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The Operational and Financial Implications of the Harmonized Sales Tax

BY BRIAN TITANICH

Back in February 2004, municipalities heralded the federal government announcement to increase the GST rebate to 100% as an end to the compliance nightmare associated with GST reporting. For many municipalities, this meant gone were the days of tracking individual expenses to determine if they were entitled to a full or partial input tax credit (ITC), and/or a partial rebate or no recovery at all. Fast forwarding to July 1, 2010, the recent government announcements in Ontario and British Columbia to implement a harmonized sales tax (HST) has many municipalities once again having to formulate a business strategy to deal with sales tax compliance. Being able to correctly capture an ITC versus a rebate, self-assessing the provincial component of the

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HST (7% or 8%) on imported supplies from both inside and outside Canada, and accounting for the GST/HST on property that may be subject to change of use rules are just some of the issues that municipalities may face under the new HST regime.

Add to this the potential for municipalities to have an increased risk of incorrectly administering the HST (e.g., not collecting HST on a supply that the municipality believed to be exempt) would result in an assessment equal to 12% or 13% as opposed to 5% and could make municipalities an audit target for the Canada Revenue Agency. How a municipality will respond to the new tax policy will depend on the type of activities and transactions entered into by the municipality, and whether the municipality is currently registered for the GST/HST. For purposes of the following discusion, it is assumed that the municipality is registered for the GST/HST and does not qualify as a large business.[1]

I.
PLANNING CONSIDERATIONS

Some of the areas that need to be considered by most businesses, including municipalities, are as follows:

a) Budgeting and cash flow related to the increase in tax from 5% to 12% or 13%
b) Adjustments to accounting systems to correctly account for the HST (e.g., sales and purchasing)
c) Review of contracts (existing and new) and transitional rules
d) Pricing (tax inclusive versus tax extra)
e) Staff training (e.g., accounts payable) related to HST implementation

BUDGETING AND CASH FLOW

Both Ontario and B.C. have indicated that the prescribed rebate percentages for municipalities (78% in Ontario and 75% in B.C.) are based on the current estimated PST cost that is borne by municipalities (either directly charged or embedded in costs incurred by the municipality). To the extent that this estimated cost is correct, municipalities should not see the HST having a significant impact on annual budgets. However, depending on the purchasing patterns of individual municipalities, there may be winners and losers with respect to the actual bottom line impact the HST will have on each municipality, and budgeting for a potential overriding cost may be warranted.

It is anticipated that the cash flow impact on municipalities is more probable than budget overruns, especially for municipalities that have a history of filing for significant GST refunds. Although it is doubtful that the impact on cash flow would warrant changing a municipality's filing frequency (e.g., annual to quarterly), it is an option to consider. Alternatively, municipalities may want to ensure that the processes for filing their GST/HST returns are as efficient as possible to avoid late filing and subsequent late refund payments from CRA. It is hoped that CRA will make every effort to process municipality returns as quickly as possible, such that refunds are received within one month of the date on which the return was filed.

ADJUSTMENTS TO ACCOUNTING SYSTEMS

Probably the most important undertaking that needs to be completed by municipalities in preparation for the HST is re-configuring their accounting and billing systems to ensure correct coding and invoicing of the HST. Depending on the accounting system currently being used by the municipality, this may involve a "dusting off" of the coding system used in 2004. However, due to the split components of the HST (5% GST = 100% rebate; 7% or 8% provincial component = 75% or 78% rebate) modifications will still have to be implemented. Add to this the possible requirement to self-assess the provincial component of the HST on imported supplies, and purchases of goods and services that straddle the implementation date and major system adjustments may be required.

Municipalities will need to capture the HST on expenses to the extent that it can be claimed as either an ITC or rebate. If the expense qualifies for a full ITC (e.g., used 100% in commercial activity) the entire HST is captured in the ITC account.[2] If the expense must be allocated between commercial and non-commercial activity (e.g., the item is only used 70% of the time in commercial activity), the municipality will need to allocate the 30% of tax that is not eligible for an ITC into three categories; the GST (100%) rebate account, the 75% or 78% rebate account, and the remaining amount to an expense account.

Billing systems will also need to be adjusted to ensure that the HST rate is being charged and disclosed correctly on invoices. Fortunately, except for select items that qualify for point of sale rebates (e.g., books and children's clothing) the HST will generally apply to the same tax base as the GST. In addition, it is unlikely that a municipality will make many, if any, supplies outside of its home province. If this is the case, a municipality should not have to go through the complex process of determining if a supply is made in an HST or non-HST province.

REVIEW OF CONTRACTS

If possible, a review of all contracts, existing and contemplated, should be conducted. The review should include contracts for both the making of supplies by the municipality as well as purchasing contracts. A review of supply contracts should be aimed at

[1] A large business includes those entities that exceed $10 million in annual GST/HST taxable sales. ITC restrictions have been announced and will form part of the implementation of the HST with the plan to eliminate these restrictions within five to eight years.

[2] This treatment is dependent on the municipality not being restricted on claiming ITCs as a large business.

> It is also suggested that any construction contracts that will straddle the July 1, 2010, implementation date be reviewed to maximize tax savings.

confirming the GST/HST tax status of the contracts (taxable or exempt), and where the supply is taxable, ensuring that the transition rules related to charging the HST and PST (if applicable) are followed. It is important to remember that a misapplication of the HST would result in an additional 7% or 8% assessment. In addition, confirming the tax status of the supply allows for the correct coding of expenses related to it (ITC versus rebate).

Take for example a municipality that has been renting out parking space for the last five years to a medical clinic. Payment is received on the first day of every month via wire transfer. The payment is automatically coded into the accounting system, capturing the 5% GST. In 2010, the payment that is paid on July 1 should include the HST. To ensure that the HST is not overlooked, the municipality should issue a letter to the medical clinic, in advance of July 1, advising them that starting with the July 1 payment, HST will be due on the monthly payments. A review of purchasing contracts should conclude whether the municipality is entitled to claim either ITC or rebates, and ensure the accounting program is correctly coded to capture the ITC and/or rebates. The review should also confirm if any of the contracts require self-assessment of the Ontario or BC portion of the HST.

For example, Clear Water County, an Ontario municipality, is a GST registrant. Clear Water has entered into a services contract with *We Are Saskatchewan*, a staff recruitment firm that specializes in finding potential employees located in Saskatchewan who may wish to relocate to Ontario. All of the services performed by *We Are* under the contract are performed in Saskatchewan and the supply of services would be deemed to be made in Saskatchewan for GST/HST purposes. The agreement allows for Clear Water to contact *We Are* any time a particular recruitment service is needed. Once *We Are* identifies potential candidates it arranges for representatives of Clear Water to interview these candidates either physically in Saskatchewan or via conference call.

The supply is subject to GST and *We Are* invoices Clear Water for the GST but not the HST, since the supply is made in Saskatchewan. The supply of the service would be for consumption and use by Clear Water exclusively (100%) in exempt activities in Ontario. Clear Water would be viewed as having imported the services of *We Are* into Ontario and would be required to self-assess the Ontario component of the HST (8%). Clear Water would be entitled to a 100% rebate of the GST that was paid to *We Are* and to a 78% rebate of the Ontario portion of the HST. However, if Clear Water was entitled to a full ITC on the service (e.g., the service related to hiring staff for a position involved entirely in commercial activity) it would not be required to self-assess the Ontario component of the HST and would be entitled to claim the ITC related to the GST paid to *We Are*.

Another situation in which municipalities may have to self-assess the HST relates to purchase agreements that are entered into after October 14, 2009, and before May 1, 2010. To the extent these

ONTARIO and **B.C.** will harmonize their provincial sales tax with the federal goods and services tax July 1, 2010.

transactions result in property or services being delivered or performed for the municipality after June 30, 2010, the municipality may be required to self-assess the provincial component of the HST.

For example, on January 1, 2010, Sparkling Water Municipality, located in Southern B.C., purchases an annual membership to a local museum (*Museums R Us*) that provides unlimited access to the museum along with receipt of museum newsletters and a 50% discount on the purchase of merchandise at the museum gift shop from January 1, 2010, to December 31, 2010. GST is payable and collected by *Museums R Us* on the membership. The membership is used exclusively by a Sparkling Water staff member to take visiting dignitaries to the museum. ITCs are not eligible to be claimed, but Sparkling Water has claimed, in the past, a 100% rebate of the GST.

Museums R Us is not required to collect the HST on the six months of the membership that are provided from July 1, 2010, to December 31, 2010. However, the transitional rules would require Sparkling Water to self-assess the provincial component of the HST as of July 1, 2010, and report that tax in its GST/HST return that covers July 1, 2010. Sparkling Water would be entitled to claim a 75% rebate of the provincial component of the HST.

Purchase contracts that are up for renewal or are being contemplated should be reviewed to ensure the tax benefits are maximized. For example, renewing the purchase of a fleet of new vehicles that will incur unrecoverable PST if purchased before July 1, 2010, may be substituted for a leasing contract that should result in unrecoverable PST being minimized. After July 1, 2010, the municipality may wish to renew the contract and enter into a purchase and sale agreement with the vendor. It is also suggested that any construction contracts that will straddle the July 1, 2010, implementation date be reviewed to maximize tax savings.

PRICING: TAX INCLUSIVE OR TAX EXTRA

The decision to disclose the HST on an invoice can take several forms, a separate line for the HST, a separate line for each of the GST and the provincial component of the HST, or a statement that the total price includes the HST. The benefit to customers of showing a separate line for each component of the HST is that if the customer does not have an accounting system that automatically extrapolates the different components of the HST, it makes A/P coding much easier.

It has also been announced by both the Ontario and BC governments that a transitional rule would be introduced to help provide certainty and clarity to both vendors and purchasers with respect to the application of the PST for tax-included sales during the transitional period. Where PST-included pricing is used for the sale of goods or taxable services, and payment is paid or becomes due after October 14, 2009, and before May 2010, and if the seller does not disclose in writing to the purchaser the amount of PST in the stated price, the stated price is deemed to include PST regardless of any other transitional rule that may apply.

STAFF TRAINING

An accounting system is often only as good as the people who input the information (and vice versa). This is especially true of the accounts payable and billing functions and the importance these roles play in correctly capturing the numbers that are rolled up and reported in the sales tax returns. For a municipality that does not make any supplies outside of its HST province, the challenge of correctly coding the sales tax is minimized because only two options truly exist[3]: either the HST applies, or no tax applies (exempt or zero-rated). For most systems, these options should be easily programmed into the billing system.

Complexity can occur if taxable supplies straddle the implementation date of July 1, 2010. Billing staff will have to be aware of the transitional rules to ensure the GST/HST/PST is correctly being applied based on the specifics of the transaction. However, this complexity will cease once we have passed the implementation date. The larger challenge probably rests with the accounts payable function. Coding, if done correctly, should be able to breakdown the HST into either the ITC account or the two rebate accounts depending on the activity (e.g., cost center) to which the expense relates. This will require that staff is trained on recognizing an expense and knowing how it should be coded for tax purposes.

A well-trained A/P staff will also recognize exceptions that will need to be followed-up with and questioned. For example, PST that is charged on invoices issued after June 30, 2010, will need to be reviewed. As should invoices that are issued after October 14, 2009 and before May 1, 2010, for supplies of property or services that are delivered or performed after July 1, 2010, to determine if the municipality is required to self-assess the provincial component of the HST. As mentioned previously, invoices that have only GST charged may require the municipality to self-assess the provincial component of the HST.

Informal discussions with government authorities have confirmed that, based on the current transitional rules, a 'person', such as a municipality, may encounter situations in which the requirement to pay PST to the vendor and to self-assess the provincial component of the HST may exist. Clarification related to these situations is expected to soon be released from both provincial and federal government authorities. The benefits of harmonizing the PST and GST have been purported by government officials to be numerous and include the following:

- Encourage new investment;
- Create growth in the economy;
- Create jobs in local community;
- Eliminate hidden costs for consumers; and
- Reduce compliance costs for businesses.

To maximize these benefits, municipalities will need to ensure a good implementation plan.

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[3] Assuming none of the supplies qualifies for point of sale rebates announced by Ontario and B.C.