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

Cost Estimate of Election Campaign Proposal

Publication date:	2019-10-11
Short title:	Limiting excessive use of interest deductibility
Description:	For corporations with net interest expenses of more than $150,000, this policy would limit the amount of interest a corporation may deduct in computing its income to no more than 20 per cent of its income before interest, taxes, depreciation and amortization (EBITDA). Interest is deductible above the 20 per cent threshold if the corporation is part of a corporate group, up to the worldwide group ratio of interest expense to EBITDA. The policy would also limit hybrid debt mismatch arrangements which are cross-border transactions that exploit differences in tax laws in two or more jurisdictions.
Operating line(s):	Corporate income tax

Data sources:

Variable	Source
Interest expenses	General Index of Financial Information (GIFI)
Interest paid to non-residents	T2 Schedule 29
Interest paid to non-resident affiliates	T106 form
EBITDA	GIFI, T2 schedule 1 and T2 Corporate tax return
Hybrid mismatch revenue in other countries	HM Revenue & Customs, UK Government; Inland Revenue, New Zealand Government
Corporate income tax revenue	Organisation for Economic Co-operation and Development (OECD); PBO
Gross domestic product	OECD

Estimation and projection method:

Limiting excessive use of interest deductibility

We used T2 corporate tax data to estimate each corporation's interest payments including those paid to foreign and domestic affiliates. We assumed that a corporation's interest deductions were the maximum reported interest payments from the GIFI, Schedule 29 and T106 forms.

We constructed an estimate of their EBITDA by re-including deducted items from Schedule 1 and our estimate of interest payments back into their net profit. Interest payments in excess of 20 per cent of a corporation's EBITDA were re-included into its taxable income and assumed to be taxed at the applicable corporate rate (using the current CIT rate of 15% for large corporations). We also present the estimate for the interaction with an increased corporate income tax rate from 15% to 18% on large firms. The additional tax payable comprises the revenue impact of this policy measure.

The proposal allows for interest deductions above the 20 per cent threshold if the corporation is part of a corporate group and the worldwide ratio of total net third party interest expense to EBITDA of that group exceeds this level. We used the Canadian group ratio as a proxy for the worldwide group ratio since we did not have data on interest payments of foreign affiliates. Net third party interest expense was calculated by subtracting interest payments on the T106 from the total interest expense. We assumed that corporations that are part of a group could deduct interest up to the group's interest expense ratio.

We assumed that this policy change does not apply to corporations with less than $150,000 in net interest payments (interest payments minus interest revenues).

This proposal also interacts with a another proposal presented by the same party which would deny deductibility of payments made to foreign affiliates in transactions where there is no economic substance. This interaction slightly reduces the revenue generated by the interest deductibility cap since some of the interest payments made to foreign affiliates would not pass the economic substance test either. The cost estimate for this interaction presented in the table on the last page is using a CIT rate of 18% for large corporations.

Anti-hybrid arrangements

We estimated the potential for additional tax revenue from fully implementing the OECD's recommendations on hybrid debt mismatch arrangements in Canada using international comparables analysis.

We used revenue estimates from similar policies in the United Kingdom and New Zealand along with OECD corporate income tax and gross domestic product data to estimate:

- The ratio between additional revenue forecasted from hybrid mismatch arrangement policies and a country's estimated corporate income tax base in tax year 2019; and,
- The revenue potential for similar policies in Canada, forecasted forward using PBO projections of Canada's corporate income tax base (assuming a CIT rate of 18% for large corporations).

We based our estimate on the UK's ratio of additional revenue to the corporate income tax base, resulting in a lower estimate than that for New Zealand. We believe an estimate based on the UK example is more prudent given the potential for aggressive tax planning by corporations.

Additional information

We assumed that these policy changes come into effect as of April 1, 2020.

To project future tax revenue for all the above measures, we used the United Kingdom's HM Revenue and Customs' basic attrition guidelines to account for the decline in revenue that results from corporations discovering new avoidance routes.

Uncertainty assessment:	The estimate has high uncertainty. These policies are designed to stop tax avoidance, so corporations engaged in "aggressive" tax planning may try to pursue new avoidance routes or reorganize their activities to take advantage of other known routes that have not been closed yet. We use attrition rates to adjust our forecast accordingly. However, future behavior from corporations with respect to avoidance is very difficult to predict and quantify. For our estimate of changes to interest deductibility, our estimate of interest payments per corporation was constructed in part using non mandatory fields from the GIFI. We had to estimate missing interest expenses of some corporations using schedule 29 of the T2 and form T106. Further, we were not able to evaluate corporations' interest ratio at the worldwide group level, nor could we identify interest paid to related Canadian corporations when computing the net third party interest expense. The behavioural response is expected to be large given that most of the additional revenue will come from a relatively small number of corporations. The estimate is also sensitive to changes in global interest and exchange rates. Our estimate of revenue from anti-hybrid rules relies heavily on the estimates produced internationally – specifically that for the United Kingdom.

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
Interest deductibility	-	-2,477	-2,339	-2,201	-2,064	-1,926	-1,789	-1,651	-1,514	-1,376
Interaction with 18% CIT rate	-	-495	-468	-440	-413	-385	-358	-330	-303	-275
Interaction with economic substance test	-	54	51	48	45	42	39	36	33	30
Anti-hybrid arrangements	-	-108	-102	-96	-90	-84	-78	-72	-66	-60
Total cost	**-**	**-3,026**	**-2,858**	**-2,690**	**-2,522**	**-2,354**	**-2,185**	**-2,017**	**-1,849**	**-1,681**

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