

Collateral damage

On July 1 2010, both Ontario and British Columbia will replace their outmoded PST with a tax imposed on an almost identical base to the federal GST (Ontario at 8%, B.C at 7%). The tax is imposed in a chapter of the federal Excise Tax Act, and will be collected and administered by the Canada Revenue Agency. This bold move improves the competitive edge of these two provinces, and is long overdue. For suppliers of goods and services in every sector except one, overall compliance cost will be reduced, and PST savings will further reduce the cost of doing business.

The financial sector is the unlucky one for which the change is not positive. This brief article explains why those supplying goods and services which are exempt from GST/HST will be damaged by the change as currently structured. It suggests ways to lessen the damage at the same time as improving the policy outcome.

GST/HST exemption – That's a good thing, right?

Financial services present a unique challenge to value-added taxes such as the GST. Unlike the production chain for goods, where each supplier in the chain reclaims tax borne on costs (e.g. lumber) and then charges GST on sales (e.g. furniture), remitting GST on the 'value-added', it is not possible to calculate the value-added component inherent in say, loan interest or an insurance premium. In the case of a loan, the value-added component of the financial service is not the interest rate charged to the borrower.

Rather, the value-added is a function of the spread between the interest rates paid and charged by the bank, plus many other variables that defy quantification.

The policy compromise adopted under virtually all value-added tax systems is to exempt financial services. In the case of an exempt supply, there is no visible tax on consideration paid by the consumer for the service or instrument, *but the supplier is not able to recover the GST borne on its costs*. Exemption of financial services is a way of taxing them, to the extent of the non-recoverable tax incurred by the supplier. The policy intention of such 'taxation by exemption' is that *the supplier will factor the GST cost it incurs into the price it charges the consumer for the service or instrument*.

What is the damage?

When the tax rate changes from 5% GST to 13% GST/HST in Ontario (and 12% in B.C.) on July 1, 2010, can a bank simply pass all that tax on to the consumer? No. Suppliers of GST/HST taxable goods and services will calculate the higher rate and charge the consumer, and also enjoy a cost saving of the vanished PST. In sharp contrast, suppliers of financial services are unable to revise many of their prices, being subject to fixed-price contracts, such as mortgages, running over a number of years. The increased tax is intended to be borne by the consumer, but when 'taxation by exemption', a dramatic (160%) tax rate increase, and fixed-price contracts all come into confluence, the supplier gets crunched. How crunched? Harmonization in these two provinces will cost the banks approaching \$400 million a year.

It gets worse, however; there are three more provinces still having the old PST format, and the expectation is they will now feel compelled to level the competitive playing field and harmonize. In addition, Quebec may also revise its harmonized model, with potentially more cost for banks. Make that \$400 million and rising.

Is there a fix?

Only when modernization of Canada's sales taxes into one tax, on a unified base at one rate is achieved will we maximize the economic benefit of introducing the GST. Given the inevitability of this development, detailed thought on the ways to improve the policy outcome for suppliers of financial services has been in progress for some years.

The good news is there are a range of simple and practical policy options available to improve the outcome. These options would not just move the outcome closer to the original design intent that the tax remains a tax on the consumer instead of an accidental levy on the supplier. They could also further improve the overall efficiency of the GST by removing hidden or cascading tax in the manufacturing chain further reducing the tax drag on exports. Options range from solutions unique to the structure of Canada's GST, to measures already in place in other VAT jurisdictions. One option involves minor adjustments to annual tax calculations already performed by financial institutions, to mitigate the impact or at least to phase it in over a timescale that recognizes pricing constraints. Another involves allowing the full GST/HST to be charged on interest

borne by manufacturers and retailers (who recover all their GST/HST) so that the GST currently 'baked into' the finance and insurance costs of exported goods is removed. Still another involves allowing a percentage of tax borne on costs of making an exempt supply to be recovered, in recognition of the increasing need for financial institutions to outsource and the barrier that unrecoverable GST can be to such business imperatives.

Now what?

The motivation for provincial harmonization was improvement of the competitive position overall, and the manufacturing sector in particular. Financial services are acknowledged as a vital component of the growth potential of Canada. Consequently, practical options to improve the negative outcomes for this sector, while enhancing the effect of the HST as a whole, should be embraced and implemented.

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