2023 Issue No. 32
16 August 2023

Tax Alert — Canada

Finance releases further revisions to 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 4 August 2023, 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[1] and their subsequent revision through draft legislative proposals that were released on 3 November 2022[2] (the 4 February 2022 and 3 November 2022 draft legislative proposals are collectively referred to herein as the "Initial EIFEL Proposals" and the 4 August 2023 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 8 September 2023.

By way of background, 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.

[1] See EY Tax Alert 2022 Issue No. 13, *Proposed EIFEL rules*, which was released on 9 March 2022.
[2] See EY Tax Alert 2022 Issue No. 43, *Revised EIFEL proposals*, which was released on 10 November 2022.

Building a better working world

As outlined in our 9 March 2022 and 10 November 2022 Tax Alerts, the EIFEL rules have two separate sets of provisions, which are primarily set out in proposed sections 18.2 and 18.21 of the *Income Tax Act* (Canada) (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 financing 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 are largely in alignment with the Initial EIFEL Proposals apart from certain key changes. The following is a summary of the key changes contained in the Revised EIFEL Proposals.

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, which is described in more detail in our 9 March 2022 and 10 November 2022 Tax Alerts.

Under the Revised EIFEL Proposals, the following changes have been made to the definition of ATI.

Pre-regime non-capital losses

- Where a non-capital loss from another taxation year (referred to as the "taxpayer loss year") has been deducted in a particular taxation year, the definition of ATI generally requires an amount to be added back to ATI in respect of the deduction claimed. However, the amount added back (under paragraph (h) of Variable B) must be adjusted to the extent of any net IFE (as well as other adjustments) that may have been deducted in determining the non-capital loss for the taxpayer loss year. New paragraph (i) of Variable B contains an elective carveout for a "specified pre-regime loss", a new defined term contained in proposed subsection 18.2(1). Taxpayers may elect to treat a non-capital loss for a taxpayer loss year that ends before 4 February 2022 as a "specified pre-regime loss". If such an election is made, paragraph (h) of Variable B no longer applies and 25% of the amount deducted by the taxpayer in the particular taxation year under paragraph 111(1)(a) in respect of the specified pre-regime loss will be added back to ATI under new paragraph (i) of Variable B.

- The explanatory notes (accompanying the Revised EIFEL Proposals) state that this election is intended to ease compliance in respect of non-capital losses arising from taxation years that ended before the release of the initial 4 February 2022 EIFEL proposals, acknowledging the complexity involved in determining the IFE and IFR arising from a pre-regime taxpayer loss year. This is a welcome change that should address uncertainty arising under the Initial EIFEL Proposals in situations where the IFE or IFR (among other information required under paragraph (h)) for a particular "specified pre-regime loss" year is unattainable from the financial records available. Filing the election should provide taxpayers with certainty over the results.

Investment tax credits and government assistance

- Paragraph 12(1)(t) generally includes certain investment tax credits in income while paragraph 12(1)(x) includes in income amounts that are received as certain forms of government assistance. Such amounts are naturally captured under Variable A of ATI through their inclusion in taxable income. New paragraphs (l) and (m) of Variable B ensure that to the extent that such amounts are not included in income, and have instead been applied to reduce the cost or capital cost of certain properties, they are nevertheless included in ATI under Variable B. As described in the explanatory notes, this ensures that the receipt of government assistance and the deduction of certain tax credits do not erode interest deductibility capacity.

Interest and financing revenues

Paragraph (g) of the definition of IFR adds to a taxpayer's IFR a portion of the relevant affiliate interest and financing expenses (RAIFE) of a controlled foreign affiliate (CFA) based on the taxpayer's specified participating percentage in the CFA. The RAIFE amount included in paragraph (g) is reduced by the foreign accrual tax gross-up mechanism under subsection 91(4) in respect of the affiliate taxation year.

Under the Revised EIFEL Proposals:

- As requested in various submissions to the Department of Finance, this reduction is modified by carving out the portion of the amount deducted under subsection 91(4) that is in respect of Canadian withholding tax paid under subsection 212(1).

Foreign affiliates

The Initial EIFEL Proposals contained significant amendments to address 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. Generally, the definitions of both IFE and IFR were amended to include certain FAPI/FAPL amounts from a CFA through the introduction of the concepts of RAIFE and relevant affiliate interest and financing revenues (RAIFR).

The Revised EIFEL Proposals include the following key changes in respect of the foreign affiliate regime:

Relevant affiliate interest and financing expenses

- The definition of RAIFE now includes an explicit carveout for amounts that are deductible in computing income or a loss that is re-characterized as income or a loss from an active business under paragraph 95(2)(a) and certain amounts paid or payable under financing structures described in clause 95(2)(a)(ii)(D).
- The definition of RAIFE also now includes a carveout for "relevant inter-affiliate interest" that is netted under subsection 18.2(19), as further detailed below.

Relevant inter-affiliate interest

- The Revised EIFEL Proposals introduce new subsection 18.2(19), which provides a highly technical set of rules that act as an automatic netting mechanism to determine the portion of "relevant inter-affiliate interest" (a new defined term contained in proposed subsection 18.2(1)) that is included in a particular CFA's RAIFE or RAIFR. The explanatory notes state that this mechanism is similar to the excluded interest election available for certain interest payments between taxable Canadian corporations; however, the relevant inter-affiliate interest netting mechanism differs in that it applies automatically rather than electively, does not provide a full exclusion in all cases and does not necessarily provide for symmetrical treatment in respect of the payer affiliate and recipient affiliate.
- Relevant inter-affiliate interest is defined as interest paid or payable by a CFA (referred to in new subsection 18.2(19) as the "payer affiliate") of a taxpayer to another CFA (referred to in new subsection 18.2(19) as the "recipient affiliate") of the taxpayer, or of an eligible group entity in respect of the taxpayer (both referred to herein as the "relevant taxpayer").
- New paragraph 18.2(19)(a) determines through a detailed formula the portion of the relevant inter-affiliate interest that is included in the payer affiliate's RAIFE for an affiliate taxation year (referred to in new subsection 18.2(19) as the "payer affiliate year"). Generally, the amount included in the RAIFE of the payer affiliate represents the portion of inter-affiliate interest that can be regarded as eroding the tax base by reducing an income inclusion in respect of FAPI due to a positive spread between the specified participating percentages of the relevant taxpayer in respect of the payer affiliate and recipient affiliate. In addition, the payer affiliate must determine the portion of its relevant inter-affiliate interest that could be offset by its net RAIFR calculated without regard to the payer affiliate's inter-affiliate interest for the payer affiliate year (referred to herein as the "Payer Affiliate Net RAIFR Amount") and include the amount so determined in its RAIFE.

- New paragraph 18.2(19)(b) determines through a detailed formula the portion of the relevant inter-affiliate interest that is included in the recipient affiliate's RAIFR for an affiliate taxation year (referred to in new subsection 18.2(19) as the "recipient affiliate year"). Generally, if the payer affiliate does not have a Payer Affiliate Net RAIFR Amount for the payer affiliate year, none of the relevant inter-affiliate interest will be included in the recipient affiliate's RAIFR. If the payer affiliate does have a Payer Affiliate Net RAIFR Amount, the portion of the Payer Affiliate Net RAIFR Amount that is allocable to the relevant inter-affiliate interest, as adjusted to reflect the total specified participating percentages of relevant taxpayers in respect of the payer affiliate and recipient affiliate, is included in the recipient affiliate's RAIFR. This mechanism is intended to ensure that the payment of the relevant inter-affiliate interest does not inappropriately convert the payer affiliate's Payer Affiliate Net RAIFR Amount into FAPI that does not have that character in the hands of the recipient affiliate.

Election in respect of FAPLs

- New clause 95(2)(f.11)(ii)(E) provides an election to effectively forgo a FAPL in order to avoid including amounts that gave rise to the FAPL in a taxpayer's IFE. The explanatory notes acknowledge that there may be instances where a FAPL may never be used to reduce Canadian taxable income because a foreign affiliate's FAPL can only be applied against its FAPI and not against the Canadian shareholder's own income. Despite this, the IFE that generate the FAPL are nonetheless included in a CFA's RAIFE and can negatively impact the Canadian shareholder's ability to deduct its own IFE. The election in new clause 95(2)(f.11)(ii)(E) is introduced to rectify this outcome.

- Under this election, the Canadian shareholder may determine one or more "elected amounts" in respect of all or a portion of one or more components of the foreign affiliate's otherwise deductible IFE. The elected amounts so determined are not deductible in computing the foreign affiliate's FAPI. As a result of this, each elected amount is excluded from the CFA's RAIFE, and the CFA's FAPL is reduced to the extent of the total of the elected amounts. To ensure that the elected amounts are only in respect of IFE of a CFA that contributes to a FAPL, the total of the elected amounts in an affiliate taxation year is limited to the lesser of the affiliate's FAPL and RAIFE for the affiliate taxation year (each of those amounts determined without regard to new clause 95(2)(f.11)(ii)(E)).

- The election is to be filed in prescribed form by the Canadian shareholder on or before the filing due date of the Canadian shareholder's tax return for its taxation year in which the taxation year of the foreign affiliate ends and should specify the following amounts:

  - Each of the elected amounts;

  - The foreign affiliate's RAIFE for the taxation year, determined both with and without regard to new clause 95(2)(f.11)(ii)(E)); and

  - The foreign affiliate's FAPL for the taxation year, determined both with and without regard to new clause 95(2)(f.11)(ii)(E)).

Group ratio regime

Generally, 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 fixed ratio, and the group can demonstrate that this is based on audited consolidated financial statements.

The operative provision of the Group Ratio Rules is contained in proposed subsection 18.21(2), which determines the amount of interest deduction capacity (referred to herein as the "allocated group ratio amount" (AGRA)) that may be allocated to an eligible member of the consolidated group (referred to herein as the "Canadian group member") and used as an alternative to the interest deduction capacity determined by applying the fixed ratio.

The Revised EIFEL Proposals include the following key changes in respect of the Group Ratio Rules:

10% uplift to the group ratio

- The group ratio has been increased by a factor of 10% by modifying the definition of "group ratio" such that the ratio between Variable A (which equals the group net interest expense of the consolidated group) and Variable B (which represents the group adjusted net book income of the consolidated group) is multiplied by a factor of 1.1. The explanatory notes indicate that this 10% uplift is recommended in the BEPS Action 4 Report to mitigate against book-tax timing differences that may arise from the group ratio calculation.

AGRA upper limit

Paragraph 18.21(2)(c) calculates the upper limit of the AGRA that may be allocated to a Canadian group member for a relevant taxation year as the least of three amounts. The first of these three amounts is determined by multiplying the group ratio of the consolidated group for the relevant period by the ATI of each Canadian group member for its relevant taxation year. Under the Initial EIFEL Proposals, this limitation was not applicable in instances where the group ratio for the relevant period is nil.

Under the Revised EIFEL Proposals:

- This limitation applies even if the group ratio is nil. As a result, in instances where the group ratio of the consolidated group is nil, the AGRA available to be allocated to Canadian group members will now also be nil by virtue of the limitation in subparagraph 18.21(2)(c)(i).

Exempt interest and financing expenses

The definition of "exempt interest and financing expenses" is intended to provide for an exemption from the EIFEL rules for IFE incurred in respect of the financing of typical Canadian public-private partnership (P3) infrastructure projects since these expenses are generally not expected to pose a significant BEPS risk.

The Revised EIFEL Proposals make the following changes to the definition:

- The reference to "real or immovable" property in paragraph (a) of the definition has been removed and replaced with a broader reference to "property" in general. This change allows for qualifying P3 infrastructure projects involving property other than real or immovable property to benefit from the exemption.
- The requirement in paragraph (a) of the definition that the public sector authority that enters into the agreement with the taxpayer or a partnership of which the taxpayer is a member must also own the property that is subject to the agreement has been relaxed. This requirement is now satisfied if any public sector authority owns, has a leasehold interest in or has a right to acquire the property that is subject to the agreement.
- The arm's length funding condition in paragraph (d) of the definition has been modified to allow for back-to-back funding structures wherein the IFE paid by the taxpayer or a partnership of which the taxpayer is a member to an intermediary that does not deal at arm's length with the taxpayer or partnership can still benefit from the exemption, provided that all or substantially all of the amount paid or payable to the intermediary was paid or payable by the intermediary to a person that deals at arm's length with the taxpayer or partnership.

Section 216

Generally, under section 216, nonresidents earning rent on real or immovable property in Canada may elect to be taxed on such income under Part I of the Act as though they were resident in Canada instead of paying a tax pursuant to Part XIII of the Act. The Initial EIFEL Proposals had not addressed the manner in which the EIFEL rules would apply to taxpayers who elect under section 216.

The Revised EIFEL Proposals clarify that, generally, taxpayers that elect under section 216 are subject to the EIFEL rules. New paragraph 216(1)(e) provides that such taxpayers cannot be "excluded entities", "eligible group entities", or "fixed-interest commercial trusts" as defined in proposed subsection 18.2(1) and are not eligible to apply the Group Ratio Rules. Furthermore, the explanatory notes indicate that taxpayers who file under section 216 continue to be subject to the rules in paragraphs 216(1)(a) to (d) and confirm that paragraph 216(1)(c) should prevent such taxpayers from deducting restricted IFE under proposed paragraph 111(1)(a.1).

Financial holding corporation

The Initial EIFEL Proposals restricted the ability of a "financial institution group entity" (as defined in proposed subsection 18.2(1)) to transfer its excess capacity under proposed subsection 18.2(4) by permitting it to transfer its excess capacity only to another "financial institution group entity", an "insurance holding corporation" or a "special purpose loss corporation" within its group, subject to certain limitations.

Under the Revised EIFEL Proposals:

- The definition of "insurance holding corporation" has been replaced with "financial holding corporation", a new defined term contained in proposed subsection 18.2(1).
- Generally, the definition of "financial holding corporation" includes a corporation if, throughout the year, the fair market value of the corporation is primarily attributable to any combination of shares or indebtedness of certain financial institution group entities that are controlled by the corporation. Alternatively, a financial holding corporation includes a corporation incorporated under the *Insurance Companies Act*, the shares of which are listed on a designated stock exchange.
- This definition for "financial holding corporation" is significantly broader than the prior definition for "insurance holding corporation", which had been defined to mean a corporation, the fair market value of which is primarily attributable to shares or indebtedness of insurance corporations that had to be subsidiary wholly owned corporations.

New filing requirement and extended reassessment period

The Revised EIFEL Proposals introduce new subsection 18.2(18), which requires taxpayers to file a new prescribed form containing prescribed information with respect to the deductibility of its IFE. This new prescribed form will need to be filed with the taxpayer's tax return for the year.

If the new prescribed form under subsection 18.2(18) is not filed on time or is incomplete, the normal reassessment period is extended pursuant to new paragraph 152(4)(b.9). Generally, the extended period for reassessment (which could be either three or four years depending on the classification of the taxpayer under subsection 152(3.1)) only starts once the taxpayer files the properly completed prescribed form. The extended reassessment period is applicable only in respect of the application of the EIFEL rules.

Learn more

For more information, contact your EY or EY Law tax advisor, or one of the following professionals:

Toronto

Eric Xiao
+1 416 943 2943 | eric.c.xiao@ca.ey.com

Leslie Ivany
+1 416 943 4595 | leslie.a.ivany@ca.ey.com

Linda Tang
+1 416 943 3421 | linda.y.tang@ca.ey.com

Mark Kaplan
+1 416 943 3507 | mark.kaplan@ca.ey.com

Phil Halvorson
+1 416 943 3478 | phil.d.halvorson@ca.ey.com

Terri McDowell
+1 416 943 2767 | terri.mcdowell@ca.ey.com

Trevor O'Brien
+1 416 943 5435 | trevor.obrien@ca.ey.com

Quebec and Atlantic Canada

Albert Anelli
+1 514 874 4403 | albert.anelli@ca.ey.com

Angelo Nikolakakis
+1 514 879 2862 | angelo.nikolakakis@ca.ey.com

Brian Mustard
+1 514 887 5521 | brian.mustard@ca.ey.com

Nicolas Legault
+1 514 874 4404 | nicolas.legault@ca.ey.com

Nik Diksic
+1 514 879 6537 | nik.diksic@ca.ey.com

Philippe-Antoine Morin
+1 514 874 4635 | philippe-antoine.morin@ca.ey.com

Prairies

Mark Coleman
+1 403 206 5147 | mark.coleman@ca.ey.com

Liza Mathew
+1 403 206 5663 | liza.mathew@ca.ey.com

Vancouver

Eric Bretsen
+1 604 899 3578 | eric.r.bretsen@ca.ey.com

Janette Pantry
+1 604 648 3699 | janette.pantry@ca.ey.com

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation is available via ey.com/privacy. For more information about our organization, please visit ey.com.

About EY's Tax Services
EY's tax professionals across Canada provide you with deep technical knowledge, both global and local, combined with practical, commercial and industry experience. We offer a range of tax-saving services backed by in-depth industry knowledge. Our talented people, consistent methodologies and unwavering commitment to quality service help you build the strong compliance and reporting foundations and sustainable tax strategies that help your business achieve its potential. It's how we make a difference.

For more information, visit ey.com/ca/tax.

About EY Law LLP
EY Law LLP is a national law firm affiliated with EY in Canada, specializing in tax law services, business immigration services and business law services.

For more information, visit eylaw.ca.

About EY Law's Tax Law Services
EY Law has one of the largest practices dedicated to tax planning and tax controversy in the country. EY Law has experience in all areas of tax, including corporate tax, human capital, international tax, transaction tax, sales tax, customs and excise.

For more information, visit http://www.eylaw.ca/taxlaw