OFFICE OF THE PARLIAMENTARY BUDGET OFFICER
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Cost estimate of Election Campaign Proposal

Publication date:	2019-10-11
Short title:	New Digital Services Tax and Deductibility of Advertising Expenses by Canadian Resident Businesses
Description:	The first part of the proposal is to replicate the proposed digital services tax announced by the French government. A 3% tax on the revenues of the targeted digital services would be introduced as a value-added tax (VAT). The tax would target advertising services and digital intermediation services and apply to businesses with worldwide revenues of at least $1 billion and Canadian revenues of more than $40 million. The second part of the proposal is to amend the Income Tax Act Article 19 to restrict the deductibility of internet advertising expenses paid by Canadian resident businesses to only the expenses for advertising on Canadian-owned websites and on other Canadian-owned internet-delivered media. Both measures would be implemented on October 22, 2019. Interactions between the two measures are considered. This proposal also interacts with the proposal to increase the corporate income tax (CIT) rate from 15% to 18%.
Operating line(s):	Corporate Income Tax (CIT), Other Excise Taxes/Duties

Data sources:

Variable	Source
Public company revenues	Capital IQ[1]
T2 income tax return	Statistics Canada
Nominal GDP	World Bank database
Behavioural response adjustment factor	Office for Budget Responsibility, Economic and fiscal outlook—October 2018
Total, TV, and Internet advertising expenses	IAB and Think tv
Google Advertising revenues	Form 10-k of Alphabet Inc.
Facebook Advertising revenues	Facebook annual report 2018
Exchange rate	PBO economic model
Financial and taxation statistics for enterprises	Statistics Canada
Foreign border station losses due to Section 19(1)	Nordicity estimates

[1] The statements, findings, results, conclusions, views and opinions contained and expressed in this analysis are based in part on data obtained under license from S&P Global Market Intelligence (all rights reserved) and are not those of S&P Global Market Intelligence or any of its affiliated or subsidiary entities.

Estimation and projection method:

To estimate the tax revenue generated from the digital services tax, a tax base was first established. It was determined using data from the financial statements of the public companies that meet the criteria. Where the data was not broken down to indicate Canadian revenues, an estimate was made. The tax base was then projected using the historical average growth rate in the T2 income tax return data for the companies in question. The tax base was also scaled down to account for the behavioural response effect, based on the work of United Kingdom's Office for Budget Responsibility presented in its Economic and fiscal outlook—October 2018.

The digital services tax acts as a VAT and the effective tax rate was estimated by accounting for variations in the revenues of the businesses subject to the new tax. The decrease in tax revenue due to revenue variations was estimated using the marginal CIT rate. The total revenue from the proposed digital services tax was then calculated by multiplying the effective tax rate by the tax base determined above.

To estimate the CIT revenues generated from amending Article 19 of the *Income Tax Act*, a tax base was established as follows. The total advertising expenses were estimated and projected using a linear regression trendline of the historical expenses. The total internet advertising expenses were calculated as a share of the total advertising expenses. This share was projected by assuming an annual increase of five percentage points until reaching 81% and was then held constant, as per historical increases and projected shares.

The CIT revenue from this measure was then calculated by multiplying the weighted net CIT rate for small/medium and large corporations by the estimated market share of those expenses. A behavioural impact was considered; some revenues were assumed to shift back to Canadian-owned media, based on a Nordicity study examining the impact of subsection 19(1) of the *Income Tax Act* on the media industry.

Interactions between the two measures were also considered. Due to the assumed shift in advertising expenses towards Canadian-owned media, revenues are expected to fall for foreign advertising companies, leading to an increase in expense deductibility, hence a reduction in CIT revenues. This proposal also interacts with the proposal to increase the CIT from 15% to 18%.

Uncertainty assessment:

The estimate has high uncertainty. The uncertainty derives primarily from the difficulty in accurately estimating the tax base. In addition, data volatility creates much underlying uncertainty in the tax base projection. Furthermore, the proposal's scope depends on companies' worldwide revenues which Statistics Canada does not collect. It is also expected that businesses in the targeted sectors will adjust their services and prices in response to the new law. These behavioural changes are difficult to estimate and depend on strong assumptions, which adds uncertainty to the estimate. The behavioural response from shifting revenues back to Canadian-owned media could be different from what is estimated in the literature taking into consideration the novelty of the policy.

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
Total cost	-668	-1,753	-1,937	-2,124	-2,290	-2,401	-2,513	-2,634	-2,765	-2,907

Supplementary information

	Description	Operating line	2019-2020	2020-2021	2021-2022	2022-2023	2023-2024	2024-2025	2025-2026	2026-2027	2027-2028	2028-2029
Cost	Digital Services tax	CIT	-203	-540	-600	-660	-730	-810	-890	-980	-1,090	-1,200
	Amending Article 19 of the Income Tax Act	CIT	-396	-1,054	-1,159	-1,268	-1,358	-1,385	-1,412	-1,439	-1,465	-1,492
	Interaction effect	CIT	3	27	30	32	35	35	36	37	37	38
	CIT rate increase from 15% to 18%	CIT	-71	-187	-207	-229	-236	-241	-247	-252	-247	-252
Total Cost			-668	-1,753	-1,937	-2,124	-2,290	-2,401	-2,513	-2,634	-2,765	-2,907

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