the supplier would not have to pay tax on its mark-up. Suppliers holding tax-free inventories, who would be obliged to pay tax on their selling prices to such contractors, would be at a competitive disadvantage. In addition, vendors will be required to determine the business status of the parties to whom goods are being sold. These problems would be particularly acute for real property contractors.

(i) Licensing

A good sales tax should impose the least possible compliance burden and cost on both taxpayers and Revenue Canada. The wholesale tax appears to involve at least 20,000 more licensees than the present system. In addition, its reliance on authorizations and the "50/30" rules will not only cause increased paper work and unproductive administrative procedures, such as keeping track of the exchange of goods among retailers, the collection of exemption certificates from contractors and repair shops and the need to analyse the categories of purchasers on a continuing basis, but it will also lead to disparities between authorized and unauthorized firms.

(j) Transitional Provisions

Under the wholesale tax certain firms would be required to convert tax-paid inventory to tax-free inventory. The details which have been released indicate that those firms who have consistently purchased inventory on a tax-included basis would be required to absorb an arbitrary 25% discount in obtaining a refund on the sales tax content of such inventory unless they can definitely establish the tax content of the inventory supplied to them and on hand at the transition date. Notwithstanding that some of such inventory will have been acquired from other distributors, in which case some discount is warranted, where goods have been purchased from the manufacturers of those products it is unfair to require wholesalers to absorb a 25% discount and thereby to obtain a refund which in some cases is less than the tax actually paid.

Other costs related to the conversion will not be minimal for most firms. Such firms will be required to make costly adjustments to computer systems, invoices, purchase orders, internal records, catalogues and price lists. They may also be required to renegotiate existing contracts for the supply of goods and services. For companies using notional values, major adjustments will be required to comply with new rules while other companies will find notional values available to them for the first time. Companies which have never used notional values will have to adapt to this complicated system. In fact, for at least 20,000 new licensees under a wholesale tax system, all of the rules must be mastered including tax calculation (rules for determining sale prices and allowable deductions from sale price such as discounts, transportation and installation, etc.) notional valuation and tax payment.

Certain firms will face further complexity when attempting to cope with the calculation requirements of the Large Retailer Tax, the special rules for contractors, the necessity, in some circumstances, to identify freight-in to ensure its deductibility, and the need to calculate the foreign freight component of certain imports.

VI. Taxation of Gasoline and Diesel Fuel

The Committee has actually been able to study a Canadian wholesale tax system in operation. In April 1980 the tax on motive fuels was returned to the *ad valorem* basis and the tax level shifted to the wholesaler, by deeming wholesalers to be manufacturers. Serious problems have arisen in calculating these taxes which have been exacerbated by the increasing volatility of the gasoline market. Many major oil companies make a large percentage of their sales directly to consumers either through company operated service stations or through consignment sales by independent service stations. Notional values must be established for such transactions by reference to the prices at which sales are made to independent retailers who purchase for resale to consumers, requiring an immense amount of calculation to arrive at notional values.

This problem is compounded when one considers that the oil companies may have several hundred specific zones for which separate calculations must be made. Since not all companies sell in the same areas and in the same volumes it is likely that a notional value established by one company in one zone may not be exactly the same as that established by another company for a similar zone and thus there may be differences in the tax content of the consumer dollar spent on fuels between competing brands even in the same area. Since only a few grades of motive fuels are sold and since the products are quite similar from company to company we question the need for the usual type of *ad valorem* tax. A move back to a unit per litre tax on sales of motive fuels would greatly simplify and equalize the tax-paying situation, even if this figure had to be changed each month to reflect price changes in the retail market.

Such a procedure is currently being used by the provinces to collect provincial motive fuel taxes. While specific methodology varies among the provinces, generally the provincial tax is levied as a fixed percentage of "an average retail price" determined and fixed, usually on a quarterly basis, by means of a representative statistical sampling of prices of that fuel.

VII. Modifying the Manufacturer's Sales Tax As an Interim Solution

The Committee fully recognizes the defects in the present manufacturer's sales tax which have motivated the proposal to shift to a wholesale tax, that is, to a tax levied on the prices paid by retailers, whether they purchase from manufacturers, distributors or wholesalers or whether they import directly. While, on balance, we are not prepared to recommend such a change, we are not content to leave the manufacturer's sales tax in its present form. Its defects will, however, have to be addressed within the framework of the present tax system until the Government is ready, willing and able to institute some form of tax at the consumer level in its place.

The defects which must be addressed are the following:

1. The tax advantage which imported goods enjoy in some circumstances over competing domestically produced goods.

2. The absence of a legally valid, workable system of discounts from a manufacturer's actual selling prices, in order to deal with the disparity of tax burden on domestic goods marketed through different distribution channels.

3. Defects in the concept of marginal manufacturing.

4. The proper tax treatment of wholesaler's and retailer's private brands.

5. Establishing a proper assessment and appeal procedure.

6. Providing an allowance for sales tax purposes in respect of a manufacturer's bad debts.

7. Eliminating criminal penalties for non-payment of tax, not amounting to tax evasion.

8. Eliminating the liability of an innocent vendor in respect of incorrect exemption certificates supplied to him by purchasers.

1. Countering the Tax Advantage Enjoyed by Some Imported Goods

There can be little doubt that in certain circumstances the present tax system favours imported goods over competing domestically produced goods. For example, whereas a Canadian manufacturer of a product which does not go through the wholesale level in Canada, but is sold directly to retailers, ordinarily pays tax on his selling price to these retailers, a Canadian importer of similar goods who also sells to retailers pays tax on the duty paid value, i.e., on the value for duty plus customs duty, if any. (Duty paid value will in many cases be equivalent to landed cost, exclusive of inbound transportation charges, but these figures are not necessarily equivalent where special valuation

rules apply under the Customs Act).[4] All the costs associated with warehousing, advertising and selling such imported goods, as well as the importer's profit margin, escape sales taxes in these circumstances, whereas they are fully taxed when domestically produced goods are sold.

One sees this problem most clearly when one compares the sales tax treatment of automobiles produced and sold in Canada with that of automobiles produced in Japan and sold in Canada. Analysis of information derived from Statistics Canada catalogues no. 63-007 and 65-007, shows that in 1982 the average Japanese car imported into Canada had a value for duty of $5,046. Using the 1983 duty rate of 12.1% the duty would amount to $611. Sales tax at 9%, amounting to $509, was payable on the duty paid value of $5,657. The average retail price of these automobiles was $8,706, excluding provincial sales tax, and the average cost to the dealer, excluding federal sales tax, was estimated at $6,963. If this automobile had been produced in Canada and if it had been sold to the dealer for the same figure of $6,963 plus sales tax, the federal sales tax would have been levied on this figure and would have amounted to $627, a difference of $118 per automobile, or 23.2%. A similar calculation in respect of light trucks indicates a differential of $158 per truck or 32.1%. In 1982 about 178,000 Japanese cars and 34,000 Japanese light trucks were sold in Canada, with the result that the total sales tax advantage enjoyed by imported Japanese automobiles and light trucks amounted to about $26,400,000. Many other examples of such tax differentials are available. However, the importance of automobiles in terms of sales tax revenue makes this example most dramatic. It is estimated that the tax on motor vehicles currently accounts for 12 to 13% of total sales tax revenues.[5]

The example which has been given involves a domestic industry in which goods are sold directly by manufacturers to retailers, where tax is charged on actual selling prices to these retailers, while competing goods are imported by wholesalers who also sell to retailers, but who pay tax on the duty paid value of their imports. However, there are other situations in which analogous types of discrimination take place:

(a) where a Canadian manufacturer of automobile parts sells to wholesalers and accounts for tax on his actual selling prices, whose competing goods are imported by a distributor who also sells to wholesalers but who pays tax on the duty paid value of his imports; and

(b) where a Canadian manufacturer of office machines sells to users and accounts for tax on his actual selling prices, while competing goods are imported by a retailer who also sells to users but who pays tax on the duty paid value of his imports.

In all these cases, we can deal with these problems within the framework of a manufacturer's sales tax by amending the present statute in order to permit the tax authorities to deem these importers to be manufacturers for sales tax purposes. Deeming someone

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[4] The present Canadian customs valuation rules will be replaced on January 1, 1985 by new rules adopted at the Tokyo Round of GATT negotiations. The effect of these new rules will be to eliminate a number of features of the present rules which artificially increase value for duty and provide greater tariff protection for Canadian imports. Since imported goods are subject to sales tax on their duty paid value (i.e., on their value for duty plus the duty), there may be a significant reduction in the sales tax on many imported goods, commencing in 1985, which will make the need for change in the sales tax rules more urgent.

[5] An anomalous situation exists with regard to U.S.-made automobiles which are imported duty free under the Auto Pact; this situation is described on p. 36 of this Report.

to be a manufacturer who would not ordinarily be so regarded would not be a novel feature of the Excise Tax Act; the present subsection 2(1) already includes a number of provisions which deem certain persons to be manufacturers. An importer who would be deemed to be a manufacturer would have a licence entitling him to avoid payment of sales tax at the time he brought the goods into Canada, but he would be required to pay sales tax on his sales.

Our proposal is that if importers of a particular kind of goods are selling them to persons who are at the trade level at which Canadian manufacturers of that kind of goods are paying tax, a procedure should be adopted whereby these importers will be deemed to be manufacturers. Then, the sales which they make to persons at the trade level at which Canadian manufacturers are paying tax will also be taxed at that level. To revert to the example of imported automobiles, since importers sell to retailers and Canadian manufacturers also sell to retailers and pay tax on the selling price to retailers, these importers would be deemed to be manufacturers. However, if a retailer imported automobiles, he would continue to pay tax on their duty paid value. If the importer made some of his sales to retailers and some directly to users, at higher prices, he would still be required to be licensed as a manufacturer. However, while he would pay tax on his sales to retailers based on his actual selling prices to them, he would pay tax on his sales to users, based on the prices charged to retailers, in accordance with our proposal relating to notional values.

It is important to recognize that this proposal is not intended to require all importers to be licensed as manufacturers. If we revert to the three examples previously given and modify them somewhat, this can be clearly demonstrated:

(a) If Canadian manufacturers sell to wholesalers and account for tax on their sales at that trade level, an importer who sold to retailers would not be deemed to be a manufacturer and would continue to pay tax on the duty paid value at the time of importation.[6]

(b) If Canadian manufacturers sell to distributors and account for tax on their sales at that trade level, an importer who sold to wholesalers would not be deemed to be a manufacturer.

(c) If Canadian manufacturers sell to users and account for tax on their sales at that trade level, an importer who bought for his own use would not be deemed to be a manufacturer.

Subsection 32(1) and paragraph 49(1)(a) of the draft legislation proposed a somewhat similar solution, within the framework of the wholesale tax, in order to deal with the tax advantage which might be enjoyed by retailers who imported goods for resale to users, where Canadian manufacturers of such items as telecommunications equipment sold

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[6] In theory, tax will be levied on the cost to the wholesaler, which is the same trade level as the duty paid value in respect of which tax is paid by the importer. In fact, however, the manufacturer may remain at a disadvantage, since the importer may be performing functions akin to those performed by the manufacturer, although those functions are not captured in the sales tax base. We can find no mechanism other than a reference to trade level which simultaneously offers redress to the manufacturer, natural justice to the importer and guidance to the courts. No solution short of a shift in the application of the tax to the retail level can redress these potential disadvantages.

Similar reasoning applies to the two following examples.

them directly to users. The proposal which we have made is similar in concept to that proposed in these draft provisions relating to the wholesale tax, although it is framed in terms of a manufacturer's sales tax.

The terms of reference of the Committee require that we recommend solutions that "do not contravene Canada's obligations under GATT and will not cause retaliation by its international trading partners." We have requested legal opinions from the Department of Justice on this important question and we are satisfied that since the effect of our proposal would simply be to equalize the taxes imposed on domestic and imported goods, rather than to discriminate against imported goods, it ought not to be regarded as infringing our obligations under the General Agreement on Tariffs and Trade.

Since the proposal involves the levying of an internal, indirect tax on imported goods, the compatibility of this proposal with the GATT requires an analysis of Article III of the Agreement.

The critical internal tax provisions of Article III are paragraphs 1 and 2.

> *"1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.*
>
> *2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1".*

Paragraph 1 states the general principle that internal taxes should not be applied so as to afford protection to domestic production. The first sentence of paragraph 2 prohibits discriminatory taxes on like imported products, which are not to be subject directly or indirectly to internal taxes in excess of those applied directly or indirectly to like domestic production. The second sentence of that paragraph prohibits the imposition of internal taxes on imported or domestic products in a manner that would afford protection to domestic production.

The converse situation, such as the one with which we are concerned, where the application of an internal tax discriminates against domestic production, has been considered by a number of GATT working groups. The concept of imposing "equalization charges" upon imports so as not to discriminate against domestic production appears to be accepted both by the OECD and by the GATT. Such equalization charges may be imposed even if the customs duties on the goods have been the subject of international agreement in GATT tariff negotiations. Thus, where an equalization charge is imposed on the imported goods so as to eliminate the discrimination against domestic goods caused by the application of the internal tax, there can be no valid charge of violation of the principles of Article III. There seems no reason why the amount of tax exigible on imports could not vary from product to product, depending upon the trading pattern and the degree of integration in the distribution network.

The procedure to be followed in deeming an importer to be a manufacturer must meet the requirements of natural justice. The Committee is concerned that the proposed subsection 32(1) and paragraph 49(1)(a) of the draft amendments simply provide for a regulation to be made by the Governor-in-Council treating the importer of a particular class of goods as a wholesaler for the purposes of the wholesale tax, without any procedural safeguards whatever. We suggest that before any importer is deemed to be a manufacturer a two-level procedure should be followed, commencing in the Excise Branch of the Department of National Revenue but with a right of appeal to the Tariff Board.

This type of proceeding would ordinarily be initiated by a Canadian manufacturer who complained to the Excise Branch that imported goods which competed with his own production enjoyed a tax advantage. However, the Excise Branch could itself initiate the proceeding. The Minister would then notify all interested parties and publish a notice in the Canada Gazette. A relatively informal hearing would then take place within the Excise Branch (perhaps in consultation with the Department of Finance and the Department of Industry, Trade and Commerce) concerning the trading patterns in respect of both domestic and imported goods, resulting in a published decision as to whether or not the Minister would recommend to the Governor-in-Council that this particular class of imported goods be made subject to a regulation treating as manufacturers those importers who sell to persons who are at the same trade level as that at which Canadian manufacturers of such goods are paying tax.

If no appeal were lodged from this decision within a certain period of time, the recommendation would go forward to the Governor-in-Council and, presumably, an Order-in-Council would then be made. However, it would be possible for an interested party who objected to it to appeal the Minister's decision to the Tariff Board, which would then hear the matter, in a more formal manner, upon appropriate notice to all interested parties, including publication in the Canada Gazette.[7] If the Tariff Board so decided, it would recommend to the Minister that he recommend to the Governor-in-Council that an appropriate Order-in-Council be issued in respect of the particular class of goods. The Tariff Board's decision should not of itself have the effect of changing the law and requiring an importer to be treated as a manufacturer; it should operate only as a recommendation to the Minister, which he may choose to accept or reject, but he should be prepared to justify his action to Parliament.[8]

In order to simplify the administration of this proposal, we suggest that an importer who would otherwise be deemed to be a manufacturer under this proposal should have the option to avoid the complications of licensing and accounting for tax on his sales by paying a surcharge or "uplift" on the sales tax which is payable at the time of importation. The amount of this "uplift" would be set by Order-in-Council on the recommendation of the Minister of National Revenue, as part of the procedure for deeming importers to be manufacturers in respect of a particular product. The amount would be such as would, in the opinion of the Excise Branch, roughly equate the sales tax positions in respect of imported and domestic goods.

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[7] The experience of the Tariff Board in dealing with many difficult customs and sales tax matters recommends it as the appropriate tribunal to handle these appeals. However, its personnel might have to be increased in order to deal with the additional duties which we have proposed for it under this recommendation and the others we are making.

[8] One might imagine a situation where the Tariff Board was not prepared to recommend that importers of a particular product be deemed to be manufacturers, but the Minister may be more concerned about unemployment in the Canadian firms manufacturing that product and might decide that it was in the national interest to treat these importers as manufacturers.

In some cases it may be more convenient for the Minister to combat tax discrimination in favour of imported goods by giving Canadian manufacturers the right to account for tax on a lower determined value, which would have the effect of bringing the price level on which they would pay tax to one which was comparable to the duty paid value of imported goods.[9] We do not rule out this alternative solution to the problem, particularly where the volume of imports is large and the volume of Canadian production is small.

An objection may perhaps be raised to this proposal, on the ground that it does not require the issuance of licences to second and third tier wholesalers, in situations where domestically produced goods are sold directly by manufacturers to retailers and tax is paid on their actual selling prices to retailers. If only the actual importer of competing goods were required to be licensed as a manufacturer, any wholesalers to whom he sold or to whom purchasers from him sold would not be affected and the tax discrimination in favour of imported goods would not be entirely eliminated. However, it seems to us unlikely that there would be any second or third tier wholesalers dealing in imported goods in situations where that particular kind of domestic good was sold directly from manufacturers to retailers. In addition, the difficulty of tracing and identifying the goods after they have been imported and sold by the actual importer and when they are in the hands of second and third tier wholesalers, particularly those who deal in many kinds of goods, seems formidable.

A more serious question arises as to whether our proposal could result in encouraging foreign exporters to set up Canadian subsidiaries to act as importer-distributors and to resell their products to wholesalers who previously imported directly on their own account. Even if the foreign exporter's Canadian subsidiary were deemed to be a manufacturer and required to pay tax on its selling price, its markup would be relatively modest and the tax advantage enjoyed by imported goods would continue. However, it seems to us that this situation is also unlikely to occur very often, since an importer would be unlikely to encourage the establishment of such a Canadian subsidiary by his foreign supplier with whom he dealt at arm's length, for fear that it might lead to his displacement. If the Canadian wholesaler did not deal at arm's length with the foreign supplier and its Canadian subsidiary, the transfer price could be adjusted for tax purposes by the Minister under the present section 34, as amended in accordance with our proposals. Finally, if the Canadian subsidiary of the foreign supplier were merely a company without visible functions apart from invoicing, jurisprudence of long standing under the Excise Tax Act could be used to justify treating it as a sham and ignoring it for sales tax purposes.[10]

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[9] It is interesting to note that between 1923 and 1943 the Special War Revenue Act (subsequently renamed the Excise Tax Act) provided for a refund or reduction of sales tax, not exceeding 25%, for goods manufactured or produced in Canada, when similar goods were imported into Canada free of customs duty and evidence satisfactory to the Minister was produced that such Canadian goods were at a disadvantage in competition with similar imported goods. Presumably, any disadvantages relating to imported goods which were subject to customs duty could be dealt with by suitable adjustments to the rates of duty.

[10] An alternative approach to the one suggested in the body of this report has been proposed to us, based on the view that the problem of sales tax discrimination in favour of imported goods is primarily either a private brand problem or one involving exclusive distribution rights. The solution proposed involves expanding the definition of those who are deemed to be manufacturers or producers under the present paragraph 2(1)(b) of the Excise Tax Act to include all those non-manufacturers who either own private brand trade marks or trade names or who have exclusive distribution rights which effectively give them control over such trade marks or trade names in Canada. *(continued on p. 31)*

RECOMMENDATION NO. 1

If importers of a particular kind of goods sell them to persons who are at the trade level at which Canadian manufacturers of that kind of goods are paying sales tax, the Excise Tax Act should provide a procedure by which such importers can be deemed for sales tax purposes to be manufacturers and required to be licensed and to pay sales tax at the same trade level. However, such importers should have the alternative of paying a surcharge or "uplift" at the time of importation, if they do not wish to be licensed as manufacturers. In some cases, where the volume of imports of a particular kind of goods is large and the volume of Canadian production is small, the Canadian manufacturer could instead be allowed to pay tax on a lower determined value, comparable to the duty paid value of competing imported goods.

2. Treatment of Notional Values under a Modified Manufacturer's Sales Tax System

One of the least satisfactory aspects of the present Excise Tax Act is its treatment of notional values. Although the Act requires that sales tax be paid on the actual selling price of goods sold by a manufacturer, it was recognized long ago that a literal application of this requirement would create great unfairness when goods were sold by a manufacturer to more than one trade level of customer. For example, if a manufacturer sold a particular item to wholesalers for $1.00 per unit, to retailers for $1.20, and directly to consumers for $1.50, and if tax had to be charged at, say, 10% on all these prices, a wholesaler who paid tax of only 10¢ per unit would enjoy a competitive advantage in dealing with retailers over the manufacturer himself, who would have to charge 12¢ per unit on his sales to retailers. Similarly, if the manufacturer had to charge 15¢ tax on his sales to users, he would be at a competitive disadvantage as compared with both wholesalers and retailers.

It is certainly true that most imported goods which are generally regarded as enjoying a sales tax advantage over domestically-produced goods bear trade marks or trade names which are extensively advertised. However, where these trade marks or trade names belong to the importer, the problem which we face is not essentially different from the general private brand situation which exists in respect of all domestically-produced goods that are sold under the private brand of a wholesaler or retailer. The difficulty in extending paragraph 2(1)(b) to include all wholesaler's and retailer's private brands is referred to elsewhere in this report; although the matter is not free from doubt, we are not prepared to recommend such extension.

However, in the more typical case, the trade mark or trade name of imported goods belongs to a foreign manufacturer and the goods are advertised and promoted in Canada by an exclusive Canadian distributor. In some cases this exclusive distributor is a subsidiary or affiliate of the foreign manufacturer, but in other cases there is a true arm's-length relationship. An arm's-length distributor can be expected to engage in extensive advertising and marketing of a product only if his distributorship rights are protected by a contract of some reasonable duration. It has been suggested that where an importer has exclusive Canadian distribution rights for an imported product he ought to be treated as the manufacturer for sales tax purposes, under an extended version of paragraph 2(1)(b), even though the trade mark or trade name belongs to the exporter. At first blush, this does not seem at all unreasonable in principle, particularly since such distributors in many cases sell to the same trade levels of customers as do Canadian manufacturers; distributors of imported automobiles come first to mind, since they carry on extensive advertising activities.

However, there are a number of problems which have to be faced if this concept is to be adopted:

1. Some imported brand name products are marketed in Canada by importers who have exclusive distribution rights only in their own regions and who are not permitted to sell in other regions. If, for example, a foreign manufacturer has appointed exclusive distributors for each of five regions, the Atlantic provinces, Quebec, Ontario, the Prairie provinces and British Columbia, each of whom is independent of the others and of the exporter, none of them would qualify as the exclusive Canadian

(continued on p. 32)

In order to deal with these situations, an administrative practice was developed whereby a manufacturer could, in certain circumstances, account for tax on all his sales to retailers and consumers at the price he charged to wholesalers, called the "established wholesale value", provided that a certain minimum percentage of sales were made to wholesalers with whom he dealt at arm's length. For example, paragraph 6 of Memorandum ET-202 provides:

> *"A manufacturer who has an established price to wholesalers for goods of his manufacture may account for tax on shipment or transfer of these goods from his manufacturing premises or his wholesale branch*
>
> *(a) on sale to retailers or users, or*
>
> *(b) on consignment (except salesmen's samples), or*
>
> *(c) for stock in his retail branch*
>
> *computed on his established price to wholesalers, except where specific instructions to the contrary have been issued."*

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distributor and yet there would be little reason to treat them differently for sales tax purposes than an exclusive Canadian distributor.

2. In some cases, an importer may not have any sales tax advantage at all over a Canadian manufacturer, even if he has an exclusive right to distribute an imported product in Canada. If the importer does not engage in extensive advertising of the product and if he is not obliged to finance major marketing activities, but merely carries on relatively modest selling efforts, as would be quite common with goods which are purchased primarily by businesses or institutions, it would be difficult to justify treating him as the manufacturer for sales tax purposes.

3. It is by no means inconceivable that a distribution contract, even one negotiated at arm's length, could appear on its face to involve a non-exclusive distribution right in Canada. However, it may be terminable on relatively short notice and the parties may have an oral understanding that it will be terminated by the distributor if the foreign manufacturer appoints any other distributor. In order to deal with this type of situation, it might be necessary for the law to deem a non-exclusive distributor to be the manufacturer of an imported product if he accounted for some very large percentage, say, 80% of the volume of imports over a period of years. However, where other Canadian importers were not merely casual dealers in these goods, it would be unfair to treat only the largest importer as a manufacturer. Giving the Minister of National Revenue discretion to deem the largest importer to be a manufacturer for sales tax purposes does not seem to improve this situation.

4. The proposal would affect imports of private branded goods and imports of goods which are subject to exclusive or nearly exclusive distribution rights even where there are no Canadian-made equivalents and where no disparity can exist between imported and domestically-produced goods.

5. It would be inappropriate, and perhaps contrary to Canada's obligations under GATT, to treat an exclusive distributor of an imported product as the manufacturer for sales tax purposes unless exclusive distributors of domestically-produced product were similarly treated. We have been unable to arrive at a satisfactory method of dealing with the domestic private brand situation and we have recommended against any extension of paragraph 2(1)(b) to include all wholesaler's and retailer's private brands. We would be inconsistent if we were to treat exclusive distribution rights in respect of domestically-produced goods as being sufficient to cause the distributor to be deemed to be a manufacturer and, having regard to GATT, we are not prepared to recommend treating a Canadian distributor of imported goods any differently.

In view of these considerations, we are forced to conclude that, while some exclusive or nearly exclusive distributors of imported goods ought to be treated as manufacturers for sales tax purposes, the criterion for designating them as manufacturers ought to be whether there is tax discrimination arising from a difference between the trade level at which imports are taxed and the trade level at which competing domestically-produced goods are taxed, rather than the simple possession of distribution rights or of a private brand.

In addition, where the manufacturer is unable to meet the requirements of Memorandum ET-202, but there is a significant wholesale level of distribution in Canada in the class of goods in which he dealt, the Minister often prescribes a "determined wholesale value", based upon the Excise Branch's analysis of Canadian wholesale margins in that class of goods. Similar arrangements are often made for manufacturers who sold directly to consumers, by either a system of established values or determined values.

There are a number of serious defects in the present system of notional values:

1. It is totally lacking in legal validity.[11] Since the Act requires tax to be paid on the actual selling price, for the Minister to allow tax to be paid on any amount which is less than that price amounts to an extra-legal concession, which can be granted or withheld at his officials' discretion. While it is a tribute to the integrity and wisdom of these officials that there are so few complaints concerning their handling of such matters, it is unseemly, and even shocking, that a manufacturer who believes in good faith that he ought to receive a greater discount from his actual selling prices to retailers or consumers than the Excise Branch is prepared to allow him must remind himself that if he were to take the matter to court he would get no discount at all.

2. The Excise Branch considers that, while it has a moral obligation to prevent unfair price competition based on differences in tax content in respect of a particular class of goods between those selling at different trade levels, it has no obligation to equalize the tax content of different non-competing classes of goods. For example, since there is no wholesale trade level in respect of Canadian-produced automobiles, tax is paid by manufacturers on their actual selling prices to retailers. On the other hand, manufacturers of certain automobile parts for the automotive aftermarket who sell exclusively to distributors, who in turn resell to wholesalers, account for tax on their actual selling prices to those distributors. In the end result, the percentage tax content of automobiles purchased by retailers may greatly exceed that of automotive parts purchased by retailers, even though the nominal tax rate under the Excise Tax Act is the same for both classes of goods.

3. Over the years Canadian distribution patterns have changed greatly, and it is by no means unusual to find that in a particular trade there are no wholesalers at all and that goods are sold directly by manufacturers to retailers, but at widely varying prices, based upon the volume of their purchases, their bargaining power, their credit-worthiness, etc. This problem is not currently addressed by the Excise Branch, which requires tax to be paid on the manufacturer's actual selling prices to his various customers, even though this may create the same sort of unfair competition based on tax advantages which the wholesale discount procedure was intended to eliminate.

It is commendable that the Government has now indicated that it is prepared to give the discount procedure a proper statutory basis, at least as regards its main elements. The draft wholesale tax legislation provides, in effect, that if a wholesaler regularly makes at least 15% of his sales of a particular class of goods to two or more independent retailers, he can account for tax on his sales to users based on the average prices charged to retailers.

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[11] As early as 1928, the Supreme Court of Ontario held in *Attorney General of Canada v. Coleman Products Co.*, [1929] 1 D.L.R. 658, that it was beyond the powers of the Minister to make any regulation that would vary, modify or change the statutory rule that tax was payable on the actual selling price.

While this Committee approves the intent of this proposal, which we assume would be suitably modified, more or less along the lines of Memorandum ET-202, if the manufacturer's sales tax were retained, we believe that this type of legislation no longer meets the needs of contemporary distribution networks. The distinctions between distributors, wholesalers and retailers have become somewhat blurred, and manufacturers may sell to customers at all these trade levels at varying prices which are usually unrelated to the purchaser's classification as one or other type of dealer.

Accordingly, we suggest that the principle which should be followed in drafting new notional value legislation should be that a manufacturer should be entitled to account for tax on all his sales of like goods based on his actual selling prices to those customers at any trade level to whom he regularly makes sales at the lowest prices. However, a majority of our Committee questions the long established requirement that these sales be made to at least two independent customers with whom the manufacturer deals at arm's length; in their opinion, one independent customer should be sufficient. Nevertheless, at least 15% of the manufacturer's sales should be made to the most favoured customer or customers in order to permit these sales to be used as the basis for accounting for tax on other sales.

The operation of this proposal can be illustrated by assuming that a manufacturer sells a particular product to the following customers:

A, to whom he makes 10% of his sales at a price of $95 per unit,

B, to whom he makes 8% of his sales at a price of $100 per unit,

C, to whom he makes 4% of his sales at a price of $105 per unit, and

a large number of other customers, to whom he makes the remaining 78% of his sales at a price of $110 per unit.

In order to encompass 15% of his sales, the manufacturer would have to include in his calculations the sales to both A and B. Under our proposal he would have to account for tax on a notional sale price of $100 on his sales to all customers other than A and B; tax would still be accounted for on sales to A and B based on actual selling prices. Inclusion of this principle in the new legislation would, we believe, substantially improve the Government's proposal to give a statutory basis to the present system of established wholesale values.

Perusal of section 37 of the draft wholesale tax legislation, the section which provides a statutory basis for determining notional values where a wholesaler sells directly to users, reveals how extraordinarily complex such legislation has to be in order to accomplish its intended purpose. Such complexity inevitably leads to the need for further modification and refinement in order to remove anomalies and to respond to changing conditions. It is a great deal easier to modify regulations issued under a statute than to amend the statute itself. We should, therefore, prefer that only the general principle which we have stated be embodied in the sales tax legislation and that the Governor-in-Council be authorized to issue regulations which will spell out its detailed application. Our experience with the very detailed regulations dealing with capital cost allowances under the Income Tax Act encourages us to believe that this is the better approach.

The present system of determined wholesale values presents much greater problems, since it requires an analysis of trading patterns in a whole industry rather than those of a particular manufacturer. At present, if a manufacturer sells only to retailers, but

some of his competitors sell to wholesalers, the Excise Branch will frequently investigate the industry and fix a determined wholesale value, usually based on a percentage discount from the first manufacturer's selling prices to retailers.[12] Like established wholesale values, determined wholesale values have no legal basis under the present Excise Tax Act. However, unlike established wholesale values, it is much more difficult to envisage how determined wholesale values can be given a legal basis which will be perceived to be fair and reasonable.

Usually, only the Excise Branch has full access to information as to the trade patterns and mark-ups of the manufacturer's competitors. In the first instance, therefore, determined wholesale values ought to be set by the Governor-in-Council, on the recommendation of the Minister of National Revenue, who, of course, will be advised by officials of the Excise Branch. However, a manufacturer who believes that the value which has been determined in this manner is unduly high should have some right of appeal to an independent tribunal. Since the information in the possession of the Excise Branch must be kept confidential, a quasi-judicial hearing, with all witnesses being examined and cross-examined under oath, appears quite impractical. It is for this reason that the draft legislation for the wholesale tax provided an objective basis, not depending upon administrative discretion, for establishing notional values when goods were sold by a wholesaler both to retailers and users, but provided for notional values simply to be determined by the Governor-in-Council, without any right of appeal, when goods were sold by a wholesaler only to users.

The Committee has been unable to find an entirely satisfactory method for fixing determined wholesale values under a modified manufacturer's sales tax, one which would give manufacturers the feeling that officials of the Excise Branch who are responsible for recommending these values are not acting as judges in a cause in which the Branch has a direct financial interest. In order to avoid this situation, we consider that it would be preferable if the Tariff Board, which is independent of the tax collection machinery, were empowered to make this type of investigation, using its own staff, in conjunction with officials of the Excise Branch. After investigation, the Board could make a recommendation to the Governor-in-Council as to whether or not a determined wholesale value should be established and, if so, what that value should be. The independence of the Tariff Board would provide a greater degree of assurance to manufacturers that their concerns are recognized, in situations in which the need for confidentiality precludes an ordinary quasi-judicial hearing. Reasonable time constraints should be inserted in the legislation, to ensure that a manufacturer's request for a determined value is dealt with promptly by the Excise Branch and the Tariff Board.

RECOMMENDATION NO. 2

A manufacturer should be entitled to account for sales tax on all his sales of like goods based on established values equal to his lowest selling prices to independent customers at any trade level to whom he regularly makes at least fifteen percent (15%) of his sales. A similar principle should be used by the Minister in fixing determined values, based on industry-wide figures, when a manufacturer cannot take proper advantage of the established values system, but determined values should be subject to appeal.

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[12] For some reason, the Excise Branch is at present without legal authority to examine the books and records of a business in order to obtain information which it requires in order to fix a determined value for other firms in the same industry. We suggest that the legislation specifically permit this type of investigation.

3. Marginal Manufacturing

Paragraph 2(1)(f) of the Excise Tax Act states that "manufacturer or producer" includes "any person who, by himself or through another person acting for him, assembles, blends, mixes, cuts to size, dilutes, bottles, packages, repackages or otherwise prepares goods for sale, other than a person who so prepares goods in a retail store for sale in that store exclusively and directly to consumers."

This provision, which was enacted by Statutes of Canada, 1980-81, chapter 68, subsection 1(3), and which came into force on January 1, 1981, to some extent merely restates the law which existed prior to its enactment, insofar as it refers to any person who "assembles", "blends" or "mixes" goods. It possibly also merely restates the pre-existing law in respect of a person who dilutes liquids. However, the Supreme Court of Canada had previously held that a person who purchased large rolls of aluminum foil and cut them to size and packaged them for domestic sale was not a manufacturer or producer; [13] the inclusion of the words "cuts to size" therefore effected a change in the prior law. In addition, it seems clear that before 1981 anyone who bottled, packaged or repackaged goods was not a manufacturer or producer.

The enactment of paragraph 2(1)(f) has had a significant effect on sales taxation. In some cases, where goods had previously been imported in bulk for packaging and distribution in Canada, treating packaging as "marginal manufacturing" has encouraged importers to import fully packaged goods and thereby to avoid being treated as manufacturers, a situation which may have actually reduced Canadian employment by these importers and their purchases from the Canadian packaging industry. For example, in its submission to the Committee, the Canadian Toy Manufacturers Association has claimed that the implementation of the marginal manufacturing rule has resulted in the loss of 325 jobs for the two largest Canadian companies (both of which carry on business as both manufacturers and importers).

The reference in paragraph 2(1)(f) to any person who "otherwise prepares goods for sale" has had some startling results. For example, the Excise Branch has ruled that where an automobile importer attaches decals to an imported car in the form of "racing stripes", he is thereby preparing the car for sale and he will be subject to tax as a manufacturer or producer on his selling prices to retailers. It has even been suggested by some persons outside Government that if an automobile importer simply removes protective wrappings which have been used to prevent damage to an automobile in transit, he is thereby rendering himself liable to tax as a manufacturer or producer under this paragraph; if this preparation were done by a retail dealer, rather than by the importer, it would be excluded from the operation of this paragraph, by reason of the last clause in paragraph 2(1)(f). Other unusual examples of marginal manufacturing have been pointed out to us, such as changing the keys on a word processor from blank to engraved keys, and making very minor modifications to imported electrical equipment to bring it into conformity with Canadian Standards Association specifications.

Although imported goods may sometimes enjoy a sales tax advantage over domestically produced goods, there are also situations in which they may suffer a significant disadvantage. For example, when U.S. built automobiles are imported into Canada by Canadian manufacturers under the terms of the Auto Pact, they are not subject to customs duty, but sales tax is paid on their "duty-paid value", which, under the present

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[13] *The Queen v. John Stuart Sales Ltd.*, [1956] C.T.C. 64, affg [1955] C.T.C. 78 (Ex. Ct.).

Customs Act, is equal to the price charged by the U.S. manufacturer to U.S. auto dealers, converted into Canadian funds. At present, because of the relatively low value of the Canadian dollar and the competitive situation in Canada, this duty paid value actually exceeds the prices charged Canadian dealers for these automobiles. This unusual state of affairs would actually encourage the Canadian importer of U.S. built automobiles to bring itself within the scope of the marginal manufacturing rule, by performing some relatively nominal amount of preparation for sale of the imported, U.S.-made cars.

Since inclusion of these words in the statute has produced some absurd results, we recommend that the words "otherwise prepares goods for sale" be deleted.

At the time it was enacted, it was considered that paragraph 2(1)(f) was merely a prelude to the establishment of a general sales tax at the wholesale level, a situation where its effect would be so modest as to be inconsequential. However, if sales tax is to remain at the manufacturer's level, it seems clear that the definition of marginal manufacturing in paragraph 2(1)(f) will have to be substantially narrowed. A useful suggestion has been made to this Committee by the Society of Management Accountants of Canada, which proposed that "persons who add only a minimum value to goods be excluded from the provisions of subsection 2(1) by providing a threshold amount in the regulations." It seems to us that this proposal could be modified suitably, in order to provide that where bottling, packaging or repackaging does not involve more than a 10% increase in the merchant's direct costs of labour and materials for a particular product, it should not be regarded as manufacturing or production.

Finally, there should be an exclusion for goods subjected to the operations listed in paragraph 2(1)(f) if they are carried out in a retail outlet by and for the operator of that outlet for sale exclusively and directly to consumers.

RECOMMENDATION NO. 3

The definition of "marginal manufacturing" in paragraph 2(1)(f) of the Act should be amended:

(a) to delete the words "otherwise prepares goods for sale";

(b) to exclude the operations of bottling, packaging or repackaging, where they do not involve more than a ten percent (10%) increase in a merchant's direct costs of labour and materials for a particular product; and

(c) to exclude goods which are subjected to the operations listed in the paragraph in a retail outlet by and for the operator of that outlet for sale exclusively and directly to consumers.

4. The Private Brand Problem

One of the most difficult problems in the sales tax field involves the taxation of "private brands". Such products are usually marketed under the brand name of a person other than the physical manufacturer. Under a manufacturer's tax, the value of advertising, "reputation", warranty and warehousing will usually not be subject to tax, unlike the treatment accorded "national-brand" goods marketed by the physical manufacturer under its own label.

The 1977 Brown Paper, issued by the Department of Finance, commented on this problem:

> *"Views on the subject of private brand goods were divided. Several submissions associated private brands exclusively with retail organizations and thus failed to recognize that many such goods are marketed by persons at the wholesaler-to-retailer level of trade. Chain retailers stated that private-brand goods are not a problem because they are purchased at arm's-length negotiated prices and the price advantage they enjoy arises solely from volume purchasing. Other submissions, in particular those from manufacturers who market under national-brand names and sell directly to retailers, recognized the advantages that accrue to persons dealing in private brands and supported measures aimed at taxing these goods on the same basis as regular-line goods. The wide range of differing views on the subject of private brands is indicated by the many comments contained in the submission. One major wholesaler stated that since almost all private-brand goods are bought by retailers directly from manufacturers, the imposition of sales tax on the price at which retailers purchase goods would have little impact upon the perceived inadequacy of the present system."*

A different opinion was expressed by the Canadian Institute of Chartered Accountants, which observed that:

> *"An increasing amount of private brand merchandise is manufactured for and distributed by wholesalers. A federal sales tax at the wholesale level would eliminate the sales tax advantage of private-brand merchandise in such arrangements."*

The views of wholesalers and retailers are indicated in two briefs from associations whose members are in these categories. The first, from a wholesaler association, and the second from a retailer group, state, respectively:

> *"If, in the case of private-brand goods tax inequality is actually important, the Act could include as a legal manufacturer anyone having private brands manufactured for him."* [Canadian Grocery Distributors' Institute]

> *"The selling price of private-brand goods is arrived at in a competitive market at the manufacturing level with the significant pricing factor being volume and not the specific identification of costs. Thus the Council sees no reason for a special treatment on private-brand goods simply because their selling price is different."* [Retail Council of Canada]

The proposed wholesale tax appears to solve only part of the private brand problem. Sales tax would, under that type of tax, be applied to the selling price of wholesaler's private brands, whether these were imported or domestically produced. However, retailer's private brands would continue to be taxed on their cost, thereby leaving an element of promotion, warranty, etc. untaxed. One submission stated:

> *"Any sales tax reform which solved the problem of wholesaler's private brands without dealing with retailer's private brands could hardly be called a major improvement."*

In our view, the wholesale tax cannot be regarded as a suitable method of dealing with the private brand problem.

The addition of a Large Retailer Tax (LRT) further complicates the matter. Given that the LRT is applied to the tax content of purchases by "large retailers", whether they consist of private brands or national brands, it likewise cannot be regarded as a suitable method of dealing with the private brand problem, which must be attacked directly or not at all.

The Excise Tax Act presently contains a provision which has been used in some cases by the Excise Branch successfully to tax vendors of private brand goods on their selling prices. Paragraph 2(1)(b) of the Excise Tax Act defines "manufacturer or producer" as including:

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

Unfortunately, as a commentator has pointed out,

> *"this rather obscurely worded provision has been responsible for some of the most difficult tax litigation in Canada."*

While there have been only four reported judicial decisions (*The King v. Reuben Shore,* [1949] Ex. C.R. 225; *Goodyear Tire & Rubber Co. v. T. Eaton Co.,* [1955] Ex. C.R. 229, usually referred to as the "Private Brand Tire Case" (reversed on other grounds by the Supreme Court of Canada); *Rexair of Canada Limited v. The Queen,* [1958] S.C.R. 577; and *Turnbull Elevator Co. of Canada Limited (formerly Gutta Percha Tire & Rubber Limited) v. The Queen,* [1963] Ex. C.R. 221), it is extremely difficult to reconcile the decisions and to derive a set of legal principles concerning the application of paragraph 2(1)(b). One interpretation of these cases is as follows:

> *"...it is submitted that so long as purchasers do not exercise such close supervision over the production of goods which are made by others as to make them goods which are manufactured "for or on their behalf by others", the fact that the goods bear the purchaser's trade mark and the fact that the purchaser therefore presumably holds a "sales or other right" to the goods is irrelevant; the purchaser is not affected by the extended meaning of "manufacturer or producer" contained in section 2(1)(aa)(ii) [now paragraph 2(1)(b)]. In the Shore, Rexair and Gutta Percha cases the purchasers did in fact exercise such close supervision over the production that it could quite properly be said that the goods were manufactured "for or on their behalf by others". That is, the relationship was not simply that of purchaser and vendor of goods, although it may not be necessary to find as a fact that, to use Mr. Justice Thorson's language in the "private brand tire" case, the supplier was manufacturing the goods for the purchaser, in the sense that it was working for the purchaser as its instrument or* alter ego *in their manufacture and the purchaser was in reality the manufacturer of them.*
>
> *It is suggested that the Gutta Percha case has not drastically altered the law relating to private brands and that where a vendor produces goods of standard formulation for a purchaser, bearing the purchaser's trade mark, but the relationship between them is merely that of vendor and purchaser, the fact that the goods bear the purchaser's trade mark is not sufficient to make the purchaser the manufacturer for sales tax purposes. If, however, the purchaser supplies the designs or specifications or supplies the equipment, or some of the equipment,*

with which the goods are manufactured or sends inspectors into the vendor's plant to supervise the manufacturing operations, it is likely that a court will find that the goods are being manufactured "for" the purchaser. Then, if the purchaser's trade mark is affixed to the goods by the physical manufacturer, the section will apply and the purchaser must be treated as the manufacturer for sales tax purposes."

It seems difficult to support this type of legislation, which discriminates between various types of "private brand" situations, taxing some purchasers as manufacturers and ignoring many others whose economic position is substantially identical. In 1956 the Sales Tax Committee headed by the late K. Le M. Carter, F.C.A., (later Chairman of the Royal Commission on Taxation) recommended to the Minister of National Revenue that the predecessor of Paragraph 2(1)(b) be repealed and replaced by a provision which would deem a merchant to be a manufacturer for sales tax purposes:

(a) if an agency relationship existed between him and the manufacturer; or

(b) in the case of merchandise bearing the merchant's special brand name.

The first part of the Carter Committee's recommendation presents no problems, since it is really redundant. Even if Paragraph 2(1)(b) were deleted from the Act, it would still be the case that if A manufactured goods as B's agent, B would, in law, be regarded as the manufacturer. The legal maxim *qui per alium facit, per seipsum facere videtur* (he who does anything by another is deemed to have done it by himself) merely expresses the fundamental legal principle that an agent's acts are, in law, those of his principal. To call a person the *alter ego* of another is merely to express the same result in somewhat less precise language.

In the years since the Report of the Carter Committee, we have had a great deal more experience with the "private brand" situation, which leads us to be somewhat sceptical about the second part of the Committee's proposal, that a merchant be deemed to be a manufacturer for sales tax purposes in respect of all merchandise bearing his special brand name. Such scepticism is based upon the following considerations:

(1) We are no longer quite sure what a "private brand" consists of. The introduction of generic or so called "no name" items by grocery supermarkets is a case in point; are these private brands in any significant sense, or are they unbranded goods which are sold by supermarkets on the stength of their general reputation as retailers?

(2) Merchants have found that consumers frequently want to know who manufactures their "private brands" for them, and that these consumers rely to a considerable extent on the reputation of the physical manufacturer. As a result, some wholesalers have begun to market "restricted brand" products which carry both the trade name of the manufacturer and that of the wholesaler. It is unclear whether this should be treated in the same manner as the manufacturer's national brand or as the wholesaler's private brand.

(3) We understand that some manufacturers of nationally branded large household electrical appliances now sell to certain retailers who may provide their own servicing and warranty facilities, in return for a lower price on their purchases.

(4) It is possible in some cases for manufacturers to shift part of the costs of advertising nationally branded goods to their customers through co-operative advertising arrangements.

(5) The price differentials between nationally branded products and private branded products appear to have narrowed, where both are being purchased from manufacturers in similar large quantities.

Having regard to these factors, this Committee is not convinced that it would be wise to adopt the second part of the Carter Committee's recommendation concerning private brands. The seriousness of the "private brand" situation seems to be diminishing and whatever remains of the problem will be removed if and when Canada eventually adopts a federal sales tax at the retail level. Accordingly, we recommend that there be no change in the existing law in order to deal specifically with private brands.

RECOMMENDATION NO. 4

Paragraph 2(1)(b) of the Act should be strengthened by adding a provision deeming the purchaser of goods to be a manufacturer if an agency relationship exists between him and the physical manufacturer, but no further changes should be made to deal with wholesaler's and retailer's private branded goods.

5. Assessments and Appeals

It is curious that the present Excise Tax Act is almost entirely lacking in provisions for assessments and appeals. Monies due to the Crown for sales taxes are recoverable in the Federal Court and any other court of competent jurisdiction. In addition, the Tariff Board has a very limited jurisdiction under Section 59, which states:

> *"Where any difference arises or where any doubt exists as to whether any or what rate of tax is payable on any article or on transportation by air under this Act, the Tariff Board constituted by the Tariff Board Act may declare what rate of tax is payable thereon or that the article or transportation by air is exempt from tax under this Act."*

In the *Private Brand Tire Case,* the Supreme Court of Canada, reversing the Exchequer Court, held that the Tariff Board had no jurisdiction to decide whether Eaton's was the manufacturer of the tires in question which it purchased from Dominion Rubber Company.

The Government has acknowledged the deficiencies of the present law and has stated its determination to rectify this situation by proposing amendments which will provide appropriate assessment and appeal procedures. We have been shown early drafts of amendments dealing with these matters, although they have not been published. In general, we heartily approve of them, but we have a number of suggestions for their improvement:

(a) It is inappropriate, in our view, for the statutory limitation period for assessment of a licensee to be related to the date on which an audit of his books is commenced by the Excise Branch, since this is a date which may be difficult to determine even a few years later. Instead, we recommend that an assessment must be made within 4 years of the date on which the tax in question became payable, in the absence of fraud or misrepresentation due to neglect,

carelessness or wilful default. This rule would be similar to that in subsection 152(4) of the Income Tax Act, but it takes into account the fact that manufacturers would not be routinely assessed on an annual basis for sales taxes.

(b) A taxpayer's right to object to or appeal an assessment should not depend upon his having paid the disputed tax. We see no reason why the procedure for objection and appeal should not be completely separate from the tax collection machinery, as it is under the Income Tax Act. Under that Act, once tax has been assessed, it becomes payable, even though an objection or appeal is pending, but the Minister may, and usually does, accept security for payment if the taxpayer is objecting to or appealing the assessment and if he wishes to defer payment. The requirement for payment of disputed tax at the time of importation of goods can probably stand, since the tax will be refunded by the Crown in the event it is found not to be due.

(c) A proper method must be devised to enable an unlicensed purchaser from whom tax has been demanded by a vendor, but who believes that the law does not require tax to be paid on his purchase, to litigate the matter. Situations may arise in which the vendor simply insists on collecting tax on the transaction and is not interested in litigating the question himself. The draft proposals which we have seen do not appear to deal satisfactorily with this situation.

Apart from these relatively minor criticisms, we consider that the provisions for assessment, objection and appeal contained in the draft legislation which we have seen are satisfactory. We do not anticipate any large number of objections or appeals but it is important that a full opportunity be given to Canadians to question their liability for sales taxes before an appropriate tribunal.

The present subsection 28(1) permits the Minister to determine the sale price for tax purposes whenever goods are sold under circumstances or conditions which render it difficult or impossible to determine a sale price. The Minister's power under this subsection relates to the following situations:

"Whenever goods are manufactured or produced in Canada under such circumstances or conditions as render it difficult to determine the value thereof for the consumption or sales tax because

(a) a lease of such goods or the right of using the goods but not the right or property therein is sold or given;

(b) such goods having a royalty imposed thereon, the royalty is uncertain, or is not from other causes a reliable means of estimating the value of the goods;

(c) such goods are manufactured by contract for labour only and not including the value of the goods that enter into the same, or under any other unusual or peculiar manner of conditions; or

(d) such goods are for use by the manufacturer or producer and not for sale,

the Minister may determine the value for the tax under this Act and all such transactions shall for the purposes of this Act be regarded as sales."

The proposed paragraph 36(6)(a) of the draft legislation implementing the wholesale tax, which is intended to replace subsection 28(1), states:

> *"Notwithstanding any other provision of this Part, for the purposes of this Part, the Minister may determine or specify a method for determining the sale price of any non-excisable goods, if the goods are, in the opinion of the Minister, sold or imported under circumstances or conditions that render it difficult or impossible to otherwise determine the sale price."*

The proposed paragraph 36(6)(a) substantially extends the Minister's power in two ways. First, it no longer enumerates the situations in which he may exercise this power; while it is recognized that transferring the tax to the wholesale level requires consideration of more cases than are dealt with under the present subsection 28(1), there seems no reason why these cases should not be specifically enumerated. Secondly, the introduction of the phrase "in the opinion of the Minister" allows the Minister not merely to determine the sale price or to specify a method for determining it, but also to determine whether or not the factual conditions exist which would entitle him to exercise this power at all. This is an extraordinary power, which seems entirely unnecessary and impossible to justify, since we have been able to get along for many years without giving the Minister power to determine these factual matters, without right of appeal. We therefore recommend that the Minister's determination of the sale price or specification of a method for determining it, under legislation similar to the present subsection 28(1), should be based on a determination of fair market value, subject to appeal.

This comment applies to an even greater extent to the proposed paragraph 36(6)(b), which permits the Minister to determine or specify a method of determining the sale price of any non-excisable goods if they are sold at a price that, in the opinion of the Minister, is less than the fair price on which tax should be imposed. This provision, which is modelled on the present section 34, has been criticised many times over the years. In 1942, the Supreme Court of Canada held in the *Noxzema* case[14] that the Minister's determination under what is now section 34 was not appealable to nor reviewable by any court, a situation which places a manufacturer completely at the mercy of the Department of National Revenue by denying him the ordinary rights of appeal. This provision was originally enacted at a time when it was much more common to vest extensive discretionary powers in the Minister of National Revenue.

Since 1948 we have considerably reduced the number of discretionary powers in the Income Tax Act and we have relied instead on provisions such as paragraph 69(1)(b) of that Act, which provides that where a person has disposed of anything to a person with whom he was not dealing at arm's length for no proceeds or for proceeds less than the fair market value thereof at the time he so disposed of it, he shall be deemed to have received proceeds of disposition therefor equal to that fair market value. Both the 1956 Carter Committee Report and the 1966 Carter Royal Commission Report, as well as other unofficial commentators, have proposed that the present section 34 be replaced by a provision similar to paragraph 69(1)(b) of the Income Tax Act, thereby giving a licensee a full right of appeal to the courts from the Minister's determination. We agree, and recommend that the Government amend section 34 in order to restrict its application to non-arm's-length transactions and to replace the concept of "fair price" by the

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[14] *The King v. Noxzema Chemical Co. of Can. Ltd.*, [1942] C.T.C. 21.

objective standard of fair market value. This should look after the ordinary cases of non-arm's-length transactions.

However, suppose a manufacturer of goods of a class which is sold exclusively to retailers, where there is no wholesale trade level, and who has previously been obliged to account for tax on his actual selling prices, decides to establish an affiliated sales company which will purchase goods from the manufacturer in non-arm's-length transactions and resell them to retailers. In such a case, the Minister can be expected to exercise his power under the present section 34 by requiring the manufacturer to account for tax on his sales to the sales company, based on the prices at which the sales company resells to retailers. If the present section 34 were simply amended along the lines of paragraph 69(1)(b) of the Income Tax Act in order to enable the Minister to determine the fair market value of the goods which are being sold to the affiliated sales company, this might not be fair to other firms in the same industry, which would still be required to account for tax on their selling prices to retailers, while the manufacturer who sold to his affiliated sales company would be accounting for tax on a basis which is equivalent to a wholesale price. Nevertheless, it should be possible to deal with this situation without giving the Minister an unlimited discretionary power to determine the transfer price for sales tax purposes, such as exists under the present section 34. The Minister's power could be restricted to determining the price at which the goods would have been sold if they had been sold at the trade level at which tax was paid by vendors of competing goods of the same kind, and requiring that the manufacturer account for tax on his sales to his affiliated sales company at this determined price. That is, where tax is being paid on competing goods of the same kind at a different trade level than that of the transaction in question, the Minister should have power to determine the fair market value at which the goods would have been sold at the trade level at which tax is being paid by vendors of competing goods. This type of determination could then be the subject of an ordinary appeal.

Where there are no vendors of competing goods of the same kind the Minister should have power to determine the price at which tax would have been paid if the non-arm's-length transaction had been ignored.

Let us suppose that a manufacturer who has previously been selling goods such as auto parts to both large and small retailers at widely varying prices establishes an affiliated sales company through which he channels his sales to all customers other than those who purchase at the lowest prices. Should this manufacturer then be entitled to account for tax on transfers to the sales company based on the lowest prices charged to his customers? The solution to this problem, we think, lies in our proposal regarding notional values generally, where we have suggested that whenever a particular class of goods is regularly sold by a manufacturer at varying prices to different customers, the manufacturer should be entitled to account for tax on his lowest selling price to an independent customer or customers whose combined purchases amount to at least 15% of the manufacturer's sales. This solution, which does not depend upon whether the customers are at the same trade level but merely on the volume of their purchases, would give every manufacturer substantially the same advantages as he would have enjoyed if he had set up an affiliated sales company through which he channelled his sales to arm's-length customers. As a result, there would be little incentive to set up affiliated sales companies for sales tax purposes, and the Minister would have little occasion to exercise his powers under a modified section 34 in order to deal with this situation.

RECOMMENDATION NO. 5

A system of objections and appeals should be instituted for assessments made under the Act, similar to that presently in use for income tax matters. In this connection, however, the following points should be noted:

(a) in the absence of fraud or misrepresentation due to neglect, carelessness or wilful default, we recommend that an assessment must be made within four (4) years of the date on which the tax in question became payable;

(b) a taxpayer's right to object to or appeal an assessment should not depend upon his having paid the disputed tax;

(c) a proper method should be devised to enable an unlicensed purchaser from whom tax has been demanded by a vendor, but who believes that the law does not require tax to be paid on his purchase, to litigate the matter;

(d) Subsection 28(1) of the Act, which enables the Minister to determine the sale price in certain unusual circumstances, should be amended in order to require him to determine the fair market value of the goods or the transaction in question, subject to appeal;

(e) Section 34 of the Act, which enables the Minister to determine the "fair price" on which tax should be levied, should be amended in order to restrict its operation to non-arm's-length transactions and to require the Minister to determine the fair market value of the goods in question, subject to appeal. However, a special definition of "fair market value" will be required in order to prevent a person engaged in a non-arm's-length transaction from gaining an unwarranted advantage over his competitors.

6. Administrative Provisions Regarding Tax Refunds

(a) Bad Debts

Since the Excise Tax Act simply imposes tax on vendors in respect of the sales which they make, until now there has been no relief for a vendor who has made a sale on credit to a customer from whom he is unable to collect. For many years this has been the subject of complaint from business people and the government has now indicated that it is prepared to respond to this complaint. We recommend insertion in the Act of provisions along the following lines:

"(1) Where a licensed manufacturer or producer who has sold goods on credit to a person with whom that manufacturer or producer is dealing at arm's length subsequently establishes, in accordance with generally accepted accounting principles, that the debt owing him in respect of the sale has become in whole or in part a bad debt the Minister may, on application by that manufacturer or producer, pay to him;

(a) where the debt in whole has become a bad debt, an amount equal to the aggregate of the taxes under Part IV or V in respect of the sale; or

(b) where the debt in part has become a bad debt, an amount equal to that proportion of the aggregate of the taxes so paid that the amount of such part of the debt is of the amount of the whole debt.

(2) No payment may be made pursuant to subsection (1) to a manufacturer or producer if

(a) the debt has not been written off as a bad debt on the books of account of that manufacturer or producer at the time he applies for the payment;

(b) the taxation year of that manufacturer or producer in which the debt has been written off has not ended at the time he applies for the payment; or

(c) the sale occurred before this provision came into force.

(3) Where a person, subsequent to applying for a payment under subsection (1), recovers all or part of the bad debts in respect of which the application is made, he shall repay the amount equal to that proportion of the amount, if any, paid to him under that subsection in respect of the bad debt that the amount of the debt so recovered is of the amount of the debt in respect of which the amount, if any, is paid to him under that subsection."

We consider that these provisions are entirely fair and reasonable and that they fully satisfy the need for reform in this area.

(b) Interest on Refunds and Overpayments of Tax

In its recommendations at Section 6.2 of the April, 1982 Proposal to Shift The Federal Sales Tax to The Wholesale Trade Level, the Government has proposed to pay interest on refund claims filed and other overpayments outstanding more than 60 days after a valid application for the refund, drawback or repayment has been made. The amended draft legislation to implement this procedure, which we have examined, seems entirely appropriate and we endorse it.

(c) Deductions in Lieu of Refunds

Licensed manufacturers and licensed wholesalers who have monthly obligations to file and pay current taxes may at the same time have the right to file for and receive refunds of overpaid taxes. For many years the Excise Branch has administratively approved arrangements with some taxpayers to allow them to deduct the taxes recoverable by refund from their current tax remittances, subject to review by the Branch when it audits the taxpayer. We recommend that the Government proceed to make this convenient and fair administrative procedure available for all persons entitled to refunds who are also obliged to pay taxes under the Excise Tax Act.

(d) Deductibility of Certain Penalties for Tax Purposes

The Excise Tax Act today imposes a late filing penalty of 1½ % per month on all taxes not paid in the time prescribed by the Act. This penalty is considered to be unduly onerous if it cannot be deducted from the income of a business for income tax purposes.

We propose that this late payment penalty be modified so as to consist of a penalty of one-half percent per month and an interest charge at a specified rate that will vary from time to time. The objective of this proposal is to establish more clearly the deductibility for income tax purposes of the monthly charge the Government can reasonably be expected to make to compensate for the benefit a taxpayer derives from taxes which are not paid on time.

RECOMMENDATION NO. 6

(a) We approve of the provisions which the Government has proposed for providing tax relief for licensed vendors who make sales on credit to customers from whom they are unable to collect in full.

(b) We also approve of the proposals in respect of the payment of interest on tax refunds and the crediting of refunds against monthly tax remittances.

(c) However, we propose that the present 1½% per month penalty for late payment of tax be separated into a penalty of ½% per month and an interest charge at a prescribed rate.

7. Criminal Penalties For Non-Payment Of Tax

The present Act provides, quite properly, that all taxes, interest, penalties and other sums payable under the Act are debts due to Her Majesty in right of Canada and are recoverable in the Federal Court or any other court of competent jurisdiction. However, the Act also provides a criminal penalty for non-payment of tax in subsection 55(1), which states:

> *"Every person who, being required, by or pursuant to this Act, to pay or collect taxes or other sums, or to affix or cancel stamps, fails to do so as required is guilty of an offence and, in addition to any other penalty or liability imposed by law for such failure, is liable on summary conviction to a penalty*
>
> *(a) not being less than the aggregate of twenty-five dollars and an amount equal to the tax or other sum that he should have paid or collected or the amount of stamps that he should have affixed or cancelled, as the case may be, and*
>
> *(b) not exceeding the aggregate of one thousand dollars and an amount equal to the aforesaid tax or other sum or aforesaid amount of stamps, as the case may be;*
>
> *and in default of payment thereof to imprisonment for a term of not less than thirty days and not more than twelve months."*

It should be clearly understood that these provisions are not concerned with tax evasion, which is dealt with primarily under subsection 56(2), which states:

> *"When*
>
> *(a) a return is filed as required by or pursuant to any Part except Part I, or*
>
> *(b) an application in writing is made pursuant to Part VI for a refund of tax paid or for payment of an amount equal to tax that was paid,*
>
> *every person who makes, assents to or acquiesces in the making of, false or deceptive statements in the return or application, is guilty of an offence and liable to a penalty*
>
> *(c) not being less than the aggregate of one hundred dollars and an amount equal to*

(i) double the amount of the tax that should have been paid in or in respect of the period covered by the return, or

(ii) double the amount of the tax or other sum that he obtained and accepted by reason of the application, and

(d) not exceeding the aggregate of one thousand dollars and an amount equal to double the amount of the tax or other sum;

and in default of payment of such penalty to imprisonment for a term of not more than twelve months."

Subsection 55(1) deals with simple non-payment of tax, in circumstances which do not amount to tax evasion. Under the Act, even if the vendor's non-payment of tax arose from his inability to collect from the purchaser, he is liable to this criminal penalty and if he fails to pay, he will go to jail. If the Government introduces its proposed legislation dealing with bad debts, this aspect of the problem will be removed. However, there will still be other situations in which a vendor who is entirely innocent of any wrongdoing will be subject to criminal liability for non-payment of tax, for example, if the vendor has collected in full from the purchaser and deposited the monies in his bank account, but the vendor is unable to pay the tax because the bank has called its loan and has applied the monies on deposit in his account against the loan. In these circumstances, to impose criminal liability on the vendor is simply to threaten him with imprisonment for debt, a practice which in other situations Canada abandoned many years ago as barbaric.

The situation, in fact, may be even worse, since that portion of the fine which is imposed under subsection 55(1) is not necessarily applied on account of the vendor's tax liability. In a typical case of failure to pay sales tax, A, B and C, carrying on business as A and Company, can be jointly charged with failure to pay sales tax. They will be convicted, although their failure to pay the tax was due to their being overdrawn at the bank and the bank's refusal to honour the firm's cheque. The Court must then impose fines on each of them which include the whole amount of the tax owing. The Crown may then proceed civilly in the Federal Court to collect the tax a fourth time. That this extreme situation has not been more frequently invoked speaks more for the restraint of Government officials than for the wisdom of the statutory provisions.

The position of a director of a corporation is particularly hazardous. Subsection 55(3) provides:

"Where an incorporated company has been convicted of any offence against this Act, every officer, director or agent of the company who has directed, authorized, condoned or participated in the commission of the offence, is liable to the like penalties as such company and as if he had committed the like offence personally and he is so liable cumulatively with the company and with such officers, directors or agents of the company as may likewise be liable hereunder."

No one ought to condone the actions of someone who deliberately seeks to evade sales tax or to evade payment of tax which is lawfully due. However, threatening with a fine or imprisonment someone who, through no fault of his own, is unable to pay sales tax seems entirely unreasonable and unnecessary.

RECOMMENDATION NO. 7

The criminal penalty for non-payment of tax, not amounting to tax evasion, contained in subsection 55(1) of the Act should be repealed.

8. Liability Of Vendors For Payment Of Tax

As previously mentioned, since the Excise Tax Act is framed as a tax on vendors it has generally ignored the question whether the vendor has collected from the purchaser the tax which ought to have been paid. This can create a very onerous liability on a vendor who acts in good faith in accepting a certificate in proper form from a purchaser, on the basis of which the purchaser claims exemption from tax. Subsections 70(1) and (3) of the Excise Tax Act provide as follows:

> *"(1) Where a purchaser of goods from a wholesaler, producer, manufacturer or importer has falsely represented that the goods were intended for a use rendering them exempt from tax under any provision of this Act, the wholesaler, producer, manufacturer or importer, as the case may be, is entitled to recover from the purchaser the taxes paid by him under this Act in respect of those goods.*
>
> *(3) Where a manufacturer or wholesaler holding a licence granted under or in respect of Part III or V has purchased goods from another such licensed manufacturer or licensed wholesaler and has incorrectly stated or certified that the goods were being purchased for a use or under conditions rendering the sale of such goods to him exempt from any tax imposed by Part III or V, such purchaser and the licensed manufacturer or licensed wholesaler from whom he purchased the goods are jointly and severally liable for payment of the tax and any penalty provided by subsection 50(4)."*

It should be noted that subsection 70(3) does not attempt to impose tax liability on an unlicensed purchaser who improperly claims exemption from tax, such as a farmer purchasing some item which would be exempt if he purchased it for his farm, but which he is in fact purchasing for a relative who is not entitled to exemption. In addition, although a licensed purchaser who improperly claims exemption on a purchase may be forced to pay the tax, if the Excise Branch chooses to pursue him, it may be much easier for the Branch to collect the tax from the vendor, particularly if the vendor is filing a refund claim which the Branch can reject. Once the vendor has paid the tax, subsection 70(1) purports to give him a right to recover it from the purchaser.

However, there is doubt whether the Parliament of Canada can give a vendor the right to recover tax in this manner, since it appears to be a matter of property and civil rights, which is within provincial legislative jurisdiction. Under provincial law, if the purchaser has fraudulently misrepresented that he is entitled to the exemption which he has claimed, the vendor will, no doubt, be entitled to recover the tax from him. However, if the purchaser acts in good faith, believing that he is entitled to the exemption, but it is subsequently determined that he was not actually so entitled, the vendor may not have any remedy under provincial law.

The draft amendments which we have seen have broadened the purchaser's liability to include all purchasers who claim exemption when they are not entitled to do so,

whether they are licensed or not. We agree that this is a desirable reform. However, this provision still imposes joint and several liability on both vendor and purchaser. While it may be proper to impose liability on a vendor who is careless about accepting a certificate of exemption or who acts in collusion with purchasers who are not entitled to exemption, many submissions have been made to this Committee to the effect that a vendor who has acted in good faith and who has exercised due care in accepting an exemption certificate, having regard to the circumstances of the transaction, should not be liable for payment of the tax and that the Branch should pursue only the purchaser in such a case. These submissions seem entirely reasonable to us, although we believe that the onus of establishing bona fides and due care should be placed by the statute on the vendor, since he manages his business in his own way and since he is in possession of the evidence relating to the transaction. A similar principle should apply in respect of refund claims by an unlicensed vendor.

There may be situations in which a vendor may be unable to establish to the satisfaction of the Branch or an appeal tribunal that he has acted in such manner as to avoid liability for payment of tax in respect of an improper exemption certificate. In such a case, he should be liable for the tax jointly and severally with the purchaser. However, if the Branch chooses to collect the tax from him, he should have a legally effective method of collecting it from the purchaser, whether or not the purchaser has made a false representation. Since we have doubts as to the constitutional validity of the present subsection 70(1), it would be preferable if the Act were to provide that payment of tax by the vendor in these circumstances had the effect of assigning to him the Crown's right to collect tax from the purchaser, thereby enabling him to sue the purchaser.

RECOMMENDATION NO. 8

Where a vendor of goods has acted in good faith and with due care in accepting an exemption certificate from a purchaser, he should not be subject to joint and several liability, together with the purchaser, if the certificate is improper. In such a case, only the purchaser should be liable for the tax. However, where the vendor cannot establish that he acted in good faith and with due care, upon payment of the tax he should be entitled to an assignment of the Crown's tax claim against the purchaser.

VIII. A New Direction for Canadian Sales Tax

1. Introduction

For almost 30 years the Canadian government has been concerned with the deficiencies which are inherent in the existing manufacturer's sales tax and has sought advice from various sources as to how the more serious of these deficiencies might be corrected. In the latter stages of this review process the government has focused on shifting the tax from the manufacturer's level to the wholesale level. Throughout this process, however, the Canadian taxpaying community has voiced serious concerns about the proposals to shift the tax from the manufacturer's level.

We regard the formation of our Committee as an effort by government to understand the criticisms which have been levelled at its proposal to move the tax to the wholesale trade level and to develop meaningful alternatives to this proposal.

The submissions which we have received from, and the discussions which we have had with, various taxpayer groups, as well as our own deliberations have led us to believe that there is little merit in moving the federal sales tax from the manufacturer's level to the level at which retailers purchase goods. However, they have also led us to believe that the modifications to the manufacturer's tax which we have proposed can result only in a limited solution, since our proposals do not provide a common tax base for imported and domestically manufactured goods in all situations, notional values must continue to be used to provide tax equity to domestically manufactured goods distributed through different channels and, to a large degree, the problems associated with private brands and marginally manufactured goods will remain.

It is our considered opinion that the Canadian government should immediately undertake intensive and serious study, in co-operation with the provinces, with regard to shifting the tax at the earliest possible date to the level at which consumers purchase goods in Canada.

The remainder of this section attempts to provide a framework in which that study can take place.

2. The Necessity for a Sales Tax

In the course of its deliberations our Committee has had the opportunity to reflect on the role of the sales tax in the government's revenue mix. A tax on consumption has an important and meaningful role to play in the federal fiscal system; it provides a stable revenue source and it is an effective means of influencing consumption and resource utilization.

Some commentators have suggested that the federal government abandon the federal sales tax and turn this tax room over to the provinces, presumably in exchange for a larger federal share of the personal income tax field. Such a suggestion overlooks the fact that the provinces may prefer their present degree of participation in the income

tax field to exclusivity in the consumption tax field. This suggestion also fails to recognize that the federal government is well served by a tax mix which taxes consumption as well as income.

3. Criteria for Evaluating a Sales Tax

Any salestax must meet a number of criteria if it is to be regarded as fair and equitable by the taxpaying community. The criteria which we have been able to identify are the following:

(a) Equity

In terms of a theoretically pure sales tax, equity should mean that each taxpayer pays a similar percentage of his discretionary income in sales tax.

All forms of sales tax, be they manufacturer's sales tax, wholesale tax or retail sales tax, can be criticized on the basis of equity. By nature, they are regressive, in that those with lower incomes will pay a higher percentage of their disposable incomes in sales tax than will those with higher incomes. To cope with this problem of regressivity, governments have chosen to provide exemptions for a wide range of goods.

Further criticism can be levied at sales taxes which do not tax services as well as goods. In a complex society such as Canada, consumers may purchase a wide variety of services as well as a broad range of goods. Consequently, a consumer should not be able to avoid or modify the burden of tax through choosing services over goods. However, the administrative complexities and inequities associated with the taxation of all services might weaken public acceptance of the tax.

In Canada, this concern with regressivity, as well as other fiscal policy considerations, have led to the existing manufacturer's tax being imposed on a rather narrow base of goods. If the tax is to continue to provide substantial revenue to the government and is to be levied at rates which continue to be accepted by the public, it may be necessary to broaden the tax base even though, in broadening the base, the regressivity of the tax may be increased. This regressivity will have to be dealt with using other mechanisms available to government in its revenue mix or expenditure programs.

Despite this criticism of consumption taxes, it is the Committee's conclusion that the revenue structure of the government is best served by having a broad based sales tax on goods and selected services. For instance, Professor Sijbren Cnossen, in a recent paper, stated that "there is a strong case for making the base of a consumption type tax as broad as possible. Preferential treatment distorts consumer as well as producer choices".[15] In this regard, equity considerations would be best served by imposing this tax at the level at which taxable goods and services are acquired by the consumer.

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[15] *Sales Taxation in OECD Member Countries*, Sijbren Cnossen; International Bureau of Fiscal Documentation – Bulletin, April, 1983

(b) Neutrality

One of the government's major concerns in attempting to move the tax from the manufacturer's level has been the lack of neutrality in the sales tax system when it is imposed at the manufacturer's level. Neutrality exists, in one sense, when there is a constant ratio of tax to final sale price to consumers for all taxable goods. Our investigations have revealed that neutrality is not achieved today between domestically manufactured goods and imported goods in certain circumstances. The sales tax advantage enjoyed by Japanese automobiles over domestically manufactured automobiles is an example of this type of discrimination. As well, there is abundant evidence that neutrality is not achieved where domestically manufactured goods are taxed at different levels in the production-distribution network. For example, many Canadian manufacturers must account for sales tax on their actual selling prices to both wholesalers and retailers, even though the sale price to wholesalers is lower, because they do not qualify for tax equalization under the provisions of Memorandum ET-202.

Neutrality also requires minimization of the number of circumstances in which taxpayers can organize their affairs so as to reduce the burden of the tax. Such tax planning takes place today when certain functions such as advertising, warranty, warehousing and servicing are moved beyond the point of imposition of the tax.

The taxpaying community has continually criticised the proposed move to the wholesale level, because it does not achieve a desirable level of neutrality for the following reasons:

(i) retail margins may differ significantly both:

- for similar goods, and
- for goods which compete for the consumer's dollar;

(ii) competing goods can be sold either directly to consumers or through retailers; and

(iii) goods can be imported directly by either retailers or consumers.

If a desirable level of neutrality is to be achieved, this can be accomplished only by imposing the tax at the level at which goods are sold to the final consumer.

(c) Administrative Feasibility

The administration of a sales tax in a complex society is never an easy matter. Some of the reasons for this complexity are:

(i) the number of registered licensees;

(ii) taxpayer identification;

(iii) definition of the value base;

(iv) definition of exempt goods and services;

(v) the separation of goods and services; and

(vi) the possibilities of evasion.

If we wished only to minimize the number of licensees, then we would obviously choose the manufacturer's level. Our observation is that a move to the wholesale level will require the licensing of approximately 20,000 additional taxpayers. A move to the retail level, either as a single stage tax or as a value-added tax, could require the licensing of perhaps 300,000 additional firms, most of whom are presently licensed for provincial sales tax purposes. Consequently, as one moves toward the consumer level of taxation, administration of the tax will become a heavier burden, at least as regards the number of licensees. This additional administrative burden must be traded off against the gains that will be made with regard to neutrality.

The proposals to shift the tax to the wholesale level have encountered severe criticism concerning the difficulties involved in identifying who should be licensed. The need to have special rules to deal with wholesaler/retailers and the treatment of contractors are two examples of the complexities of taxpayer identification under a wholesale system.

The need to retain notional values for non-arm's-length transfers and sales to consumers is another criticism of a move to the wholesale level. Under the proposed wholesale system the number of notional values might increase, although they might apply to a smaller tax base than is the case under the current manufacturer's system.

A move toward the consumer level of taxation should not add any more complexity than already exists within the current sales tax system or the wholesale tax system, with regard to taxpayer identification, the definition of sale price and exemptions. In fact, broadening the tax base to include more goods and services would reduce complexity in these areas as well as solving some of the problems associated with the segregation of goods and services and the education of tax collectors.

If the tax point is moved to the level at which consumers purchase goods and services the number of vendors responsible for paying the tax will increase dramatically. It is often stated that a number of these taxpayers will be unsophisticated and that the system will therefore suffer from an increased level of "tax leakage". As well, direct imports by consumers may escape the tax net. In reply, we can only point out that nine of ten provinces impose a tax at this level and appear to have found the level of compliance to be acceptable.

4. Some Practical Sales Tax Problems

(a) Private Brand Goods

Throughout the tax reform process, concern has been expressed that private brand goods enjoy a tax advantage over the national brands of Canadian manufacturers. While the existence of this alleged tax advantage has been hotly debated, shifting the tax to the level at which retailers purchase goods would offer only a partial improvement. The wholesale tax proposals would eliminate the tax advantage with regard to private brands of wholesalers but not those of retailers.

A tax imposed at the level at which consumers purchase goods in Canada is the only realistic solution to the private brand problem.

(b) Transportation Costs

The government's proposal to remove from the tax base all Canadian domestic transportation was received favourably by the taxpaying community. However, our investigation has revealed that the removal of domestic transportation, coupled

with the taxing of transportation to the Canadian border, would be administratively difficult, if not impossible, and that it would create many anomalies, especially for air cargo and marine transport.

Therefore, the Committee recommends that if the manufacturer's sales tax is retained, outbound transportation from the manufacturer's gate remain deductible or excludable, as it is under the present legislation. It is also our opinion that the administrative difficulties involved in including freight to the border in the tax base for imported goods outweigh the advantage of doing so.

If the tax is moved to the level at which consumers purchase goods and services in Canada, it is the Committee's opinion that all transportation charges should be included in the purchase price of taxable goods and services. If the government wishes to provide relief to those in outlying areas, this can be best provided through a tax credit mechanism using the individual consumer's income tax return.

(c) Contractors

The Committee agrees that, whatever reform is attempted, consideration be given to the construction industry so as to:

(i) ensure that prefabricated construction components are taxed at an equivalent level to those alternatives constructed on site; and

(ii) minimize the tax refund complexities for contractors involved in exempt projects.

5. Options for New Directions

Our deliberations have led us to conclude that neither an improved manufacturer's tax nor the proposed wholesale tax can be justified as long term solutions for sales taxation in Canada. This has led us to look at other options. The viable options available to the Canadian government appear to be only a federal-provincial retail sales tax, a federal retail sales tax and a federal value-added tax.

(a) Federal-Provincial Retail Sales Tax

Such a tax would be jointly administered at the retail level by the federal government and the various provinces. To operate most efficiently, this tax should be imposed on a common base throughout Canada. The revenues derived from the tax would be shared between each province and the federal government on the basis of their respective rates. A less attractive alternative would involve differing bases for federal and provincial taxes. This would mean that some goods or services would be subject to both taxes, some to neither, some only to federal tax and some only to provincial tax.

While it is certainly possible to impose such a tax, it is the Committee's opinion that it would be difficult to do quickly. For instance, the Province of Alberta does not presently impose a retail sales tax. As well, the tax base and tax rate vary dramatically from province to province today. If the federal government were to attempt to reach agreement with the provinces on a common base and a common tax rate, the deliberations could be expected to be quite protracted.

This is not to say that this option should be rejected out of hand. In fact, it may be useful to explore the possibilities of imposing such a tax within the framework of federal-provincial fiscal relations. However, the rates of tax which would have to be employed, as well as the reduced fiscal flexibility which might then be available

to both parties, lead us to believe that the process may not permit a satisfactory conclusion within a reasonable length of time.

(b) Unilateral Federal Retail Sales Tax

It would be possible for the federal government to levy its own sales tax at the retail level, in much the same manner as do nine of the ten provinces. This would require the federal government to have a separate administration to deal with vendors, who would be required to be licensed to collect the tax. In turn, these vendors would have to cope with the federal sales tax which would be imposed at a different rate than that imposed by the various provincial authorities and, as well, to deal with goods and services that might be taxed differently for federal and provincial purposes.

It may be possible, however, to mitigate some of these difficulties by imposing an indirect tax on retailers in respect of their sales of a broad range of goods and some selected services.

(c) Federal Value-Added Tax ("VAT")

The federal government could attempt to levy a tax on the sale price to consumers, collected through the value-added mechanism. It would be possible for this tax to be an indirect levy imposed on a broad range of taxable goods and selected services and collected from those who provide such taxable goods and selected services throughout the production-distribution network.

Such a system is used by almost all members of the European Economic Community (EEC) and by non-EEC members such as Norway and Sweden. These countries have made the transition from some other form of consumption tax to the value-added approach relatively recently and with a minimum of disruption.

The United Kingdom introduced a value-added tax in April of 1973. Its importance as a source of tax revenue has increased and the policy of the present government has been to shift the burden of taxation from direct taxation to indirect taxation. In the United Kingdom VAT must be charged by nearly all businesses on the value of their sales, but the cost of the tax falls on the ultimate consumer. A businessman who incurs VAT on his expenses will normally be able to reclaim it. The tax applies only to sales made in the United Kingdom and is also payable when goods are imported. The standard rate of VAT is currently 15%.

A purely private transaction (e.g., the sale of a second-hand car) would be outside the scope of the tax, but any sale made in the course of business attracts the tax. In order that the tax is effectively borne by the ultimate consumer, it is charged and collected at each stage in the manufacturing and distribution process. Hence, VAT affects the registered businessman in two ways. First, he has to charge VAT on taxable sales of goods and services and this is called his "output tax". Second, he will buy certain goods and services himself for his business on which he may pay VAT (e.g.: on raw materials and components, capital equipment and certain services). This is called his "input tax".

The registered trader must account to Revenue for the output tax he charges his customers, but he is allowed to recover his input tax, either by deducting it from the output tax he would otherwise pay to Revenue, or by a direct repayment from Revenue. Hence, all the input tax should be recovered by the business and ultimately be borne by the consumer.

VAT is potentially a regressive tax. To counteract this, certain basic supplies are not taxable for VAT purposes. This is achieved by either zero-rating the supply or exempting it from VAT altogether. Although both methods achieve the objective of reducing the VAT to nil, they are fundamentally different. Zero-rating means that the supply is a taxable supply but at a rate of 0%. Therefore, any VAT paid as input tax can be recovered, but only by a straight repayment, since there will be by definition no output tax against which to offset it.

Exemption means that the supplies are not taxable supplies, with the result that a person who makes only exempt sales cannot register and is unable to reclaim any VAT he may suffer as input tax.

The businessman may pass on all or part of his VAT cost to the customer if the market will bear it. Thus, the tax is ultimately borne by the consumer.

The imposition of such a tax would require the licensing of numerous taxpayers but would provide the advantages of:

(i) neutrality;

(ii) tax relief for producer inputs;

(iii) reduction in the tax content of exports; and

(iv) improvement in government cash flow.

If Canada were to impose such a tax it would achieve a high degree of neutrality, as the tax would be calculated, in the final analysis, by reference to the sale price to final consumer. Consequently, a constant ratio of tax to final sale price should be achieved for all taxable goods and services. As well, there should be little incentive to organize business affairs to shift the burden of tax, as it will be imposed at the consumer level.

The tax would be a consumption based value-added tax, where each firm paid tax with respect to all its taxable sales and took as a deduction any tax paid with respect to its production inputs, regardless of their nature (i.e., raw materials, components, capital equipment, taxable services, etc.). This would provide a much broader relief to producers' inputs than is the case with the present manufacturer's tax, the proposed wholesale tax, or the retail sales taxes which presently operate in Canada.

Under a value-added system it is possible to provide tax relief for goods exported from Canada both with respect to tax on their sale price and any tax associated with the inputs used to produce them. This reduces the tax content of exported goods beyond a level normally achievable under a manufacturer's, wholesale, or retail system of taxation.

A value-added system would impose tax, with off-setting relief for tax paid on inputs, at each stage in the production-distribution network. Hence, it would provide a much smoother cash flow to the government than any single stage tax.

As well, there should be a reduced risk of tax evasion under a value-added system. Since the tax is collected in stages, even if the final taxpayer absconds with the tax he may have collected from his customer, he will not receive relief for the tax which he has already paid on his inputs.

Before imposing such a tax, the government would, of course, have to consider whether the substantial gains in equity and neutrality would offset the additional administrative complexity.

Although the provinces presently do not have constitutional authority to levy indirect sales taxes, a long-term solution might envisage a constitutional amendment to permit them to do so, followed by a jointly administered federal-provincial value-added tax. Such an arrangement might be very attractive to the provinces, since it would reduce "leakage" on interprovincial retail sales and direct imports by consumers, reduce administrative costs and encourage exports by eliminating their sales tax content.

If the imposition of a multi-stage value-added tax resulted in some distortion in the allocation of total tax revenues among the provinces, this might require adjustment through the federal-provincial tax equalization system.

RECOMMENDATIONS

(a) That the government immediately explore the feasibility of imposing the federal sales tax at the level at which taxable goods and services are provided to final consumers and that the government involve the provinces in this process at an early stage.

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

Unofficial translation

Appendix:

Minority Report of Committee Member Normand Guérin

Overview

I share the opinion of the majority of the Committee of not recommending that a change be made at this time in the level of imposition of federal sales tax, but to recommend, instead, that modifications be made to the manufacturer's tax in order to correct its defects.

With regret, however, I am unable to share the opinion of the majority of my colleagues of the Committee regarding the manner in which the manufacturer's tax structure should be improved. I do not believe the recommendation endorsed by the majority of the Committee will effectively correct the existing bias in favour of imported goods nor do I share the belief that the bias in favour of private brand goods cannot, or need not, be corrected within the framework of a manufacturer's tax.

In my opinion, both of these deficiencies would be adequately addressed by a different solution. Briefly, the solution that I shall recommend in the following pages will be to amend the law to deem as manufacturers all persons who have a right giving them the exclusivity of the brands of the goods that they sell, thereby requiring them to pay sales tax on their selling price.

I also disagree with the recommendations regarding notional values, marginal manufacturing and bad debts. In all these instances, I make alternative recommendations. Finally, I do not share the opinion of the majority which rejects any form of wholesale tax as a long-term solution and which recommends a retail sales tax instead. I shall recommend, if it is eventually established that the deficiencies of the present tax system cannot be solved adequately within the manufacturer's tax structure, that a suitably improved wholesale tax be adopted.

My report is presented in the following order:

I Recommendation for an Improved Manufacturer's Tax

II Defects of the Plan Proposed by the Majority to Correct the Import Bias

III A Better Solution to the Import Bias and the Private Brand Bias

IV "Notional" Values

V Marginal Manufacturing

VI Bad Debts

VII Retail Sales Tax

VIII The Wholesale Tax as a Long-Term Solution

I Recommendation for an Improved Manufacturer's Tax

After having considered the pros and cons of the proposal to shift the level of imposition of federal sales tax to the wholesale level, I share the opinion of the majority of the Committee of not recommending that the proposal be implemented at this time.

In my opinion, such a change is inadvisable, because I believe the more serious deficiencies of the present tax structure can be corrected with the appropriate legislation. Moreover, I believe that before making a change having such consequences, more research must be done in order to determine its effects on the numerous kinds of businesses in existence and to correct its defects.

I believe, however, that a wholesale tax system can be improved sufficiently to eventually become an efficient form of taxation in Canada. This will be discussed in the last part of my report.

The two main deficiencies of the present tax structure that our Committee was asked to address are the disparity of the tax burden between domestic goods and imported goods and the disparity of the tax burden between domestic goods sold at different trade levels.

Of these two deficiencies, the first one is obviously more serious because it impairs the ability of Canadian manufacturers to compete with imports. In view of Canada's current unemployment problems, this deficiency requires urgent attention.

The main recommendation of the majority of the Committee is directed at the import problem but, as I shall explain, the recommended solution, in my opinion, will not provide an adequate answer to the problem whereas another solution would.

With respect to the disparity of the tax burden between domestic goods sold at different trade levels, it is necessary to make a distinction between competing and non-competing goods.

The disparity that exists between the tax burden of non-competing goods, such as the one that exists between automobiles and electrical accessories (products that are marketed differently), can only be corrected effectively by moving the tax to the retail level as the report indicates. Fortunately however, this is not the type of disparity that hurts the most. With the present moderate rate of tax, it is highly improbable that this disparity would truly influence the consumers in their choice of products.

The disparity is more serious when it arises between similar goods, because it can then favour one manufacturer at the expense of another. This kind of disparity has been solved to some extent by Revenue Canada which allows manufacturers, in certain circumstances, to compute tax by reference to their selling price to wholesalers when sales are made to retailers and users. Similarly, when sales are made to retailers and users, the tax may be calculated by reference to the selling price to retailers. However, many situations remain where the lack of uniformity of the tax burden causes a serious hardship on certain manufacturers.

The most flagrant example of this situation is the one involving products marketed by national distributors. The costs of advertising, distribution, warranty, etc. incurred by such persons are not included in the taxable value whereas the same costs are taxable when incurred by manufacturers who do their own marketing.

Often the distributor is a person who is perceived by the public to be a manufacturer but who in fact has contracted out his manufacturing activities, or purchases from other manufacturers goods that complete his lines, or exchanges goods with other manufacturers. Nearly all of these situations involve goods bearing a private brand, exclusive to the distributor. This is so because otherwise there would exist no justification for incurring heavy marketing costs.

The majority of the Committee has come to the conclusion that the only solution to the problems of the private brand goods lies in a shift to a retail sales tax. I do not agree with this conclusion. As I will explain, I believe a solution exists that would put an end, immediately, to the discrimination that certain manufacturers have to suffer. The solution would also block the tax avoidance schemes and stop the erosion of the tax base that is currently taking place.

Before elaborating on that other solution, I shall describe what I believe are the main defects of the plan recommended by the Committee. Many of these points are discussed in the report of the Committee but, in my opinion, they have not been answered satisfactorily.

II Defects of the Plan Proposed by the Majority to Correct the Import Bias

The majority of the Committee recommends that the deficiencies in the present tax structure concerning imported goods should be corrected by deeming importers to be manufacturers, if they are situated at an earlier trade level than that at which similar Canadian goods are sold. In this way they would become taxable on their sales price. The majority recommends a two-level procedure to accomplish this. First, a complaint would be made to Revenue Canada by a Canadian manufacturer of similar goods or Revenue Canada would itself initiate the proceedings. After proper notification of all interested parties, an informal hearing would take place at Revenue Canada and this would be followed by the Minister's recommendation to the Governor-in-Council who would then decide if importers of that type of goods, who are situated at a determined level, should be deemed to be manufacturers. The second procedure would consist of a hearing by the Tariff Board if an interested party objects to the Minister's recommendation. The Tariff Board would make its recommendation to the Governor-in-Council which may again accept or reject it.

In my opinion, this recommendation will not adequately correct the bias in favour of imported goods because it has the following defects:

1. Heavy prescription process

Canadian manufacturers who suffer from an import bias will often be in a situation of conflict of interest preventing them from lodging a complaint. This will happen when they import goods themselves, or when the offender is one of their important customers. It is true that the plan provides that complaints can also be initiated by the tax authorities, but they may have difficulty in recognizing the instances of discrimination and obtain the necessary evidence, without the willing participation of manufacturers.

This process will necessarily involve long delays due to the time involved in the accumulation of data to prove injury and to arrive at a final determination. In the meantime, the Canadian manufacturers will suffer the consequences of such delays.

The cost involved to determine whether a complaint should be made and to prove the existence of discrimination and periodically prove again its existence will be prohibitive for small manufacturers or anyone who produces goods in limited quantities.

The cost to government of investigating complaints, including possibly numerous unfounded ones, and the cost of providing adequate hearings to all interested parties, and subsequently administering the decisions, will be out of proportion to the benefits to be derived.

The required market investigation will cause undue administrative disruption in the affairs of major wholesalers and large retailers where these enquiries will be concentrated.

Manufacturers will have no assurance of the outcome until the time of the final decision since it will rest at the political level.

2. Multiplicity of products

Given the myriad of products on the market, the numerous new products put on the market every day and the many variations within similar products due to their durability, construction features, capacity, etc., a product-by-product investigation will be an insurmountable task. Investigations based on broad classes of goods will not be an effective answer either because this will produce an excessive tax burden in some cases and an insufficient one in others.

3. Continued bias in favour of many imported goods

The proposal will not remove the bias in favour of imported goods of a type not produced in Canada. The selling price of these goods is often very superior to their duty-paid value as a result of expensive advertising and marketing activities. Examples where the selling price was four times the duty-paid value have been brought to the attention of our Committee. Since importers of these products compete for the same consumer dollars as Canadian manufacturers, these products would continue to benefit from an unfair advantage by remaining taxable on their duty-paid value.

The proposal will not remove the bias in favour of imported goods if the importer is at the same trade level as purchasers of Canadian goods but engages in marketing functions of a kind normally carried out by Canadian manufacturers. This problem will be particularly acute with certain classes of goods, such as products related to the grocery trade, where Canadian producers sell to businesses that resell to wholesalers at a small margin. Importers of such goods will be able to act as national distributors and sell to wholesalers and retailers and still pay tax on the duty-paid value.

4. Adverse effect on Canadian manufacturing

The proposal will not encourage importers to open plants in Canada and will then be an incentive for them to take action to close existing ones so that tax continues to apply on the duty-paid value. It is paradoxical that a measure intended to protect Canadian manufacturers should have such effects.

5. Hardship on some importers

Under the proposal, all importers situated at a trade level earlier than purchasers of Canadian goods will become taxable on their selling price even if they enjoy no price advantage over persons situated at the next level. In those instances where importing wholesalers will be deemed manufacturers, small wholesalers, who probably pay no more for their goods than large retailers, will become taxable on their selling price but large retailers will continue to pay tax on the duty-paid value.

This situation can create an injustice for taxpayers who have a corporate structure different from that of their competitors. For example, companies which market to consumers through franchised retailers will be at a disadvantage when compared to retailers operating a chain of corporate stores. Where the prescription is at the wholesale level, the former will be taxed on their selling price, whereas the latter will pay tax on the duty-paid value, even though both may pay the same price.

6. Potential for tax avoidance

It will be possible for importers to avoid the prescription by entering into an agency agreement with their customers. Thus the importation would be made in the name of the customer, who would not be subject to the additional tax because he is at the next trade level.

It will also be possible for importers to cause the law to lose much of its desired effects by inserting a low profit intermediary between themselves and the exporter. (I do not agree with the majority of the Committee that this situation is unlikely to occur).

Importers who sell to customers situated at different trade levels will be able to minimize the impact of the prescription by forming separate corporate entities to import and sell to customers situated at the later trade levels. For example, an importer who sells to wholesalers and to retailers, and who is deemed to be a manufacturer because of his sales to wholesalers, could form a separate company to import and sell to retailers. That second company would continue to pay tax on the duty-paid value.

7. Disruption of normal trading patterns

With the proposed plan, manufacturers will have an incentive to bypass the wholesale level in order to get importing wholesalers classified as deemed manufacturers. On the other hand, when Canadian manufacturers sell to wholesalers, importers will have an incentive to bypass the wholesale level also because by selling directly to retailers, they will escape the increased tax burden. The same phenomenon will occur regarding all intermediaries that precede wholesalers. Wholesalers and preceding intermediaries may thus find their existence in jeopardy in two ways.

8. Complexity of the uplift provision

To overcome the problem of stock identification that would exist when a business sells goods for which it is deemed a manufacturer and goods for which it is not, the proposed plan provides that all persons be given the option to pay tax at the time the goods are imported but on an uplifted value. The amount of the uplift is to be determined at the time of the investigation. In my opinion, this recommendation

does not take sufficiently into consideration the difficulties of determining an adequate uplift. It will also give importers the additional burden of having to choose between the two alternatives.

9. GATT consideration

Although the proposal of the majority was found by an authority on the matter not to contravene Canada's obligation under the General Agreement on Tariffs and Trade (GATT), it would appear desirable, to me, to ensure that all aspects of the question have been fully considered. Two points in particular appear to me to be doubtful. The first one is the fact that an amendment would be made in the law to specifically impose an added tax to importers situated at levels preceding that of purchasers of Canadian goods without a corresponding provision being added to increase the tax burden on Canadian goods in the reverse situation. The second point is the fact that a provision would be made, as I explain later, to allow Canadian producers to pay tax on their lowest selling price without a similar provision being made to allow a corresponding privilege to all imported goods.

III A Better Solution to the Import Bias and the Private Brand Bias

As mentioned previously, the bias in favour of imported goods results from the fact that importers can undertake functions normally carried out by Canadian manufacturers such as advertising, sales promotion, warehousing, warranty, customer service, etc. and exclude such costs from the tax base, whereas Canadian manufacturers must include them in their taxable selling price. In my opinion, this problem is important only when the marketing costs incurred are substantial, and this occurs mainly when the importers have exclusivity over the brands that they sell. Otherwise, they would be incurring expenses for the benefit of others.

This makes it possible, therefore, to solve the import bias by requiring persons, who have the exclusivity of the brands of goods that they sell, to pay tax on their selling price as deemed manufacturers. This would make it possible, therefore, to avoid the pitfalls of the product-by-product prescription plan suggested by the majority. At the same time, the solution would correct the bias in favour of domestic goods sold at different levels of trade which, as I explained previously, also occurs mainly when the vendor sells products bearing his exclusive or private brand.

As the report of the Committee indicates, the majority of the members have rejected this plan but, in my opinion, the objections that have been raised against it can be overcome by suitable adjustments.

Recommendation

To correct the disparity of the tax burden between domestic and imported goods, and the disparity between domestic goods sold at different trade levels, I recommend, therefore, that the law be amended to deem as manufacturers all persons who have a right giving them the exclusivity of the brands of goods that they sell.

The idea behind this recommendation is not new. It was suggested as early as 1956 by the Carter Committee and it was taken up again by the Royal Commission on Taxation in 1966. Although the Commission recommended a change in level, it saw this as a

desirable improvement to the manufacturer's sales tax. It recommended however, that the measure be limited to wholesalers.

As is the case with any modification of the law, the recommendation has incidental problems which must be resolved.

1. Partial exclusivity and exclusivity without rights

It is foreseeable that situations will occur where persons who do not have brand exclusivity assured by contract or by any other right will in fact be the only persons, or practically the only persons, selling the products of a given name and will undertake marketing activities similar to those who have a right of exclusivity. To deal with this situation, the law could contain a provision to include in this category of deemed manufacturer persons, who, without having a right of exclusivity, are in fact the only persons, or practically the only persons, selling the products of a given brand. In order not to tax persons who do not carry on extensive marketing but who, perhaps without knowing it, are the only persons in Canada through which are sold all the products of a given brand, this provision in the law could be drafted so as to limit its application to persons who undertake the marketing of a product across the country or a large region.

2. Private brand goods sold with the same markup as manufacturers' brand goods

The main objection that was always voiced in the past against the introduction of legislation to deal with private brands, has come from retailers who indicate that their markup on private brand goods is equal to their markup on goods bearing a manufacturer's brand. This is a valid objection and to deal with it, the law could permit this type of deemed manufacturer to deduct from the selling price a percentage equal to the margin realized on sales of significant quantities of similar goods for which they do not have brand exclusivity. For example, if a private brand product costing $65 is sold at $100 whereas a manufacturer's brand product selling also for $100 costs $70, the deemed manufacturer would pay tax on only $5.

Such a provision coupled with the regulation concerning determined wholesale values should satisfy that main objection, which has always been the stumbling block to the proposal.

It is true that such a measure will require a detailed analysis of activities by the persons involved in order to determine the profit margins on the different classes of goods sold. However, since the businesses that sell private brand goods are generally large enterprises with elaborate accounting systems, such data should be easily obtainable without substantial administration costs.

3. Tax paid and tax exempt inventories

In order to ease the product identification problems that would result when a person is deemed to be a manufacturer for only a portion of the goods sold, a provision could be inserted in the law to permit such persons to acquire goods on a tax-paid basis and pay tax at the end of the month or at the end of the year on the gross profit realized on sales of private brand goods.

4. Regional exclusivity

As is indicated in the report of the Committee, it is possible that some persons could attempt to circumvent the brand exclusivity rules by separating their distribution network into different regions. This may not be a serious problem as might first appear because it is doubtful that persons with only regional exclusivity would engage in the type of elaborate marketing activities that produces tax discrimination. In any event, if it were found that the law was being circumvented in that fashion, appropriate legislation could be passed to address the problem.

Advantages of this solution

When comparing the solution recommended by the majority with the one I recommend based on brand exclusivity, it will be seen that the latter has the following advantages:

(a) It provides an effective answer to the import bias where the greatest disparity exists, that is, where goods are the object of extensive advertising and marketing.

(b) It provides an established rule as opposed to a case-by-case approach thereby minimizing delays and uncertainties.

(c) It avoids substantial administrative costs to both the taxpayers and the government.

(d) It eliminates the bias in favour of all imported goods and not only those of a kind produced in Canada.

(e) It provides an effective answer to the bias in favour of private brands in instances where it truly exists.

(f) It stops the erosion of the tax base.

(g) It makes it possible to repeal the marginal manufacturing provisions. (This is explained in a later section).

(h) It makes it possible to treat cosmetics in the same manner as other goods. This would eliminate the administrative complications of the present law which forces wholesalers to follow procedures on sales of cosmetics that are altogether different from those applied to other goods.

(i) It does not contravene Canada's commitment under GATT.

(j) It does not discriminate between businesses having corporate structures different from those of their competitors.

(k) It does not interfere with the current trading patterns.

(l) It does not act as a deterrent to manufacturing in Canada.

IV "Notional" Values

I do not concur with the majority's recommendation regarding the modification to be made to the rules which presently allow manufacturers to pay tax on the price they charge to wholesalers when they sell to retailers and consumers. The Committee recommends that a manufacturer be permitted to account for tax on his lowest selling price, provided 15% of his sales are made at that price, regardless of the level of the customers to whom he sells.

While the majority's recommendation appears, at first glance, very attractive to taxpayers who have visions of great tax savings, the reality may be quite different. By reducing the value for tax to its lowest expression, the rate of tax, of necessity, will increase correspondingly if the government is to maintain the same revenue. Thus, the perceived gain would be illusory. Moreover, the proposal would cause an administrative nightmare for both the taxpayers and the government. It would mean that a large number of sales, perhaps up to 85% of all sales, would be taxable not on the actual selling price as shown on the invoice but on a "notional" value. This, in my opinion, is not acceptable for several reasons:

- The computation of tax on notional values is time consuming for the taxpayers and for the tax administrators.

- The use of the lowest price would favour companies that sell a portion of their production to very large customers.

- The use of the lowest price as the tax base violates the principle that sales tax should not interfere with economies of scale. If all sales are taxed at the lowest price, the tax burden of customers who buy in large quantities will be proportionately higher than that of those who buy in small quantities.

- The recommendation that the tax be paid on the lowest price regardless of the trade level of the customers on the basis that trade levels are now blurred, is inconsistent with the other recommendations of the majority of the Committee. The recommendations regarding imported goods, the one regarding determined values and the one regarding the fair values, are all based on the assumption of the existence of clearly partitioned levels of trade.

- The recommendation could be in violation of Canada's obligation under the GATT, since it would permit Canadian manufacturers to pay tax, in most cases, on amounts less than their selling price, whereas imports would be taxed on the full amount paid by the importers (duty-paid value).

- The proposal would incite taxpayers to use tax avoidance schemes such as price manipulation, model modifications, etc.

- The recommendation is contrary to our Committee's terms of reference since it could substantially increase the use of notional values.

In place of the majority's recommendation, I propose that the rules for computing determined values be maintained in more or less their present form, but that they be reviewed in depth to ensure that they accomplish what they were set out to do.

V Marginal Manufacturing

By adopting the recommendation calling for private brand vendors to be deemed manufacturers, the need for marginal manufacturing legislation is practically eliminated. One of the main justifications for the present marginal manufacturing provisions is that repackaging or relabelling operations can change the market value of goods drastically. Generally, the cause of the increase in value is not the value of the packaging itself, but the fact that the products acquire a brand name which benefits from extensive advertising, or enjoys a favourable reputation. If persons having brand exclusivity are deemed to be manufacturers by a distinct provision, then the need for a marginal manufacturing provision is greatly diminished.

A marginal manufacturing provision may still be considered desirable, however, to ensure that goods packaged or prepared for sale by the customers of the manufacturers, are treated on the same basis as those packaged by the manufacturers themselves. If that aspect of the question were considered sufficiently important to justify the retention of the marginal manufacturing rules, then I would recommend that the law be amended so that marginal manufacturers be obligated to acquire their goods tax-paid and be required to pay tax at time of sale but only on the portion of their selling price which corresponds to the ratio of the cost of packaging to the total cost of the goods. I make this recommendation because I believe it would produce essentially the same tax that would otherwise be payable if the goods were acquired fully packaged.

This recommendation would put an end to the very regrettable situation that has developed since the introduction of marginal manufacturing, that is, the shifting of packaging operations outside Canada. This situation occurs in those instances where the tax benefit exceeds the resulting increases in freight costs and customs duties. Packaging outside Canada has meant lost jobs in Canada both in packaging and in the manufacturing of packaging materials. This situation is in urgent need of correction.

I do not concur with the majority's recommendation to limit the application of the marginal manufacturing rules to instances where the packaging costs represent more than 10% of the cost of the goods. Such a provision, when applicable, would still cause goods to be packaged outside Canada and it would produce undue discrimination between goods above and below the 10% threshold. Further, it would favour companies with automated packaging equipment and it would discriminate against manufacturers who package their own goods.

VI Bad Debts

The majority of the Committee recommends that tax relief be given to manufacturers, with respect to their uncollectible accounts, in a manner similar to the one contained in the proposal to move the tax to the wholesale level. All manufacturers will no doubt welcome such a measure. However, in transposing such a measure from a wholesale tax to a manufacturer's tax, a problem of equity arises. Allowing a tax recovery to manufacturers for sales made directly to retailers and users and not allowing one to licensed and unlicensed wholesalers who make similar sales, would be inequitable. The inequity becomes more evident when one considers that on sales to retailers and users, manufacturers remit the tax only on the sale price to wholesalers.

I believe, nevertheless, that some relief for uncollectible accounts is justified in order to prevent a form of double taxation that would otherwise occur since on credit sales the

taxable selling price already includes an element for loss. I recommend, therefore, that tax relief be allowed to manufacturers with respect to uncollectible accounts but that it be allowed only on sales that are taxable on the full selling price.

VII Retail Sales Tax

The majority of the Committee has come to the conclusion that neither the present manufacturer's tax nor the proposed wholesale tax are satisfactory and that the ideal tax would be a retail tax, possibly jointly administered with the provinces, and collected by the value-added method.

While it is undeniable that a single uniform tax to replace the present dual tax system would much simplify the compliance burden of taxpayers, I am unable to conclude, as the majority of the Committee does, from such little amount of study as we have done, that a federal tax at the manufacturer's or at the wholesale level is not a valid long-term solution, and that all efforts should be put towards a move to a jointly administered retail sales tax.

As indicated in the report of the Commodity Tax Review Group in 1977, moving the tax to the retail level and imposing it jointly with the provinces would entail numerous difficulties. The main one would be the necessity to develop a uniform base for the federal and provincial taxes across the country. The range of goods and services presently taxed differ significantly with each government. Agreement on a common base may be difficult to realize since it would deprive both levels of government of the useful tool which they have used regularly in the past to achieve economic and social goals and would mean a loss of fiscal autonomy. Therefore it must be anticipated that it would take many years to reach such an agreement especially since, for some of the parties involved, there is no perceived crisis. In the interim, the problem of the current tax, which urgently requires resolution, would remain unsolved.

The alleged superiority of a retail sales tax is open to question. Consider the following:

- It is said that a retail sales tax has greater neutrality but often the argument is overstated. In my opinion, neutrality is an important factor principally when one compares the tax burden borne by competitive products. This type of neutrality can be achieved in the case of most goods under a wholesale tax, and to a lesser extent under a manufacturer's tax. As to the lack of neutrality with respect to noncompetitive products, I do not believe it should be the most important factor to govern the choice of the tax level, because with the moderate rate of tax presently imposed, it is unlikely that the disparity would truly influence customers to buy one product instead of another.

- Advocates of a retail sales tax argue that such a levy is more easily administered than a manufacturer's tax or a wholesale tax, because it avoids the notional value problem. While this problem does exist under these latter forms of taxes, it must be remembered, however, that it exists only for a relatively small number of taxpayers. On the other hand, a retail sales tax would entail licensing some 300,000 new taxpayers and training their employees to correctly apply the tax on every sale. After considering all aspects of the question, I do not believe it can be said that a retail sales tax is superior in that respect.

- A retail sales tax is said to facilitate the imposition of tax on services. The imposition of a tax on goods and a tax on services does not need to be at the same level. This is proven by the fact that the Federal Government currently imposes at the sale-to-user level a tax on air transportation and more recently, a tax on telecommunication programming services, whereas the tax on goods is imposed at the manufacturer's level.

- Finally, it must be remembered that a combined federal and provincial sales tax which would produce as much revenue as the present taxes, would require a rate in the range of 15% to 18% in some provinces. With such a high rate, evasion could become a serious problem. A value-added tax would minimize tax evasion but would impose a heavy administrative burden on taxpayers and would probably cause border adjustment problems between provinces.

VIII The Wholesale Tax as a Long-Term Solution

As to the wholesale tax, I agree with the majority of the Committee that its advantages over an improved manufacturer's tax are insufficient to justify its adoption at this time. However, I do not believe the problems that have been identified are so great or so insurmountable as to make this form of tax less desirable than a retail tax as a long-term solution.

In my opinion the main problems which have been raised with the proposal to impose sales tax at the wholesale level are:

1. The large retailer tax

The most significant stumbling block to any wholesale tax is the difficulty of providing adequate treatment to large retailers who perform wholesale functions. The large retailer tax contained in the proposal, which was established by reference to the difference between the margins of large and small retailers, has been justifiably criticized because it applies indiscriminately to all large retailers, whether or not they perform wholesale functions. In my opinion however, this is not to say that the problem cannot be solved. I believe that further attempts should be made to measure more precisely the wholesale functions of large retailers.

For example, it would appear possible to design a tax which would be calculated on the basis of the additional gross profit margin that a large retailer makes over the margin earned by medium and small retailers. Normally, this excess should represent the value of the wholesaling functions assumed. Admittedly, this may require a detailed analysis of the business involved, but since there are approximately only 200 large retailers in the country, the total administrative cost involved would be insignificant compared to those of a retail sales tax.

2. The product mix

The proposed wholesale tax would require wholesalers to allocate their sales between goods taxable at 9%, at 5% and those that are exempt. This can be a serious problem where wholesalers handle a multitude of different products. This problem could be solved by redrafting certain of the exemptions and by adopting a uniform rate. For example, instead of assisting the construction industry by imposing a reduced rate on construction materials, a complete exemption could be given

on sales of certain basic materials such as structural steel, cement and lumber, and the full rate applied on sales of other construction goods. Another solution would be to use a system of direct subsidies instead of granting any exemption.

3. Vertical integrations, agency agreements and buying groups

A wholesale tax is also criticized because it favours the vertical integration of wholesalers and retailers, encourages them to enter into agency agreements and leads to the formation of buying groups. This problem is identical to the one concerning large retailers because in all of those instances, the small and medium retailers would effectively become large retailers. By taxing the excess margin as suggested previously, the problem could be solved.

4. Retailers who sell to other retailers

Firms that are basically retailers, but that make a certain percentage of their sales to other retailers anticipate difficulties with the proposal, because they will be taxable on the gross profit realized on such sales, if such sales exceed $50,000 per year. The problem might be simplified by increasing the threshold, or perhaps by relating it to the gross profit realized on such sales, so as to eliminate accommodation sales often made between retailers.

5. Classification of contractors

The proposal defines sales made to contractors as "sales by wholesale" but treats these sales differently depending on the status of the supplier. The difference in treatment creates an injustice. The proposal also creates an administrative burden in requiring all vendors to segregate sales to contractors from sales to other consumers, which can be difficult. Many of these problems could be avoided if contractors were classified as users.

6. Reducing the rate from 9% to 8%

Many of the briefs received by the Committee alleged that the proposed rate reduction from 9% to 8% does not compensate for the fact that the base will increase by the wholesaler's gross margin. It is perceived by some persons that the additional tax will be passed on and fuel inflation. Others complain it will eat into profits already depressed by the current recession.

According to the information given to our Committee by statisticians of the Department of Finance, a wholesale tax at a rate of 8% would achieve essentially the same revenue as the 9% manufacturer's tax. However, this is an overall average. On a product-by-product basis the results are quite different. Manufacturers of certain products, such as gasoline and Canadian automobiles, stand to gain substantially with the reduced rate because these products are already taxed on the selling price to retailers. Other manufacturers, on the other hand, stand to lose a corresponding amount since the total revenue is to remain the same. It has been said that this is justified because it eliminates a tax advantage presently enjoyed by certain taxpayers over others.

Nevertheless, I find it impossible to endorse a proposal that takes money away from one taxpayer in order to give it to another. It must be admitted, however, that this happens whenever a change is made in the law to increase the general rate of tax or eliminate certain exemptions. What really matters is that all competing goods bear a comparable burden of tax. The wholesale tax accomplishes this goal.

As to the timing of the introduction of the reduced rate of tax, I believe it should be made to coincide with the introduction of the wholesale tax, and not six months later as proposed. It is true that this is intended to compensate the government for the refunds of tax on wholesalers' inventories, but another solution should be found because the delay would cause pricing complications and would be inequitable to those who cannot pass on the extra cost.

7. The need to retain notional values

The wholesale tax has been criticized because it must necessarily contain a system of notional values to deal with sales made by wholesalers directly to users when similar goods are being taxed on their selling price to retailers. This is true, but in appraising this argument it is necessary to take into consideration the difficulties which exist when taxes are imposed at any other trade level. Also, it should be recognized that under a wholesale tax, there would be proportionally less sales subject to tax on notional values than under the present manufacturer's tax.

8. The transitional problems

Much of the resistance to the wholesale tax proposal stems from the transitional problems, such as the need for additional taxpayers to become licensed, the need to determine the tax included in inventories, the need to adjust selling prices, to modify computer programs, to renegotiate contracts, educate staff, etc. These problems no doubt exist and satisfactory solutions must be found for them. However, the same problems would exist to a much greater extent if Canada were to move to a retail tax, as the majority of the Committee recommends.

To sum up, I believe solutions exist to the problems of the wholesale tax which would render this form of tax more attractive. The main advantages of a wholesale tax are that it is easily administered, since it limits the number of new taxpayers to a minimum, and the possibility that it can be introduced within a short period of time.

I therefore recommend, if it is eventually established that the deficiencies of the present system cannot adequately be solved within the manufacturer's tax structure, that the wholesale tax be adopted to replace it.

I also recommend that more extensive research be done on a continuing basis to seek solutions to the deficiencies of the existing tax and to find answers to the weaknesses of other tax structures that could be used to replace it. In my opinion, the decision to change the level of imposition should not be made before all the implications have been studied much more thoroughly. The amount of revenue generated by this tax, $6 billion, and its important impact on the economy of Canada is ample justification for a greater investment in this area.

Respectfully submitted,

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