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Tax Alert – Canada

Revised EIFEL proposals

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 3 November 2022, the federal government released for public comment revised legislative proposals on the proposed excessive interest and financing expenses limitation rules (the EIFEL rules) to take into account various comments received since their initial release on 4 February 2022 (the 4 February 2022 draft legislative proposals are referred to herein as the Initial EIFEL Proposals[1] and the 3 November 2022 draft legislative proposals are referred to herein as the Revised EIFEL Proposals). Interested parties are invited to provide comments in respect of the Revised EIFEL Proposals by 6 January 2023.

The stated objective of the EIFEL rules is to address Base Erosion and Profit Shifting (BEPS) concerns arising from taxpayers deducting excessive interest and other financing costs, principally in the context of multinational enterprises and cross-border investments, as raised by the Organisation for Economic Co-operation and Development/G20 in its BEPS Action 4 report. However, the EIFEL rules can also apply to purely Canadian businesses, subject to certain exceptions. It should also be noted that the EIFEL rules may apply in addition to other existing restrictions, such as the general interest deductibility rules in paragraph 20(1)(c), the transfer-pricing rules in section 247 and the thin capitalization rules in subsection 18(4) of the *Income Tax Act* (the Act).

[1] See EY Tax Alert 2022 Issue No. 13.

Building a better working world

As outlined in our 9 March 2022 Tax Alert, the EIFEL rules have two separate sets of provisions, which are primarily set out in proposed sections 18.2 and 18.21 of the Act, that determine the amount by which to restrict the deductibility of net interest and financing expenses, being the amount by which "interest and financing expenses" (IFE) exceed "interest and financing revenues" (IFR). Very generally, under the "Fixed-Ratio Rules", net interest and finance expenses may be deducted in an amount that does not exceed a fixed percentage of the taxpayer's "adjusted taxable income" (ATI, which approximates tax-adjusted earnings before interest, taxes, depreciation and amortization (EBITDA)) for the year. Alternatively, where certain conditions are met and a group of corporations and/or trusts so elects, a higher "group ratio" may be applied in lieu of the Fixed-Ratio Rules (the Group-Ratio Rules).

The Revised EIFEL Proposals include extensive changes from the Initial EIFEL Proposals. The following is a summary of the key changes between the two sets of proposals:

Effective date

As requested in various taxpayer submissions, the effective date of the EIFEL rules has been delayed and is now proposed to be effective in respect of taxation years that begin on or after 1 October 2023 (instead of 1 January 2023 as outlined in the Initial EIFEL Proposals). This is welcome news for many taxpayers and allows for additional time to determine the impact of the EIFEL rules to them and to refinance existing obligations, as needed. As a consequence, the so-called "transition" period has also been reduced and will impact fewer taxpayers. For taxation years beginning on or after 1 October 2023 and before 1 January 2024, the ratio of permissible expenses will be 40%, and the ratio will be reduced to 30% for all taxation years beginning on or after 1 January 2024.

Excluded entities

The EIFEL rules apply to any taxpayer that is not an "excluded entity", as defined in proposed subsection 18.2(1), in recognition that only certain entities and situations pose a material BEPS risk.

In the Revised EIFEL Proposals, the definition of an excluded entity has been amended to mean:

(a) A Canadian-controlled private corporation that, together with any associated corporations, has taxable capital employed in Canada of less than $50 million (increased from $15 million in the Initial EIFEL Proposals to align with the amended upper value of the phase-out range with respect to the small business deduction, as announced in the 2022 federal budget[2]);

[2] See EY Tax Alert 2022 Issue No. 23.

(b) A corporation or trust if, together with all other Canadian resident affiliated corporations or trusts (each an "eligible group entity", as defined in proposed subsection 18.2(1)), the total net IFE of the group (including both interest and financing expenses plus exempt interest and financing expenses for this purpose) is not more than $1 million (increased from $250,000 in the Initial EIFEL Proposals);

(c) A taxpayer resident in Canada that meets the following conditions:

   (i) The taxpayer and all eligible group entities carry on all or substantially all of their businesses, undertakings and activities in Canada;

   (ii) The group's foreign holdings, if any, are *de minimis* — meaning the greater of the book cost of the foreign affiliate shares held by the group or the fair market value of the assets of all foreign affiliates held by the group does not exceed $5 million (this condition was added in the Revised EIFEL Proposals);

   (iii) No person or partnership is a specified shareholder or specified beneficiary (both as defined in subsection 18(5)) of the taxpayer, or any eligible group entity in respect of the taxpayer, that is not resident in Canada; or a partnership where more than 50% of the fair market value of the interests in the partnership is held by nonresidents, and the property of the partnership includes 25% or more of the vote or value in the particular taxpayer or any eligible group entity (this condition was added in the Revised EIFEL Proposals); and

   (iv) All or substantially all of the IFE of the taxpayer and each eligible group entity in respect of the taxpayer are paid or payable to persons or partnerships other than tax-indifferent investors (generally defined to mean nonresidents of Canada and tax-exempt entities) that do not deal at arm's length with the particular taxpayer or any eligible group entity.

Foreign affiliates

In the Initial EIFEL Proposals, the treatment of foreign accrual property income (FAPI) and/or a foreign accrual property loss (FAPL) of a foreign affiliate of a taxpayer resident in Canada was not addressed. Consequently, there was uncertainty as to whether these amounts would be included in the definitions of IFR and IFE in certain cases or simply form part of a taxpayer's adjusted taxable income (ATI). However, in the Revised EIFEL Proposals, various provisions have been added and modified to consider these matters.

The most significant addition is the amendments to the definitions of both IFE and IFR to include certain FAPI/FAPL amounts from a controlled foreign affiliate (the rules do not apply to a foreign affiliate that is not a controlled foreign affiliate). For this purpose, two new terms and concepts are introduced:

- "Relevant affiliate interest and financing expenses" of a controlled foreign affiliate of a taxpayer, which generally means an amount that would be the affiliate's IFE for the purpose of determining each amount referred to in subparagraph 95(2)(f)(i) or (ii) (i.e., a capital gain or FAPI/FAPL). New paragraph (j) of Variable A of the definition for IFE requires that any relevant affiliate interest and financing expenses be included in IFE to the extent of the taxpayer's "specified participating percentage" in respect of the affiliate for the affiliate taxation year; and

- "Relevant affiliate interest and financing revenues" of a controlled foreign affiliate of a taxpayer, which generally means an amount that would be IFR for the purpose of determining the affiliate's capital gain or FAPI/FAPL. New paragraph (g) of Variable A of the definition for IFR requires that any relevant affiliate interest and financing revenues be included in a taxpayer's IFR to the extent of the taxpayer's specified participating percentage, less of any foreign accrual tax deduction claimed under subsection 91(4) for any taxation year applicable to such amount. A tracing approach is to be used to determine the extent to which foreign accrual tax is in respect of the relevant affiliate interest and financing revenues.

- FAPI that does not form part of the relevant affiliate interest and financing expenses or relevant affiliate interest and financing revenues is simply included in a taxpayer's ATI.

- For purposes of determining the adjustment to a taxpayer's adjusted cost base (ACB) in respect of a foreign affiliate, the Revised EIFEL Proposals provide that the ACB adjustments are determined without regard to any adjustments under the EIFEL rules.

For purposes of computing FAPI, the reading rules contained in paragraph 95(2)(f.11) have been amended as follows:

- First, clause 95(2)(f.11)(ii)(A) is amended to clarify that the EIFEL rules should not restrict the amount of IFE incurred by the affiliate for the purposes of calculating the FAPI (FAPL) of a foreign affiliate. This was an expected change and is consistent with the treatment of other provisions, such as the thin capitalization rules, which are disregarded for the purposes of this computation.

- Second, clause 95(2)(f.11)(ii)(D) is added. If it is determined under proposed subsection 18.2(2) that a taxpayer's IFE for a taxation year is excessive and thus subject to a denial, the same proportion of a controlled foreign affiliate's relevant affiliate interest and financing expenses are similarly denied for purposes of computing the affiliate's FAPI for a relevant taxation year. We note, however, that unlike the treatment of restricted IFE, which may be carried forward and deducted in a subsequent year depending on the excess capacity position, the denied deduction for purposes of computing FAPI of a foreign affiliate does not appear to be carried forward and deductible in a future tax year.

Other notable amendments include the following:

- Subparagraph (a)(iii) of the definition of "earnings" has been amended in Regulation 5907(1) such that for surplus purposes, a foreign affiliate that is required to compute its earnings from an active business in accordance with Canadian rules does not need to consider the EIFEL rules in proposed section 18.2. Interestingly, paragraph (b) of the definition of "earnings", which covers recharacterized income from an active business, was not amended in the Revised EIFEL Proposals.
- The definitions of "net earnings" and "net loss" have been amended in Regulation 5907(1) to provide that for surplus purposes, such amounts should be determined without regard to the application of new clause 95(2)(f.11)(ii)(D) of the Revised EIFEL Proposals.
- In respect of a foreign merger or liquidation, Regulation 5903(5) has been amended to extend application to new section 18.2 to ensure that, in computing ATI, a foreign merger or liquidation does not prevent the application of certain add-backs in respect of FAPL of a controlled foreign affiliate.

Each of these amendments is applicable for taxation years of foreign affiliates ending in the taxation year of a taxpayer beginning on or after 1 October 2023.

Interest and financing expenses

Under the Revised EIFEL Proposals, the notable changes in the definition of IFE are as follows:

- Paragraph (c) of Variable A includes interest amounts arising in a year that were capitalized and claimed as deductions in respect of capital cost allowance (CCA) or added to certain resource expenditure pools. To facilitate compliance, only capitalized amounts that are paid or payable on or after 4 February 2022 will be included.
- Paragraph (d) of Variable A was added to include a terminal loss of a taxpayer that can reasonably be considered to represent capitalized interest or financing expenses described in subparagraph (c)(ii) of Variable A.
- Paragraph (e) of Variable A was expanded to clarify that the cost of funding includes costs that may arise as a result of any hedge of the cost of funding or of the borrowing or other financing.
- Paragraph (j) of Variable A, as discussed above, was added in the Revised EIFEL Proposals to provide for the inclusion of "relevant affiliate interest and financing expenses".

Interest and financing revenues

The definition of IFR includes certain interest income, income from guarantee and similar fees, certain lease revenues, and certain amounts earned from agreements or arrangements entered into in relation to a loan made, or other financing provided by the taxpayer. Changes to the definition of IFR are important since every dollar of IFR should provide capacity to deduct one dollar of IFE.

In the Revised EIFEL Proposals:

- Paragraph (b) of Variable A has been amended to include imputed interest income amounts arising under subsection 12(9) or section 17.1; and
- Paragraph (g) of Variable A, as discussed above, was added in the Revised EIFEL Proposals to provide for the inclusion of "relevant affiliate interest and financing revenues".

Note that the definition of IFR was not amended to include amounts under section 16.1, section 17, subsection 247(2), proposed section 12.7, or proposed subsection 113(5).

Exempt interest and financing expenses

The definition of "exempt interest and financing expenses" is a new definition added in proposed subsection 18.2(1) as part of the Revised EIFEL Proposals. The new definition is intended to provide for an exemption from the EIFEL rules for interest and financing expenses incurred in respect of the financing of typical Canadian public-private partnership (P3) infrastructure projects since these expenses are not expected to pose a significant base erosion and profit shifting risk.

As noted in the draft Explanatory Notes, expenses that would otherwise be IFE of a taxpayer will be exempt interest and financing expenses where the following conditions are met:

- The taxpayer or partnership entered into an agreement with a "public sector authority" (defined to include His Majesty in right of Canada or a province, certain government authorities or entities described in paragraph 149(1)(c) to (d.6)) to design, build and finance, or design, build, finance, maintain and operate, real or immovable property owned by a public sector authority;
- The borrowing or other financing was entered into in respect of the agreement;
- It can reasonably be considered that all or substantially all of the expenses were economically borne by the public sector authority; and
- The expenses were paid or payable to arm's length persons.

Excluded interest

Excluded interest allows for two members of the same corporate group elect to have a payment of interest or a lease financing amount (reference to lease financing amount was added in the Revised EIFEL Proposals) be excluded from the EIFEL rules. In addition to the broadening of the rule to include lease financing amounts, the definition of excluded interest has also been expanded to apply to a payer and payee that is a partnership, provided certain conditions are met.

Additionally, in respect of the election made under paragraph (e) of the definition of excluded interest, the wording has been amended to take into account a loan balance that fluctuates throughout the year. Accordingly, the election now only needs to specify the amounts outstanding at the beginning and the end of the period if the payment is an interest payment, or the fair market value of the particular property at the time the lease began if the payment is a lease financing amount.

Adjusted taxable income

As defined, ATI means the taxpayer's taxable income as adjusted for certain amounts. More specifically, this is the amount determined by the formula A + B – C.

Under the Revised EIFEL Proposals:

- Paragraph (b) of Variable B has been adjusted to treat deductions from certain resource pools and CCA deductions in a consistent manner. Add-backs in Variable B now include deductions made under paragraph 59.1(a), subsection 66(4), 66.1(2) or (3), 66.2(2), 66.21(4), 66.4(2), 66.7(1), (2), (2.3), (3), (4) or (5).

- Variable B has also been adjusted to include an amount deducted under subsection 20(16) as a terminal loss. Similar adjustments were made in respect of the income or loss of a partnership.

- Paragraph (h) of Variable B is expanded to add back the portion of a non-capital loss for another taxation year (referred to as the "taxpayer loss year") that is deducted under paragraph 111(1)(a). The Initial EIFEL Proposals included an add-back to the extent that the non-capital loss included IFE in the taxpayer loss year. The Revised EIFEL Proposals go further to also require an add-back to the extent that the non-capital loss comprised other amounts described in paragraphs (b) to (g) or (i) of Variable B in the ATI definition for the taxpayer loss year, and further requires a reduction to ATI to the extent that the non-capital loss included IFR earned in that taxpayer loss year.

  Finance also provided clarity in the draft Explanatory Notes that paragraph (h) of Variable B in the definition for ATI should apply where a taxpayer claims a deduction in respect of a non-capital loss carried forward from a pre-regime taxation year that derives from an amount described in Variable B. As noted in the Explanatory Notes, although the EIFEL rules do not apply in respect of a pre-regime taxation year, it is intended that a taxpayer can nevertheless be considered to have IFE and IFR for those years, to the extent such amounts are relevant for purposes of applying the EIFEL rules for a taxation year in which the rules apply. Accordingly, the definitions are intended to apply in determining the extent to which a pre-regime loss is derived from a Variable B amount. This suggests that taxpayers may have to go back to determine what their hypothetical IFE and IFR, as well as adjustments described in paragraphs (b) to (g) or (i) in Variable B of the ATI definition, *would have been* in respect of all pre-regime taxpayer loss years, as those amounts now appear to be relevant when applying the EIFEL rules in a future year in which the loss is applied.

Transfer of cumulative unused excess capacity

A taxpayer's "cumulative unused excess capacity" is generally the total of the taxpayer's "excess capacity" for the year and the three immediately preceding years, less absorbed capacity in those years and amounts that are electively transferred to other eligible group members under proposed subsection 18.2(4). Thus, this mechanism effectively allows a three-year carryback of restricted IFE for a year.

Under the Revised EIFEL Proposals, the requirement that excess capacity could only be transferred to/received by eligible group corporations that have the same functional currency was removed. Thus, taxpayers now have the ability to transfer/receive cumulative unused excess capacity within the group, even if the transferor and transferee report their Canadian tax results in a different tax reporting currency.

In addition, the Revised EIFEL Proposals generally expand the ability to elect to transfer and receive excess capacity among eligible entities that are not only taxable Canadian corporations; as such, an election may now be made in respect of "fixed interest commercial trusts" (as defined in proposed subsection 18.2(1)).

There are also a number of provisions specific to financial institutions intended to permit the transfer of capacity among financial institution group entities, as well as other provisions intended to facilitate certain loss-planning arrangements involving financial institution group entities.

It should also be noted that the Revised EIFEL Proposals retained a requirement found in the Initial EIFEL Proposals that the election to transfer excess capacity under proposed subsection 18.2(4) is not valid if the designated amount of transferred capacity for any transferor exceeds the transferor's cumulative unused excess capacity for the year. In other words, even if the designated amount exceeds the cumulative unused excess capacity by $1, the entire election would appear to be invalid and there would be no transferred or received excess capacity.

Elective transitional rules for cumulative unused excess capacity

A set of transitional rules is included for the purpose of determining a taxpayer's cumulative unused excess capacity for a taxation year. For pre-regime taxation years, the excess capacity is generally deemed to be nil and, thus, taxpayers have no amounts to carry forward from pre-regime years in determining cumulative unused excess capacity for a regime year. However, if the taxpayer and all other eligible group corporations in respect of the taxpayer jointly elect, and the election is filed with the Minister on or before the taxpayer's filing due date for its first taxation year in which the EIFEL rules apply, a series of transitional rules applies.

In the Initial EIFEL Proposals, a group was generally expected to have to make two allocations in its joint election: one for the group net excess capacity determined using a 40% ratio (which is relevant for determining the cumulative unused excess capacity for any regime year in which the 40% ratio applies) and a second allocation determined using a 30% ratio (relevant for taxation years in which the 30% ratio applies). Since the 40% ratio is only available for a short timeframe under the Revised EIFEL Proposals (for taxation years that begin on or after 1 October 2023 and before 1 January 2024), only one election is expected to be required for most taxpayers in respect of determining the cumulative unused excess capacity for the pre-regime years.

Related and affiliated

Under the Revised EIFEL Proposals, proposed subsections 18.2(16) and (17) were added to provide clarity in determining whether certain entities are eligible group entities.

An eligible group entity can include a corporation, or a trust, resident in Canada if such entity is related to the taxpayer or would be affiliated with the taxpayer if section 251.1 were read without reference to the definition "controlled" in subsection 251.1(3). For purposes of determining whether a corporation, or a trust, is related to a taxpayer, proposed subsection 18.2(16) clarifies that a reference to a trust does not include the trustee and entities are not deemed to be related solely because of control by the Crown.

For purposes of determining whether a corporation or a trust is affiliated with a taxpayer, proposed subsection 18.2(17) clarifies that entities are not deemed to be affiliated solely because of control by the Crown or because an entity is a beneficiary that is a majority interest beneficiary that is also an arm's length registered charity or non-profit organization.

Anti-avoidance provisions

New proposed subsection 18.2(13) was introduced in the Revised EIFEL Proposals to prevent a taxpayer's IFR from being inflated, or IFE from being understated, as a result of certain types of transactions.

Paragraph (a) addresses certain transactions involving foreign affiliates that are not controlled foreign affiliates. Specifically, this provision is intended to prevent an inappropriate tax benefit to arise where a taxpayer has an increase in their IFR from a foreign affiliate that is not a controlled foreign affiliate.

Paragraph (b) addresses certain transactions involving non-arm's length entities that are not subject to the EIFEL rules where an unintended increase in the payee's capacity to deduct IFE may arise.

Specifically, amounts included under Variable A in the definition of IFR, or amounts included in Variable B of the definition of IFE, are not to be so included in IFR or deducted from IFE, as the case may be, if the amounts are paid from/to non-arm's length excluded entities or natural persons or, if the taxpayer is not a financial institution group entity, from a financial institution group entity.

This provision is intended to prevent the ability to increase IFR or decrease IFE with an otherwise related tax indifferent investor that is not subject to the EIFEL rules, and as such, would not be impacted by their corresponding decrease to IFR or increase to IFE. Of note, paragraph (b) appears to replace an otherwise problematic provision in the Initial EIFEL Proposals that had the effect of excluding from IFR interest received from related nonresident corporations. For greater certainty, the Revised EIFEL Proposals appear to include all interest received or receivable from nonresident corporations into IFR.

Paragraph (c) addresses transactions involving both arm's length and non-arm's length persons, which requires one of the main purposes of a transaction to result in an increase to a taxpayer's IFR (and thus increases a taxpayer's capacity to deduct more IFE).

Group-ratio rules

If all of the conditions in proposed subsection 18.21(2) are met, the Canadian group members (including corporations and/or trusts) can jointly elect into the Group-Ratio Rules in lieu of the Fixed-Ratio Rules for a taxation year.

The Group-Ratio Rules, set out in proposed section 18.21 of the Act, may allow a taxpayer to deduct IFE in excess of the ratio of permissible expenses, provided that the taxpayer is a member of an accounting consolidated group whose ratio of net third-party interest expense to book EBITDA exceeds the 30% or 40% fixed ratio, as the case may be, and the group can demonstrate that this is based on audited consolidated financial statements.

Under the Revised EIFEL Proposals:

- Paragraph 18.21(2)(a) was amended to remove the requirement that the tax reporting currency of Canadian group members must be the same. Accordingly, the Group-Ratio Rules can now apply to a broader base of taxpayers that have different entities within the group that report their Canadian tax results in different tax reporting currencies.

- Amendments were also proposed with respect of the computation of "group adjusted net book income", which is the denominator in the Group-Ratio Rules. Specifically, there are a number of amendments that allow an adjustment in computing the income or loss that results from the application of fair value accounting (i.e., where an amount is included in the net income or loss on the consolidated financial statements of the consolidated group where the carrying value of an asset or liability is adjusted by applying the fair value method of accounting). To include fair value adjustments in group adjusted net book income, a taxpayer must elect to apply this methodology under proposed subsection 18.21(4) and the election must be made at the same time the joint election is made to

apply the Group-Ratio Rules under proposed subsection 18.21(2). The election cannot be made after year one.

- Amendments were also made to the definition of "group ratio" to remove the progressive grind that was included in the Initial EIFEL Rules (i.e., paragraph (b) of the definition of "group ratio" from the Initial EIFEL Rules).

Amended and late-filed elections

Under the Revised EIFEL Proposals, new proposed subsections 18.2(5) and 18.21(3) were added to allow a taxpayer to either amend or late-file an election under proposed subsections 18.2(4) (the transfer of cumulative unused excess capacity) or proposed subsection 18.21(2) (to apply the allocated group ratio), subject to Ministerial approval, respectively.

These provisions are intended to allow for corrections from income tax assessments but are not intended to facilitate retroactive tax planning. It remains to be seen how much discretion the Minister will display in situations where a taxpayer made reasonable efforts to determine the cumulative unused excess capacity for a year and filed a joint election to transfer some or all of this amount, only to later learn there was an error.

Learn more

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