Ontario Construction Secretariat

The Impact of the HST on the ICI Construction Industry

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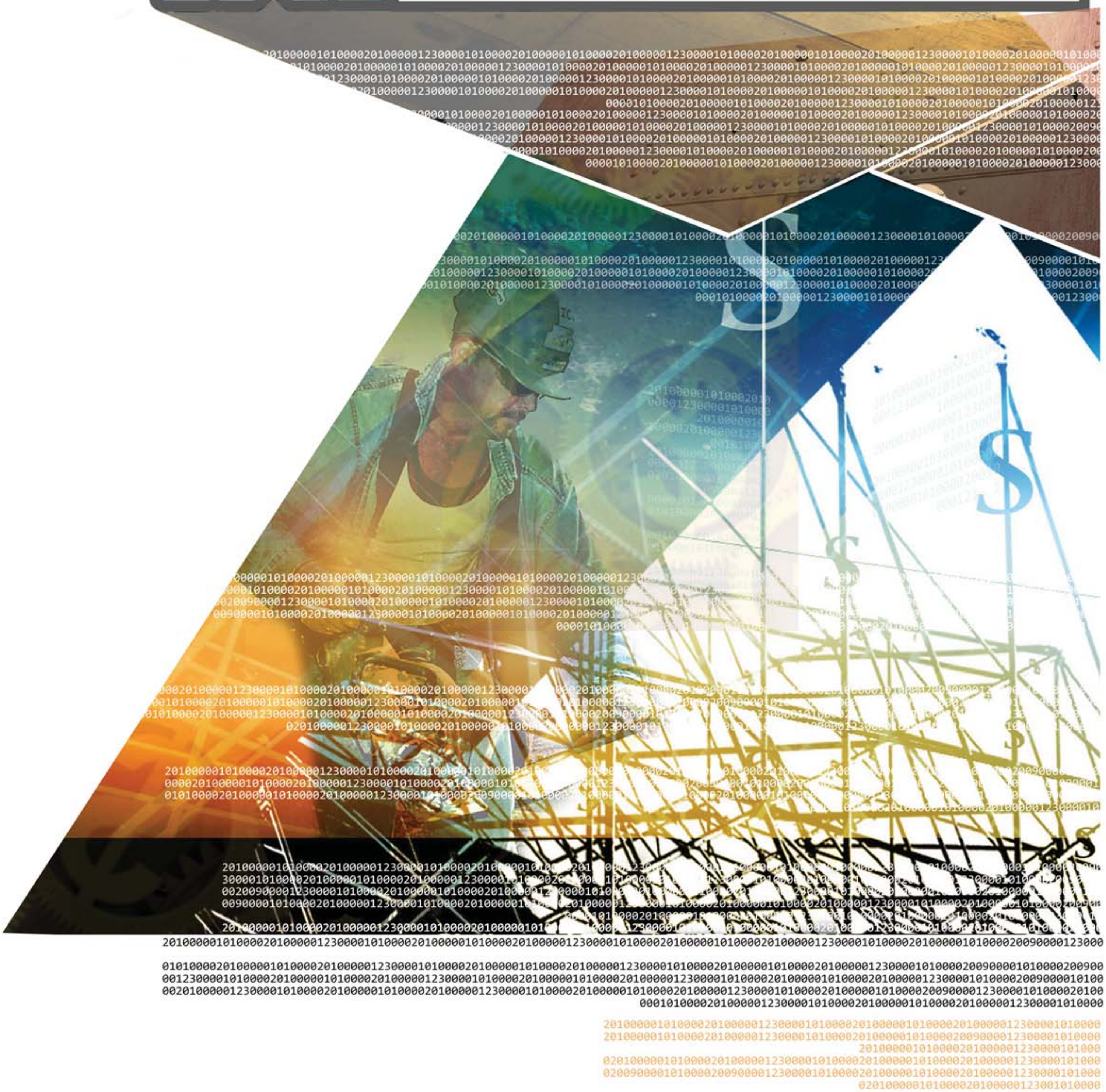

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The Impact of the HST

On July 1st 2010, the provincial Retail Sales Tax (RST) - also commonly called the PST - and the federal Goods and Services Tax (GST) will be combined to form a Harmonized Sales Tax (HST) in both Ontario and British Columbia. The move to a value-added tax like the HST is purported to make businesses more competitive, increase business investment, create new jobs and raise incomes. While business groups have long been supporters of a single value-added tax, like the HST, some consumers and sectors worry about the impact the new tax regime will have on consumer prices.

The HST: How is it going to work?

The RST will be replaced with a value-added tax and combined with the federal GST to create a federally administered HST. The provincial portion of the HST will be eight per cent — the same as the general RST rate — and the federal portion will be five per cent, for a combined HST rate of 13 per cent.

Under the existing regime, business purchases of inputs used in the production process are subject to the RST. This tax becomes part of the cost of production and is passed on in the sale price of the goods or services produced. As a result, this tax becomes integrated in the cost of goods at each phase of the production, distribution and retail processes. The consequence is a compounding of tax upon tax that is ultimately paid by consumers through higher prices.

The HST would remove this embedded tax by allowing businesses to claim input tax credits on their purchases, as under the federal GST. These credits would reimburse businesses for the tax they paid in the course of commercial activities which would reduce business costs and ultimately, it is believed, consumer prices.

It should be noted that financial institutions and large corporations with taxable sales greater than $10 million dollars will have to wait 5 years before they can claim tax credits on the provincial portion of the HST paid on certain business costs. After this 5 year period, full input tax credits will be available but phased in over a three-year period.

Harmonized Tax - A Strategic Policy for Improving Ontario's Competitiveness

"... harmonization of Ontario's sales tax with the federal Goods and Services Tax is one of the most readily available tax policy options ... that will immediately realize significant benefits to the taxpayer and the economy as a whole." Ontario Chamber of Commerce

"Within ten years, the lower tax burden on investment will lead to increases in capital investment of $47 billion and in annual incomes of between 4.4% and 8.8%, and to the creation of an estimated 591,000 net new jobs." Jack Mintz, Ontario's Bold Move to Create Jobs and Growth

As discussed above, businesses stand to benefit from tax harmonization through lower operating and capital costs which will encourage investment (and employment), raising long-term growth potential and enhancing competitiveness. TD Economics estimates that the effective tax rate on business inputs will be lowered by 0.9% in Ontario and 0.8% in British Columbia resulting in a combined total savings of $6.9 billion.

A study by the C.D. Howe Institute estimated that machinery and equipment investment rose 12% above trend levels following the 1997 introduction of a harmonized tax in the Atlantic Provinces. The Ontario Chamber of Commerce estimates that the amount of investment capital in Ontario's economy could be 1% higher in the near-term and as much as 1.5% higher over a longer-term horizon versus what it would have been, as a result of the HST. Boosting capital investment will lead to enhanced productivity which will ultimately address concerns about potential labour shortages as the baby boomers continue to retire. The HST is a positive step towards accomplishing the policy goal of raising productivity to compensate for looming labour shortages.

The HST will also result in a more streamlined tax system, providing efficiency gains for businesses. Companies in Ontario will only have to file one return as opposed to two and will no longer be subject to audits by two separate government levels, drastically reducing paperwork. According to the Ministry of Finance, $500 million dollars in savings per year should accrue to businesses because of lower compliance costs.

But, What about Consumers?

When the HST takes effect on July 1, consumers will be paying the new combined 13% tax rate on many items (particularly services) that are currently only subject to the 5% GST. These include but are not limited to: electricity, new home purchases, real estate commissions, newspapers, magazines, internet access fees and professional services provided by accountants, architects, engineers and lawyers. Given that the tax will be levied on a new set of goods and services, TD Economics estimates that Ontario consumers will experience an 8 percentage point increase on 19% of their expenditures.

Most economists believe that the introduction of the HST will cause a permanent shift upwards in the level of consumer prices given the broader range of consumer goods that will now be subject to a tax. However, the impact is expected to be dampened by businesses passing on to consumers some of the savings accrued to them from lower input costs. Overall, the combination of these two effects is expected to result in the national price level being 0.4% higher than it would have been without harmonization.

Significant Cost Savings for the Construction Industry

It is anticipated that the construction industry will be one of the biggest beneficiaries of the HST. The buyers of construction materials at any level - whether they are owners, contractors, or subcontractors - will now be able to regain the previously unrecoverable RST charged on material purchases through Input Tax Credits. This is significant as nearly 40% of inputs used in non-residential construction are currently subject to the RST, according to the Chamber of Commerce.

The Ministry of Finance has estimated the annual cost savings which will accrue to industries in Ontario due to the implementation of the HST. According to their calculations, businesses in the province will see approximately $4.5 billion in annual savings with the construction industry alone accounting for over half the savings ($2.3 billion). Notably, the transportation, manufacturing and mining/oil/gas industries also stand to see significant savings. As these sectors are major suppliers to the construction industry, contractors should expect, and perhaps demand, that the RST savings be passed on through lower prices.

The example on the next page illustrates the benefits of the harmonized tax for the non-residential construction industry. While gross taxes paid will be higher when the HST is introduced, net taxes will be lower because the full HST amount will be able to be claimed back. Under the current structure, credits cannot be claimed on material inputs. As a result, the tax paid on them is simply an unrecoverable, out-of-pocket cost ($320,000 dollars in our example). Under the new regime, this expense will be recouped, thereby lowering total operating costs.

Example of Sales Tax Costs on Industrial Construction in Ontario

	RST/GST (2009)	HST (2011)
Size of facility (square feet)	**100,000**	**100,000**
Per square foot cost of construction (excluding tax)[1]	**$80**	**$80**
Total construction costs (excluding tax)	**$8,000,000**	**$8,000,000**
Assumed Allocation[2]		
Materials	**50%**	**50%**
Labour	**50%**	**50%**
Refundable Sales Tax Rates		
Federal GST	**5%**	**5%**
Ontario HST	**-**	**8%**
Non-refundable Sales Tax Rates		
Ontario RST	**8%**	**-**
Sales Taxes Paid		
Federal GST		
Materials	**$200,000**	**$200,000**
Labour	**$200,000**	**$200,000**
Ontario RST or HST		
Materials	**$320,000**	**$320,000**
Labour	**exempt**	**$320,000**
Total Sales Taxes Paid	**$720,000**	**$1,040,000**
Less refundable Input Tax Credits	***($400,000)***	***($1,040,000)***
Total Sales Tax Cost	**$320,000**	**$0**
Total Construction Costs (including taxes)	**$8,320,000**	**$8,000,000**

(1) Average cost of industrial construction for Toronto, per Competitive Alternatives 2008, *KPMG's Guide to International Business Location*.

(2) Actual allocation between materials and labour varies based upon the type of construction, but is broadly estimated by various sources to range between 40% - 60% of total construction costs in each of materials and labour. A split of 50:50 is assumed in this example.

Source: KPMG, Competitive Alternatives – Focus on Tax, November 2009

While full input tax credits may be claimed on new construction and repair and maintenance work in both the commercial and industrial sectors, only partial input tax rebates will be able to be claimed by the public sector (Municipalities, Universities, Hospitals, Schools). Because the provincial component of the HST will be separately eligible for public sector rebates, public sector bodies will need to track the federal and Ontario portions of the HST paid on inputs.

Public Sector Rebates		
	Federal	Ontario
Municipalities	100%	78%
Universities/Colleges	67%	78%
School Boards	68%	93%
Hospitals	83%	87%
Charities and qualifying non-profits	50%	82%

Transition Growing Pains

While the HST is generally positive for the construction industry, its implementation has caused apprehension on two fronts. Firstly, it was unclear how contractors should bid on work prior to the July 1st HST date. Secondly, there was some confusion around the treatment of projects already started prior to the implementation of the HST that would run past the implementation date.

In an effort to clarify these issues, various industry groups have met with provincial officials to ensure contractors have the proper information and guidelines to make a smooth transition to the HST. On the issue of how to bid projects, it has been suggested by industry groups that bid prices should factor in the transition to the HST - including removing RST from relevant items after June 30th. Also, industry stakeholders have advised that bid contracts should be amended so that it is clear that they are already based on the HST and therefore on July 1st, no changes in tax treatment need to be undertaken.

In the case of projects starting before July 1st and running through the implementation date, it looks as though firms will have to incorporate the RST for the portion of their work completed prior to July 1st. On the deadline date and thereafter, the remainder of the work will be subject to the HST.

A Note on Residential Construction

There has been much more concern and debate about the introduction of the HST for businesses operating in the residential sector. The HST will apply to new home purchases and home closing costs as well as repairs and renovations. This means that the taxes paid to own a new home will be higher than in the existing regime. Under the current tax structure, the purchase of a new home is exempt from the RST.

Though taxes paid on new home purchases will be higher when the HST is implemented, the province is proposing rebates which will help ease the burden. Homes at all price ranges will qualify for a rebate of up to $24,000. This means that the provincial portion of the HST for the first $400,000 of the purchase price of a new home will effectively be 2% (8% provincial portion of HST less the 6% rebate). The tax rate on the provincial portion of the HST would then rise to 8% for value of the home in excess of $400,000.

Though difficult to quantify, many analysts believe that a higher tax rate on new purchases could "pull-forward" both sales and building activity originally slated for the second half of 2010 as buyers rush to make their purchases ahead of the HST implementation and builders hurry to supply homes. The effect of this would be to dampen both home sales and new housing construction in the second half of the year.

The Bottom Line

Both economists and industry stakeholders believe that the implementation of the HST will be a boon to the construction industry in Ontario and the province as a whole. By allowing businesses to claim tax credits on non-labour inputs, the effective tax rate on firms in Ontario will be reduced. This will have the beneficial impact of stimulating investment thereby increasing productivity in the province. Another positive that will flow out the change will be a reduction in compliance costs that firms face.

The construction industry currently pays retail sales taxes on the highest proportion of their inputs when compared to other major sectors of the economy. Therefore, the implementation of the HST should prove very beneficial to the industry.

The transition to the HST will pose some challenges to the residential market and to consumers who will now face a higher price level for certain goods and services purchased. On balance, however, the implementation of the HST appears to be a solid step towards improving the competitiveness of Ontario both now and the future.

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