Revised EIFEL legislation in implementation bill

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Osler's National Tax Group has prepared in-depth analysis of these developments. See our Updates on Bill C-59 and the clean energy tax credits.

The *Fall Economic Statement Implementation Act, 2023* includes a variety of tax measures that were introduced in Parliament on November 30, 2023, as Bill C-59. The Canadian federal government also released Explanatory Notes [PDF] in respect of most of the measures in Bill C-59, including the excessive interest and financing expenses limitation (EIFEL) rules, on the same day.

Bill C-59 contains a number of revisions to EIFEL rules first announced in Budget 2021. The proposed EIFEL rules are intended to limit the deduction of interest and financing expenses (IFE), net of interest and financing revenues (IFR), that are considered by the Canadian government to be "excessive" compared to earnings — or, more specifically, based on whether they exceed a fixed ratio equal to 30% of adjusted taxable income (ATI) (or, in some circumstances, a higher group ratio).

Draft legislation for the EIFEL rules was originally released on February 4, 2022, and revised on November 3, 2022, and August 4, 2023 (collectively, the previous EIFEL proposals).

The core EIFEL rules are proposed to be added as new sections 18.2, 18.21 and paragraph 12(1)(l.2) of the *Income Tax Act* (Canada) (the Act).

Effective date and transitional rules

The proposed coming-into-force date for the EIFEL rules has not changed: once enacted, the EIFEL rules will generally apply to corporations and trusts with taxation years beginning on or after October 1, 2023. The 40% transitional fixed ratio would only apply for taxation years that begin before January 1, 2024.

Excluded entity – changes to foreign affiliate *de minimis*

threshold in domestic exception

The EIFEL rules provide that a taxpayer that is an "excluded entity" is exempt from the rules. The definition of "excluded entity" contains three broad exceptions commonly referred to as the small CCPC exception, the *de minimis* exception and the domestic exception.

Under the previous EIFEL proposals, a taxpayer would generally qualify for the domestic exception if the taxpayer was part of a group with no material foreign ownership and minimal activities or entities outside of Canada. More specifically, one of the conditions of the domestic exemption in the previous EIFEL proposals was that the taxpayer is part of a group whose holdings in foreign affiliates, if any, do not exceed a $5-million threshold.

The $5-million threshold would be breached if the book cost of all foreign affiliate shares held by the group exceeded $5 million or if the fair market value of the assets of all foreign affiliates held by the group exceeded $5 million. This meant that if a taxpayer only owned 10% of the shares of a foreign affiliate with assets worth $6 million, the $5-million threshold would be breached and the domestic exception would not apply. Bill C-59 now provides that only the taxpayer's group's proportionate interest in the value of a foreign affiliate's assets is considered. This is a welcome change because it more closely reflects the group's actual economic interest in the foreign affiliate. However, this may still result in the application of the rules where a large MNE group has a relatively modest investment in a foreign affiliate.

Bill C-59 also clarifies how partnerships with foreign affiliates are treated in the context of the domestic exemption: if a taxpayer or a group entity is a member of a partnership, and that partnership has an interest in a foreign affiliate, then the foreign affiliate will be considered a foreign affiliate of the partnership itself, but not of the members of the partnership.

Interest and financing expenses

Under the proposed EIFEL rules, a taxpayer includes in its IFE the amounts described in Variable A (e.g., interest and typical financing expenses) and deducts the amounts in Variable B.

Paragraph (e) in Variable A includes in IFE amounts paid or payable or a loss that is not otherwise described in Variable A but that can reasonably be considered part of the cost of funding in respect of a borrowing or other financing of the taxpayer or non-arm's length person or partnership, as well as certain ancillary arrangements. A capital loss could be captured by paragraph (e) — for example, a foreign currency loss that is deemed a capital loss under subsection 39(2). The Explanatory Notes clarify when an allowable capital loss described in paragraph (e) is included in computing IFE: the allowable capital loss is included in computing IFE in the year the loss is realized only to the extent it offsets taxable capital gains in that year; otherwise, the allowable capital loss is not included in computing IFE until the year the loss is deductible under paragraph 111(3)(b).

Interest and financing revenue

The definition of IFR is an important concept since every dollar of IFR allows a taxpayer to deduct a corresponding dollar of IFE. Similar to IFE, the definition of IFR includes amounts described in Variable A (e.g., interest income, income from guarantee and similar fees, etc.) less amounts described in Variable B.

Bill C-59 expands certain amounts that are deducted in computing IFR under Variable B in respect of a loss or capital loss under or as a result of a loan or other financing owing to or provided by the taxpayer or certain ancillary hedging arrangements.

Bill C-59 also excludes from IFR any amount of income that is not subject to tax because of an Act of Parliament.

The definition of “relevant inter-affiliate interest” is modified to provide a formula to calculate the amount to be included in the recipient affiliate’s IFR.

Adjusted taxable income

ATI means the taxpayer’s taxable income as described in Variable A, subject to 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.

Bill C-59 contains a few changes to the calculation of ATI, including a loss continuity rule in respect of non-capital losses of a subsidiary corporation that become losses of the parent corporation on a wind-up of the subsidiary. The previous EIFEL proposals contained a similar rule in respect of amalgamations.

Exempt interest and financing expenses in respect of Canadian P3 projects

The definition of “exempt interest and financing expenses” (EIFE) is relevant for purposes of providing an exemption from the EIFEL rules for IFE incurred in respect of the financing of certain Canadian public-private partnership (P3) projects.

Bill C-59 does not provide any significant changes to the concept of EIFE. However, the Department of Finance expands its discussion of EIFE in the Explanatory Notes to provide further guidance on the treatment of EIFE; the rationale of EIFE (according to the Department of Finance, it does not pose a base erosion concern); and how income (or losses) attributable to activities funded by borrowings that result in EIFE *vis-à-vis* other types of funding (e.g., equity financing) should be deducted (or added back) in computing ATI so as not to unfairly distort ATI.

Under Bill C-59, taxpayers with EIFE will need to report specific information regarding their EIFE in addition to the other information that taxpayers may already be required to report in prescribed form under the EIFEL rules.

Restricted interest and financing expense and addition in respect of capital losses

The previous EIFEL proposals contained a new tax attribute in subsection 111(8) referred to as “restricted interest and financing expense” (RIFE), which will generally include the amount of a taxpayer’s IFE that was not deductible because of the EIFEL rules as well as any amount included in the taxpayer’s income in respect of the taxpayer’s share of IFE of a partnership of which the taxpayer was a member. In general terms, a taxpayer will be able to deduct its RIFE in taxation years where the taxpayer has excess capacity or received capacity from another group member.

Bill C-59 provides an addition to RIFE to the extent that an allowable capital loss cannot be used to offset taxable capital gains in a current year or is not deductible under section 111 in another year because of the EIFEL rules.

Expansion of definition of ‘financial institution group entities’

The EIFEL rules restrict the ability of a “financial institution group entity” to transfer excess capacity to other group members, primarily because financial institution group entities are expected to have higher amounts of IFR relative to IFE. Under the previous EIFEL proposals, financial institution group entities were defined to include banks; credit unions; insurance companies; businesses offering services as a trustee to the public; financial institutions whose business consists of, among others, lending money to persons dealing at arm’s length and purchasing debt obligations with arm’s length parties; and particular eligible group entities.

Bill C-59 expands this definition to include entities or partnerships that are eligible group entities in respect of most of the other categories of financial institution group entities and that primarily derive income from providing portfolio management, investment advice, fund administration or management in respect of real estate.

Excess capacity election for pre-regime years

The previous EIFEL proposals generally permit taxpayers that are taxable Canadian corporations or fixed-interest commercial trusts within an eligible group to elect to transfer “cumulative unused excess capacity” to eligible group members. Cumulative unused excess capacity for a year is generally the total of “excess capacity” for previous years and excess capacity from the three immediate pre-EIFEL regime years if a valid election is made, less “absorbed capacity” and amounts transferred to another group in previous years.

Bill C-59 states that additional information must be provided in the election to add excess capacity in respect of pre-regime years. This additional information includes the excess interest, the excess capacity and the net excess capacity for the taxpayer and each eligible pre-regime group entity for the pre-regime years. If an election does not contain the relevant information, the excess capacity amounts for pre-regime years is deemed to be nil. Bill C-59 provides some relief where an election must be amended as a result of an assessment or reassessment.

Bill C-59 also excludes amounts in respect of persons exempt from tax under Part I of the Act from being included in computing pre-regime excess capacity.

Other proposals relating to partnerships

Bill C-59 contains a number of other technical changes relating to partnerships, including in the context of computing “relevant affiliate interest and financing expenses” and “relevant affiliate interest and financing revenues”, which are concepts that may be relevant in determining an upstream Canadian resident taxpayer’s IFE and IFR.

If you have any questions or require additional analysis on Bill C-59 and the revised EIFEL rules, please contact any member of our National Tax Department.