IMPACT OF WHITE PAPER SALES TAX REFORM PROPOSALS ON THE SOUND RECORDING INDUSTRY

Prepared For The Department of Communications

CLARKSON GORDON
DRAFT
FOR DISCUSSION PURPOSES ONLY

November 1987

A Report From:

WOODS GORDON
A Member of Arthur Young International

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THE IMPACT OF FEDERAL STAGE I SALES TAX PROPOSALS ON THE SOUND RECORDING INDUSTRY

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EXECUTIVE SUMMARY

The Department of Communications commissioned Woods Gordon Gordon to assess the impact of Stage I sales tax proposals on the sound recording industry and to suggest alternatives.

Given the time and resources available, Woods Gordon was to assess the proposals on the basis of data and information already available in published form. There are, however, no published studies or reports that document the application of the federal sales tax to the sound recording industry. Even the information about the sales, volumes, and prices published by Statistics Canada was found to be grossly inadequate for the analysis. It was thus necessary for Woods Gordon to contact the industry members directly to obtain the necessary information which formed the basis for this analysis and most of its conclusions.

At present, there is considerable confusion and uncertainty in the industry about the application of the federal sales tax. There are significant variations in the tax being paid from one company to the next. There have also been disputes, yet unresolved, between Revenue Canada and taxpayers about the proper application of tax. If the legislation is left unchanged, then in our view most major labels will eventually be able to reduce their tax base to 12 per cent of the duplicating cost, as opposed to their sale price to rack jobbers. Independent labels, however, would continue to be liable for tax on their sale price to distributors and would thus be discriminated against.

The White Paper proposal to shift the tax to the wholesale level will result in a substantial increase in tax - 20-25 cents per record or tape for independent label products and 25-60 cents for major label products. While resolving existing inequities, it would create a new set of inequities. In particular, it would favour rack jobbers who sell through their own retail outlets, as opposed to those who sell to franchised retail stores.

This study suggests alternatives to the White Paper proposal. Our findings lead us to conclude that, pending comprehensive sales tax reform in Stage II of tax reform, the federal sales tax should be calculated using prices of records, tapes, and compact discs specified by the Governor-in-Council Regulation. The tax would be payable on these values by the duplicator or importer at the applicable tax rate. This would ensure simple and uniform application of tax to all sales in Canada.

INTRODUCTION

This study was commissioned by the Department of Communications to determine the impact on the sound recording industry of the two sales tax reform measures proposed by the federal government in its June 18 White Paper on Tax Reform. The measures include:

- the shift in the application of the federal sales tax on records, prerecorded and blank audio tapes, and compact discs from the manufacturing to the wholesale level; and
- the application of federal sales tax at the level of marketing companies where they are related to the manufacturer of the goods.

It is Part I of a two part study examining the overall impact of tax reform on the cultural sector. The implications of the income tax reform package on the cultural sector will be addressed in Part II of the study.

To determine the effect of the proposed sales tax reform measures on the sound recording industry, we contacted various members of the industry, including representatives of the Canadian independent record companies, the foreign-owned record companies, and distributors and retailers of records and tapes. We also held discussions with the Canadian Independent Record Production Association (CIRPA) and the Canadian Recording Industry Association (CRIA). These discussions focused on three issues:

- the structure of the industry;
- the current application of federal sales tax to the industry; and
- the industry's assessment of the impact of the sales tax reform measures.

In addition, we reviewed a range of secondary materials describing the industry, including a 1982 in-depth Woods Gordon study entitled <u>Sound</u>

Recording Industry Study, also commissioned by the Department of Communications. This study evaluated the need for a federal government support strategy for the sound recording industry in Canada and the most appropriate strategy for providing industry support.

Other secondary sources included Statistics Canada publications about the industry that provided information about sales, prices and the composition of the industry and submissions on tax reform presented by industry associations to the House of Commons Standing Committee on Finance and Economic Affairs.

Finally, we referred to the Excise Tax Act (ETA) for the relevant provisions of the current federal sales tax (FST) regime as they apply to the sound recording industry.

WHITE PAPER TAX REFORM PROPOSALS

The June 18, 1987 White Paper proposes two changes as interim measures pending comprehensive reform of the sales tax regime. These are:

1. *Changes in Trade Level for Imposition of Federal Sales Tax*

Under this proposal, the application of the FST will shift to the wholesale level:

"Changes are proposed in the level of imposition of the sales tax on certain products to address disparities and anomalies in the application of tax and the bias in favour of imports. The government proposes to shift the application of the existing tax to the wholesale trade level, effective January 1, 1988, for the following products...
...records, prerecorded and blank audio and video tapes, compact discs, video discs and related accessories."

2. *Application of Tax to Marketing Companies Related to Manufacturer*

Under this proposal, the incidence of tax will shift from the sale price of the physical manufacturer to the sale price of a related marketing company, where the manufacturer sells primarily through a related person:

"The new marketing company rules will apply where:

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

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

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

In a press release dated November 3, 1987, the Minister of Finance has announced a six-month delay (from January 1, 1988 to July 1, 1988) in the implementation of these measures. The Minister indicated that the measures were being delayed to take into account the concerns of the businesses affected. This analysis should thus provide a useful input to the Department of Finance in their current reevaluation of the proposals.

CURRENT (PRE-REFORM) TAX LEGISLATION/ADMINISTRATION

The federal sales tax applies on the sale price of goods manufactured in Canada and on the duty-paid value of imports (i.e. the value for customs duty purposes plus the amount of the duty). The ETA contains a number of special rules defining what constitutes manufacturing or designating certain persons to be manufacturers even though they may not have physically manufactured or produced the goods. There are two such sections in the ETA that are applicable to the sound recording industry.

First, under the ETA, Section 2(1)b defines manufacturer to include:

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

Thus, where the physical manufacturer manufactures goods on behalf of others, the person, firm or corporation who holds, claims or uses a patent, proprietary, sales or other right to the goods is deemed to be the manufacturer.

Traditionally, Section 2(1)(b) has applied to the major record label companies who purchase master tapes from the parent company and have them duplicated in Canada. Master tapes are imported duty free under tariff item 69615-1. They are exempt of FST on importation as production equipment under Part XII Schedule III Section 1(a) of the ETA. Historically, most major companies have been paying FST as manufacturers on the selling price of the duplicated copies of the master, on the grounds that they hold patent or proprietary rights in the copies being made in Canada.

Independent record producers operate in the same manner, with the exception that they make their own master tapes. They have a similar relationship with the duplicators. Historically, they have also been considered manufacturers by virtue of Section 2(1)(b). They similarly do not pay FST on the masters as they are exempt of FST under Part XIII of Schedule III of the ETA.

Over the past four or five years, the application of Section 2(1)(b) has been questioned by several taxpayers and they have restructured their affairs to minimize its effect. This can be done in three ways:

(i) This section, as currently worded, applies to only goods being "manufactured" in Canada. Recording of sound only on records or blank tapes has been determined to be "production" of goods, not a manufacture of them. On March 13, 1987, Revenue Canada issued a ruling (No. 1100/55-1) confirming this understanding. As a result, record companies can now acquire the records tax-paid from duplicators, and are no longer liable for tax on their selling price to rack-jobbers and other distributors.

(ii) Traditionally, Revenue Canada has not attempted to apply Section 2(1)(b) to non-resident firms who would otherwise be considered to be the manufacturers. To take advantage of this, record companies in Canada can transfer the patent and proprietory rights in the tapes and records to their foreign parent. The tax will then be paid by the duplicator on his charge for duplication.

(iii) It is possible for record companies to make a sale to a related marketing company who then resells to rack-jobbers and other independent distributors. The initial sale would be priced so that it excludes all of the marketing and distribution costs and much of the profit. Thus, even if the record company is deemed to be a manufacturer, it can effectively exclude the marketing and distribution costs and a part of the profit from the tax base.

The second section that affects the sound recording industry relates to marginal manufacturing. Section 2(1)(f) of the ETA states that:

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

Pursuant to this section, where the record company supplies packaging materials such as "J or U card" inserts for plastic cassette tape cases or album jackets to the duplicator, or does its own packaging, it is held to be the manufacturer and is required to remit FST on its sale price of the duplicates.

Another provision that affects the calculation of FST in this sector is an administrative one and relates to the use of notional values for calculating the tax. Where a manufacturer makes sales to both wholesalers and retailers, Revenue Canada allows the tax on sales to retailers to be calculated in effect, by using the price charged to wholesalers. This administrative practice is designed to ensure a fair and uniform application of tax to both types of customers.

Revenue Canada has, however, indicated that notional values are only permitted when variations in the taxable selling price are due to variations in the trade level of the customers. In most cases in this industry, the selling price varies according to volume sold rather than trade level. As a result, the industry is generally not able to benefit from the administrative policy and has been remitting FST on sale price, regardless of whether it is selling to the wholesale or retail level.

INDUSTRY STRUCTURE

(1) The Players

The industry is composed of two types of recording companies (a) the major recording company with a national distribution operation with an artist and repertoire department and full time promotional staff and several recording labels and (b) the independent recording company which usually records on one label with a limited number of artists. The independents generally do not have their own distribution network. Most of the large majors have a foreign parent corporation.

Majors	Parent Company and Location
A&M Records of Canada	A&M Records Inc. - U.S.A.
Capital Records - EMI of Canada Ltd.	Thorn-EMI Ltd. - U.S.A.
CBS Records (Canada) Ltd.	CBS Inc. - USA
MCA Records (Canada)	MCA Inc. - U.S.A.
Polygram Inc.	Philips-Netherlands 50% & Seimens - West Germany 50%
~~Quality Records Ltd~~.	~~Selkirk Communications - Canada~~
BMG Incorporated	~~RCA Corporation - U.S.A~~.
WEA Music of Canada Ltd.	Warner Communications Inc. - U.S.A
Walt Disney Music of Canada Ltd.	

The independents are more difficult to identify as many are part-time or dormant operations.

The 1986 membership list of the Canadian Independent Record Producers Association includes 150 members. The parallel organization in Quebec, ADISQ has 370 members. Some of the prominent independents are:

Anthem	Phonodisc
Aquarius	Pro-culture
ATTIC	Royalty Records
Boot	True North

Table 1 illustrates the total sales by record companies by the trade level of customers for 1980 and 1986. Record companies in both 1980 and 1986 include those respondents who indicated on the Statistics Canada questionnaire that they were engaged in sales of records or pre-recorded tapes produced from master tapes that they either owned or leased or the sale or lease of masters for duplication. In 1986, the definition of record company in the questionnaire was expanded to include corporations which released new records/tapes produced from masters by the corporation itself or another corporation.

Record companies are also commonly referred to as "label" companies. The "distributor" in this table refers to the trade level immediately prior to the wholesaler who moves finished records from the point of manufacture to the point of sale or to other sub-distributors. Generally, sub-distributors, called rack jobbers, sell to retailers, including one-stops, record clubs, department stores and other retailers.

As Table 1 illustrates, the bulk of the sales by record companies are made to distributors, or rack jobbers. For purposes of sales tax, however, many rack-jobbers may be considered to be retailers because they resell the goods to consumers through their own retail stores, as opposed to independent franchised stores. We are unable to segregate them in the table given the available data.

The table also indicates a substantial growth in sales to "distributors" and a decrease in "unspecified" sales. We have not been able to obtain any satisfactory explanation for this pattern from Statistics Canada. It could reflect simply a better classification of the sales that were previously categorized as "unspecified". Alternatively, it could also be indicative of the greater use of "related marketing companies" (classified as distributors) to minimize the FST on sales by record companies.

TABLE 1

RECORD COMPANY SALES BY CUSTOMER CATEGORY

	1980		1985	
	Millions of dollars	Percent of total	Millions of dollars	Percent of total
Distributors	24.8	10.5	125.5	48.8
Rack Jobbers	106.1	45.1	109.1	42.5
One-stops	1.1	0.5	1.2	0.5
Record Clubs	(1)	(1)	0.4	0.2
Department Stores	2.4	1.0	3.7	1.4
Other Retailers	24.0	10.2	2.1	0.8
Direct Sales	5.9	2.5	9.4	3.7
Other	.2	0.1	0.9	0.4
Unspecified (incl. clubs)	70.6	30.1	4.6	1.8
Total	235.1	100.0	256.9	100.0

(1) Confidential, included with unspecified.

Source: Statistics Canada: Culture Statistics - Recording Industry Cat. 87-615; 1980 advance information taken from Woods Gordon Sound Recording Industry Study 1982; 1985 figures taken from Statistics Canada, Cultural Industries Section, Education, Culture & Tourism Division.

(2) Marketing and Distribution Channels

There are several types of marketing and distribution channels used in the recording industry. They vary principally according to who is considered the producer -- that is, who holds the responsibility for duplicating tapes or records made from an original master. In general, the distribution channels rely heavily on the established networks of distribution to the retail level by rack jobbers.

In the first scenario, independent labels produce the duplicates, either from a master produced in-house, or from an artist who produces his or her own. The independents are the producer for tax purposes in view of section 2(1)(b) of the ETA. Tax is payable on their sale price of duplicated tapes or records. These are sold to a major label company. The major label company then distributes records and tapes across Canada to a second level of distribution called rack jobbers which distribute to various retail outlets. The rack jobber stocks merchandise, and assumes the functions of ordering recordings, arranging displays and exchanging unsold items. Frequently, rack jobbers act as retailers as well, making sales directly to the public through their own retail outlets. Figure 1 illustrates this channel of distribution. The figure also indicates the approximate sale price at each trade level, assuming that the final price of a record or tape to the consumer is $10.00.

In the second scenario, the major label company is the producer holding responsibility for the duplication of the recording. Master recordings are produced by the label company itself, or are sold to the label by a parent company. FST is exigible on the sale price of the transfer from the label company to the rack jobber. The base on which tax is calculated is higher than in Scenario 1 since both production and distribution costs are incurred by the label. The manufacturer and distributor are effectively one unit. Figure 2 illustrates this distribution pattern.

The non-resident parent company of a label company is the producer in the third scenario, holding responsibility for duplication of the recordings. However, it is not liable for FST under 2(1)(b) of the ETA because it is located abroad. The taxpayer in this structure is the duplicator itself. The label company purchases duplicates from the parent and sells to a distributor who again sells to a rack jobber. This pattern is illustrated in Figure 3.

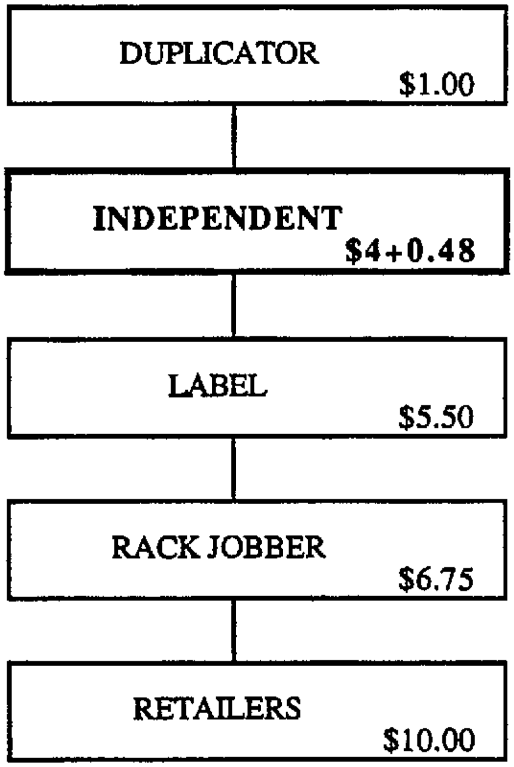
The fourth distribution pattern, like Scenario 2, involves the label company as manufacturer. The label company is the taxpayer and remits tax on its sale price to a related distributor, on a transfer price which excludes marketing and distribution costs. The related distributor sells to rack jobbers, who distribute the product to the retail trade level. Figure 4 illustrates this distribution pattern.

Figure 5 illustrates a variation of distribution which is possible in all four scenarios. The label company or related distributor may sell to a pure rack jobber who is only a wholesaler or may sell to a rack jobber which has both wholesale and retail operations. Also, the label company or related distributor may sell directly to the retail level, bypassing the rack jobber completely. As will be discussed, this deviation from the normal distribution pattern will have a significant impact on the base on which FST is paid, if the government moves the tax to the wholesale level.

Figure 6 illustrates the pattern of distribution for compact discs. Currently a large portion of compact discs are imported and are subject to duty on entry to Canada under tariff item 65812-2 with a Most Favoured Nation duty rate of 11.3% and FST on the duty paid value which is much smaller than their first resale price to an arm's length person in Canada.

The tax on domestically produced compact discs (CD's) could vary significantly depending upon the patent and copyright arrangements, as discussed earlier in the case of records and tapes. CINRAM is one of the largest producers of compact discs in Canada. The duplication charges for CD's vary by volume, but are in the range of $2.00 per unit, not including the packaging costs.

FIGURE 1



<u>Note:</u>

The taxpayer under the current tax regime is highlighted in bold.

FIGURE 2

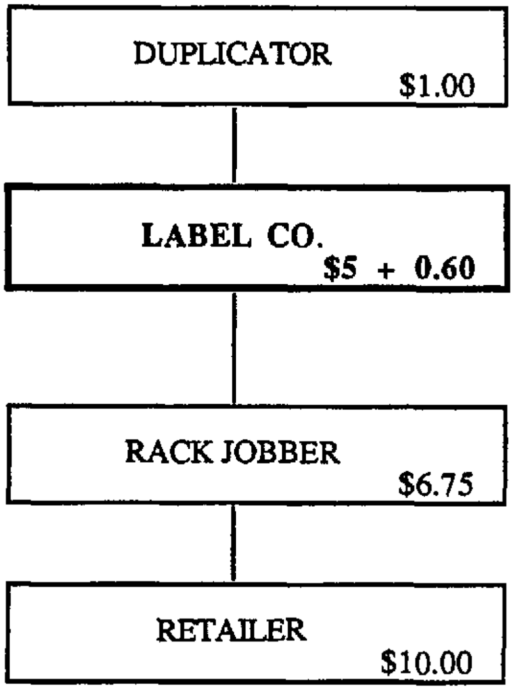


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FIGURE 3

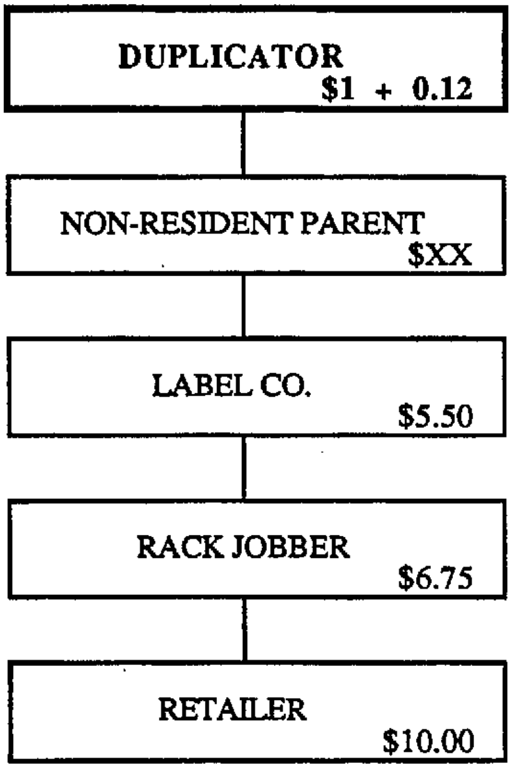

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FIGURE 4

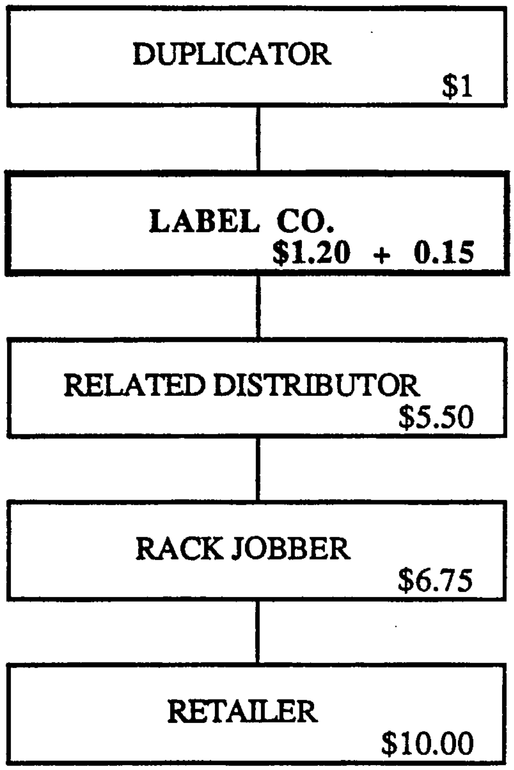

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FIGURE 5

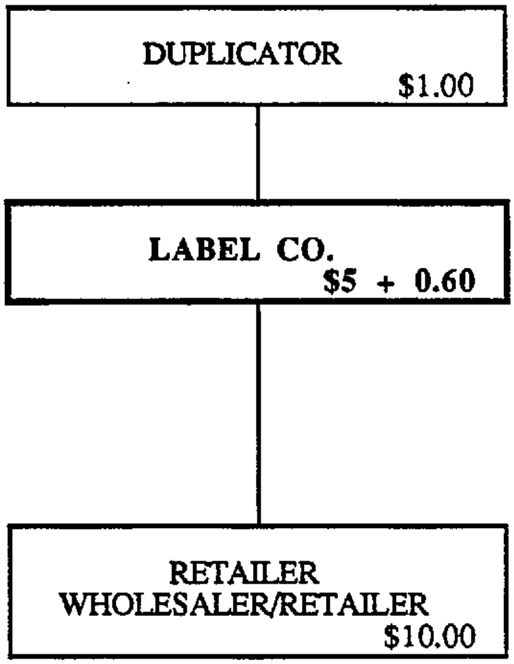

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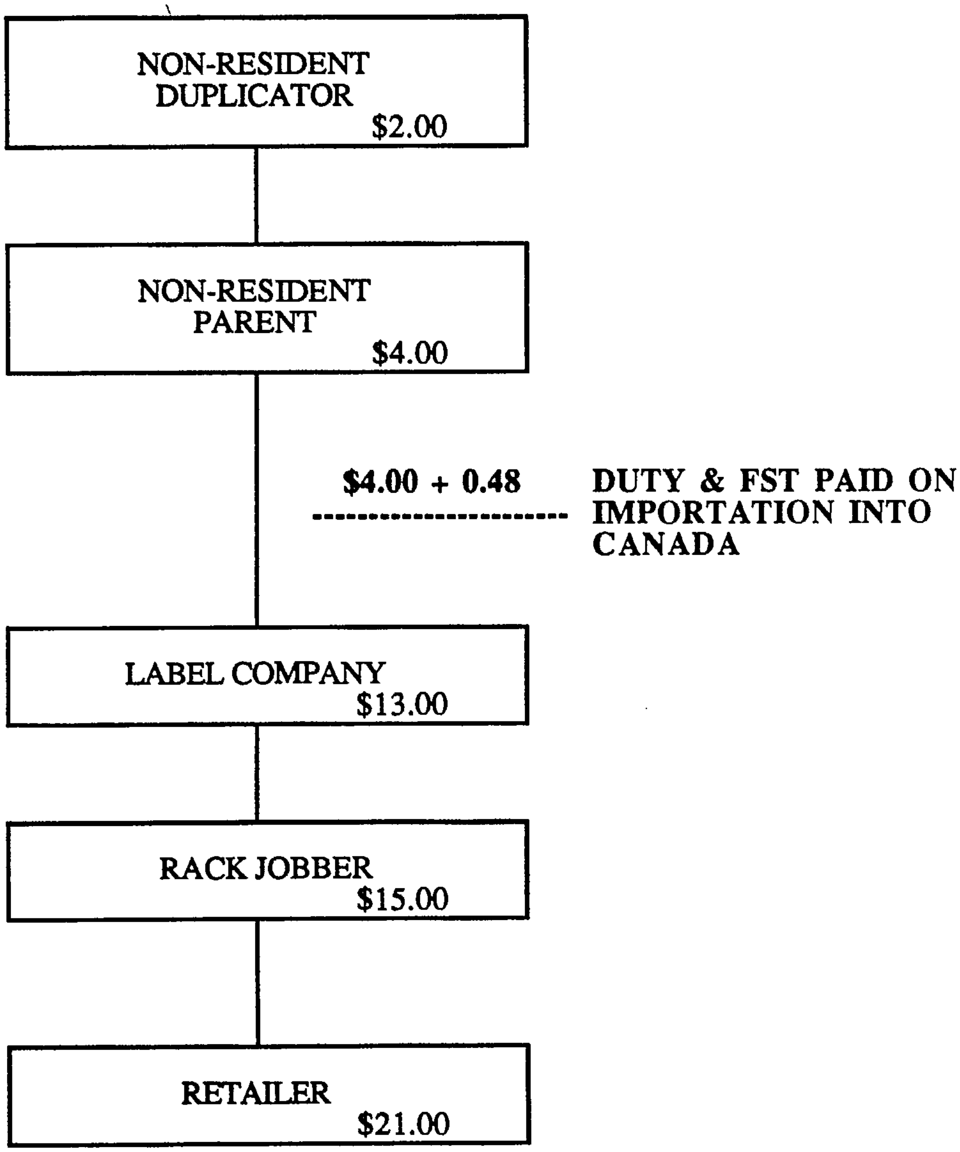
FIGURE 6

COMPACT DISCS



<u>Note:</u>

The taxpayer under the current tax regime is highlighted in bold.

(3) Industry Sales/Volumes/Price Patterns

This section is based, in large part, on Statistics Canada data. Unfortunately, Statistics Canada does not produce any data on prices of records and tapes at different trade levels. As a result, it has not been possible to reach any definite conclusions on all issues in this part.

(a) Records

Between 1978 and 1986, the volume of sales of records has decreased by over 48 per cent, as illustrated in Table 2 and 3. The most dramatic drop in volume of sales over a one year period occurred between 1984 and 1985, when net shipments declined over 18 per cent.

Over the same time period, between 1978 and 1986, the net value of sales also declined, but to a lesser extent. 1985 was the low point in net value of sales, corresponding to low volume of sales in that year.

The distribution price, which is an average of the sale price of both the 7 inch and the 10 inch discs, increased over the period, however, most notably in 1985 and 1986. The total increase in distributor's prices over the eight year period was 62 per cent. This price is the sale price of the distributor rather than the retail price of the goods to consumers.

(b) Tapes and discs

Cassette tapes and compact discs, on the other hand, have absorbed an increasing share of the market since 1978 as illustrated in Table 4 and 5, with net shipments increasing by 85 per cent from about 23 million to over 42 million cassettes per year. Net value of sales also increased, by almost 150 per cent. The years 1983 and 1984 witnessed the most dramatic increases, as cassettes continued to increase their share in the market. Sales levelled off in, 1985 and 1986, however, despite the introduction of compact discs in the market.

Amid this growth, distributors' sale prices remained relatively constant, increasing over the eight year period by 35 per cent. The biggest price change occurred between 1985 and 1986, where average distributors' prices rose 15 cents per tape. This price increase, however, is largely a statistical anomaly. Average prices in the table were calculated by dividing the dollar value of sales by the units sold. In the case of tapes, the dollar value of sales also includes sales of compact discs which have a much higher unit price than tapes. The price increase thus reflects the increase in the sales volume of discs as opposed to a unit price increase for tapes. The rate of growth in the volume of shipments of tapes has declined significantly, suggesting demand has peaked and that the market may be saturated or alternatively, that consumers are taping their own recordings, in lieu of purchasing new pre-recorded tapes.

(c) General

Market demand for records and tapes appears to be relatively elastic. Distributors' price increases will have a negative effect on volume of sales. However, in order to evaluate whether consumers will continue to buy records and tapes, it is necessary to examine price trends at the retail level. This would also illustrate the profit margin squeeze facing the retailers, who have experienced higher input costs from distributors but a relatively constant retail sale price.

Unfortunately, no data are readily available on price movements at the retail level or on the industry profit margins. Our discussions with industry representatives did not lead to any definitive conclusions. Most of the major record companies indicated that they have been able to maintain their profit margins either through an increase in their market share, or a marked growth in CD sales or a combination of both. While one or two major label companies indicated that their prices have been flat, others have increased their prices at rates slightly below those of the CPI. The prices of CD's have been coming down because of the growth in their volume and the economies of large scale production.

TABLE 2

NET SHIPMENTS, NET VALUE OF SALES[1] AND DISTRIBUTORS' AVERAGE SELLING PRICE PER UNIT

PHONOGRAPH RECORDS

	Net Shipments (millions)	Net Sales ($ million)	Price per Unit (Average for 7" and 10" discs) $
1978	71.1	183.5	2.58
1980	69.1	209.8	3.04
1982	50.2	162.7	3.24
1983	50.6	163.4	3.23
1984	47.7	151.4	3.17
1985	39.1	138.2	3.53
1986	36.4	152.4	4.18

1. Net value of sales is based on distributors' net selling price which is the price which the distributor invoices the dealer or retailer, net of sales tax, outward transportation charges, sales discounts and allowances.

Source: Statistics Canada Production and Sales of Phonograph Records and Pre-recorded Tapes in Canada 1982-1986 catalogue No. 47-004.

TABLE 3

PERCENTAGE CHANGES IN
NET SHIPMENTS, NET VALUE OF SALES[1] AND DISTRIBUTORS'
AVERAGE SELLING PRICE PER UNIT

PHONOGRAPH RECORDS

	Change In Net Shipments %	Change In Net Sales %	Change In Price per Unit (Average for 7" and 10" discs) %
1978	-	-	-
1980 [2]	-2.8	14.3	17.8
1982 [2]	-27.4	-22.4	6.6
1983	0.9	0.4	0.0
1984	-5.6	-7.3	-0.3
1985	-18.1	-8.6	11.3
1986	-6.9	10.2	18.4
1978-1986	-48.8	-16.9	62.0

(1) Net value of sales is based on distributors' net selling price which is the price which the distributor invoices the dealer or retailer, net of sales tax, outward transportation charges, sales discounts and allowances.

(2) Changes in these years are over a two-year period.

Source: Statistics Canada Production and Sales of Phonograph Records and Pre-recorded Tapes in Canada 1982-1986 catalogue No. 47-004.

TABLE 4

NET SHIPMENTS, NET VALUE OF SALES[1] AND DISTRIBUTORS' AVERAGE SELLING PRICE PER UNIT

PRE-RECORDED TAPES

	Net Shipments (millions)	Net Sales ($ million)	Price per Unit $
1978	23.0	70.0	3.04
1980	15.4	60.3	3.91
1982	19.9	77.9	3.90
1983	27.8	109.2	3.92
1984	35.5	143.0	4.02
1985 (2)	41.1	162.1	3.95
1986 (2)	42.5	174.4	4.10

(1) Net value of sales is based on distributors' net selling price which is the price the distributor invoices the dealer or retailer, net of sales tax, outward transportation charges, sales discounts and allowances.

(2) Includes compact discs.

Source: Statistics Canada Production and Sales of Phonograph Records and Pre-recorded Tapes in Canada 1982-1986 catalogue No. 47-004.

TABLE 5

PERCENTAGE CHANGE IN
NET SHIPMENTS, NET VALUE OF SALES(1), AND DISTRIBUTORS'
AVERAGE SELLING PRICE PER UNIT

PRE-RECORDED TAPES

	Change in Net Shipments %	Change in Net Sales %	Change in Price per Unit %
1978	-	-	-
1980 (2)	-33.0	-13.9	28.6
1982 (2)	29.2	29.1	0.0
1983	39.3	40.2	0.5
1984	27.8	30.9	2.5
1985 (3)	15.5	13.4	-1.7
1986 (3)	3.6	7.5	3.8
1978-1986	84.7	149.1	34.9

(1) Net value of sales is based on distributors net selling price which is the price which the distributor invoices the dealer or retailer, net of sales tax, outward transportation charges, sales discounts and allowances.

(2) Changes in these years are over a two-year period.

(3) Includes compact discs.

Source: Statistics Canada Production and Sales of Phonograph Records and Pre-recorded Tapes in Canada 1982-1986 catalogue No. 47-004.

IMPACT OF THE TAX REFORM PROPOSAL ON THE INDUSTRY

(1) Current Situation

Our discussions with industry representatives suggest that at present there is a significant amount of confusion in the industry about the application of the FST. No two major record companies appear to be applying the same amount of tax per unit. There have been disputes between taxpayers and Revenue Canada about the proper interpretation of the legislation, which are still not resolved. Our tentative conclusions about the current application of tax are as follows:

(i) Most independent companies are paying tax of 48-50 cents on their sale price of approximately $4 (excl. tax). As they do not have any non-resident affiliates, it is difficult for them to restructure their operations so as to avoid the application of section 2(1)(b) or 2(1)(f) of the ETA deeming them to be manufacturers.

(ii) The tax paid by major label companies varies from a low of 15 cents per record to a high of 55 cents. It is our understanding that given time most of them would be able to restructure their operations to reduce the tax to 25-30 cents per unit. As noted previously, historically, most major label companies have paid tax on their sale price of approximately $5-5.50 per unit.

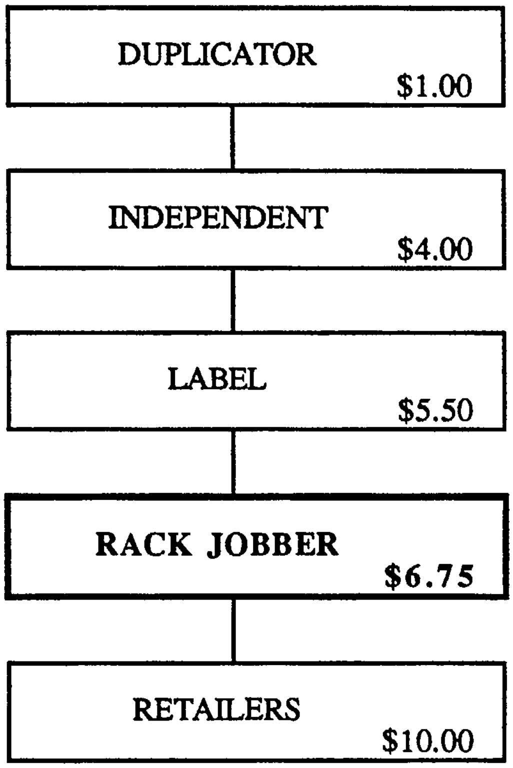
(2) Tax Reform Proposals

For the sound recording industry, the proposal to shift the tax to the wholesale level is much broader than the one relating to marketing companies. It would result in the tax applying on the sale price of rack jobbers, as illustrated in Figures 7 to 12. The tax would increase to approximately 70-75 cents per record or tape. Where the major label companies make sales to rack jobbers who are considered to be retailers the tax would be much lower - approximately 55 cents. For the CD's, the tax will increase from 50 cents per disc to approximately $1.50 per disc.

As virtually all marketing/distribution companies related to manufacturers are wholesalers, the marketing company proposal does not have additional impact in this industry. In other sectors, some of the marketing companies related to manufacturers are retailers. The marketing company proposal deems them to be manufacturers even though they may not be affected by the shift in the tax to the wholesale level.

In summary, the tax reform proposals result in a tax increase of approximately 25 cents per unit for the independent label products and of 25-60 cents per unit for the major label products. Their impact on aggregate FST revenues is estimated to be in the range of $20-25 million per annum.

FIGURE 7

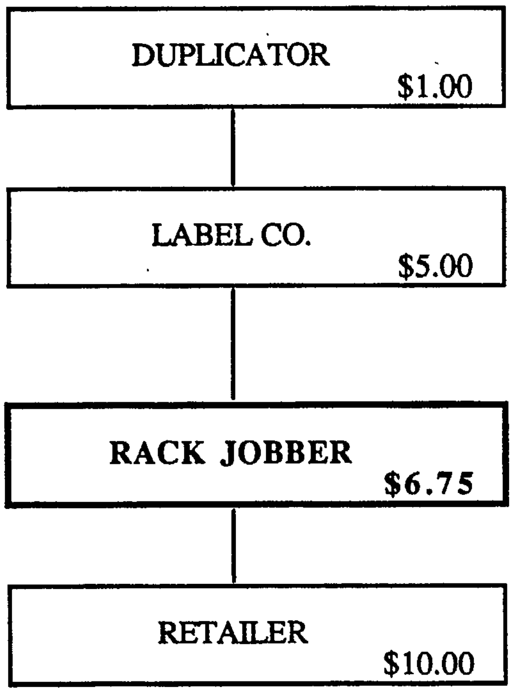


Note:

The taxpayer under the proposed tax regime is highlighted in bold.

Prices at each trade level under the new system would depend upon how the tax is shifted.

FIGURE 8

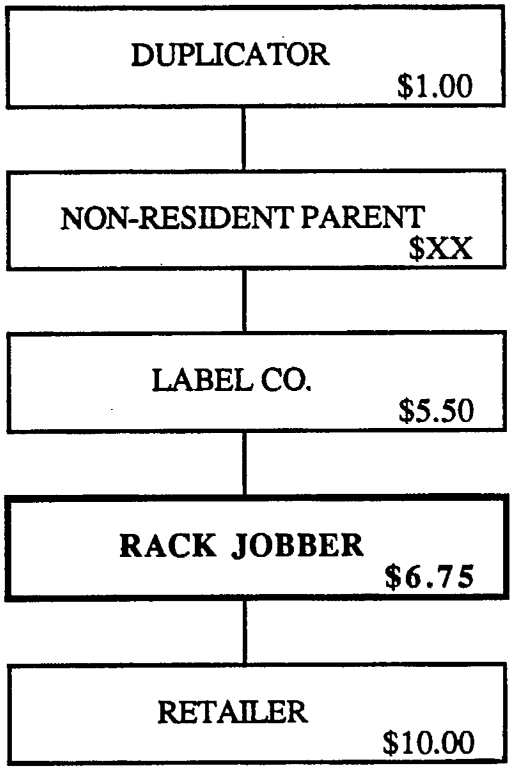


Note:

The taxpayer under the proposed tax regime is highlighted in bold.

Prices at each trade level under the new system would depend upon how the tax is shifted.

FIGURE 9

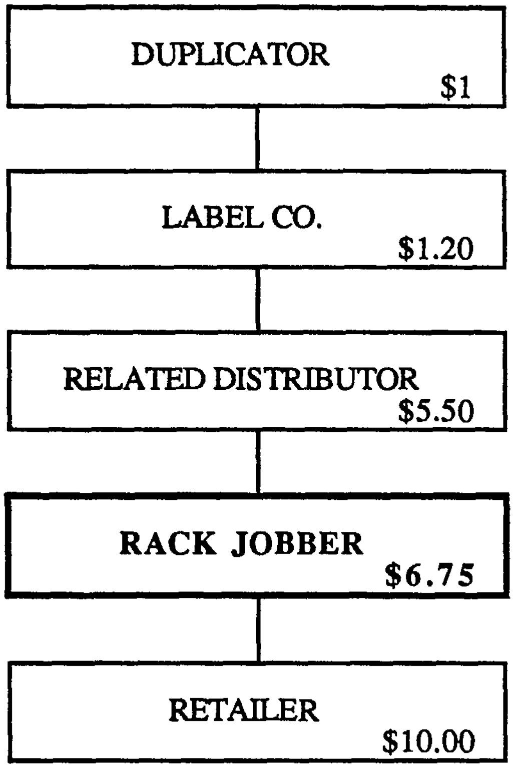


<u>Note:</u>

The taxpayer under the proposed tax regime is highlighted in bold.

Prices at each trade level under the new system would depend upon how the tax is shifted.

FIGURE 10

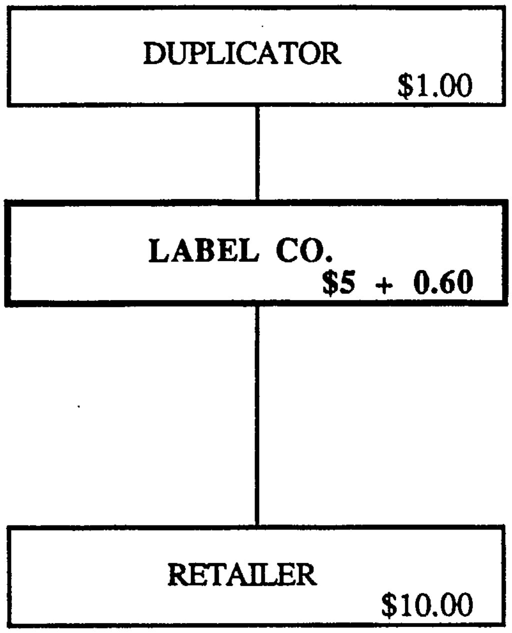


Note:

The taxpayer under the proposed tax regime is highlighted in bold.

Prices at each trade level under the new system would depend upon how the tax is shifted.

FIGURE 11



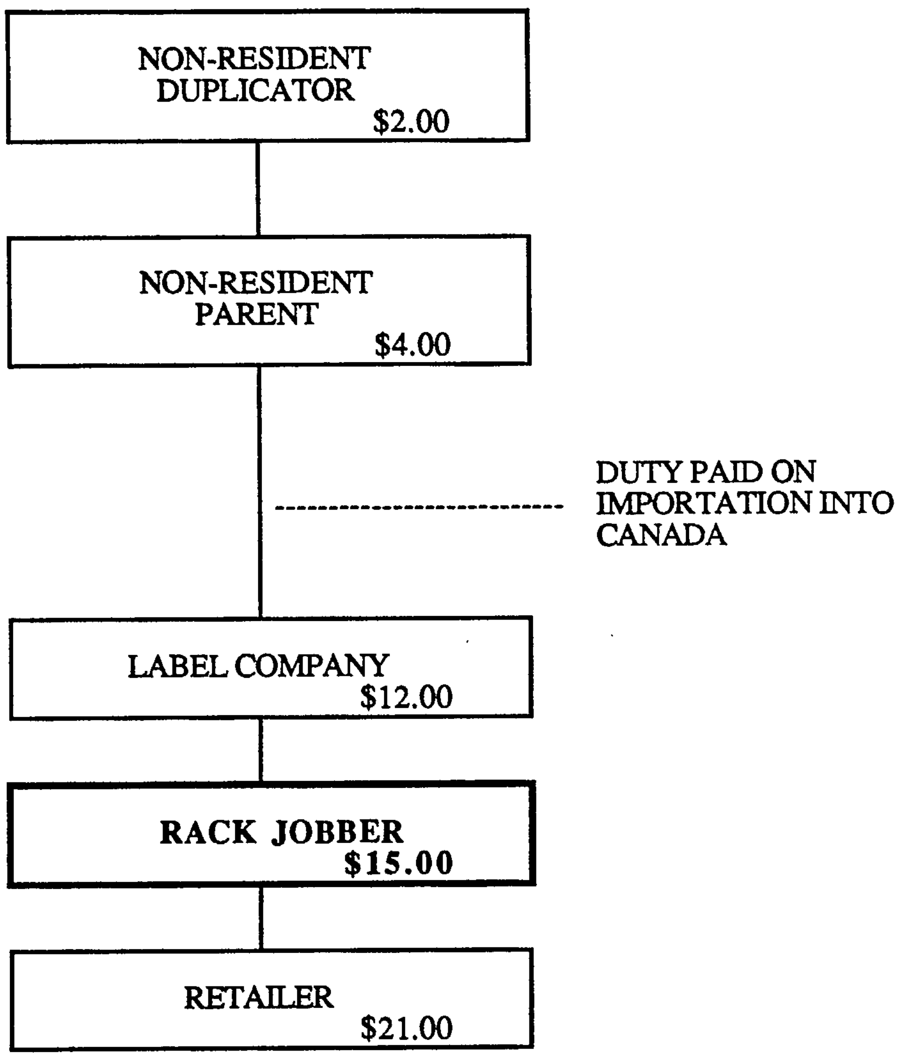
<u>Note:</u>

The taxpayer under the proposed tax regime is highlighted in bold.

Prices at each trade level under the new system would depend upon how the tax is shifted.

FIGURE 12

COMPACT DISCS



<u>Note:</u>

The taxpayer under the proposed tax regime is highlighted in bold.

Prices at each trade level under the new system would depend upon how the tax is shifted.

(3) Industry Reaction

The reaction of the industry representatives to the tax reform proposals has been mixed. While many felt the need for government action to remove the uncertainty and confusion surrounding the current system, few endorse the White Paper proposals. Their main concerns and our own assessment of the concerns are as follows:

Independent Labels:

In our discussions, independent label companies and their representatives identified several issues. First, initially they were under the impression that they were paying 10-12 cents less tax per unit than the major labels under the present system. They were concerned that the government proposals would remove this tax advantage in their favour which they needed to stay competitive. However, our investigations do not provide support to their beliefs. They, in fact, pay substantially more tax than the majors under the present system.

Second, the independent labels are concerned that major labels who act as their distributors and rack jobbers may try to shift the FST increase (of 20-25 cents) back to them, which would create an unsustainable squeeze on their profit margins. This concern is based, in part, on their feeling that there is a great deal of consumer resistance to higher prices of records and tapes. It could lead to much greater home taping and a significant drop in volumes. One or two major labels and rack jobbers also expressed this view.

Our own findings do not enable us to reach any definite conclusions in this area. We have not been able to obtain any time series data on retail prices of records and tapes. Distributors' prices have gone up over the past four or five years at rates in the range of 3-4% per annum. We presume that similar price increases have occurred at the retail level. We are also led to believe that independent labels are generally priced the same as major labels at the retail level. Thus, the degree of forward and backward shifting of the tax should be similar for both, and determined largely by the major labels which dominate the market.

Notwithstanding the above, it is the case that the independent labels have much smaller profit margins and thus much less capacity to absorb any tax increase. The previous Woods Gordon study explains in detail why their profit margins are smaller. Thus, any tax increase, to the extent it cannot be passed on to consumers, has the potential to create serious financial difficulties for them.

<u>Major Labels</u>:

The key concern of major labels is also one of forward and backward shifting of the tax increase. They support the search for any proposals that result in a uniform application of tax to all companies. The White Paper proposals, however, result in a substantial increase in tax. They do not understand why the sound recording industry has been singled out for making additional contribution to the government revenues.

As regards shifting of the tax increase, many members of the industry expressed the view that that portion of the tax increase that relates to the wholesalers' (rack jobbers') margin will most certainly be passed on to the consumers. The profit margins of the rack jobbers are quite thin and do not allow much room for the absorption of the tax increase. The balance of the tax increase relates to the difference between the label companies' sale price and the duplication cost or some other base price on which the tax is currently being calculated. This amount varies from company to company and many companies are awaiting the final outcome of their deliberations with Revenue Canada before taking any firm decisions as to how they should change their prices to reflect the reductions in FST. In these circumstances, it is probable that any tax increase up to the levels that record companies have historically remitted to the government would be absorbed by them, leaving the balance to be shifted forward to consumers.

Many companies expressed the view that the government proposal, by involving many more taxpayers, would unnecessarily complicate tax compliance. Given that many rack jobbers sell directly to consumers, they would be faced with complicated tax calculations and the need to segregate their wholesale and retail inventories.

Rack Jobbers/Retailers:

The single most important concern of rack jobbers is that the tax would not apply uniformly to them all and that the proposal would create new inequities between rack jobbers who make sales through their own retail outlets and those that make sales to other independent or franchised retailers. The former would enjoy a tax advantage of 20-25 cents over the latter. While this may be a small percentage of the final retail price, it can make a substantial dent in their profit margins if it cannot be passed on to consumers for competitive reasons. The company-owned and independent retail stores operate side by side in many locations and have to offer the product at the same price. The major retailers of records in Canada, A&A Records, is also a rack jobber and would have a significant advantage over its competitors in respect of its retail operations.

It is the case that rack-jobbers/wholesalers are allowed to keep their inventory tax free. But, the resulting interest savings are only a small fraction of the additional sales tax that they would incur on their mark-ups.

ALTERNATIVE OPTIONS

It is now generally recognized that a sales tax that does not extend to the retail level will always give rise to non-neutralities and competitive distortions. The government's proposal to replace the federal sales tax by a multi-stage sales tax (MSST) is designed to address the problems of the current system. However, interim measures may still be appropriate to minimize the inequities that arise under the current system.

There are two alternatives to the government proposals that warrant consideration as interim measures:

ALTERNATIVE A:

Amend section 2(1)(b) of the ETA to correct its weaknesses and to ensure that the record companies pay tax on their sale price to arm's-length persons in Canada.

This could be achieved by extending the scope of section 2(1)(b) to goods "manufactured" or "produced" in Canada and by deeming certain domestic persons to be manufacturers where the patent or proprietory rights are held by a non-resident person. Rather than elaborating on technical details of the proposal here, it would be preferable to discuss them directly with Finance and Revenue Canada officials if this option were to be pursued.

The following considerations apply to this option:

(i) It would reestablish tax to the levels that have historically prevailed in this industry.

(ii) Independent labels would pay 10-12 cents less tax than the major labels, as was the case until recently.

(iii) The tax would remain at the record company level, avoiding the additional compliance burden on rack jobbers.

(iv) The rack-jobbers/wholesalers would pay the same tax as the rack-jobbers/retailers.

(v) The tax may not apply uniformly to imported and domestically-produced duplicates, if the government does not proceed with the related-marketing company proposals. This would be of particular concern in the case of CD's which are imported as well as produced domestically.

ALTERNATIVE B:

Deem the manufacturer's selling price and the taxable value of imported goods to be a fixed amount set by the Governor-In-Council Regulations. There would be separate amounts prescribed for tapes, 10" discs, 7" discs, and CD's. These amounts could be changed from time to time as market prices change. The tax would be payable by the duplicator or importer.

This option would be similar to the one already adopted by the government for the imposition of tax on motor fuels. It ensures uniform application of tax and simple compliance.

It has considerable appeal as an interim measure for the next two or three years. Given that there are only five or six items in this industry, which are sold at relatively uniform prices by different distributors, it should be fairly straight forward to define them in the regulations and to set the appropriate prices. It is unlikely that there would be sufficient movement in the prices of records and tapes over the next two or three years to warrant frequent changes in the values set for calculating the tax. The value for CD's may have to be revised downward as their market prices come down with increases in their volumes.

On balance, Alternative B appears preferable over Alternative A, though both result in much greater uniformity in the application of tax than the current system. One of the reasons for our preference for Alternative B is that it is simple to draft. The other alternative requires complex legislation with no assurance that it would work as intended.

If the government were to proceed with Alternative B, we would recommend that the tax values be set so as to yield no more revenues than what was being collected historically before the anomalies/weaknesses of section 2(1)(b) became apparent. This criterion would point to tax values in the range of $4 to $5 for an LP or a tape.