

# Cost Estimate of Election Campaign Proposal

---

Publication date: 2019-10-11

Short title: Deny deduction for transactions with foreign subsidiaries without any economic substance

Description: Corporations will be required to demonstrate a foreign subsidiary is carrying out economic activity to be able to deduct payments made to this subsidiary from their taxable income.

The date of the policy implementation is April 1, 2020.

Operating line(s): Income taxes: Corporate income tax

Data sources:	<u>Variable</u>	<u>Source</u>
	Expenditures to foreign affiliates	T106
	Number of full-time employees	T1134
	Taxable income	T2 tax return

Estimation and projection method: These cost estimates are based on actual corporate income tax (CIT) administrative microdata provided to Statistics Canada by the Canada Revenue Agency (CRA). The calculations are based on data for tax year 2016.

We used information on the number of full-time employees in controlled foreign affiliates entered on T1134 forms as a proxy to determine if any economic activity was taking place. We assumed that if the box on the form "More than 5" employees was checked, there was indeed economic activity, while when the box "1 to 5" was checked, there was none. We then used the T106 forms to determine the sum of expenditures made by Canadian corporations to foreign affiliates deemed as not having any economic activity (we only considered expenditures reported in Part III of the T106). The value of all these transactions that would no longer be deductible was then added back to the corporation's taxable income (line 360 of the T2). Corporations exempt from CIT were excluded from the calculation. The revenue estimate was calculated using the general CIT rate of 15%. We also present the estimate for the interaction with an increased corporate income tax rate from 15% to 18% on large firms.

Since the tax microdata that we use is anonymized, we could not directly link a T106 form filed for a given affiliate with a T1134 form filed for the same affiliate based on the name or address of the affiliate. Instead, we had to link T106 and T1134 forms by country of residence of the foreign affiliate. Thus, if more than one affiliate was located in a given country, we considered the highest number of employees reported in that country for the economic substance test. If that number was higher than five, we assumed all

transactions reported in the T106 with affiliates in that country would not be denied as deductions in computing the taxable income of the Canadian corporation.

To project future tax revenue, we used Her Majesty's Revenue and Customs' (HMRC) basic attrition guidelines to account for the decline in revenue which results from corporations changing their behavior and exploring new avoidance routes.

Uncertainty  
assessment:

These estimates have high uncertainty. As new policies are designed to stop tax avoidance, corporations engaged in aggressive tax planning will try to explore new avoidance routes or will reorganize their activities to take advantage of other known routes that have not been closed yet. We use attrition rates in our forecast to acknowledge this reality. However, future behavior from corporations with respect to avoidance is very difficult to predict. While we used the same attrition rates for the estimates with a CIT rate of 15% and 18%, this behavior change would likely be more important when corporations are facing a higher CIT rate.

Corporations are only required to file a T106 when the sum of all reportable transactions with foreign affiliates is above \$1 million. Therefore, we are possibly underestimating tax revenue because of corporations that did not need to report transactions that would be subject to the proposal. We are also possibly overestimating tax revenue since some foreign affiliates with less than six employees could pass the economic substance test. The estimate does not make provisions for additional administration or enforcement measures related to this proposal.

### Cost of proposed measure

\$ millions	2019-2020	2020-2021	2021-2022	2022-2023	2023-2024	2024-2025	2025-2026	2026-2027	2027-2028	2028-2029
Static estimate (15% CIT rate)	-	-2,314	-2,253	-2,192	-2,131	-2,070	-2,009	-1,949	-1,888	-1,827
Interaction effect of 18% CIT rate	-	-463	-451	-438	-426	-414	-402	-390	-378	-365
Total cost	-	-2,777	-2,704	-2,631	-2,557	-2,484	-2,411	-2,338	-2,265	-2,192

**Notes:**

Estimates are presented on an accruals basis as would appear in the budget and public accounts.

Positive numbers subtract from the budgetary balance, negative numbers contribute to the budget balance.

"-" = PBO does not expect a financial cost.