OSLER

Finance releases revised draft EIFEL rules

NOVEMBER 24, 2022 16 MIN READ

Related Expertise

- International Tax
- Tax
- Tax Advisory Services

Authors: Kim Maguire, Matias Milet, Firoz Ahmed, Ilana Ludwin

Introduction

The Department of Finance released revised draft legislation and explanatory notes for the proposed excessive interest and financing expenses limitation (EIFEL) rules on November 3, 2022 (the Revised Proposals), concurrent with the Fall Economic Statement 2022. The revisions respond to submissions to Finance in response to the original draft legislation released on February 4, 2022 (the Original Proposals). While the Revised Proposals address many key issues raised in submissions to Finance and the delayed effective date provides taxpayers more time to prepare for implementation of the EIFEL rules, the rules continue to be highly complex and may impose a heavy tax and compliance burden on many taxpayers.

The deadline for providing comments on the Revised Proposals is January 6, 2023.

The proposed EIFEL rules contain limitations intended to address the deduction of interest and financing expenses (IFE), net of interest and financing revenues (IFR), that are considered to be excessive compared to earnings — or, more specifically, that exceed a fixed ratio equal to 30% of tax-adjusted earnings before interest, taxes, depreciation and amortization (EBITDA), also known as "adjusted taxable income" (ATI).

This Update provides a summary of the key adjustments to the proposed EIFEL rules in the Revised Proposals. For an overview of the basic structure and original features of the EIFEL rules, see the Osler Update on the Original Proposals.

Effective date and transition rules

The EIFEL rules are now proposed to apply in respect of taxation years beginning on or after October 1, 2023, rather than January 1, 2023, as initially proposed. However, the higher 40% transitional fixed ratio will only apply for taxation years that begin before January 1, 2024. As a result, although taxpayers with taxation years beginning between January 1 and September 30 will not be subject to the EIFEL rules as quickly as initially proposed, they conversely will not be allowed to benefit from the higher transitional ratio.

Excluded entities and exemption for Canadian P3 infrastructure projects

The Original Proposals provided that a taxpayer that qualified as an "excluded entity" would be exempt from the EIFEL rules subject to a specific anti-avoidance rule now in proposed subsection 18.2(14). In the Revised Proposals, the requirements for the three categories of

excluded entities have been relaxed, and a sector-specific exemption was also introduced.

Small CCPC exception: The taxable capital employed in Canada threshold for the so-called "small" Canadian-controlled private corporation (CCPC) exemption was raised from less than $15 million for the CCPC (together with any associated corporations) to less than $50 million. The increased threshold reflects the new top end of the phase-out range for the small business deduction proposed in the 2022 Federal Budget.

De minimis exception: The second exception is for taxpayers that, together with each "eligible group entity", have IFE and exempt interest and financing expenses (net of applicable IFR) of $1 million or less for the particular year. Under the Original Proposals, the relevant threshold was $250,000 or less.

Domestic exception: The Revised Proposals also include adjustments to the exception for groups with no or minimal activities or entities outside of Canada and no material foreign ownership. While these adjustments will be meaningful to many taxpayers, they do not fully address concerns that the EIFEL rules go beyond the recommendations of the BEPS Action 4 Report. The changes include:

- The requirement that all or substantially all of each business be carried on in Canada is modified to require that all or substantially all of the businesses, undertakings and activities be carried on in Canada.
- A group may now include foreign affiliate holdings up to a *de minimis* threshold of $5 million of either book cost of the shares of the foreign affiliates or the fair market value of all of the assets of such foreign affiliates, compared to the original requirement that the group not have *any* foreign affiliates. The asset value test is applied at the level of the foreign affiliate, so a small interest in a foreign affiliate with at least $5 million of assets will preclude the application of the domestic exception.
- Finally, the requirement that all or substantially all of a group's IFE must be paid to a person or partnership other than a tax-indifferent investor is narrowed to non-arm's length tax-indifferent investors. Unfortunately there are no proposed changes to the definition of "tax-indifferent investor", such as removing the references to certain Canadian trusts, and therefore a group could fail to meet this exception even if there is no connection outside Canada.

Canadian public-private partnership (P3) infrastructure projects: The Revised Proposals introduced a new exemption for expenses relating to certain Canadian public-private partnership (P3) infrastructure projects. The exemption can be found in the definition of "exempt interest and financing expenses" and only applies where all or substantially all of the relevant expenses are directly or indirectly borne by the public sector authority. Prior to this change, it was anticipated that entities engaged in such projects (which are typically highly-leveraged) would need to rely on the group ratio rules for relief from the 30% fixed-ratio limit.

FAPI and FAPL rules

One of the most significant changes introduced in the Revised Proposals are the proposals clarifying how foreign accrual property income (FAPI) and a foreign accrual property loss (FAPL) of a foreign affiliate controlled by a Canadian resident taxpayer will be treated under the EIFEL rules. The Original Proposals were generally silent on this front, leaving taxpayers to question whether FAPI and FAPL would be included in IFR or IFE, or simply form part of

ATI.

Generally summarized, the Revised Proposals provide that FAPI and FAPL will be incorporated into the EIFEL rules as follows:

- The new proposals only apply to a "controlled foreign affiliate" (CFA) of a Canadian resident taxpayer as defined in subsection 95(1).
- A CFA's "relevant affiliate interest and financing expenses" for a CFA's taxation year are included in the taxpayer's IFE for the taxpayer's taxation year in which the CFA's taxation year ends, but only to the extent of the taxpayer's "specified participating percentage" in respect of the CFA.
- Similarly, a CFA's "relevant affiliate interest and financing revenue" for a CFA's taxation year are included in the taxpayer's IFE for the taxpayer's taxation year in which the CFA's taxation year ends, but only to the extent of the taxpayer's "specified participating percentage" in respect of the CFA, less any foreign accrual tax deduction claimed under subsection 91(4) for any taxation year applicable to such amount.
- The amount of IFE or IFR "imputed" to the taxpayer will thus impact the application of the IFE denial rule in subsection 18.2(2).
- If a portion of a taxpayer's IFE deduction is denied under the EIFEL rules, the same proportion of CFA's relevant affiliate interest and financing expenses is similarly denied for the purposes of computing the affiliate's FAPI for the relevant taxation year. The Revised Proposals do not specifically provide that the CFA's restricted expenses may be carried forward and deducted in a later year.
- Any residual FAPI is included in computing the taxpayer's ATI.

If enacted, these amendments would be applicable for taxation years of CFAs ending in the taxation year of a taxpayer beginning on or after October 1, 2023.

Interest and financing expenses

The EIFEL rules are intended to limit a taxpayer's ability to deduct IFE that are considered excessive. The Revised Proposals contain a number of additions to IFE, including:

- IFE will include 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 (Variable A, paragraph (c)). To facilitate compliance, only capitalized amounts that are paid or payable on or after February 4, 2022, will be included.
- IFE will include a terminal loss of a taxpayer that can reasonably be considered to represent capitalized interest or financing expenses (Variable A, paragraph (d))
- Clarification that costs that may arise as a result of a hedge may be included in computing the cost of funding, borrowing or other financing (Variable A, paragraph (e)).
- IFE will include "relevant affiliate interest and financing expenses" in respect of a CFA, as described above.

Interest and financing revenues

The definition of IFR is a very important concept for taxpayers since every dollar of IFR allows a taxpayer to deduct a corresponding dollar of IFE.

While the Revised Proposals do provide for additional inclusions in IFR — imputed interest income under subsection 12(9) and section 17.1 as well as "relevant affiliate interest and financing revenue" as described above — the definition of IFR was not amended to include all amounts of imputed income amounts. Notably there is no inclusion for amounts in section 17 or the hybrid mismatch arrangement rule in section 12.7.

Under the Original Proposals, interest earned by a taxpayer on loans to non-arm's length non-resident corporations and partnerships did not generate IFR due to an anti-avoidance rule. This rule has been amended so that interest received or receivable from non-resident corporations should be included in IFR, subject to limited exceptions.

Adjusted taxable income

As defined, ATI means the taxpayer's taxable income (Variable A) as adjusted for certain additions in Variable B and certain deductions in Variable C. The higher a taxpayer's ATI, the more capacity it will have to deduct IFE.

- The Revised Proposals provide for a number of changes to the computation of ATI, including the following: The reference to net capital loss in variable A has been removed. This means the starting point for computing ATI (which can be a negative number) is the taxable income or non-capital loss of the taxpayer for the year.
- Paragraph (b) of Variable B is amended to add back certain resource pool deductions, consistent with the add-back for CCA deductions.
- Variable B is also amended to add back 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 Original Proposals included an add-back only to the extent that the non-capital loss included IFE in the taxpayer loss year. The Revised Proposals go further to also require an add-back to the extent that the non-capital loss comprised other amounts described in 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.
- The draft explanatory notes provide that paragraph (h) of Variable B in the definition for ATI should apply where a taxpayer claims a deduction in a particular taxation year in respect of a non-capital loss carried forward from a pre-regime taxation year if that loss is derived from an amount described in Variable B. A taxpayer may therefore need to compute IFE and IFR for pre-regime taxation years to the extent such amounts are relevant for purposes of applying the EIFEL rules for a taxation year in which the EIFEL rules apply. This could add significantly to the already complex compliance burden on taxpayers posed by the EIFEL rules.

The Revised Proposals also include adjustments to Variable C (which effectively reverses amounts otherwise included in taxable income), including income inclusions for "recapture" income and dispositions of resource properties or other recovery of resource expenses.

Carryforward of denied IFE

The Original Proposals allowed IFE that were denied under the EIFEL rules to be effectively carried forward for up to 20 years (or back for up to three years through the carry-forward of excess capacity). The 20-year restriction has now been removed, meaning denied IFE can potentially be claimed in any subsequent year in which the taxpayer has sufficient capacity.

Excess capacity transfers

The EIFEL rules generally permit taxpayers within an eligible corporate group to elect to transfer "cumulative unused excess capacity" to other group members under proposed subsection 18.2(4). 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 transferred in previous years.

The Revised Proposals contain a number of changes to the proposed rules for the transfer and receipt of unused capacity among eligible group members:

- Eligible group entities may include "fixed interest commercial trusts" (as defined in proposed subsection 18.2(1)).
- Eligible group entities with different tax reporting currencies will be permitted to transfer and receive cumulative unused excess capacity.
- The transfer of capacity among financial institution group entities is permitted (as noted below).
- An election under proposed subsection 18.2(4) may be amended or late-filed subject to Ministerial approval. While Finance indicates this change is intended to apply in the context of an income tax assessment, one would hope that Ministerial approval would also be granted to remedy taxpayer mistakes since an election is invalid if the transferred capacity amount is off by even one dollar.
- The elective transitional rules that apply for the purposes of determining a taxpayer's cumulative unused excess capacity in respect of pre-regime years were relaxed slightly given the shortened time frame for the transitional 40% fixed ratio — in effect, many taxpayers who would have been required to make two allocations in the election, are now only required to make one allocation.

Group ratio rules

The Original Proposals contain an alternative regime under which, if certain conditions are satisfied, Canadian group members can elect for a "group ratio" to apply instead of the 30% fixed ratio (or the transitional 40% fixed ratio). The group ratio rules are generally intended to provide relief for groups operating in sectors that are typically highly-leveraged.

The Revised Proposals include the following changes to the group ratio rules:

- Similar to the capacity transfer rules, the requirement for all group entities to have the same tax reporting currency was removed. The requirement for all group entities to have the same taxation year end as the "ultimate parent" was also removed.
- A number of amendments were made to the computation of "group adjusted net book income", specifically with respect to adjustments that result from the application of fair value accounting. The election to apply that methodology must be made *in year one*.
- The definition of "group ratio" was amended to remove the progressive grind that was included in the Original Proposals (i.e., paragraph (b) of the definition of "group ratio" from the Original Proposals).
- Taxpayers are permitted to amend or late-file a group ratio election under proposed subsection 18.21(2), subject to Ministerial approval. According to Finance, this change is intended to allow for corrections from income tax assessments, but not to facilitate "retroactive tax planning".

Excluded interest and loss consolidation arrangements

The concept of "excluded interest" allows two related or affiliated taxable Canadian corporations to elect for certain interest payments to be excluded from the IFE and IFR. One purpose of this concept is to accommodate typical loss consolidation arrangements within related and affiliated groups. The Revised Proposals expand the concept of "excluded interest" to apply to lease financing amounts and some partnerships (but still not to trusts). The rules are also adjusted such that interest paid or payable by a financial institution group entity cannot be "excluded interest" unless the payee is also a financial institution group entity.

Financial institution changes

The Revised Proposals replace the "relevant financial institution" concept from the Original Proposals with "financial institution group entity." The new term is defined to include financial institutions such as banks and insurance companies that provide regulated financial services as their regular business, as well as other entities where substantially all of their activities support other financial institution group entities (e.g. back office services). While "relevant financial institutions" were prohibited in the Original Proposals from participating in the group ratio regime, no such restriction applies to a financial institution group entity under the Revised Proposals. Financial institution group entities will, however, be restricted in their ability to transfer excess capacity. Under the Revised Proposals, financial institution group entities can only transfer their excess capacity to other financial institution group entities within the same group (with a limited exception intended to accommodate loss consolidation arrangements in insurance company groups).

Anti-avoidance rules

There are specific anti-avoidance rules sprinkled throughout the EIFEL rules, but the primary anti-avoidance rules in the Original Proposals were contained in proposed subsections 18.2(13) and (14). These provisions were intended to target transactions that would reduce a taxpayer's IFE or increase a taxpayer's IFR, respectively. The wording in proposed subsections 18.2(13) and (14) in the Original Proposals was very broad and sparked concerns among taxpayers that the rules could potentially apply where a taxpayer takes reasonable steps to mitigate the impact of the EIFEL rules (e.g. arranging for a non-related non-resident to assume debt to reduce the taxpayer's IFE) or to other innocuous transaction.

In the Revised Proposals, the anti-avoidance rules in subsections 18.2(13) and (14) in the Original Proposals are consolidated into subsection 18.2(13) and, in some ways, significantly narrowed to capture specific types of transactions. If these anti-avoidance rules apply to a particular amount that would otherwise be included in computing IFR, or deducted in computing IFE, then such inclusion or deduction is denied.

Broadly speaking, proposed subsection 18.2(13) targets three categories of transactions:

1. *Transactions involving non-controlled foreign affiliates:* Paragraph (a) of proposed subsection 18.2(13) applies where the particular amount is deducted in computing the FAPI of a corporation that is a foreign affiliate, but not a CFA (non-CFA) of the taxpayer or of a person or partnership not dealing at arm's length with the taxpayer. Finance provides an example of where a taxpayer receives an interest payment directly from a non-CFA of the taxpayer (or indirectly from such an affiliate through an intermediary) and the interest payment is deductible in computing the affiliate's FAPI. But for this rule, the interest would create IFR for the taxpayer without an offsetting IFE.
2. *Transactions involving payments from certain non-arm's length persons or partnerships:* Paragraph (b) of proposed subsection 18.2(13) addresses certain transactions involving non-arm's length entities that are not subject to the EIFEL rules — because they are an "excluded entity" or natural person — where the transaction would otherwise result in an increase in the taxpayer payee's IFR (or decrease in IFE), and the payor is generally indifferent to the impact of its corresponding decrease in IFR (or increase to IFE) since it is not subject to the EIFEL rules. If the taxpayer is not a "financial institution group entity", paragraph (b) may also apply where the payor is a non-arm's length financial institution group entity.
3. *Transactions where a main purpose is to reduce IFE or increase IFR:* Paragraph (c) of proposed subsection 18.2(13) addresses transactions involving both arm's length and non-arm's length persons, where one of the main purposes of the transaction or series of transactions is to cause an increase to a taxpayer's IFR or a decrease to a taxpayer's IFE, and results in the circumstances described in subparagraphs (i) and (ii):
    - Subparagraph (i) generally describes circumstances where there is an asymmetry in how an amount between two persons (or partnerships) is treated under the EIFEL rules, e.g. where a taxpayer receives an amount included in IFR from a person who is indifferent to whether the amount results in an increase to their IFE.
    - Subparagraph (ii) generally describes circumstances where it can reasonably be considered that a particular amount that does not increase IFR (or reduce IFE) is converted to, replaced by, or substituted with another amount that would result in an increase (or reduction).

In the explanatory notes to proposed paragraph 18.2(13)(c), Finance explains that the main purposes are generally determined from the perspective of the taxpayer whose IFR or IFE is impacted, as well as any other person or partnership who would benefit from the taxpayer's increased capacity (including a person to whom the taxpayer transfers excess capacity).

Finance specifically notes in its explanatory notes to the Revised Proposals that proposed subsection 18.2(13) does not purport to address all scenarios that are "considered not to be appropriate in policy terms" and warns that the general anti-avoidance rules in section 245

may apply in such circumstances.

Conclusion

The proposed EIFEL rules represent a shift in both policy and in resources required by taxpayers to comply with increasingly complex income tax rules. If you have any questions or require additional analysis on the proposed EIFEL rules, please contact any member of our National Tax Department.