

December 2007

## The Issue: *Clarity in Ontario's Retail Sales Tax*

One of the expectations elemental to the way government operates is that it will apply laws fairly to all, particularly where taxation is involved, and write those laws in such a way that they can easily be understood. In addition to being fair, taxation policies should reflect the realities of the marketplace; that's a basic tenet of democracy. Above all, government should not introduce complexity and uncertainty into tax law, particularly when audits might lead to punitive action.

In Ontario, retail sales tax (RST) law affecting ICT suppliers is currently in opposition to both those concepts.

At the root of the problem is wording included in Guide 650 on Computer Programs and Related Services, which was revised by Ontario's Finance Ministry in April 2006. Guide 650 covers a broad range of topics, but creates unnecessary complexity and uncertainty in two key areas: the definition of non-taxable computer services and what qualifies as "custom software." More than 18 months after the release of the revised guidelines, audit results have failed to clarify the intent of the guidelines vis a vis the original tax legislation, and the government has not been forthcoming with additional details.<sup>1</sup>

One of the key issues regarding IT service exemptions involves project planning services previously deemed RST-exempt in the legislation, including: analyzing specifications, determining and verifying hardware and software prerequisites, scheduling, preparing reports, reviewing documentation, and discussions between vendor and client. Guide 650 suggests that such services are not exempt if they are performed to supply a

service that is taxable. If planning services are provided throughout a project, only those provided in the initial stages are exempt.

Not only does this interpretation seem to run counter to the legislation, and the Ministry's earlier interpretations, but it ignores the reality that planning for large IT implementation projects is often ongoing, and involves adjusting initial plans to meet the customer's evolving requirements or to address unanticipated setbacks.

The Guide goes on to state that certain services, such as training, are non-taxable regardless of whether they are provided with taxable goods or services, as long as a separate charge is made. Although exemptions are always welcome, why is one service always exempt, while another is subject to a number of conditions in order to qualify for the same treatment?



As well as generating additional complexity in the tax policy, the new guidelines create uncertainty about the fate of other exempt services, and leave IT service providers and their customers wondering if they will be liable for taxes they should have paid.

Guide 650's wording related to what constitutes "custom software" raises more uncertainty.

While the guide reinforces the concept that custom computer programs are exempt from RST, it states: "A computer program does not qualify as custom if:

<sup>1</sup> ITAC is grateful to Audrey Diamant and PricewaterhouseCoopers for various articles on this subject from which this paper borrows extensively.

- it is designed and developed for the use of more than one person (i.e., more than one legal entity), or
- the intent at the time of development is to resell the computer program to others (e.g., the developer retains the rights to the source code or the program), or
- the same core program is used to develop a program for each person, and only minor modifications are made to that program.”

This fails to clarify how the original software is treated under tax law should the same program be sold – and taxed – to another, related corporate entity. Does such an occurrence render subsequent work related to the original program taxable, and in fact is the original sale rendered taxable retroactively?

The provision that “rights to the source code or the program” must be transferred to the purchaser overlooks the reality that, while software may be created for one user incorporating new elements, the program may still include some sub-routines and strands of code to which the programmer either cannot or will not cede control. Reusable elements may include a code for standard security routines that do not reflect or compromise the true and unique nature of the program but, for convenience, is used time and again. It is not unusual for a vendor to develop software with the objective of it being used solely by a particular purchaser while retaining various rights to the intellectual property embedded in the program. The guidelines appear to ignore the fact that it is typical for developers to rely on some amount of pre-written code developed by others – combining it with the developer’s original code to achieve a unique program for one customer.

While Ontario has generated uncertainty among IT service providers, software developers and their clients, British Columbia has moved in the opposite direction, eliminating provincial sales tax on all software-related services.

ITAC believes that both these areas of Ontario’s RST provisions require clarity. As it stands, the broad, ambiguous statements contained in Guide 650 – and the seeming inconsistency between the guide’s provisions and the wording of the original legislation – threaten to create unneeded conflict in an audit, where general positions are often favoured over nuanced views.

In addition, to ensure that the intention of the law is followed, RST guidelines should reflect the reality of the way services are provided and software is

manufactured. Planning elements related to tax-exempt services should clearly not be taxed, and guidelines should be re-drafted to make that clear, unless the law is to be changed.

Software developers should be allowed to reuse basic elements of code that are intrinsic but not essential without jeopardizing the custom nature of the software being sold.

ITAC’s advocacy on these issues follows the spirit of the law, and the spirit of the greater principle that tax laws should be written – and interpreted – to transfer value for the good of many, rather than to exploit the efforts of a few.



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