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Lessons from Canada and the WTO: The U.S. Should Embrace a VAT

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We suggested on these pages in 2012 that the time was right for the United States to adopt a value-added tax (''VAT'').[1] We were not the first to advocate for a VAT, and we acknowledged the political challenges to enactment.

Fast-forward to 2017, where the political landscape has changed radically. Republicans are in control of both the White House and Capitol Hill. Their campaigns included comprehensive tax reform as a major goal. As a result of these changes, many commentators now believe that real tax reform is likely in the near future. Accordingly, big changes — such as enacting a VAT — may now be possible.

Politics make for strange bedfellows (they say) and the present support for a VAT is at best hazy. Republicans are arguing for a border adjustment tax (''BAT''), which is like a VAT — but unusual enough to break with VAT tradition.[2] As we explore below, a traditional VAT would not attract complaints from the World Trade Organization (''WTO''). As in Canada (see the Appendix to this article for the history), we believe that voters would ultimately accept a VAT.[3] Therefore the hurdles to VAT enactment are actually lower than they have ever been.

This article thus renews our suggestion that the United States adopt a VAT now. We review the Canadian experience and suggest a ''long lens'' approach to surmount the likely hurdles.

In particular, this article examines Canada's experience with its VAT — the goods and services tax (''GST'') — and concludes that although the short-term political costs could be significant, a VAT in the United States could eventually, as in Canada, come to be viewed as a fair necessity, if an unpleasant one. Therefore, rather than getting stung by a deadly ''third-rail'' of politics, courageous politicians would ultimately be rewarded for their honesty and the transparency available through adoption and implementation of a VAT.

THE REPUBLICAN BLUEPRINT: BAT NOT A VAT EXCEPT FOR THE WTO

In June 2016, before the recent change in Washington's political climate, the GOP released a tax policy

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[1] Peter A. Glicklich and Megan J. Grandinetti, *VAT Can Be the Answer to the Leadership Question*, 41 Tax Mgmt. Int'l J. 3 (Jan. 13, 2012) (''G&G Article 2012''). We do not renew the arguments from that earlier article but recommend its separate reading. A VAT is a consumption tax where a business pays a transfer tax on the sale of goods or services, but that tax is partially offset by a deduction for any tax paid by the business's suppliers with respect to its inputs. Under this system, the business at each stage of a supply chain only pays tax with respect to the ''value added'' by that company.

[2] As discussed more fully below, a BAT is a tax on goods and services imported into the United States.

[3] One argument against a VAT is that the tax is ''regressive.'' Canada addresses this in part by zero-rating or exempting some items that are considered necessities. There is also a quarterly payment to low-income individuals and families to help offset the GST that they have to pay. Another approach in the United States would be to provide a refundable income tax credit — checks in the mail are popular with voters, but vulnerable to mail fraud.

paper that has commonly come to be referred to as the Republicans' tax ''Blueprint.''[4] This policy paper provides an analysis of the current federal tax system and provides recommendations on what should be done to the tax law to prevent ''the sun sink[ing] ever lower on the age of American excellence.''[5] One element of the plan described in the Blueprint is for the United States to implement a BAT as part of a destination-based cash flow tax (''DBCFT'').

The proposed by the Republicans, which includes a BAT, is, in the words of the Brookings Institution, essentially a VAT with a deduction for wages.[6] Although some have described Americans' opinion of the VAT as ''VAT-phobia,''[7] the proposals currently being considered in Washington may pave the way to the adoption of this tax.

According to the Blueprint, under foreign VAT systems, sales by foreign producers outside of the home jurisdiction generate a tax rebate, while sales by those same producers to home-country customers are subject to the VAT. When products are imported into the VAT country, the goods or services become subject to the VAT, which places the home-country and importing producers on equal footing with respect to home-country customers.

The United States, of course, does not have a VAT. Therefore, claims the Blueprint, a foreign country's VAT rebate means that the treatment of U.S. imports and exports is asymmetrical: Imports into the United States are effectively tax-free for the foreign producer because of the VAT rebate, while exports from the United States into the foreign country are subject to that country's VAT. Ultimately, this means that the foreign producers can sell their goods more cheaply in the United States than domestic producers can. The Blueprint states that these tax regimes create a ''self-imposed unilateral penalty on U.S. exports and a self-imposed unilateral subsidy for U.S. imports.''[8]

The Blueprint proposes to correct this problem by implementing a ''cash-flow tax'' approach for businesses through a move toward a consumption-based tax system. According to the Blueprint, this would allow trade imbalances to be corrected by adjustments at the border. The Blueprint does not provide much detail on how these arrangements would be implemented. Since the Blueprint was released, however, there have been massive discussions by economists and tax practitioners about how the proposed DBCFT regime might work.

The BAT seeks to ''level the playing field'' with respect to foreign countries' system of VAT rebates for cross-border sales. Because a foreign business receives a VAT rebate with respect to a product it sells into the United States, the United States would charge a border adjustment with respect to that product upon entry. Conversely, a U.S. business's export of a product into a foreign jurisdiction would not be subject to the BAT, and it is assumed that the foreign jurisdiction would impose a VAT with respect to the product when it arrives there. The BAT thus is said to cancel out any tax advantage that foreign producers currently get from the absence of a VAT regime in the United States.

The other major feature of the DBCFT described in the Blueprint is a deduction for wages paid by U.S. producers of goods and services. This makes the DBCFT different from a traditional VAT, which does not include a deduction for wages. This deduction would enable U.S. businesses to operate with less tax cost than, and thus a competitive advantage over, businesses in foreign jurisdictions that have a more traditionally structured VAT.[9]

GETTING WTO APPROVAL

As described in the Blueprint, the goal of the Republicans' DBCFT is to ''end the self-imposed unilateral penalty for exports and subsidy for imports that are fundamental flaws in the current U.S. tax system.''[10] According to the Blueprint, the BAT will enable U.S. businesses to compete on a level playing field with foreign businesses by allowing the United States to impose a tax on foreign importers of goods and services, while allowing domestic producers to export goods and services free of such tax.[11] As described above, this is intended to offset the VAT imposed on imports and rebated on exports by the U.S.'s trading partners.

The BAT, however, looks like an import tariff, which is subject to regulation by the WTO. Under applicable WTO rules, an import tariff in the form of a VAT (considered an ''indirect tax'') is permissible, but an import tariff in the form of an income tax (consid-

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[4] *A Better Way: Our Vision for a Confident America* (June 24, 2016), *available at* abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf (the ''Blueprint'').

[5] Blueprint at 5.

[6] William G. Gale, *Understanding the Republicans' Corporate Tax Reform* (Jan. 10, 2017), *available at* www.brookings.edu/opinions/understanding-the-republicans-corporate-tax-reform.

[7] Martin A. Sullivan, *Unlike VAT, Cash Flow Tax Helps Exports, Hits Imports*, 154 Tax Notes 187 (Jan. 9, 2017).

[8] Blueprint at 15.

[9] Martin A. Sullivan, *Unlike VAT, Cash Flow Tax Helps Exports, Hits Imports*, 154 Tax Notes 187 (Jan. 9, 2017).

[10] Blueprint at 15.

[11] Blueprint at 28.

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ered a ''direct tax'') is prohibited.[12] Countries whose imports into the United States would be subject to the BAT are likely to oppose it. It has been reported that the European Union is already making plans to bring a WTO case to challenge the BAT.[13] Other commentators see a confrontation as less likely, on the grounds that President Donald Trump would respond to such a loss by simply having the United States leave the WTO.[14]

Republicans are confident, however, that the DBCFT would withstand such a challenge. The Blueprint states that its ''move toward a consumption-based tax approach'' gives the United States the opportunity to impose border adjustments consistent with the WTO rules regarding indirect taxes.[15] One House Republican, Ways and Means Committee Chairman Kevin Brady (Texas), has even dismissed the possibility of a WTO challenge, and is reported as saying ''Frankly, what will they do? [Say] 'stop copying us?' 'Stop border-adjusting your taxes as we do?' ''[16]

The Republicans' confidence that the WTO will accept their proposed BAT may be optimistic. Professor Alan Auerbach believes that border adjustments ''are not trade policy'' and that they can ''create a level tax playing field for domestic and overseas competition,'' but he is skeptical that the BAT as proposed will ultimately be sustained given the WTO's interpretation of the relevant provisions. For instance, although Professor Auerbach describes the distinction between direct and indirect taxes as having ''little meaning'' and ''no bearing on any economic outcomes,'' he still thinks that it is not clear that the DBCFT would be successfully characterized by the WTO as an indirect tax.[17]

Economist Martin Sullivan also views the inclusion of a wage deduction in the DBCFT as a greater barrier to WTO passage than the BAT alone.[18] After all, the BAT is meant as a neutral measure to eliminate trade distortions and not as a preference. The wage deduction in the DBCFT does seem to give U.S. producers an advantage in comparison to producers in other countries. Unlike Auerbach, Sullivan suggests that it would be logical for the DBCFT to pass muster at the WTO. He has written that ''if separately a VAT and a wage tax cut are not in violation of WTO rules, it is hard to see how doing both in combination by enacting a destination-based cash flow tax should not also be compliant with WTO rules.''[19]

COULD A VAT BE THE SOLUTION?

Unlike a VAT, which would clearly be acceptable to the WTO, the innovations in the DBCFT cast considerable doubt over whether the DBCFT would be allowed to stand. Approval by the WTO might be granted after years of litigation. While a cynic might applaud such a delay, it seems logical to ask whether it would make any sense for the United States to enact a VAT, which would provide substantially similar economic effects and avoid any WTO challenge.

The Republicans are already defending the DBCFT on the grounds that it is essentially a VAT. For instance, in discussing his belief that the DBCFT would be approved by the WTO, Rep. Brady has said that the United States is ''no longer merely adjusting an income tax; we're transforming ourselves to this cash flow tax, based on consumption here.''[20] Likewise, Rep. Peter J. Roskam (R-Ill.), also on the Ways and Means Committee, believes that the DBCFT would be approved by the WTO on the grounds that ''we are moving toward a consumption tax, we are mirroring essentially what the rest of the world is doing, and we are asserting a right to be treated in the same fashion as the rest of the world is.''[21]

If DBCFT proponents are claiming that the DBCFT should be approved by the WTO because it is essentially the same as a VAT, why not take the next step and simply adopt a traditional VAT?

The answer may be that the Republicans simply never considered proposing a VAT in the first place. More likely, however, they decided that an outright switch to a VAT was too extreme for the American people. Conservatives, especially, are thought to consider a VAT to be politically unpalatable.[22]

The principal advantage of a traditional VAT over the currently proposed DBCFT is that the WTO

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[12] *See* Morgan Klinzing, *The Blueprint's Border Adjustment: Basis for Challenge Under the WTO and Bilateral Income Tax Treaties*, 46 Tax Mgmt. Int'l J. 140 (Mar. 10, 2017).

[13] Jonathan Curry, *In Trump Meeting, Retailers Voice Border-Adjustable Tax Concerns*, 154 Tax Notes 924 (Feb. 20, 2017).

[14] Alexander Lewis, *Commentators Disagree over Costs, Benefits of House GOP Plan*, 154 Tax Notes 660 (Feb. 6, 2017).

[15] Blueprint at 28.

[16] Dylan F. Moroses and Stephen K. Cooper, *Brady and Roskam Confident About WTO Compliance*, 154 Tax Notes 798 (Feb. 13, 2017).

[17] Alan J. Auerbach and Douglas Holtz-Eakin, *The Role of Border Adjustments in International Taxation* (Nov. 30, 2016), available at https://www.americanactionforum.org/wp-content/uploads/2016/11/The-Role-of-Border-Adjustments-in-International-Taxation.pdf.

[18] Martin A. Sullivan, *Unlike VAT, Cash Flow Tax Helps Exports, Hits Imports*, 154 Tax Notes 187 (Jan. 9, 2017).

[19] *Id.*

[20] Dylan F. Moroses and Stephen K. Cooper, *Brady and Roskam Confident About WTO Compliance*, 154 Tax Notes 798 (Feb. 13, 2017).

[21] *Id.*

[22] Mindy Herzfeld, *What Is a Reciprocal Tax?* 154 Tax Notes 1176 (Mar. 6, 2017).

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would clearly approve of a VAT, as it has done with many other countries already. The novelty of the DBCFT, including the U.S.-favorable wage deduction described above,[23] make it difficult to predict whether the DBCFT would have the intended effects or would bring unintended consequences. In addition, the DBCFT has been thought to be difficult to explain: President Trump called it ''too complicated.''

DISADVANTAGES OF VAT

The DBCFT shares certain disadvantages with VATs in general. For instance, some economists are worried about whether currency exchange rates will adjust quickly enough to offset the increased price of imports.[24] Other commentators argue that the DBCFT would disproportionately penalize the U.S.'s highest value-added sectors because they rely on imports to produce goods.[25] Finally, one commentator summed up the political problems with the DBCFT by asking ''whether Congress should respond to the working-class anger seen in the recent presidential election by adopting a corporate tax cut that would, in effect, raise consumer prices.''[26]

The most significant obstacle to adopting a VAT, therefore, is the assumption that proposing and defending it would be political suicide. New taxes are never popular, and it does not help that a VAT would increase the out-of-pocket costs of most goods and services purchased by an ordinary consumer.

THE CANADIAN EXAMPLE: WHAT TO AVOID

Canada adopted its GST in 1991.[27] The GST was put forward by the Progressive Conservative government of Brian Mulroney, but the new tax was so unpopular that Mulroney had to take advantage of some obscure procedural rules to secure passage by the Canadian Senate.

The GST was also unpopular after it was enacted. The province of Alberta led a series of constitutional challenges, which were eventually heard before the Supreme Court of Canada. Jean Chrétien's Liberal Party called for the abolishment of the GST, and this position was part of a platform that enabled the Liberal Party to oust Mulroney's Progressive Conservative government in 1993. Once elected, the Liberals opted to keep the GST. The Progressive Conservative Party never recovered from this defeat, and it ultimately merged with the Canadian Alliance in 2003 (now known as the Conservative Party of Canada).

Although the GST is law in Canada to this day, some blame it, at least in part, for the demise of the political party that forced it into law.[28]

THE LEGACY OF THE GST IN CANADA

While the adoption of the GST seems to have hurt the Progressive Conservative Party of Brian Mulroney, in hindsight the GST seems to be a success. While it continues to be unpopular — the provincial component Harmonized Sales Tax (''HST'') was repealed in British Columbia in 2011 and replaced with a classic sales tax system — no tax is ever truly popular.[29] But representative governments adopt procedures to assure that they can raise enough revenue to support their spending priorities. The GST is not worse than other taxes:[30]

- **Rate.** At 5%, the federal GST rate is relatively low. With the provincial HST or Quebec Sales Tax (''QST'') component, it can get as high as 15%. In many European countries, VATs may reach 20% or 25%.[31]
- **Transparency.** In Canada, the prices of goods and services must be stated exclusive of the GST so the amount of tax is always stated separately.[32] This is in contrast to the previous Canadian sales tax, which was already included in the price of the product on the shelves. The effect of this tax disclosure is that Canadians are constantly aware whether they are being charged GST and what the amount of the GST is. Accordingly, it is not possible for the government to raise the GST rate without attracting attention. Some commentators see this approach as a great strength.[33] Many people think that taxes are a necessary evil, so

[23] Mindy Herzfeld, *A Better Way on Border Adjustability*, 154 Tax Notes 901 (Feb. 20, 2017).

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] An outline of the history and mechanics of the GST is included in an Appendix to this article.

[28] Richard M. Bird, *The GST/HST: Creating an Integrated Sales Tax in a Federal Country*, Rotman School of Management Working Paper No. 2115620 (Jan. 1, 2012) (''There were, of course, other issues than the GST — notably opposition to NAFTA — that produced this dire result.'').

[29] The GST also applied to a wide range of services that were not previously subject to sales taxes.

[30] This contrasts with Mexico's VAT, which is considered flawed by economists. *See, e.g.,* Richard T. Ainsworth, *Trump and VAT: NAFTA, Trade Barriers, and Retaliatory Tariffs*, 154 Tax Notes 463 (Jan. 23, 2017).

[31] G&G Article 2012.

[32] QST is stated separately from the GST. Where HST applies, only the total tax is shown.

[33] *See, e.g.,* W. Jack Millar, *Policy Forum: The Case for Main-*

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there may be a limit to how well-received any tax can be. Over the years, the public controversy about the GST has faded. This suggests that, despite the disastrous consequences of its enactment, most Canadians grudgingly accept paying the GST.

- **Prevalence of VAT.** The vast majority of economies around the world have a VAT. Accordingly, the GST does not impose on Canadian taxpayers a burden that is unusual in an international context.
- **Massive Revenue Source.** In most countries, the VAT raises more revenue than any other tax. The relatively low rate of Canada's GST limits the amount of revenue in comparison with other countries.[34]
- **Integration with Pre-Existing Taxes.** In Canada, certain provinces piggyback on the federal system, with HST and QST being collected through the same basic mechanism as the GST.[35] This has enabled some of the provinces to move from a sales tax to a consumption tax.[36] There is a commercial advantage for this as well, as businesses have a much simpler sales tax system to navigate than in the United States with its myriad state and local taxes.

CONCLUSION

When we wrote about the prospect of a VAT in the United States previously, we suggested that it was inevitable, and that the biggest barrier to U.S. VAT adoption was politics.[37] The emergence of the DBCFT last year shows that tax policymakers have taken a step toward implementing a consumption-based tax regime like a VAT. The Trump administration appears to be going ahead with plans to implement the DBCFT, which was featured in an eight-page letter from U.S. Trade Representative Stephen Vaughn describing the U.S.'s trade objectives for the imminent renegotiation of NAFTA.[38]

Canada's experience with the GST suggests that the proponents of a VAT may experience some short-term political pain, but that in the long term, a VAT can provide substantial benefits to a country's tax system. The DBCFT can be a first step in that direction in the United States. Given the prospect of WTO challenges, and the lessons learned from a longer historical view of the Canadian experience, we suggest that Washington lawmakers take a deep breath, dump the DBCFT (and the BAT), and embrace the VAT.

APPENDIX

HISTORY AND MECHANICS OF CANADA'S VAT: THE GOODS AND SERVICES TAX

Before the GST

Federal Sales Tax

Canada first adopted a federal sales tax in 1920 as a 1% ''turnover tax'' that applied to all sales except at retail. The turnover tax was replaced in 1924 by a 6% tax on sales by manufacturers (''MST''). The rate of the MST was later lowered to 1% in 1930 but, following the Great Depression, was increased to 8% in 1936, with further increases after WWII. By 1989 the rate had risen to 13.5%.[39]

The MST was considered a hidden or embedded tax, because sales prices included this tax. While many Canadians were blissfully unaware of the tax, the MST was flawed. Most importantly, it was not a true VAT. In operation the MST had cascading effects, taxed investment and exports and favored imports. The MST did not help Canada's international competitive position. This became even more evident upon adoption of the pre-NAFTA Canada-United States Free Trade Agreement in 1988.[40]

Provincial Sales Tax

The city of Montreal, in Quebec, imposed a broad sales tax (a retail sales tax (''RST'')) at the municipal level in 1935. The first provincial RST was adopted

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taining Tax-Exclusive Pricing, 58 Canadian Tax J. 77 (2010).

[34] According to the Appendix in G&G Article 2012, consumption taxes accounted for 24% of Canada's tax revenue for 2008. For other countries, the average was 32%, and ranged up to 59% for Mexico.

[35] There is separate legislation for the QST, but those rules have been essentially harmonized, and the QST requires a separate registration number. In Quebec, the provincial government administers both GST and QST.

[36] British Columbia, Manitoba, and Saskatchewan retain their ''classic'' provincial sales tax systems in addition to the federal GST. The QST in Quebec is harmonized with the GST, with the same basic rules.

[37] G&G Article 2012.

[38] Seven Chase and Adrian Morrow, *U.S. Sets Out Demands for NAFTA Talks*, The Globe and Mail (Mar. 31, 2017).

[39] Richard M. Bird, *The GST/HST: Creating an Integrated Sales Tax in a Federal Country* (Jan. 1, 2012). Rotman School of Management Working Paper No. 2115620. Available at SSRN: https://ssrn.com/abstract=2115620 or http://dx.doi.org/10.2139/ssrn.2115620, at p. 4.

[40] *Id.* at p. 5.

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by the province of Saskatchewan in 1937. Other provinces followed, adopting RSTs after WWII: from British Columbia in 1948 to Manitoba in 1967.[41] The RSTs were, like the federal MST, not VATs.

Enter the GST

Introduction and Adoption

In response to growing discontent with the MST, in 1989 the Progressive Conservative government of Brian Mulroney proposed to replace the MST[42] with the GST. In his Budget Speech of 1990, then Minister of Finance Michael H. Wilson explained the need for what he referred to as a ''sales tax reform''[43] by saying this about the MST: ''The existing tax destroys jobs. It makes our exports less competitive and favours imports over Canadian-made products.''[44]

At the time, the Liberal Party held a majority of seats in the (unelected) Senate and refused to pass the GST. In order to ensure adoption, Prime Minister Mulroney invoked a somewhat obscure constitutional provision (*Constitution Act, 1867*, s. 26),[45] which allowed him to increase temporarily the number of senators, thereby giving the Progressive Conservatives a majority in the chamber.[46] However, the Liberals launched a filibuster and delayed the legislation. Ultimately, the Liberals were outmaneuvered, and the legislation passed. The GST thus came into effect in January 1991 as part of Canada's *Excise Tax Act* (''ETA'').[47] The initial tax rate was 7%, lower than the 9% originally proposed. The new legislation also included a system whereby GST paid on supplies that are intended for consumption, use or supply in the course of commercial activities could be recovered in the form of input tax credits (''ITCs'').[48]

The GST at the SCC

The GST was subject to a series of constitutional challenges led by the province of Alberta, which ultimately made its way to the Supreme Court of Canada (''SCC'') in the *Reference re Goods and Services Tax*.[49] Alberta argued *inter alia* that the federal government did not have the constitutional power to adopt the GST. This argument turned in part on the extent to which the non-revenue-raising portions of the *ETA* (i.e., the ITC system) could be extricated from the revenue-raising portions. A majority of the SCC ultimately upheld the GST and its ITC:

> The GST Act is properly characterized as being in relation to a mode or system of taxation. Its sole purpose is to raise revenue for the federal government, and the effects produced by the Act on matters within provincial jurisdiction over property and civil rights are incidental to this purpose. The means chosen to raise revenue is a tax on value added throughout the chain of production, with input tax credits granted in respect of taxable supplies used in the production of other taxable supplies. To sever the system of input tax credits from the revenue-raising portions of the Act would fundamentally change the character of the tax, from a valueadded tax to a federal retail sales tax, and would carve out an exception to the text of s. 91(3) which the words any Mode or System of Taxation cannot reasonably bear.[50]

Interestingly, the province of Ontario had also intervened in the proceedings, arguing that the *ETA* had never been properly passed through Parliament, because the government-imposed time limits on debate (''guillotine''), invoked in the passage of the *ETA*, were *ultra vires*. The SCC declined to consider these arguments.[51]

Evolution

In 1993 the Liberal Party came to power under the leadership of Jean Chrétien, in part on their promise to abolish the GST and replace it with a different tax. Once elected, however, Prime Minister Chrétien instead tried to restructure the tax and merge it with the provincial sales taxes in each province. The restructured tax was to be called the ''Blended Sales Tax.'' but its detractors referred to it as the ''B.S. Tax.'' So the name was changed to ''Harmonized Sales Tax.'' Initially, only three Atlantic provinces (Nova Scotia, New Brunswick, and Newfoundland and Labrador) agreed to form this plan, starting in 1996, and they were joined by British Columbia and Ontario in 2010, and Prince Edward Island in 2013.[52] The HST was particularly unwelcome in British Columbia and — as a result of a local referendum in 2011 — British Co-

[41] *Id.* at p. 6.

[42] As well as the 11% federal telecommunications tax.

[43] In fact, he also promised that ''[t]here will be no new taxes in this budget,'' which is naturally how the federal government saw the GST, but not necessarily how the Canadian public viewed it.

[44] Published by the Department of Finance (Feb. 20, 1990).

[45] 30 & 31 Victoria, c. 3 (U.K.).

[46] Bird, above n. 37, at p. 7.

[47] RSC, 1985, c. E-15.

[48] *ETA*, s. 169(1).

[49] [1992] 2 SCR 445.

[50] *Id.*, p. 450.

[51] *Id.*, p. 466.

[52] The combined GST/HST (or GST/QST in Quebec) rate is now 13–15%, depending on the province.

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lumbia repealed the HST (and effectively reinstated a modified version of its previous RST, a classic sales tax system and not a VAT).[53] Manitoba and Saskatchewan still have their own RST, but the GST applies nationwide. Alberta only has GST.

The Conservative government reduced the rate of the GST to 6% in 2006 and further reduced the rate to the current 5% in 2008 in fulfillment of a campaign promise.

Mechanics of the GST

The GST generally applies to supplies of goods and services that are made in the course of a commercial activity and that are made in Canada. The *ETA* contemplates three classes of goods and services: (a) taxable supplies, (b) zero-rated supplies, and (c) exempt supplies.

It is important to remember that the GST is separate from the Canadian income tax system; thus, for example, income tax losses cannot be applied against the GST.

Taxable Supplies

Taxable supplies attract the tax of 5% each time they are sold, plus applicable HST or QST.[54] To the extent that the purchaser of a taxable supply uses that good or service in the production of other taxable supplies, it is entitled to an ITC and can recover the tax it has paid from the government. By definition, to the extent that taxable supplies are not used by the purchaser to produce other taxable supplies, they are consumed by the purchaser. To this extent, the purchaser cannot recapture the tax already paid through the ITC mechanism. Hence, the GST is collected and refunded down through each stage of the production process to the ultimate consumption of a taxable supply, at which stage the tax paid is not recoverable by the purchaser.

Most property and services supplied in or imported into Canada are subject to GST.

Zero-Rated Supplies

Zero-rated supplies do not attract any tax from the ultimate consumer.[55] In principle, zero-rated supplies attract the GST in the same way as any other taxable supply as they move through the production chain to the ultimate consumer. However, the consumer pays a tax set at 0%, and suppliers are entitled to the ITC, so that no net revenue is raised for the federal government at any stage in the production chain by the production and sale of these goods.

[53] Bird, above n. 37, at p. 8.

[54] *ETA*, s. 165(1).

[55] *ETA*, s. 165(3).

Schedule VI to the *ETA* lists the zero-rated supplies which include for example: (a) prescription drugs, (b) basic groceries, and (c) exports.

Exempt Supplies

Exempt supplies likewise do not attract any direct tax from the ultimate consumer.[56] However, in respect of exempt supplies, the vendor, while paying the GST on purchases, is not entitled to an ITC. In consequence, in the case of exempt supplies GST is paid to the federal government at the penultimate stage in the production chain rather than by the ultimate consumer (which in the end bears the economic cost in the form of a higher price, but does not have GST directly added).

Schedule V to the *ETA* lists the exempt supplies which include for example sales of used residential real estate, financial services, residential rentals, and certain health care services.

Advertising

The GST is notably different from the VATs in all other countries in that in other countries prices are shown inclusive of tax but in Canada, prices are generally shown exclusive of tax.[57] The practical effect of this is that consumers are constantly made aware of the GST when they pay for goods and the price at the cash register is markedly higher than the advertised price. The reason why Canada has ''tax-exclusive'' pricing is likely the result of a combination of constitutional provisions. Advertising of prices generally falls under provincial legislative jurisdiction,[58] so the federal government cannot require ''tax-inclusive'' pricing. At the same time, provincial sales taxes are only within provincial legislative jurisdiction to the extent that they constitute ''direct taxation within the province.''[59] ''Tax-inclusive'' pricing may thus be an *ultra vires* form of indirect taxation in that it effectively taxes the vendor instead of the purchaser who is the actual consumer of the supply.[60]

Imported Goods and Services

GST applies not only to domestic purchases but also to certain imports of goods and services.[61] GST

[56] *See generally ETA*, s. 123(1) definition of ''exempt supply.''

[57] With the exception of *inter alia* fuel pump prices and taxi meters.

[58] *Constitution Act, 1867*, s. 92(13).

[59] *Constitution Act, 1867*, s. 92(2).

[60] David M. Sherman, *Policy Forum: Tax-Included Pricing for HST — Are We There Yet?* Can. Tax J. 57 (4): 846–848.

[61] Provincial taxes such as QST and HST may also apply to imported goods and services.

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on importation of goods is imposed with reference to the *Customs Act*:[62]

> Every person who is liable under the *Customs Act* to pay duty on imported goods, or who would be so liable if the goods were subject to duty, shall pay to Her Majesty in right of Canada tax on the goods calculated at the rate of 5% on the value of the goods.[63]

There is an important distinction between GST on supplies made in Canada and that on goods imported into Canada. For supplies made in Canada, GST is calculated at the rate of 5% of the consideration paid for the goods, whereas for goods imported into Canada the calculation is based on the *value* of the goods. In the case of imported goods, the value is deemed to be equal to the total of:

(a) the value of the goods, as it would be determined under the *Customs Act* for the purpose of calculating duties imposed on the goods, and

(b) the amount of all duties and taxes, if any, payable on the goods under any law relating to customs.[64]

This means *inter alia* that any customs duties imposed are added to the value of the goods and the 5% GST is then calculated on the total value.[65]

Certain goods however, are not subject to GST when imported into Canada.[66] These are listed in Schedule VII of the ETA. Businesses that pay GST on the importation of goods into Canada in the course of making taxable supplies are able to obtain a refund as an ITC of these amounts, thus resulting in no net tax cost under these circumstances.

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[62] RSC, 1985, c. 1 (2d Supp.).

[63] *ETA*, s. 212.

[64] *ETA*, s. 215.

[65] *See* GST Memo. 300-8, *Tax on Supplies, Imported Goods*, Ottawa (Feb. 6, 1991).

[66] *ETA*, s. 213.

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