Submission on Bill C-59,
Fall Economic Statement Implementation Act, 2023

February 20, 2024

Executive Summary

Imperial Tobacco Canada (ITCAN) welcomes the opportunity to comment on Bill C-59, *Fall Economic Statement Implementation Act, 2023*. Our feedback is focused on the provisions dealing with excise stamps for vaping products (Part 4) and the framework for a proposed cost recovery fee on the tobacco industry (Division 4 of Part 5).

On the former, ITCAN welcomes the proposed changes to the excise stamping regime. This will make implementation of the upcoming harmonized vaping product tax much more efficient and should help prevent supply shortages. However, we remain concerned about the timeline for implementation, which is extremely tight.

Regarding the cost recovery fee, it is important to consider its potential unintended consequences in light of Canada's challenges with illegal tobacco, where approximately one-third of the market comprises illicit cigarettes. The dynamic of this market is significantly influenced by the price difference between legal and illegal products. Introducing the proposed fee may inadvertently increase this disparity, thereby providing illegal operators with an additional competitive edge. This could, in turn, benefit the organized crime groups involved in the illegal tobacco trade, complicating efforts to address this issue effectively.

At its core, the proposed cost recovery fee introduces a structure that may unfortunately pave the way for potential misuse. This structure allows a departmental branch to determine its own financial plan, impose the cost on others, and then operate without clear performance benchmarks or accountability for its expenditures. Should this model be adopted more widely within government operations, it could severely undermine the integrity of the fiscal framework and erode the principles of performance-based budgeting.

About ITCAN

ITCAN, established in 1908, is a wholly owned subsidiary of BAT – the world's largest vaping business by market share. ITCAN has expanded its portfolio of available products in Canada with the introduction of our 'Reduced Risk Products' portfolio,[1] which includes vaping products. ITCAN has also recently launched a new nicotine replacement therapy, following authorization from Health Canada.

ITCAN is dedicated to conducting its business responsibly, in a manner that meets society's expectations of a responsible tobacco and nicotine products company. ITCAN recognizes the health risks associated with tobacco and nicotine consumption and believes that youth under the legal minimum age ("Underage Youth") should not consume and should be prevented from accessing tobacco or nicotine products.

We support constitutional, proportional, reasonable, and evidence-based regulation, especially measures aimed at keeping tobacco and vaping products out of the hands of Underage Youth. At the same time, we are committed to contributing to tobacco harm reduction and ensuring that adult consumers are provided with a range of less risky alternatives to combustible cigarettes.

Context for Bill C-59

ITCAN welcomes the opportunity to comment on Bill C-59, *Fall Economic Statement Implementation Act, 2023*. This comes at an interesting historic moment for ITCAN. We are in the process of an organizational transformation in which at its core lies our ambition to reduce the health impact of our business. A critical enabler to achieving this will be to encourage smokers who would not otherwise quit cigarettes to switch to 'Reduced Risk Products' – like vaping products.

We acknowledge the Government's goal of reducing the smoking rate to 5% by 2035 and feel Reduced Risk Products must be central to achieving that. As such, the regulatory and taxation regime for vaping products is of critical importance to ensure these products remain appealing and affordable alternatives for adult smokers.

While we are trying to encourage remaining smokers to switch to Reduced Risk Products, we must still acknowledge around 11% of Canadians continue to smoke, and the key question should be whether the Government would prefer those people purchase cigarettes through a legal, regulated and taxed market, or an illegal, unregulated and untaxed free-for-all. With an illegal tobacco market share of roughly one-third in Canada, that is not a hypothetical question. Unfortunately, the proposal for a tobacco industry cost recovery fee is oblivious to this reality.

We will expand on both points in this submission.

---

[1] We use the term 'Reduced Risk Products' (or RRPs) to cover tobacco and nicotine products that are reduced risk compared to cigarettes based on the weight of evidence and assuming a complete switch from cigarette smoking. These products are not risk free and are addictive.

Canada's Illegal Tobacco and Vaping Product Reality

Canada has an immense illegal tobacco problem. At the national level, we estimate illegal tobacco makes up roughly one-third of the market, and this rate has been growing in recent years.

Seeking to validate internal data that suggested a surge in illegal tobacco activity in late-2021 and through 2022, ITCAN engaged Abacus Data to conduct an independent market assessment of Alberta, British Columbia and Ontario. Abacus Data measured the illegal tobacco rate in Alberta at 36%, in BC at 34%, and in Ontario at 33%. For Alberta and BC, these are the highest rates we have ever seen. The Abacus Data assessments were based on research conducted in the second half of 2022.

Further evidence of the national nature of this problem came in September 2023 with the release of a report to the Convenience Industry Council of Canada by EY Canada. It estimates the illegal market share in BC to be at least 32% and as high as 45%; in Ontario to be at least 39% and as high as 69%; and in Newfoundland and Labrador to be at least 31% and as high as 44%.[2] EY Canada used a different methodology to assess the illegal market share than Abacus Data, but reached similarly alarming conclusions on the size of the illegal market in 2022.

Illegal tobacco is costing the federal and provincial governments $2.5 billion in lost tobacco tax revenue annually.[3] Meanwhile, the organized crime groups behind Canada's illegal tobacco trade continue to use it as a cash cow to fund other criminal activities, including drug and weapons trafficking, human smuggling, money laundering and terrorist financing.[4]

When contemplating new taxes or regulatory measures for the legal tobacco industry, it is crucial to factor in the current challenges it faces. Regrettably, the cost recovery fee seems to overlook this context. This fee is set to substantially raise expenses for the legal tobacco sector, inadvertently providing illegal operators with an additional competitive edge, since they appear to be exempt from these costs.

This trend of increasing costs and regulations on the legal industry, most or all of which are ignored by the illegal operators, is not sustainable. Canada could easily end up with an illegal tobacco rate of 50% or more. If you think that is exaggerated, consider that parts of Northern Ontario are already estimated to have an illegal tobacco rate as high as 70%.[5]

In addition, there is evidence of a growing market for illicit vaping products in Canada: (a) in illicit smoke shacks in Ontario, BC, and Quebec, and (b) vape shops and online retailers across Canada not respecting provincial or federal regulations related to product standards, packaging, or marketing not appealing to youth. Due to a lack of regulatory enforcement, Canada is becoming

---

[2] https://convenienceindustry.ca/wp-content/uploads/2023/09/EY-Report-on-Contraband-Tobacco-in-BC-Ontario-and-Nfld-September-2023.-FINAL.pdf

[3] Estimate based illegal market share versus Federal and Provincial Tobacco Tax revenues as detailed in Public Accounts.

[4] See https://www.opp.ca/index.php?id=115&lng=en&entryid=590a25088f94ac74657b23c6, and https://2009-2017.state.gov/documents/organization/250513.pdf

[5] https://kenoraonline.com/articles/new-policing-powers-sought-to-fight-illegal-cigarette-trade

one of the least controlled vaping product markets in the world. For example, ITCAN recently identified over 200 vape shops in Quebec that were selling prohibited flavours and/or products that exceed maximum volume requirements.

Health Canada has told stakeholders the cost recovery fee will eventually include vaping product manufacturers as well. This raises two concerns. First, as with the tobacco dynamic described above, imposing a cost recovery fee on legal operators while ignoring illicit counterparts will give a cost advantage to the latter. Second, as there is seemingly so little oversight and control of the vaping product market, it is beyond comprehension how Health Canada could ever properly apportion market share for a cost recovery fee.

Cost Recovery Fee

The cost recovery fee outlined in Bill C-59 presents significant concerns. It overlooks the critical issue that one-third of Canada's tobacco market consists of illegal cigarettes. This market thrives on the price gap between legal and illegal offerings, and the introduction of this new fee risks exacerbating this fundamental economic situation.

Furthermore, by effectively tackling the issue of illegal tobacco, the Federal Government could potentially reclaim over $1.06 billion each year in foregone tax revenue. This figure surpasses the expected proceeds from the proposed new fee by more than a factor of 16.[6] (Based on projected tobacco tax revenue of $3.2 billion in 2021-22,[7] to which 33% could be added with the elimination of the illegal trade).

Similarly, the fee would follow implementation of a $4/carton tobacco tax increase in the 2021 federal budget. That increase was projected to raise over $400 million in additional tobacco tax revenue annually – or more than six times the amount projected for the new fee.[8] To look at that another way, with projected annual tobacco tax revenue of $3.2 billion, tobacco taxes already pay for Canada's Tobacco Strategy more than 57 times over.

More broadly, the fee presents challenges rooted in three key principles. Firstly, fairness dictates that any fee imposed on the tobacco industry should be applied uniformly to all licensed tobacco manufacturers in Canada, including those operating on First Nations territory. Achieving this equitable application is complex and likely requires continuous, independent audits of their business practices. Such scrutiny is essential to accurately assess the volume of product they introduce into the Canadian market.

Second, according to a written response to an Order Paper question tabled in the House of Commons on January 27, 2020, by its own admission Health Canada said only around $30 million

---

[6] The proposed amount of the fee is $66 million annually. This comparison is offered to show the potential revenue gains from addressing illicit tobacco. It is not an acknowledgment the full $66 million should be paid by the tobacco industry.
[7] https://www.smoke-free.ca/SUAP/2020/totaltax.pdf
[8] The proposed amount of the fee is $66 million annually. This comparison is offered to show the impact of recent tax increases. It is not an acknowledgment the full $66 million should be paid by the tobacco industry.

of its spending under the Tobacco Strategy is used for “the health portfolio portion,” meaning the other half is used for other priorities – some of which are problematic when it comes to the notion of a cost recovery fee. For example, it includes money for fighting illicit tobacco. It seems counterproductive to levy charges on the legal tobacco industry for issues that stem directly from the substantial cost advantage held by illegal operators.

Lastly, implementing a cost recovery fee raises concerns about economic efficiency and fiscal responsibility. It grants a department's branch the autonomy to determine its budget without ensuring accountability to the overarching fiscal structure or flexibility to reallocate funds to more urgent needs. Should this approach be adopted more widely within the Federal Government, it would significantly diminish the Department of Finance's oversight of the fiscal framework. Essentially, it would enable a government branch to establish its financial plan, pass the costs onto others, and then operate without being held accountable for the results or performance.

The one positive aspect in Bill C-59 related to the proposed cost recovery fee is that it requires the Minister to consult prior to its implementation. We plan to raise several issues through that process, including:

- How much of the $66 million spent annually for Canada’s Tobacco Strategy should be assessed on the tobacco industry when only $30 million is spent on health promotion, with the rest going to things like illegal tobacco enforcement, litigation, and First Nations health.
- In a briefing with Health Canada officials on December 8, 2023, they suggested the fee will be retroactive. There are serious questions about the legitimacy of applying a tax retroactively. It also creates an extremely challenging business environment.
- In the December 8 briefing, Health Canada officials suggested the fee will ultimately be applied to the tobacco and vaping industries. However, initially it will only apply to the tobacco industry. As such, how will market share be calculated between tobacco and vaping products? If vaping represents 25% of the tobacco market, for example, will 25% be reduced from the proposed $66 million annual fee?
- How will the Federal Government accurately measure the volume put into market by First Nations tobacco manufacturers?
- What controls will be put in place to prevent bureaucratic empire building by Health Canada if it can simply set its own budget every year for the Tobacco Strategy?

These are complex questions with profound implications for the legitimate implementation of this policy. As such, it is unfortunate Parliamentary scrutiny of this process will end with the passage of Bill C-59. Health Canada must not be allowed to proceed with this fee without accounting for the roughly one-third of the market being fed by tobacco manufacturers operating on First Nations.

Excise Stamps for Vaping Products

ITCAN supports the notion of a vaping product tax and has expressed its support for the federal harmonized vaping product excise duty framework. While we have concerns about the tax rate and structure, a harmonized excise duty rate is a preferred approach when compared to every province having its own tax on vaping products.

However, this does create a challenge around the stamping of vaping products because each province will have a unique tax stamp. In the case of ITCAN, our vaping products are manufactured in China and have a nine-month supply chain to get to retail in Canada. At present, ITCAN is defined as a "prescribed person" under the legislation, which allows us to import stamped vaping products, but not to manufacture them in Canada.

With Ontario, Quebec, Northwest Territories and Nunavut scheduled to be the first provinces and territories to harmonize on July 1, 2024, you can see the challenges presented as the tax stamps are not yet even available. Products imported for sale for these provinces and territories after July 1, 2024 must have a stamp.

However, the *Draft Regulations Making the Excise Duties on Vaping Products Regulations and Amending Various Regulations Relating to Excise Duties* (the "Draft Regulations") have yet to be finalized. Until the regulations are finalized, stamps cannot be issued. Under the current stamping framework, it would be virtually impossible for us to comply as products destined for the Canadian market on July 1, 2024 would have had to have been shipped on October 1, 2023 – months before stamps are available. With our current nine-month supply chain, even if stamps were to become available on April 1, 2024 (the current target date for the Canada Revenue Agency), it would be January 1, 2025 before stamped product would arrive in Canada – meaning we would be potentially out of supply from July 1 until January 1. This is particularly problematic since two of the provinces scheduled for July 1 implementation – Ontario and Quebec – represent 65% of Canadian volume.

Bill C-59 addresses this challenge as it will allow a vaping product licensee to import packaged vaping products for stamping by the vaping product licensee in Canada. As a result, ITCAN will be able apply for a vaping product license to stamp product in Canada, which will greatly help us meet the July 1, 2024 target for the harmonized tax and stamping requirement to take effect.

However, the timeline remains very tight because the Draft Regulations for the stamp are not yet final, meaning provincial stamps are not available for purchase. At the same time, we cannot stamp in Canada until Bill C-59 is law. Therefore, we are at the mercy of two timelines that are completely out of our hands: the regulatory process to get the final stamping guidelines in place, and the legislative process to pass Bill C-59. Any significant delays with either and Canada faces the risk of severe product shortages in the biggest markets of Ontario and Quebec.

We believe the solution lies in ensuring the regulations take effect six months after final publication, rather than a specified date (July 1, 2024) as currently proposed, with an added three-month transition period for retailers.

Finally, even if this issue is addressed, the requirement for each province and territory to have a unique stamp is going to create in a lack of product offerings in smaller provinces and territories. It does not make economic sense to stamp a production run for a particular province or territory when upwards of 90% of that product could go to waste simply due to market size. With fewer legal vaping product offerings available, consumers are more likely to find illicit options or return to smoking.

Excise Rate and Illicit Vaping Products

While ITCAN supports the harmonized tax, we are concerned about the rate – set at $2.00/2 milliliters of vaping liquid or fraction thereof for containers with less than 10 milliliters of liquid, and for containers with more, $10 for the first 10 milliliters and $2 for every additional 10 milliliters or fraction thereof.

As a result, a two-pack of our 1.9 milliliter pods will have a harmonized tax of $4. This rate greatly exceeds the position of vaping products on the nicotine risk continuum, with Public Health England declaring vaping products to be 95% less harmful than cigarettes.[9] In other words, the tax on vaping products should be only 5% that for tobacco. However, analysis conducted by EY Canada[10] found the harmonized tax rate in Ontario would equate to a total tax rate of 58% that for cigarettes. For Quebec, EY Canada found the proposed harmonized rate would equate to 60.4% of the comparable tax burden on cigarettes.

The key question is whether the tax regime facilitates the transition of smokers to vaping, which should be the public health goal for those consumers who do not want to stop using nicotine. Therefore, it will be important to monitor its impact on switch rates and smoking and vaping incidence to ensure no unintended consequences.

As noted earlier in this submission, there is already evidence of a growing market for illicit vaping products in Canada. There is a strong risk the harmonized tax, as currently designed, will drive vapers to this illicit market.

With both the above, if there is evidence the tax is proving a disincentive to get smokers to switch to vaping products, or if the illicit market expands, the harmonized tax rate will need to be reconsidered.

We are also concerned about the tax structure. As noted above, the tax rate differs based on volume: $2.00/2 milliliters of vaping liquid or fraction thereof for containers with less than 10 milliliters of liquid, and for containers with more, $10 for the first 10 milliliters and $2 for every additional 10 milliliters or fraction thereof.[11]

---

[9] https://www.gov.uk/government/news/e-cigarettes-around-95-less-harmful-than-tobacco-estimates-landmark-review

[10] The Federal Government's Proposed Excise Duty Framework on Vaping Products: A Commentary with Recommendations, EY Canada, May 9, 2022

[11] Rates shown are those under the federal harmonized framework.

It should be fairly obvious this structure has a distorting market impact, favouring purchases of large volume vaping products over smaller-volume vaping pods. However, in announcing this framework in the 2022 budget, the Federal Government did not offer a justification for discounting larger volume purchases. As a result, this would seem to violate the principle of tax neutrality, in which a tax structure is not designed to favour one sort of product over another, as noted in the EY Canada analysis:

> "This rate structure continues to discriminate against closed systems sold at convenience stores compared to open systems sold in vaping shops by placing a much higher federal tax burden on them. There may be a policy reason or objective for this discrimination, but if so, it is not obvious and is not stated transparently in the budget documents. This effective 'volume discount' in the tax actually encourages large volume purchases of vaping liquid and that could in turn have the perverse effect of leading to more vaping consumption, not less."[12]

There is evidence of this market distorting impact. Since this framework was put in place in September 2022, the vaping product market has changed at a rapid pace, primarily with changes to the types of products consumers are purchasing. ITCAN estimates that roughly 50% of the disposable vaping devices sold in specialty vape stores have a volume greater than 10 millilitres, up from just 1% in September 2022.[13]

This shift towards large format disposable vaping products creates a disproportionate market advantage for some producers over others. In addition, the migration of consumers towards large-format vaping products will generate lower than anticipated government revenues. We estimate the Federal Government is currently losing $108 million annually because of the discounted tax on larger volumes of liquid.

Potential excise collection if 10ml removed	**Excise - VPT**	**Excise - VAT**	**Total**
Open	$ 83,015,313	$ 8,301,531	$ 91,316,845
Disposables	$ 13,698,634	$ 1,369,863	$ 15,068,498
Closed	$ 1,474,597	$ 147,460	$ 1,622,056
Total	**$ 98,188,544**	**$ 9,818,854**	**$ 108,007,398**

Therefore, ITCAN proposes that the current excise advantage for volumes over 10 milliliters be eliminated. This change is better adapted to the rapidly changing behaviours of Canadian vaping product consumers, while removing the fiscal advantage for producers of large-format vaping products.

[12] The Federal Government's Proposed Excise Duty Framework on Vaping Products: A Commentary with Recommendations, EY Canada, May 9, 2022

[13] For the purpose of these estimates, ITCAN has assumed that all disposable vaping devices stating they contain 6,000 puffs or above have volume of vaping substance greater than 10 milliliters.

Alternatively, the Government could limit the volume of liquid in vaping products and vaping liquid refill containers, as well as the capacity of open system vaping devices, to 10 milliliters. This would align with the limit set in the Directive 2014/40/EU1 ('Tobacco Products Directive' or 'TPD') for dedicated refill containers. It would also better reflect the relatively higher risks associated with open system vaping devices and refill containers. Furthermore, this change would reduce administrative complexity of the vaping excise regime.

Conclusion

The proposed cost recovery fee is significantly problematic and warrants reconsideration. At its most benign, it overlooks the complexities of Canada's illegal tobacco market. At its most detrimental, it inadvertently aids illegal operators. Beyond the significant issue of illegal tobacco, the fee contradicts the principles of accountable governance and results-oriented budgeting. Considering these substantial concerns, it becomes crucial for Parliamentarians to closely monitor this policy as it progresses into the consultation phase.

As for the changes to the excise stamping regime for vaping products, these are welcomed. In fact, they are necessary. Without them, there will be severe shortages of vaping products in Canada when the harmonized tax takes effect on July 1, 2024 in Ontario, Quebec, Northwest Territories and Nunavut. However, even with this change, manufacturers remain at the mercy of regulatory and legislative timelines for the stamping of vaping products that are completely out of our control. If either one of those encounter significant delays, the risk of supply shortages will increase greatly.