BDO Dunwoody LLP
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Tax Bulletin

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Getting Ready for Ontario Sales Tax Harmonization

On March 26, 2009, the Ontario government announced in its annual budget that it will eliminate its existing provincial sales tax (PST) and introduce a harmonized sales tax regime with the Federal GST. This will take effect on July 1, 2010.

The province is proceeding with this change as a GST-style tax is far more efficient for businesses. The GST is a value-added tax applied to goods and services, which is designed to be paid by the ultimate consumer. Tax paid by businesses during the production or marketing of these goods and services are recovered through the claiming of input tax credits (ITCs), meaning that sales tax is not included in business costs. PST, on the other hand, while still charged to the consumer, is also payable on many business inputs, increasing business costs.

The purpose of this bulletin is to outline how harmonization will impact your business, and what you need to think about to prepare your business for its implementation.

Advantages of Harmonization

The biggest winners with the introduction of harmonization will be the Ontario business community. Businesses will realize the following advantages from the introduction of a harmonized sales tax (HST):

Recovery of PST

Unlike the GST, Ontario businesses pay PST on many business inputs with no ability to recover the tax. This embedded PST becomes part of the costs of the business. Examples of unrecoverable PST include the PST incurred on fixed asset purchases or goods that are used in the business (i.e. not resold to customers). Under a harmonized sales tax system, ITCs will be available to recover the provincial component of the tax, which will result in lower costs – savings which can be passed on to consumers through lower prices.

Reduction of Paperwork

Instead of dealing with two sales tax systems, businesses will find their compliance burden substantially reduced by a harmonized sales tax system. There will only be one tax collector – and as a result, only one sales tax return to file. Businesses will no longer be subject to sales tax audits by two levels of government. Purchase exemption certificates, which allow for the purchase of certain business inputs to be exempt from PST, will become a thing of the past as the provincial component of an HST will be recovered by claiming an ITC. For entities who are eligible to claim full ITCs, there will also be no need to self assess any sales tax on goods purchased from non-registered vendors that are used in a business in Ontario, which is something that PST auditors currently look for on tax audits.

Implications of Harmonization

Ontario is not the first jurisdiction to harmonize its sales tax with the federal GST. The Maritime provinces (Nova Scotia, New Brunswick and Newfoundland and Labrador) harmonized their sales tax with the GST when they introduced their HST in 1997. (While the province of Québec has a value-added tax, it is not fully harmonized with the GST.) Like the HST in the Martimes, the Ontario HST will be administered by the CRA, allowing the province to save millions of dollars in administration costs. Ontario's HST will be 13%, which is comprised of the 5% GST plus an 8% Ontario tax. The Ontario HST will generally use the same rules and tax base as the GST.

Details of how the HST will be implemented will be released in the coming months. It is expected that a comprehensive HST agreement with the federal government will be concluded by September 2009, with complete policy and administrative details to be released by the end of March 2010.

As part of the transition to the harmonized system, two specific measures were announced in the budget.

Small Businesses

To help reduce the compliance cost of the move to the new system for small businesses, a credit of between $300 and $1,000 will be allowed for the first reporting period after harmonization (a small business will generally be one that has annual taxable revenue of less than $2 million).

The following table illustrates the small business transition credit:

Total taxable revenues in first full fiscal quarter commencing after June 30, 2010	**Amount of transition credit**
Up to and including $15,000	$300
Over $15,000 and up to and including $50,000	2% of taxable revenue for that quarter
Over $50,000 and up to and including $500,000	$1,000

Phase-In of Input Tax Credits for Larger Businesses

Although the ability to claim ITCs will be a key component of the new system, ITCs will be restricted during the first 5 years of the new system for financial institutions and businesses with taxable sales in excess of $10 million annually, and after that, full ITCs will be phased in over 3 years. These restrictions will apply to ITCs related to:

- Energy (except for energy used for farming or the production of goods for sale);
- Telecommunication services other than internet access or toll-free numbers;
- Road vehicles weighing less than 3,000 kilograms and related fuel, parts and certain services; and
- Food, beverages and entertainment.

The eight year restriction on the ability to claim full ITCs will increase the implementation cost of harmonization for larger businesses and will negatively impact their cash flows.

Getting Ready for Harmonization

It is not too early to start thinking about how harmonization will impact your business. The following are things that all businesses need to think about as harmonization approaches:

Conversion of systems

Many businesses will likely find the conversion to the HST a costly and challenging endeavour as systems will need to be changed to accommodate the HST. Invoices, sales receipts, purchase orders and expense reports will likely require modification. Those businesses with complex billing cycles that straddle the transition time may find the transition to a harmonized sales tax particularly onerous.

Budgeting for HST

The impact of the introduction of the HST on budgets and cash flow projections will have to be evaluated. The ability to recover previously unrecoverable PST as ITCs will reduce business costs once the HST is implemented. Cash flows will also be impacted due both to the collection and remittance of the HST on a broader range of goods and services sold, and the payment of the HST on business inputs. Larger organizations will have to take into account the restrictions on claiming ITCs on certain expenditures during the first eight years of harmonization. Implementation costs, including any required system changes, will also have to be factored into budgets.

Contractual obligations

Businesses will need to review their contractual obligations to determine the impact of harmonization on these agreements. Harmonization also needs be considered in negotiating new contracts that extend beyond July 1, 2010. Transitional rules should be carefully reviewed when issued to ensure compliance with the legislation and refund opportunities, if any, are considered.

Planning Considerations

Businesses should review planned expenditures as the conversion date approaches and determine whether these expenditures are subject to PST that can't be recovered. If possible, these expenditures should be incurred after June 2010 so that the provincial component of the tax paid qualifies for an ITC. Consumers on the other hand will no doubt be reviewing expenditures that will become subject to the provincial component of the harmonized tax, so that these goods or services are bought before the harmonized tax comes into effect.

In addition, small businesses who file GST returns on a quarterly or annual basis should consider whether they want to file HST returns monthly, if a significant amount of the supplies they sell are zero-rated under the GST. GST does not have to be charged on zero-rated supplies – that said, businesses making zero-rated supplies are still entitled to recover all of the GST paid on business inputs as ITCs. Filing monthly will allow these businesses to recover the HST they pay on a more frequent basis than filing returns on a quarterly or annual basis. Businesses who will have a significant amount of zero-rated supplies will include exporters, grocery stores and farmers. Note that while businesses can change their reporting periods by filing an election, the change will only take effect on the first day of a fiscal year.

Interprovincial Issues

For businesses that operate exclusively in Ontario that are already registered for the GST, the transition to a harmonized sales tax will likely be smooth – and may simply involve a rate change on July 1, 2010. For businesses that operate in both Ontario and other provinces, however, the transition may not be as smooth. They will have to ensure that their systems enable them to determine whether to collect the 5% GST or the 13% HST on shipments of goods or supplies of services (which will depend on where the supply is provided). Many businesses will not have these systems in place, unless they currently make supplies in the Maritime provinces and therefore have been dealing with that HST. Even then, these systems will likely have to be modified.

Issues for Specific Industries

The move to a harmonized sales tax impacts various industry sectors in different ways. Following are some issues that need to be considered by different sectors:

Retail

Businesses in the retail sector will find that the HST will tax a much broader range of goods and services. These businesses must also ensure that their systems will be equipped to distinguish between items which are fully taxable from those that are subject to the new point-of-sale rebates. As outlined in the 2009 Ontario budget, there will be a point-of-sale rebate for the provincial component of certain items including books, children's clothing and footwear, children's car seats and car booster seats, diapers, and feminine hygiene products, meaning that these products continue to be exempt from the 8% Ontario tax.

Construction and Real Estate Development

The introduction of the HST has effectively introduced a new tax on new housing. Currently, new housing is only subject to the 5% GST (with a GST rebate available of 36% of the tax paid on the first $350,000 of the purchase price, which is phased out for homes priced between $350,000 and $450,000). Under harmonization, new homes will be subject to the 13% HST.

To ease the burden of the new tax, the 2009 Ontario budget provided for a new housing rebate. This rebate is a partial rebate of the provincial component of the HST, on new housing priced up to $500,000. For new homes priced up to $400,000, the rebate is 75% of the provincial component of the HST paid, meaning that the effective Ontario tax rate will be 2%. The rebate was to be reduced for new homes priced between $400,000 and $500,000 and was not to be available for homes priced at more than $500,000.

On June 18, 2009, the Ontario Ministry of Revenue announced enhancements to the new housing rebate. All new homes purchased as primary residences will now qualify for a rebate of up to $24,000 of the 8% provincial component, regardless of the purchase price. Effectively what this means is that the provincial component of the HST will be 2% on the first $400,000 of the purchase price of a new home, and 8% on the purchase price above that amount.

The June 18th announcement also provides for a rebate for new rental housing, including investment properties to be rented out. This rebate will apply across all price ranges up to a maximum rebate of $24,000, with the intention that new rental housing under $400,000 will not be subject to additional tax compared to the PST currently embedded in the price.

The transitional rules announced on June 18, 2009 for this rebate are quite complex and vary depending on the type of property (i.e. new home or new rental property) and the date that the agreement to rent or purchase was entered into. As well, special grandfathering rules were also provided for written agreements entered into on or before June 18, 2009.

Public Service Bodies

Many of the supplies made by entities in the MUSH sector (Municipalities, Universities and Colleges, School Boards and Hospitals) and Charities and Qualifying Non-Profit Organizations are exempt from GST/HST, meaning that no tax is collected on these supplies. As a result, these entities are unable to claim ITCs on most of their purchases.

To ensure that the introduction of the HST is neutral for each public service sector, rebates similar to those allowed under the GST system will be allowed. As with the GST, the rebates would be calculated as a percentage of the tax paid. These entities will need to track the provincial component of the new HST in order to claim the provincial rebate.

The following table sets out the rebates for the various public service bodies as announced in the 2009 Ontario budget:

Rebates for Public Service Bodies	Sector Rebate
Municipalities	78%
Universities and Colleges	78%
School Boards	93%
Hospitals	87%
Charities and Qualifying Non-Profit Organizations	82%

Summary

Even though harmonization only takes effect July 1, 2010, it is important that you start to think about the transition to a harmonized sales tax now. Contact your BDO advisor to discuss how harmonization will impact your organization.