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Supplemental Comments on Implementation of Ontario's Harmonized Sales Tax



September 8, 2009

On September 8, 2009, TEI filed supplemental comments on issues relating to the implementation of a harmonized sales tax in the Province of Ontario. The letter was prepared under the auspices of TEI's Canadian Commodity Tax Committee and the Toronto Chapter's Ontario Tax Committee, whose chairs are Diana M. Spagnuolo Imperial Oil Limited and Carol Nixon of Lanxess Inc., respectively. Materially participating in drafting the supplemental letter were Vincent Alicandri of Hydro One Networks, Inc; Carol Felepchuk of TD Bank Financial Group; Larry R. Querin of ReveraInc.; D. Paul Revell of Rexel Canada Electrical Inc.; Richard Taylor of Rogers Communications Inc.; and Michael J. Willis of LaFarge Canada Inc. Mary Lou Fahey, TEI's General Counsel, served as legal staff liaison on this project. A meeting with Ontario's Ministry of Finance is scheduled for October 16.

This letter supplements TEI's August 24, 2009, comments on implementation issues relating to the adoption of a harmonized Ontario value-added tax (OVAT), addressing issues relating to financial institutions, residential care facilities, and tax-included pricing. We appreciate the Ministry's willingness to consider the Institute's views and look forward to our meeting on October 16.

Financial Institutions

A. Special Attribution Method (SAM).¹ The current SAM formula uses the provincial allocation set forth in the Income Tax Regulations as a proxy for determining the percentage of federal goods and services tax (GST) that relates to the harmonized province and on which the related adjustment to net tax for harmonized sales tax (HST) purposes is based. The income tax allocation, however, may not accurately reflect consumption, and thus it may be useful to develop alternatives that more closely reflect consumption in the province. For example, the provincial income tax allocation for banks is based on a combination of 1/3 salaries and wages and 2/3 loans and deposits. An alternative that could more closely approximate consumption could be based on other factors, e.g., headcount and the number of customer accounts by province.

Currently, the SAM formula allows an adjustment to net tax under ETA section 225.2 ("HST liability") to be reduced only by the provincial component of HST paid or payable in the current fiscal year. Thus, where the HST is not identified in the financial records in the year in which it is incurred, it may be inadvertently excluded from the HST paid amount.

TEI recommends that the SAM formula be amended to permit a reduction of the final HST liability by the provincial component of the HST paid or payable in the current or previous year, so long as this amount was not included in the SAM calculation in the prior year. This change would be consistent with the two-year window that is currently available to selected listed financial institutions (SLFIs) to claim input tax credits (ITCs).

B. The Australian Approach. Australia employs an ITC methodology to permit financial institutions to take advantage of the cost and productivity savings that can be derived from outsourcing. This approach could also provide relief to mutual fund trusts in respect of their management and administration fees.

Currently, Australia permits a 75-percent ITC for specific processing (i.e., outsourced) services used to further exempt financial activities. This treatment recognizes that, in making the decision to outsource, financial institutions must consider replacing nontaxable salary costs with taxable services provided by a third party. The enhanced ITC helps financial institutions deal with these

increased costs and encourages them to take advantage of the cost and productivity savings resulting from outsourcing.

Australia also permits an enhanced ITC on supplies made between related parties, which is helpful for financial institutions receiving outsourced services from a nonresident related entity (*e.g.*, a branch) with which they are not permitted to elect to treat the services as exempt supplies.² This expanded treatment allows financial institutions to take advantage of global synergies and the development of centres of excellence. In Canada, it could be expanded to cover management and administrative fees paid by mutual fund trusts if determined to be in the nature of outsourced services.

C. Future Approaches. Although TEI continues to believe that financial services should be treated as zero-rated supplies, Ontario should consider working with the federal government to develop a methodology for taxing financial services. Other countries have implemented solutions under which financial services are taxable when supplied to business consumers (who, in turn, are eligible for ITCs based on their level of commercial activities). This mitigates the cascading of tax on financial services, permitting financial institutions to recover ITCs related to their supplies of financial services to business customers. This is similar in operation to Canada's treatment of exported financial services, the supply of which entitles financial institutions to recover ITCs on purchases made in respect of those supplies.

Place-of-Supply Rules: Residential Care Facilities

Implementation of the HST potentially benefits Ontario in respect of services provided to and within an enterprise located in the province with a national presence (*e.g.*, the entity owns and operates residential care facilities located throughout Canada). These enterprises commonly operate under structures that involve several entities within each structure and procure "national" contracts for goods and services covering homes located in several provinces. Management and administrative support may be provided centrally, say in Ontario, for the benefit and use throughout homes in Canada.

Under the federal GST, closely related entities that provide exempt services (*e.g.*, long-term care and retirement services) must charge tax on such support. To the extent that the supplies made under these national contracts or inter-entity support arrangements are currently taxable under the GST — and will be considered supplied in Ontario under the HST place-of-supply rules — an additional 8-percent tax will be imposed on these supplies, even though the benefit realized from the contracts and support is outside Ontario. Because the activities of these enterprises are exempt for GST purposes, the HST will not be recoverable, imposing an additional cost to the companies. In these circumstances, these enterprises may well seek to procure services outside the province or relocate their head office functions. TEI believes it is unfair to apply the HST to costs incurred for the benefit of homes located outside Ontario.

To address this issue, the place-of-supply rules should ensure that the 8-percent provincial component of the HST is not incurred in respect of facilities located outside Ontario. There are two ways in which to accomplish this result:

- Employ a modified version of the SAM calculation that currently applies to SLFIs because of the national nature of their operations. SAM provides a proxy for the use and benefit in different provinces of taxable supplies acquired and does not encourage an SLFI to acquire supplies in one province over another; or
- Permit recovery of the 8-percent provincial component of the OVAT paid on national contracts or taxable inter-entity supplies to the extent that the supplies are for use and benefit outside Ontario. National residential care providers could be permitted to develop their own methodologies to determine the amount of the 8-percent OVAT that is recoverable.

In addition, the province should permit entities within a closely related group (or single economic unit) to elect to deem supplies made between members of the group to be exempt supplies. This type of election currently exists (ETA, § 150) for listed financial institutions (*e.g.*, banks, insurers, brokers, etc.). The election should be broadened to permit elections by non-corporate entities (*e.g.*, partnerships), as well as entities that are part of the closely related group.

Tax-Included Pricing

Ontario's budget did not address the issue of tax-included pricing. Division XI of the ETA provides authority for the use of such pricing. The rules under this Division, however, are not effective until participating provinces representing at least 51 percent of Canada's population have enacted the HST and required suppliers to include the HST in their indications of prices.

Tax-included pricing places an unnecessary burden on businesses. TEI urges the governments to provide as much consistency as possible as more provinces seek to harmonize their taxes with the federal GST. In respect of the ITC restrictions, Ontario should provide clear rules to permit business to comply with the new sales tax regime and to avoid penalties.

Conclusion

Tax Executives Institute appreciates the opportunity to provide additional comments on the implementation of Ontario's harmonized sales tax. We look forward to our meeting on October 16 with you and members of your Ministry to discuss this and other issues more fully. If you should have any questions about TEI's letter, please contact TEI's Vice President for Canadian Affairs, Sherrie Ann Pollock, at 416.955.7373 (sherrieann.pollock@rbcdexia.com). Alternatively, questions may be directed to Diana M. Spagnuolo, Chair of TEI's Canadian Commodity Tax Committee, at 403.237.2948 (diana.m.spagnuolo@esso.ca).

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1 Excise Tax Act, R.S.C., ch. E-15, § 225.2 (1985) (hereinafter cited as the "ETA").

2 See ETA § 150.

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