OFFICE OF THE PARLIAMENTARY BUDGET OFFICER
BUREAU DU DIRECTEUR PARLEMENTAIRE DU BUDGET

Cost Estimate of Election Campaign Proposal

Publication date:	2019-09-25
Short title:	End offshore tax dodging by corporations

Description:

Introducing three measures to reduce offshore tax dodging by corporations:

1. 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.
2. Interest payments made to foreign affiliates will be capped at 10% of the corporations' earnings before tax (EBT).
3. Corporations will have to pay a withholding tax of 1% on the value of business assets they hold in certain jurisdictions considered as tax havens.

   Jurisdictions considered as tax havens in this estimate are: Andorra, the Bahamas, Barbados, Belize, Bermuda, the British Virgin Islands, the Cayman Islands, the Channel Islands, the Cook Islands, Hong Kong, The Isle of Man, Mauritius, Liechtenstein, Monaco, Panama, and St. Kitts and Nevis.

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

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

Data sources:

Variable	Source
Expenditures to foreign affiliates	T106
Number of full-time employees	T1134
Interest expenditures to foreign affiliates	T106
Earnings before taxes	Schedule 125 (income statement) and schedule 1 of the T2
Investment in tax havens	T106 and T1134

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.

For the first measure, 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 slips 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). The revenue estimate was calculated using the general CIT rate of 15%. Corporations exempt from CIT were excluded from the calculation.

Since the tax microdata that we use is anonymized, we could not directly link a T106 slip filed for a given affiliate with a T1134 supplement filed for the same affiliate based on the name or address of the affiliate. Instead, we had to link T106 slips and T1134 supplements 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.

For the second measure, we arrived at a corporation's EBT by adding the provisions for current and deferred income taxes (lines 101 and 102 from schedule 1 of the T2) to the net income/loss after taxes (line 9999 from schedule 125 [income statement] of the T2). We then calculated the interest deduction cap by multiplying EBT by 10%. Negative values were set to zero (implying that a corporation with a net loss would be denied the deduction of any interest payments to foreign affiliates). Form T106 was used to calculate, for each corporation, the sum of interest expenditures to foreign affiliates (these amounts were also validated using schedule 29 of the T2). The portion of interest payments in excess of the earnings cap was added back to the corporation's taxable income (line 360 of the T2). The revenue estimate was calculated using the general CIT rate of 15%. Corporations exempt from CIT were excluded from the calculation.

For the last measure, we estimated the value of business assets held by Canadian corporations in tax havens by using the ending balance of investment on non-resident form T106, only for foreign affiliates located in the countries considered as tax havens (see the country list in the description section). These numbers closely line-up with the equity component of Canadian direct investment abroad, as well as with the book cost of shares of foreign affiliates as reported on form T1134. To reflect the likely value of these assets in 2019, we scaled them up by applying the average annual growth rate of Canadian FDI between 2016 to 2018 over three years. The value of these business assets in tax havens was then multiplied by the 1% tax rate to arrive at the revenue estimate for this measure.

To project future tax revenue for all of the above measures, 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. The first two estimates also accounted for the interaction with an increased corporate income tax rate from 15% to 21% on large firms.

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, because otherwise our costing would be unrealistically optimistic. 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 21%, 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 in all three measures because of corporations that did not need to report transactions that would be subject to the proposed measures. The estimates do not make provisions for additional administration or enforcement measures related to these proposals.

Cost of proposed measures

$ millions	2019-2020	2020-2021	2021-2022	2022-2023	2023-2024	2024-2025	2025-2026	2026-2027	2027-2028	2028-2029
Measure 1	-594	-2,314	-2,253	-2,192	-2,131	-2,070	-2,009	-1,949	-1,888	-1,827
Interaction effect of 21% CIT rate	-237	-926	-901	-877	-852	-828	-804	-779	-755	-731
Measure 2	-304	-1,152	-1,088	-1,024	-960	-896	-832	-768	-704	-640
Interaction effect of 21% CIT rate	-122	-461	-435	-410	-384	-358	-333	-307	-282	-256
Measure 3	-451	-1,715	-1,625	-1,444	-1,264	-1,083	-903	-722	-542	-361
Total cost	-1,708	-6,567	-6,302	-5,947	-5,591	-5,236	-4,880	-4,525	-4,170	-3,814

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