RESEARCH REPORT

Impact of HST on the PEI Agricultural Sector

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Introduction

The purpose of this report is to provide more information on the impact of harmonization of Prince Edward Island's sales tax with the federal Goods and Services Tax and more specifically, the impact it will have on the agricultural sector. The report begins by discussing the impact of harmonization in other jurisdictions, including the rest of the Atlantic Provinces and more recently, Ontario and British Columbia. Next, the report summarizes the recent announcement respecting harmonization in Prince Edward Island and identifies differences in how the current Provincial Sales Tax applies to agriculture versus the Harmonized Sales Tax. This includes some analysis of the financial impact on farmers. Finally, the report provides conclusions respecting harmonization.

HST in Nova Scotia, New Brunswick & Newfoundland & Labrador

The Harmonized Sales Tax (HST) first came into effect on April 1, 1997 and was implemented in the provinces of Nova Scotia, New Brunswick, and Newfoundland and Labrador. It replaced the provincial sales tax in each province. When first introduced, the HST was established at a rate of 8% on the same tax base as the Goods and Services Tax (GST) for a combined value added tax rate of 15% (7% GST + 8% HST). This was the first successful joint initiative between provinces and the federal government to introduce a single comprehensive value added sales tax. Previously, Quebec had adopted its own value added tax structure.

There is a strong economic rationale in favour of a value added tax. Under a provincial sales tax (PST), business inputs could be taxed multiple times, which in the case of Nova Scotia meant that roughly 30% of the PST revenue base was business inputs, estimated at $240 million. In contrast, a value added tax does not tax each stage of business activity, with the exception of exempt supplies (i.e. real property, financial services). Businesses pay the HST, but when they file their HST return they can claim input tax credits (ITCs) on the HST they paid on their business inputs. They net their ITC claim against the HST they collected on their sales and only remit the net portion to the Canada Revenue Agency (CRA). The HST thus removes any tax cascading effect and is therefore deemed to be a more efficient tax than the PST.

The economic evidence shows that the savings as a result of the switch to a value added tax are substantial, leading to increased jobs and incomes. The savings to business are passed along to customers via lower prices and businesses are also more likely to invest. In a study for the CD Howe Institute in 2007, Michael Smart concluded the HST resulted in a 12% increase in business investment in the three HST provinces in Atlantic Canada.[1] International exports also become more price-competitive under a HST because of no embedded tax.

There are also other benefits to an HST regime. Administrative costs for government and business are lower as there is only one tax administrator, the Canada Revenue Agency (CRA). It was estimated that the HST reduced tax administration costs for the Nova Scotia government by $8 million.

The HST is also considered to be a fairer tax as it is spread across a wider tax base. Prior to the HST, PST was applied on-top of the GST. In Nova Scotia's case, the effective PST rate was 11.77% (11% PST + 11% x 7% GST), while Newfoundland and Labrador had a 12% PST and New Brunswick had an 11% PST. However, the PST applied mostly to goods, with most services exempted. There were also a number of other exclusions or special provisions. In Nova Scotia, fuel was not taxable under the PST and electricity was taxed at a lower rate - 3%. As a result, the PST tax base in Nova Scotia represented about 63% of the GST tax base at the time of harmonization.

Harmonizing sales taxes to the broader base of the GST which applies to most goods and services allowed provinces to reduce their tax rates. By adopting the 8% HST rate, the HST provinces actually took a revenue hit. All three harmonized provinces received compensation from the federal government to offset their tax losses from moving to the HST. Nova Scotia received $249 million in compensation which it booked over 3 years.

Nova Scotia assumed 50% of the savings to business from reduced sales tax on business inputs would be passed onto consumers via lower prices, thereby limiting the impact of harmonization on consumers due to the broadening of the tax base to include services. When Nova Scotia implemented the HST in April 2007, the Consumer Price Index (CPI) rose by 0.2% versus March 2007. The HST provinces introduced a Low Income Tax Reduction (LITR) program to offset the increase in the sales tax burden for low income households.

Under the HST, Nova Scotia introduced a printed book rebate, a new housing rebate (used housing is not taxed under the HST), a volunteer fire department rebate, a persons with disabilities motor vehicle rebate, and a segregated fund rebate. Nova Scotia matched federal

[1] Smart, Micheal, (2007), Lessons in Harmony: What Experience in the Atlantic Provinces Shows About the Benefits of a Harmonized Sales Tax, C.D. Howe Commentary No. 253, July, p. 1.

public sector body GST rebate rates with its HST rebates for public sector bodies (municipalities, universities, schools, hospitals, charities and non-profit organizations).

The HST provinces were allowed to assume the GST tax room on private sales of used vehicles. Nova Scotia taxes these sales at 15%. Nova Scotia introduced a temporary auto surtax of 2% and 1% in years 1 and 2 of the HST to discourage people from postponing new and used car purchases from a car dealer until April 1, 1997.

On July 1, 2010, Nova Scotia increased its HST rate to 10%. At the same time, Nova Scotia introduced an Affordable Living Tax Credit for low income individuals and households, as well as point of sale rebates for diapers, children's clothing and footwear, and feminine hygiene products. Nova Scotia also provides a home energy rebate on the provincial portion of the HST rate for all energy sources used to heat a home. Nova Scotia replaced its new housing HST rebate with a First Time Home Buyers rebate in 2002, which it doubled to a maximum of $3,000 in 2012.

Ontario HST

Ontario introduced an 8% HST on July 1, 2010. Ontario's PST rate was 8%. Exclusions under the HST include:

- Qualifying prepared food and beverages sold for $4.00 or less
- Print newspapers
- Children's clothing and footwear
- Children's car seats and car booster seats
- Diapers
- Feminine hygiene products
- Books (including audio books)

Ontario also introduced a 75% HST rebate on new homes.

Ontario businesses paid $4.5 billion in embedded tax under the 8% PST. TD Bank estimated an 80% pass through of business savings to consumers via lower prices in Ontario.[2] Ontario's marginal effective tax rate on businesses was cut in half, according to tax policy expert Jack

[2]Drummond, Don and Petramala, Diana, (2009), The Impact of Sales Tax Harmonization in Ontario and B.C. on Canadian Inflation, TD Economics Special Report, September, p. 8 and Burleton, Derek and Petramala, Diana, (2010), The Economic Impact of HST Reform, TD Economics Special Report, July, p. 2.

Mintz, when it implemented the HST.[3] Ontario introduced the HST as part of a much more comprehensive tax reform package, including personal and corporate income tax reductions.

Small businesses received $1,000 in HST one time transition funds costing a total of $400 million. Middle and low income individuals and families received $300 and $1,000, respectively in one time, transitional assistance. Ontario introduced a low income sales tax credit to offset the tax burden on low income households. Every individual and child received $260 per year. Ontario also introduced partial public sector body HST rebates.

Ontario received $4.3 billion in federal compensation over 2 years, with $3 billion in year 1. Ontario estimated the move to the HST reduced compliance costs by $500 million. Moving to the HST placed Ontario on a more level playing field with Quebec.

British Columbia HST

British Columbia (BC) introduced a 7% HST on July 10, 2010. BC's PST rate was 7%. BC businesses paid $1.9 billion in embedded tax under the 7% PST. The marginal effective tax rate on business investment was reduced by 40% by moving to the HST, putting BC on a more level playing field with Alberta – who has no sales tax (on business inputs). BC businesses saved $150 million annually in compliance costs under the HST.

BC received $1.6 billion in federal compensation. A majority of BC residents voted in a referendum to return to the PST and the target date to eliminate the HST and return to the PST is March 31, 2013. BC will have to repay the $1.6 billion in transitional assistance that it received.

Prince Edward Island

The Government of Prince Edward Island (PEI) announced in its 2012 budget that it intends to harmonize its sales tax with the GST on April 1, 2013 at a rate of 9%. The combined GST/HST rate will be 14% versus the current combined GST/PST rate of 15.5%. The HST will not apply to home heating fuel, children's clothing and children's footwear. PEI intends to reduce its provincial excise tax rate on gasoline/diesel and tobacco to keep its fuel and tobacco prices competitive with nearby jurisdictions. The province will introduce a low income tax credit to offset the impact of an increased HST burden on low and modest income families. This credit will be valued at between $150 to $200 per household for households with a family income of $55,000 or less. HST legislation will be introduced in the Fall of 2012, so more details will be

[3] Mintz, Jack, (2009), Ontario's Bold Move to Create Jobs and Growth, School of Public Policy, University of Calgary, November, p. 10.

available then. PEI will receive $39 million in HST compensation from the federal government ($25 million in 2012-13 and $14 million in 2013-14).

Under the current 10% PST, PEI expects to collect $218.6 million in sales tax in 2012-2013. With tax charged on top of the GST, PEI's effective sales tax rate is 10.5%. PEI also levies a sales tax on used motor vehicles, at a rate of 12.5% on autos and light trucks and at a rate of 10% on all other vehicles.

PEI exempts the following purchases from PST under its *Revenue Tax Act* that are key business inputs for a commercial farmer: gasoline, diesel fuel, fuel oil, oil, electricity, firewood, machinery and equipment (purchased or leased, as well as repairs and parts), drugs and medicine prescribed by a veterinarian, veterinary services and medical supplies, livestock, horses, feed, bedding materials (straw), safety clothing and safety footwear, tobacco (raw leaf), admission charges to agricultural fairs, admission to harness racing, fertilizer, pesticides, seeds, and packaging material. PEI also has a general exemption for renewable energy and has a specific exemption on consulting services (including advertising) for farmers, as well as a PST rebate on building materials for farm structures with an environmental benefit, all-terrain vehicles used for commercial farming and culvert and bridge building materials used by commercial farmers. APEC estimates that theses exemptions reduced the sales tax burden to PEI farmers by $29.4 million in 2009. PEI also offers other PST exemptions that benefit the farming sector, such as basic food and fruit juice beverages (excluding candies, prepared food, prepared meals, and carbonated and alcoholic beverages), machinery and equipment used in manufacturing (i.e. food processing), and goods to be manufactured (food commodities used in food processing).

Only bonafide farmers are subject to the above PST exemptions and must earn at least $10,000 or 25% of the gross annual income from farming or be registered in the Future Farmer Program to receive a Revenue Tax Exemption Permit. Part-time farmers can apply to the Minister for a PST refund. The PST refund for part-time farmers includes blueberry, cranberry and apple farms, as well as other farm types.

Some business inputs purchased by farmers and food processors are subject to PST, such as office supplies, computers, most tools (except veterinary and blacksmith tools), telecommunication services, legal services, accounting services, and any motor vehicle required to be registered under the Highway Traffic Act, including repair, parts and labour for these motor vehicles. Pari-mutuel betting at a harness racing event is subject to a special PST rate (8.5% or 15.5%; 11% for races held outside PEI). APEC estimates that PST paid by farmers on these taxable goods and services was $3.9 million in 2009. A 2007 study for the PEI Federation of Agriculture on the impact of the PST estimated a sample of 12 farms paid $39,414 in PST in total.[4] Pro-rating an average of this small sample for the total number of farms in PEI implies a PST burden of $3.8 million, which validates APEC's estimate.

Introducing a HST will change the tax status of some goods purchased by farmers, plus make more services taxable. Goods and services are either taxable or exempt under the GST/HST. Taxable goods and services are either fully taxable or zero-rated. Goods and services that are taxable (including zero-rated) are usually eligible for full Input Tax Credits (ITCs), such that the vendor (i.e. farmer) is eligible to get back 100% of the sales tax on their business inputs. This assumes they are registered to collect the GST/HST on their sales. Farmers selling less than $30,000 a year in taxable sales are not required to register for the GST/HST, but they are unable to claim full ITCs. Some commercial farmers may not exceed this small supplier threshold. However, they can voluntarily register to collect the GST/HST even though most of their sales are zero-rated, such that they can claim ITCs on their business inputs. Exempt goods and services are not eligible for ITCs, but no GST/HST is charged on the sale of exempt supplies.

Goods and services that will be taxable under the HST include gasoline, diesel fuel, oil, electricity, firewood, leased machinery and equipment, machinery and equipment repairs and parts, new motor vehicles, drugs and medicine prescribed by a veterinarian, veterinary services and medical supplies, horses, feedlots, safety clothing and safety footwear, admission charges to agricultural fairs, admission to harness racing, legal services, accounting services, consulting services, domestic freight transportation (excluding that which is not part of a continuous international outbound journey), application services, monetary share-cropping fees (excluding the share of the crop), harness racing purses for the driver/trainer, peat, and packaging material. Food-processors will also pay tax on most of their business inputs, including machinery and equipment, but basic food commodities will be zero-rated. Farmers, food processors, and harness race operators can claim ITCs if they are registered to collect the GST/HST. Prepared food and prepared meals, as well as carbonated and alcoholic beverages, are taxable under the HST. Used motor vehicles are not subject to GST/HST, but are usually subject to a private sales tax in the harmonized provinces.

Goods and services that will be zero-rated under the HST include basic food commodities (including potatoes, milk, eggs, bread, various other fruits and vegetables), farm machinery and equipment, livestock, poultry eggs (used in a hatchery), grain, milled products, and other agricultural feed (including hay or silage, fodder crops, food processing by-products), other crops (including hops, barley, flax, straw, sugar beets), wool, raw leaf tobacco, fertilizer (including manure), pesticide, seeds, market quotas, share crop agreements (excluding the monetary fee

[4] Beaton Fitzpatrick Murray Chartered Accountants, Chartered Accountants and Advisors, (2007), Impact of Sales Tax on PEI Farms, January, p. 4.

portion), and international freight transportation (including domestic freight transportation that is part of a continuous international outbound journey). Exports outside of Canada, including for processed food products, will be zero-rated. Farmers and food processors can claim ITCs on the purchase of taxable business inputs related to the sale of taxable supplies, including zero-rated supplies.

Goods and services that are exempt under the HST include harness racing purse for owners, pari-mutuel betting on harness racing, the sale of farmland, grants and subsidies (including an on-going program of financial support for farmers from government) and financial services. Exempt suppliers are not eligible for ITCs related to the sale of exempt supplies, but they can claim ITCs on the purchase of taxable business inputs related to the sale of taxable supplies, including zero-rated supplies.

A minor concern of harmonization for farmers is its impact on short-term cash-flow. Farm operating and capital expenses subject to the 5% GST rate will now be subject to a 14% HST rate under harmonization. APEC estimates that PEI farmers will allocate $12.6 million in working capital annually to pay HST until ITCs are received. However, in the long-run there is a nil impact on cash flow due to the receipt of ITCs, a major benefit compared to the existing unrecoverable PST.

Conclusion

At a macro-level, PEI business investment should increase as a result of harmonization. While farmers will begin paying sales tax on a number of goods and services that are currently exempt under the PST, farmers that opt to register for the HST will receive full ITCs, thereby benefitting from paying less overall sales tax in the long-run. That is because certain taxable items under the current PST will be subject to ITCs under the HST.

Farmers will receive significant tax savings on certain business inputs, especially new motor vehicles and repairs, parts and labour for motor vehicles used in commercial farming. However, the savings will depend on the extent of commercial versus personal use. Part-time farmers not eligible for a PST refund can also make gains under a HST, as long as they register.

PEI farmers will need to consider the impact of increasing working capital tied up in HST, and may want to file their GST/HST returns more frequently to receive HST refunds sooner (i.e. since most of what farmers sell is zero-rated, they will effectively receive a HST refund via ITCs). For example, a farmer filing their GST returns annually may want to start filing their HST returns quarterly or even monthly instead in order to minimize the cash-flow impact on their budget.

The agricultural sector in other jurisdictions has been very supportive of the HST as they realize the net benefits – including the BC Agricultural Council. The Ontario Federation of Agriculture estimated the HST created $30 million in savings for Ontario farmers by reducing the PST burden and placing farmers on an equal footing with other harmonized provinces – while giving them a competitive advantage over farmers in non-harmonized provinces.[5] Likewise, the 2009 Report of the Commission on the Future of Agriculture and Agri-Food on PEI (Growing the Island Way) was very supportive of harmonization to eliminate a competitive disadvantage to PEI agriculture.[6]

[5] Ministry of Finance, The Tax Plan is Working: For Farmers, HST: Making Ontario Stronger, Government of Ontario, http://www.fin.gov.on.ca/en/taxchange/farmers.html
[6] Commission on the Future of Agriculture and Agri-Food on Prince Edward Island (2009), Growing the Island Way: The Next Chapter for the Agriculture and Agri-Food Economy of Prince Edward Island, January, p. 32.

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