



October 2006

Retail Sales Tax

Common RST Audit Issues

SBP 911

Cette publication est disponible en français en appelant le 1 866 ONT-TAXS (1 866 668-8297).

About this Pointer

A Retail Sales Tax (RST) audit involves a review of a vendor's records, accounting systems and internal controls to verify that all tax collectable and/or payable has been properly remitted to the Minister of Revenue and to identify any areas of overpayment of RST. This *Pointer* highlights, in no particular order, common issues encountered during RST audits.

Common RST Audit Issues

The following are areas where auditors commonly encounter issues:

- Registration
- Filing of RST Returns
- Clerical Errors
- Inadequate Books and Records
- Manufacturing Contractors
- Goods Acquired for Own Use
- Exempt Sales
- Transfers Between Related Parties
- Real Property Transactions.

Registration

Failure to Register

Some vendors believe that there is a minimum sales level to be met before registration is required. Unlike the federal Goods and Services Tax (GST), where there is no requirement to register if your revenues are \$30,000 or less for the year, there is no minimum sales level for RST. If you regularly sell taxable goods or provide taxable services you must obtain an Ontario Vendor Permit to charge, collect, and remit RST on your taxable sales.

Taxable Sales

Vendors are sometimes unaware that the products and/or services they sell are taxable. You are responsible for determining whether or not the goods you sell or the services you provide are taxable under the *Retail Sales Tax Act* (RST Act).

If you are unaware of registration and tax remittance requirements see **Small Business Pointer 901 - The Basics of Retail Sales Tax** for additional information.

Filing Returns

Filing Late

Sometimes vendors file their returns late. RST returns are normally due on or before the 23rd day of the month following the end of the filing period. Late-filed returns are subject to a penalty of 10 per cent of Line 2 and 5 per cent of Line 3. There is no maximum penalty amount.

Reporting Tax and Sales Incorrectly

When filing their RST returns, vendors sometimes report their sales incorrectly. Line 1 of the return should include total taxable and non-taxable sales, as well as items sold for export and sales made over the Internet. The total sales figure should not include any taxes charged. You must file returns even if there have been no sales for the reporting period. In such a case, simply write zero (0) on Line 1 of your RST return.

Sometimes vendors fail to remit all RST that they collect. It is important to ensure that all RST that you collect on your sales is sent to the Ministry of Finance with your periodic return.

Reporting Line 3 Tax on Line 2

During an audit, the auditor will compare the amount of tax reported on Line 2 of your RST return to your tax liability account. If you have included tax on own use, the figures will not reconcile. This could result in you being over assessed since the penalty for Line 2 is 10 per cent and the penalty for Line 3 is 5 per cent (if the RST return is late filed). In addition, if you include tax for own use in Line 2, your compensation will be incorrectly calculated.

Compensation Errors

As a vendor, you receive compensation for collecting RST on behalf of the province. The amount of compensation that you are allowed to claim is based on the amount of RST charged on sales for the reporting period (i.e., the amount reported on Line 2 of the RST return). The maximum amount of compensation that you can claim is \$1,500 for each legal entity for the 12 month period from April 1 to the following March 31. Some vendors claim more than their entitlement, others do not claim enough or sometimes the amount is calculated incorrectly. If you have not claimed any compensation or the full amount of compensation to which you are entitled, you may adjust your RST return to include eligible compensation not taken in a prior reporting period.

Clerical Errors

Types of Errors

Vendors sometimes make the following errors:

- failure to reconcile sales and tax amounts from their accounting records to their RST returns
- addition or posting
- reporting and/or remitting GST instead of RST, and vice versa
- timing differences such as back posting or changing the previous period.

For example, if an invoice was omitted in error and posted after the return was submitted for that period you must ensure that the related RST from that invoice is included on Line 2 of the next period's return.

Books and Records

Inadequate Books and Records

Vendors sometimes fail to maintain adequate books and records, or are reluctant to provide access to all books and records and/or fail to respond to the Ministry's requests in a timely manner. If you are a manufacturer, wholesaler, importer, jobber, agent, vendor of taxable services or vendor of TPP you are required to keep records of all your purchases and sales, whether they are for your own use or for resale.

Keeping Books and Records

You must keep all records (hard copy or electronic) for seven years and you must make them available to the auditor. If the records are located outside Canada, you must make them available for audit in Ontario. Failure to comply with these requirements, as well as failure to produce records or information requested by the Ministry is an offence under the *RST Act*.

Examples of the records auditors will review include sales invoices, bills of sale, cash register tapes, purchase invoices, books of accounts, cost records, financial statements and income tax returns. (See *Tax Information Bulletin - Retention/Destruction of Books and Records*).

Manufacturing Contractors

Types of Errors Made

Some manufacturing contractors make errors when:

- calculating manufactured cost, i.e., direct labour, direct materials and manufacturing overhead
- determining when manufacturing for own use occurs
- accounting for RST on items manufactured that are incorporated into real property
- determining if the cost of goods manufactured meets the \$50,000 threshold
- charging RST on the total contract price.

Who is a Manufacturing Contractor?

You are a manufacturing contractor if you manufacture or produce taxable goods for your own use in real property contracts where the manufactured cost of the goods is more than \$50,000 in a fiscal year. For example, a kitchen cabinet maker that supplies and installs cabinets for its customers is a manufacturing contractor.

Taxable goods (fixtures) manufactured and installed by manufacturing contractors may include doors, windows, aluminum siding and roofing.

Calculating Manufactured Cost

Errors that often occur when calculating manufactured cost:

- incorrectly including, in manufactured cost, shipping charges for goods sold
- failing to allocate, to manufacturing labour, a reasonable amount of funds drawn by the owner of a sole proprietorship who is directly involved in manufacturing
- failing to include the bonus paid by a corporation to a shareholder/owner in lieu of or in addition to wages even though the owner is directly involved in manufacturing
- not including salaries of a factory superintendent or a production manager in manufacturing overhead
- using the previous fiscal year's actual costs to estimate direct labour and manufacturing overhead for the current fiscal year and failing to recalculate the actual cost figures and making the necessary adjustments to the amount of RST owed.

(See *RST Guide 401 - Manufacturing Contractors*, and *Small Business Pointer 903 - Manufacturing Contractors*).

Goods Acquired for Own Use

Incorrect Accounting of Goods Acquired for Own Use or Change in Use

Vendors sometimes fail to either pay RST on taxable goods acquired for own use or self assess when there is a change of use in goods. RST is payable on any equipment or supplies purchased for use in the business, such as office equipment, office supplies, shop equipment and cleaning supplies.

Any items that you remove from tax exempt inventory for your own use or for the use of others become taxable. For example, a retailer of office furniture who permanently removes a desk and chair from tax exempt inventory to furnish their own office would have to pay RST on the cost of the desk and chair.

If items are taken out of inventory on a temporary basis (less than 1 year) and used for personal or business use, RST should be self-assessed using a monthly temporary use tax formula (i.e., 8 per cent of the cost of the TPP at the time it was purchased, manufactured or produced by the vendor x 1/36).

Manufacturing Exemptions

Vendors sometimes incorrectly claim manufacturing exemptions on goods purchased for use in non-manufacturing areas. Manufacturing exemptions only apply to machinery and equipment which is used primarily (i.e., more than 50 per cent of the time) and directly in the manufacturing process.

Examples of exempt equipment include manufacturing machinery, pollution control equipment, and safety equipment. The exemption does not apply to items such as office equipment, supplies and installation equipment. (See *RST Guide 400 – Manufacturers*).

Goods Purchased from Non-Residents

Vendors are often unaware of the requirement to self-assess RST on taxable goods, services, and insurance brought into Ontario or purchased from non-registered non-residents. Vendors incorrectly believe that customs brokers collect all applicable taxes at Ontario's borders.

If you purchase taxable goods or services from a supplier outside Ontario for your own use, you must self assess RST on the fair value (in Canadian Dollars) when the goods and services are brought into Ontario. The fair value includes selling price, delivery or shipping charges billed by the seller, plus customs duties and federal excise taxes, but not the GST. RST that is self-assessed should be reported on Line 3 of your RST return.

Exempt Sales

Improper Documentation for Exempt Sales

Vendors do not always obtain Purchase Exemption Certificates (PECs) from their customers at the time they make a tax exempt sale. You are required to charge RST on taxable goods, taxable services, or taxable contracts of insurance or benefit plans unless the customer provides you with a properly completed PEC. If a Vendor Permit number is given without a PEC, RST must be charged to the customer because a Vendor Permit number is not a tax-exempt number. All PECs provided should be kept on file to support exempt sales.

Identity Cards

You can now accept valid identity cards from authorized persons entitled to claim an exemption from RST on the purchase of taxable goods and taxable services, or when entering into a contract of insurance or a benefits plan. Farmers, foreign representatives and officials, Status Indians, and blind persons may now use valid identity cards instead of PECs. (See *RST Guide 204 – Purchase Exemption Certificates*).

Goods Shipped Outside Ontario

Vendors often fail to keep adequate documentation to support the shipment of goods directly to a location outside Ontario. When goods are shipped to customers directly out of Ontario, you must keep proof of the shipment, such as shipping documents or bills of lading.

Internet Sales

Vendors sometimes do not keep adequate documentation for tax exempt sales made over the Internet. You must keep proper documentation to support tax exempt Internet sales. If you sell taxable goods or services via the Internet, you must charge RST on the total value of the goods that are delivered to Ontario, or the services that are rendered in Ontario, regardless of where the sale takes place. (See **RST Guide 651 - Internet Related Services**).

Sales to Status Indians

Status Indians, Indian bands or band councils are entitled to an exemption from RST on most items purchased for use on reserves. All goods and services purchased for use off the reserve are taxable. RST must be paid on accommodation and prices of admission purchased off the reserve. RST applies to off reserve purchases of prepared food products over \$4.00 unless they are delivered by the vendor to a reserve address. RST must be paid on all alcoholic beverages purchased off the reserve, regardless of where the beverages are consumed.

To claim an exemption for goods or services purchased for use on a reserve, Status Indians must show their federal "Certificate of Indian Status" identification card issued by the federal government. You must record the name of the Status Indian, band number, card number and a description of the items purchased. Indian bands or band councils must provide a valid PEC to claim an exemption.

When Status Indians, Indian bands or band councils purchase motor vehicles from a vendor located off the reserve, RST must be charged unless the Status Indian presents a valid ID card or the Indian band or band council provides a valid PEC **and** the vehicle is either registered to a reserve address or delivered to a reserve address by the vendor.

Refer to RST Guide 808 - Status Indians, Indian Bands and Band Councils.

Transfers Between Related Parties**Erroneous Exemptions Claimed**

Vendors sometimes claim exemptions, in error, when transferring merchandise between related parties including inter-company transactions. If you purchased business assets tax exempt or goods for resale, you are not eligible to claim the related party exemption on the transfer of these goods.

To qualify for exemption from RST, a transfer of property between two parties must meet all of the following criteria:

- One party must own directly or indirectly at least 95 per cent of all shares of the other party
- The parties must continue to be related for at least 180 consecutive days following the date of the transfer, and
- RST must have been paid on the property for it to be considered eligible property.

You must keep sufficient documentation to support the exemption claimed, e.g., applicable tax was originally paid on the property.

Real Property Transactions**Who Pays RST?**

With real property transactions, there is often a lack of understanding as to who is responsible for paying RST. RST is a consumption tax. This means that the person who consumes taxable goods or services pays the RST. In real property contracts, it is the contractor who is considered to be the consumer of items installed into real property, and who is required to pay RST on all materials incorporated into real property.

RST Charged in Error

Contractors sometimes charge RST in error on the selling price of real property transactions. If you are a contractor who supplies and installs items that become real property or fixtures, you must not charge or show RST on your customer's billing. The RST that you paid on items bought or manufactured for these contracts forms part of the cost used to determine the final contract price. If you are a contractor, you can be assessed for the applicable RST on items you buy or manufacture for these contracts even though RST may have been incorrectly collected from your customers. The installation labour is not taxable.

Contracts That Include Fixtures and TPP

Supply and install contracts may include fixtures and items that remain tangible personal property (TPP).

TPP is anything that can be seen, felt, touched, weighed, or measured; that is, anything that we can perceive with our senses (e.g., tables, chairs). It also includes computer programs, natural gas and manufactured gas.

Fixtures are items of TPP that, after installation, are permanently attached to real property. Permanently attached means attached by screws, nails, bolts, or embedded in concrete. Doors, windows, built-in appliances, counters, cabinets and shelving are examples of items that become fixtures to real property upon installation. Fixtures are not taxable to the customer when incorporated into real property. It is the contractor who pays RST on the cost of the materials incorporated into real property. You should separate the charges for fixtures and labour to install them, from the charges for TPP and labour to install TPP on your customer's billing.

Examples of contracts that include fixtures and TPP are:

- all blinds are fixtures attached to real property, however, with drapes, the drapery tracks are fixtures but the drapes remain TPP
- wiring or cabling that runs through a wall, floor, or ceiling becomes part of the building and is real property, however, cabling from the equipment to the outlet or first connection is TPP.

(See *RST Guide 206 - Real Property and Fixtures*).

For More Information

The information contained in this publication is only a guideline. For more information, please contact the Ontario Ministry of Revenue at 1 866 ONT-TAXS (1 866 668-8297) or visit our website at ontario.ca/revenue.

This Pointer uses plain language to explain the most common situations faced by small businesses. The explanations are provided for guidance only. Whether tax applies in your situation will depend on the specific facts involved. Please contact us if you have questions.

