

Tax Pyramiding in Canada: A Growing Concern

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INTRODUCTION

The Canadian Home Builders' Association (CHBA) approached Altus Group Economic Consulting to examine the issue of tax pyramiding in Canada. Tax pyramiding is said to exist when one tax is embedded in the price of a good and subsequent taxes are applied to that price. It is a 'tax on tax'.

This report examines some existing tax on tax practices in Canada and argues that those practices are neither ethical nor efficient, based on the principles of good taxation. This study uses the recently-proposed Single Sales Tax (SST) in Ontario as an example to illustrate the effect of such tax practices.

KEY ISSUES

Tax on tax occurs when a good or service is taxed by one order of government and then further taxes are applied to the after tax value of that good or service by other orders of government. Tax on tax schemes score poorly in terms of principles of good taxation, including equity and fairness, simplicity, certainty, stability, accountability, transparency, visibility, and neutrality.

Government-imposed charges embedded into the prices of new homes, which are then subject to sales taxes, is a form of tax on tax that is of growing concern. Over the past decade, the amount of government-imposed charges on new housing has been rising sharply, making the tax on tax issue more acute.

Using the proposed Ontario Single Sales Tax (SST) and a typical home in Mississauga, Ontario, as an example, some new homebuyers would pay, potentially, sales taxes at marginal rates of over 21% on various government-imposed charges. It is neither ethical nor fair to ask taxpayers to pay a 21% tax on the value of taxes already levied.

When municipalities impose DCCs on new homebuyers they effectively transfer public-sector debt into household mortgages, which is a serious concern from a public policy perspective. The over 21% SST tax (in the Ontario case) severely exacerbates this situation. The tax on tax nature of this system means that municipalities are not accountable for the full impact on homebuyers from their tax policy decisions.

On top of this, as municipalities raise DCCs, more and more homebuyers lose their eligibility for a full tax rebate.

BACKGROUND

There is a strong possibility for tax on tax to occur, whenever various orders of government levy taxes on the same good or service. One order of government's tax levied on top of another order's tax results in a tax on tax. This practice is widespread across Canada, for example:

- The provincial sales tax in Quebec and PEI is applied to the retail selling price of taxable goods and services, which include the federal Goods and Services Tax (GST);
- With the exception of Alberta, all provinces apply sales taxes to the retail price of gasoline, which already includes federal excise taxes. In fact, the GST on gasoline is a tax applied to the federal government's own excise tax;
- New vehicles sold in Canada are subject to GST and PST. Those taxes apply to the final retail price of the vehicles, which contains various government fees and charges (for example, the Tax for Fuel Conservation in Ontario); and
- The federal government and some provinces levy sales taxes on the price of new homes, which encompass various municipal fees and charges, such as development cost charges (DCCs), land dedications, infrastructure charges, development application and processing fees and building permit fees.

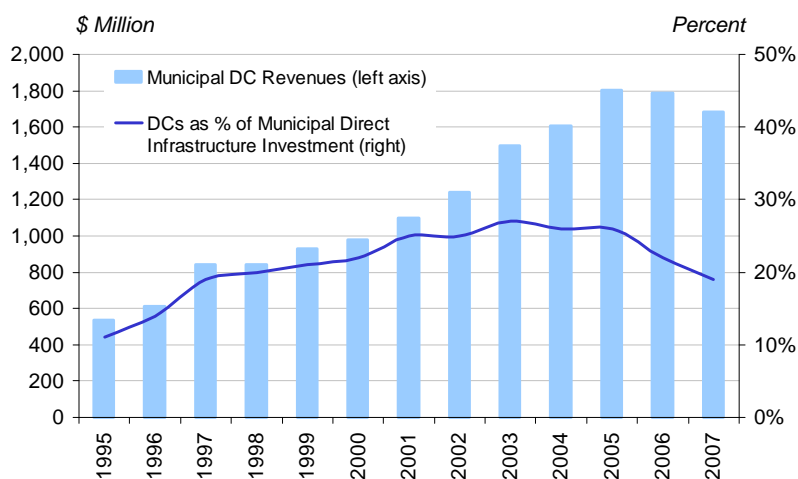
In Canada, the GST/HST is applied to the final retail price of new homes, which includes various municipal charges. To this effect, the GST/HST is calculated on top of other taxes, such as municipal DCCs, warranty fees, etc., all resulting in tax on tax. The amount of government levies and fees embedded in the final retail price of new homes has been rising sharply over the past decade, which is making this problem more acute.

Using development charges as an example, until recently, local municipalities have relied increasingly on development charges as a source of infrastructure financing – the share of development charges as a source of funds for basic urban infrastructure increased from about 10% in 1995 to just below 20% in 2007. Total development charges collected by municipalities almost tripled

during the period of 1995-2007. Development charges levied by municipalities on new homes increased from less than \$600 million in 1995 to over \$1.8 billion in 2005. Since 2005, there has been some moderation in both the amount of DCC revenue to municipalities both in dollar terms and as a proportion of their infrastructure investment (Figure 1).

Figure 1

Municipal Development Charge Revenue and Direct Investment in Infrastructure, 1995-2007



Source: Altus Group Economic Consulting based on revised data from Statistics Canada, Cansim (385-0024 and 031-0002)

The increased reliance on DCCs by municipalities as a means of financing infrastructure has left them vulnerable to a funding source that is very cyclical. The reliance of the federal government and some provincial governments on GST/HST revenue levied on top of this cyclical tax has also left them increasingly vulnerable.

Altus Group Economic Consulting prepared a report for CHBA in 2009: *“The Time Is Right – Alternatives to Development Charges”*, which found that it is unfair and inefficient to rely on development charges to finance basic urban infrastructure investment:

- **Development charges are unfair:** It is unfair to ask new home buyers to pay for basic urban infrastructure that delivers benefits to the entire community and across several generations;
- **Development charges transfer debt from the public sector to the private sector:** Ideally, municipalities should borrow to finance

growth-related basic urban infrastructure, because they can do so through debt instruments that match future revenues related to that infrastructure with future debt service requirements. By relying on development charges to finance infrastructure, municipalities shift this funding burden to home buyers, who are likely to finance much of this obligation with a personal mortgage. Effectively, a growing portion of the public capital stock in Canada is being financed privately through personal mortgages;

- **Development charges distort real estate markets:** The increasing financial responsibility of funding a municipality's basic urban infrastructure for new home buyers places upward pressure on housing prices and distorts developers' location decisions for new housing developments; and
- **Development charges create a "revenue trap" for municipalities:** By increasing their reliance on development charges as a source of revenue, municipalities have set themselves up for the downside of a cyclical revenue source; development charge revenue will decline as the housing sector slows down.

As the sales tax is levied on the final retail price of new homes, rising municipal fees and charges on new homes amplify the economic distortions associated with the DCCs – it is both unfair and economically inefficient.

PRINCIPLES OF GOOD TAXATION

Governments predominantly raise revenues to finance their requirements through taxes. Taxes fund the running of government operations, social programs and infrastructure investment. Taxes can generally be levied on wealth (such as property), income, consumption, and estate (i.e. inheritance). There are flat taxes (excise tax) and ad valorem taxes (including regressive, progressive or constant taxes). The ultimate purpose for taxation is to finance government activities.

The following are some commonly accepted principles for good taxation:

- **Equity and Fairness:** The burden of taxation should be distributed among taxpayers and the system should treat similar taxpayers similarly. Taxation should be viewed as ethical and fundamentally sound;

- **Simplicity:** The tax system should be as simple as possible so that taxpayers can understand the rules and easily comply, and tax administrators can verify compliance in a cost-effective manner. A complex tax system, which contains a range of rates and exemptions, increases the possibility of errors being made by taxpayers and administrators. It will be more costly to administer;
- **Accountability:** An effective tax system ensures that there is a strong degree of accountability to those bearing the tax. Governments levying a tax should make clear the full impact of the tax and be accountable for that impact;
- **Certainty:** Taxpayers should have the ability to be certain about the amount of taxes they have to pay. The tax system should introduce a degree of certainty in order that taxpayers can budget appropriately;
- **Stable Tax Base:** A good tax system should have a relatively stable tax base over time, so that tax revenue is reliable. Governments prefer fairly stable and predictable tax revenue since a majority of government spending (income transfers, social programs and debt servicing) is relatively stable. Stable tax bases, resulting in stable tax revenue, help governments weather short-term fluctuations in the economy and keep their fiscal houses in order;
- **Transparency and Visibility:** Taxpayers should know the extent of a tax, how and when it is to be imposed, and ideally where the money is to be used. In a good tax system, informed taxpayers easily understand how taxes are calculated, collected and complied with. Taxpayers should be able to understand the tax base, the tax rate, the relevant exemptions and the ultimate use of the funds; and
- **Neutrality:** It is almost impossible for a tax to avoid completely distortions in the economy. A good tax system should minimize effects on taxpayers' economic decisions. The tax system should interfere as little as possible with individual decisions made in the market place.

ISSUES WITH TAX ON TAX PYRAMIDING

Governments should avoid tax systems that lead to tax on tax, because they score poorly among tax principles:

- **Tax on tax is not fair:** Taxes should be levied on property, income, consumption, and estate (i.e. inheritance). However, tax on tax is a tax levied on a form of liability (i.e. taxes and government fees are seen as a liability for private citizens). Levying a tax on a liability runs contrary to the principle that tax should only be levied on wealth not obligations. Tax on tax is neither ethical nor fundamentally sound;
- **Tax on tax fundamentally erodes tax transparency:** Tax on tax introduces another layer of tax on products and services. Additional levels of tax on a product or service, particularly when they leverage off one another, make it more difficult for taxpayers to estimate the final tax bill;
- **Tax on tax destroys accountability.** A government levying a tax should be accountable to those bearing the tax for the impact. In the case of a tax on tax, the impact of a change in tax rates at one level (the first tax) will have an impact through the second tax. If a municipal government, for example, raises a development charge, they are not fully accountable for the impact on the homeowner whose tax liability changes not just by the amount of the charge, but also by the provincial and federal taxes that are levied on top of the charge;
- **Tax on tax leads to an unstable tax base:** Compared to other taxes, tax on tax has an extra tax base – taxes and fees from another level of government. This introduces another uncertain element into tax revenue. Through economic cycles, not only could underlying taxable wealth fluctuate (i.e. incomes, retail sales and real estate property values move with economic cycles), but also the taxes and fees from other orders of government can change as governments attempt to stabilize the economy.

Sales tax on new homes is an example of tax on tax introducing instability. When the economy is suffering, local municipalities have strong incentives to freeze or reduce DCCs to stimulate construction activity and facilitate economic growth. The reduction in government charges and fees cut into sales tax revenues.

Tax on tax schemes also potentially lead to one order of government seeing its revenue base being strongly affected by tax policy decisions

by other orders of government. The Provinces of Quebec and PEI (which levy PST on the post-GST price of eligible goods or services) both lost sales tax revenue when the federal government reduced the rate of GST from 7% to 5%, thus reducing the “base” for their provincial sales taxes. In general, tax on tax has a relatively unstable tax base and its total tax revenue has a greater fluctuation through the economic cycle; and

- **Tax on tax significantly distorts market functionality:** Tax schemes have the potential to influence consumption and production decisions of the private sector, especially, when there is a laddered tax rate mechanism (or tax rebate structure) embedded in the scheme. This is illustrated in detail by the example of the proposed Ontario Single Sales Tax – and its high marginal tax rates – in the next section.

VALUE ADDED TAXES, LIKE THE GST/HST, COMBINED WITH MUNICIPAL DCCS LEAD TO TAX-ON-TAX PYRAMIDING

The Province of Ontario proposes to move Ontario’s sales tax to a value added tax and harmonize it with the federal Goods and Services Tax (GST). The new combined tax would be known as the Single Sales Tax (SST). The new Ontario SST is proposed to replace two taxes, the federal GST and the provincial retail sales tax (RST), which is generally applied to goods, but not to services.

In addition to Ontario’s proposal, several provinces already apply sales taxes to a broad array of goods and services, including New Brunswick, Nova Scotia and Newfoundland and Labrador (which each have a Harmonized Sales Tax) and Quebec and P.E.I. (which each impose a provincial sales tax on the post-GST price of eligible goods and services.)

The proposed SST (including both the federal and provincial components of the tax) is essentially a tax on tax: it is levied on the final retail price of new homes, which includes various municipal charges. Although there is a rebate structure in the tax system, the rebate mechanism results in high “marginal tax rates” for middle-priced homes (Figure 2):

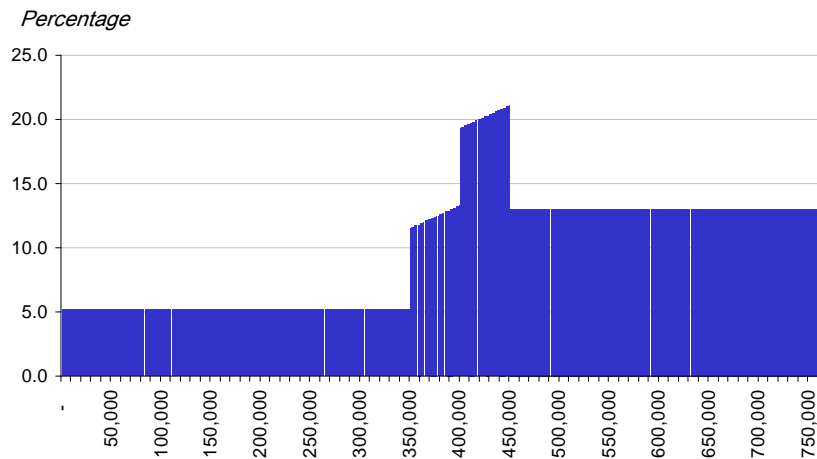
- The marginal tax rate measures the effective tax rate (net of rebates) on the “last dollar” of a purchase. The illustration in Figure 2 shows

that for every additional \$1,000 increase in home value, the marginal SST tax rate for certain homes reaches as high as 21.1%; and

- For example, a buyer considering a \$400,000 home would face a SST tax liability of some \$24,400 after applicable rebates. If they consider a \$450,000 home (say for example, they consider upgrades offered by the builder) their tax liability rises to \$34,500 – a rise in tax of some \$10,100. That home buyer is effectively paying over 21% tax on the last \$50,000 of the home.

Figure 2

Marginal Tax: The Additional Ontario Single Sales Tax (SST) Revenue from the Last \$1,000 of a Tax Base



Source: Altus Group Economic Consulting

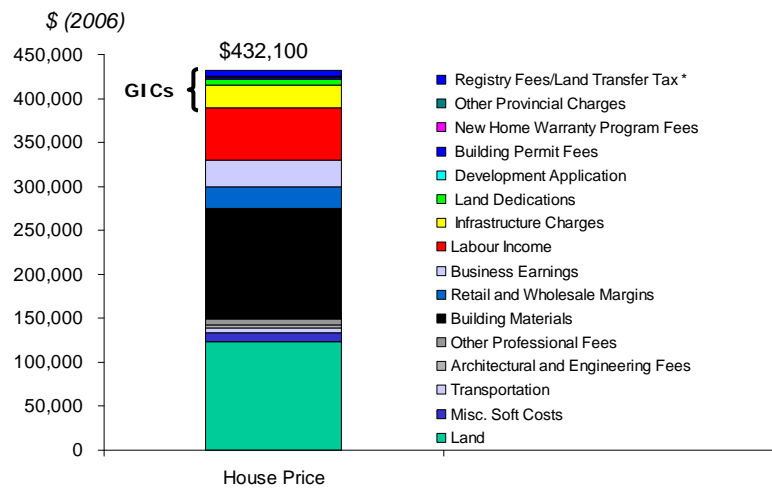
Ontario new home buyers already face a number of taxes. Many of the taxes and levies are built into the price of the home before provincial retail/harmonized taxation is applied. These include development charges, land dedications, levies, fees, etc. All of these taxes, charges and fees add to the ultimate price of the home to the buyer, and contribute to the additional SST payable.

To this effect, the proposed SST worsens the issue of tax on tax on new housing. Using a typical single-detached home in Mississauga, as an example, this report examines the effect of the SST on new housing cost:

- Based on 2006 statistics, a typical single-detached home in Mississauga should be valued around \$390,000 before development charges and other municipal levies (Figure 3)¹;
- Various government charges and fees levied on the new home sums up to over \$42,000, pushing up the final cost of the new home, prior to SST, to over \$432,000. SST is levied on a final price of \$425,000 (the estimated \$7,100 in registry fees and land transfer tax is not included in the price used to calculate SST);

Figure 3

Example of Tax-on-tax Pyramiding: A Single-Detached Home in Mississauga



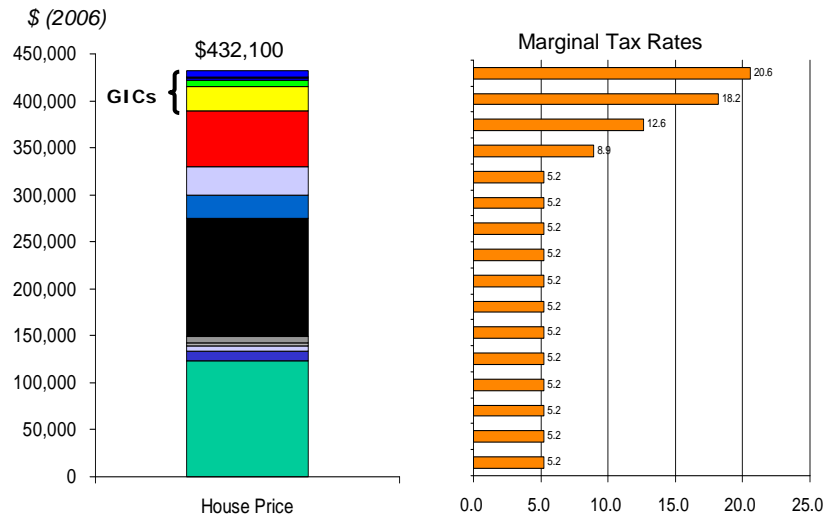
* Registry fees and the LTT not subject to SST
 Source: Altus Group Economic Consulting based on data from Statistics Canada, CMHC

- Because of the rebate structure in the proposed SST, the marginal tax rate for taxes on top of the existing taxes reaches 21% (Figure 4);
- Effectively, for certain homes in Mississauga, the municipality levies a development charge, and the home buyer will have to pay over 21% tax on top of the DCC's value;
- While government charges and fees, in total, account for some 10% of the final retail price of the home, taxes levied on those fees can represent as much as 22% of the total SST paid on a new home in this example (Figure 5);

¹ CMHC, *Government-Imposed Charges On New Housing in Canada*, January 2009, and Input-Output model from Statistics Canada.

Figure 4

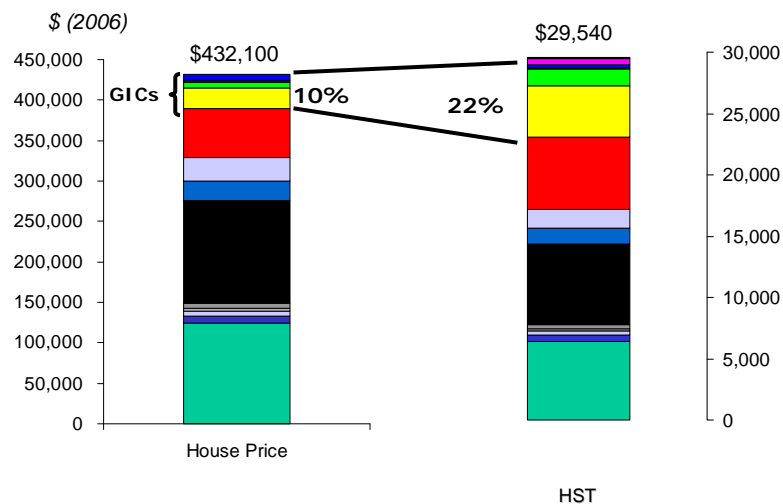
Example of Tax-on-tax Pyramiding: A Single-Detached Home in Mississauga



Source: Altus Group Economic Consulting based on data from Statistics Canada, CMHC

Figure 5

Tax-on-Tax Pyramiding



Source: Altus Group Economic Consulting based on data from Statistics Canada, CMHC

- It is unfair and questionable for a housing taxation system to impose taxes on top of other taxes onto new home buyers;

- As a tax on tax scheme, the proposed SST has an unstable tax base – small changes in DCCs by municipalities could result in large fluctuations in SST revenue for both the federal and provincial governments; and
- The proposed SST is not transparent – few new home buyers understand the magnitude of the tax base and know that the SST is levied on various municipal fees and charges.

This example shows clearly that the tax on tax nature of DCCs erodes the accountability of the tax system. When a municipality raises its DCCs, the province and the federal government become large beneficiaries in terms of additional SST tax revenue. In this way, the municipality is not fully accountable for their tax policy decision. This lack of accountability is exacerbated, as in the example, when a municipal decision to impose DCCs on a homebuyer causes that homebuyer to lose eligibility for a full SST rebate.

Often municipal DCCs are levied on homebuyers to offset costs associated with municipal infrastructure. Effectively, rather than the municipality borrowing for infrastructure (and paying off over time through the tax base) municipalities that levy DCCs pass this obligation on to homebuyers who ultimately finance them through personal mortgages. The tax on tax nature of this arrangement means not only is the debt burden transferred from the public sector to the household sector, but the amount of that debt burden on the household sector is ratcheted up by the up to 21% tax on tax the homebuyer pays on top of the municipal infrastructure charges.

In an era of increasing concerns over the size of the household debt burden, the fact that municipalities are transferring their infrastructure debts to the household sector to an increasing degree is a serious concern. The fact that the Province of Ontario and the Federal Government propose to tax those transfers by up to 21% - ever increasing the potential debt burden on households – makes it all the more concerning.

CONCLUSION

CHBA approached Altus Group Economic Consulting to examine the issue of tax pyramiding in Canada. Tax pyramiding is said to exist when one tax is embedded in the price of a good and subsequent taxes are applied to that price. This practice exists in various forms in Canada.

Government-imposed charges embedded into the prices of new homes, which are then subject to sales taxes such as Ontario's proposed Single Sales Tax (SST), is a form of tax on tax that is of growing concern. Over the past decade, the amount of government-imposed charges on new housing has been rising sharply, making the tax on tax issue more acute.

Tax on tax schemes score poorly in terms of principles of good taxation, including equity and fairness, simplicity, accountability, certainty, stability, transparency, visibility, and neutrality. Using the proposed Ontario SST and a typical home in Mississauga, Ontario, as an example, some new homebuyers would pay, potentially, marginal tax rates of over 21% on various government-imposed charges. It is neither ethical nor fair to ask taxpayers to pay a 21% tax on top of taxes already levied.

When municipalities impose DCCs on new homebuyers they effectively transfer public-sector debt into household mortgages, which is troublesome from a public policy perspective. The up to 21% SST tax (in the Ontario case) severely exacerbates this troublesome situation. The tax on tax nature of this system means that municipalities are not accountable for the full impact on homebuyers from their tax policy decisions.