



# GST/HST Memoranda Series

## 16.3.1 Reduction of Penalty and Interest in Wash Transaction Situations

September 2000

### Overview

This memorandum sets out the guidelines for the reduction of penalty and interest in wash transaction situations where the amount of penalty and interest has been assessed under section 280 of the *Excise Tax Act* (the Act). Consequently, it does not apply to the tax on the importation of goods, which is paid and collected under the *Customs Act*.

### Disclaimer

The information in this memorandum does not replace the law found in the *Excise Tax Act* and its Regulations. It is provided for your reference. As it may not completely address your particular operation, you may wish to refer to the Act or appropriate Regulation, or contact a Canada Revenue Agency (CRA) GST/HST Rulings Centre for more information. These centres are listed in GST/HST Memorandum 1.2, *Canada Revenue Agency GST/HST Rulings Centres*. If you wish to make a technical enquiry on the GST/HST by telephone, please call the toll-free number 1-800-959-8287.

If you are located in the Province of Quebec, please contact Revenu Québec by calling the toll-free number 1-800-567-4692 for additional information.

### Note

This memorandum of Chapter 16 supersedes Technical Information Bulletin B-074, *Guidelines for the Reduction of Penalty and Interest in wash transaction Situations*, dated November 28, 1994. Due to the number of changes, the revisions have not been side-barred.

### Note - HST

Reference in this publication is made to supplies taxable at 7% or 15% (the rate of the HST). The 15% HST applies to taxable (other than zero-rated) supplies made in Nova Scotia, New Brunswick and Newfoundland (the "participating provinces"). If a person is uncertain as to whether the supply is made in a participating province, the person may refer to Technical Information Bulletin B-078, *Place of Supply Rules under the HST*, available from any Canada Customs and Revenue Agency (CCRA) tax services office.

## Wash transactions

### Meaning of wash transaction

1. A "wash transaction" occurs when a supply that is taxable at 7% or 15% is made and the supplier has not remitted an amount of net tax by virtue of not having correctly charged and collected the tax from the recipient who is a registrant who would have been entitled to claim a full input tax credit (ITC) if the tax had been correctly applied.

### Closely related groups or associated persons

2. A wash transaction may also occur where tax is collected and reported (or ITCs are claimed) by the wrong entity within a closely related group as defined in subsection 128(1) of the Act, or between associated persons as defined in section 127 of the Act, all of the members or persons of which are engaged exclusively in commercial activities.

ME-16-03-01-0001-E

La version française de ce mémorandum est intitulée *Réduction des pénalités et des intérêts dans les cas d'opérations sans effet fiscal*.

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Quick Method of accounting

3. A wash transaction may involve a supply made to a recipient who has elected to use the Quick Method of accounting. In this situation, the Quick Method percentage rate used by the recipient takes into account the full ITC. However, a wash transaction does not include a supply made to a recipient who would have been entitled to claim a rebate, as opposed to a full ITC, if the tax had been correctly charged.

4. Where a full ITC is not available to the recipient, the transaction will not be considered to be a wash transaction. Examples of recipients who may not be entitled to full ITCs include persons such as listed financial institutions, charities, non-profit organizations and municipalities. The only exception to this is where a registrant fails to charge tax on a taxable supply to a department of the Government of Canada, or to a participating provincial government entity which pays the HST. When a registrant fails to charge tax on a taxable supply to a department of the Government of Canada or to a participating provincial government entity, a wash transaction may occur.

Ministerial authority s 281.1

5. The Minister has the authority to waive or cancel penalty and interest payable by a person under section 280. This memorandum provides guidelines on how this authority will be exercised in wash transaction situations. This authority to waive or cancel penalty and interest is also exercised in extraordinary circumstances beyond a person's control. Detailed information on the guidelines for waiving or cancelling penalty and interest in these circumstances is available in GST Memorandum 500-3-2-1, *Cancellation or Waiver of Penalties and Interest*, dated March 14, 1994.

Cancellation or waiver of penalty and interest s 281.1

6. The cancellation or waiver of penalty and interest is an exceptional matter; however, it is recognized that, on occasion, an error in applying the tax does not result in any net revenue loss to the government. In such situations, the CCRA will assess the supplier's net tax to account for the tax collectible and, if the circumstances warrant, may consider waiving or cancelling a portion of the penalty and interest payable by the supplier. The following administrative guidelines set out the circumstances in which the CCRA may consider waiving or cancelling a portion of the penalty and interest payable in respect of a wash transaction.

#### Administrative guidelines in “wash transactions”

Waiving or cancelling of penalty and interest

7. Where there is a wash transaction, the CCRA will consider waiving or cancelling the portion of the penalty and interest, payable at the time of assessment, that is in excess of 4% of the tax not properly collected by the supplier where the conditions identified in paragraph 11 are satisfied.

8. Where it is determined that the penalty and interest will be reduced to 4% of the tax not collected, the CCRA will first waive or cancel all or a portion of the interest. In most cases the remaining 4% will be penalty which is payable, in addition to the amount assessed, to account for the 7% GST not properly charged.

Due diligence

9. In the case of a wash transaction where the penalty and interest is reduced to a penalty of 4% of the tax not collected and the CCRA has determined that the person has exercised due diligence, the remaining penalty will be cancelled. For further information on due diligence, refer to Policy Statement P-237, *The Acceptance of a Due Diligence Defence for a Penalty Imposed Under Subsection 280(1) of the Excise Tax Act for Failure to Remit or Pay an Amount When Required*.

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Voluntary disclosure 10. Where a voluntary disclosure involving a wash transaction has been made and is accepted by the CCRA as a valid disclosure in accordance with GST Memorandum 500-3-4, *Voluntary Disclosure* (to be re-issued as GST/HST Memorandum 16.5), the 4% penalty will not be applied to the transaction identified as a wash transaction and reported in the course of a voluntary disclosure. In such circumstances, only the taxes that should have been collected originally by the supplier for that transaction will be sought by the CCRA.

#### Conditions to be met

11. The CCRA will consider waiving or cancelling the portion of the penalty and interest that is in excess of 4% of the tax not collected in a wash transaction where the following conditions are satisfied:

- (a) it must be demonstrated that the taxable supply in question was made to a registrant who would have been entitled to a full ITC if the tax had been correctly applied, or to a federal department, or to a participating provincial government entity;
- (b) the supplier must not have been previously assessed for the same mistake and must have a satisfactory history of voluntary compliance;
- (c) the supplier must have remedied the situation to ensure that tax is collected on future supplies of a similar nature; and
- (d) the supplier must not have been negligent or careless in the conduct of its affairs to ensure that tax is collected on all taxable supplies.

12. These conditions will be applied to any audit period under review by the CCRA, and may be adjusted in the future if the CCRA considers it necessary.

13. In all circumstances where the CCRA is considering whether to waive or cancel penalty and interest, the CCRA retains the right to either waive or cancel only a portion of the penalty and interest, or only one of the components in whole or in part.

14. The waiver of penalty and interest in excess of 4% of the tax not properly charged in a wash transaction will normally be considered automatically by the CCRA during the audit process. The CCRA may also consider requests that are made after a notice of assessment has been issued.

Period for assessments 298 15. Generally, reassessments must occur within a four-year limitation period.

#### Examples

Example 1 A registrant located in Manitoba who is a wholesaler supplied a retailer who is also a registrant with goods and did not charge the GST based on the assumption that the supplies were zero-rated. An audit determines that the supplies were, in fact, taxable at 7%. However, the retailer would have been entitled to claim full ITCs if the GST had been properly charged by the wholesaler.

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In this example, the CCRA will assess the wholesaler's net tax for the GST collectible that was not taken into account by the wholesaler in its net tax calculation for the reporting period. However, subject to the conditions listed above in paragraph 11, the CCRA will consider waiving the penalty and interest that is in excess of 4% of the GST not properly charged.

#### Example 2

Corporation A claims ITCs to which it was not entitled. Its related Corporation B was entitled to claim these ITCs, but did not. An audit of Corporation A disallows the ITCs, resulting in an assessment of \$139,408 in net tax, \$31,000 in penalty and \$27,000 in interest. Corporation B has since claimed the ITCs that were disallowed to Corporation A. Corporation A has a satisfactory history of voluntary compliance, has not been previously assessed for the same mistake and has taken steps to ensure that, in the future, it does not claim ITCs to which it is not entitled.

Although the CCRA will assess Corporation A's net tax for the ITCs that it claimed in error in its net tax calculation for the reporting period, subject to the conditions listed above in paragraph 11, the CCRA will consider waiving the penalty and interest that is in excess of 4% of the ITCs that were claimed in error.

#### Example 3

A registered supplier believed that it had received a grant or subsidy with respect to certain of its activities from the Government of Canada. However, an audit determines that the amount received was not a grant because there was a direct link established between the funds received and the activities. It was, therefore, determined to be consideration for a taxable supply and the registered supplier was assessed the tax payable.

Although the federal government is not eligible to claim ITCs for tax paid, there is an offset of the tax mechanism available to it pursuant to the *GST Federal Government Departments Remission Order* (P. C. 1990-2854). Therefore, subject to the conditions listed above in paragraph 11, the CCRA will consider waiving the penalty and interest that is in excess of the 4% of the GST not properly charged.

#### Example 4

A retailer located in New Brunswick who is a registrant supplied goods to consumers and did not collect the HST based on the fact that the retailer was not charged the HST. An audit determines that the supplies were, in fact, taxable at 15%. As such, the retailer was required to charge and collect the HST from the consumers. The supplies between the retailer and the consumers are not wash transactions as the consumers would not have been entitled to claim ITCs for the 15% HST payable on their purchases if the HST had been properly charged by the retailer.

In this example, the CCRA assesses the retailer's net tax for the 15% HST collectible that was not taken into account by the retailer in its net tax calculation for the reporting period. Furthermore, the retailer will be assessed penalty and interest as provided for under section 280 of the Act unless there is a reason under the fairness guidelines to waive or cancel all or a portion of the penalty and interest.

All GST/HST memoranda and other Canada Customs and Revenue Agency publications are available on Internet at the CCRA site <a href="http://www.ccradrc.gc.ca/">http://www.ccradrc.gc.ca/</a> under the heading "Technical Publications" in "Tax".
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