INDIRECT TAX ALERT

Collins Barrow

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RESTRICTED INPUT TAX CREDITS

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The Harmonized Sales Tax (HST) was introduced in Ontario on July 1, 2010, bringing about changes for many businesses. Most notably, it introduced a requirement that "large businesses" be required to repay or "recapture" the portion of any available input tax credits (ITCs) attributable to the provincial portion of the HST that becomes payable, or is paid without having become payable, in respect of a specified property or service that is acquired.

At the time of introduction, many businesses were able to identify themselves as meeting the criteria of a "large business." But since that time, how many more have possibly grown their businesses, expanded their sales, made acquisitions, or changed their corporate structures such that their associated group structures now meet the definition? How many other businesses have expanded their operations into Ontario?

For purposes of the Restricted Input Tax Credits (RITC) requirement, a person is considered to be a large business during a particular recapture period if the person is a GST/HST registrant and the person's RITC threshold amount for that recapture period is greater than $10 million, or the person is a financial institution.

The definition of the threshold amount is quite long and convoluted. Simply put, it is the total of all consideration for taxable supplies made in or outside of Canada in the last recapture period, as well as the supplies of all associated corporations, including any inter-company transactions, with rules in place to account for short years.

What is restricted?

In general, specified property and services include:

- qualifying motor vehicles, including certain vehicle parts and services, and in Ontario, motive fuel (other than diesel fuel) for use in motor vehicles;
- specified energy
- specified telecommunication services; and
- specified meals and entertainment that are currently subject to an ITC repayment requirement of 50 per cent under the *Excise Tax Act*.

However, the RITC requirement generally would not apply to the following specified property and services:

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

Persons subject to the RITC requirement may not simply forgo claiming these recaptured ITCs in their calculation of net tax, but are required to separately identify any recaptured ITCs in their GST/HST NETFILE returns. Large businesses that fail to account for RITCs in the proper manner will be subject to penalties.

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"Recapture period" means a one year period that (a) begins immediately after June 30 of a particular calendar year and ends immediately before July 1 of the following calendar year, and (b) occurs during the period that the RITC requirement is in effect (i.e., during the period on or after July 1, 2010, and before July 1, 2018).

The rates of recapture will be 100 per cent for the first five years that the HST is in effect, and will be phased out by reducing the rate of recapture in equal increments over the following three years. The ITC recapture rates will be as follows:

Period	ITC Recapture Rates
July 1, 2010 to June 30, 2015	100%
July 1, 2015 to June 30, 2016	75%
July 1, 2016 to June 30, 2017	50%
July 1, 2017 to June 30, 2018	25%
On or after July 1, 2018	0%

If a person that is not a large business at the beginning of a particular recapture period has a fiscal year-end during that recapture period, and its threshold amount exceeds $10 million at that point, the person generally will not be considered a large business until the beginning of the next recapture period.

Conversely, if a person that is a large business at the beginning of a particular recapture period has a fiscal year-end during that recapture period, and its threshold amount is below $10 million at that point, the person generally will continue to be considered a large business until the end of that recapture period. It is important to revisit these criteria annually during tax filings to ensure compliance, particularly for businesses near the threshold amount.

Accounting for RITCs

Where a large business purchases specified property or services and pays HST in a province with ITC restrictions, it must ensure that it has a system in place to account for the required recapture of the provincial component of the HST paid on those purchases. The amount of the recaptured HST input tax credits must be reported separately.

As a first step, a large business should use different general ledger accounts for tracking the provincial portion of the HST paid in the province that must be recaptured. The business is required to account for RITCs in its GST/HST return for the reporting period in which the ITCs first become available – that is, in the first reporting period in which the provincial component of the HST to which the input tax credits relate becomes payable or is paid without having become payable.

Penalties

Significant penalties may apply for failing to properly account for recaptured ITCs in the proper reporting period. Under Regulation SOR /2010-150 Electronic Filing and Provisions of Information (GST/HST) Regulations – section 7, any failure to correctly report the required recapture amount in a particular reporting period may result in a base penalty equal to five per cent of the difference between the amount that was required to be reported and the misstated amount. In addition, a further one per cent penalty may be applied for every complete month that the recapture amount remains misreported, to a maximum of five months, prior to the error being brought to the attention of the Canada Revenue Agency (CRA) or the misreported amount being included in an assessment of net tax for the reporting period in question. Essentially, within six months, any failure to report a recapture amount in the proper reporting period, or an error that misstates the amount of recapture in a particular reporting period, could result in a penalty equal to ten per cent of the under-reported amount.

Further, once a particular recapture error or omission has been identified for a particular reporting period, similar errors in subsequent periods could conceivably be eligible for the gross negligence penalty.

The CRA has indicated that a large business may correct any improperly reported recaptured ITCs for a particular reporting period by sending a letter to its local tax centre requesting that its GST/HST return for the period in question be adjusted to report the correct recapture amount.

The province of Ontario has been under the HST regime for more than four years now. The intricacies of dealing with restricted supplies and understanding what is and what isn't included in the definition, including methodologies to minimize the tax impact of these restrictions, require the assistance of specialists in the area of the HST. Contact your Collins Barrow advisor for help.

GST/HST DOCUMENTARY REQUIREMENTS AND COMMON AUDIT ISSUES

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We continue to see Canada Revenue Agency (CRA) auditors aggressively challenge GST/HST registrants with the documentary requirements under subsection 169(4) of the *Excise Tax Act* (ETA). It is a fundamental principle underlying the GST/HST that no tax should be included in the cost of property and services by a registrant in the course of its commercial activities. However, registrants must satisfy the general rules for claiming input tax credits (ITCs) found in subsection 169(1) before being eligible to claim the ITCs in their GST/HST returns.

The CRA continually emphasizes ensuring that registrants obtain sufficient documentary evidence to substantiate any ITC claimed. Subsection 169(4)(a) of the ETA establishes the information required to support the ITC claim and determine the amount, including information prescribed under the Input Tax Credit Information (GST/HST) Regulations.

In a previous *Indirect Tax Alert* from October 25, 2011, entitled *Input Tax Credits and Documentation*, Chantal A. Guilmette reviewed the documentary information required for specific dollar thresholds (http://www.collinsbarrow.com/en/cbn/publications/input-tax-credits-and-documentation). Some of the documentary information requirements that seem to have become audit issues or areas that the CRA tends to challenge include:

- validity of GST/HST registration
- adequate supporting documents
- recipient name

Validity of GST/HST registration

Where the supplier charges GST/HST and the total amount paid or payable for the supply is $30 or more, the supplier must indicate its GST/HST registration number on the supporting documentation. The recipient acquiring the supply is not entitled to claim an ITC for the supply if a false or incorrect GST/HST registration number is provided. Where an auditor discovers an invoice without the required GST/HST registration number, a reasonable amount of time is normally granted to obtain this information from the supplier. If the supplier is no longer in business and the recipient is therefore unable to obtain the GST/HST registration number, the ITC will be denied.

Technically, the ETA establishes an obligation for a registrant claiming an ITC to verify the supplier's GST/HST registration number. Anyone may check a supplier's number at www.cra-arc.gc.ca/gsthstregistry or www.registreentreprises.gouv.qc.ca in Quebec. A person may also call the CRA’s business enquiries line at 1-800-959-5525 or Revenu Québec to verify another person's number. The CRA and Revenu Québec will provide verbal or written GST/HST registration confirmation where there is a valid need to know that a person is a registrant.

It is good business practice to verify the validity of GST/HST registration numbers provided by suppliers on a regular basis.

Supporting documents

For various reasons, the CRA may request documentation to support sales and GST/HST collected in addition to purchase invoices and general ledger (G/L) detail of ITCs claimed. When preparing the documents for submission, ensure that they are complete and meet all requirements to avoid a denial of the ITC. There is no requirement that the documentary information or evidence be contained in a single document. It is not uncommon, particularly where written agreements and contracts are concerned, for primary documentation to be supplemented by additional material. For example, a contract for services may specify the particulars concerning the supplier, the recipient and the terms of payment, but the consideration and the tax paid or payable may be determined only on a periodic basis and documented on separate invoices. Both the written agreement and the invoice are required to satisfy the documentary requirements to claim an ITC. The CRA does not make it a practice to ask for additional information that may support ITC claims, so ensure that submissions contain all of the documentary information required.

Recipient name

Ensuring that an invoice is issued to the correct recipient is important. Generally, the recipient of a supply is the person liable under an agreement to pay the consideration for the supply. A common audit issue arises where Company A is issued an invoice for a supply for the commercial activities of Company B, a related company. Company B pays the invoice and claims the ITC, but as the invoice is issued to Company A, which is liable to pay the consideration, the ITC may be denied to Company B upon audit. There are three ways to address this issue: 1) the supplier must correct the recipient name and reissue the invoice; 2) Company A must resupply the goods to Company B and issue an invoice; or 3) ensure that there is an agency agreement in place whereby Company A acts as an authorized agent for Company B.

Another common audit issue arises when an owner purchases goods on behalf of a corporation and the invoice is issued to the owner personally. The CRA is becoming very strict when conducting audits and is denying ITCs claimed by the corporation if the documents identify the owner as the recipient. One solution is for the owner to be reimbursed by the corporation, but this causes additional paperwork and auditors are not receptive to having these expense claims back-dated. Though ITCs may be taken in the most current reporting period if within prescribed time limits, interest may be applicable at the time ITCs are denied during the audit.

On occasion, a supplier may enter into an agreement for the making of a single taxable supply to more than one person. If there is more than one recipient for the supply, each recipient may be eligible to claim an ITC for the part of the GST/HST it is liable to pay in respect of the supply to the extent that the recipient's part of the supply is for consumption, use or supply in the course of that recipient's commercial activities, provided all the other ITC criteria are met. Generally, the allocation of the ITC between multiple recipients must be determined by reference to other documentary evidence such as letters, written agreements or other supporting documentation.

In certain circumstances, even though a person is not the recipient of a supply, this person may be eligible to claim ITCs for the tax paid by the recipient. For example, when employers, charities and public institutions pay allowances to or reimburse employees or volunteers, the employers, partners, charities or public institutions may be eligible to claim ITCs in respect of the payments.

The best way to avoid some of these common audit issues is to obtain sufficient documentary evidence to substantiate any ITC claimed. Contact your Collins Barrow advisor for help.

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Collins Barrow periodically publishes an *Indirect Tax Alert* for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While *Indirect Tax Alert* suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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