RELEASE OF THE FEDERAL BUDGET, 2021

by Jennifer C. Leve

On Monday, April 19, 2021, Canada's Deputy Prime Minister and Minister of Finance, Chrystia Freeland, released the first official budget in the past two years, titled, *Federal Budget 2021: A Recovery Plan for Jobs, Growth, and Resilience* (the "Budget"). The Budget proposed over $100 billion in spending, and, among the more significant measures, the Budget proposes extending the Canada Emergency Wage Subsidy (CEWS) and the Canada Emergency Rent Subsidy (CERS), and Lockdown Support through September 2021. The Budget also introduces a new Canada Recovery Hiring Program.

Of note, and relief to many, the Budget did not introduce measures to increase the capital gains inclusion rate (currently 50%), eliminate or modify the principal residence exemption, restrict surplus stripping plans, or impose a wealth tax.

In brief, the Budget:

- Puts limitations on interest deductibility by corporations, trusts, and partnerships to a percentage of tax-basis EBITDA;
- Enhances Canada's mandatory reportable transaction disclosure rules (subject to public consultation);
- Proposes to consult on the transfer pricing rules;
- Imposes new rules to target hybrid mismatch arrangements;
- Reduces corporate tax rates on eligible zero-emission technology manufacturing and processing income;
- Amends the capital cost allowance system by providing for temporary immediate expensing of up to $1.5M per taxation year of capital property acquisitions to Canadian-controlled private corporations (CCPCs);
- Provides further details of a proposed digital services tax, to be effective January 2022;
- Proposes a new tax on luxury items over a certain threshold: automobiles, planes, and boats;and
- Proposes a new tax on the inefficient use of foreign-owned Canadian housing.

International Tax Measures

In the Budget, Canada reiterated its commitment to being an active participant in the multilateral efforts to address base erosion and profit shifting or "BEPS." Canada proposes to address BEPS with two new measures:

Interest Deductibility

In light of concerns with BEPS that have been on the radar since the OECD released guidance for such initiatives several years ago, Canada intends to address several concerns, including the erosion of the Canadian tax base through interest payments to related non-residents in low-tax jurisdictions, the use of debt to finance investments that earn non-taxable income, and circumstances where a Canadian business bears a disproportionate amount of a multinational group's third-party borrowing.

To this end, the Budget proposes enhanced restrictions on the deductibility of interest and other financing-related expenses, with certain exceptions, to corporations, partnerships, and trusts. These restrictions would be in place to limit the amount of a net interest expense that could be deducted in computing taxable income to no more than a fixed ration of "tax EBITDA." "Tax EBITDA" is considered to be the entity's taxable income before taking into account interest expense, interest income, income tax, and deductions for depreciation and amortization, where each of these items is as determined for tax purposes. Tax EBITDA would generally exclude dividends to the extent they qualify for the inter-corporate dividend deduction/deduction for dividends received from foreign affiliates and interest that is not deductible under existing income tax rules (including the thin-capitalization rules).

These new rules will be set to come into force on January 1, 2023, with the proposed fixed ratio for 2023 set at 40% for that taxation year and 30% for taxation years thereafter.

Small businesses, in particular, CCPCs that (together with their associated group) have less than $15M of taxable capital employed in Canada will be excluded from the application of the rules, along with groups of corporations and trusts with less than $250,000 in aggregate net interest payments.

The Budget proposes rules to carrying forward or back interest denied under these new rules, and a "group ratio" rule that would allow a taxpayer to deduct interest in excess of the fixed ration of tax EBITDA where the taxpayer demonstrates that the ratio of net third party interest to book EBITDA of its consolidated group implies that a higher deduction limit would be appropriate.

Hybrid Mismatch Arrangements

Hybrid mismatch arrangements involve entities or instruments treated differently under Canadian tax law and foreign tax law to produce a particular tax result and aggregate benefits for a consolidated cross-border group.

The Budget focuses on two types of hybrid mismatches: (1) a "deduction, non-inclusion" mismatch, which arises where a country allows a deduction in respect of a cross-border payment, but its receipt is not included in income and/or fully included in income within a reasonable time following its receipt/payment in the other jurisdiction, and (2) a "double-deduction" mismatch, which arises where a tax deduction is available in two or more countries in respect of a single economic expense.

These concerns with hybrid mismatches were addressed in a 2015 OECD report which recommended rules to limit the tax benefits from the use of hybrid mismatch arrangements, many of which have already been effectively implemented in the US, the UK, and the EU.

The Budget proposes to deny a deduction for a payment by a Canadian resident under a hybrid mismatch arrangement to the extent that it gives rise to a further deduction in another country or is not included in the ordinary income of a non-resident recipient. In turn, if a non-resident makes a payment under a hybrid mismatch arrangement that is deductible under foreign tax law, no deduction in respect of the payment would be permitted against the income of a Canadian resident. Further, a payment made by a non-resident to a Canadian resident under a hybrid mismatch arrangement would be included in ordinary income of the Canadian resident to the extent the amount is deductible under foreign law. If the payment is a dividend, it would not be eligible for the deduction otherwise available for certain dividends received from foreign affiliates.

These new rules aim to neutralize a mismatch by aligning the Canadian income tax treatment with the income tax treatment in the foreign jurisdiction(s). While no legislation has yet been drafted, the Budget provides some guidance, noting that (i) the new rules would apply mechanically; in other words, no purpose test would need to be met, (ii) the rules would apply to a payment between related entities, and to the extent that the payment is designed to create a hybrid mismatch, between unrelated entities; and (iii) the ordering rules as set out in the OECDs report (e.g., a deduction denial is given priority over an inclusion rule) will apply in order to ensure the proposed rules are coordinated with similar rules in other countries.

The Budget proposes to introduce new legislation in two separate packages, with the first available for stakeholder comments later this year, with those rules applying in respect of deduction, non-inclusion mismatches arising from payments in respect of financial instruments. These rules would be set to come into effect July 1, 2022. The second legislative package would address the other hybrid mismatch concerns and be released for stakeholder comments after 2021, and those rules would apply no earlier than 2023.

Transfer Pricing

The Budget makes it clear that the government is concerned about perceived shortcomings in the current transfer pricing rules, which it believes can encourage the inappropriate shifting of corporate income out of Canada. This concern appears to be based on the Federal Court of Appeal's decision in Cameco, in which the Court disagreed with the government's broad interpretation of the recharacterization rule, concluding that the government could not change the nature of a transaction where the arrangements are objectively reasonable, even if the structure is tax-motivated.

The Budget proposes to begin a consultation process on Canada's transfer pricing rules to protect the integrity of the Canadian tax system while preserving Canada's attractiveness for foreign investment.

Business Tax Measures

Immediate Expensing (CCPCs)

The Budget proposes to provide temporary and immediate expensing in respect of certain property acquired by a CCPC by amending the capital cost allowance (CCA) system. This will apply concerning certain depreciable property that is "eligible property" acquired after April 18, 2021, and that becomes available for use before January 1, 2024, up to a maximum of $1.5M per taxation year (subject to sharing among associated group members and proration for short taxation years). Eligible property will be capital property subject to the CCA rules, other than certain long-lived assets.

Immediate expensing will be available only for the year the eligible property becomes available for use, with no carry-forward of excess deduction capacity permitted.

Property that has been used, or acquired for use, for any purpose before it was acquired by the CCPC will only be eligible for immediate expensing if neither the CCPC nor a non-arm's-length person previously owned the eligible property and the eligible property was not acquired by the CCPC on a tax-deferred (rollover) basis.

Where a CCPC has capital costs in excess of $1.5M, it is permitted to select which asset class would be immediately expensed, with any excess subject to the ordinary CCA regime. All other enhanced deductions available to CCPCs under the ordinary CCA rules will continue to apply.

Rate Reduction for Zero-Emission Technology

The Budget proposes a temporary measure to reduce the corporate income tax rates applicable to qualifying zero-emission technology manufacturing and processing income. The general corporate rate applicable to eligible zero-emission technology manufacturing and processing income will be reduced from the general corporate rate of 15% to 7.5%, and the small business tax rate applicable to such eligible income will be reduced from 9% to 4.5%.

In order to qualify for the reduced rates, at least 10% of a taxpayer's gross revenue from all active business carried on in Canada must be derived from eligible activities.

These reduced rates would apply to taxation years that begin after 2021 and would be gradually phased out, starting in 2029, with a full phase-out after 2031.

Canada Recovery Hiring Program (CRHP)

In addition to the CEWS, the Budget introduces a new program to assist eligible employers negatively impacted by the Covid-19 pandemic. The CRHP will provide eligible employees with a subsidy of up to 50% of the "incremental remuneration" paid to eligible employees between June 6, 2021 and November 20, 2021. An eligible employer would be permitted to claim either the CRHP or the CEWS for a particular qualifying period, but not both.

Employers eligible for the CEWS would generally qualify for the CRHP. Such eligible employers would need to meet the test to be a "qualifying recovery entity" for a qualifying period which is defined to mean an "eligible entity" (as defined for purposes of the CEWS) that meets additional conditions. These additional conditions include that the eligible entity has an existing payroll account on March 15, 2020, if it is

a taxable corporation, it must be a CCPC, and it has a revenue reduction percentage greater than 0% (for the qualifying period between June 6 and July 3, 2021), and 10% (for the qualifying periods between July 4 and November 20, 2021).

An eligible employee must be employed primarily in Canada by an eligible employer throughout a qualifying period. The CRHP would not be available for furloughed employees.

The types of remuneration eligible for the CEWS would also qualify for the CRHP, and incremental remuneration for a qualifying period means the difference between an employer's total eligible remuneration paid to eligible employees for the qualifying period and its total eligible remuneration paid to eligible employees for the baseline period (March 14 to April 10, 2021). In both the qualifying and baseline periods, eligible remuneration for each eligible employee will be subject to a maximum of $1,129 per week.

Provided that an eligible employer's decline in revenues exceeds the revenue decline threshold for a qualifying period, its subsidy in that qualifying period would be equal to its incremental remuneration multiplied by the applicable CRHP rate for that qualifying period.

The proposed CRHP subsidy rates are as follows:

- 50% for qualifying periods between June 6 and August 28, 2021;
- 40% for the qualifying period between August 29 and September 25, 2021;
- 30% for the qualifying period between September 26 and October 23, 2021; and
- 20% for the qualifying period between October 24 and November 20, 2021.

Reportable Transactions

Canada's tax regime requires certain persons to file an information return in respect of "reportable transactions," which are generally considered to be "avoidance transactions" carried out primarily to obtain a tax benefit and are defined for the purposes of the general anti-avoidance rule in Canadian tax legislation. The hallmarks of an "avoidance transaction" is where any two of the following three criteria are met:

- Contingent fees are paid to a promoter or a tax advisor that are attributable to the tax benefit or on a tax benefit being obtained, or dependent on the number of participants that participate in the transaction;
- A promoter or tax advisor has "confidential protection" in respect of the avoidance transaction (i.e., anything that prohibits disclosure to any person or the Canadian tax authorities of the details or structure of the transaction);
- A promoter, tax advisor, participant, or certain non-arm's-length person has or had contractual protection in respect of the avoidance transaction, such as insurance that protects against a failure to receive a tax benefit.

The Budget provides that a consultation will be undertaken with respect to a number of additional reporting requirements, which include, among others, that mandatory reporting will be required if only one of the above three criteria is met and require that reporting be made by all participants, promotors, and tax advisors within 45 days of entering into the transaction. If these additional reporting requirements are enacted, they will apply to taxation years beginning January 1, 2022. The new compliance and reporting requirements, if enacted, will impose significant penalties for failure to comply; in some cases, penalties will be upwards of 25% of the tax benefit.

Input on the proposed measures will be released in the coming weeks, with comments needing to be submitted by September 3, 2021.

Excise Tax Measures

Application of GST/HST to E-Commerce

The Budget proposes amendments to the new measures announced in the Fall Economic Statement 2020 that would come into force on July 1, 2021.

The 2020 proposals introduced changes to the GST/HST rules targeting e-commerce, requiring distribution platform operators to collect and remit the GST/HST on sales by non-registered vendors to Canadian purchasers.

Following comments received on the 2020 proposals, the Budget suggests various amendments, including allowing deductions for bad debts. This new relief to the amendments was considered to be reasonable since non-residents required to register under the 2020 proposal rules are required to register under a new modified system (not the normal GST/HST registration system) and collect and remit tax on taxable sales to Canadian consumers, but not be allowed to claim input tax credits (ITCs). Hence, the Budget introduces changes to the 2020 proposals allowing non-residents to deduct amounts regarding uncollectible bad debts from the GST/HST they are required to remit for a reporting period. If appropriate, non-residents could instead consider registering under the standard GST/HST registration system to claim ITCs.

The Budget also proposes new rules to protect platform operators by (1) imposing joint and several or solidary liability for the collection and remittance of applicable GST/HST on the third-party operator and non-resident vendor where the non-resident has provided false information, and (2) limiting the liability of the platform operator where the platform operator reasonably relied on information provided by the non-resident vendor.

The Budget clarifies that: (1) supplies of digital products or services that are GST/HST-free (i.e., zero-rated) are not included in the calculation of the $30,000 threshold amount for determining if a person is required to register for the GST/HST under the new rules and simplified framework, (2) the requirement to file an annual information return applies only to platform operators that are registered or are required to be registered for the GST/HST, and (3) the Minister of National Revenue has the authority to register a person that the Minister believes should be registered under the new (or simplified) framework.

The Budget confirms the following concerning the 2020 proposals:

- Non-resident vendors and distribution platform operators supplying digital products or services to Canadian consumers must register and collect GST/HST on the taxable supplies they facilitate to consumers in Canada.
- Supplies of short-term accommodations in Canada facilitated through digital accommodation platforms will be subject to GST/HST, with GST/HST required to be collected and remitted on such supplies by either the property owner or the accommodation platform operator.
- Distribution platform operators are required to register under the normal GST/HST registration system to collect and remit applicable GST/HST on sales of goods shipped from fulfillment warehouses in Canada when such sales are made by non-registered vendors through distribution platforms.
- Non-resident vendors making sales on their own (not through a distribution platform) will also be subject to new GST/HST registration and collection requirements in respect of goods shipped from a fulfillment warehouse.

A 12-month grace period following the coming into force of the new rules will begin on July 1, 2021, during which discretion in administering the new measures will be implemented, to the extent that the non-resident or platform operator can demonstrate that it has taken reasonable measures to comply with the new rules.

Digital Services Tax

The Budget proposes implementing a digital services tax (DST) as originally announced in the 2020 proposals, which is set to come into force on January 1, 2022. This new DST would be an interim measure until a multilateral approach comes into effect with respect to the affected businesses.

The DST is designed to ensure that revenue earned by large businesses, either foreign or Canadian, from sales and interactions with Canadian online users, including through the collection, processing and monetizing of data and content contributions from those users is subject to Canadian tax.

Those taxpayers subject to the DST would include any corporation, partnership, or trust that meets (or that is a member of a business group that meets) two conditions: (1) global revenue from all sources of €750M or more in the previous calendar year, and (2) in-scope revenue associated with Canadian users of more than $20M in a particular calendar year.

Rate and Base: the DST will apply at a rate of 3% on revenue ("in-scope revenue") earned from certain digital services that rely on Canadian users' engagement, data, and content contributions.

In-Scope Revenue: This is revenue associated with Canadian users from four online business models in which the participation of users is a key value driver: (1) online marketplaces, (2) social media platforms, (3) online advertising, and (4) the sale or licensing of user data collected from users of an online interface.

Deductibility vs. Credit: The DST would not be creditable against income tax but may be deductible against income based on general principles (i.e., if it is incurred for the purpose of earning the entity's income subject to Canadian income tax).

In general, the proposed DST would apply to revenue from services provided through:

1. Online marketplaces that match sellers of goods and services with potential purchasers (whether or not the platform facilitates completion of the sale is irrelevant) will have their revenue subject to the new DST. Revenue in respect of optional "premium" services which enhance basic functions and/or affect commercial terms of a platform would be included within the scope of the DST as well. The Budget proposes that DST apply only on in-scope revenue associated with Canadian users; thus there are revenue sourcing rules that will be used to determine whether the Canadian user connection is met. For example, revenue associated with a particular transaction would be sourced to the user's location who interacts through the interface and would be considered to be sourced 50/50 between the location of the buyer and seller. Revenue from an online marketplace not associated with one single transaction, for example, subscription fees, would be sourced to the location of the user of the interface on a formulaic basis.
2. Social media interfaces that facilitate interaction between users or between users and user-generated content would be subject to the DST on revenue from such services. Revenue from such an online interface would be sourced on a formulaic basis. For example, the revenue associated with Canadian users would be equal to the total of the relevant revenue multiplied by the ratio of the number of active Canadian users compared to all users (i.e. non Canadian users) of the interface. However, the DST would not apply to an interface where the sole purpose is to facilitate communication services, i.e., telephone services.
3. Online targeted advertising that generates revenue based on data gathered from users of an online interface would be subject to the DST. This would include revenue from online interfaces such as online marketplaces and social media platforms, as well as internet search engines (including preferential search listings), digital content streaming services and online communications services. DST would apply to both revenue earned by an interface for displaying targeted ads as well as revenue earned from accepting third-party ad placement on their platform.
4. User data from online interfaces that generates revenue by its sale or licensing would be subject to the DST. The Budget proposes that such revenue would be sourced to the location of the user to whom the data relates. Similar to revenue calculated on a formulaic basis for social media interfaces, where such revenue is generated from data of both Canadians and non-Canadians, such a ratio would give rise to the amount of revenue taxable in Canada and subject to the DST.

The Budget provides that the DST would not be intended to catch sales of goods and services by a seller on its own account (including the sale, licensing, or streaming of digital content), revenue in respect of the storage or shipping of tangible goods that are sold online through an online marketplace, or the trading of financial instruments and commodities.

Tax on Certain Luxury Items

Effective as of January 1, 2022, the Budget proposes a new luxury tax on the retail sale of passenger vehicles and personal aircraft priced over $100,000 and boats priced over $250,000. Certain exceptions, such as if the item will be used for commercial or public sector purposes, will apply. The proposed tax would apply at the final point of sale if the final price payable by the consumer (excluding GST/HST or provincial sales tax) exceeds the noted thresholds. The tax is calculated at the lesser of 10% on the total value of the particular item, or 20% of the value above the applicable threshold. GST/HST would apply to the price inclusive of the proposed tax.

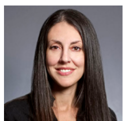
Tax on Unproductive Use of Canadian Housing

The Budget confirms the 2020 proposals to implement a national tax targeting the unproductive use of Canadian real estate owned by non-resident non-Canadians. The annual tax will take effect January 1, 2022, and will be levied at 1% on the value of the residential property in Canada that is considered vacant or underused and owned by a non-resident non-Canadian.

Starting in 2023, filing with CRA will be required annually by an owner of a Canadian residential property who is a non-resident and non-Canadian (neither citizen nor permanent resident) regarding such property owned during the previous calendar year. Information such as address, value, and owner's interest will be declared, as well as whether any exemption is available. Significant penalties will apply for failure to file when required.

The Budget did not include any draft legislation on this proposal and comments from stakeholders will be requested in the coming months.

ABOUT THE AUTHOR



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