

Canada proposes significant tax amendments to align with OECD BEPS recommendations

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In 2022, the federal government released draft legislation to adopt many of the OECD's BEPS recommendations, including those related to interest deductibility, anti-hybrid measures and mandatory disclosure. These and other proposals will have an impact on a wide range of tax issues, both domestic and international. Many of the proposals will apply retroactively to the date of announcement, making it important for taxpayers to track the progress of and amendments to the draft legislation to plan and ensure compliance.

EIFEL: New interest deductibility limits proposed

The government released draft legislation creating a new limit on interest deductibility based on [OECD BEPS Action 4](#) on February 4, 2022, followed by a revised draft on November 3, 2022. The new rules are open for comments until January 6, 2023 and are proposed to be effective for taxation years beginning on or after October 1, 2023.

The proposed excessive interest and financing expenses limitation (EIFEL) rules will limit the deduction of specified expenses — generally, interest and other financing expenses — that the government considers to be excessive. The EIFEL rules preclude the deductibility of expenses that exceed 30% of “adjusted taxable income,” which is roughly the taxpayer’s earnings before interest, taxes, depreciation and amortization (EBITDA) as computed under the tax rules (rather than accounting rules). For taxation years beginning in 2023, the limit is 40%, rather than 30%, as a transitional measure. In addition, certain corporate groups may elect to use a higher “group ratio” in lieu of the 30% limit in certain circumstances. The group ratio rules are generally intended to provide relief where a group has a high level of third-party debt.

Taxpayers may, under certain circumstances, effectively carry forward or back denied expenses for deduction in another year, carry forward unused capacity to deduct, and transfer unused capacity to certain other group members.

Certain taxpayers are exempt from the EIFEL rules, including those in a group with less than \$50 million taxable capital employed in Canada or with no more than \$1 million of net interest and financing expenses. Also exempt are corporate groups that carry on substantially all of their business in Canada and do not have significant non-resident shareholders or subsidiaries, or significant payments to non-arm’s length tax-indifferent investors (such as non-residents and tax exempts). The EIFEL rules also contain an exemption for interest and financing expenses incurred in respect of typical Canadian public-private partnership (P3) infrastructure projects. In addition, the rules are intended to permit commonly used loss consolidation arrangements between related and affiliate group members.

The new limit will apply after the application of other rules that may limit deductibility. Notably, existing thin capitalization rules will continue to apply. These rules generally limit interest deductibility on amounts owing to certain non-resident shareholders based on a debt-to-equity ratio of 1.5 to 1. In addition, general restrictions that may apply under transfer pricing rules remain in effect. The EIFEL rules also contain specific rules to account for interest and financial expenses capitalized to undepreciated capital cost and resource expenditure pools.

“Financial institution group entities” are subject to special rules in respect of the transfer of excess capacity. These entities include financial institutions, such as banks and insurance companies, that provide regulated financial services as their regular business. They also include other entities where substantially all of their activities support other financial institution group entities, such as back office services. Financial institution group entities can only transfer their excess capacity to other financial institution group entities within the same group.

Submissions to the federal Department of Finance in response to the initial draft legislation noted many significant issues with the draft, including overly broad anti-avoidance rules and other undue restrictions. Many of these issues were addressed in the revised legislation released on November 3, 2022, but further issues are likely to be raised in the current consultation process.

Once in force, the detailed and complex EIFEL rules will require taxpayers to pay careful attention and devote significant resources to ensuring compliance.

Anti-hybrid rules

The Department of Finance released the first of two packages of draft legislation implementing new anti-hybrid rules on April 29, 2022. This draft legislation is designed to implement recommendations from the first two chapters of the final report on [OECD BEPS Action 2](#). A public comment period ran until June 30, 2022. The proposed effective date of the draft rules is July 1, 2022, which was the first day after the comment period closed. The anti-hybrid rules are therefore already presumptively in force for all relevant payments made on or after July 1, 2022, including payments under pre-existing agreements.

The rules target three types of arrangements: hybrid financial instrument arrangements, which involve financial instruments directly; hybrid transfer arrangements, which involve the transfer of a financial instrument; and substitute payment arrangements, which involve payments related to other payments or amounts under a financial instrument that was transferred.

Arrangements that fall within one of these three categories and that are either between non-arm's length parties or “structured arrangements” where the economic benefit of the mismatch is reflected in the price, fall within the anti-hybrid rules.

The rules can have multiple implications if engaged. They can apply to deny a deduction, require an income inclusion in Canada or deny a dividend received deduction, in each case to the extent of any “hybrid mismatch amount.” The hybrid mismatch generally consists of the amount of any deduction or non-inclusion mismatch arising from the relevant arrangement.

The draft legislation also applies to certain structures that do not involve an element of hybridity. For example, the rules broadly apply to interest-free loans from a Canadian corporation to a Luxembourg subsidiary. The draft legislation is complicated and may have unexpected outcomes for taxpayers. It is important for taxpayers to review the rules closely.

A second legislative package addressing the other hybrid mismatch scenarios and reverse hybrid arrangements covered in OECD BEPS Action 2 is expected to be released in the near term. We expect that these rules would not apply before 2023.

Additional information is included in our [Osler Update from May 4, 2022](#).

Mandatory disclosure rules

On February 4, 2022, the federal government released draft legislation setting out sweeping changes to Canada's transaction disclosure rules for tax purposes. The government subsequently proposed revisions in August 2022 reflecting some of the comments received during the comment period for the first draft. The mandatory disclosure rules expand the existing "reportable transactions" rules and introduce new rules for "notifiable transactions" and "reportable uncertain tax treatments." The rules will apply to reportable transactions and notifiable transactions entered into after royal assent for the implementing bill and to reportable uncertain tax treatments in respect of taxation years that begin in 2023.

The reportable transactions rules currently apply to "avoidance transactions" within the meaning of the General Anti-Avoidance Rule (GAAR) if any two of three "hallmarks" are present. The three hallmarks are (1) certain contingent fees are paid to the promoter/tax advisor; (2) confidential protection is afforded to the promoter/tax advisor; and (3) contractual protection is afforded to the taxpayer and certain other enumerated parties.

The proposed amendments would expand these rules by changing the meaning of "avoidance transaction" to require that only one of the main purposes of the transaction or series be to obtain the tax benefit. In addition, only one of the three hallmarks needs to be present. The amendments would, more helpfully, narrow the third hallmark by excluding certain types of insurance offered on normal commercial transactions.

The new notifiable transaction rules will require taxpayers to disclose any transactions that are substantially similar to those transactions on a list published by the Minister of National Revenue. One example provided by the government is "straddle loss creation transactions using a partnership." A similar notification regime is already in force in Québec.

Finally, the reportable uncertain tax treatments rules require certain corporate taxpayers to report any tax treatment to the CRA in respect of a transaction or series that gives rise to uncertainty reflected in the audited financial statements of the corporation (or its consolidated group) for the year.

The proposed mandatory disclosure rules have resulted in many submissions identifying significant issues with the draft legislation. Information on Osler's submission regarding the reportable uncertain tax treatments rules is contained in our [Osler Update from April 7, 2022](#).

International tax reform: The two pillars

Canada continues to work with a variety of international organizations on international tax reform projects, most significantly the OECD/G20 Inclusive Framework on BEPS. A high-level agreement regarding the two-pillar approach to tax reform was reached in 2021, with the expectation at the time that the agreed-upon approach would come into force in 2023. The progress on Pillar One, which provides qualifying jurisdictions with a new taxing right for a portion of the residual profits of large multinational enterprises, appears to have stalled. In particular, the required support for Pillar One from the United States appears unlikely – particularly with the now divided House and Senate. If Pillar One does not come into effect by

the end of 2023, Canada's domestic digital services tax will become collectible in 2024 with a retroactive effective date of January 1, 2022.

Many countries are looking to enact Pillar Two rules with effect in 2024. The OECD released model rules for Pillar Two, the proposed global minimum tax of 15%, in December 2021, and subsequently released commentary on the model rules in March 2022. Canada and many other countries have indicated an intention to implement Pillar Two, although the Canadian federal government has not yet introduced draft legislation.

The European Union's efforts to move forward have been delayed by Hungary on the basis that Pillar Two should only be implemented in conjunction with Pillar One. The Hungarian position effectively means that Pillar Two may not progress in the EU in a timely manner, although certain EU members have suggested they may proceed without unanimity.

Additional information regarding the OECD model rules for a global minimum tax is included in our [Osler Update from December 23, 2021](#).

GAAR consultation

Initially proposed in the fall of 2020, the government opened the long-promised public consultation process on the GAAR and released an accompanying consultation paper on August 9, 2022. For more information regarding the proposed changes to the GAAR, please see our [Tax disputes](#) article.

Looking forward to 2023 and beyond

As Canada and the rest of the world look to reshape the international tax system, there will be many new challenges (and potential planning opportunities) for Canadian businesses and multinational enterprises. The scope and wide range of the draft legislation and proposed changes released to date by the federal government, with the expectation of additional legislation to come, will make for a busy and uncertain 2023 for taxpayers. It will be essential to proactively monitor and seek advice on tax developments, which continue to increase in volume and complexity.

Further information about the topics discussed above is available in our [Osler Update from February 7, 2022](#) and our [Osler Update from August 12, 2022](#). Osler's [Federal budget briefing 2022](#) offers insights regarding additional proposals and changes not specifically addressed here.