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HST and Retail Issues

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Harmonization: What's old is new again.

Ontario (and quite possibly other "PST provinces") are now moving forward and melding their sales taxes with the GST.

When the Atlantic provinces harmonized in 1997, Canada's retailers expressed a number of concerns, not least of which was the proposal for tax-inclusive pricing. While that particular threat was overcome, it remains a risk, as this 1997 CICA Symposium Paper details.

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I. INTRODUCTION

a) Harmonization and Uniformity—A Laudable Aim

Throughout the process of review by the House Finance Committee in 1994 of possible alternatives to the GST, many of the opinions voiced were agreed on at least one thing - that in order to realize the full benefits of introducing the GST in place of the unwieldy FST, harmonization of all provinces in Canada, with the same rate of tax applied to a uniform base, was necessary. These goals were mentioned in many public documents emerging at the time, including one published by the CICA, "Do the Right Thing", which encouraged the government to continue to press for a harmonized national sales tax, rather than abandoning the reform process and switching to a completely different form of taxation. There was general agreement, therefore, that harmonization was a good thing. Had that harmonization taken place nationally to produce one rate on a uniform base, then the process for Canada's retailers would have been a comparatively smooth one, and there would probably not even have been a need to review retail issues connected with harmonization at this year's Commodity Tax Symposium.

b) Partial Harmonization—The Darkness Before the Dawn

Once the concept of introducing a harmonized sales tax in only three provinces of Canada was unveiled, a myriad of complex issues and concerns, both real and perceived, were raised by provincial governments and various industries, as they came to accept the reality that progress towards a harmonized system could only be achieved in stages.

The hope now is that harmonization rapidly "creeps" westward province by province, and so any system modifications or business decisions must contemplate the addition of more participating provinces. On the April 1st, 1997, Canada entered a new sales tax era - the era of "creeping harmonization", which era can only be said to end at the point when full national harmonization is achieved. Registrants, consumers and taxpayers can only hope that the era will span years rather than decades.

When faced with the task of modifying a national design for a harmonized sales tax, to suit it for initial application to only three provinces in Canada, there are essentially two stages:

- Some characteristics of the overall design for a national system are simply not workable in a system of partial harmonization and so have to be deferred or removed - the most notable being the infamous tax-inclusive pricing rules.
- The harmonized system has to include novel features to deal with the national "border" between the harmonized and non-harmonized zone in a fashion which balances the need to eliminate distortion with the requirement that it be workable for registrants.

This document reviews the outcome of both stages which are of particular relevance to retailers.

II. TAX-INCLUSIVE PRICING

a) Coming into Force Provisions—Lunacy Merely Deferred

That part of Bill C-70 encompassing the various tax-inclusive pricing provisions for the participating provinces, complete with all the various definitions of "price information", "price tag", "written advertisement", "national catalogue", and the offence provisions now come into force ...

"... on a day fixed by order of the Governor in Council, which day shall not be before the first day on which provinces together having at least 51 % of the total population of all provinces that are participating provinces (within the meaning of subsection 123(1) of the Act) or that impose a general retail sales tax at a percentage rate on all goods (other than those specifically enumerated in the legislation that imposes the tax) or a general value added tax at a percentage rate on all goods and services (other than those specifically enumerated in the legislation that imposes the tax) have enacted laws requiring that suppliers include the tax under part IX of the Act in indications of the prices of property or services supplied. "...

... whenever that day may be. The significant point to note here is that the concept of tax-inclusive pricing being imposed at the retail/consumer level on less than a national basis is alive and well, and still remains a very real threat for Canada's retailers. That this concept of differential pricing still retains any credibility can only indicate that many simply do not understand the practical problems which any national retailer would face in complying. Those Problems, and the resulting costs, remain the same whether a separate tax-inclusive pricing requirement exists for one province, for three, or on one side of the peculiar dividing line chosen by the Standing Committee on Finance which, although it indicates some sympathy, may evidence less than complete comprehension on the part of the Committee. In addition to the practical issues for the retailer, there is also the consumer confidence (or confusion) issue arising in the marketplace, this being particularly acute at the border of the "harmonized zone". Consequently, even though these rules did not apply from April 1, 1997, it is appropriate to invest some effort in a review of the daunting practical problems and costs of implementing a ghastly mess which has been deferred, but not yet completely averted.

b) The Practical Problems

The practical problems of supporting two pricing systems would extend through all of the central systems of a company's operations including inventory marking and pricing by the supplier, inventory control and allocation, shipping and logistics, pricing and stock valuation and advertising. Consider the following:

i) Systems

Different systems of pricing for two zones of Canada would require changes to almost every system used by national retailers. A modern national retailer relies totally on many systems, each of which has evolved over time to cope with the needs of the specific function it supports and all the other systems with which it interacts. Put another way, the "system" of any retailer is not analogous to one spider covering all functions, but to a hundred spiders holding hands.

Additional areas of complexity arise where retailers use the retail price as a central reference point, i.e., where systems rely on a tax-exclusive retail price. Tax-inclusive pricing on a less than national basis would necessitate at least two reference points. The functionality of the system will change as a result.

Additional costs would arise in the area of point-of-sale scanning systems where separate, discrete reference systems will need to be created for pricing purposes only, while preserving the interface with other systems such as those governing inventory.

A further problem arises where a retailer is part of a multi-national group, because any group normally aims to preserve uniformity in systems planning and design. The following grid is just an overview of how fundamental and pervasive the systems changes would be.

SYSTEM / PROCESS IMPLEMENTATION ISSUES

Legislation	People Resources	Financial Resources	Complexity	Specific to Differential Pricing
x			x	proposed legislation will change
	x	x		computer programmers already precommitted
	x	x		cannot commit resources without legislation
	x	x	x	integration into international accounting and reporting systems
		x		use of cash - \$ not available to invest in new profit generating systems
		x		use of cash decreases availability of cash for purchases, hence profits
	x	x		productivity losses through duplication of work

			x	deal with many colours, sizes, styles, customers, low \$ per item. Therefore. high cost % per item
			x	new type of sales tax errors created, charged to retailer (retailer cannot collect tax after sale)
	x	x		reduce customer service by reticketing, lose sales
			x	new codes developed to indicate price status
		x		higher logistics, distribution costs for similar products
	x	x	x	training required
	x	x	x	new signage for stores in harmonized zone
x	x	x	x	future tax "harmonization" in other provinces. - unable to plan - no consensus -speculation
	x	x	x	final selling price determination - pricing points, many low \$ items, tax changes
	x	x	x	higher carrying costs similar products with different pricing - more tracking required
			x	greeting cards preprinted, North American market, low price
			x	magazines pre-printed, worldwide market, low price
	x	x	x	customers taking off repriced tickets - theft. Anti-theft considerations, costs?
		x	x	purchase new point of sale equipment
			x	dealing with one-time implementation. No experience available
			x	retail systems were developed independently over many years
			x	may be many controlling "Systems" within the same company; e.g., division. franchises, stores
	x	x	x	each system must integrate with incentive pay programming (payroll)
	x	x	x	each system must integrate with accounts payable programming
	x	x	x	each system must integrate with accounts receivable programming
	x	x	x	each system must integrate with purchase order programming
	x	x	x	each system must integrate with general ledger programming
	x	x		catalogues produced very far in advance of possible announcements by government
	x	x	x	each system must integrate with point of sale equipment, programming
	x	x	x	each system must integrate with tax collection, remittance programming
	x	x	x	each system must integrate with pricing programming
	x	x	x	each system must integrate with audit programming
	x	x	x	each system must integrate with merchandise planning programming
	x	x	x	each system must integrate with merchandise planning programming
	x	x	x	each system must integrate with sales reporting programming
	x	x	x	each system must integrate with buyers' planning programming
	x	x	x	each system must integrate with warehouse programming
	x	x	x	each system must integrate with logistics programming

	x	x	x	each system must integrate with personnel costs tracking programming
	x	x	x	cash register re-programming
		x	x	incorrect guesses by purchaser for province will increase carrying costs
			x	no simple solution - "canned" software not available
			x	goods for sale at Christmas are purchased nine months earlier - planning
			x	goods must be tracked for long periods of time, often years
	x	x	x	advertising planned approximately nine months earlier
x	x	x	x	new taxes and tax increases planned to replace "lost" PST
			x	some systems track all costs of all goods from purchase order to final sale (x Retail Method)
		x	x	national system requirement for a small percentage of customers (Atlantic only)
	x		x	programmers need to understand retail and company's highly specialized programs
			x	Retail Method of Accounting - complexity with tax-included
	x			existing programmers already deployed
	x			new programmers non-existent
			x	new product number identification required for cash register
		x		recession has left customers with less money - less retail profits - less \$ to spend to convert
		x	x	use of pre-budgeted money. Retailers need cash to buy goods for sale - borrowing complexities
			x	budgets planned five years in advance. next year is already fixed
	x	x	x	retailers have already spent millions of dollars in computer upgrades - yet some new equipment required

ii) National Retail Advertising

- The Canadian retail market relies on significant flyer and catalogue advertising. A very conservative estimate would be 220 million catalogues and 2.5 billion flyers annually. Split-runs or modifications to accommodate specific rules may be required for each, and would be unwieldy and expensive.
- Where the consumer buys directly from a catalogue (a significant market), retailers may face the potential costs of producing zone-specific catalogues. When taking orders and shipping, they would need to quiz and inform the consumer on his/her residency and, if it differs, delivery address.
- **It is not difficult to see how non-resident mail-order companies will benefit over resident retailers, as, given the practical enforcement problems, they may still choose to present a uniform price to the customer on a tax-excluded basis.** The eventual delivered cost to the customer would of course be the same, but that may not be evident to all consumers when they make the purchasing decision, at which point the Canadian supplier has lost the sale.
- Modern retailing involves extensive use of in-store information tools ("shelf-talkers", demo videos and signage), to inform, attract and educate the consumer. Much of this material is price-oriented and so the creation of multiple pricing regimes necessarily involves multiple small, and consequently expensive, production runs for all of these information tools. The pricing requirements could simply render these selling aids too expensive to use in some cases.

iii) Supplier Ticketing

Many retailers now use the supplier to ticket items at source - in the case of some retailers this practice extends to eighty-five percent of merchandise. The proposal would necessitate abandonment of source ticketing or installation of re-ticketing and double handling of goods destined for the harmonized zone. The impact on the costs and efficiencies of the distribution function would be huge. For example, a supplier that currently tickets for the retailer would be required to segregate the finished production into separate populations for each tax-inclusive harmonized rate, and ticket each population separately.

iv) Warehousing

Warehousing and inventory control would have a new aspect to monitor - that of segregation of pre-ticketed goods destined for the harmonized and non-harmonized zones. This would require higher levels of inventory, taking up more space and more tracking, all of which mean more cost. For example, a truck being loaded with stock may be calling at three retail outlets, which could quite possibly straddle the harmonized "border". The process of loading and labeling the various pallets and the sequence of loading would become more complex. At each stop before the final one, the truck may have to be partly unloaded and then reloaded, simply to facilitate separate pricing for some provinces.

v) Distribution

To the extent that merchandise is moved between stores to satisfy demand, a completely new and artificial cost would now be introduced with an additional handling process being required if the move is across the "harmonized border". For example, topping-up of one neighbouring retail site from another with, say, toothpaste, would involve staff in reticketing each and every item before display, distracting the staff from their sales function.

Each of the above systems and processes would require further modification each time harmonization "creeps" to a new province.

c) Summary

Consumers, when stopped in the street, may say they like tax-inclusive pricing. National sales tax harmonization may be desirable, but is only currently achievable in three provinces. Mandatory tax inclusive pricing in Canada may only be possible in the context of a harmonized or provincial tax for Constitutional reasons.

The sum of the above three statements do not provide any justification for imposing a requirement on retailers to present different prices on their wares in different zones. The issue here is enforced differential pricing, not tax-inclusive pricing. The goals of sales tax harmonization and tax-inclusive pricing are not interdependent. This sector can only operate with a tax-inclusive pricing system with one rate across Canada - it cannot manage tax-inclusive pricing in either a partly harmonized or fully harmonized multi-rate system.

Returning to Finance Minister Paul Martin's announcement of the HST package on April 23, 1996, we could test this aspect of the proposals against some of the statements made.

... a simpler tax system for both consumers and business "	NO
"For business, harmonization will mean lower costs and less paperwork."	NO
"Harmonization will also help lower prices through a reduction in the cost of doing business."	NO

Zero out of three. The obligation to support two pricing systems is ill-conceived and would not constitute progress. Hopefully we will never see it imposed.

III. PRICE ADJUSTMENTS

To the extent that any adjustments in price are made, all of the various mechanisms providing mandatory or elective corrections to the amount of tax involved must be modified to recognize whether the adjustment is relevant to a supply of goods made within or without the harmonized zone. Consequently, the modifications in this area necessary to accommodate the HST are entirely logical. The evolution here, therefore, is simply one of additions or corrections to the system for any retailer. The preference which may emerge will perhaps be a switch to tax-exclusive adjustments, wherever possible, to avoid the need to track whether GST or HST was levied on the original taxable supply.

a) Volume Discounts

In the case where manufacturers pay volume discounts to retailers, Section 232(2) allows the manufacturer to adjust the tax or not, at its discretion. To the extent that manufacturers are supplying goods to retailers, then both parties were indifferent in real cost terms, as to whether the tax was adjusted, because the original amount of tax borne by the retailer was fully recoverable in any event. After the inception of the HST, however, manufacturers and retailers may prefer to have the adjustments made net of tax. This is because the amount of tax to be adjusted on the volume discount is the amount actually paid, and so to make the correct adjustment in the case of a volume discount for supplies made within and without the harmonized zone, a manufacturer would have to calculate how much FIST and GST had been borne. Given that HST and GST have been fully recovered by retailers, this seems like a pointless exercise. Consequently, to the extent that tax was previously included on volume discounts, we can expect to see a shift to a "net of tax" discount.

b) Goods Returned

Goods returned also fall into the category of a price adjustment for GST/HST purposes. To the extent that goods are returned by retailers, therefore, the adjustment or credit by the manufacturer will need to recognize the amount of GST, or HST, as appropriate on the particular goods. Where a manufacturer makes available goods to a retailer by delivering those goods both in and outside of the harmonized zone, that population of goods is subsequently shifted around by the retailer and then some goods are returned to the manufacturer from various sites, then how does the manufacturer identify whether the goods bore GST or HST? In practical terms, it probably cannot. From an audit perspective, however, this seems to be a difficulty without any real consequences, as the retailer can fully recover the tax in any event. Manufacturers may choose to make these adjustments without tax in future, however, for the sake of simplicity.

c) Rebates

The rules in Section 181.1 are limited to cases where:

- a registrant makes a taxable supply (property or service)
- a person acquires the property or service (from the registrant or otherwise)
- the registrant pays a rebate to the person who acquires the supply
- the registrant **provides a written indication that the rebate includes tax** and
- Section 232(3) does not apply to the rebate.

The logical treatment here is that the registrant paying the rebate (which has been stated to be taxinclusive) should be entitled to claim an ITC equal to the tax included in that rebate, putting the registrant in a position whereby it has accounted for tax on the net amount of the consideration, following the adjustment for the rebate. Modifications to Section 181.1 were obviously necessary with the introduction of the HST. The input tax credit claimable by the registrant is now 15/115 of the amount of the rebate if tax was originally payable at 15% HST on the original supply, or 7/107 in any other case.

In cases where the recipient of the rebate is a registrant who was entitled to claim an input tax credit or rebate in respect of the property acquired, then, as one would expect, the amount of tax embedded in the rebate is remittable by that person. Specifically, Section 181.1(f) deems the person to have made a taxable supply and to have collected the amount of tax determined by the formula:

$$\frac{A \times B \times D}{C}$$

where:

- A is the tax fraction in respect of the rebate,
- B is the input tax credit or rebate under Division IV that the particular person was entitled to claim in respect of the acquisition of the property or service,
- C is the tax payable by the particular person in respect of the acquisition of the property or service, and
- D is the amount of the rebate paid to the particular person by the registrant.

In other words, the amount of tax which it originally would have recovered in respect of the acquisition of the service or good to which the rebate relates.

To give an example, a tire dealership supplies truck tires to a trucking firm. The tire manufacturer initiates a rebate program where there is a \$100, tax-inclusive, rebate available on each tire purchased. The trucking firm accumulates 50 rebate certificates and presents them to the tire manufacturer to receive a payment of \$5,000. Assuming all of this occurs in Ontario, then in respect of the rebate, the manufacturer is entitled to claim an input tax credit equal to $\frac{7}{107}$ th x \$5,000, i.e., \$327.10. In addition, the trucking firm is deemed to have made a taxable supply and to have collected GST of \$327.10 on that supply.

Similarly, because the formula for the ITC and the rebate is geared to the tax fraction, if all of the above occurred in Nova Scotia, then the tire manufacturer would be entitled to an ITC of \$5,000 X $\frac{15}{115}$, i.e., \$652.17, and the trucking firm would be obliged to remit an identical amount.

Now, what if the tire dealership is a national organization and so is the trucking company? Trucks will receive repairs and tires will be made available to it, both at its central locations and out on the road as circumstances dictate. The national rebate scheme is geared to a fixed amount per tire and so, this mechanism becomes problematic. To support anything greater than an ITC of $\frac{7}{107}$ th, the manufacturer will presumably have to substantiate that the original supply of the tire was made in a participating province. Similarly, assuming the trucking company has an earnest desire to comply, it needs to know where tires were supplied in order to determine the correct amount of tax to remit on its deemed supply.

Obviously, in circumstances where rebates attach to singular large ticket purchases or are mailed to consumers at fixed addresses, the system works. But once the flow of goods to which the rebates relate does not conform to these patterns, this system becomes awkward, to put it mildly. For the tire manufacturer in our example, the only way to maintain clarity would be to have a different rebate with a specific form, document or certificate for tires delivered in a participating province to those delivered in a non-participating province. A ludicrous extension of this would be that a repair centre at the border of the harmonized zone would need to stock both certificates and elect which one to provide to the trucking company, depending on at which point on the highway a roadside repair was necessary.

d) Coupons

Section 181 provides different and specific rules for the treatment of "coupons" (defined as a voucher, receipt, ticket or other device but excluding a gift certificate), depending on whether the coupon is nonredeemable, if it is redeemable and issued for a fixed amount, or redeemable and issued for other than a fixed amount. To deal with each in turn:

Non-Redeemable Coupons

Where a registrant accepts a coupon in full or partial consideration for a supply which is taxable at a positive rate, and cannot expect to be paid an amount for redemption by another person, and the coupon is for a fixed dollar amount or fixed percentage, the registrant has a choice:

Option 1 [S181(3)(a)(i)]

It can treat the coupon as reducing the value of the supply upon which tax is levied.

[S181(4)].

Option 2 [S181(3)(a)(ii)]

It can account for tax on the full value of the supply (i.e., ignoring the coupon), and claim an ITC for the relevant tax fraction (i.e., 7/107 or 15/115) applied to the value of the coupon [S181(2)].

Redeemable Coupons for a Fixed Amount

Where a registrant accepts a coupon which:

- entitles the bearer to a reduction of a fixed dollar amount;
- the coupon is accepted in payment (or part payment) for a supply which is taxable at a positive rate, and
- the registrant can reasonably expect to be paid an amount on redemption (i.e., this is a "redeemable coupon"), then,
 - i. **Supply by registrant (i.e., the retailer)**
The GST or HST will be calculated on the value of the supply before deducting the value
 - ii. of the coupon [181(2)];
Payment of redemption amount to the retailer
The payment on redemption is not subject to GST or HST [181(5)];
 - iii. **Recovery of ITC by manufacturer**
The manufacturer making the redemption payment is entitled to claim an input tax credit equal to the "tax fraction" (i.e., 7/10 or 15/115) of the reimbursement.

Before introduction of the HST, a fixed value coupon presentation in Canada was worth the same to a consumer anywhere. The design of these rules, however, now creates a different value to the consumer, in that the coupon's value is redeemable against the tax paid value, and so a consumer in a participating province enjoys less of a benefit than one in a non-participating province.

There is also a distinction in the result for the manufacturer (or its agent) which administers the payments on redemption, as, in common with rebates, the location of the supply against which the coupon is redeemed determines the amount of the ITC (i.e., 7/107 or 15/115). Life for the retailer is less complicated than for the manufacturer making the redemption payments, therefore.

Coupons for other than a fixed amount

Where a coupon is redeemable for other than a fixed amount, (e.g., a percentage discount) then the retailer computes the amount of GST or HST on its supply after deducting the amount of the reduction resulting from the presentation of the coupon. When the retailer receives the payment on redemption of the coupon from the manufacturer, neither party needs to recognize GST/HST, i.e., there is no ITC for the manufacturer, and the retailer is not required to account for GST/HST. This arrangement does provide a uniform benefit to consumers in participating or non-participating provinces.

e) Gift Certificates

Where a gift certificate is issued, section 181.2 deems there to be no supply. When the certificate is given for a supply of property or a service, the certificate is deemed to be money and so for the retailer accepting the certificate (e.g., a book or record token for a fixed dollar value), the amount of GST/HST payable on the supply is unaffected.

IV PROMOTIONAL ALLOWANCES

As a result of the introduction of the HST, new rules for promotional allowances had to be introduced. The new rules (S232.1) provide that where:

- a registrant supplies tangible personal property by way of sale,
- that registrant pays or credits (or allows a discount on supplies made) to another registrant in return for the promotion of the tangible personal property by the other registrant, and
- all or substantially all of the tangible personal property acquired by the other registrant is for supply by way of sale for a price in money in the course of commercial activities of the other registrant,
then
- the amount paid, credited is not consideration for any supply
- where the amount is allowed as a discount then the value of the "discounted supply" is determined net of the discount, and
- the payment or credit of the allowance is deemed to be a rebate for the purposes of S181.1.

The effect of the final deeming provision is simply that if the supplier of the TPP indicates in writing that the rebate or allowance include tax, then both parties would have to account for GST/HST by applying the relevant tax fraction. Given that these new rules were introduced purposely to overcome the need to distinguish whether supplies were made within or without a participating province, such an election by the supplier/manufacturer seems unlikely.

Absent that complication, therefore, what we have is a very simple system which no longer recognizes the service of promoting products as a barter transaction. Where a magazine distributor, for example, allows a retailer a 2% discount in return for the retailer's guarantee that magazines will be displayed in a certain way or in a given proximity to the cash register then, whether the allowance is in the form of a separate payment or a discount, neither party is obliged to recognize any GST/HST adjustments – most pertinently, they do not have to go through a "place of supply" analysis to determine the GST/HST split of that adjustment, hence the desired result of the new system.

When applying the new rules, however, it should be noted that the wording of section 232.1 does not appear to admit all arrangements for payment of promotional allowances which may exist. For example, the rules only apply to a payment or credit by the "particular registrant", i.e., the registrant which made the original supply of TPP in respect of which the promotional service is rendered. What happens if one company in a corporate group (perhaps a captive advertising company) makes all payments of promotional allowances for products supplied by group members? What happens if a U.S. parent makes all North American payments of promotional allowances, including those for promotion of goods supplied by a Canadian subsidiary? It would seem there is still a service being supplied with all the ugly GST/HST analyses the rules were supposed to remove. Some form of relaxation, perhaps admitting payments by related companies would resolve this.