# The Non-Profit Sector and the Multi-Stage Sales Tax

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This article provides a general overview of how the federal Government's sales tax reform proposals will affect the non-profit sector and suggests some representations which the non-profit sector might make to the federal government. Two areas of tax planning are also discussed.

**A New Regime of Benefits and Burdens**

The federal government's June 18, 1987 White Paper on Tax Reform and the companion document, Sales Tax Reform, propose significant changes to the sales tax treatment of charities, non-profit organizations and health and educational services. The proposed Multi-Stage Sales Tax (MSST) would usher in a new regime of commodity taxation which would both benefit and burden the non-profit sector. Before we identify some of these benefits and burdens, we should understand the general features of the MSST system.

*Defining the MSST System*

As the Sales Tax Reform document indicates, the MSST is collected from all vendors of goods and services in the production and distribution network on all their sales. Tax is levied and collected as goods move from primary producers to manufacturers and processors and thence to wholesalers, retailers and, finally, to consumers. During this progression, business will charge tax on its sales but receive credit for any tax paid on its purchases, so that there is a tax on the value added by each business.

*Some of the Burdens*

The proposed MSST system will impose certain burdens on the non-profit sector as many of the traditional sales tax preferences enjoyed by the sector are slated for termination. This is part of the federal government's plan to broaden the sales tax base. For example, the federal *Excise Tax Act*, which currently includes provisions for extracting the manufacturers' sales tax content from buildings erected by schools and universities, as well as for exempting school supplies and books, will be gone. Numerous federal sales tax exemptions which affect other members of the non-profit sector will also be missing, e.g., the production of certain works of art will be taxable.

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In addition to the federal exemptions and rebates which are currently enjoyed by the non-profit sector, there are numerous provincial sales tax rebates and exemptions for religious bodies, charitable or benevolent organizations, certain volunteer groups, public libraries, museums and art galleries, as well as educational institutions and hospitals. These exemptions and rebates would be slated for termination under the National Sales Tax variant of the MSST, which is the variant discussed in this paper.

The non-profit sector does not enjoy unbounded rebates of, and exemptions from, federal and provincial sales tax at present. Nevertheless, the proposed MSST portends new sales tax burdens for the non-profit sector, burdens which do not seem to be offset by the many general benefits of the MSST. For example, tax-free exports should help Canada's export trade but this benefit does not seem particularly useful to the non-profit sector.

*Some Mixed Blessings*

The mechanics of the MSST system will both benefit and burden the non-profit sector. The MSST will be imposed on vendors of goods and services and collected at each stage of the production/distribution system. For example, raw materials will be taxed on their sale price and finished materials will be similarly taxed, as will manufactured goods, and so on. It is assumed that this tax can be passed along in the price of goods and services so that it will be borne by the ultimate consumers.

The government has decided however, that it will not, in most cases, charge MSST on the non-profit sector's prices. The non-profit sector will also not be subject to MSST on its activities. The Sales Tax Reform document, therefore, declares the non-profit sector to be tax-exempt, an exemption that is the key benefit to the sector. An ancillary benefit is the fact that most non-profit sector organizations will not have to register as taxpayers. (Such benefits may not be viewed favourably by the private sector, especially where private sector enterprises are in direct competition with goods and services supplied by the non-profit sector.)

These benefits are, however, offset by the fact that the non-profit sector will have to bear the burden of the MSST which is included in its purchases since, unlike most businesses, exempt entities cannot claim an input tax credit for the tax content of their purchases. This prohibition extends to the tax included in capital purchases. Like all other ultimate consumers, the non-profit sector will have to bear the MSST and will have to look to its supporters to cover this increase in tax costs.

It should also be mentioned that the non-profit sector will have to report its purchases of imported services and to pay tax on those purchases. The non-profit sector is the *only* sector expected to do this. For example, the contemplated self-assessment procedure would be triggered when a foreign speaker is invited to speak to a non-profit entity in Canada and renders an account for this service. If members of the sector foresee that this provision would be administratively burdensome, representations to the government may be in order.

## Implications For The Non-Profit Sector

*(i) Charities*

Charities will generally be tax-exempt under the MSST system. One of the issues which confronts each member of the non-profit sector, however, is how the government will decide that a non-profit entity carries on activities which may be characterized as "supplies of a commercial nature". In this regard, the Sales Tax Reform document lists four activities which will be taxable even if undertaken by a charity. These include:

1) The sale of goods in a retail store;
2) The sale of food or drink in a restaurant, cafeteria or pub;
3) The sale of admissions to professional performances; and
4) The sale of land to individuals for residential or personal use.

If a charity does carry on one of these activities, there are two situations in which tax will not be required (except if the supply of land is involved): first, if these supplies are for activities undertaken by wholly, or almost wholly, volunteer organizations and, second, if they are undertaken by organizations whose revenue from otherwise taxable supplies is $5,000 or less each year. The $5,000 exemption is comparable to the limited MSST exemption for individuals which has also been proposed by the government.

*(ii) Non-Profit Organizations*

Non-profit organizations will also qualify for exemption under the proposed MSST; however, the category "non-profit organizations" will not be deemed to include social and recreational clubs which provide various services to members. This means that squash and golf club fees, and the like, will undoubtedly rise as members will have to meet the added costs of the new MSST.

Non-profit organizations will be taxable, to use the language of the Sales Tax Reform document, "on any commercial activity involving the supply of property or services of the type that is generally supplied by a commercial business". It can be expected that determining what does and what does not fall into this category will be contentious. Consider sheltered workshops, for example; do they make "supplies of a commercial nature"? There will undoubtedly be numerous issues of this sort.

In conformity with the general MSST proposal, the activities of the non-profit sector which the government decides to make taxable will be allowed to credit MSST tax paid on their purchases against the MSST liability for their sales. This provision should eliminate the double taxation or tax cascading which would arise if a non-profit entity were required to bear tax on its purchases and pay tax on its sales without an input tax credit being available. Had this provision not been made, the resulting double taxation would bias consumers against purchasing services supplied by the non-profit sector.

(iii) *Health Services*
Two types of suppliers of health services could be subject to the MSST: medical institutions and medical practitioners. However, the vast majority of publicly funded health services provided in Canada will be exempt from tax. Examples of exceptions:

a) since the exemption is based on whether the services are paid for under the *Canada Health Act* or any other government-funded social welfare programs, dental services in Ontario could be subject to the MSST;

b) even if the medical practitioner is within the publicly funded system, certain procedures such as some cosmetic surgery will not be covered; and

c) a portion of some nursing home fees will be subject to the MSST.

The health services exemption does include those goods that are supplied in the course of providing an exempt health service. Drugs administered in a hospital will be exempt from tax, however, drugs could be taxable when sold at retail. The taxability of drugs could be a severe burden on individuals who have chronic diseases, such as diabetes, which require expensive medication. The provision of tax-exempt medication by hospitals could encourage patients and their physicians to use expensive hospital services more frequently than they otherwise would.

(iv) *Educational Services*
Educational services provided by non-profit educational institutions including primary schools, secondary schools and post-secondary schools will be exempt from the MSST. This exemption will extend to independent schools which are non-profit entities. Privately run business schools and professional development services which are operated with a view to profit will be taxable.

**Suggested Representations and Defensive Tax Planning**
Various parties will be making representations to the government concerning the proposals to reform the sales tax system. Such representations are being solicited and it seems probable that well-organized, well-researched representations could be effective. The non-profit sector could achieve significant gains through such representations.

As outlined above, exempt entities will have to bear the tax which is included in their purchases of goods and services. The MSST system does, however, contemplate completely tax-free treatment for some goods and services. For example, the White Paper proposes that exports be tax-free. Thus, if the non-profit sector feels that a good case can be made for complete tax-free treatment, the precedent exists for such treatment within the MSST system. It should be noted, however, that the government is considering imposition of the MSST on food. It may, therefore, be politically inexpedient to seek complete tax-free treatment for the non-profit sector if food becomes subject to MSST taxation.

The government has proposed that tax-exempt entities be ineligible to claim an input tax credit on capital property unless that property is used in a taxable activity. This clearly discriminates against capital projects in the non-profit sector and representations should be made to seek the same treatment for the sector as will be available to commercial activities. In the absence of any change in the government's proposal, and in anticipation of a ban on tax credits for capital expenditures, the non-profit sector should consider defensive tax planning by advancing the starting date for currently planned capital projects so it will precede implementation of the MSST. In this way, projects can take advantage of the tax exemptions currently available.

The second area of tax planning for the non-profit sector is known as self-supply. Self-supply, which could be the single most important MSST tax-planning device for the non-profit sector, is a strategy whereby an exempt entity minimizes the value of goods and services which it purchases and thereby minimizes the amount of tax which it must bear. This is achieved by supplying the services it must use to itself so there is, of course, no tax charged.

The government proposes to develop a rule limiting self-supply and will be under considerable pressure from the private sector to do so. To appreciate the magnitude of this issue, it is only necessary to consider the self-supply opportunities available to one category of non-profits: hospitals. Hospitals contract out the provision of many goods and services which will become taxable with the introduction of the MSST. Contracted-out services may include security services, laundry services, computer and information services, cleaning services, ambulance services and meal services, for example, so the tax content of contracted-out services will be significant. Since this tax content can be reduced or eliminated through self-supply, the non-profit sector should examine self-supply as a method of minimizing the MSST which it must bear and should make representations to secure a broad self-supply rule in the MSST.

It would also be appropriate for the non-profit sector to make representations to the government on behalf of its preferred variant of the MSST. The Government has advanced three variants for discussion. The National Sales Tax, the subject of this article, seems to be the least favourable to the non-profit sector since it would have a common federal and provincial base so that both federal and provincial exemptions and rebates would be eliminated. For this reason, the non-profit sector should lobby against the National Sales Tax.

The federal Goods and Services Tax variant of the MSST may be less disadvantageous to the non-profit sector since it would remove exemptions only at the federal level. The Goods and Services Tax is, nonetheless, disadvantageous to the non-profit sector because it is calculated from financial books and records which cannot be sufficiently attenuated to exempt specific goods or taxpaying entities. Because exemptions cannot be refined in a Goods and Services Tax system, they are usually quite narrow. This would, undoubtedly, be harmful to the non-profit sector.

The least disadvantageous MSST system for the non-profit sector appears to be the federal invoice-based Value Added Tax (VAT). This variant of the MSST could provide some flexibility for reducing the rates of tax on certain goods and services which the non-profit sector purchases. Of course, representations to obtain preferential rates of tax (or zero rating) for certain goods would be required. The mechanism for permitting such treatment would, however, be in place with an invoice-based VAT.

Invoice-based VAT systems are used throughout the European Economic Community. It should be noted, however, that in Canada representatives of small business have opposed the VAT because it entails a tremendous paper burden and, they argue, would increase operating costs.