

# **An Assessment of the Impact of the Harmonized Sales Tax on Municipal Public Transit Services**

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*Prepared by London Transit  
on behalf of the Ontario Transit Industry*



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### **Overview**

Effective July 1, 2010 a Harmonized Sales Tax (HST) system will take effect in Ontario, replacing the current provincial Retail Sales Tax (RST). Under the HST, or single value-added sales tax system, the treatment of the provincial portion of the tax would, for the most part, be the same as the federal Goods and Services Tax (GST).

There are however a number of exceptions to this general rule in relation to Ontario; one of the most notable exceptions impacting public transit is the continuation of RST on insurance (notwithstanding GST does not apply) items such as:

- insured employment benefit program premiums; and
- general insurance program premiums as may be applicable (noting auto/public liability premiums are not subject to RST).

While RST continues to apply to the above expenditures, the RST paid on these expenditures would not be eligible for input tax credits or the GST/HST municipal rebates (i.e. the 78% rebate for municipalities for the provincial component of HST).

The fixed 78% rebate on the provincial component of the HST is designed to be fiscally neutral relative to the RST that municipalities currently pay; noting the objective of being fiscally neutral applies on a sector-wide basis. The sector-wide basis means that while some Ontario municipalities and/or services within a municipality would experience a net increase in costs relating to the provincial component of the HST versus the current RST, others would incur a net saving; when the sum of the two potential outcomes are considered for all municipalities collectively, the impact on average would be fiscally neutral. The neutrality is in respect to both capital and operating expenditures.

The extent to which a municipality or municipal service experiences a fiscally neutral impact is directly related to the nature, extent and timing of operating and capital expenditure by the municipality as well as to the application of the HST in terms of defining the service, that is:

- if the service provided by the municipality is a taxable supply, the municipality would generally be eligible to claim input tax credits for GST/HST paid on inputs to provide the taxable supply.
- if the service provided by the municipality is an exempt supply, the municipality would be eligible to claim the GST rebate and the 78% provincial rebate for the provincial portion of the HST paid on inputs to provide the exempt supply.

Note that eligible municipalities may use the Special Quick Method of Accounting to eliminate the need to keep track of actual GST/HST paid on purchases or to separate out purchases for use in taxable activities or exempt activities.

Municipal transit services, defined as conventional and specialized transit services, are considered exempt services, accordingly HST paid on purchases to supply municipal transit would be eligible for the 78% rebate on the provincial component of the HST, noting such services (assuming the service provider is defined as a municipality) are currently eligible and would continue to be eligible for a 100% rebate on the federal component (GST) of the HST.

As an exempt service, conventional and specialized transit fares (e.g. cash, ticket, passes) are exempt from the HST (i.e. both federal and provincial components of the HST).

While conventional and specialized transit services are considered exempt services, certain services that may be supplied by municipal public transit systems would be considered a taxable supply for the purpose of the HST, as they are currently taxed under GST. Taxable transit services include:

- charter services provided by a municipal transit authority;
- city tour services provided by a transit authority if, in addition to the transportation services, passengers get a commentary by a tour guide;
- any transit services supplied by a private company and charged to a municipality; and
- transit advertising revenue (i.e. ad space on shelters, benches and rolling stock, etc.).

For these taxable services, providers would be eligible for input tax credits for HST paid on inputs to provide these taxable services. Specific to transit advertising revenue, where same exceeds \$10 million annually, any design decisions with respect to the temporarily restricted input tax credits (including whether they apply to public service bodies such as municipalities) are expected to be addressed with the pending release of transitional rules.

A further nuance associated with the HST pertains to situations where supplies are made between municipalities. The *Excise Tax Act* provides for an exemption for a broad range of supplies made between any of the following bodies:

- a local municipality (including a city, town, village, or other form of local government or an organization designated under subsection 123(1) of the Act to be a municipality);
- the regional municipality having jurisdiction in the area encompassed by the local municipality;
- para-municipal organizations of the local municipality; and
- para-municipal organizations of the regional municipality.

The exemption does not extend to supplies between different local municipalities e.g. Toronto and York Region or to supplies between para-municipal organizations of different local municipalities.

Under the HST, there are a number of operating and capital expenditures that become taxable in terms of the provincial component of the HST versus the existing RST system. The expenditures include:

- energy, including diesel/gasoline cost, electricity and natural gas
- conferences
- membership fees
- landscaping and snow removal
- professional services – legal, audit, consulting
- service contracts – contracted public transit services, garbage collection, security, janitorial etc.

To the extent, these expenditures relate to the provision of an exempt service, the 78% rebate of the provincial component of the HST applies.

Municipalities are also expected to benefit from indirect savings in the move from RST to HST on their supplier contracts based on the premise that suppliers providing taxable supplies to municipalities will pass on their savings accrued from the proposed new tax structure.

### **Municipal Transit Eligibility for HST Rebate (100% GST and 78% Rebate on Provincial Component)**

In addition to being eligible for the 78% rebate on the provincial component of the HST paid, municipalities will continue to qualify for a full rebate for the federal portion (GST) of the HST paid.

The question of who is eligible is based upon the definition of a municipality as set out in GST/HST legislation. Application of the definition will be important to transit systems given the various structures in existence supporting the delivery of municipal public transit services, particularly specialized transit

services.

The various organizational structures include:

- departments of a municipality directly providing the service (providing all operating and capital system requirements) and/or managing, in whole or part, service delivery contracts;
- autonomous bodies directly providing the service (providing all operating and capital system requirements) and/or managing, in whole or part, service delivery contracts; and
- non-profit organizations (largely specialized transit services only).

For GST/HST purposes, a municipality means an incorporated city, town, village, metropolitan authority, township, district, county or rural municipality, or other incorporated municipal body, however designated. The designation as a municipality is critical to receiving both the 100% rebate of the federal component (GST) and the 78% rebate of the provincial component of the HST paid.

Municipalities often create autonomous boards, commissions and other local authorities to carry out certain municipal activities e.g. public transit. To qualify as a municipality, such local authorities have to meet the following conditions:

- be established by one or more municipalities, or by a province at the request of one or more municipalities; and
- be owned or controlled by one or more municipalities.

A local authority is considered owned by one or more municipalities if:

- one or more municipalities own 90% or more of the local authority's shares or capital; or
- one or more municipalities hold title to the local authority's assets or control their disposition so that in the event of a winding-up or liquidation, these assets are vested in the municipality or municipalities.

A local authority is considered controlled by one or more municipalities if:

- the municipality or municipalities must approve the local authority's operating budget and, where applicable, capital budget; and
- the municipality or municipalities appoint the majority of the members of the local authority's governing body such as the directors, governors, or commissioners.

### **Projected Fiscal Impact of HST on Municipal Public Transit Services**

Key considerations associated with assessing the fiscal impact of the new HST on municipal public transit services, as set out in this paper, are as follows:

- the operating costs for the respective Ontario public transit services as set out in Enclosures I and II represent 2007 direct operating costs for the services;
- the operating costs are for conventional and specialized services and include taxable service costs such as charters;
- the cost assessment is based solely upon application of the provincial component of the HST noting municipal services such as public transit are and will continue to receive 100% rebate on the federal component (GST) of the HST;
- assessment of the impact on capital expenditures is presented as a theoretical narrative only noting the absence of detailed capital expenditure information i.e. nature and extent of the various capital programs;
- in assessing the fiscally neutral objective of the new HST in terms of public transit, the costing model considers 2007 aggregate operating expenditure for the Ontario municipal transit services, exclusive of GO Transit;

- the principal objective of the costing model, for operating expenditure, is to determine an “order of magnitude” in terms of the expected impact of the HST on operating budgets for municipal transit services at large;
- as an exempt supply, regardless of size municipal public transit service, such services do not give rise to input tax credits and as such would not be impacted by input tax credit restrictions applying to large commercial operations in terms of certain expenditures including fuel and utility costs;
- the potential lower costs associated with suppliers passing on savings they may experience in respect of the HST to the end user is not reflected in the costing assessment; and
- the assumptions as described above and as set out in the respective enclosures are reflective of the current understanding of HST, recognizing certain of the assumptions may change once transition rules have been finalized and approved.

A secondary objective associated with constructing a costing model in respect of assessing the operating budget impact was to provide a model that was readily usable by individual systems to assess their own circumstances. The model was tested by four systems and considered reasonable in determining the expected impact.

#### *Operating Budget Impact*

The following table provides a summary of the costing assessment as set out in Enclosures I and II respecting the annual operating budget impact for both conventional and specialized municipal public transit services of the HST.

As indicated, it would appear that the objective of the HST being fiscally neutral for the municipal sector at large has been realized in respect of municipal public transit services.

#### **Summary of Operating Budget Impact – HST Ontario Municipal Public Transit Services (Amounts in 2007 Dollars)**

Description	Enclosure I Conventional	Enclosure II Specialized	Total
Total current estimated net annual RST (pre July 1, 2010)	\$ 26,861,279	\$ 1,662,677	\$ 28,523,956
Total estimated net annual provincial component of HST	21,856,813	2,303,936	24,160,749
Net increase (decrease) in provincial tax per HST	\$ (5,004,466)	\$ 641,259	(4,363,207)
<hr/>			
Total 2007 direct operating expenditure	\$ 1,993,225,638	\$ 152,680,300	\$ 2,145,905,938
Percent increase (decrease) of total 2007 expenditure	(0.25)%	0.42%	(0.20)%

While on a sector-wide basis the HST is assessed as having a cost neutral impact on municipal transit operating budgets, as envisioned in the program design, there will be systems that will have to absorb higher costs under HST than currently under the RST system. The systems most likely to fall into this category are those who outsource the delivery of public transit services, in whole or in part, and where such contract costs represent the largest portion of the system's total operating budget. An example would be York Region where contract service costs for both conventional and specialized transit services represent approximately 80% of total direct operating cost for the system resulting in a net increase in provincial related tax expenditure (i.e. provincial component of HST versus current RST) of approximately \$1.4 million or 1% (based upon 2007 dollars) of expenditure. As one would expect, an increase of 1% in operating expenditure that is solely tax driven presents a significant concern to York Region. The negative impact of the HST on municipal transit, specific to the issue of “contracted service cost”, will be the most significant in terms of specialized transit given municipalities rely on contract service for some or all of the actual delivery of the service.

The above table excludes the potential impact associated with the expectation that municipalities will

benefit from indirect savings by the move from RST to HST on their supplier contracts. The potential for such savings is based on the premise that suppliers providing taxable supplies to municipalities will pass on their savings accrued from the proposed new tax structure.

### *Capital Budget Impact*

The capital expenditure program for specialized and conventional transit services for 2007 totalled \$1.4 billion with the split being \$14 million for specialized and \$1.373 billion for conventional. Data on the make-up of expenditure (asset being acquired) and the capital investment information is not readily available; making the assessment of the impact of HST on capital expenditure problematic. What is known is that there will be an increase in the provincial taxes (i.e. HST versus RST) to be paid given the number of new items subject to HST which are currently excluded under the existing RST, the most obvious, in terms of capital, being professional services such as consulting, architectural and engineering. The increased cost of the exposure would be offset in part by the application of the 78% rebate on the provincial component of the HST as it applies to both existing and new items of expenditure under the HST.

As previously noted, the extent to which a municipality (transit system) is impacted (negatively or positively) will be related directly to the nature and extent of capital expenditure incurred. The following tables provide a summary analysis of the impact of the HST on two types of capital investment i.e. facility construction and purchase of rolling stock. The two projects represent the most common and significant expenditures incurred by transit systems.

#### **Summary Impact of HST – Facility Construction Projects**

Description	Base Cost	Current RST	HST Impact		
			Provincial Component	78% Rebate	Net New Prov Tax
Architectural and engineering services	\$ 200,000	N/A	\$ 16,000	(\$12,480)	\$ 3,520
Electrical, HVAC services	100,000	N/A	8,000	(6,240)	1,760
Construction (structure)	600,000	N/A	48,000	(37,440)	10,560
Landscaping/paving	100,000	N/A	8,000	(6,240)	1,760
<b>Total</b>	<b>\$ 1,000,000</b>	<b>\$ -</b>	<b>\$ 80,000</b>	<b>\$(62,400)</b>	<b>\$ 17,600</b>
<b>Amount and percent increase (decrease) in expenditure</b>				<b>\$ 17,600</b>	<b>1.8%</b>

As indicated, in terms of facility construction projects, one can expect that for every \$1 million in capital costs the HST will add approximately 2% to the cost of the project in comparison to the current RST system, noting the 2% additional costs exclude potential cost savings associated with suppliers passing on savings, via lower bids as a result of lower cost they may experience in respect to the HST. Such savings may be difficult to isolate given the traditional competitive bidding process that is followed by municipalities.

While one can anticipate higher costs for facility construction projects, the opposite holds true for the acquisition of rolling stock as evident in the following table. As indicated the HST produces an approximate saving of 6% per vehicle purchased.

#### **Summary Impact of HST – Rolling Stock Purchase**

Description	Base Cost	Current RST	HST Impact		
			Provincial Component	78% Rebate	Net New Prov Tax
Purchase price - 40' bus	\$ 430,000	\$ 34,400	\$ 34,400	\$(26,832)	\$ 7,568
Ancillary equipment - radio, fareboxes	40,000	3,200	3,200	(2,496)	704
<b>Total</b>	<b>\$ 470,000</b>	<b>\$ 37,600</b>	<b>\$ 37,600</b>	<b>\$(29,328)</b>	<b>\$ 8,272</b>
<b>Amount and percent increase (decrease) in expenditure</b>				<b>\$(29,328)</b>	<b>(5.8)%</b>

**Conclusion**

Based upon the assumptions set out in this paper, including those in the attached enclosures, the Provincial government's objective to have the move from RST to HST be fiscally neutral on a sector-wide basis for municipalities has been accomplished specific to the operating costs for municipal transit services. While, on aggregate, fiscal neutrality is expected to be obtained, there would be certain systems whose costs would increase while others would see a decrease. The impact on individual systems would be subject to size, the nature of expenditures and whether or not the organizational structure delivering the service is considered a municipality.

The costing model and assumptions should be revisited once all rules/regulations (including transitional rules) respecting the HST have been finalized.

In terms of capital expenditure, given the lack of detailed expenditure information the issue of fiscal neutrality cannot be assessed. However, specific to the purchase of rolling stock (fleet), which tends to be most consistent and significant capital investment by transit systems, the HST will result on average in an estimated 6% reduction in capital cost of a bus.

The operating costing model and the illustrations of the potential impact on capital programs exclude the potential favourable impact on costs associated with the expectation that municipalities will benefit from indirect savings by the move from RST to HST on supplier contracts. The potential for such savings is based on the premise that suppliers providing taxable supplies to municipalities will pass on their savings accrued from the proposed new tax structure.

**Enclosures**

- I - Costing Model – Ontario Conventional Transit Services
- II – Costing Model – Ontario Specialized Transit Services

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