Policy Forum: Canada’s GST and Financial Services—Where Are We Now and Where Could We Be?

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PRÉCIS
L’assujettissement des services financiers à la taxe sur la valeur ajoutée (TVA)/taxe sur les produits et services (TPS) demeure la question de politique de fiscalité indirecte la plus épineuse de toutes. Comme la plupart des pays qui administrent une TVA/TPS, le Canada exonère la plupart des services financiers. L’auteur revoit les contextes économique et légal de ce traitement ainsi que les problèmes qu’ils soulèvent. Il conclut que le traitement actuel est hautement insatisfaisant. Après avoir revu l’expérience internationale à la lumière de celle du Canada, il conclut que le modèle sud-africain serait le meilleur système de remplacement pour le Canada.

ABSTRACT
The treatment of financial services remains the last unconquered frontier in the design of a value-added tax (VAT)/goods and services tax (GST). Like the vast majority of its VAT/GST peers, Canada exempts most financial services under the GST. The author reviews the legal landscape surrounding this treatment as well as the economic issues it raises. He finds that the current treatment is deeply unsatisfactory from many angles. He then reviews the international experience with the Canadian experience in mind and concludes that the South African model would be the best alternative for Canada.

KEYWORDS: GST ■ EXEMPTIONS ■ FINANCIAL SERVICES

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INTRODUCTION

The incorporation of financial services into the base of a value-added tax (VAT) operated on a transaction-by-transaction basis using the invoice-credit method remains the last unconquered frontier for this type of tax. The inability to do all of these things at once in a technically correct and practical way has frustrated policy makers, academics, and practitioners in many countries for a long time. Many fine surveys have covered the field over the years. While the abundant survey work has narrowed down the outstanding issues and uncovered additional technical issues, it has come to a frustrating conclusion: either more work is needed, or more action is needed. The frustration does not appear to have been as palpable in the case of Canada’s goods and services tax (GST)/harmonized sales tax (HST) as it has in other contexts, such as the European Union, Australia, New Zealand, Singapore, and South Africa. There has been relatively little policy work on this issue in the public domain in Canada.

This article will not throw another survey into the mix or take an in-depth look at the experience accumulated outside Canada in attempting to improve the situation. Instead, it focuses on the current situation with the GST in respect of financial services in Canada. It begins with an account of where we are now from both legal and economic perspectives, and then continues with a discussion of what could be done to improve the situation in Canada in light of the Canadian institutional context and existing constraints. The article is not concerned about a policy response to the recent financial crisis: the focus rests entirely on GST design and practice. I recommend that policy options be considered following the principles of the Department of Finance’s recent examination of the GST/HST treatment of financial

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services. I close by expressing my preference for the adoption of the South African model in Canada.

WHERE ARE WE NOW?

The vast majority of financial services are exempt from GST/HST when supplied in Canada. This has been the case since the inception of the GST in 1991. The exempt treatment was maintained when the system was expanded to three provinces with the first round of HST harmonization agreements in 1996 and in subsequent HST adoptions in British Columbia, Ontario, and Prince Edward Island. The second round of harmonization (after the first in 1992) between the Quebec sales tax (QST) and the GST expanded the exempt treatment further: the government of Quebec agreed to mirror under its QST legislation the rules for the treatment of financial services and institutions under the GST/HST legislation. In effect, this meant that Quebec has abandoned its unique—and in some circles admired—policy of zero-rating financial services in favour of the exemption policy in effect under the GST/HST. In what follows, I examine the existing system from its legal and economic angles.

The Legal Landscape

Statutory authority resides in the ETA. The sections that are most directly relevant to this article include the following:

- Subsection 123(1) provides definitions of financial services, financial instrument, and other related terms such as insurance policy, money, and so on.
- Section 139 provides for financial services in a mixed supply.
- Section 141.02 provides for input tax credit apportionment rules for financial institutions.
- Section 149 defines financial institutions.
- Section 150 provides for the election for financial institutions to deem supplies within a closely related group to be exempt.
- Schedule V, part VIII contains the exemption provision for the financial services that are not zero-rated.
- Schedule VI, part IX contains the zero-rating provisions for supplies of financial services made to non-residents.

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2 Subsection 123(1) and schedule V of the Excise Tax Act, RSC 1985, c. E-15, as amended (herein referred to as “the ETA”). Unless otherwise stated, statutory references in this article are to the ETA.

3 Canada and Quebec, Comprehensive Integrated Tax Collection Agreement Between the Government of Canada and the Government of Quebec (Ottawa: Department of Finance, 2012).

4 ETA, supra note 2.

The aforementioned portions of the ETA amount to about 45 pages of annotated law, half of which belongs to section 141.02. Those sections are supported by GST/HST regulations. The financial services and financial institutions regulations\(^6\) and the input tax credit allocation methods regulations\(^7\) (which refer to banks, insurers, and securities dealers) are the most directly relevant. Together, they amount to about four annotated pages.

The ETA and GST/HST regulations are supported by a large body of written guidance whose purpose is to help GST registrants and taxpayers comply with their obligations, without having the force of law. This written guidance comprises GST/HST memorandums, technical information bulletins, policy statements, info sheets, and GST/HST notices.\(^8\) Memorandums provide detailed guidance on the interpretation of the law and administrative policy. The chapter on “Special Sectors: Financial Institutions” is 77 pages long.\(^9\) Technical information bulletins are issued to announce changes to administrative policy. The older ones have sometimes been incorporated into memorandums, but the new ones stand until the memorandums undergo revision. A handful of important technical information bulletins concerning financial services and institutions has been issued since 2011. Policy statements consist of technical summaries of administrative policies and simple rulings for use by the Canada Revenue Agency (CRA). Those often deal with narrow issues but are of very limited interest for the treatment of financial services. Info sheets offer guidance in less technical ways than the other publications. Again, with limited exceptions, they are of limited interest for the treatment of financial services.

Court cases, interpretations, and rulings complete the legal picture. There have been a number of important court cases involving GST and financial services, especially in the last decade. Since space restrictions preclude a discussion of those cases and their substantive issues, I will only offer a few remarks. Many cases involve boundary (scope) and definitional issues.\(^10\) One particular problem seems to concern the notion of “arranging for” a financial service in relation to the exemption of financial services.\(^11\) Firth and McKenzie illustrate the idea and its convolutions:

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\(^6\) Financial Services and Financial Institutions (GST/HST) Regulations, SOR/91-26, as amended.

\(^7\) Input Tax Credit Allocation Methods (GST/HST) Regulations, SC 2010, c. 12, section 91.

\(^8\) References are to David M. Sherman, ed., 2015 GST Memoranda, Bulletins, Policies & Info Sheets, 22d ed. (Toronto: Carswell, 2015).


\(^10\) Interested readers may begin by identifying cases using good secondary sources such as Danny Cisterna and Maria Scullion, “Wolf of Bay Street or Wolf of Main Street? ‘Arranging for’ 4 Years Later,” in 2014 CPA Canada Commodity Tax Symposium (Toronto: Chartered Professional Accountants of Canada, 2014), paper 3; and Firth and McKenzie, supra note 1, at 133.

beautifully when they refer to “legislative changes in 2010 relating to the narrowing of the exemption of arranging for services related to financial services.”

Typically, services recently excluded from the scope of the exemption include services of managing credit and services that are preparatory to the provision or potential provision of a service. Examples include credit checks, the creation and maintenance of credit records, the collection and provision of information, promotion, and market research. Interpretations and rulings on the “arranging for” issue are not publicly available on the CRA website, but some are available from secondary sources.

Two other major issues that have been identified with financial services include the treatment of imported services (especially the issue of “loading” or adding expenses to arrive at the value of consideration for a supply) and retroactive amendments. The cumulative result of those issues appears simple: more GST revenue from inputs purchased by financial institutions and intermediaries (FIIs). A perception exists that a resolution under the current system is not anywhere in sight.

Taken in one block, the legal and regulatory architecture supporting the GST treatment of financial services is extremely complex and has wide ramifications. The system is supported by numerous rules with numerous exclusions and exceptions. In light of the numerous business transactions between FIIs and other sectors that make taxable supplies for the benefit of those FIIs, the volume of rules and exceptions reflects a contamination effect that stems from two opposing forces: on the one hand, the wish to enforce a broad-based exemption of financial services, and on the other, the wish to maintain the integrity of the GST system by taxing as many goods and services as possible outside the financial sector. The evolution of the system suggests some policy concern for the impact of the system on prices, the way certain transactions are conducted, and their result. Could this be evidence of central planning thinking? I cannot escape the impression of the profound absurdity of the notion that such a complex system is meant to support an actual exemption of financial services as opposed to their taxation.

I would surmise that the system also gives rise to large collection costs (the sum of taxpayer compliance costs and tax administration costs). Yet it could be construed as a very sophisticated mechanism to raise GST revenue from the financial sector by taxing its business inputs. This begs the question “Why not tax inputs (such as payroll and/or assets) directly?” That would be very distorting economically, but far simpler and cheaper in terms of collection costs.

12 Firth and McKenzie, supra note 1, at 158.
13 Cisterna and Scullion, supra note 10, at 47.
14 Firth and McKenzie, supra note 1.
16 For a good general discussion, see Cisterna and Scullion, supra note 10. For a discussion focused on a specific set of services, see Simon Thang, “Financial Loans Intermediation Services: Canada,” in Robert F. van Brederode and Richard Krever, eds., VAT and Financial Services: Comparative Law and Economic Perspectives (Singapore: Springer Science + Business Media, 2016).
To conclude, the system remains inconsistent with the ultimate objective of a broad-based VAT/GST, namely, to tax all final consumption. Intermediate input consumption by FIIs is a poor proxy for final consumption of their services. Economists would insist that a VAT/GST should tax final consumption in a way that does not distort input decisions. The broad exemption of financial services fails to achieve either objective.

An Economic Perspective

Surveys of VAT and financial services usually repeat the well-known mantra about the distortions caused by a broad exemption: that it creates incentives to (1) self-supply inputs in order to avoid irrecoverable VAT/GST on purchased inputs, and (2) import financial services since they should be exported by an outside jurisdiction free of VAT/GST (zero-rated). Another general statement about the effects of a broad exemption goes as follows: it results in the overtaxation of financial services used by businesses and FIIs, and in the undertaxation of financial services used by consumers and unregistered businesses. The former point results from the fact that FIIs bear VAT/GST on inputs. The latter point stems from the fact that the last piece of value added, from the seller of services to the final consumer—which largely stems from the labour, creativity, and ingenuity of the financial service provider—remains untaxed.

The economic damage from those distortions is always presumed but never measured or quantified. The incentive to self-supply and the tax burden on inputs are presumed to be serious, although the 5 percent GST would be much less of a concern than any EU member state’s VAT. Of course, I am not mentioning the provincial component of HST, which makes the GST/HST more burdensome than first appears. One should also note that firms that operate in oligopolistic market structures such as Canada’s banking and insurance industries may be well positioned to shift the input VAT/GST that they bear forward to final consumers in some product and customer segments. In any event, after over 20 years of GST, the inefficiencies in input use are priced into the system, so to speak. In other words, they are already capitalized in margins and fees.

The extent of undertaxation of final consumption is also tricky to assess since it depends on market structure, as well as on price elasticities of demand and supply, and cross-price and income elasticities of demand. Those variables are difficult to measure accurately and comprehensively in any case. Moreover, obtaining estimates would require access to confidential information that no financial institution or intermediary would be willing to share for competitive reasons. It is important to remember that we are talking about big numbers in terms of potential additional GST base and even bigger ones if we include the provincial component of the HST. To give an idea, GST revenues amounted to $31.349 billion during fiscal year 2014-2015. In 2014, gross domestic product (GDP) at basic prices in finance and insurance

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amounted to $110.228 billion, or 6.75 percent of GDP (all figures are expressed in constant dollars for 2007). Credit intermediation and monetary authorities accounted for 58.1 percent of the finance and insurance total, while insurance carriers and related activities accounted for 24.5 percent.

Another important unknown number that should command more attention is collection costs. It is inconceivable that such an extraordinarily complex system would not impose large collection costs. For taxpayers, compliance costs have a significant fixed component, so complexity penalizes smaller institutions and intermediaries more. The CRA might worry too, in particular about the resources it devotes to the financial sector. To be complete, all costs related to litigation should be added to collection costs to arrive at collection and litigation costs. Although they are almost never mentioned, those costs are much easier to measure than the economic distortions noted earlier. The CRA and larger FIIs should have internal estimates of administrative and compliance costs, respectively.

Next, there is a potential political cost to the exemption to consider. For the sake of the debate, let’s label the exemption “taxation by exemption,” as is done by some commentators. It is a wonderfully clear phrase. While it is obvious that taxation by exemption is contrary to the logic and purpose of VAT/GST, it is perhaps less obvious that taxation by exemption is a clever but fundamentally anti-democratic revenue tool. It is anti-democratic because most consumers lack sufficient understanding of VAT/GST and especially the distinction between zero-rating (relatively clear) and exemption (apparently clear). This discussion relies on issues and contrasts in arguments similar to those expressed in a debate in this journal on GST-inclusive versus GST-exclusive pricing. In contrast to the health, education, and cultural sectors, in the case of financial services arguments that the exemption is justified on the basis that it applies to merit goods are of no help. As will be shown below, some countries have found ways around the “hard to tax” argument that has been nailed on financial services for a long time.

A separate but related political cost concerns perceptions of inequity. The demand for financial services by households (business-to-consumer, or B2C services) is almost certainly income-elastic in the sense that the quantity demanded rises with household income. Given that the exemption takes final consumption out of the GST base, it confers a larger absolute benefit as household income increases, with

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20 Cisterna and Scullion, supra note 10, at 14.
the highest benefit going to high-income households. This effect is amplified by the larger shares of expenditures on financial services for high-income households. In this sense, the exemption of financial services is regressive and inequitable. A better understanding of the effect of the exemption would further intensify the existing public perception that the GST is regressive. Strictly speaking, the role of the GST should be to raise revenue efficiently without explicit consideration for vertical equity (ability to pay). At the same time, policy decisions should be made so that the GST should do no more harm than necessary from a vertical equity point of view. The broad exemption of financial services crosses that line.

It may well be that FIIs shift the GST on inputs forward in higher prices or wider margins (such as the difference between the interest rates that banks charge on loans and the rates they pay on deposits). The effects are unpredictable and hard to measure, however, since they depend on market conditions and the relevant elasticities, which may vary by product. Again, institutions such as banks and insurance companies operate in oligopolistic market structures. While they are also subject to some internationally set prices, interest rates, and rates of return, they are able to shift GST on inputs forward depending on market conditions. According to standard economic theory, firms with market power are better able to do this than competitive firms.22 Backward shifting is also possible. The size of the financial sector exceeds the socially optimal size owing to the undertaxation of financial services used by consumers and unregistered businesses. This undertaxation increases the quantity demanded of financial services, ceteris paribus, which also increases input use in the sector over the socially optimal level, a situation that perversely produces GST revenue even though financial services are exempt. Because of their purchasing power, banks and insurance companies could, in principle, drive down the prices that they pay third-party suppliers for purchased taxable inputs. In the end, the fact that institutions may shift the tax forward or backward cannot be part of the policy design calculus because no policy or set of rules can guarantee a particular result in any situation. The exemption is inequitable ex ante, and that is all that matters here.

It must be noted that the revenue impact of the exemption, as opposed to the alternative of full taxation, is very difficult to assess with precision. I am not aware of any publicly available estimates for Canada. Interestingly, the Department of Finance does not produce an estimate of the GST revenue forgone as a result of the exemption of domestic financial services.23 In one study conducted using general equilibrium models for Germany, the authors found that repealing the exemption of financial services would increase VAT revenues by 1.3 percent of existing revenues and produce an economic welfare gain equal to about half of 1 percent of GDP.24

Why Change?
The unvarnished word from the street suggests that the GST treatment of financial services generates a healthy amount of revenue, flawed as it is, and that is why it continues to exist. This good revenue yield is a curse. It introduces significant policy inertia of a kind similar to that which has been used to support keeping old gross receipts (turnover) taxes such as Canada’s own federal sales tax prior to 1991 and the GST and turnover taxes in many developing countries. A lot of “bad” revenue is better than an insufficient amount of “good” revenue.

Sectoral revenue data do not fall within the public domain. It would be very difficult to reconstruct the revenues based on taxable input use. As suggested earlier, the potential numbers are big. The financial sector is an important sector that produces significant GST revenue. Can it continue to do so but more efficiently and fairly?

WHERE COULD WE BE?
Theoretical conceptual thinking to solve the problem of applying VAT/GST to financial services has reached a point of strongly diminishing returns: the technical issues and opportunities are known. We also know what we do not know. The numerous surveys have identified the many possible practical solutions to the problem. This means that the discussion must focus on the most promising practical solutions, and on what other countries have done. As a starting point, I reject solutions based on non-transactional methods (accounts-based VAT’s) and methods based on national accounts and macroeconomic data. Such methods suffer from several potentially fatal shortcomings. They

- take the financial sector outside the rest of the GST—not a practical move, given the many commercial relationships between the financial sector and the other sectors in the economy;
- create many opportunities for data manipulation and gaming; and
- may exacerbate an existing public perception that the financial sector receives preferential tax treatment from governments.

26 See supra note 1.
27 For a description of different accounts-based VAT approaches, see Schenk et al., supra note 1, at chapter 2; and for an example of a method based on national accounts and macroeconomic data, see Julio López-Laborda and Guillermo Peña, “A New Method of Financial VAT” (Department of Public Economics, University of Zaragoza, 2015).
I also reject specific taxes that would fall on financial transactions without credits for input taxes. Those taxes could damage the financial system and have a host of unintended consequences.

The International Experience

The vast majority of countries with a VAT have chosen to stay away from reforming the exemption of financial services. For the many developing countries with a VAT, that is a wise move, given their limited administrative capacity and their need to focus on the fundamentals of VAT operation and major revenue sources, which usually relate to other sectors. Some of the countries in a position to do something have done so and have followed different approaches. Those may be summarized very briefly and somewhat simplistically as follows:

- **Australia:** Reduce cascading and the incentive to self-supply by providing for formula-based input tax recovery, subject to conditions.
- **European Union:** Reduce the scope of the exemption by applying a combination of an option to tax, a redefinition of financial supplies, and VAT grouping.
- **New Zealand:** Reduce cascading by zero-rating some business-to-business (B2B) services, subject to conditions, and impose a reverse charge (self-assessment of tax by a registrant) on imported services; also reduce the scope of the exemption by taxing non-life insurance.
- **Singapore:** Reduce the scope of the exemption with taxable fees for intermediary services; and reduce cascading and the incentive to self-supply by providing formula-based input tax recovery, subject to conditions.
- **South Africa:** Reduce the scope of the exemption by taxing all fees and short-term (property and casualty) insurance.

A few remarks are in order concerning the above list. First, there have been attempts to test methods to tax margin-based services and life insurance. In the mid-1990s, Ernst & Young conducted pilot studies with selected financial institutions in EU member states to test the Poddar-English cash flow VAT method with a

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29 Anything more detailed is beyond the scope of this article owing to space restrictions. For a survey, see Schenk et al., supra note 1, at chapters 11 and 12; the taxonomy of methods follows Schenk, supra note 1, at 437.

I worked on this team for a while, and for a number of different institutions in separate countries, and can say that the method worked and produced the correct result. It was cumbersome to use because of the rudimentary state of information systems in use in the 1990s. Today's enterprise and information systems should accommodate the requisite tax calculation programs without difficulty. Much of the negative feedback by institutions at the time was due to the fact that no institution likes the perception that the services it offers will be taxed, when the starting point is the public perception that the services are untaxed because they are exempt. I return to the cash flow VAT below.

Second, approaches that skirt around the problem never achieve much because they do not solve any of the fundamental problems created by the exemption. They may address some symptoms. This describes many of the ideas for reform in the European Union. In fact, such approaches require more rules to function and are not effective if some countries can opt in and some can opt out. I will not discuss EU approaches further.

Third, zero-rating of B2B transactions creates its own problems. It does not solve the exemption issue. It merely mitigates the problem of cascading and self-supply, at the cost of some complexity in rules and an increased risk of tax-planning behaviour. It can cause revenue leakage when tax-planning opportunities are exploited so that transactions that should not be zero-rated (because they relate to self-supply for own consumption or exempt supplies) are zero-rated. In that case, the tax on inputs is lost. In the Canadian context, where federal and provincial taxes work together under the GST/HST system, those tax-planning opportunities would be more numerous, and the various allocation and place-of-supply rules would have to be complicated even more to deal with those possibilities. It does not seem to be worth the risk in light of the other methods available (such as a cash flow VAT).

Finally, and most importantly, the position that FIIs that make exempt supplies should receive partial credits for VAT/GST paid on inputs is conceptually wrong. For the sake of simplification of this argument, call this approach "exemption with rebate" and assume that institutions make only exempt supplies and that all their purchased inputs are taxable. Recall that under the standard mechanics of a VAT, tax paid on purchased inputs engaged to render exempt supplies is never deductible or creditable against output VAT because there is none, owing to the exempt status of the supplies. That tax cannot be refundable or refunded either. This effectively represents the social compact of the VAT/GST: the right to deduction of input VAT is earned by the collection of output VAT. Refunding that tax is like granting a subsidy.

Some commentators have raised the Diamond and Mirrlees production efficiency theorem to remove input taxes at all costs and hence justify the compensation of

exempt suppliers for input VAT. This position amounts to a weak practical defence of an exemption with rebate for FIIs for a few reasons:

- In a mature VAT system with a longstanding broad exemption of financial services, the inefficiencies attributable to irrecoverable input VAT are priced in (capitalized) since profit-maximizing institutions and intermediaries will have extracted all the possible efficiencies by shifting the tax forward and/or backward as they see fit.
- Removing the inefficiency ex post by means of a rebate cannot be presumed to achieve the same impact on prices as removing it naturally by taxing services ex ante and providing a normal right to deduct the tax. In a second-best world, the two scenarios will have very different effects on product pricing and efficiency.
- Rebates would create two new non-neutralities, the first offsetting an existing non-neutrality (input choice distortions), and the second providing preferential treatment of the financial sector that is not available to other sectors.
- An exemption with rebate may be interpreted as a subsidy (too much credit) to suppliers. Luckily, that would be of no direct consequence for international trade since exports of financial services should be zero-rated anyway.

To sum up, the case for exemption with rebate for the financial sector is weak on both efficiency and equality-of-treatment grounds.

**The Canadian Experience**

No dramatic changes to the GST treatment of financial services have taken place in 20 years, aside from continuous regulation-making and the occasional court case and retroactive amendment response. Ironically, it took a recent round of GST harmonization to bring about change. Under the Comprehensive Integrated Tax Collection

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33 For a defence of the spirit of this approach, see Firth and McKenzie, supra note 1; for a general but neutral discussion of efficiency considerations in relation to the GST, see Bass and Gendron, supra note 15, at 8:3.
34 One could argue that the public service bodies (PSB) rebate under the GST/HST achieves this result too since it is effectively an exemption-with-rebate system parallel to the main GST/HST system. That is correct, but with two important distinctions: first, many PSBs make many non-commercial supplies not for profit whereas FIIs make exclusively commercial supplies in the pursuit of profit; second, many supplies by PSBs should be taxable, and straightforwardly so, under the regular GST/HST system. For GST-PSB and exemption regime reform proposals, see Pierre-Pascal Gendron, “Canada’s GST at 21: A Tax Expenditure View of Reform” (2012) 1:2 World Journal of VAT/GST Law 125-48; and Pierre-Pascal Gendron, “VAT Treatment of Public-Sector Bodies: The Canadian Model,” in VAT Exemptions: Consequences and Design Alternatives, supra note 25, 103-33.
35 See Cisterna and Scullion, supra note 10; and Firth and McKenzie, supra note 1.
Agreement Between the Government of Canada and the Government of Quebec, the latter agrees to follow the GST base for the treatment of financial services under the QST. In effect, this means that the QST system has transitioned from zero-rating of financial services to exemption. Over the years, many pundits have wished for zero-rating treatment to be extended to the GST/HST, without perhaps knowing that the government of Quebec imposed, as offsets, compensatory taxes on financial institutions and restrictions on input tax refunds to large corporations. Financial institutions were deemed large corporations under this regime. Now that it is done, there is a silver lining in the Canada-Quebec deal: it presents a more or less uniform GST base for financial services as a starting point for future reform.

Another very important development in 2012 was the Department of Finance’s examination of the GST/HST treatment of financial services. Finance acknowledged that the system is very complex and wanted to determine whether changes could improve the system. The examination was to be comprehensive and was to follow the principle of broad revenue neutrality (my emphasis) as well as the general tax policy principles of efficiency, fairness, and simplicity. Finance chose five design considerations to explore—definition and scope of financial services, treatment of inputs, import rules, grouping rules, and subnational considerations—and used an analytical framework containing the following elements:

- neutrality and economic efficiency,
- certainty and simplicity,
- administrative efficiency,
- flexibility/adaptability,
- revenue impacts, and
- provincial considerations.

The process involved rounds of meetings with numerous industry stakeholders (industry associations, institutions, professional associations, advisers, etc.) and feedback, followed by analytical work and policy option development, development of recommendations, and a commitment to consult stakeholders if changes will be made. While it does not look as though the examination will lead to major changes in the treatment of financial services, in my opinion it was a very important step in the right direction, and the process could serve as a road map for actual reform.

The approach that Finance followed in its examination was eminently reasonable. Some remarks are in order. I prefer to interpret “broad revenue neutrality” in a very broad sense indeed by taking it to mean that revenue neutrality should be achieved

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36 Supra note 3.
37 This section is based on discussions with Department of Finance officials in January and February 2016 as well as a copy of a presentation that Finance officials made to financial industry stakeholders in 2012.
within the overall GST system. This perspective could avoid unnecessary and nonsensical limitations on reform options. Should reforms be contained strictly within the GST as it concerns the financial sector and FIIs? After all, the current treatment of financial services contaminates elements of the GST that lie outside the financial sector and financial services. Broadly interpreted, revenue neutrality could mean that any revenue loss from a reform of the treatment of financial services could be offset by eliminating ineffectual GST tax expenditures, for example. To press the point further, it might even be desirable to rely more on the GST in exchange for income tax reductions. This recommendation was made recently in Quebec.\(^{38}\)

The analytical framework described by Finance does not provide much detail on the necessary modelling. It would be highly desirable to conduct economic studies to estimate the price elasticities and income elasticities of various financial services. Obviously this would require data from client files with financial institutions. The latter will be reluctant to share those data for confidentiality and competitive reasons. Presumably Finance has the partial equilibrium and general equilibrium models to produce sectoral estimates.

**Policy Options for Canada**

I agree that any policy options to improve Canada’s GST/HST treatment of financial services should follow Finance’s principles of good tax policy and its analytical framework. Here are my own operational principles for a preferred approach for Canada, given the history of GST/HST and financial services, and the case law:

1. Changes in rules and regulations will not fix the problems. GST law, regulations, rules, and technical guidance cannot keep up with the complexity of financial services and innovation in products, service delivery, and information technology. The GST is not an economic planning tool.
2. Input tax credits would be allowed only to the extent that some outputs are taxable.
3. FIIs that made a combination of taxable and exempt supplies would be allowed credit for input GST based on suitable input allocation models.
4. Input allocation models to deal with mixed supplies should ideally be agreed upon between FIIs and the CRA, and be based on industrywide consultations.\(^{39}\)
5. All business services that are not genuine financial services should be taxable, and so a strict economic substance test should be applied when drafting the definition of what constitutes a financial service and the attendant rules.

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Policy options for Canada are split into short-term to medium-term, and long-term. In the short to medium term, Canada should adopt the South African model:

- Tax all fee-based financial services.
- Tax all property and casualty insurance, including intermediary fees related to such insurance.\(^{40}\)
- Zero-rate only exports of financial services by registered financial institutions.
- Exempt only margin-based services and *term* insurance, including any policy with a savings element.\(^{41}\)

While space restrictions prevent a full discussion of all the advantages and disadvantages of the South African model and its operational performance—this has been done elsewhere\(^{42}\)—it is helpful to make a few remarks. First, the alleged problem of substitution of margin-based remuneration for fee-based remuneration in the presence of the tax does not seem to have materialized in any serious way in South Africa. There are often good business and economic reasons to use a certain mode of remuneration, which may not be overturned by a tax. The relatively low rate of the GST (5 percent) should be reassuring in this regard. Second, many financial services purchased by consumers are fee-based, so taxing fees brings the effective GST base closer to the ideal. This is reinforced by the addition of property and casualty insurance where, again, household consumption is important. Finally, medium- to high-income households would now pay GST on financial services in a transparent way. This would remove a benefit from the exemption to such households, an important selling point for the public. In my opinion, this model comes closest to the principles dear to the Department of Finance, including especially simplicity and equity (and a broader notion of efficiency, if one considers the possibility of very significant reductions in collection costs). For the longer term, Finance should think of ways of completing the reform. It should therefore study, in consultation with the industry, the applicability of the cash flow VAT method with a tax calculation account in taxing margin-based services. It is reassuring to note that the authors of the latest comprehensive state-of-the-art review of tax design are bullish on the cash flow VAT method, especially if it is accompanied by the tax calculation account methodology.\(^{43}\)

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\(^{40}\) This means that separate provincial taxes on property and casualty insurance should be abolished since they would be redundant and economically inferior to the GST.

\(^{41}\) In South Africa, a long-term policy is defined to include an assistance policy; a disability policy, fund policy, health policy, or sinking fund policy; or a contract comprising a combination of any of those policies.

\(^{42}\) Morden, supra note 39.

\(^{43}\) Mirrlees et al., supra note 28, at chapter 8.
CONCLUSION

The taxation of financial services under the GST presents a formidable policy challenge in several dimensions. The current treatment—a broad exemption—is deeply unsatisfactory to all stakeholders. In this article, I have examined the legal and economic landscape and concluded that there is a strong case for making financial services taxable and simplifying the existing system. On the basis of international and Canadian experience, I believe that the best approach is to follow the model that South Africa adopted effective October 1, 1996. Under that model, all fee-based services and property and casualty insurance would be subject to GST (and HST if participating provinces go along).