The Canadian Council for
Public-Private Partnerships

Le Conseil Canadien pour
les Partenariats Public-Privé

EXCESSIVE INTEREST AND FINANCING LIMITATIONS AND PUBLIC-PRIVATE PARTNERSHIPS

A public-private partnership (P3) is a tool used by governments, Crown corporations and other public authorities to procure, deliver and finance significant public infrastructure projects by bringing together integrated project teams that engage the expertise and innovation of the private sector and the discipline and incentives that accompany capital-at-risk.

P3s are a method for government entities to procure infrastructure projects that they would otherwise internalize. All of the costs of the infrastructure project are borne by the public authority or by public users (e.g., in the case of toll roads or pay per use). As such, P3s do not involve a risk of base erosion or profit shifting.

While the projects are procured by government entities (i.e., federal, provincial, municipal or other agencies thereof) across Canada, they are delivered by the private sector through a Special Purpose Vehicle (SPV) that is often, but not always, structured as a general or limited partnership, all of whose direct members are comprised of Canadian resident entities created to provide legal containment of a project. The creation of an SPV allows a P3 to deliver the project facilities secured bylong-term third-party debt, which can be 90 per cent or greater in most P3 projects. The SPV structure isolates the P3 project from extraneous risks, while also ensuring the SPV's assets and taxable income remain subject to tax in Canada. The SPV is asset rich (has ownership of the government asset) and its borrowing is to support the delivery of the government asset to the public sector.

The level of debt and equity in a project is determined as part of the bidding process and is set at Financial Close before construction commences. In almost all current P3s, the government sponsor makes fixed payments through the life of the contract, which is typically 30 years or more, and does not allow the private sector to bill out-of-scope work or other costs due to changes in legislation. The fixed payments are often expressed as a unitary charge that is intended to be sufficient to pay a range of project expenses, including the interest and interest equivalents to be paid on the long-term third-party debt. In some P3s, the government sponsor permits the SPV to levy permitted charges such as tolls or pay per use fees to recover its costs and expenses.

The SPV's substantial borrowings are used to finance the construction, and in many cases also the operation of the project, resulting in substantial interest expenses that are not matched by interest and financing revenue. While the government payments, and additional charges in the case of projects with tolls or pay per use fees, are established at project commencement to cover all expenses including interest, the timing of those payments does not necessarily match the payment of interest and the form of the payments does not explicitly set out a specific "interest recovery" amount.

In addition, an SPV's cash flow does not give rise to tax EBITDA in a manner which allows for interest to be compared to a stable ratio from period to period. For example, the construction period cash flows from the procuring authority to the SPV may include milestone payments, but often are limited to a Substantial Completion payment made at the end of the construction

period. For tax purposes, such payment is not considered revenue and therefore not factored into tax EBITDA. Rather any milestone or substantial completion payments are typically applied as a reduction of the asset's value. The proceeds of this payment are principally used to retire the short-term construction period debt.

Limitations of the draft legislation

The Council is concerned the draft proposals and the proposed excluded entity provisions will not provide appropriate exemption for P3s. If full exemption for P3s is not allowed, the Council is also concerned the application of the rules to existing projects with years left in the long-term contract will be severe.

With more than 300 P3 projects currently in various phases across Canada, the Council estimates **more than $100 billion of existing long-term project debt could be adversely affected** by this proposal. The Council's market information is that the cost of project equity would rise by 500 basis points (bp) to 600bp and the project weighted average cost of capital (WACC) would rise by 50bp to 60bp. For projects previously financed, this may lead to a ratings downgrade of the project debt and may in cases have such a severe financial impact that the private sector partner(s), lacking the ability to readjust the project cash flow to offset the increased cost, may hand back the keys to assets prior to the contract ending, thereby defeating the intent and purpose of the P3 model.

Despite the fact: (i) the P3 model by its very nature meets all of the criteria of a Public Benefit Project, as described in paragraph 66 of the Base Erosion and Profit Shifting (BEPS) Action 4 report (BEPS 4), and (ii) cashflows and project activities remain largely within Canada, thereby creating no risk of base erosion and profit shifting, there is currently no provision for an exemption in the legislation as currently drafted. This in the Council's view represents a material deviation from the BEPS 4 principles and the approach taken by the United Kingdom, the United States and European Union member states and others as outlined in Annex A.

Recommendations to address the limitations of the draft legislation

To prevent P3 projects being unfairly and disproportionately impacted by the proposed rules, and for Canada to align itself with its global peers, the Council strongly recommends a blanket exemption from EIFEL for the P3 industry. As such, the Council suggests amending the proposed legislation by modifying the definition of an "excluded entity". In particular, 1) the calculation of interest would need to be made at the SPV level (and not at the level of its partners in the case of a partnership); and 2) raising the *de minimis* threshold in paragraph (b) of the definition of "excluded entity" from CAD$250,000 to approx. CAD$4 million and to align the threshold with the safe harbour (rather than hard cap) approach of other jurisdictions (e.g., the UK, France, Germany, etc.).

In addition, the Council is concerned that equity sponsors of P3 projects may also borrow subject to existing limitations in the Tax Act and that they would be adversely affected by the EIFEL proposals. For Canadian entities that have made borrowings that have been invested (by debt, equity or ownership of a partnership interest) to a P3 entity, they should not be limited by the new rules in respect of that debt to the extent that the borrowing is directly traceable to their equity investment in the P3. Without such a rule, existing long term P3 projects entered into

under the existing rules will face a substantial increase in cost that they will be unable to pass through to the government agencies. For future transactions, this increase in tax cost (and future tax uncertainty) will be priced into future P3 projects to the detriment of government agencies desiring low cost P3 funding. In the P3 environment, all borrowings (at the SPV level and at the sponsor level) are borne by the government agencies.

The Council understands other ancillary definitions may need to be amended, which we have not discussed herein. However, as a starting point, please consider the following possible modification to the term "excluded entity" described below.

Definitions

excluded entity for a particular taxation year means

(b) a particular taxpayer resident in Canada, if $4,000,000 is not less than the amount determined by the formula

$$A - B$$

(d) a Canadian resident corporation or Canadian resident partnership contractually obligated with Her Majesty in right of Canada or a province, or an entity that is described in paragraphs 149(1)(c) to (d.6), or an entity described in paragraph 149(1)(f) that is a school, hospital or university ("Government Agency") to provide goods and services in the public interest and all or substantially all of the assets of which are used or expenses of which are incurred to provide such goods or services where

(i) it is reasonable to conclude that the payments to be received from the Government Agency or from payments by the public for use of the assets of the entity over the term of its contractual obligation with the Government Agency compensate the entity for interest paid or payable by the entity;

(ii) all or substantially all of the assets of the entity and Government Agency are ordinarily located within Canada and any obligations and expenses are incurred in connection with the assets of the entity or Government Agency; and

(ii) the main purpose of each borrowing by the entity is not to avoid the EIFEL rules.

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Annex A – Summary of BEPS exclusions by other relevant countries

In an analysis of other OECD and non-OECD countries that are collaborators on the Base Erosion and Profit Sharing initiative — with an emphasis in nations with active and mature P3 markets similar to Canada — the Council has found the following:

Europe

According to a report by Deloitte in January 2022, 18 of the 28 countries in the European Union had implemented an exclusion of loans for long-term public infrastructure projects under the *Anti-Tax Avoidance Directive 2016/1164* in response to BEPS including markets comparable to Canada such as France, Italy, the United Kingdom, Ireland and the Netherlands.

Oceania

In addition to the United Kingdom, Canada has largely monitored, learned from and adapted the experiences of Australia and New Zealand in the implementation of its P3s. While the new government in Australia has announced it will move forward with the implementation of BEPS Action 4, it has not yet started the consultative process.

In June 2018, the New Zealand government enacted the *Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018*, which provided an infrastructure project finance exemption for debt related to public project assets.

North America

Both the United States and Mexico have enacted exemptions related to public infrastructure projects.

The United States' interest expense limitation rule has an exception for public infrastructure projects under *Section 163(j) of the Internal Revenue Code*, commonly referred to as the "infrastructure safe harbour."

Mexico has excluded project debts for the construction, operation or maintenance of productive infrastructure linked to strategic areas from its rules.