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Canada's Fall Economic Statement: Tax Highlights

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The Honourable Chrystia Freeland, Deputy Prime Minister of Canada and Minister of Finance, has released the Liberal Party's first economic statement (Fall Economic Statement) since the start of the global COVID-19 pandemic.

A record deficit of over \$381 billion is projected for 2020-2021. This deficit reflects the fiscally expansive approach the government has adopted to combat the unprecedented challenges presented by the global pandemic, which the Fall Economic Statement emphasizes are limited and temporary. As described below, the Fall Economic Statement, which was released on November 30, 2020, sets out details for the Canada Emergency Wage Subsidy (CEWS) and Canada Emergency Rent Subsidy (CERS) through March 2021 (and subject to further extension to June 2021). Corporate and personal tax rates remain unchanged and no other stimulus tax measures are included in the Fall Economic Statement.

Rather, the Fall Economic Statement sets out an investment plan for recovery based on post-pandemic stimulus spending of \$70 to \$100 billion over three years, with the magnitude and timing of such spending dependent upon health and economic factors. The stimulus plan will target specific sectors with the intention of building a "more inclusive, more competitive, more productive and greener economy."

The Fall Economic Statement does not propose to introduce new personal taxes, such as a wealth tax, to raise revenue for the increased spending; nor does it include an increase to the capital gains rate, which had been considered in the 2016 Liberal Election platform. Instead, the Fall Economic Statement contains a small number of more focused tax measures. Included are the previously announced changes to the taxation of employee stock options and harmonized sales tax, along with other changes directed at the digital economy. The Fall Economic Statement also emphasized the government's ongoing focus on tax evasion and tax compliance, by providing the Canada Revenue Agency (CRA) with additional funding over a five-year period commencing 2021-2022 and initiating a consultation process regarding potential amendments to Canada's anti-avoidance rules. The principal business tax measures announced in the Fall Economic Statement are discussed further below.

Stock Options

Under the existing rules, employees of corporations and mutual fund trusts who are issued stock options are able to access preferential personal income tax treatment (50% of ordinary tax rates) on qualifying stock option benefits (Option Deduction) that replicates capital gains' rates. The Fall Economic Statement contains updated proposals to limit the Option Deduction for employees in respect of certain options granted on or after July 1, 2021. The proposals are similar to those announced in 2019 (2019 Proposals, see [Draft Legislation on the Taxation of Stock Options](#)), but they contain a number of further limitations on the Option Deduction and related rules and other provisions that address some concerns raised by the tax community.

Issuers Subject to the Rules

Like the 2019 Proposals, options granted by Canadian-controlled private corporations (CCPCs) will not be subject to the Option Deduction limitations. The Fall Economic Statement also provides that the Option Deduction limitation would not apply to non-CCPCs whose annual gross revenue does not exceed \$500 million; previously, it had not been clear how options issued by startups, emerging or scale-up companies would be excluded from the Option Deduction limitation.

Employee Rules

The proposed rules continue the approach of the 2019 Proposals to limit the availability of the Option Deduction for options that have the same “vesting year” to the extent that the fair market value of the securities under the options exceeds \$200,000 at the time the options are granted. A vesting year in respect of an option agreement is typically the calendar year in which the employee is first able to exercise the option as specified in the option agreement. If the vesting year is unclear on the date of grant, the option will be deemed to vest on a pro-rata basis over the term of the option agreement up to a maximum of five years. This concept of ratable vesting is a change from the 2019 Proposals, which would have deemed options to vest in the first year the options could have been exercised. This revised approach should provide a better result for options with performance-based vesting criteria.

In addition to the Option Deduction, the Fall Economic Statement contains a limitation on the charitable deduction available in respect of stock options. Under current rules, an employee who donates public company shares and certain other securities acquired under an option plan is entitled to an additional deduction so that no net amount would be included in the employee’s income in respect of the stock option benefit. The Fall Economic Statement would limit this donation deduction to the same extent as the Option Deduction, so that the employee could benefit only from the additional donation deduction on \$200,000 of securities on the basis of the fair market value at the time of the original grant.

Employer Rules

The Fall Economic Statement proposals provide employers with a deduction in respect of the stock option benefits included in their employee’s income to the extent that the employees are not entitled to an Option Deduction because of the \$200,000 limit. In addition, the proposals provide that an employer may take a deduction in respect of all of an employee’s stock options that would otherwise qualify for the Option Deduction if the employer elects not to provide any Option Deduction to its employees in respect of these options. Submissions had been made to the Department of Finance to extend an employer deduction for options that do not qualify for the Option Deduction for other reasons, but the Department did not expand this deduction in the Fall Economic Statement. In addition, the Fall Economic Statement confirms that CCPCs and other employers that would not be subject to the rules cannot elect to enter this regime in order to claim a deduction in respect of its employee stock options.

Employers would be responsible for compliance with the Option Deduction limitation and be required to notify their employees and the CRA which of their options, if any, are subject to new Option Deduction limitations.

Coming into Force

The new stock option rules come into force for options granted on or after July 1, 2021, other than options that replace those granted before July 1, 2021 (under a tax-deferred rollover of options).

GST/HST on E-commerce

The Fall Economic Statement proposes detailed changes to the GST/HST rules targeting e-commerce. As the Department of Finance acknowledged, the GST/HST system in many ways still reflects the pre-digital economy of the early 1990s, when the tax was first introduced. The proposals, which are particularly aimed at digital sales and websites advertising short-term accommodation, would be effective July 1, 2021. The government estimates that, together, these changes would increase federal revenues by \$3.16 billion over five years.

The Department of Finance is following Québec’s lead with this modernization of its GST/HST legislation. Québec adopted very similar rules, which have come into force progressively since January 2019. The new specified QST regime had a successful debut, generating roughly \$100 million of QST in its first year (compared with the \$28 million expected).

Cross-Border Digital Products and Services

Under the current GST/HST rules, persons that carry on business in Canada are generally required to register for the GST/HST and collect and remit tax on their taxable supplies of goods and services in Canada. Non-resident persons that do not carry on business in Canada are generally not required to register, collect or remit the tax. Instead, when physical goods are purchased from a non-resident

vendor, the GST/HST is levied on importation. In the case of digital products or services, a Canadian consumer of such services is required to self-assess and pay the tax directly to the CRA, though in practice this may not always occur.

New GST/HST rules are proposed for non-resident vendors that have no physical presence in Canada and that sell digital products or services to Canadian consumers (defined for these purposes as any entity or person that is not registered for GST/HST). Such products and services would include mobile apps, online video games, video and music streaming services; they would also include traditional services, such as legal, accounting and management services. These vendors would be required to register for GST/HST and collect and remit tax on taxable sales to Canadian consumers.

A simplified GST/HST regime would apply for these entities. For example, supplies made to Canadian consumers would be subject to the new rules, but supplies made to businesses that are registered for the GST/HST would not. Such businesses would instead continue to be required to self-assess and pay the applicable GST/HST, unless the purchase is exclusively for use in the commercial activities of the business. Effectively, if a business is not entitled to claim an input tax credit in respect of the GST/HST paid, it would be required to self-assess.

Online Marketplaces and Fulfillment Warehouses

Non-resident vendors often sell goods through an online marketplace or distribution platform. Vendors' goods may be stored in a fulfillment warehouse in Canada, with shipments to Canadian consumers made from the warehouse. While GST/HST will have been levied on these goods by the Canada Border Services Agency when they were imported into Canada, under the current rules, there is typically no requirement to collect and remit GST/HST when the goods are sold to a Canadian purchaser, since the non-resident vendor would typically not be carrying on business in Canada, and the distribution platform operator is not the supplier of the goods.

The proposed changes would require distribution platform operators (and non-resident vendors that do not sell through a distribution platform) to collect and remit the GST/HST on sales to Canadian purchasers by non-registered vendors of goods shipped from a fulfillment warehouse or other location in Canada. Who exactly would constitute a distribution platform operator would be a critical element of this legislation; generally, it would not include a person that operates a website that simply allows vendors to list their goods for sale or that is solely a payment processor.

The new rules would also impose information-reporting obligations on service providers. In particular, distribution platform operators would be required to provide information to the CRA on vendors using their platform. Also, persons providing the service of storing goods in Canada that are offered for sale by non-residents would generally be required to notify the CRA that they are carrying on such a business and to maintain certain records relating to their non-resident clients.

Short-Term Rental Accommodation

GST/HST would apply to all platform-based short-term rental accommodation supplied in Canada. The burden of collecting and remitting the GST/HST would fall on either the property owner, if registered for the GST/HST, or the digital accommodation platform if the owner is not registered. Short-term rental accommodation would generally include residential rentals of less than one month for an amount of more than \$20 per day.

A non-resident accommodation platform operator that is not carrying on business in Canada would be able to utilize a simplified GST/HST framework. Thus, as with non-resident vendors of digital products and services, supplies made to Canadian consumers would be subject to the new rules, but supplies made to businesses that are registered for the GST/HST would not. Such businesses would be required to self-assess and pay the applicable GST/HST unless the purchase is exclusively for use in the commercial activities of the business.

Digital Tax Measures

The government proposes to implement a tax on corporations providing digital services starting from January 1, 2022. Canada has been working within the 137-country OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) with a view to developing a coordinated approach to the tax challenges arising from digitalization by mid-2021. While the government remains committed to a

multilateral solution, it is concerned about the delay in arriving at a consensus. This seems so especially considering past reluctance of the United States regarding the BEPS “Pillar 1” blueprint changes to the profit allocation and nexus rules applicable to the income taxation of business profits. The Fall Economic Statement does not provide details on the exact measures the federal government will pursue, but it appears to be considering a digital services tax similar to the one adopted by France, consistent with prior statements made by the governing Liberal Party as part of its re-election platform. On a provisional basis, the government estimates that the new measure would increase federal revenues by \$3.4 billion over five years. These proposed changes would be in addition to the GST/HST proposals concerning e-commerce, discussed above. Further details are expected in Budget 2021.

The Fall Economic Statement does not discuss other BEPS proposals, such as the “Pillar 2” blueprint of the OECD/G20 Inclusive Framework, which proposes to address remaining BEPS challenges and is designed to ensure that large internationally operating businesses pay a minimum level of tax regardless of where they are headquartered or the jurisdictions they operate in; but these may also be addressed in future budgets.

Canada Emergency Wage Subsidy

The Canada Emergency Wage Subsidy (CEWS) is the largest fiscal measure enacted by the government in response to the global pandemic (discussed in [Canada Emergency Wage Subsidy: An Updated Guide for Businesses](#)). The CEWS was recently extended by the government to June 2021.

For the current qualifying period commencing November 22, 2020, and ending December 19, 2020, a subsidy of up to 65% of eligible wages is available to all eligible employers that experience a decline in revenue, with a base subsidy amount of up to 40% of eligible wages and an additional top-up subsidy amount of up to 25% for employers that experience a decline in revenue of 70% or more. This top-up subsidy will be increased to 35%, from 25%, of eligible wages for the qualifying periods running from December 20, 2020, through to March 13, 2021. This will increase the maximum wage subsidy for these employers to 75%, from 65%, of eligible wages for these qualifying periods. Details of the wage subsidy for any periods beyond March 13, 2021, will be proposed at a later date.

Canada Emergency Rent Subsidy

The government introduced the Canada Emergency Rent Subsidy (CERS) in September 2020 to provide financial assistance to businesses, charities and non-profits that have suffered a loss of revenue by subsidizing rent and commercial mortgage expenses.

The CERS currently provides a subsidy, on a sliding scale, up to a maximum of 65% of eligible expenses, with a top-up emergency rent subsidy of 25% for organizations temporarily shut down by a mandatory public health order.

The government is proposing to extend to March 13, 2021 the current rate structure for the base rent subsidy and the top-up emergency rent subsidy, which were each set to expire on December 19, 2020. Details of the rent subsidy for any period beyond March 13, 2021 will be proposed at a later date.

Consultation on Anti-Avoidance Rules

The Fall Economic Statement indicates that the government will be launching a consultation in the coming months on potential amendments to Canada’s anti-avoidance rules, including the General Anti-Avoidance Rule.

The government is concerned that individuals and businesses are using “increasingly complex structures in order to artificially lower their tax obligations in a manner that does not serve an economic purpose, including by shifting profits offshore and creating artificial tax deductions.” To address this, the government is proposing to launch a consultation on how to “modernize” the anti-avoidance rules so that they “are sufficiently robust for tax authorities and courts to address this sophisticated and aggressive tax planning.”

Tax Compliance

The government is proposing to provide additional funding to enable the CRA to target offshore tax compliance by committing an additional \$606 million over five years, commencing in 2021-2022.

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