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CHARTERED ACCOUNTANTS

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HST CHANGES ARE HERE — EVEN IF YOU’RE NOT IN ONTARIO OR B.C.

Most Canadians know by now that Ontario and British Columbia are both replacing their provincial retail sales tax with the Harmonized Sales Tax (HST) on July 1, 2010. And some may have heard that Nova Scotia is increasing its HST rate from 13% to 15%, also on July 1. But did you know that even if you don't live in Ontario or B.C., these changes may affect you?

Here's a basic introduction to the HST and some of the new rules you may need to know.

A. What is the HST?

The HST is essentially just the Goods and Services Tax (GST) at a higher rate. It is administered by the Canada Revenue Agency as part of the GST. In fact, CRA documents and forms refer to it as the “GST/HST”, as one integrated tax.

The HST has been in place since April 1997, when it was introduced in Nova Scotia, New Brunswick and Newfoundland (the province has since changed its name to “Newfoundland and Labrador”).

When the HST applies, instead of the GST applying at 5%, the HST applies at a higher

rate, that includes a 5% federal component and a 7-10% provincial component.

Beginning July 2010, here are the HST rates:

Ontario, New Brunswick, and Newfoundland & Labrador:	13%
British Columbia:	12%
Nova Scotia:	15%

(Saskatchewan, Manitoba and Prince Edward Island still have the old retail sales tax system. Alberta and the territories have no provincial sales tax. Quebec has the Quebec Sales Tax, which is very similar to the GST but not harmonized with it, as we explain in E below.)

B. HST is integrated with the GST

A key feature of the HST is that it is **integrated with the GST** at all levels: payment, collection, remittance and administration. Thus, for example:

- Both the GST and the HST are enacted by the same legislation, in the *Excise Tax Act*. (The HST rules for Ontario and B.C. were added to the *Act* last December, although detailed regulations have not yet been released.)
- HST applies only if GST applies (and if the supply is “made in” an HST province as discussed in C below). If services are exempt from GST, they are automatically exempt from HST.
- GST and the provincial portion of the HST are normally not shown separately on invoices. If HST applies, it is a single 13%, 12% or 15% tax.



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- A business that collects GST or HST need not track or separate how much GST vs. HST it has collected. It simply totals up both together and remits the total (net of input tax credits for GST/HST it has paid) to the CRA.
- Similarly, a business that pays GST or HST on purchases need not track how much it pays of each. Both amounts go into the same pot of “**input tax credits**”, to be claimed back by the business on its GST/HST return (subject to a special rule for large businesses described in D below). **This is true whether or not the business is located in an HST province.**

Thus, for example, suppose you live in Alberta and your business is GST-registered. You travel to Toronto on business in July 2010 and pay HST at a hotel and for a car rental. You can recover the 13% HST charged to you by the hotel and by the car rental agency, simply by including them in your input tax credits, the same way you already include amounts of 5% GST charged to you in Alberta.

- When the CRA audits or issues assessments for GST, it will audit and assess for HST as well, as part of the same process and the same assessment.

C. New “place of supply” rules effective May 1

In conjunction with the expansion of the HST to Ontario and B.C., the government has revised the “**place of supply**” rules, which determine what province a “supply” of property or services is “made in”. If the supply is “made in” an HST province, then

(provided GST applies in the first place) the HST rate applies.

In many cases the “place of supply” is obvious. If you walk into a store in Vancouver and buy a computer, the “place of supply” is B.C. and you will be charged 12% HST beginning July 1.

In other cases the “place of supply” is not so obvious, which is why there are detailed rules.

Here are some of the key rules in the revised “place of supply” regulations, effective May 1, 2010. Some of these rules are new, while others are the same as applied before May 2010:

- A sale of **real property** (e.g. land and buildings) is taxable based on the province in which the real property is located.
- A sale of **goods** is taxable based on the province in which the goods are **delivered** or made available.

Example: You operate a business in Winnipeg. A customer in Toronto orders goods from you. Since you are shipping the goods to Toronto, you must charge 13% HST beginning July 1.

- For **services**, the general rule is that tax is based on the customer’s **address** that the business has. (More complex rules apply when the business has more than one address for the customer.)

Example: You are in Ontario and you provide consulting services to a client in Edmonton. Even though you perform all your services in Ontario, you charge only 5% GST on these services.



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- There are many other special rules for services. For example:
 - **Personal services** (e.g. haircuts) are taxed based on where they are performed.
 - **Location-specific services tied to an event** (e.g. a conference or performance) are taxed based on the location of the event.
 - Lawyers' services for **litigation** are taxed based on the province under which the court or tribunal is established (e.g. litigation in the Nova Scotia Supreme Court is subject to 15% HST). For tax litigation in the Tax Court of Canada or Federal Court of Appeal, since these are federal courts, the general rule applies, normally based on the customer's address.
 - **Freight transportation** services are taxed based on the **destination**. *Example:* a charge for shipping goods from Calgary to Toronto will be subject to 13% HST.
 - **Passenger transportation** services are taxed based on the **origin** of the trip. *Example:* a return air ticket from Calgary to Toronto is subject to only 5% GST. However, if the passenger buys two separate tickets, Calgary-Toronto and Toronto-Calgary, the first bears 5% GST and the second bears 13% HST.

The above descriptions are highly simplified. There are all kinds of additional special rules and exceptions, including rules to cover situations where only part of a service falls under one of the rules described.

D. Complexity upon complexity for businesses in Ontario and B.C.

Ontario and B.C. implementation is subject to numerous special rules:

- Special **new housing rebates** apply for Ontario and B.C., different from the GST new housing rebate. As well, there is a transitional tax and a transitional rebate, and special transitional rules for determining whether HST applies to a new home. These rules are designed to avoid having either an incentive or a disincentive to completing construction before or after July 1, or to closing the deal before or after July 1.
- **Large businesses** (over \$10 million in group annual sales) and certain financial institutions must “recapture” (pay back) the **provincial portion of input tax credits** on purchases of most vehicles, vehicle fuel, energy, telecommunications and meals and entertainment. This rule will be in place for five years and then is supposed to be phased out from 2015 to 2018.
- There are extensive new **transitional rules** for determining how the HST applies to transactions that cross the July 1 threshold in some way (e.g. payments before July 1 for services to be rendered later).
- Under the HST since 1997, **printed books** were not subject to the provincial portion of the tax. Technically this is done by a “point of sale rebate”, where the vendor theoretically charges the full HST and then refunds the provincial portion to the customer. In practice the vendor charges just the 5% GST. As of July 1, this applies to the following (there



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are detailed descriptions for what qualifies in each category):

Product	N.S.	N.B.	Nf&L	Ont.	B.C.
Printed books	x	x	x	x	x
Children's clothing/ footwear	x			x	x
Diapers, feminine products	x			x	x
Car seats / booster seats				x	x
Gasoline and diesel motor fuel					x
Printed newspapers				x	
Prepared food up to \$4 per purchase				x	

- Public service bodies such as **charities, schools, municipalities, universities, hospitals and public colleges** are eligible for rebates of a portion of the HST they pay. The rates for the provincial portion of the HST are different from the rates for the GST, and differ from province to province:

Type of public service body	N.S.	N.B.	Nf&L	Ont.	B.C.
Charity, qualifying NPO*	50%	50%	50%	82%	57%
Hospital authority	83%	0	0	87%	58%
School authority	68%	0	0	93%	87%
University, public college	67%	0	0	78%	75%
Municipality	57%	0	0	78%	75%

*Non-profit organization that is at least 40% government-funded.

- Large businesses, as well as new home builders, will now be required to **file GST/HST returns electronically** — no more paper GST returns. This will allow the CRA to collect certain information it needs for the administration of the HST.

**E. Quebec the “distinct society”:
harmonization without harmonization**

Quebec has had a form of GST, the Quebec Sales Tax (QST), since 1992. In many respects it operates the same as the GST and applies to the same goods and services. It is administered by Revenu Québec together with the GST in Quebec. The QST rate is 7.5%, but calculated on GST-included prices, so it is really 7.875% (7.5 x 1.05). It is scheduled to increase to 8.5% in January 2011 and 9.5% in January 2012.

However, **the QST is not part of the HST** and is not directly harmonized with it.

Most notably, a business that pays QST *cannot* recover it on its GST/HST return by way of input tax credit. However, if the business is doing business in Quebec and is QST-registered, it can claim QST it pays as an “input tax refund” on its QST return.

Example: you operate a business in Ontario and you are GST-registered. You travel to Montreal for a business meeting or conference. You pay both GST and QST on your hotel bill and to a car rental agency. You can claim the 5% GST back as an input tax credit on your GST/HST return, but you cannot claim the 7.875% QST because you are not QST-registered and do not file a QST return.



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**PERSONAL SERVICES BUSINESSES
MAY BE USEFUL AGAIN**

If you set up a corporation to provide your employment services, the *Income Tax Act* imposes severe restrictions on the corporation.

These rules, called the **personal services business** (PSB) rules, apply only where your corporation provides your services to a third party, and, but for the corporation, you would reasonably be regarded as an *employee* of the third party. (The rules do not apply if you are an independent contractor — i.e., already carrying on business, not working as an employee — and you incorporate that business.)

For this purpose, “your corporation” would be any corporation in which you, or a family member, own 10% or more of the shares of any class.

Where a corporation carries on a PSB, the following restrictions apply:

- The corporation **cannot claim the small business deduction**. All of the corporation’s business income will be taxed at the top corporate rate rather than the “small business” rate that normally applies to the first \$500,000 of active business income.
- The corporation **cannot deduct any expenses other than salary** and benefits actually paid to you as the “incorporated employee”, and certain other expenses that you would be allowed anyway as an employee. No deductions for amounts paid to other employees of the corporation. No deductions for business expenses (after

all, as an employee you would not be able to claim such deductions). And no deductions for bonuses accrued but not paid out to you.

For the past 30 years, conventional tax planning wisdom has been that one should avoid setting up a PSB, because of the above restrictions.

However, with recent changes in tax rates, **PSBs may now be useful**. The “high” corporate tax rate, when the small business deduction does not apply, is going down to about 25% over the next few years (depending on the province), which is much lower than the top tax rate on employment income (about 45% depending on the province). As well, dividends paid out from such income (so-called “eligible dividends”) receive an enhanced dividend tax credit, so that they are taxed at a significantly lower rate than regular income. Indeed, for a person with no other income, up to about \$60,000 of dividends can be received before any tax has to be paid.

If you have a spouse and/or adult children with little or no income, it may now be worthwhile to incorporate your employment relationship, by creating a corporation of which they are shareholders. Despite the relatively “high” corporate tax rate on the income ineligible for the small business deduction, you may be able to pay out dividends on that income to your spouse and children at low tax cost, with a net savings over you earning the income directly. Note that this strategy is not generally advisable in respect of minor children, because they would be subject to the «kiddie tax» on the dividends at the highest marginal rate of tax.



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CAN YOU SUE THE CRA?

Taxpayers who have been treated badly by the Canada Revenue Agency often wonder whether they can sue the Agency. The answer is yes. However, it is important to realize two things:

First, suing the CRA has **nothing to do with contesting a tax assessment**, and the Agency's actions are generally irrelevant when you are appealing your assessment. The fact that the auditor did things he should not have, or that Collections officials overstepped their authority, or that a supervisor did not return your calls before the assessment was issued, has *no bearing* on your appeal, and the judge will ignore these issues. The only thing that matters on an appeal to the Tax Court of Canada is whether the assessment is correct. (There are some situations where, if the CRA obtained information illegally, they cannot use that information in Court, but this is mostly limited to criminal prosecutions where you are protected by the *Charter of Rights*.)

Second, if Agency officials were acting within the bounds of their authority and were not acting maliciously, you will not succeed in a lawsuit simply because they did something wrong. You will normally have to show negligence or malice.

A lawsuit against the CRA for negligent or malicious acts can be brought in either Federal Court or the province's superior court. Note that there may be short time limits within which you must start your lawsuit, and that these can vary by province (based on the *Crown Liability and Proceedings Act*).

Examples of lawsuits that have succeeded include the following:

- *Chhabra* (1989 — Federal Court of Appeal). The Court awarded damages (including exemplary damages, which are similar to punitive damages) for **malicious action** on the part of Revenue Canada Collections officials in trying to collect taxes owing.
- *Luo* (1997 — Ontario Superior Court). An employee of the Unemployment Insurance Commission negligently provided an individual with **wrong information** about entitlement to benefits, and the individual relied on that information to his detriment. The government was found liable.
- *Hamel* (1999 — Federal Court of Appeal). Hamel carried on a business of buying and selling horses. He frequently bought horses in the U.S. and brought them back to Canada. Customs officials, acting on a tip from the RCMP who suspected that the horses were being used for drug smuggling, seized the horses. The tip proved wrong. Canada Customs and the RCMP were found liable to pay \$75,000 in damages for the **wrongful detention and examination** of the horses, as well as for loss of business and defamation of reputation.
- *James Thomson* (2003 — Federal Court, Trial Division). Thomson owed money to Revenue Canada personally, and his company was owed a refund which was in dispute. He claimed that he had been **promised that the eventual refund would be used to offset his debt**, but that, in breach of that promise, Revenue Canada officials enforced collection of his debt. He sued



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for **breach of contract**. His **claim was allowed in part**; one of several agreements under which he claimed relief was found to have been validly made.

- *Neumann* (2009 — British Columbia Supreme Court, currently under appeal to the B.C. Court of Appeal). Neumann operated a company, which was audited. As part of the investigation, the CRA **obtained a search warrant to seize documents** relating to payments. One of the locations was Neumann's company, whose address was Neumann's home. He argued that the **invasion of his home was a breach of his Charter right to be free of unreasonable search**. The jury (in a 6-2 verdict) awarded Neumann \$150,000 for pain, injury, suffering and loss of enjoyment of life, \$50,000 for loss of income, \$100,000 for aggravated damages, and \$1 million for breach of Neumann's *Charter* rights — a total of **\$1.3 million**.

AROUND THE COURTS

GST self-supply rule bites new home builder

In the recent case of *Construction MDGG inc.*, a company **built several new homes and rented them out**. It did not report and remit the GST and QST on the **self-supply** (deemed sale to himself at market value). It later sold the homes as new homes, and **collected and remitted the taxes** from the purchasers. Years later, Revenu Québec (which as noted above administers both the GST and QST in Quebec) assessed MDGG for the taxes not remitted on the self-supply. MDGG appealed, arguing that Revenu Québec had received the taxes when the

homes were sold. The Court dismissed the appeal, as the self-supply rule clearly applied. The homes were exempt when sold, but since MDGG had collected the taxes from the purchasers, it had to remit these taxes, and was still liable for the earlier self-supply! The fact the **government ended up collecting the tax twice** did not matter.

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Should you have any questions regarding the foregoing or other tax matters, please contact our tax group at (403) 262-2116.

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This letter summarizes recent tax developments and tax planning opportunities. We recommend that you consult with an expert before embarking on any of the opportunities in this letter, which may not be appropriate to your own specific circumstances.