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Ontario Harmonized Sales Tax - Restrictions on Input Tax Credits for Large Businesses

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Overview of the Ontario Harmonized Sales Tax (HST)

Starting July 1, 2010, Ontario will be a HST province and the GST rate of 5% will be replaced by the HST rate of 13%. There will no longer be any Ontario retail sales tax. The following information is based on legislation that has been passed. Generally, forms are not yet available.

This memo should be read in conjunction with our memo on the general operation of HST— "How Will the HST Affect Your Business?

On February 1, 2010, the Ontario Ministry of Revenue released Information Notice No.5 which deals in detail with the temporary recapture of Input Tax Credits (ITCs). Information Notice No.5 is available on the Ontario Ministry of Revenue Web site at www.rev.gov.on.ca/en/notices/hst/05.html. The following is a basic summary of the information provided.

Temporary Recapture of Input Tax Credits

During the initial period of the HST in Ontario, large businesses – those making taxable supplies worth more than $10 million annually and certain financial institutions – will be required to repay or recapture some of the ITCs on certain very specific costs of the provincial component of HST that becomes payable (i.e. 8%), in respect of specified property and services acquired (defined below), or brought into Ontario, by a large business for use by that business in the province. This temporary restriction on certain ITCs for large businesses is referred to as the Recapture of Input Tax Credits (RITC).

Businesses subject to the RITC requirement have to separately identify recaptured ITCs on their GST/HST returns and cannot simply forego claiming these ITCs in their calculation of net tax. Therefore, it is necessary to track them separately.

The rate of RITC would be 100% for the first five years that the HST is in effect in Ontario. The RITC requirement would then be phased-out by reducing the rate of recapture in equal increments over the following three years. Thus, the ITC recapture rates would be:

- 100% for the period from July 1, 2010 to June 30, 2015
- 75% for the period from July 1, 2015 to June 30, 2016
- 50% for the period from July 1, 2016 to June 30, 2017
- 25% for the period from July 1, 2017 to June 30, 2018
- 0% on or after July 1, 2018.

Definitions

The meanings of the terms, as defined under Excise Tax Act (ETA), are as follows:

"recapture period" means a one-year period that (a) begins immediately after June 30th of a particular calendar year and ends immediately before July 1st of the following calendar year, and (b) occurs during the period that the RITC requirement is in effect; and

"specified property or service" generally means a road vehicle, fuel used in a road vehicle, energy, a telecommunication service, or a meal or entertainment that is acquired, or brought into Ontario, by a large business for use by that business in the province.

Large Businesses

In general, only large businesses would be subject to the RITC requirement. For the purposes of the RITC requirement, a business would be considered to be a large business during a particular recapture period if the business is a GST/HST registrant **and**:

a. the business's taxable sales made through permanent establishments in Canada are greater than $10 million (the $10 million threshold is based on the taxable sales of the associated group); or
b. the business is a financial institution for the purpose of the ETA subject to few exceptions.

A business would be considered to be a large business even if it does not have a permanent establishment in Ontario. There are similar rules for partnerships and joint ventures and their members (other than an individual). ITCs on an allowance or a reimbursement to an employee or a partner are also covered by RITC rules, for large businesses.

Changes in Status During a Recapture Period

If a business that is not a large business at the beginning of a recapture period has a fiscal year end during that recapture period and its RITC threshold amount exceeds $10 million at that point, the business would generally not become a large business until the beginning of the next recapture period. Conversely, if a business that is a large business at the beginning of a recapture period has a fiscal year end during that recapture period and its RITC threshold amount is below $10 million at that point, the business would generally continue to be a large business until the end of that recapture period.

There are some special rules in regards to the timing of the requirement to begin RITC for mergers and amalgamations during the year.

Specified Property and Services

The RITC requirement would generally apply to specified property and services that are acquired, or brought into Ontario, by a large business for use by that business in the province. Property and services that are acquired in Ontario for use outside Ontario would generally not be subject to the RITC requirement.

In general, specified property and services would include:

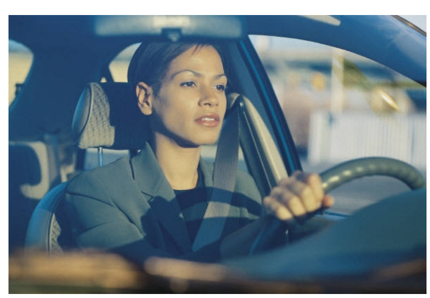
A) specified road vehicles, including certain vehicle parts and services, and motive fuel (other than diesel fuel) for use in specified road vehicles;
B) specified energy;
C) specified telecommunication services; and
D) specified meals and entertainment that are currently subject to an ITC repayment requirement under the ETA (generally at a 50% repayment rate).

However, the RITC requirement would generally not apply to:

- specified property acquired by a large business for the sole purpose of being re-supplied by that business (i.e., by way of sale, or by way of lease, license or similar arrangement);
- specified property that is acquired by a large business for the sole purpose of it becoming a component part of tangible personal property that is to be supplied by that business; or
- a specified service acquired by a large business for the sole purpose of being resupplied by that business.

A) Specified Road Vehicles

A specified road vehicle would generally mean a vehicle that is a motor vehicle, licensed under applicable provincial laws for use on public highway and weighs less than 3,000 kg. A trailer, semi-trailer or detachable axle would not be considered a specified road vehicle. Specified road vehicles would include vehicles that are acquired by way of sale, or by way of lease, license or similar arrangement.



Capital Purchase or Periodic Lease Payments

There are RITC requirements applicable to the capital purchase or lease payments for the vehicle.

Parts and Services

There are RITC requirements for vehicle parts and services provided within 12 months of the acquisition or bringing into Ontario of the vehicle itself e.g. the acquisition and installation of a vehicle anti-theft system. The 12-month condition is even for vehicles that are acquired, or brought into Ontario, prior to July 1, 2010**.** The good news is that routine repairs and maintenance of a specified road vehicle are not subject to RITC requirements.

Use Before Resupply (Demo Cars)

If a large business acquires, or brings into Ontario, a specified road vehicle for the purpose of resupplying it, but uses that vehicle before resupplying it, the business would be required to recapture a portion of the ITCs that it claimed in respect of the acquisition or bringing in. For each month, or part thereof, that the business uses the vehicle, it must recapture the portion of the provincial component of the ITCs claimed that is attributable to 2 percent of the cost of the vehicle.

Example: In April 2011, a car dealership that is a large business acquires, for the purpose of resale, a vehicle that costs $20,000 and claims ITCs in respect of that acquisition (i.e., with no recapture), then subsequently uses the car as a demo vehicle for two months before selling it. The dealership would recapture $64 of the ITCs claimed in respect of the acquisition of that vehicle: $20,000 (cost) × 2% × 8% (provincial component of HST) × 2 months = $64.

Fuel

There is an RITC requirement for fuel (other than diesel fuel) that is acquired, or brought into Ontario, to the extent that the fuel is for use by that business in the engine of a specified road vehicle (even if that vehicle was acquired, or brought into Ontario, prior to July 1, 2010).

B) Specified Energy

Specified energy would generally include electricity, gas, fuel and steam that are acquired for use in the province by a large business. Delivery charges or regulatory fees are also part of Specified energy.

With an all inclusive lease payment on a rental real property, the lessee is not subject to the RITC requirement, but the lessor would be subject to the RITC requirement on the energy.

Generally, the RITC requirement would not apply to specified energy used by a large business directly in manufacturing goods for sale. There is an election available for some specified business activities to determine the exempt portion of specified energy for RITC purposes.

The RITC requirement generally would not apply to specified energy used by a large business directly in activities that are eligible scientific research and experimental development (SR&ED) activities in Ontario.

C) Specified Telecommunication Services

The RITC requirement generally applies to services such as local and long-distance telephone, cable and pay television, satellite television, facsimile, video, audio and computer link-ups and data transmission acquired by a large business for use in Ontario by the business.

However, the RITC requirement generally would not apply to:

- internet access services;
- web-hosting services;
- toll-free telephone services (e.g., 1-800, 1-888 or 1-877 telephone services); and
- telecommunication services acquired by a sponsor or organizer of a convention for use exclusively at that convention.

Supplies that are provided by means of telecommunication, but are not themselves telecommunication services, generally would not be subject to the RITC requirements, such as a right to access a data bank, building surveillance services and services provided by means of a 1-900 telephone service.

If a large business receives an invoice for a single supply that includes both specified telecommunication services and other services and/or goods (i.e., that are not subject to the RITC requirement), and the large business cannot readily ascertain which portion of the provincial component of the HST applicable to the supply is attributable to these other services and/or goods, the large business would be allowed to use the following proxies to make that determination:

1. If the supply covered by the invoice includes specified telecommunication services, other services, and goods (e.g., telecom equipment rental), then 14% of the invoice amount would be deemed to be attributable to the other services and goods.
2. If the supply covered by the invoice includes specified telecommunication services and other services (but no goods), then 4% of the invoice amount would be deemed to be attributable to the other services.
3. If the supply covered by the invoice includes specified telecommunication services and goods (but no other services), then 11% of invoice amount would be deemed to be attributable to the goods.

D) Specified Meals and Entertainment

Meals and entertainment that are purchased by a large business in Ontario, to the extent that they are subject to the existing (50%) ITC repayment requirement in the ETA, are also subject to the RITC requirement.

Thus, meals and entertainment subject to the RITC requirement would include:

- business dinners;
- tickets for a theatre, concert, athletic event or other performance;
- private boxes at sports facilities; and
- admissions to nightclubs, athletic, social and sporting clubs.

Conversely, meals and entertainment that would not be subject to the RITC requirement would generally include:

- meals or entertainment acquired solely for the purpose of resupply (e.g., by a restaurant);
- meals or entertainment acquired for certain events where all employees from a particular location are invited (e.g., an office Christmas party); and
- meals or entertainment for an employee in situations where the expenses are required to be included in the employee's income as a taxable benefit under the ITA.

Accounting for Recaptured ITCs

When to Account for Recaptured ITCs

A large business would be required to account for RITCs in its GST/HST return for the reporting period in which the provincial component of the HST to which the ITCs relate first becomes payable.

Transitional Measure

If a large business is the recipient of a supply of a specified property or service, and the consideration for the supply first becomes due, or is paid, after October 14, 2009 and before May 2010, then to the extent that:

- the specified property is delivered, and ownership of the property is transferred, to the large business on or after July 1, 2010, or
- part of the specified service (at least 10%) is performed on or after July 1, 2010,

the large business would generally be required to self-assess the restricted provincial component of the HST in respect of that property or part of the service either: (i) in the GST/HST return for the reporting period of the large business 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.

How to Account for Recaptured ITCs

Large businesses would be required to calculate and report their ITCs on the GST/HST return. A large business would complete the GST/HST return in the following manner:

- The amount of the "gross" ITCs would be reported in a separate information field on a schedule to the GST/HST return. "Gross" ITCs are the ITCs and adjustments that a GST/HST registrant is entitled to claim before taking into account any RITC adjustments.
- The amount of RITCs would be reported in separate information fields on the schedule: one field for RITCs in respect of the provincial portion of the HST in Ontario and another field for British Columbia.
- The net amount of ITCs, which is the gross ITCs less the RITCs, would then be calculated and reported in an information field on the schedule. This net amount would be eligible to be claimed as an ITC in the GST/HST return in the "Total ITCs and Adjustments" field.

Generally, if a registrant fails to report recaptured ITCs in the appropriate reporting period, any subsequent reporting of the recaptured ITCs would be done through an amended return for that period.

It is important to note that large businesses would not be allowed to simply forego claiming ITCs in order to fulfill the RITC requirement (even if the effect on net tax would be the same). Failing to recapture ITCs could result in penalties.

Filing of the GST/HST Returns

If the annual taxable revenue is greater than $1.5M, a GST/HST return must be electronically filed (Netfile) for all reporting periods ending on or after July 1, 2010.

Option to Use an Estimation/ Installation Approach

In order to help simplify compliance with the RITC requirement, a large business would generally be allowed to make an election to use an estimation, installment and reconciliation approach to accounting for recaptured ITCs (Estimation/Installment Approach). The election would be filed with CRA within three months after the end of a large business's fiscal year and would apply for at least one year. Large businesses would, before the introduction of the HST in Ontario on July 1, 2010, generally be able to elect to use the Estimation/Installment Approach.

Under the Estimation/Installment Approach, for each province that has an RITC requirement, a large business would:

- estimate the amount of ITCs it would be required to recapture during a fiscal year;
- based on this estimate, make equal installment payments of recaptured ITCs in each reporting period during a one-year period; and
- at the end of the fiscal year, determine the actual amount of ITCs it should have recaptured during that year and reconcile any differences between the estimated and actual amounts.

Large business would still have to identify the specified property and services that it acquires or brings into a province in such a way that it could determine the actual amount of available ITCs that are subject to the RITC requirement. However, this Approach would allow the large business to account for these recaptured ITCs on an annual basis and on the basis of aggregate financial information.

Method of Estimation/Installments

Step 1: Estimation

At the beginning of a fiscal year, a large business that has filed the election would estimate the amount of ITCs it would be required to recapture, for each province with an RITC requirement, during that fiscal year (Estimated RITCs). This estimate would be based on:

- ITCs that it would have been required to recapture during its most recently completed fiscal year, if the RITC requirement had been in place throughout that year; and
- any additional ITCs that it would be required to recapture in its current fiscal year because of anticipated changes in circumstances from its previous fiscal year.

A large business would not be allowed to use an Estimated RITCs amount that is less than the actual amount of ITCs that the large business was required to recapture in its previous fiscal year; however, it could use a greater amount.

Step 2: Installment

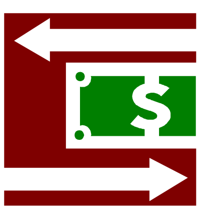
A large business using the Estimation/ Installment Approach would be required to report its Estimated RITCs, for each province with an RITC requirement, over the course of a year-long period that begins three months after the beginning of its fiscal year and ends three months after the end of that fiscal year (the Installment Period).

To determine the amount of RITCs that must be reported in each reporting period during the Installment Period, a large business would divide the relevant Estimated RITC amount by the number of GST/HST reporting periods in the Installment Period (e.g., a monthly filer would divide the amount by 12). The equal installment amounts would be reported in the GST/HST return of the large business as RITCs for each reporting period in the particular Installment Period.

Step 3: Reconciliation

After the end of its fiscal year, a large business using the Estimation/Installment Approach would review its financial records and determine the actual amount of ITCs it would have been required to recapture, for each province with an RITC requirement, during that year, if the RITC requirement had been in effect throughout that year (Actual RITCs).

The Actual RITCs amount would be compared to the Estimated RITCs amount for the same fiscal year. The large business would report any differences between these two amounts in its GST/HST return for the reporting period that includes the date that is three months after the end of its fiscal year.



Some Special Cases

Specified Members of a Qualifying Group

If a large business is a specified member of a qualifying group of closely related persons that has made an election for nil consideration under the ETA, and that large business acquires a specified property or service from another specified member of the same qualifying group, the large business would, under the RITC requirement, generally be required to account for the provincial portion of ITCs that are available (or would be available if the supply were not deemed to have been made for no consideration) in respect of that acquisition of the specified property or service.

Non-Arm's Length Transactions

If a supply of a specified property or service is made for no consideration, or for consideration that is less than fair market value, between persons who are not dealing with each other at arm's length for purposes of the ETA, the recipient of the supply (if it is a large business) would generally be required to recapture ITCs as if the supply had been made at fair market value (i.e., even if the property or service was acquired, or brought into the province, for consumption or use exclusively in commercial activities of the large business).

Anti-avoidance

Large businesses that fail to account for recaptured ITCs in the proper manner would generally be subject to penalties.

Existing anti-avoidance rules in the ETA would generally apply to transactions to which the RITC requirement applies. Additional anti-avoidance rules may be implemented.

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Restrictions on Input Tax Credits for Large Businesses

The following is a brief summary. For more information, refer to our HST memo — "Restrictions on Input Tax Credits for Large Businesses."

When is it applicable	**If Sales from locations in Canada greater than $10 million** **Based on the sales of the fiscal year ending between July 1 and June 30 of the next year (recapture period)** **If sales surpass $10 million, then considered large business in the next recapture period** **e.g. If the sales for year ended August 31, 2010 were $11 million (previous year $9 million), then for the period July 1, 2012 to June 30, 2013 then it is a large business**
What is the effect	**Specified Property and Services will have the input tax credits for the Ontario portion of the HST restricted (denied)**
What is the rate of restriction	**100% for July 1, 2010 to June 30, 2015** **75% for July 1, 2015 to June 30, 2016** **50% for July 1, 2016 to June 30, 2017** **25% for July 1, 2017 to June 30, 2018** **0% on or after July 1, 2018**
What are Specified Property and Services	**Specified Vehicles**: **weighs less than 3,000 kg** **parts and special services supplied in the first year of purchase for such vehicles** **fuel (except diesel) used in the vehicles** **Specified Energy**: **electricity** **gas** **fuel** **steam** **except if the fuel is used in manufacturing** **Specified Telecommunications**: **local and long distance telephone** **Cable, pay TV, satellite TV** **Computer link-ups and data transmission** **not included** **internet access** **web-hosting** **toll-free** **Specified Meals and Entertainment**: **same items that are only 50% deductible for income tax**
How is this accounted for	**Transitional**: **required to self assess for specified property and services delivered after July 1, 2010 which were billed prior** **Estimate/Instalment Approach**: **file election within 3 months after year end, or before July 1, 2010** **estimate amount of RITC, send in instalment, reconcile difference by 3 months after year end** **Otherwise**: **report RITC on your HST return (separate line)**