HST: Pitfalls and Recovery Opportunities for Municipalities

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AGENDA

1.) HST Recovery/Planning Opportunities

   i. Taxable vs. Exempt Supplies – regular reviews

   ii. ITC Allocation Methods – what's fair & reasonable

   iii. Section 211 Election – demystified

   iv. Intra Municipal Supplies & Other Opportunities

2.) HST Pitfalls

   i. Agency *vs*. Supply/Re-supply

   ii. Self-assessment on Imports

   iii. CRA Audits – Areas of Concern

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Municipalities face a changing landscape but the legislation just isn't keeping up!!

Taxable *vs.* Exempt Supplies

- Many exemptions for PSBs (including municipalities) were written decades ago
- Role of municipalities and the types of services they provide have evolved and continue to do so…
- If exemptions were updated to better reflect the current role of municipalities, its hard to say where the taxable-exempt lines would be drawn

Taxable *vs.* Exempt Supplies

- Supplies by municipalities today may no longer fit well into the pre-existing exemptions

- For instance, in many cases supplies have been “de-bundled” into separate supplies which may put them outside the exemptions – e.g. admin fees for cost recovery

Taxable *vs.* Exempt Supplies

- Recommendation:

- Undertake regular reviews of supplies for which fees are charged

ITC Allocation Methods

- **<u>ITC rules</u>**
- Operating expenses – ITC’s based on actual percentage of commercial activity
- Capital expenditures – all or nothing rule applies – i.e., full ITCs if commercial activity is greater than 50% and no ITCs if commercial use is 50% or less.

ITC Allocation Methods

- Methods for determining use of capital property in commercial activities (typically called ITC allocation methods) must be “fair and reasonable and used consistently throughout the fiscal year.

- Since municipalities are typically involved in mixed activities (commercial and exempt) they can employ various ITC allocation methodologies to claim ITC’s for indirect costs (e.g., overhead, common area expenses) based on the extent to which their capital property is used in commercial activities.

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ITC Allocation Methods

- **Allocation methods**
- Direct allocation – generally preferred for direct inputs (e.g., square footage of dedicated floor space)
- Input & Output based methods – where direct allocation not viable
  - Input based – number of employees, time spent, number of transactions, etc.
  - Output based – revenue, etc.

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Section 211 Election

- **Election can be made on a property-by-property basis, provided:**
- The real property is capital property of the PSB,
- The real property of the PSB is held by the PSB in inventory for the purpose of supply, or
- The real property acquired by the PSB by way of lease, license or similar arrangement for the purpose of making a supply of the property by way of lease, license or similar arrangement or making a supply of the arrangement by way of assignment.

Section 211 Election

- **Benefits of filing a section 211 election for capital real property**

- Allows municipality to opt out of "all or nothing rule" and into the "extent of use rule" that applies to for-profit corporations
- Only be beneficial if use in commercial activities is between 10% and 50% prior to filing the election – if over 50% full ITCs are available so there's no need to file a section 211 election
- Can claim an ITC on all past and present leasehold improvements as well as the cost of acquiring the real property

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Section 211 Election

- For example use of land and building in commercial activities is 30%
- Without election: no ITCs can be claimed on acquisition of property, construction of building and capital improvements made subsequent to building construction
- With election: 30% ITCs can be claimed on this inputs

Intra-municipal supplies

- Regional municipalities typically make supplies to municipalities within their region or county. In addition, municipalities also make supplies to para-municipal entities.
- In some situations these supplies can be taxable and in others exempt for GST/HST purposes.

- <u>Exempt intra-municipal supplies — A supply between</u>

- a municipal body and any of its para-municipal organizations,
- a para-municipal organization of a municipal body and any other para-municipal organization of the same municipal body,

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Intra-municipal supplies

- a regional municipality and any of its local municipalities or any para-municipal organization of any of those local municipalities,
- a para-municipal organization of a regional municipality and any local municipality of the regional municipality or any para-municipal organization of the local municipality, or
- a regional municipality or any of its para-municipal organizations and any other organization (other than a government) the designated activities of which include the provision of water or municipal services within an area over which the regional municipality has jurisdiction (paragraph e),

Intra-municipal supplies

- but not including
- a supply of electricity, gas, steam or telecommunication services made by a municipal body or a para-municipal organization, or a branch or division thereof, that acts as a public utility, or
- any supply made or received by

  (i) a provincially established designated body,

  (ii) a para-municipal organization designated under section 259 of the ETA or section 22 or 23, or

  (iii) another organization referred to in paragraph (e),

  otherwise than in the course of the designated activities of the body or organization, as the case may be.

Agency vs. Supply/re-supply

- **<u>Scenario 1</u>**
  - ❖ Municipality acting as an agent on behalf of recipient.

  - Invoice from third party vendor should be addressed to recipient;
  - It can state c/o “municipality”;
  - Not included in the municipalities books and records; and
  - The recipient can claim the appropriate ITC, if entitled.

Agency vs. Supply/re-supply

- **<u>Scenario 2</u>**

❖ Business or resident of municipality that uses the municipality to engage a third party vendor to complete a construction project. Typically done to ensure that construction is to code and meets engineering standards.

- Third party contractor is engaged by municipality;
- The actual recipient (of work done) is the business or resident;
- Upon completion of work the third party vendor issues an invoice to the municipality – making municipality recipient for GST/HST purposes;
- Municipality would claim an **ITC** for this expense; and
- Re-issue an invoice to the recipient for the net amount plus HST.

Agency vs. Supply/re-supply

- **Scenario 3**

❖ Two adjacent municipalities (muni A and muni B) agree that muni A will engage a third party contractor to complete work on a shared road. Upon completion of the work muni B will reimburse muni A under a cost sharing agreement for its share of the cost.

- muni A receives all invoices in relation to the work being completed;
- muni A pays all invoices to the third party;
- muni A claims its appropriate federal and provincial rebate;

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Agency vs. Supply/re-supply

- **Scenario 3 - continued**

- **If, muni A is acting as an agent**, then the reimbursement of cost by muni B will not be considered payment for a supply;

- **If, muni A is not acting as an agent**, then the reimbursement can be considered payment for a supply;
- Determination of the applicability of HST is dependent on the nature of the property or service being supplied; and
- If the supply is not exempt, then the supply is taxable

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Self-assessment on Imports

- Section 218 and sub-section 218.1(1) requires registrants to self-assess the 5% GST and 8%/10% HST portion for "imported taxable supplies“;
- These rules apply to purchases of most goods, services and intangibles.
- Typically for goods the 5% GST is collected upon importation
- However for services and intangibles, failure to self-assess can result in substantial penalties and interest.

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Self-assessment on Imports

- **Example:**
- A municipality purchases custom designed software from a US-based company that is not resident in Canada and is not registered for GST/HST. The software is downloaded through a website hosted on a server in the US. The municipality is required to self-assess the 13% HST (i.e., the 5% federal portion as well as the 8% provincial portion).
- The municipality will be entitled to claim an ITC on the amount self assessed to the extent that software is used in its commercial activities. To the extent that the software is used to make exempt supplies, the municipality can claim a 100% federal municipal rebate and 78% provincial rebate.

CRA Audits – Areas of Concern

- Correctly charging and collecting HST on taxable supplies
- Over claiming of ITC’s
- Mixed use facilities
- Self-assessment requirement for purchases outside of Ontario in lower GST jurisdictions as well as purchases made from vendors outside of Canada
- PST on insurance premiums – not entitled to an ITC

CBT Sales Tax Review

- Comprehensive review of entire A/P process on a transaction by transaction basis
- Acquire data remotely and perform analysis prior to commencing onsite portion of review
- Proprietary algorithms used to prepare various exceptions
- Comprehensive review of revenue side to ensure compliance
- Large emphasis placed on specific issued based reviews
- Previously 20% of recoveries from errors and 80% from issues
- Contemporary observations indicate recoveries come from 5% error rate and 95% issue based

Key Takeaways

- 1. Municipalities should be aware of their taxable and exempt activity to ensure that GST/HST is collected correctly on taxable supplies and not collected on exempt supplies. This also ensures that ITC's are calculated correctly.

- 2. Be sure to be mindful of taxable goods/services imported into Canada and from other provinces within Canada for which municipalities are required to self-assess the HST. This is a targeted area by the CRA.

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