Unbundling the Mysteries of

Computer Software & Outsourcing Contracts

MILLAR WYSLOBICKY KREKLEWETZ LLP

Presented at the TEI's Montreal Chapter Meeting

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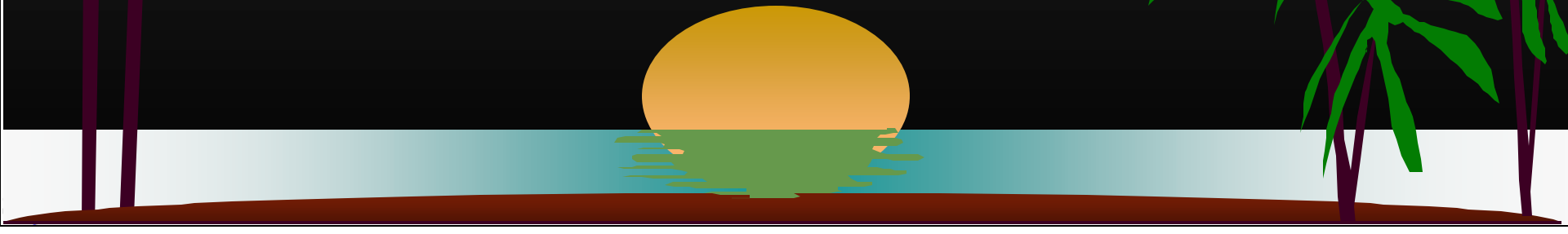
ROBERT G. KREKLEWETZ



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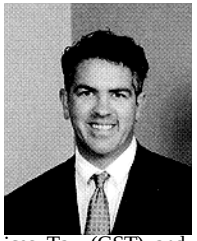
PROFESSIONAL PROFILE



ROBERT G. KREKLEWETZ, LL.B., M.B.A.

Rob is a partner at Millar Wyslobicky Kreklewetz LLP (MWK) – a boutique tax law firm specializing in all Commodity Tax, Customs & Trade matters, and in Tax Litigation. Rob has a LL.B. from Osgoode Hall Law School, and a M.B.A. from York University.

Specialized Practice Area

Rob's practice area focuses on **Commodity Taxes**, which encompasses all issues involving Canada's Goods and Services Tax (GST) and Harmonized Sales Tax (HST), as well the various other provincial sales taxes, including Ontario RST and Quebec QST. Rob also advises on the application of all other excise taxes, applying to a wide range of goods like tobacco, alcohol, jewellery, gasoline and other motive fuels.

Rob also focuses on all issues involving Canada's **Customs & Trade** laws, including Valuation, Tariff Classification, Origin, and Marking issues, NAFTA Origin Verification Reviews, Forfeitures, Seizures, and other NAFTA & WTO matters.

Finally, Rob advises on a number of other **Tax-Related Matters**, wherever involving the domestic or international movement of goods, services and labour. These would include advising non-residents on properly establishing Canadian business operations (or gaining entry into Canada of business persons), providing Transfer Pricing advice, advising on the application of Canadian federal and provincial pay-roll source deduction taxes (e.g., Ontario EHT, CPP, EI) and any and all tax or licensing law issues affecting the Canadian Direct Selling Industry.

Extensive Tax Litigation Experience

All elements of Rob's practice include Tax Litigation, and Rob has acted as lead counsel in a significant number of cases before the Tax Court of Canada, Canadian International Trade Tribunal, Federal Court (Trial Division), Federal Court of Appeal, Ontario Court of Justice, and Ontario Court of Appeal. Rob also provides Planning and Representation services in these areas as well.

Speaking Engagements / Publications / Memberships

Rob continues to speak and write extensively in all of the above areas, regularly addressing the Tax Executive Institute (TEI) – both at its Annual Conference and Chapter Meetings – and other tax organizations like the Canadian Tax Foundation, Canadian Bar Association (CBA), Canadian Institute of Chartered Accountants (CICA), Canadian Finance and Leasing Association (CFLA), as well as the Canadian Associations of Importers & Exporters (CAIE), Certified General Accountants (CGA), and Direct Sellers (DSA). He also speaks frequently at Conferences held by the Strategy Institute, Infonex, IIR and Federated Press.

Rob is the regular commodity tax contributor to the Tax Foundation's *Tax Highlights* publication, and a regular contributor to a number of other tax publications, including Carswell's *GST and Commodity Tax Reporter* and Federated Press's *Sales and Commodity Tax Journal.*

Rob is a member of the CBAO Tax Executive, a member of the CFLA's Tax Committee, and the DSA's Government Affairs Committee. Rob was a member of the CBA-CICA working group on the 1993 GST amendments, and consulted with the Department of Finance on the more recent HST.

The Real Important Stuff – Unfortunately Left to the Bottom

Rob is married to Franceen, and has a beautiful 4 year-old "pre-schooler" named William (who is not a baby, and should not be referred to as such!). When not working, Rob enjoys spending as much time with them as he can – with the only exception being the odd round of golf with William.

Jack, Dennis and Rob are proud to announce that as recently described in the L'Expert Magazine, MWK has become Canada's "brand name for Commodity Tax and International Trade work …".

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THE ROAD MAP

GENERAL FOCUS OF THE PRESENTATION

The application of Ontario retail sales tax ("RST") to computer software and outsourcing contracts has become, perhaps, two of the most difficult areas in retail sales tax in Canada – at least for most large businesses.[1]

The problems in both areas can be linked, perhaps, to a change in the "rules of the road" made in Ontario in 1997, which caused a paradigm shift in the taxation of computer software, and which was possibly an unintended effect, causing many computer related services to fall with Ontario's taxing web as well.

Unfortunately, of the many Canadian businesses that were affected by these changes, few really appreciated the extent to which the changes would be affecting them.

It has now been almost 5 years since Ontario first announced these moves (e.g., May 1997), and the people affected by the changes have now begun to realize the potential scope of the changes – and the potential exposure facing them, as Ontario begins to audit in these areas.

This presentation is aimed at reviewing some of the current issues, and examining the "self-help" steps that businesses facing these challenges can take. Some will be aimed at "self-preservation" in the face of an audit; some will be aimed at tax minimization strategies; most will focus on how businesses can stay "on-side" the new rules, and free from any possible surprises on their next Ontario RST audit.

The audience is encouraged to participate !

So feel free to ask questions <u>at any time</u>.

Navigating Through the Materials

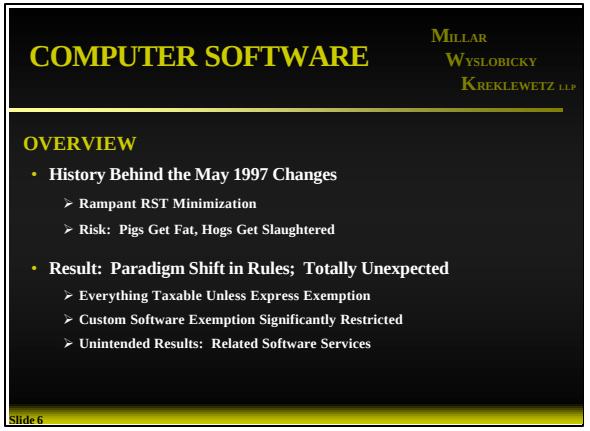
The Materials are divided into three main parts.

Part I begins with a fairly comprehensive introduction to retail sales taxes in Canada, with an emphasis on the Ontario RST. This part is designed to allow readers more focused on "income taxes" than "commodity taxes" to more fully understand the commodity tax systems in which these issues arise, before attempting to understand some of the "current issues" taking place in these systems. Part I is styled, then, as a "building block" discussion (and that is what it is). Reading it should allow all readers to proceed, on a more-or-less equal playing field, to the substantive discussion of current issues in the balance of the materials.

Obviously many readers will already have a sophisticated understanding of the Canadian retail sales taxes described in Part I. For you, there may be little or no benefit in reading Part I, and you are encouraged to skip that discussion, and proceed directly to Parts II and III of these materials.

Part II focuses on Current Issues respecting the Taxation of Computer Software, focusing on the Ontario system, but also comparing and contrasting to the RST systems in place in BC, Saskatchewan and Manitoba. Part II begins at page 12 of these materials.

Part III focuses on Current Issues respecting Ontario's Evolving Taxation of Outsourcing Contracts, and begins at page 20 of these materials.



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PART I – BUILDING BLOCKS

Overview of a Typical RST System

Who Still Has Them. As indicated, only 5 of Canada's provinces still levy a stand-alone provincial RST (i.e., BC, SK, MB, ON and PEI).[12]

Québec ("QB") has a system (the "QST") which is partially harmonized to the GST, while the Atlantic provinces of Nova Scotia ("NS"), New Brunswick ("NB"), and Newfoundland & Labrador ("NF") have a fully harmonized system, incorporated into the *ETA* (the "HST").

Alberta ("AB") and Canada's two territories do not presently employ retail sales taxing systems.

Broad Comparisons. If broad comparisons can be drawn, these RST systems are "old generation" systems, and ancestors of the more recent attempts by Québec and the Atlantic Provinces (NS, NB, and NF) – to implement partially and fully harmonized systems. To understand how the "old generation" RST systems work, it is useful to consider both where they came from, and why they evolved the way they did.

Where did they Came From ? – The Historical Background. Retail sales taxes grew out of the economic depression of the 1930s, and were a product of the needs for greater tax revenues to fund increasing need for social programmes.

Interestingly enough, the first RST system was neither federal or even provincial: it was a municipal sales tax initiative, implemented by the City of Montreal, on May 1, 1935, which applied a 2% tax on tangible personal property ("TPP"). Within the year, however, Canada's provinces followed suit, with Alberta being the first to enact a provincial system, on May 1, 1936. (Un)fortunately for Alberta, its RST system proved so unpopular, it was repealed less than two years later, and never replaced. Other provincial initiatives were somewhat more successful, with Saskatchewan implementing a system on August 2, 1937, Québec imposing a 4% tax on July 1, 1940, BC imposing a tax on July 1, 1948, New Brunswick on June 1, 1950, and Newfoundland by November 15, 1950. PEI and Nova Scotia waited until January 1, 1959 and July 1, 1960, respectively. Ontario and Manitoba became the last provinces to implement RST systems, with Ontario's tax applying on September 1, 1961, and Manitoba's applying on June 1, 1967.

Why Did They Evolve the Way They Did ? – Some Constitutional Limitations. In understanding how current RST systems operate, it is useful to observe that each system evolved within constitutional limitations imposed on the provinces by s. 92(2) of the *Constitution Act, 1867* – formerly the *British North American Act.*

Constitutionally, provinces are limited to "Direct Taxation within the Province in order to the raising of the Revenue for Provincial Purposes".

Understanding the scope of the limitation is useful. "Direct taxation" is generally accepted as a tax imposed on the person who will ultimately bear it, and was set out by the economist John Stuart Mill's as follows:

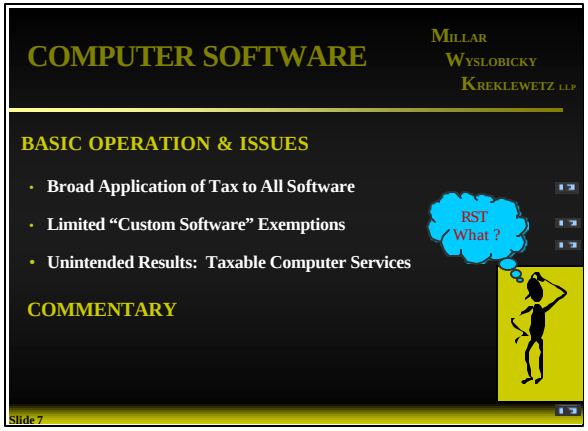
> Taxes are either direct or indirect. A direct tax is one which is demanded from the very persons who, it is intended or desired, should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another: such as the excise or customs ... Direct taxes are either on income or on expenditure ...

While a number of constitutional decisions were taken on a number of provincial attempts to tax such things as fuel and tobacco, one of the more important was the Privy Council's decision in *Atlantic Smoke Shops Ltd. v Conlon*, (1943) A.C. 550. The Court had to consider the constitutionality of New Brunswick's tax on purchasers of tobacco, and then set out the following standard for assessing an indirect or direct tax:

> It is a tax which is to be paid by the last purchaser of the article, and, since there is no question of further resale, the tax cannot be passed on to any other person by subsequent dealing. The money for tax is found by the individual who finally bears the burden of it. It is unnecessary to consider the refinement which might arise if the taxpayer who has purchased the tobacco for his own consumption subsequently changes his mind and in fact re-sells it. If so, he would, for one thing, require a retail vendor's licence. But the instance is exceptional and far-fetched, while for the purpose of classifying the tax, it is the general tendency of the impost which has to be considered.

Thus the crux of the matter fell to determining whether the "general tendency" of the tax was such that it would be borne by the person on whom it was imposed. Not surprisingly, the constitutional validity of a "retail sales tax" was eventually upheld by the Supreme Court of Canada ("SCC").[3]

> *Example.* A simple example of a "indirect tax" would be one imposed on a good that was purchased *for resale*. Since the initial purchaser (e.g., a wholesaler) would be taxed, but would also be generally expected to resell the TPP, and recover that tax in its purchase price, there could be seen to be a general tendency that the tax imposed on the wholesaler would be passed and borne by a another person (i.e., the retail purchaser). That fact makes the tax an "indirect" one – and one which none of the Provinces are constitutionally capable of levying.[4] It was probably with this concern in mind that Quebec – when making the transition from its *Retail Sales Tax Act* to its now partially harmonized QST – decided to employ the concept of "non-taxable supplies" for the purpose of recognizing instances where a provincial tax ought not be the charged on purchases acquired by businesses for purposes of resale. The concern was likely that if the QST were imposed on these purchases, it might well be considered a indirect tax – even though businesses would be entitled to a refund of the tax paid on most of their inputs.



Inter-Jurisdictional Comparisons

The following description discusses in general how the existing RST systems all operate. While an attempt has been made to canvass all existing RST systems at every stage, there is an obvious focus on the RST system currently in place in Ontario.

What are their Common Concepts ? It was only with reference to this base constitutional jurisprudence that Canada's "old generation" RST systems were formulated. Accordingly, it is not surprising that each of the remaining five RST systems have a number of very common elements – many of which can be directly related to their constitutional antecedents. What are some of the common elements ?

First and foremost, one sees that all of the RST systems are (1) aimed at imposing taxes on *the final consumer or user* of the property or services being taxed. Thus while there may well be significant differences between the structures of the taxing systems,[5] or the tax bases or the tax rates, each RST system can be seen to apply a tax at the "consumer" and "user" level .[6]

If other generalizations can be made, most RST systems also (2) apply only if the TPP or taxable services are acquired within the province for "consumption" or "use" within the province, or acquired elsewhere, but brought into the province for consumption or use therein; (3) levy the tax directly on the retail purchaser/consumer, but require "collection" of the tax by vendors, as "agent" of the province, and under threat of "penalty" for non-collection; (4) contain either special exemptions for purchases for "resale", or leave these untaxed in the first place; (5) contain special rules for determining other applicable exemptions.

How do they differ from the QST & GST/HST ? – Some Principal Differences. While the RST systems have some commonality, there are two main differences between these systems and their QST or GST/HST counterparts: the *comparatively narrow* tax base used by the RST systems, in comparison to their QST or the GST/HST counterparts; and over-all focus of the tax and provisions made for universal credits for business inputs.

Narrower Tax Bases. The most obvious is the differences in the respective tax bases. While the QST and GST/HST are all-encompassing taxes, the RST systems are aimed at comparatively narrow tax bases. For example, the GST/HST is levied on virtually all tangible personal property ("TPP"), intangible personal property ("IPP"), real property, and services.

On the other hand, the various RST systems are usually aimed at levying tax on transactions involving only TPP, and certain specially defined "taxable services". (Saskatchewan's recent expansion of its tax base to include a large number of specifically defined "taxable services" has now become the exception to this general rule).

Having said that, these provinces generally employ an all encompassing definition of TPP (see *infra*) which is capable of not only capturing virtually all TPP, but what might otherwise be conceived of as a service, and even some IPP.

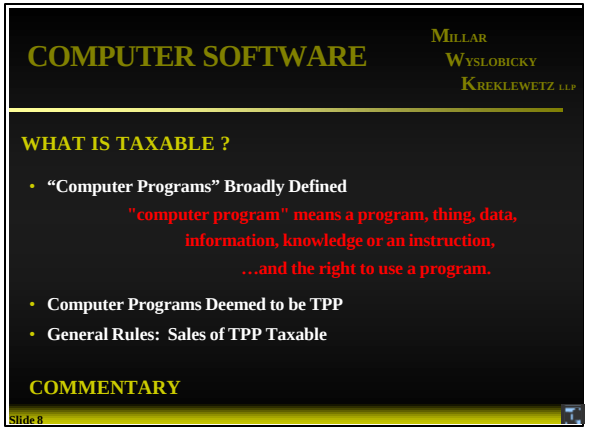
For example, each RST system now attempts to tax computer software. In terms of the specially defined "taxable services", most provinces attempt to tax services related to TPP (e.g., like services to install, assemble, dismantle, repair, adjust, restore, recondition, refinish, or maintain TPP), as well as certain other special-nature services.

Focus of the Tax & Treatment of Inputs. The second difference between the QST/GST/HST model and the various RST systems lies in the overall focus of the taxes, and the consequent treatment of business "inputs".

While the GST/HST, for example, is a multi-stage value-added tax, with a comprehensive system for taxing the value-added at each stage of the production process, and crediting tax paid at earlier stages of that process (e.g., through ITCs), the RST systems are aimed at (theoretically) imposing the RST only on the ultimate consumer of the taxable good or service. In other words, these systems attempt to create a "single incidence" tax. This poses a problem for business inputs, since situations arise where a business may be paying the RST on its business inputs, and then charging and collecting the RST again on the value of its production. Absent rules to "remove" this cascading of tax, the final manufactured product may well bear double and triple layers of tax.

While each RST system has some rudimentary rules providing for some limited exemptions (e.g., an exemption where TPP is purchased for "resale"), these rules are nothing like the "universal" ITC system available for commercial businesses paying the GST. Thus while the GST system ensures that every Canadian consumed good, service or intangible bears, at the most, a 7% GST component, the effective rate of RST imposed on a fully manufactured Canadian TPP may be much higher than the stated provincial rate. Even more troubling, to the extent there is RST imbedded in manufactured TPP, the TPP will carry that RST even when exported from Canada.

> *Example of Cascading RST.* Consider Kco, an Ontario woodworking business, which builds and sells custom-made children's beds – miniature four-posters, in fact. Assume 10 beds are produced each year and sold for $1000 each, ultimately yielding $800 in Ontario RST (8% times $10,000). To manufacture the beds, Co purchases a number of raw materials, which can be purchased exempt of Ontario RST, as well as a taxable desk and computer for $5,000, paying an additional $400 in Ontario RST. Assuming that the RST paid on the inputs is reflected in the final selling price of the beds, the effective rate of Ontario RST on the beds is much higher than 8%, perhaps approaching 12% in this simplistic example. One effect of this "cascading" of tax is to make Kco susceptible to competition from manufactures in other jurisdictions (e.g., the Harmonized Provinces) who might be entitled to ITCs for the RST paid on their business inputs, enabling them to sell their beds on a cheaper basis.



While all the taxes are at least theoretically aimed at imposing the tax burden on the ultimate consumer of a taxable item, the manner in which that is accomplished is much different across the various systems. This is markedly different than the GST/HST system – and, for that matter, the QST system – which generally affords universal input tax credits/refunds for most business inputs.

Imposition of the Tax – The "Charging Provisions". RST is generally imposed by virtue of an all-encompassing "charging provision", like that found in s. 2(1) of the Ontario Act:

> 2.(1) *Tax on Purchaser, of [TPP]* — Every *purchaser* of *tangible personal property*, except the classes thereof referred to in subsection (2), shall pay to Her Majesty in right of Ontario a tax in respect of the *consumption* or *use* thereof, computed at the rate of 8 per cent of the *fair value* thereof.
>
> *Charging provisions in the other RST systems are found in ss. 5 and 6 of the BC Act; s. 5 of the SK Act; s. 2 of the MB Act; and s. 4 of the PEI Act.*

While not entirely obvious, the addition of specially defined words, like those in *italics* above, make such charging provisions incredibly encompassing. In Ontario, s. 1 of the Ontario Act defines, among others, the following words:

> *TPP*, to mean just about anything that can be touched: "personal property that can be seen, weighed, measured, felt or touched or that is in any way perceptible to the senses and includes computer programs, natural gas and manufactured gas".
>
> *Purchaser*, to mean not only (a) a "consumer or person who acquires [TPP] anywhere", but also persons (b) acquiring TPP for the benefit of some other person, and (c) certain persons acquiring TPP for purposes of promotional distribution. Until recently, "purchaser" also included persons acquiring a taxable service at a sale in Ontario in order to fulfil warranty or guarantees or other contract for the service, maintenance or warranty of TPP.[7]
>
> *Consumption* and *use*, to include all concepts of use, and the incorporation of something into another thing.
>
> *Fair Value*, to capture virtually every type of payment that could be expected to pass from a purchaser of TPP or services to the person from whom the TPP or services were acquired.

Sometimes definitions of certain words are contained in regulations underlying the particular legislation. Thus, for example, Ontario's Reg. 1013(1) helps define TPP by excluding things like gold and silver in their primary forms. Ontario is particularly notorious for hiding important definitions in regulations, and one can also find special definitions for "manufacturer", "contractor", "food products", and a number of other important terms.

Treatment of Certain "Taxable Services" & Specially Taxed Items. Each RST system taxes more than simply TPP. Some define a whole host of "taxable services", which in Ontario include, for example, most (i) telecommunication services, (ii) labour provided to install, assemble, dismantle, adjust, repair or maintain TPP, (iii) contracts for the service, maintenance or warranty of TPP. These are taxed at a rate of 8%, while "transient accommodation" is also defined as a "taxable service", but taxed at a special rate of 5%.

There are a number of other "specially taxed" items as well, with tax rates often much higher than the general 8% rate.

For example, each of the following is subject to a special Ontario RST: liquor, beer and wine – s. 2(2); places of amusement – s. 2(5); "insurance premiums" – s. 2.1; "brew-your-own" beer and wine – s. 3.1; "new passenger vehicles or sport utility vehicles" – s. 4.1; "used motor vehicles" – s. 4.2; and the acquisition of a taxable service for the purpose of repairing, replacing, servicing or maintaining TPP under a warranty or guarantee or similar contract – s. 2.0.1. Like the case in BC and Manitoba, Ontario has now legislated a mandatory collections system for the RST exigible on items of non-commercial TPP accompanying returning residents to Ontario, as they cross the Canada-U.S. border.

In terms of the other RST systems, virtually all tax things like wine, spirits, and beer, telecommunications, and transient accommodation, but there are still some significant differences. BC and PEI tax "legal" and "professional" services, respectively, and Manitoba taxes on certain "electricity".

As mentioned previously, Saskatchewan has recently taken this approach to an extreme, and now applies its RST against a wide variety of professional services.

Timing of the Tax. A pre-requisite of every valid tax is some indication as to when a validly imposed tax is *payable*. The general rule in most RST systems is that the tax is payable at the time of the sale, and Ontario's rule is found in s. 2(6) of the Act:

> 2(6) *When Tax Payable* — A purchaser shall pay the tax imposed by this Act at the time of the *sale*, or the promotional distribution of an admission.
>
> *Timing provisions in other RST systems are s. 5 of the BC Act; s. 5 of the SK Act; s. 2(2) of the MB Act; and s. 7(1) of the PEI Act.*

Sale is, like the other terms defined in s. 1 of the Ontario Act, defined in the broadest sense, and includes, in the case of TPP, "any transfer of title or possession, exchange, barter, lease or rental, conditional or otherwise, including a sale on credit or where the price is payable by instalments, or any other contract whereby at a price or other consideration a person delivers to another person [TPP]".

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In the case of a "taxable service", *sale* is the "provision of any charge or billing, including periodic payments, upon rendering or providing or upon any undertaking to render or provide to another person a taxable service". Thus the general rule becomes as follows: tax is usually payable up-front.

Timing of RST on Leases. A special "timing" rule is usually found for leases of TPP which, by their very nature, do not involve the up-front acquisition of property. In most RST systems, the rule is like that found in s. 2(7) of the Ontario Act, with tax payable at the time of the rental payment, or other consideration paid under the lease as, for example again in Ontario, the payment on the exercise of a "purchase option".

Amounts Included in the Tax Base. The existing RST systems use one of three measures for determining what amounts are taxed: the "fair value" standard in MB, ON, PEI; "value" in Saskatchewan; and "purchase price" in BC.

While there are a number of legislative "additions" to each of these terms (usually making it necessary to review each definition), some generalizations can be drawn.

GST. First, unlike the situation in Quebec – where GST is included in the QST tax base – GST is not generally included in any sales tax base in existing RST systems (the only exception being PEI). Each RST system does includes all other federal customs or excise duty in its tax base, however.

Financing Charges. So long as financing charges are broken out (e.g., "unbundled"), the price or invoice for taxable TPP or services, they are not required to be included in the sales tax base in any of the existing RST systems. Where bundling of financing charges is occurring, tax will generally apply on the whole amount, including the financing charges, being charged for the taxable TPP or services.

Delivery Charges. The tax status of delivery charges across the RST systems is rather complex. Most other RST systems (e.g., BC, SK, MB) will require RST to be charged on any delivery charges made in respect of TPP sold on a "delivered basis" (i.e., "FOB purchaser"), but allow for some relief for delivery charges in respect of TPP sold on an "FOB vendor" basis. (In some cases, as in SK and MB, delivery charges for FOB "vendor" sales are taxed if the TPP originates from outside of the particular province). Ontario taxes virtually all types of delivery charges, whether or not broken out, and whether or not the sale is made FOB "purchaser" or "vendor".

Installation Charges. Most RST systems tax installation charges, whether bundled with contract prices for taxable TPP, or broken out separately. This is generally accomplished by defining such installation to be a "taxable service" in its own right. Saskatchewan, which was once the only province not to include installation as a "taxable service", recently moved to close that loop-hole, and now defines "repair and installation services" among the various "taxable services" that it began to tax as part of its 2000 budget.

Treatment of "Trade-ins". A number of RST systems, like that in Ontario, Manitoba and PEI allow "trade-ins" of TPP to reduce the tax base of the new TPP sold. BC and Saskatchewan do not allow for that treatment, although BC does allow limited "trade-in" treatment on purchases of "passenger vehicles." Where relief is available, some special rules and conditions would generally apply.

> *For SK's administrative prohibition for Trade-In see s. 8(14) of the SK Administrative Guides.*

Temporary Imports. Most RST systems have special rules for TPP that is temporarily imported to the province. Since the general importation rules would require a self-assessment of RST on the full value of the imported TPP (see *infra*), these "temporary import" rules are relieving in nature, and usually result in a partial taxation of the imported TPP.

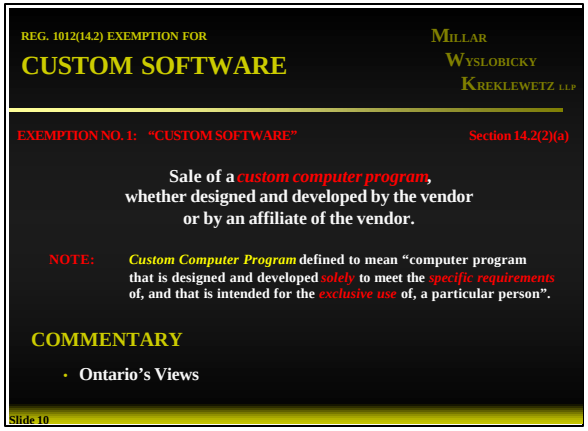
While the rules may differ, each of the other RST systems offer this same type of relief, and generally tax the TPP by applying 1/36 of its value to the regular tax rate, for each month the TPP is employed in the province.

In Ontario, for example, if TPP is imported for less than 12 months, tax is payable on a tax base equal to the "net book value" of the TPP, divided by 36, and is payable each month the TPP is present in Ontario.

Where equipment is leased, the RST systems generally attempt to tax the equipment on the basis of the lease payments being made.

> *Temporary importation rules for other RST systems are in s. 11 of the BC Act and Reg. 2.38; s. 5(9.1) of the SK Act and Reg. 1(17.3); s. 17 of MB Reg. 75/88R; s.2(21) of the Ontario Act and Reg. 1012(15.4); and s. 37 of PEI Reg. EC262/60.*

Most of the RST systems also deal expressly with the temporary importation of "big ticket" items like aircraft, railway rolling stock, and inter-provincially used transportation equipment. (In some systems, some of these items are completely exempt).



Exemptions. Each RST system imposes its own distinct set of exemptions. There are some commonalties among the exemptions afforded by the various RST systems, with the two most important one's being for *TPP purchased for resale* and *TPP delivered outside of a province by a vendor*. These exemptions exist for obvious constitutional reasons since in the absence of a "resale" exemption, the general tendency of the RST might well be interpreted as an "indirect" one; and in the absence of an exemption for TPP delivered "outside" a province, there might be some issue as to whether the RST was a direct tax "within the province". Some other exemptions that are generally common across each of the existing RST systems are as follows: [8]

> Books; food and beverages for human consumption; children's clothing and footwear; most motive fuels (for reason only that they are taxed under separate provincial systems); fuel oil; wood; certain pharmaceuticals and medical supplies (usually if prescribed); agricultural feeds and certain purchases by farmers; raw materials and components for use in manufacturing; and catalysts and direct agents.

Some notable exemptions specific to particular provinces are:

> BC: human organs, tissue, and semen; portable buildings manufactured and sold in the province for non-residential use; prescribed energy conservation equipment and materials; prototypes; repossessed TPP on which tax has been paid; 2-wheel bicycles; vitamins and dietary supplements; and, since 2001, production and manufacturing equipment.
>
> SK: beer, wine, and spirits; mail order records, cassettes, and tapes when purchased by subscription; and prototypes for R&D purposes.
>
> MB: flood control sandbags; private purchases of used TPP (except snowmobiles, aircraft and registrable vehicles); used furniture valued at $100 or less; and prototype equipment for mining
>
> ON: Gifts of cars between family members; liquor, beer, or wine purchased for consumption at a special event; R&D TPP; and production and manufacturing equipment.
>
> PEI: anti-pollution TPP; electricity production equipment; equipment to produce telephone service by telephone utilities; and production and machinery equipment.

Notably present in Ontario and British Columbia is an exemption for "production machinery and equipment". While Ontario was historically the only province affording such an exemption, British Columbia announced a similar exemption as part of its 2001 budget, and effective July 1, 2001.[9]

Exemptions by Nature of the Purchaser. Most RST systems have special exemptions by nature of the purchaser, although these are diverse. For example, the federal government (or related departments) is RST exempt in Saskatchewan, but taxable elsewhere. Similarly, provincial and municipal governments (including all departments, boards, and commissions) are generally taxable in all RST systems.

Some provinces, like Ontario, have special exemptions for certain TPP purchased by certain hospitals, and certain additional exemptions for certain types of hospital equipment, when purchased by a hospital.

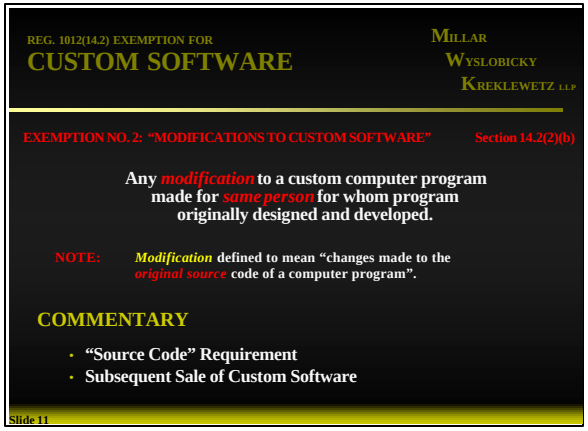
Exemption Permits. Most RST systems require "purchase exemption certificates" ("PECs") to be provided by purchasers seeking to claim an exemption, whether the exemption be for "resale" or otherwise. In Ontario, the PEC can be included in the purchase order, letter or on Ontario's prescribed form, but must be signed by the purchaser. A customer may submit a single or blanket PEC, with blanket PECs valid for up to four years from the date of issue. The purchaser would make reference to the blanket PEC when making subsequent purchases of items which it covers. The customer's vendor permit number should generally be shown on the PEC. (Ontario does have the concept of a "G" permit holder, who are not required to issue PECs; all that is required is the G Permit holder provide the vendor with the G Permit number, although it might well be advisable for the vendor to obtain a copy of the permit.)

Vendor Registration & Collection Requirements. Each RST system creates a vendor-registration and vendor-collection system. Under these systems, a vendor selling taxable TPP or taxable services in the province is usually required to register for the system (i.e., obtain a "RST licence", often called a "vendor permit"), and thereafter to begin charging, collecting and remitting RST in respect of its taxable supplies. In Ontario, for example, the relevant rule is found in s. 5 of the Ontario Act, which provides as follows:

> 5.(1) *Vendor Permits* — No vendor shall sell any taxable [TPP] or sell any taxable service or own or operate any place of amusement the price of admission to which is taxable unless the vendor has applied for, and the Minister has issued to the vendor, a permit to transact business in Ontario and the permit is in force at the time of such sale.
>
> *Collection requirements in other RST systems are s. 92 of the BC Act; s. 4 of the SK Act; s. 5 of the MB Act; and s. 13 of the PEI Act.*

Issues with Non-Resident Collection. The traditional issue relating to vendor collection requirements under RST systems is when and why a non-resident vendor, with little or no connection to a particular province, needs to register under that province's RST system. The answer comes, in part, from the definition of "vendor" employed in each RST system. In BC, for example, the definition of "vendor" provides as follows:

> *"vendor"* means a person, including an assignee, liquidator, administrator, receiver, receiver manager, trustee or similar person, who, in the ordinary course of the person's business, in British Columbia, sells [TPP] to a purchaser at a retail sale in British Columbia.
>
> *"Vendor" is defined in s. 3(o) of the SK Act; s. 1 of the MB Act; s. 1 of the Ontario Act; and s. 1(t) of the PEI Act.*



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With the exception of Ontario, all other RST systems contain a similar "carrying on business in the Province" wording. Ontario's provision does not require the vendor to be carrying on business "in Ontario", but that requirement is administered in practice – as it would probably have to be in order for Ontario's registration requirement to be within its constitutional authority. The Ontario Act defines "vendor" to mean, among other things, "a person who, in the ordinary course of business, (a) sells or licenses [TPP], [or] (b) sells or renders a taxable service ...". BC also deems certain people to be carrying on business "in BC" in certain circumstances – making, again, a review of the particular rules essential.

Carrying on Business. As indicated above, whether one "carries on business" in a particular jurisdiction falls to be determined by the facts of the situation. A number of legal tests have also been developed, largely from jurisprudence under the *Income Tax Act* ("*ITA*") and were reviewed above. As most readers will already appreciate, that jurisprudence suggests that to determine whether a person is "carrying on business" in Canada requires a factual-based analysis, focused on a couple of primary factors, and a inexhaustive set of secondary factors.[10]

The two primary factors are: (a) the place where the contract for the supply was made; and (b) the place where the operations producing profits take place. In terms of the "place where a contract is made", the jurisprudence generally accepts that the important elements of the contract are its offer, and its subsequent acceptance, and that the place the contract is "accepted" is the place where it was made.

Voluntary Registration. Each RST system allows non-residents selling TPP or taxable services into a province to *voluntarily* register, which sometimes, is the path of least resistance for persons wishing to carry on business on a national scale, although located in one particular province (or, indeed, located outside of Canada).

Collection Provisions. Once registered, each RST system imposes a *collections* obligation on vendors of the TPP or taxable services, always imposing this obligation as an "agent" of the Crown. In Ontario, this requirement is found in s. 10:

> 10. *Vendor to be Collector* — Every vendor is an agent of the Minister and as such shall levy and collect the taxes imposed by this Act upon the purchaser or consumer.
>
> *Vendor collections obligations are s. 93(1) of the BC Act; s. 8.1 of the SK Act; s. 9(2) of the MB Act; and s. 19 of the PEI Act.*

While constitutionally limited to imposing "direct taxes" on consumers, the RST systems generally enforce a vendor's obligations to collect tax by imposing penalties for non-compliance. Ontario's "vendor non-compliance" penalty is found in s. 20(3) of the Ontario Act, which provides as follows:

> 20(3) *Penalty for Non-Collection of Tax* — The Minister may assess against every vendor who has failed to collect tax that the vendor is responsible to collect under this Act a penalty equal to the amount of tax that the vendor failed to collect, but, where the Minister has assessed such tax against the purchaser from whom it should have been collected, the Minister shall not assess the vendor.
>
> *While sometimes only imposing a "deemed amount of tax collected by not remitted", similar provisions can be at s. 116(1) of the BC Act, s. 58 of the SK Revenue And Financial Services Act; and s. 22 of the PEI Revenue Administration Act.*

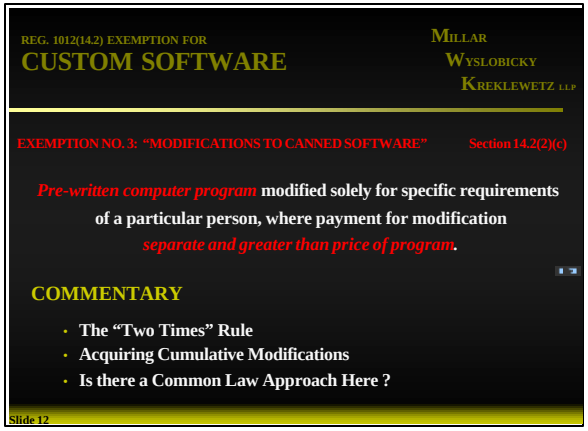
There is a general four year limitation on s. 20(3) penalties – see s. 20(5) – although tere is no limitation period in cases where the vendor's non-compliance is attributable to neglect, carelessness, wilful default or fraud. (In such cases, an additional 25% penalty can also apply: see s. 20(4)).

There is currently some issue in my mind as to whether a penalty assessed against a vendor can be "recovered" as tax by a vendor from a purchaser.

Ontario generally takes the position that a vendor can pursue a purchaser for such recovery, but there are technical problems in the Ontario Act suggesting that anything collected from a purchaser on account of "tax" would have to be remitted to the Ontario Ministry of Finance in any event. Additionally, contract law principles would seem to make it difficult for a vendor to pursue a purchaser for a "penalty" imposed on it by statute. Accordingly, there have been occasions where I have suggested to purchasers that vendors seeking recourse for "penalties" levied under section 20(3) may be without valid claims against the purchasers

Assessments & Appeals. Each RST system is based on voluntary compliance, as enforced by substantive audit activity. Assessments are, as would be expected, limited by statutory limitation periods, generally at least 4 years in length in Ontario and PEI, but up to 6 years in BC, Saskatchewan and Manitoba – although in some cases there is a 3 year limitation imposed on assessing vendors for failure to collect tax. In cases of wilful default or fraud, the statute of limitations is always extendable, and in some RST systems (most notably, Ontario), the limitations period can be extended to instances only of misrepresentation that is attributable to "neglect, carelessness or wilful default".

> *Statute of limitations rules are found at s. 115 of the BC Act; s. 18 of the Ontario Act; and s. 38 of Revenue Tax Act Regulations made under the PEI Act. While the SK and MB Act's do not specify a period of time after which a Notice of Estimate or Assessment for a particular year may not be issued, In SK, Estimates are generally assumed to be limited to a six-year period under SK Limitation of Actions Act. In MB, Assessments are generally limited by administrative practice to "two years" prior to the commencement of the audit, although the Assessments may be up to 6 years for "own use" situations.*



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Appeal Rights. All RST systems provide for appeal rights to assessments issued, both at the administrative level, and to the provincial superior courts.

> *Timing for the appeals ranges from 90 days in BC (s. 118(2)); 30 days in SK (s. 61 of the SK Revenue and Financial Services Act; 60 days in MB (s. 18(1)); 180 days in Ontario (s. 24); and 60 days in PEI (s. 9).*

Generally speaking, RST assessed is payable on issuance of the Notice of Assessment, and must be paid irrespective of administrative or judicial appeals. Under some RST systems (e.g., SK), a notice must first be issued (i.e., after the appeal is commenced) before payment becomes mandatory. Where an appeal is won, the amounts paid are repaid, with interest.

Directors & Officers Liability. Each RST system contains a special provision by which a director (or sometimes officers or mere agents) can be made personally liable for a corporation's tax debts. In a number of instances, however, there are either limitations placed on the administration's ability to pursue directors (e.g., unsuccessful attempts must first be made to collect the tax liability from the corporation), and/or the director's are given the ability to make out complete "due diligence" defences.

> *Directors' Liability provisions are found at s. 48.1 of the SK Revenue and Financial Services Act; s. 22.1 of the MB Revenue Act and s. 24.1 of the MB Act; s. 43 of the Ontario Act; and s. 22.1 of the PEI Revenue Admin. Act.*

Voluntary Disclosure Programmes. A number of RST systems have voluntary disclosure programmes, aimed at allowing taxpayers or vendors with RST exposure to come forward on a voluntary basis and, in return, to avoid civil penalties or criminal prosecutions in respect of the liability. In effect, then, all that would be payable would be the net tax owing, plus statutory interests charges. In all instances, the voluntary disclosure is required to be "voluntary" – in the sense that it is not in any way prompted by a contact by a particular provincial administration – and "full", with most systems requiring full payment of the tax and interest. Currently, all RST systems with the exception of PEI have some form of voluntary disclosure or another. Saskatchewan is currently the only jurisdiction which waives *both interest and penalty* on a voluntary disclosure.

Waiver of Interest and Penalty. Like the federal situation under the GST/HST legislation, some RST systems are beginning to be augmented with legislative provisions allowing for the waiver of interest and penalties. For example, s. 58.1 of the SK *Revenue and Financial Services Act* allows Saskatchewan to waive or cancel all or any part of any interest or penalty otherwise payable by a vendor or consumer. Absent these sorts of provisions, the only relief would be tax remission, which is generally done at the Executive Level of government, by Order of Council.

GAAR. Currently Manitoba is the only RST system with any semblance of a "general anti-avoidance rule" seen in s. 245 of the *ITA*.

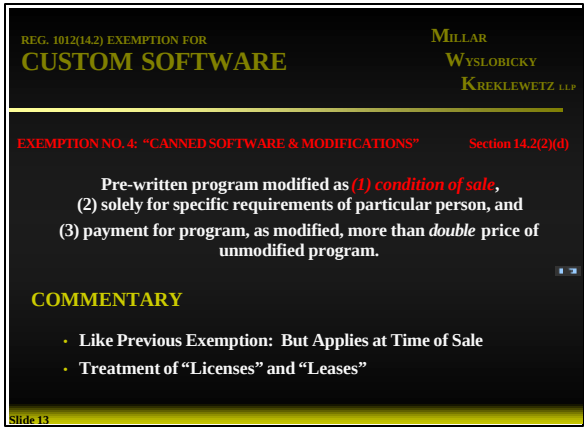
Self-Assessment Obligations. A hallmark of each RST system is a series of rules regarding self-assessment obligations in certain instances. While many RST systems now incorporate international collections agreements for the collection of RST on non-commercial importations, the RST payable on commercial importations is generally left up to the importer, both in terms of TPP imported from another country, and TPP imported from another Canadian province or territory. Generally speaking, however, the self-assessment obligation is imposed only on persons who ordinarily reside in the particular province.

Self-assessment is also required in most cases where TPP is "manufactured" for "own use", or otherwise acquired on an exempt basis (e.g., for "resale"), but thereafter committed to a different use. When such TPP is permanently put to a taxable use, the user generally falls into the definition of "purchaser", and is required to self-assess and remit tax based on the fair value of the TPP at the time of the change in use. Accordingly, vendors who permanently withdraw TPP from inventory for business or personal use must account for tax on the fair value of the TPP at that time. Special valuation rules apply to printed matter and certain other TPP manufactured for own use.

Treatment of Business Organizations and Reorganizations. The treatment of business organizations and reorganizations is also particularly complex. Bear in mind here, that the focus is on the treatment of certain sales of TPP resulting from such transactions, since the transfer of 'shares' would never generally be expected to give rise to RST liability, since such a transaction would amount only to a transfer of an "intangible". The issue arises, then, in the context of TPP, usually situated in a province, and usually tax-paid, that is to be transferred to another corporation as a result of a business organization or reorganization. While I have summarized some of the treatments across RST systems below, there are often a number of exceptions and additional conditions and requirements to the "general" rules, which means that the rules in each particular RST system ought to be consulted before considering the full RST treatment afforded to any of these transactions.

Amalgamations. As a general rule, the transfer of TPP by virtue of an *amalgamation* is generally either legislated to be exempt, or treated as exempt through administrative practice.

Wind-Ups. The transfer of TPP by virtue of a *wind-up* is generally either legislated to be exempt, or treated as exempt through administrative practice in every RST system other than Ontario. Ontario has a special rule which taxes the transfer unless the particular corporation being wound-up has previously paid tax in respect of its consumption or use of the TPP.



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Related-Party Transfers. Each RST system has rules aimed at relieving tax from TPP transferred between related parties. The rules, however, can often be quite difficult to meet. For example, most RST systems require at least a 95% shareholding between corporations before they can be considered to be related.

Bulk Sales Transactions. Most RST systems have provisions aimed at ensuring that purchasers of TPP "in bulk" (e.g., a business being acquired through the acquisition of "assets") obtain a retail sales tax clearance certificate from the vendor indicating that all sales taxes have been paid by the vendor. The vendor is then required to obtain the same from the particular provincial tax administration, thereby ensuring that in the "sale by way of assets" situation, the particular province does not suffer tax leakage because a tax debtor divests itself of all its assets. (Normally, the only time a purchaser would acquire a vendor's liabilities – for taxes or otherwise – would be in the instance where it purchased a business by way of shares, thereby acquiring all assets and all liabilities). Where "bulk sales certificates" are not obtained, the purchaser is made personally liable for any sales taxes due. Currently, the RST systems in all of the RST Provinces have bulk sales requirements.

> *Bulk sales provisions can be found in s. 99 of the BC Act; s. 51(2) of the SK Revenue and Financial Services Act; s. 8 of the MB Act; s. 6 of the Ontario Act; and s. 56 of the PEI Act.*

Government Structure & Resources. The last point in terms of the structures of the various RST systems is the structure of the bureaucratic agencies overseeing the systems, which can often play an important part in the informal resolution of assessment and appeal matters.

In Ontario, for example, the Ontario *Retail Sales Tax Act* falls under the auspices of the Ministry of Finance, and within that Ministry, the Retail Sales Tax Branch, administers retail sales tax policy set by the Ministry. Although the Retail Sales Tax Branch has input into legislation, largely through its Tax Advisory section (and in view of its practical experience), there is another body, called the Tax Design and Legislation Branch of the Office of the Budget and Taxation which has the primary input into the drafting of legislation and the wording of exemptions.

In terms of the day-to-day administration of the Ontario Act, the Audit Branch, Appeal Branch, and Collections Branches all have separate parts to play, as does the Special Investigations Branch. Separate from each of these branches, is the Office of Legal Services.

Needless to say, it can sometimes get quite involved determining just who in the Ministry of Finance has the "call" on even the most simple of audit, assessment or appeal issues.

Often times, in order to resolve matters at the Appeals or Court stage of the assessment process, consensus is need from up to 3 or 4 separate branches (e.g., the Office of Legal Services, Appeals, Tax Advisory, and possibly the first-line Audit Branch). When Branches disagree, the Deputy Minister and his ADM are often required to sign-off on the final decision.

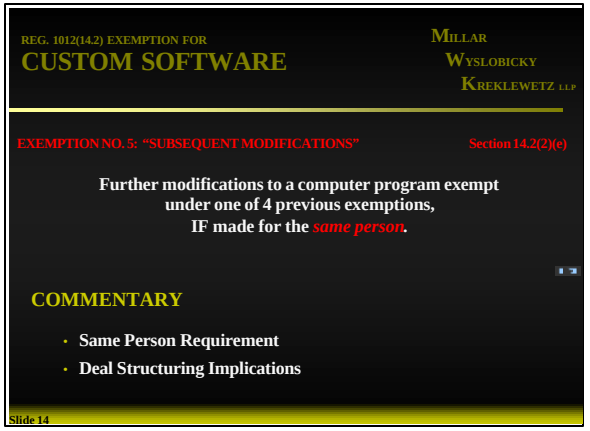
Resources. While secondary resources for determining the application of RST systems are notoriously lacking, most RST administrations attempt to publish at least their view of how the particular legislation is to be administered. In Ontario, for example, this is done through separate series of *Sales Tax Guides* and *Information Bulletins* and through the limited public dissemination of a RST Handbook called *UOST* – short for the "Understanding Ontario Sales Tax" Handbook.

While *Sales Tax Guides* are published as needed, on a topic by topic basis (e.g., Ontario Sales Tax Guide No. 210: *Partnerships*), *Information Bulletins* are usually published after an Ontario budget, or on changes to regulations, outlining changes in the law and administrative practice. *UOST* is a handbook initially compiled by the Retail Sales Tax Branch as a training aid, and as an internal reference manual for the application of Ontario RST. In many respect, the manual is the most detailed piece of "general" information available in terms of specific Ontario administrative policies. While UOST was once available in electronic form, Ontario has since made it "unavailable", ostensibly on the basis that it was "out of date".

My understanding is that an electronic version continues to be updated and in use at the Retail Sales Tax Branch, and it may well be that an electronic version of UOST is available – albeit, only to those willing to avail themselves of Ontario's *Freedom of Information Act.*

Finally, Ontario's Retail Sales Tax Branch maintains what I understand to be a formidable collection of "unsanitized" written rulings, issued and catalogued on a number of subjects. Given that the rulings contain "confidential information", Ontario has traditionally resisted publishing them, even in a semi-sanitized form. My understanding is that – again ostensibly for resource reasons – these "headquarters" rulings will not be published in the near future. While some of these ruling are commonly distributed amongst industry, and TEI members, caution should always be taken in relying on them, since the Ontario Ministry of Finance has no compunction in observing that a ruling letter issued to one person is not binding upon the Ministry in respect of the activities of another person – even if very closely related.

Other RST systems also have detailed governmental sources of information, although perhaps BC is the only system that comes close to Ontario in terms of the availability of that information. BC may well have more accessible information, since its own internal training manual ("TIM" - Tax Interpretation Manual) is widely available, and in electronic format.



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PART II

DEMYSTIFYING THE APPLICATION OF ONTARIO RST TO COMPUTER SOFTWARE

Some History: Computer Software and RST Taxation

The U.S. Influence. Since it was put more widely into use in the 1970's, computer software has been the target of progressive taxing attempts in virtually every RST jurisdiction in North American. While Canada's provinces have generally been on the scene since the early 1980's – perhaps the advent of the "personal computer" being the wake-up call that the provinces needed to target their taxing systems – they really took their lead from the approaches taken in many of the U.S. states, which considered the issues first.

In these U.S. jurisdictions, the Courts were, from almost the start, called to consider the status of computer software in a RST system that, arguably, targetted only goods.

Early cases, however, focussed on the distinction between so-called "canned" or "off-the-shelf" software – which the Courts tended to view as a "commodified" item, thereby causing them to view it as a taxable "good" – and their related cousin, "custom" software, which the Courts tended to regard as "non-taxable", for a variety of reasons.[11] (See Figure 1).

The Canadian Experience: Administrivia. The U.S. experience must not have escaped the eye of the Canadian provinces, as shortly after these cases came down, the provinces, began adopting similar administrative distinctions, and began advising taxpayers that transactions involving "canned" or "off-the-shelf" software would be taxed.

Yet by adminstratively defining software to be something that it clearly is not, and by using what ended up being some not-very-well-thought-out "administrative policy", what the provinces managed to create were systems where tax minimization was the norm, and where tax collection on software transactions was, perhaps, kept at a minimum.

This was basically true of the Ontario system, and arguably, set the stages for the May 1997 announcement that forms the basis for Ontario's current *legislative* scheme for comprehensively taxing computer software.

Figure 1: *Types of Software*

Software can generally be divided into four categories, as follows:

1.**Microcode or Firmware.** Microcode is a group of instructions encrypted or etched onto a computer chip, and physically affixed to the hardware when purchased. It provides the hardware with the basic performance instructions it needs to operate, like the basic instructions necessary to initiate programs, how to read the internal hardware installed as part of the "computer" (e.g., which drives to read first), and how to communicate with other ancillary equipment. Microcode would not generally be subject to a separate licence agreement.

2.**Canned Software.** Canned software is sometimes referred to as "shrink-wrapped", "prepackaged" or "off-the-shelf". Each moniker refers to mass produced software which is generally sold on an "off-the-shelf" basis, with shrink wrapped or adhesion-type licences.

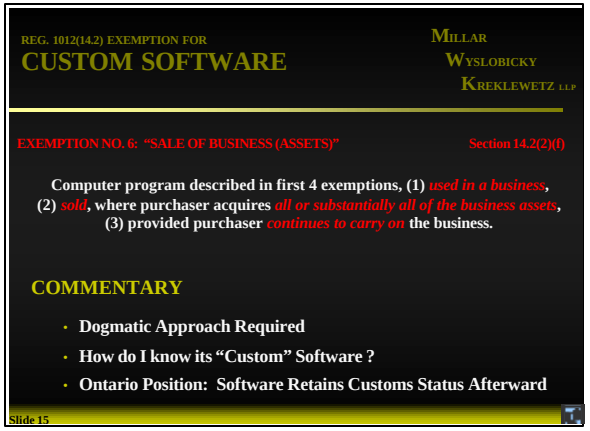
Under these types of licences, which are not signed, the terms of the licence are deemed to be accepted by the customer when and if the cellophane package containing the software is opened. Although this software is licensed to the end user, there is often a provision which allows the licence to be transferred to another party, with the original customer having no right to use the software once the transfer has been made. While canned software may be marketed by various parties and/or distributors, the shrink-wrapped licence continues to flow from the owner of the code to the end user. For all intents and purposes, then, the canned software is often considered to be "purchased outright" by the consumer, without modification. Canned software is also usually accompanied by detailed technical and installation manuals.

Canned software can be both operating software (e.g., DOS, OS/2, Microsoft Windows) or application software (Lotus 1-2-3, Lotus Notes, Microsoft Word).

3.**Custom Software.** Custom software is software that is custom-designed (sometimes entirely from scratch, sometimes from modules) and usually for one specific end-user, to that user's specification. Custom software is also usually provided by way of a specifically signed licence agreement, often also specifically negotiated by the parties. In these instances, the custom software is generally "non-transferable" to any other consumer, with precautions taken in the licence agreement for the return or deletion of the software at the end of the licence term. Sometimes the software is licensed for use on a specific machine only, with the licensor's specific consent required to transfer the software from machine to machine. Payments for the right to use custom software can either be based on a one-time charge or a monthly fee. In some cases, the custom software may also be acquired "out-right" by the end-user, who will effectively then acquire the intellectual rights to the "source code".

4.**Module-Based Software**. Module-based software is sometimes considered to be "custom" software, but differs from the more basic custom software which is designed from scratch. Module-based software is generally produced from a library of codes kept by the designer, to a particular customer's specific order, with the customer choosing selected functions from a prepared list of options. (Selections may depend on the specific type of equipment that will utilize the software, or the level of sophistication the customer wishes the software to operate at – i.e., the "bells and whistles" subscribed for). Once the particular functions have been specified by the customer, the producer then assembles the software from the modules, and writes the necessary "wrap-around" code which links the various modules together, and allows them to operate and interface in a logical manner.

Accordingly, while there is some degree of specification involved in the production of module-based software, there may only be minimum "source code" programming. Like "from scratch" custom software, module-based custom software is also normally the subject of a specifically negotiated and signed licence agreements. An example of module-based custom software is software which would run on mid-to-large scale equipment such as an IBM AS/400, and could include integrated systems and applications software.



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Ontario's Pre-1997 System. The administrative system that Ontario established for the taxation of computer software was typical of the poorly working systems described above.

Ontario's administrative position was set out in Tax *Information Bulletins 1-90* and *1-94*, but was also supplemented by unpublished (and elusive) rulings written by the Tax Advisory group at the Retail Sales Tax Branch.

Ontario's position was basically to tax (1) prewritten software, (2) provided on disks or tapes supplied by the vendor, and (3) sold under an assumed, adhesion, or shrink-wrapped licence agreement. All other software was considered to be a "non-taxable service", and not subject to Ontario RST.

The implications of such a straightforward approach should be fairly obvious: tax minimization was rampant ! Purchasers of software would either demand that their software acquisitions be effected under *signed license agreements*, or otherwise make arrangements to acquire the software *without* the use of any retained physical medium.[12]

Software producers would also organize their activities to achieve the most favourable results possible, effectively bringing a number of relatively easily planning steps into vogue.

The result was a situation where very few transactions involving computer software were taxed, even if the underlying software had "canned" or "off-the-shelf" attributes.[13]

Criticisms & Slaughtering Hogs. Ontario's RST treatment of computer software was open to a number of criticisms, the most practical of which was that its purely administrative approach led to an *ad hoc* assortment of "new and improved" policy initiatives in the software area, emerging on a "made to order" basis, and often unpublished. This led to some confusion as to how the tax was to apply, and may ultimately have led Ontario to announce, in its May 1997 budget, a move to tax computer software on a legislative basis.

A more cynical view of the May 1997 change really follows from the following adage: "pigs get fat; hogs get slaughtered".

The alternate view is that Ontario began to realize that its administrative system was not working very well, and that most of Ontario's larger consumers of software (i.e., business) had already figured out how to acquire software without paying RST – even where the software was "canned" and clearly within Ontario's view of "taxable" software. Seeing the rampant RST minimization that was occurring, Ontario decided to do something about it – and began with a model for taxation that began in British Columbia.

Figure 2a: ***Ontario Legislation***

1(1) **Definitions** — In this Act,

"*computer program*" means a program, thing, data, information, knowledge or an instruction, (a) that is used to instruct or inform a computer, machine or device, and (b) that is retained or transferred in any manner including by electronic means, and includes the types of programs described in subsection (3), documents designed to facilitate the use of all or part of a program and the right to use a program.

"*tangible personal property*" means personal property … and includes computer programs … .

…

1(3) **Types of computer programs** — The following types of programs are computer programs for the purposes of this Act:

1. A program to solve a problem using a computer, machine or device, including the sequence of automatic instructions for data processing equipment necessary to solve the problem.
2. Instructions to enable or cause a computer, machine or device to control a function or perform it or to produce a desired result and to do so either directly or using other equipment.
3. System programs, application programs, assemblers, compilers, routines, generators and utility programs.
4. Pre-written programs and any modifications to them. …

2.(1) **Tax on Purchaser, of Tangible Personal Property** — Every purchaser of tangible personal property … shall pay … a tax in respect of the consumption or use thereof, computed at the rateof 8 per cent of the fair value thereof. …

…

7.(1) **Exemptions** — The purchaser of the following classes of tangible personal property and taxable services is exempt from the tax imposed by section 2:

…

62. Computer programs designed and developed to meet the specific requirements of the initial purchaser, but only in such circumstances as the Minister may prescribe.

The May 1997 Announcement: The "Night"

If there was ever an instance where the budget announcement was like "night and day" with the actual legislation, Ontario's May 1997 budget announcement qualifies as the "night time" installment on computer software.

The precise position taken in the Budget Announcement was summarized by the Retail Sales Tax Branch some months later as follows: "Ontario's basic policy of taxing tangible personal property and exempting most services has not changed".[14]

It was unfortunately several months later – after the initial hub-bub of the budget announcement – that most Ontario taxpayers first given the opportunity of understanding just how misleading a statement that was.

October 1997 Announcement of Draft Regulations: The "Dawn"

While Tax Legislation Bulletin No. 97-3 provided some hint to the sort of system that Ontario was to implement by regulation, that only really became clear in another superceding Tax Legislation Bulletin, No. 97-4 (*Ontario Budget 1997 - Application Rules Relating To Computer Programs*, October 1997).

Bulletin 97-4 was much more detailed in scope than Bulletin 97-3, and actually contained some proposed language for the final version of the Ontario regulation (see Figures 2a and 2b for Ontario's current legislative and regulatory language, found in Regulation 1012(14.2)).

Expanded Definition of Taxable Software & Limited Exemption

It was fairly clear that the 1997 changes were significant. It was also apparent that the "exemption" for "custom software" was to be no where near as broad as it had been under Ontario's pre-1997 administrative policies. Whereas the norm prior to the May 1997 announcement was for most software to qualify as "custom software", just the opposite was to be true under the legislative scheme.

The basic legislative scheme is as follows.

Comprehensive Definition of Taxable Software. Under the new legislative scheme, Ontario's definition of TPP has now been amended to specifically refer to "computer programs", which are themselves defined (in section 1(1) of the *RSTA*) to mean a "program, thing, data, information, knowledge or an instruction, (a) that is used to instruct or inform a computer, machine or device, and (b) that is retained or transferred in any manner including by electronic means". Also included are *documents* designed to facilitate the use of all or part of a program and the right to use a program.

Then, to increase the net, a special subsection (in section 1(3) of the *RSTA*) specifically incorporates a number of other "inclusive" sub-definitions of computer programs with the end result being fairly simple: virtually all software is, *ab initio*, taxable in Ontario.

Figure 2b: ***Ontario Regulation 1012 (14.2)***

Regulation 1012 (14.2)

…

(1) In this section,

"**affiliate**" has the same meaning as in subsection 3(14) of the Land Transfer Tax Act;

"**custom computer program**" means a computer program that is designed and developed solely to meet the specific requirements of, and that is intended for the exclusive use of, a particular person, and includes a computer program that is modified as described under clause (2)(c) or (d);

"**modifications**" means changes made to the original source code of a computer program;

"**pre-written computer program**" means a pre-packaged computer program that may be purchased in a form that is ready for use without further modifications and includes a computer program that is designed and developed for the use of more than one person.

(2) For the purpose of paragraph 62 of subsection 7(1) of the Act, a computer program is considered to be designed and developed to meet the specific requirements of the initial purchaser if,

(a) the computer program is a custom computer program, whether designed and developed by the vendor or by an affiliate of the vendor;

(b) any modification to a custom computer program is made for the same person for whom the computer program was originally designed and developed;

(c) a pre-written computer program is modified solely to meet the specific requirements of a particular person and the price of or payment for the modification is separate from and is greater than the price of or payment for the pre-written computer program;

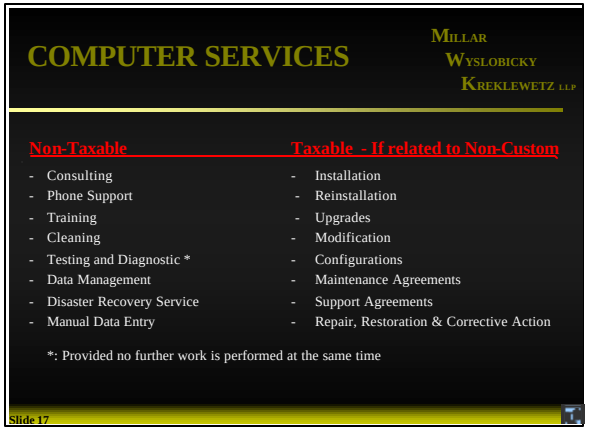
(d) a pre-written computer program is modified as a condition of its sale solely to meet the specific requirements of a particular person and the price of or payment for the computer program, as modified, is more than 200 per cent of the price that would have been the price of or payment for the computer program without the modifications;

(e) any further modifications to a computer program described in clause (a), (b), (c) or (d) are made for the same person for whom the computer program was originally designed and developed; or

(f) a computer program described in clause (a), (b), (c) or (d) that is used in a business is sold in a transaction in which the purchaser acquires all or substantially all of the business assets and will continue to carry on the business, and any modifications to the computer program provided to the purchaser.

(3) Subsection (2) does not apply to a computer program that is a copy of the computer program described in clause (2)(a), (b), (c) or (d) or that is sold or leased to or licensed for use by any person other than the person for whom the program was designed or developed.

(4) For the purposes of clause (2)(a), (b), (c) or (d), the price of or payment for the pre-written computer program is the price paid for the initial licence and does not include the price paid for any additional licences acquired by the purchaser. The price of or payment for the modifications does not include charges made for modifications on which tax was paid under this Act.



The Custom Software Exemption. Certain prescribed custom software is exempt under the Ontario RST, as provided for in section 7(1)(62) of the *RSTA*. That section is fairly limited, however, and applies only to software that has been "designed and developed to meet the specific requirements of the initial purchaser", and "only in such circumstances as the Minister may prescribe."

Simply put, the actual exemption is limited to only certain custom computer programs, being those that specifically meet Ontario's requirements under Regulation 1012.

The Main Exemption for Custom Software. The main exemption, then, is provided for the acquisition of:

> (a) A *custom computer program*, whether designed and developed by the vendor or by an affiliate of the vendor.
>
> – See Regulation 1012(14.2)(2)(d).

Here "custom computer program" means a "computer program that is designed and developed solely to meet the specific requirements of, and that is intended for the exclusive use of, a particular person".

Modifications. The Regulation also provides several possible exemptions for "software modifications", which may, in certain circumstances, be purchased on an "exempt basis", and may also, in other situations, have the effect of making certain purchased canned software, completely exempt.

Modification of Custom Software. The first of the four "modification" rules provides simply that modifications to custom software will continue to be exempt – provided the custom software is still in the hands of the initial purchaser. The rule provides as follows:

> (b) Any modification to a *custom computer program* made for the *same person* for whom the computer program was originally designed and developed.
>
> – See Regulation 1012(14.2)(2)(b).

Modification of Canned Software. The second and third of the four "modification" rules provide for special situations in which canned software can be modified, and purchased entirely exempt – including the modifications. The effect of the rules is to deem the modified program to be "custom", and therefore exempt.

The first of these applies to the situation where canned software has been purchased by the purchaser, and then modifications contracted for – perhaps with a person other than the vendor of the canned software. The rule provides as follows:

> (c) A *pre-written computer program* modified (i) solely to meet the specific requirements of a particular person, (ii) where the price of (or payment for) the modification is separate from, and (iii) greater than the price of or payment for the pre-written computer program.
>
> – See Regulation 1012(14.2)(2)(c).

The second of the rules addresses the situation where prior to the purchase of the canned software, the vendor and the purchaser (and possibly a third-party software producer) contract for the sale, such that the modifications are made part of the original sales contract. The rule provides as follows:

> (d) A *pre-written computer program* modified (i) as a *condition of its sale*, and (ii) solely to meet the specific requirements of a particular person, (iii) where the price of (or payment for) the computer program, as modified, is more than double the price that would have been the price of or payment for the computer program without the modifications.
>
> – See Regulation 1012(14.2)(2)(d).

Subsequent Modifications to Previously Exempt Software. The final of the four modifications rules provides for the exempt modification of any previously "exempt" situation described above. The rule provides, somewhat opaquely as follows:

> (e) Any further modifications to (i) a computer program described in clause (a), (b), (c) or (d), where (ii) made for the same person for whom the computer program was originally designed and developed.
>
> – See Regulation 1012(14.2)(2)(e).
>
> **NOTE**: As currently worded, Regulation 1012 provides the following definition of "modification": "modifications" means changes made to the original *source code* of a computer program. (For a full understanding of the ramifications of this definition, see the "Commentary" section below).
>
> **NOTE**: The term "pre-written computer program" is defined to mean "a pre-packaged computer program that may be purchased in a form that is ready for use without further modifications and includes a computer program that is designed and developed for the use of more than one person."

Supply of Software During Sale of A Business. The final exemption provided for by Regulation 1012 affords relief for a copy of a computer program, when supplied as a business asset, in the sale of a company. The rule provides as follows:

> (f) A computer program (i) described in clause 2(a), (b), (c) or (d), that (ii) is used in a business, (iii) is sold in a transaction in which the purchaser acquires all or substantially all of the business assets, and (iv) will continue to carry on the business (including any modifications to the computer program provided to the purchaser).
>
> – See Regulation 1012(14.2)(2)(f).

Issuance of RST Guide 650: "The Day"

While the Regulation was later published, it took some 4 years for Ontario to provide any sort of administrative guidance on the various issues that soon began cropping up. The guidance came in the form of RST Guide 650, dealing with *Computer Programs and Related Services* (the "Software Guide"), which was first made public at a March 1, 2001 meeting of the Southern Commodity Tax Consultation Group.

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Some of these tangential services may be taxable, but others – when provided separately for a separate price – are clearly not taxable.

The "bundled price" issue often arises in these situations, leaving vendors and purchasers scrambling to attempt to unbundle what is being provided.

The Software Guide is, in some respects, quite helpful in this area, by confirming that each of the following services can be acquired on a non-taxable basis, regardless of the type of software to which they relate:

- consulting services (for example, assistance or support either in person, over the phone, electronically, or via e-mail, but not hands-on)
- training services
- cleaning
- testing and diagnostic services, provided no further work is performed at the same time (see below for additional clarification)
- data management: including making, reorganizing and removing directories, creating and maintaining computer files, data back-up and storage
- disaster recovery service fees or subscription fees
- manual data entry

At the same time, however, the Software Guide makes it clear that this sort of unbundling must be conducted before-the-fact.

It will be interesting to see if the Audit Branch affords these sorts of situations with the same sort of administrative concession as made in the "Outsourced Printing" contracts referred to above.

Placement Agencies & Outsourced Non-Taxable Services. An industry that seems to have been completely taken by surprise by the changes to Ontario's computer software rules, and the intendant implications on those providing "taxable services". In these situations, the Placement Agency often contracts with third-party service providers (the "independent contractors"), and then sub-contracts their services to businesses on a needs-basis. It is often difficult to determine just what services these independent contractors perform, meaning that when it comes to differentiating between the performance of the "non-taxable" services outlined above, and services which would be "taxable" by virtue of being related to "pre-written" (i.e., not custom) software. The result is that for many of these Placement Agencies, there are no good record keeping arrangements available to substantiate the "non-taxable" nature of the independent contractor's services.

Similar issues also often arise with smaller IT providers, who may also have neglected to track or differentiate the types of services they were providing, leaving either them (as vendors) or their customers open to

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The Software Guide was long-awaited, and many had hoped that it would deal with a number of uncertainties present in Bulletin 97-4.

In many respects it did not, and only served to crystallize the Ontario's public's displeasure with the RST on computer software.

The balance of this Part focuses on some of the current computer software related RST issues, and discusses what if any impact the Software Guide has on these issues.

Commentary, Current Issues, and RST Guide 650

What will NOT Be Considered to be Custom Software. Since the general rule in Ontario is that all software is taxable unless expressly exempted, the much more interesting question is what Ontario considers to be "exempt" custom software under Regulation 1012(14.2).

The Software Guide spells that out, for the first time.

The Software Guide makes it clear that the following examples will involve *taxable* and *not* custom software:

(1) *The Developer has reserved the right to sell the program, as a whole, to others.* Apparently Ontario will be taking the view that even if developed for an initial purchaser, any plans on the producer's end to "mass-market" the software will make even the initial transaction taxable. That in my view places a premium on ensuring that the contract for the software production *precludes* the producer from selling the program to others.

On the other hand, there may well be an ability on the part of the producer to use the "code modules" and a "code library" to produce and market similar programs to others, although that would seem to leave open a gray area as to just "how different" would the mass-marketed programs have to be in order to ensure that the initial custom deal is not tainted by the producers subsequent mass-marketing efforts.

(2) *The Developer's intent at the time of the development is to resell the computer program to others.* This concept is, in my view, consistent with U.S. jurisprudence in which the Courts held that where there was an intention at the inception of the R&D to create a software program for mass-development, the software was inherently taxable as "canned software".

This again suggests that as a purchaser of "custom software" the underlying production contract would probably need a clause indicating that neither the producer or the purchaser has any "intent to sell to others".

(3) *The program is designed for a specific industry, and sold to several purchasers.* This one, I believe, can go without much explanation, as the situation described would not seem to meet the basis definition of "custom computer program" in Regulation 1012(14.2).

(4) *The same core program is used to develop a program for each customer, and only minor modifications or configurations are made.* My only comment on this one is that if Ontario decides to try and audit on the basis of this sort of policy, software producers are going to be tied up in litigation forever and ever.

The reason is that it is common for software producers to produce software (whether custom or canned) from pre-existing "software modules", and to use libraries of code to piece together programs. It appears a bit impractical in my view to suggest that this would not be the normal approach taken by software producers. Accordingly, Ontario's expected criteria, which demands a decision on whether or not "minor" modification or configurations are made seems worthy – in itself – of a detailed explanation.

Having said all of this, Ontario's view seems to be that the responsibility for determining whether something is really a "custom computer program" lies with the producer and the customer, likely making it essential for the underlying production contract to specify in some detail the "specific" and "custom" nature of the endeavour, including enough of the details to substantiate the non-collection of the RST. In Ontario's mind: 'The contract governs, the contract governs ! It's the first place we are going to look.' (See also the discussion *infra* regarding "Documentation Requirements").

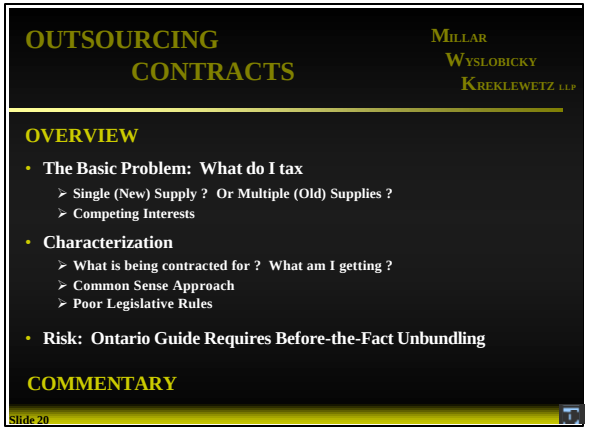
Resale of Custom Software Taxable ! A plain reading of the Regulation leaves it somewhat uncertain whether a "custom computer program" can be *resold* by the owner, on an exempt basis – although the answer from Ontario's perspective is not quite clear: a subsequent resale of "custom software" is taxable, unless falling within the "sale of business assets" exemption in Regulation 1012(14.2)(2)(f).

Whether that is in fact correct might be up for debate. In my mind, there is a legal argument available that the exemption in section 7(1)(62) forever deems a "custom computer program" to be exempt, making it a class of unconditionally exempt property.[15]

Unfortunately, Ontario does not take that view, and is of the position that the subsequent sale of a "custom computer program" is taxable, and requires the initial purchaser (now vendor) to charge and collect RST on any subsequent sale, as if the software were fully taxable – which in Ontario's view, it is.

This has currently created an important issue on the sale and re-organizations of businesses, especially where conducted via a "sale of assets". The business's "software" assets are now potentially up for grabs for RST purposes, and it often becomes difficult – even where there is a strong feeling that the software is ultimately "custom" and therefore "exempt" for RST purposes – to gain comfort that the sale of the software will be completely free from RST. While there is an exemption for sales of business assets in Regulation 1012(14.2)(f), there are requirements that must be met, perhaps the most important of which is that the software be a "custom computer program" to begin with.

Ontario has not made matters much easier, as it has continued to focus on the initial acquisition of the software (often years previous) to determine whether putatively "custom software" qualified as such from the very beginning.



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TIP: If your business has a large "custom software" component that you want to ensure is transferred on a non-taxable basis on the sale of the busienss, consider what support you have for the conclusion that the software is in fact "custom".

Application of RST to Remote Access to Software. In setting out what software will be "taxable", Ontario was careful to address the "remote use" of software and, in that respect, its policies are a bit surprising.

The Software Guide suggests that when it comes to remote access of software (e.g., software located in one province, but accessed from another), Ontario's position is as follows: (1) When software is located in Ontario, charges for accessing it are always subject to RST, even though the person accessing it may be located outside of Ontario, and (2) When software is located outside Ontario, charges for accessing it are never subject to RST, even though the person accessing it may be located in Ontario (unless the person in Ontario can "download" the software.

This suggests that the "install-at-address" will govern the taxability of the software. Accordingly, if the software is licensed for installation in Ontario (and is otherwise taxable software), Ontario RST will apply.

On the other hand, this also suggests an opportunity to avoid Ontario RST altogether. That that opportunity, it appears, would be to locate one's server outside of Ontario, in a jurisdiction which does not attempt to tax software for consumption or use tax purposes, and then simply make that software available to one's employees / personnel over the internet, or via an intranet system. The result: No RST ! No problem !

When Ontario really figures this out, however, it may ultimately do a flip-flop on this decision. Its position also seems particularly at odds with the technical application of the Ontario Act in other areas, since the position seems to overlook the general rule that persons bringing TPP into Ontario are subject to RST. (I would have thought that given the extremely broad definitions of "computer program", a person located in Ontario, and accessing software located outside of Ontario, is actually importing TPP for its own use – which Ontario has long attempted to tax.)

Acquisition in Ontario of Software, for Use Outside of Ontario. In an attempt to fix another "bug" in Ontario's legislative system, Ontario has indicated that it is currently considering what approach it should take in situations where a purchaser has obtained in Ontario a license to use a particular canned program, although intending that software for use across Canada, and indeed installing it across Canada onto various servers.

The problem here is that a potential double-tax situation could arise if Ontario demanded tax on the entire purchase price, since each of the other RST Provinces would also demand RST on the use of the software in their particular provinces.

Unlike BC's approach, which would tax only that portion of the purchase price relating to a BC use, Ontario has traditionally demanded 100% of the tax. My understanding is that Ontario may well be considering a legislative or regulatory change to fix this problem.

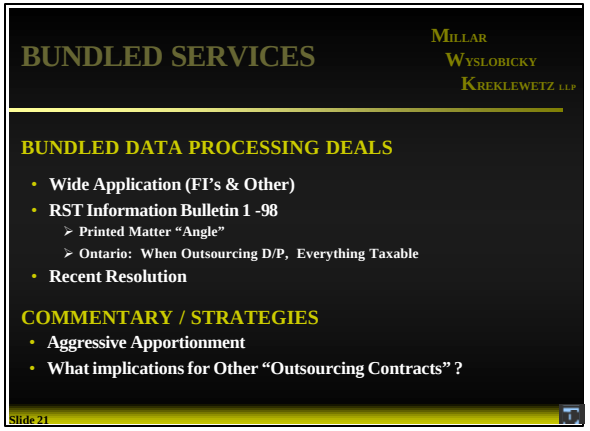
Modifications Issues. There remain a number of issues relating to modifications rules in the regulation, some of which are as follows.

Modifications Rules Require "Modification of Source Code". First and foremost, it ought to be recognized that in order to fall within the exemptions for "modifications", the modifications must be to "source code". Accordingly, charges for simply "configuring" taxable software would always seem to be taxable in Ontario. This is a sleeping giant in a lot of situation, since purchasers often automatically assume that when it says "modifications" in their contracts, the RST exemptions will apply if the "2 times" rules are met. That is not so, as "modifications" – as used in these contracts – often do not necessarily involve modifications to source code. (My information is that very very rarely would a software producer ever allow its source code to be unlocked and modified). Accordingly, unless Ontario changes this requirement through regulatory amendment, or administrative concession, the modifications rules may have only a limited application in Ontario.

Tip: Readers should note that there are some very large distributors of business and accounting software that may be seeking to use the modifications rules to 'exempt' their software, but which at the time of writing, were not engaged in modifying source code. In reality they were only writing "linkage" code, which while itself might have been exempt, would *not* have qualified as a modification sufficient to make the entire software acquisition "exempt". Purchaser's caught in these sorts of unfortunate situations face RST assessments, and could find that what they thought (and what the vendor thought) was "custom" software, is in fact taxable. It seems that the following adage is still appropriate: *caveat emptor* (buyer beware).

Readers should also note that while Ontario still has the legislative "source code" requirement, BC has addressed this situation by amending its own regulations (section 2.46(j) and (k)) to ensure that "configuration" charges can be exempted under the modifications rules.

This means that charges for installation, configuration and modification are all treated as the same sort of services for purposes of the BC modifications rules, and that any combination of such charges meeting the "2 times" rule in BC is enough to make the acquisition exempt as "custom software".



Such is not yet the case in Ontario, although the elimination of the "source code" requirement may well be expected in the future (see the discussion *infra*).

Dealing with Periodic Licence Fees. The Software Guide discusses the impact of the "modifications rules" in Ontario's Regulation 1012(14.2), which are based on the premise that the pre-written software (i.e,. that will be "modified", either as a "condition of sale", or "after-the-fact") will be "sold" for a single price.

An issue arises where the pre-written computer program is not sold, but perhaps licensed on a "monthly licence fee" ("MLC") or "annual licence fee" ("ALC") basis.

In these instances, it would be seem quite difficult to apply the modifications rules to these license fees. Clearly, in designing the "modifications rules", Ontario's Tax Design Branch may have paid too much attention to simply copying the approach adopted in BC – which is where these modifications rules really came from – and not enough time thinking about the practical application of these rules. BC's approach (and now Ontario's approach as well) simply did not take into account how the modifications rules would work when, instead of paying a single "purchase price" for a pre-written computer program, there were MLCs or ALCs. My understanding is that MLCs and ALCs are more prevalent when it comes to providing software for "larger" machines.

> **Tip:** Readers should pay close attention to the manner in which the software they are acquiring is being provided. Is the software being "sold" (in the sense that the licence contains a perpetual right to use the software, and for one all-in fee), or is the agreement for a more limited periodic licence of the software (e.g., with monthly or annual fees). If there is a perpetual right to use, for a single fee, chances are the software has been sold. If yours is the latter case, you may have the sort of MSC or ALC arrangements discussed above.
>
> Are the licenses exclusive or non-exclusive ? If the licenses are non-exclusive, is the vendor still taking the position that it is selling custom software ?
>
> Does the lease agreement really look like a financing or "conditional sales" agreement ? If there is a box checked for "conditional sale" (as one notable software distributor is known to employ), chances are that "lease" or "licence" agreement is really a conditional sales agreement, requiring all of the RST to be paid up front – as would normally be the case in "conditional sales" contract situations !

Dealing with Piece-by-Piece Modifications. The "modifications rules" also do not deal very well with piece-by-piece modifications. Another difficulty applying the "modifications rules" is determining just when billings for "modifications" can be included in the modifications calculations.

This is often referred to as an issue involving the "cumulative" or "non-cumulative" approach to modifications charges.

The Software Guide indicates that "if a contract exists but does not specify the price and extent of the modifications, you must charge RST on each periodic amount billed". Only if *one* of the periodic bills exceeds the price of the unmodified software can that amount (and future modifications amounts) be considered to be exempt.

The issue is whether this is a practical or fair system, particularly since at the time of the original contract, the extent of the full modifications required might not be known.

My view is that in taking the position it takes, the Software Guide creates some unfairness. If A contracts with B for the modification of A's pre-written $1 million software program, and the initial modifications are valued at $750,000, why should the modifications not be exempt if the modification actually provided end up being in excess of $1 million ?

Similarly, what if there is no agreement as to modifications, but over time, A spends in excess of $1 million on modifications. While I can understand Ontario insisting on RST being charged up and to the time that the modifications reach $1 million – I would have hoped that there would be a refund opportunity for A to claim back the RST paid on the previous billings. Granted, that might involve a legislative change, but as a matter of fairness, it would be something that ought to be looked at.

Documentation Requirements. Where a vendor or purchaser takes the position that the software it is selling or acquiring meets the "custom" software requirements (either because of its nature, or because of modifications), Ontario is very clear about its documentation expectations.

> If the program you are selling qualifies as a custom computer program, your contract or agreement should be properly documented to justify the non-collection of RST. The document should indicate that the charge is for the purchase of a custom computer program, and that the program meets the specific needs and is intended for the exclusive use of your customer. In the event of an audit you will be required to produce documents to support each tax-exempt sale you have made. You are not required to obtain a Purchase Exemption Certificate (PEC) from your customer for the sale of a custom computer program. More information about PECs can be found in RST Guide 204 - Purchase Exemption Certificates.

While a purchase exemption certificate is not technically required, one would have thought that it would still be a good idea, as it would provide at least some form of certification by the purchaser that the particular custom software meets the purchaser's "specific needs", and is "intended for "exclusive use". Otherwise it is a bit difficult to conceive how a vendor of software would be able to determine that the software is in fact custom software to begin with.

Clearly, the onus is put on the *vendor* of the software, however, to ensure that contractual documents are in place prior to the transaction to clarify that the software meets the "custom software" requirements. [16]

Audit Inconsistency. While demanding prior documentation, perhaps the one most difficult issue arising in the application of the RST to computer software (and related services) is the inconsistency being taken by the Ministry of Finance at the "audit level".

Auditors often take a widely disparate approach with some – on the most extreme end – treating virtually all software and related services as "taxable" unless the vendor or purchaser can prove to the auditor that the software or services are in fact exempt or non-taxable. Making matters worse, the same auditors usually take a very cynical view of the information and support being provided, often rejecting the same as "insufficient", and triggering the taxation of the software or service.

Most Recent News: Software Consultations. Following the issue of the Software Bulletin, Ontario made a budgetary announcement, as part of its 2001 Budget, to seek "input on the application of RST to computer software from taxpayers and other interested groups".

Those consultation groups were heard from in November of 2001, under the guise of the RST Simplification Project.

Most recently, the RST Simplification Project (chaired by Peter Deschamps) briefed the Minster of Finance, and was given further directions to consider possible options for fine-tuning or amending the software rules. My current information is that changes are being earmarked for the 2002 budget, but the extent of the changes may be limited by the potential revenue losses involved. In short, one should not expect the repeal of Ontario's RST on computer software anytime soon, or the repeal of the RST on related services (see *infra*). Having said that, there is some optimism regarding the RST Simplification Project that unlike other governments' consultation initiatives, that some concrete changes may well be in store.

My bet is that a "cumulative" approach will be taken for "modifications", and that the "source code" requirement will be relaxed, likely towards the more-inclusive approach now being taken in BC. As to any other changes that may be occasioned by the recent consultations, that is anyone's guess.

At the present time, the RST Simplification Project has taken some steps aimed at ensuring audit consistency, including meeting with Regional Audit Managers, and stressing the importance of a "reasonable" approach to audit issues in this area. Time will tell whether Audit actually hears that part of the message.

Unbundling Issues. Please see the discussion in Part III entitled *Unbundling Bundled Computer Software Deals.*

Unintended Effects: Non-Taxable Services. Perhaps the biggest unintended (or at least "unexpected") effect of the changes to Ontario's software rules came with respect to the application of Ontario RST to related computer services. The issue here essentially arose in the context of bundled charges for the following types of services:

- consulting services (for example, assistance or support either in person, over the phone, electronically, or via e-mail, but not hands-on)
- training services
- cleaning
- testing and diagnostic services, provided no further work is performed at the same time (see below for additional clarification)
- data management: including making, reorganizing and removing directories, creating and maintaining computer files, data back-up and storage
- disaster recovery service fees or subscription fees
- manual data entry

Arguably, these sorts of services were "non-taxable" to begin with, and never should have been taxed. Through inadvertence, however, many vendors of software included charges for these non-taxable services in their prices – leaving potential exposure for RST thought arguably should not have existed.

Where the software involved is "custom software", each of the following services is also specifically exempted by section 7(1)(2)() of the Ontario Act, as confirmed by the Software Guide as follows:

> You are not required to charge RST on any related service charges on a custom computer program, provided your customer has given you a properly completed PEC. Examples of such services include:
>
> • installation or reinstallation, upgrades, modifications or configurations
>
> • supplying additional copies of the program to the original purchaser
>
> • maintenance and support agreements
>
> • repairing, restoring or providing corrective action.

Part III discusses some current trends in "post-transaction" unbundling.

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PART III

OUTSOURCING CONTRACTS

While relating predominantly to RST, the problems associated with "bundled services contracts" (which I will refer to globally as "outsourcing contracts" is probably one of the hottest audit issues (or exposures) today.

Overview

What Do I mean by Outsourcing Contracts ? When I speak of "outsourcing", I am referring to a wide range of contracted services, where a business "contracts-out" some of its non-core functions or processes, allowing a third-party service provider to provide these services, either "in-house", or from an off-site location. The sorts of functions contracted-out can include as follows:

- security
- maintenance
- janitorial
- temporary assistance services etc.
- management information technology (e.g., data processing)
- network management activities
- private label branding
- packaging and distribution services
- logistics
- customer service
- finance and administrative processing
- human resource processing
- tax compliance
- internal audit

What is the RST challenge with Outsourcing Contracts ? When it comes to "outsourcing contracts", the real commodity tax "challenge" lies in the fact that what was once "in-house" (and not subject to any commodity taxes) has now been transformed into a possibly taxable transaction through the sub-contracting transaction.[17]

Once a "sub-contract" relationship has been established, however, there is a new "transaction" or "tax-point" to be considered. The relevant consideration then becomes, what am I receiving, and is it taxable for RST purposes ?

That is a double-barrelled question, and is the real question at the root of all outsourcing problems.

What am I receiving ? The Characterization Issue. As outsourcing contracts are typically a single contract providing for a variety of goods and/or services, the Characterization Issue usually involves trying to determine, in the context of "bundled" goods and services, just what the purchaser is receiving from the vendor. The answer is important because Ontario's default position is that if the bundle of goods and services contains something (a particular component) that is "taxable", then that taxable component may end up "tainting" the whole bundle, and causing tax to be triggered on everything: on the full value of the contract.

That brings squarely into issue the Characterization of the contract, and the various services being provided.

Characterization is a bed-rock concept for RST, as only after one determines what is being supplied, can one determine how RST applies. In the context of "services" contracts, one often sees a number of possible characterizations: "taxable goods" (i.e., as in a contract for the provision of taxable software), "exempt goods" (i.e., as in the provision of exempt custom software), "taxable services" (i.e., as in the provision of installation, configuration, or maintenance services in respect of TPP), "exempt services" (i.e., as in the provision of similar services in respect of exempt custom software) or "non-taxable services" (i.e., as in the provision of services that are unrelated to TPP, and otherwise outside of the relevant "taxable services" definitions).[18]

> **Example:** An example of the importance of Characterization can be taken from the old FST, where the issue first cropped up in the context of "bundled goods". For example, one case dealt with how to treat an "exempt" book that was packaged with a "taxable" record ? Was the resultant package taxable or exempt ? The Court focussed on whether a "new product" had been created, and found that since the new package had a new *form*, new *qualities* and new *properties*, it was properly regarded as a "new good". That was an unhappy result for the taxpayer, since that new "single supply" of a new good was taxable !
>
> Had the Court concluded that no "new good" (and no "new supply") had been created, then it would have had to have concluded the supply consisted of multiple components (i.e., a "multiple supply"), and treated each according to what it was (i.e., the value of the record would have been taxed, but the value of the book would have remained exempt). [19]

An even more complex situation arises where taxable and non-taxable services are bundled together. That might occur, for example, where a networking business provides non-taxable networking services together with access to telephone lines – which are taxable in their own right under every RST systems' definition of "telecommunications services". It might also occur where installation of taxable software is combined with general training on the use of the software.

Generally speaking, the case law again suggests that if one can be seen to be incidental to the other, the incidental one will lose its independent character. Unfortunately, the legal tests employed in the bundled services situation are still developing, and the analysis borders on the abstract.[20]

This sort of analysis is, effectively, what has to happen in an outsourcing situation, as a Court would be required to determine whether, as a whole, the outsourcing contract provides for a "single supply" of some new goods or services, or is otherwise just a bundle of "multiple supplies", taxable on the basis of the individual components.

Unfortunately, one has invariably found that Ontario auditors usually end up "discovering" that the true nature of these outsourcing contracts results in "taxable goods" and "taxable services" ! (I have yet to encounter an auditor who, after reviewing a complex situation, is able to conclude that everything is properly exempt, or non-taxable !)

Legislative & Administrative Fixes. While some provinces have provided fixes for "bundled goods", most have not dealt very well with bundled goods and services, or bundled goods alone. These rules also tend to be "piece-meal" type rules, that are not comprehensive enough to adequately deal with something like an outsourcing contract.

In Ontario, for example, the rule is set out in section 3.1 of Regulation 1012, and effectively deems packaged goods to be taxable, unless the price of exempt components is subject to a "separate and reasonable charge", and "each separate and reasonable charge is clearly communicated to the purchaser", and the vendor keeps records of that. Where the package or arrangement is comprised of 90% or more of exempt goods, the packaged goods rule deems the value of the package to be nil – effectively operating to exempt the entire package.[21]

Notably the rule does not apply to "bundled services".

BC's rule does apply to "bundled" services. In BC, if the services are bundled, worth less than $100, and the taxable portion represents more than 50% of the consideration, the whole this is taxable. On the other hand, if the combined charge is more than $100, it is taxable under these rules – assuming that BC's administrative position is upheld. Where the charges for the services are both broken out, and separated on the invoice, only the taxable services would be taxed.

The balance of this part examines, in this framework, some current issues involving Outsourcing Agreements.

Bundled Data Processing Deals. Perhaps one of the first-recognized outsourcing deals in Ontario was the common "data processing" (D/P) deal, where a business outsourced its data processing requirements, obtaining in return, the data processing services contracted for, as well as miscellaneous printing, distribution and management of its customer forms.

Ontario identified this situation in 1997, and published a detailed position in a 1998 RST Information Bulletin (1-98) Ontario, serving notice to Financial Institutions – many of whom had identified this area as a good outsourcing opportunity – that Ontario would be seeking to apply the RST to any "printed matter" that was created under these deals, and on the basis of the full fair value of the deal. (In other words, the fact that a D/P outsourcing contract resulted in some "printed matter" was enough, in Ontario's view, to taint the entire deal, and trigger tax on all of the amounts payable under the deal – no matter whether for the non-taxable D/P services, or more directly tied to the production of the (arguably) taxable printed matter.

Information Bulletin 1-98 provided as follows:

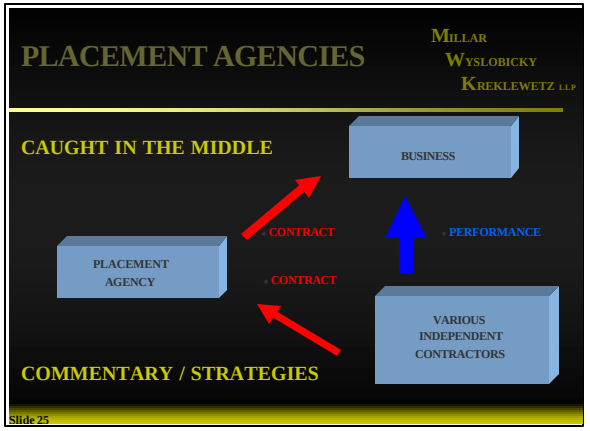
Printing by Financial Institutions

> Banks and other financial institutions often provide letters, statements, or similar documents to clients confirming financial transactions. When financial institutions produce the letters, statements, or other printed materials in a normal office setting, they are not required to remit RST on the manufactured cost of the printed matter. However, where the financial institution has a dedicated area where the main function is the production of printed matter, and the production costs exceed $50,000 per fiscal year, RST is payable on the total manufactured cost of the letters, statements or other taxable printed materials.
>
> If these letters, statements, or other printed materials are produced by an outside company based on data provided by its clients, the printed matter is not printed in a normal office setting. In these situations, usually, the financial institution inputs the core data and transfers it on a regular (usually daily) basis to the outside company and the outside company does not input any new data, alter or update records or process any information. The total amount charged to the financial institution for the printing of the letters, statements, or other taxable printed materials is subject to RST, including any charges made for blank pre-printed forms.
>
> Where this outside company also mails the letters, statements, etc., the lettershop service (ie. insertion of letters into envelopes and mailing) is not subject to RST provided such charges are shown separately on the invoice.

Ontario audited these transaction extensively, and its position was severely criticized.

On the other hand, many of these outsourcing deals provided for single monthly charges, which were not otherwise broken out or apportioned as between the taxable, exempt or non-taxable components in the agreements. And the "plain vanilla" situation described by Ontario in Information Bulletin 1-98 did look a lot like "jobbed printing" – which has traditionally been taxed for RST purposes.

Thankfully, some resolution appears to have been recently reached, with Ontario issuing one audited taxpayer a ruling letter, apparently allowing for the "after-the-fact" unbundling of the transaction, even though the monthly charges had not been previously broken out.



Ontario provided as follows:

> October 17, 2001
>
> …
>
> RST is payable only in respect of the taxable services under the Outsourcing Agreement. As the monthly fee charged by XXX is not segregated between the taxable and non-taxable services, it is our opinion that RST must apply to that part of the fee which [is] attributable to the taxable services only.
>
> **Therefore please allocate the monthy billing of $* into taxable and non-taxable components for the period from July 01, 1995 to February 21, 1999. Also provide a detailed explanation as to how the allocation was arrived at and how much allocation has been done for each service.**

What Ontario really is providing for is an after-the-fact "apportionment" of tax, as between taxable, exempt and non-taxable components, with Ontario taking the position that the items could well be broken out after the fact.

The position is at odds with the more restrictive approach taken in Ontario RST Guide 650 which only allowed for "before-the-fact" unbundling, and it will be interesting to see how far Ontario allows this approach to go. [22]

My own view is that Ontario probably took the best approach it could have in the circumstances. Jurisprudence from Ontario and the U.S. suggests that "in determining liability for tax, one must look at the nature of the transaction and the surrounding circumstances" to characterize it, [23] and that the fact that charges for a transaction are not segregated is no bar to taxing the individual components. [24] Thus, whether there is a "bundled" contract for a single price, or an "unbundled" contract with separate prices for each individual service, is not determinative; rather, it is a question of fact to be ascertained in each particular case.

> **Tip: Artificial Unbundling Unacceptable.** Despite the comments above, Readers should not3 that the "artificial" unbundling of a transaction is probably still unacceptable. [25] And Ontario appears to have put even the taxapayer above on notice that it will be vigilant in reviewing and auditing the manner in which charges are "apportioned" under its new after-the-fact approach, requiring the taxpayer to provide "a detailed explanation as to how the allocation was arrived at and how much allocation has been done for each service" – information likely necessary for just such a verification.
>
> Further, it should be recognized that in situations where the final component is taxable, Ontario would also be expected to demand that RST be payable on the full fair value linked to the service, and would generally not allow certain tasks to be segregated and treated on an isolated basis as a non-taxable service.

Figure 3: ***Section 2(9) Fair Value Provision***

Section 2(9) of the Ontario Act is an important and significant tool that Ontario is able to wield where there are issues with respect to the proper "fair value" for a taxable good or service. It provides as follows:

> 2(9) **Determination of Fair Value** — Where the Minister considers it necessary or advisable, he or she may determine the amount of any price of admission or of any premium, or the fair value of any tangible personal property or taxable service, for the purpose of taxation under this Act, and thereupon the price of admission, the premium or the fair value of the tangible personal property or taxable service, for such purpose shall be so determined by the Minister unless, in proceedings instituted by an appeal under section 25, it is established that the determination is unreasonable.

> **Tip:** Refund Opportunities ? As a further tip, where Ontario does conclude that "printed matter" is being created, and does tax the revenues earned by the vendor on the contract, consider checking the underlying RST status of the printing equipment, which may now qualify for RST exemption. Refunds can generally be claimed.

Other Bundled Outsourcing Deals. While the discussion above has focused on the application of RST to outsourcing contracts involving "data processing" services, there is no reason not to expect the same general approach from Ontario on other outsourcing deals.

The same issues will generally arise, however, and readers are cautioned that while Ontario has seemingly provided for an "after-the-fact" unbundling/apportionment opportunity, it will ultimatley be expecting its proper share of the tax.

Accordingly, where too aggressive an unbundling approach is taken, one might reasonably expect less than a favourable response from Ontario. Remember: pigs get fat, and hogs get slaughtered. Where Ontario finds that a vendor has been too aggressive in its unbundling or apportionment activities, the vendor should reasonably expect a section 2(9) assessment to be raised. (See Figure 3).

Unbundling Bundled Computer Software Deals.

While the application of Ontario RST to computer software was discussed in Part II, the "unbundling" concept applies equally to contracts involving more than just computer software. Accordingly, another area where one can see the difficulties posed by Ontario's approach to "bundled services contracts" is in software acquisitions.

In this day and age, businesses will not often acquire any software without first contracting (or ensuring) for a proper needs analysis, and post-sales service contract (including periodic maintenance, fixes, training, and more consulting).

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Some of these tangential services may be taxable, but others – when provided separately for a separate price – are clearly not taxable.

The "bundled price" issue often arises in these situations, leaving vendors and purchasers scrambling to attempt to unbundle what is being provided.

The Software Guide is, in some respects, quite helpful in this area, by confirming that each of the following services can be acquired on a non-taxable basis, regardless of the type of software to which they relate:

- consulting services (for example, assistance or support either in person, over the phone, electronically, or via e-mail, but not hands-on)
- training services
- cleaning
- testing and diagnostic services, provided no further work is performed at the same time (see below for additional clarification)
- data management: including making, reorganizing and removing directories, creating and maintaining computer files, data back-up and storage
- disaster recovery service fees or subscription fees
- manual data entry

At the same time, however, the Software Guide makes it clear that this sort of unbundling must be conducted before-the-fact.

It will be interesting to see if the Audit Branch affords these sorts of situations with the same sort of administrative concession as made in the "Outsourced Printing" contracts referred to above.

Placement Agencies & Outsourced Non-Taxable Services. An industry that seems to have been completely taken by surprise by the changes to Ontario's computer software rules, and the intendant implications on those providing "taxable services". In these situations, the Placement Agency often contracts with third-party service providers (the "independent contractors"), and then sub-contracts their services to businesses on a needs-basis. It is often difficult to determine just what services these independent contractors perform, meaning that when it comes to differentiating between the performance of the "non-taxable" services outlined above, and services which would be "taxable" by virtue of being related to "pre-written" (i.e., not custom) software. The result is that for many of these Placement Agencies, there are no good record keeping arrangements available to substantiate the "non-taxable" nature of the independent contractor's services.

Similar issues also often arise with smaller IT providers, who may also have neglected to track or differentiate the types of services they were providing, leaving either them (as vendors) or their customers open to

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ENDNOTES:

1. For these purposes, consider that there are only five Canadian provinces which still imposed stand-alone RST systems. These are: British Columbia ("BC"), Saskatchewan ("SK"), Manitoba ("MB"), Ontario ("ON") and Prince Edward Island ("PEI"). These provinces may sometimes be referred to in these materials as the "RST Provinces".

2. The existing RST systems are as follows: in BC, the *Social Services Tax Act* applies at a general rate of 7%; in SK, the *Provincial Sales Tax Act* applies at a rate of 6%; in MB the *Retail Sales Tax Act* applies at a rate of 7%; in ON the *Retail Sales Tax Act* applies at a rate of 8%; and in PEI, the *Revenue Tax Act*, 1988 applies at a rate of 10%. The Ontario *Retail Sales Tax Act* will be referred to here as simply the Ontario Act. Other provincial legislation referred to above will be referred to in the same way (e.g., the BC Act, the SK Act, etc.).

3. See, for example, *Cairns Construction Ltd. v. Government of Saskatchewan*, [1960] S.C.R. 619.

4. The logical result of this is the creation of purchase exemptions in every RST systems which, one can see, are not so much a matter of provincial generosity as they are a constitutional imperative.

5. The structures of the taxing systems in ON, PEI and MB tend to be very similar perhaps due to the timing of their respective taxes (all enacted within about 7 years of each other in the early 1960s). BC and SK, with somewhat older systems, tend to be quite different in structure, although containing each of the (constitutionally required) elements described just above.

6. While QB's QST is a sales tax system levied on purchases at all levels of the production and distribution chain, business purchasers are usually afforded refunds on business inputs, helping confirm that the QST is intended to be borne by the ultimate consumer or purchaser.

7. The recent addition of a separate charging provision in section 2.0.1 of the Ontario Act has recently obviated the need for defining purchaser in this manner, and these words were removed from the definition: see s. 2.0.1 of the Ontario Act, as added by 2000, c. 10, s. 24, effective May 3, 2000.

8. Please note that a number of exceptions and conditions apply to some of these exemptions, meaning that in each case, the actual legislative rules ought to be consulted prior to determining if a particular supply is an exempt one.

9. Effective July 31, 2001, the BC Act was amended to provide an exemption from tax on the purchase or lease of certain prescribed machinery and equipment, provided it was (1) used by qualifying manufacturers in their manufacturing operations,(2) used by persons regularly engaged in logging, or (3) used by persons regularly engaged in the exploration, discovery or development of petroleum, natural gas, coal, and mineral resources. Full details on the BC exemption for production machinery and equipment are available in new Division 13 of the BC Regulations. The BC definition of "manufacturer" is found in Regulation 13.1, with the list of "prescribed equipment" found in Regulation 13.2.

   Readers interested in the BC production and machinery exemption will also want to review a BC Consumer Taxation Branch Notice issued on September 2001, dealing with *Tax Exemption for Production Machinery and Equipment: Clarification of Requirements to Make Exempt Sales or Leases*, and styled as a "Notice to Sellers, Lessors, and Taxable Service Providers".

   Reference to new BC Consumer Taxation Branch Bulletin No. 054, *Manufacturers* (Revised July 2001) would also be in order.

10. According to the jurisprudence, other factors could include: (a) the place where the TPP were delivered, (b) the place where the payment was made, (c) the place where the TPP in question were manufactured, (d) the place where the orders were solicited, (e) the place where the inventory of the TPP is maintained, (f) the place where the company maintains a branch or office, (g) the place where agents or employees, who are authorized to transact business on behalf of the non-resident person, are located, (h) the place where bank accounts are kept, (i) the place where back-up services are provided under the contract, and (j) the place in which the non-resident person is listed in a directory.

11. Whether taxed as TPP or a "taxable service", most provinces usually draw a distinction between operational (or "systems" software) and "off-the-shelf" (or "canned") applications on the one hand, and specially designed software ("custom" software) on the other hand. While the former was almost always taxed, the latter was afforded "non-taxable" status, for a variety of reasons (e.g., it is considered the provision of a non-taxable service, or an "intangible right", etc.).

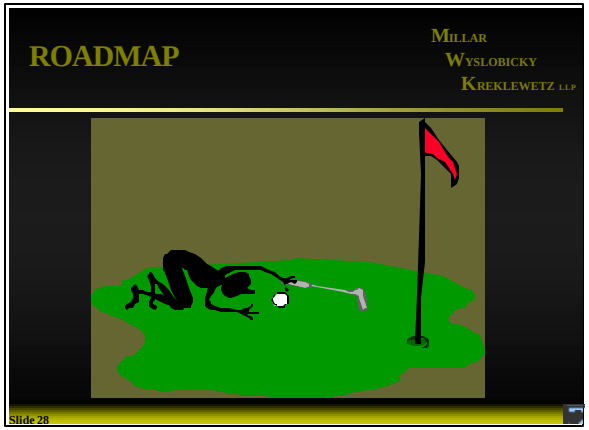
12. While many of these transactions took place prior to the modern development of the internet – i.e., the internet was around, and had been around for some time, but few people were that acquainted with it, or using it regularly as part of their business activities – arrangements were usually made to transfer the software electronically via modem, from system to system. In some cases, software developers simply provided the disks or tapes necessary to transfer the software from system to system, but stipulate that that physical media remained the property of the vendor. By also requiring the immediate return of the media, the producers took the position that this avoided the application of the Ontario RST, based on a strict reading of Ontario's policies.

13. Some of these planning steps were addressed on an *ad hoc* basis by further administrative policy, as was the case with a February 1994 "clarification" which announced that the sale of computer software by a "distributor" (i.e., a reseller, or a person other than the original licensor) was a sale of taxable TPP *regardless* of the sort of licensing arrangement in place. Thus one acquiring software from a "distributor" had to pay RST even if a signed licence agreement was used, and even if acquiring the software without the use of any physical media.

14. See Ontario Tax Legislation Bulletin No. 97-3 (*Ontario Budget 1997 Changes To The Retail Sales Tax Act*, May 1997).

15. In my mind, there is a legal argument available that the exemption in section 7(1)(62) forever deems a "custom computer program" to be exempt, making it a class of unconditionally exempt property.

16. For further information on Ontario's approach to the taxation of software see Carol E. Felepchuk & Robert G. Kreklewetz, *Current Commodity Tax Issues in Management of High-Tech Resources*, (Ottawa, Canada: A Paper presented at the 1998 Commodity Tax Symposium, 1998).



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ENDNOTES (Continued)

17. There is a basic contractual rule that suggests that one cannot contract with one's self. That means that when someone has employed another (i.e., in an employment relationship), the "fruits" of that labour accrete to the employer. There is no separate supply, and no separate transaction to tax for RST purposes. (Note that for GST purposes, this common law rule has been codified into the definition of "business", which excludes an "office or employment"; the result is to ensure that "employees" are not imposed with GST obligations in respect of their services). To perhaps clarify matters for RST purposes, section 7(1)(2)(v) exempts taxable services that are "provided by a person for the person's own consumption or use" – arguably a section that was not necessary in the first place, since it is doubtful that the "taxable services" would ever have been regarded as being provided by the person, to the person's self.

18. Note that "non-taxable" is different from "exempt", as it suggests that tax was never imposed on the particular good or service in the first place. The word "exempt" suggests that tax was initially imposed of the particular good or service, but that the supply was for some reason "exempt", based on an "exemption" elsewhere in the taxing act.

19. In a sale of a single good it is easy to see that the supply is one of TPP. Even when there is a sale of multiple goods, one can generally determine the RST status of the sale(s) without that much difficulty.

    As indicated in the Example, the common law rules that developed under the old Federal Sales Tax suggested that where goods are sold together in combinations, there would be a "single supply" of a new good if the new collection of goods had "new forms, qualities and properties". In that instance, a "new good" would be regarded to have been created, with the old "inputs" losing their separate identities as TPP: see for example *W.T. Hawkins Limited v. The Deputy MNR*, [1957] Ex.C.R. 152, *Gaston Charbonneau v. The Queen*, (1978), 79 D.T.C. 5008 (F.C. T.D.), and *Walt Disney Music of Canada Limited v. The Deputy MNR*, (1983), 9 T.B.R. 72 (Tar. Bd.).

    Where "new forms, qualities and properties" *cannot* be seen to have been created, just the opposite conclusion resulted: there was a sale of multiple goods (or the provision of "multiple supplies), with each component being taxed in its own right.

20. The supply of "bundled services" is a bit more difficult to grapple with, however. Here, the common law jurisprudence suggests a "common sense" test be applied, with one question being whether or not one of the supplies (e.g., one component of the package) is merely incidental or ancillary to the other. Another way of asking that is whether or not the purchaser really needed both supplies. If he or she did, then the conclusion would mitigate towards consider a "new" supply to exist, with the inputs losing their legal character. In the case of TPP being combined with services, that conclusion would usually lead to a "new service" – which given the current structure of the RST systems would lead to the conclusion that a new non-taxable supply had been created.

    A simple example arises when a taxable good is bundled, say, with a non-taxable service, as in the case of TPP (e.g., a crane) rented with an operator's services. Ontario recognizes that in certain instances, the TPP will be "incidental" to the provision of a non-taxable service, and therefore a new non-taxable supply. Generally speaking, however, there would only be "one charge" expected for the combined supply. (Also note that depending on the facts of the particular situation, the presence of an "operator" may not always guarantee the non-taxable nature of the supply).

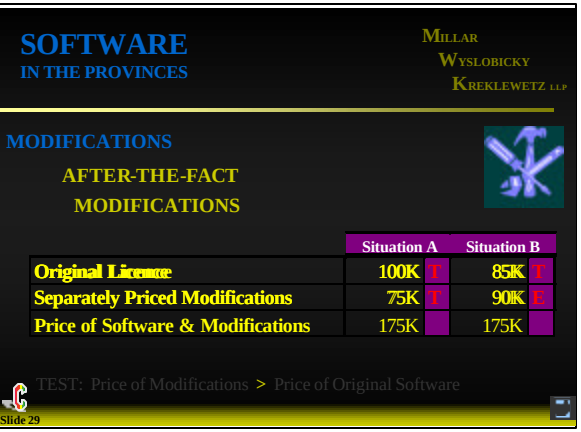
21. Please see the precise rule. There are exemptions. For example, the packaged goods rule work differently (and has some special requirements) for packages or arrangements including liquor, beer or wine.

22. Ontario's position, as set out in the Software Guide, was that when it comes to bundled contracts, "you must separate on your invoice the non-taxable charges from the taxable charges or the entire bill is taxable". (See page 4 of the Software Guide.)

23. See *Syroco Canada v. Minister of Revenue (Ontario)*, [1983] ETC (Ont. S.C.).

24. Our general view is that It is our view that neither the Ontario the Act or the Ontario Regulations support Ontario's position regarding non-allocation of single price contracts for packages of taxable and non-taxable services. Rather, it is our view that allocation is the legally correct approach to determine the "fair value" where there is one price for a package of separate services. This follows from section 2(19) of the Ontario Act, which requires that RST be "calculated separately on every purchase", as well as prevailing jurisprudence.

25. Numerous cases stand for the proposition that vendor cannot "artificially" unbundle prices so as to obtain a particular tax result. See for example: *Merlin's Caberet Ltd. v. The Queen*, (1995) BCSC (A950643) and (1993) BCSC (A933462/3); *Canadian Pacific Limited v. The Minister of Revenue (Ontario)*, (1990) 12371/86 (Sup Ct. On.), *Coquitlam Plymouth Chrysler Lt. v. The Queen (B.C.)*, [1983] 5042 ETC (BCCA) and *Sharp (Texas) v. Direct Resources for Print*, (1995) 910 S.W. 2d 535 (Court of Appeals of Texas).



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MODIFICATIONS

CONDITION-OF-SALE MODIFICATIONS

	Situation A		Situation B	
Original Licence	100K		85K	
Condition-of-Sale Modifications	75K		90K	
All-In Price	175K	T	175K	F

TEST: All-in Price of "New Software" **> 2X** Price of Original Software

Slide 30

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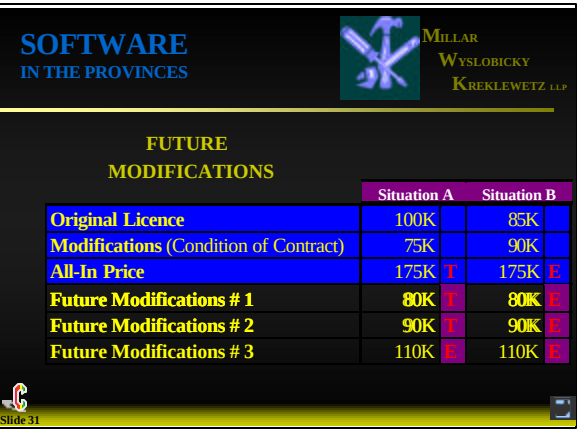

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