

TAXTALK

Ontario Harmonized Sales Tax (“HST”) - Transitional Rules

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INTRODUCTION

The 2009 Ontario Budget proposed a comprehensive package of tax changes. Central to this tax package is the proposed Harmonized Sales Tax for Ontario (HST), which, subject to legislative approval, will come into effect on July 1, 2010. The conversion to HST will have a significant impact on your business affecting purchasing and contracts, sales and pricing, budgeting and information systems. This TaxTalk provides a brief overview of HST and the transitional rules that will apply in the conversion of the current Ontario Retail Sales Tax (RST) to the HST.

OVERVIEW

The Goods and Services Tax (GST) is a value-added tax applied to a variety of goods and services, designed to be paid by the final consumer of the goods or services. Any GST paid by businesses during the production or marketing of these goods and services is recovered by claiming input tax credits (ITCs). As a result, the GST is not included in business costs. Ontario’s RST, on the other hand, while still charged to the end consumer, is also payable on many business inputs, increasing business costs, which most times flows through to the final consumer.

Ontario is not the first jurisdiction to harmonize its sales tax with the federal GST. Three of the four Maritime provinces harmonized their provincial sales tax with the GST in 1997. Quebec also has a value-added tax, but it is not fully harmonized with the GST. B.C. also plans to harmonize its sales tax with GST on July 1, 2010¹. Like the HST in the Maritimes, the Ontario HST will be administered by the Canada Revenue Agency (CRA).

It is proposed that, effective July 1, 2010, Ontario’s RST be **replaced** with the HST. The HST will have a

combined tax rate of 13% - combining the existing 5% federal GST and the 8% Ontario harmonized sales tax.

In general, a single sales tax rate of 13% will apply to all goods and services that are currently subject to GST. This will result in many services being subject to 8% more sales tax (with ITCs potentially claimable).

The proposed HST will not apply to the following items that are currently not subject to RST:

- Basic groceries
- Prescription drugs
- Some medical devices
- Municipal public transit
- Health and education services
- Legal aid
- Most financial services
- Child care
- Tutoring
- Music lessons
- Residential rents
- Condominium fees

Consumers will also **not** have to pay the 8% provincial portion of the proposed HST for:

- Children's clothing and footwear
- Children's car seats and car booster seats
- Diapers
- Feminine hygiene products
- Books (including audio books)
- Print newspapers that are published at regular intervals
- Qualifying prepared food and beverages that are sold for a total price (for all qualifying items purchased, excluding HST), of not more than \$4.00.

¹ Speculation is that other provinces that still have a separate RST will soon also adopt an HST system in the near future.

Starting July 1, 2010, Ontario's businesses will deal with one sales tax regime instead of two, one set of rules instead of two, and one level of government instead of two. Having one set of rules and one set of filings will reduce the administrative burden on businesses which currently must deal with two separate sales tax regimes with different rules and exemptions.

Businesses that are registered for GST will be required to collect the HST. To reduce the administrative burden for small businesses, Ontario will parallel the federal small supplier annual threshold of \$30,000. In general, businesses with sales under the threshold will not be required to register and collect tax.

Small suppliers that choose not to register will not be required to file an HST return and will not be eligible to claim input tax credits. If a small supplier chooses to register, it will be eligible to claim input tax credits related to its taxable supplies when it files its HST return.

Currently RST is paid by most businesses at each step in the creation of a consumer product; that is, the RST is charged multiple times during the production of a product before that product reaches the store. So it can be a tax on a tax, all hidden in the cost of a product until it gets to the end consumer.

Under the proposed HST, most taxes paid on business inputs will be refunded to the business - with the hope that these savings that can be reinvested and passed on to consumers.

It is anticipated that the implementation of the HST will by itself generate more revenues for the government, and there will be an inflationary 'push' on the economy. However, the Ontario government is positioning the HST as part of a more comprehensive tax package that includes continuing corporate and personal tax rate reductions, and enhanced personal tax credits.

TRANSITIONAL RULES

As with any change of this magnitude, the transition from RST to HST will be complex and could cause confusion.

Transitional rules determine which tax - the existing RST or the Ontario component of the HST - will apply to transactions that straddle the July 1, 2010 implementation date for the HST. Under the transitional rules, HST will generally apply to prepayments starting on May 1, 2010, for goods or services that will be provided on or after July 1, 2010.

The transitional rules generally operate on the basis of the earlier of when consideration for a supply becomes due and when consideration is paid without having become due. Under the GST [HST], consideration for a supply becomes due on the **earliest of**:

- the day the supplier first issues an invoice in respect of the supply;
- the date of the invoice;
- the day the supplier will have, but for an undue delay, issued an invoice in respect of the supply; and
- the day the recipient of the supply is required to pay the consideration pursuant to a written agreement.

For the transition from RST to HST, there are certain key dates relevant when supplies 'straddle' July 1, 2010 in some way.

KEY DATES

1. **July 1, 2010** - Implementation dates for the HST.

- **May 1, 2010** - The HST will generally apply to amounts that become due, or are paid for property and services provided on or after July 1, 2010.
- **October 14, 2009** - The HST will **not** apply to amounts that become due, or are paid on or before October 14, 2009 for goods and services to be provided on or after July 1, 2010.

Certain businesses and public service bodies may be required to self-assess the Ontario component of the HST on amounts that become due, or are paid after October 14, 2009 and before May 2010 for property and services to be provided on or after July 1, 2010.

2. **October 31, 2010** - This is the date on which any outstanding RST will become payable under the transitional rules to facilitate the efficient wind-down of the RST.

SELF-ASSESSMENT OF HST

Persons who are non-consumers² (such as businesses and public service bodies) may be required to self-assess the Ontario component of the HST on consideration for a supply of goods or services that becomes due, or is paid without having become due, after October 14, 2009 and before May 2010, to the extent that the consideration is for goods delivered or services to be performed on or after July 1, 2010.

² A non-consumer is a taxpayer who is not a consumer. A consumer is an individual who acquires property or services except in the course of a commercial activity or in the course of making exempt supplies.

The requirement to self-assess in these circumstances will generally apply only to:

- non-consumers acquiring the goods or services for consumption, use or supply otherwise than exclusively in the course of their commercial activities (e.g., a business that is acquiring the goods or services to make GST/HST - exempt supplies);
- non-consumers acquiring the property for consumption, use or supply exclusively in the course of their commercial activities but in circumstances where the property will be subject to an input tax credit restriction or recapture (e.g., leased passenger vehicles where the monthly lease payment exceeds \$800);
- non-consumers that use simplified procedures (i.e., quick method) available under the GST for calculating their net tax (e.g., certain charities, public service bodies, and small businesses); and
- selected listed financial institutions, which use a special attribution method in determining their net tax.

A person who is required to self-assess in these circumstances will be required to account for the tax either:

- (i) in the GST/HST return of the person for the reporting period that includes July 1, 2010, if the due date for that return is before November 2010, or
- (ii) in any other case, in prescribed form and before November 2010.

RULES FOR TYPES OF SUPPLIES

Goods and Services

The HST will generally apply to a *supply of goods* by way of sale to the extent that the goods are delivered, and ownership of the goods is transferred, to the recipient of the supply on or after July 1, 2010.

The HST will generally apply to a *supply of a service* to the extent that the service is performed on or after July 1, 2010. The HST will generally not apply, however, to a supply of a service if all or substantially all (90% or more) of the service is performed before July 2010.

Consideration due or paid on or after July 1, 2010:

- HST will generally apply.

Consideration due or paid on or after May 1, 2010 and before July 2010:

- HST will generally only apply where ownership of the goods passes after July 1, 2010.

- The supplier will be required to account for the Ontario component of the HST in the GST/HST reporting period of the supplier that includes July 1, 2010.
- The recipient will be able to claim any available input tax credits with respect to the Ontario component of the HST in the GST/HST reporting period that includes July 1, 2010.

Consideration due or paid after October 14, 2009 and before May 2010:

- HST will **not** apply. For persons who are not consumers, refer to the Self Assessment of HST section above.

Leases and Licences

Generally leases and licences are treated the same as GST discussed above. The only difference is HST will not apply to a supply of property by way of lease, licence or similar arrangement if the lease interval begins before July 2010 and ends before July 31, 2010.

Intangible Personal Property

The HST will generally apply to consideration that becomes due, or is paid without having become due, on or after July 1, 2010 for a supply of intangible personal property³ by way of sale.

For more information about transitional rules for certain intangible personal properties (memberships, lifetime memberships, admissions, and transportation passes), please contact us.

Real Property (Other than Residential Housing)

The HST will generally apply to a supply of real property (other than residential housing) by way of sale in Ontario if both ownership and possession of the property are transferred to the purchaser on or after July 1, 2010.

Residential Housing Rebate

To ensure that new houses are not subject to additional tax, a new rebate has been developed. This rebate will be calculated as 75% of the provincial portion of the HST (8%) up to a maximum rebate of \$24,000. This rebate qualifies for new homes purchased as primary residences on or after July 1, 2010⁴.

³ *Intangible personal property is property that is not tangible (i.e., it cannot be touched, seen or felt).*

⁴ *Unlike the GST rebate on new housing, there is no reduction of the \$24,000 rebate when the new house price exceeds \$400,000. The effect of the HST rebate is that the Ontario component of the HST will be 2% on the first \$400,000, and 8% on any sale price exceeding \$400,000.*

Rental Housing Rebate

The same rebate discussed above for new houses is available for houses which are purchased for use as rental housing. The same rate and maximum discussed above apply. For apartment buildings the rebate will be based on each rental unit, rather than one rebate for the whole building.

Special Situations

Special HST transitional rules will apply for the following situations:

- Arrangements for prepaid funeral and cemetery services
- Subscriptions to newspapers, magazines or other periodical publication
- Passenger transportation services
- Commercial parking passes
- Freight transportation services

OTHER TRANSITIONAL RULES

Restricted Input Tax Credits for Large Businesses

Large businesses with annual sales of \$10 million or more will be restricted from claiming input tax credits on the following expenses:

- energy (except where purchased by farms or used to produce goods for sale),
- telecommunication services (other than internet access and toll-free numbers),
- certain road vehicles and related expenses, and
- food, beverages and entertainment.

After the first five years, full input tax credits would be phased in over a three year period.

Residential Real Property

Generally, sales of newly constructed or substantially renovated homes under written agreements of purchase and sale entered into on or before June 18, 2009 will not be subject to the provincial portion of the single sales tax (HST) where both ownership and possession of the homes are transferred after June 2010.

Builders will be able to recover the provincial portion of the single sales tax payable on most purchases through input tax credits, as under the federal GST. However, builders of the above listed homes will generally be required to pay a transitional tax adjustment to account for tax that will have otherwise been embedded in the new homes under the current RST regime. Builders will also be required to meet certain reporting and disclosure requirements for these homes.

Transitional Tax Adjustment - Single Homes

For these sales of newly constructed or substantially renovated single detached homes, semi-detached homes and attached homes, the builder will generally be required to pay a transitional tax adjustment where the home is completed in full or in part after June 2010. The transitional tax adjustment for these homes will be calculated on the total purchase price of the home, as established for GST purposes, based on the extent of construction or substantial renovation completed as of July 1, 2010.

Transitional Tax Adjustment - Condominiums

For these sales of newly constructed or substantially renovated homes that are residential condominiums, the builder will be required to remit a transitional tax adjustment and may also be eligible for an RST transitional housing rebate. The transitional tax adjustment will be calculated at 2% of the total purchase price, as established for GST purposes, of the condominium unit or building, as applicable.

RST Transitional Housing Rebate

Homes completed prior to July 1, 2010, will have RST embedded in the costs. To provide relief for the embedded RST, individuals purchasing new homes or builders building condominiums can use the RST transitional housing rebate. The rebate is based on the proportion of construction or substantial renovation that has been completed by July 1, 2010.

Taken together, the transitional tax adjustment and the RST transitional housing rebate will approximate the tax that would have otherwise been embedded in the condominium, on average, under the current RST regime.

Progress Payments/Holdbacks

The HST will generally apply to progress payments on contracts to construct, renovate, alter or repair (hereafter referred to as "construct") real property or ships or other vessels to the extent that the progress payment can reasonably be attributed to property to be delivered or services to be performed on or after July 1, 2010.

For progress payments that become due or are paid without becoming due after October 14, 2009 and before July 1, 2010, the supplier will be required to account for the Ontario component of the HST, where applicable, in the GST/HST reporting period of the supplier that includes July 1, 2010. Similarly, the recipient of the supply will be able to claim any available input tax credits with respect to the Ontario component of the HST in the GST/HST reporting period of the recipient that includes July 1, 2010.

In the case of written contracts to construct real property, or to construct a ship or other vessel where it can be reasonably expected that the contract will require more than three months to complete, special rules apply if the construction is “substantially completed”⁵ before June 2010. Pursuant to the general GST rules, any consideration or part of the consideration payable on such a contract that had not been paid or becomes due on or before July 31, 2010 will be deemed to have become payable on July 31, 2010 and any portion of such payment attributable to construction on or after July 1, 2010 will be subject to the HST.

A holdback from a progress payment will be considered to be part of the progress payment from which it was held back. The holdback will, therefore, be subject to the same allocation under the progress payment rule as the progress payment itself, even if the holdback becomes due or is paid on or after July 1, 2010.

The progress payments rule will not apply to sales of newly constructed or substantially renovated homes, which will be subject to the transitional rules for new residential housing.

Goods and Services Brought into Ontario

The general rules discussed above apply to goods and services brought into Ontario, including the rules relating to self assessment of HST.

The Ontario component of the HST will generally not apply to property and services/commercial goods that are brought into Ontario if they are acquired by a GST/HST registrant for consumption, use or supply exclusively in the course of commercial activities of the registrant.

Imported Taxable Supplies

The Ontario component of the HST will generally apply to consideration for an imported taxable supply of:

- **goods** made to a resident of Ontario, or a GST/HST registrant to whom the goods are delivered or made available, or physical possession of the goods is transferred, in Ontario;
- **services** made to a resident of Ontario who acquires the services for consumption, use or supply primarily in the participating provinces; or
- **intangible personal property** that is made by way of lease, licence or similar arrangement to a resident of Ontario who acquires the property for consumption, use or supply primarily in the participating provinces

to the extent that the supply is transferred, or the service is performed, on or after July 1, 2010.

Consideration for imported taxable supplies will, with appropriate modifications, generally be subject to the transitional rules described in the Goods and Services, and Leases and Licences sections (as the case may be) of this TaxTalk.

Compliance Costs for 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.

WINDING DOWN THE RST

On July 1, 2010, the existing Ontario RST will generally cease to apply to:

- a sale of goods where the goods are delivered, and ownership of the goods is transferred, to the purchaser on or after July 1, 2010;
- a sale of services to the extent the services are performed on or after July 1, 2010 (however, the RST will apply where all or substantially all of the service is provided before July 2010);
- a supply of property by way of lease, licence or similar arrangement for the part of the lease or licence interval that is on or after July 1, 2010 (however, the RST will apply if the lease interval begins before July 2010 and ends before July 31, 2010);
- a sale of property or a service delivered or performed on a continuous basis by means of a wire, pipeline or similar conduit or satellite or other telecommunications facility to the extent the property or service is delivered, performed or made available on or after July 1, 2010;
- goods brought into Ontario or imported by a resident of Ontario on or after July 1, 2010; and
- a sale (including promotional distribution) of an admission, including any ticket sold on a subscription or season ticket basis, for entry to a place of amusement on or after July 1, 2010.

Consideration due or paid after October 14, 2009 and before May 2010:

Notwithstanding the general RST wind-down rules, the RST will continue to apply where consideration for a sale of goods, services or admissions becomes due or is paid after October 14, 2009 and before May 2010.

⁵ “Substantially completed” generally means 90% or more.

However, this exception to the RST wind-down rules will *not* apply with respect to goods, services or admissions purchased for use exclusively in the course of commercial activities. It also will not apply with respect to goods, services or admissions for which the self-assessment rules in respect of consideration due or paid after October 14, 2009 and before May 2010 will apply (as described above in the HST transitional rules part of this TaxTalk). If an amount is paid in error as RST in these situations, the purchaser will be able to file a general application for refund with the Ontario Ministry of Revenue, subject to the refund conditions under the RST.

Consideration due or paid on or after May 1, 2010 and before July 2010:

Where consideration becomes due or is paid on or after May 1, 2010 and before July 2010, the general RST wind-down rules will apply as set out above.

RST payable on or before October 31, 2010:

To facilitate the wind-down of the RST, a transitional rule will provide that any applicable RST not otherwise payable on or before October 31, 2010 will become payable on October 31, 2010.

Disclosure Requirements for Tax-Included Pricing in Transitional Period

A transitional rule will help provide certainty and clarity to both vendors and purchasers with respect to the application of the RST for tax-included sales during the transitional period of October 14, 2009 to April 30, 2010.

Where RST-included pricing is used for the sale of goods, a taxable service or an admission, the consideration for which becomes due or is paid after October 14, 2009 and before May 2010, and where the seller does not disclose in writing to the purchaser the amount, if any, included as or on account of RST in the stated price, the stated price will be deemed to include RST if the RST will have applied to the sale notwithstanding any other transitional rule that may apply.

Final RST Returns

Final RST returns will generally be required to be filed with the Ontario Ministry of Revenue on or before July 23, 2010. Where an amount is collected or becomes payable as or on account of RST after June 2010, the vendor will be required to account for that amount in a supplemental RST return to be filed on or before the 23rd day of the following month. All supplemental RST returns will be required to be filed no later than November 23, 2010.

TRANSITIONAL RST INVENTORY REBATE FOR RESIDENTIAL REAL PROPERTY CONTRACTS

An RST rebate will be available to provide relief with respect to the RST embedded in construction materials used in residential real property contracts that are subject to the HST.

This rebate will be available to a real property contractor for the RST paid on construction materials that are purchased or produced for the contractor's own use, held in inventory at the end of the day on June 30, 2010 and used in a residential real property contract to which the HST will apply.

The rebate will not be available with respect to inventory for which the RST is otherwise recoverable by the contractor or any other party.

Qualifying residential real property contracts will include contracts to repair or improve land and items permanently attached to land, such as buildings and patios. Residential real property contracts for repair or improvements to rental housing, condominium and apartment buildings and long-term residential care facilities may qualify for this rebate.

ADDITIONAL INFORMATION

The province is continuing to work with the federal government to develop additional transitional rules for the HST. More information about these and other circumstances will be released in the near future to help taxpayers continue to prepare for the proposed changes.

The above has provided a brief review of the rules to transition from the RST system to the HST system. There are added details in this regard. Please contact us if you require additional information.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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