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Tax Alert — Canada

Proposed EIFEL rules

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On 4 February 2022, the federal government released for public comment a package of draft legislative proposals to implement various tax measures. Included in these measures are rules aimed at limiting the amount of interest and other financing expenses that businesses may deduct for income tax purposes based on a proportion of earnings, as previously announced in the 2021 Federal Budget. These new rules are described as the excessive interest and financing expenses limitation (EIFEL) rules.

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 (OECD)/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 restrictions, such as under the existing "thin-capitalization" rules, transfer-pricing rules in section 247, and other rules.

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The EIFEL rules have two separate sets of provisions 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 default "Fixed-Ratio Rules", net interest and other 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. This fixed ratio, referred to as the "ratio of permissible expenses" of a taxpayer, will generally be 40% for the first taxation year(s) (i.e., for taxation years beginning on or after 1 January 2023 and ending before 1 January 2024) and 30% for taxation years beginning after 2023 (subject to an anti-avoidance rule applicable if taxpayers deliberately shorten a taxation year to take advantage of the 40% ratio).

Alternatively, where 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 rule (the Group-Ratio Rules). In certain cases, the Group-Ratio Rules can also apply to a single corporation or a purely Canadian group.

Generally, electing under the Group-Ratio Rules will allow a taxpayer to deduct IFE in excess of the fixed ratio, if 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 is able to demonstrate this based on audited consolidated financial statements. The "consolidated group" is defined in the proposals as an ultimate parent and all the entities that are fully consolidated in the parent's consolidated financial statements, or that would be if the group were required to prepare such statements under IFRS.

The EIFEL rules are extensive and detailed, with 27 pages of draft legislation, and a helpful 69-page discussion in the accompanying draft Explanatory Notes released with the draft legislation.

We would also note that, as drafted, the EIFEL rules give rise to a number of technical and other concerns, only some of which are discussed below.

The deadline for making submissions in respect of the EIFEL proposals is 5 May 2022.

In-scope taxpayers: The EIFEL rules apply to any taxpayer that is not an "excluded entity", which is defined to mean:

- A Canadian-controlled private corporation that, together with any associated corporations, has taxable capital employed in Canada of less than $15 million (which represents the top end of the phase-out range for the small-business deduction);
- A corporation or trust if, together with all other Canadian resident affiliated corporations and trusts (each an "eligible group entity"), the total net IFE for the group is not more than $250,000;

- Certain stand-alone Canadian resident corporations and trusts, and groups consisting exclusively of Canadian-resident corporations and trusts that meet specified conditions (i.e., that they carry on substantially all of their business in Canada, that no nonresident is a foreign affiliate of, or holds a significant interest in, any group member, and that no significant amount of IFE is payable to a "tax-indifferent investor" (defined generally to mean nonresidents of Canada and tax-exempt entities)).

Interest and financing expenses: Consistent with what was announced in Budget 2021, the amount of IFE that is to be considered should generally be the amount by which all such expenses exceed the total IFR for the year. It is the net IFE that is relevant. As such, every dollar of IFR should provide capacity to deduct one dollar of IFE, whereas the taxpayer's ATI supports a deduction only up to the ratio of permissible expenses.

For these purposes, IFE generally includes interest (other than "excluded interest") paid or payable in respect of a year on account of interest as well as certain other amounts. Notably, some of those other amounts included in IFE are as follows:

- Certain financing costs
- 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
- Amounts paid or payable, or losses incurred, under certain agreements or arrangements that can reasonably be considered to be part of the cost of funding of the taxpayer, or a non-arm's length person or partnership, and expenses related thereto (including amounts paid or payable under certain hedging or funding derivatives, or presumably agreements meant to charge what is not technically interest but economically similar to interest)
- Imputed interest in respect of certain leases

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.

However, of note, subsection 18.2(12) sets out that no amount received or receivable from a non-arm's length person or partnership is included in computing IFR, except to the extent that it is included in computing the IFE of a taxable Canadian corporation or a trust that is resident in Canada and that is subject to tax under Part I of the *Income Tax Act* (Canada) (the Act). Based on the wording in the draft legislation, interest received from any non-arm's length nonresident appears to be *excluded* from IFR. If excluded from IFR, these amounts would be included in adjusted taxable income and would result in a 30% capacity per dollar of income rather than 100% capacity if included in IFR. As worded, this would include denying IFR treatment in respect of interest paid by a nonresident that arose in relation to a taxable branch in Canada where the interest paid is itself tested under the EIFEL rules, resulting in potential double denial. So too could this apply if a Canadian parent, acting as the market-facing entity for a group of companies, borrows from the market (thus incurring IFE) and then on-lends to its foreign affiliates.

In our view, the results of subsection 18.2(12), as drafted, do not appear to align with the final recommendations in the BEPS Action 4 report, which contemplates that interest from a foreign subsidiary should be taken into consideration in computing the parent's net IFE. We expect that the Department of Finance will provide clarification around subsection 18.2(12).

Excluded interest: Where certain conditions are satisfied, interest paid or payable in respect of a debt between two eligible group corporations (that are taxable Canadian corporations) may, if the relevant eligible group corporations so elect, be considered "excluded interest". Excluded interest is not to be included as IFR to the recipient, nor as IFE to the payor (and would thus remain within the computation of ATI). This ensures that a particular amount of interest is not denied to the taxpayer (and would create no additional capacity to the recipient), which may be useful in the context of implementing traditional intra-group loss planning arrangements, by effectively allowing a transfer of ATI between group members.

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.

For these purposes, variable A is the positive or negative amount that is generally the taxpayer's taxable income for the year (before the application of these rules) less its non-capital loss (also before the application of these rules) and its net capital loss for the year, if any. Notably, this ATI amount is determined after deductions claimed in respect of dividends under sections 112 (domestic Canadian-sourced dividends) or 113 (dividends from foreign affiliates), and also after deductions claimed under subsection 91(4) in respect of foreign accrual tax applicable to foreign accrual property income (FAPI) or subsection 91(5) in respect of dividends received out of previously taxed FAPI. It is also reduced by prior year losses deducted in the current year under section 111, subject to an add-back under paragraph (g) of variable B to the extent that a non-capital loss from the loss year is attributable to deductions in respect of interest or finance expenses from that year, as discussed below.

Variable B adds back a number of amounts so as to reverse the impact on the taxpayer's ATI of deducted IFE, CCA deducted under paragraph 20(1)(a), amounts deducted under paragraph 110(1)(k) (in respect of Part VI.I tax) or new paragraph 111(1)(a.1) (in respect of restricted IFE from prior years and claimed in the current year) and amounts earned by a trust but deducted under subsection 104(6) as amounts attributed to beneficiaries under the trust. There are also add-backs for certain amounts flowing through partnerships and for components of other-year losses deducted in the current year. This is an area in which there may be several technical and other issues.

For example, although amounts for interest capitalized to certain resource pools may be expressly denied under these rules, any such amounts that were permitted to be capitalized and deducted are not added back for these purposes. Problems may also arise with respect to the manner in which the add-backs address components of other-year losses deducted in the current year — in particular, in that they may not properly address losses attributable to CCA.

Variable C effectively reverses income inclusions for several amounts that are included in computing the taxpayer's taxable income. Examples of such amounts are IFR, foreign income covered by tax credits claimed under subsection 126(1) and (2), notional taxable income arising under section 110.5, amounts included as a beneficiary under a trust in subsection 104(13), or income that is not otherwise subject to tax under Part I because it is exempt from tax under the Act or any other Act of Parliament. Here, too, there may be technical and other problems. For example, there appears to be a circularity problem with respect to foreign income, in that the amount of tax credits to which the taxpayer may be entitled under subsections 126(1) or (2) could be affected by its deductible IFE, which cannot be determined without first taking into account the tax credits.

Cumulative unused excess capacity: A taxpayer's "cumulated unused excess capacity" is the total of the taxpayer's "excess capacity" for the year and the three immediately preceding years, thus effectively allowing a three-year carryback of denied IFE for a year. However, technically, this is a carryforward of capacity into the current year, as opposed to a carryback of IFE into the prior years.

Excess capacity, for a particular taxation year, in general terms, is the amount, if any, by which the maximum amount of IFE a taxpayer is allowed to deduct for the year (determined as its fixed ratio of its ATI, plus its IFR for the year) exceeds its actual IFE for the year. A taxpayer is treated as not having excess capacity for any taxation year in which it is subject to the Group Ratio Rules. A taxpayer's unused excess capacity is the portion that has not been either used to deduct the taxpayer's own IFE for another year or transferred by the taxpayer to another group member in a previous year. For these purposes, there is an ordering rule that the taxpayer must first apply its own balance of cumulative unused excess capacity as absorbed capacity (i.e., to reduce its own interest limitation position) before transferring any remaining balance. The resulting balance, i.e., the cumulative unused excess capacity, represents the maximum amount that the taxpayer may transfer to other eligible group taxable Canadian corporations in that year.

The excess capacity for any taxation year to which the EIFEL rules do not apply (a pre-regime year) is generally deemed to be nil. However, see below for a discussion regarding electing to have certain transitional rules apply in order to determine a taxpayer's cumulative unused excess capacity for a particular taxation year, which may look back to include excess capacity in respect of pre-regime years.

Transfer of cumulative unused excess capacity: Conditions under which cumulative unused excess capacity may be transferred by a transferor to a transferee are set out in new subsection 18.2(4). Some of the relevant conditions include:

i. The taxation year of the transferor ends in the taxation year of the transferee;

ii. The transferor and transferee are both taxable Canadian corporations (no transfers are permitted from or to a trust) that are eligible group corporations in respect of each other and have the same reporting currency (within the meaning assigned by subsection 261(1));

iii. The transferor is not a relevant financial institution (as defined);

iv. Both transferor and transferee file an election in prescribed form within the specified time periods; and

v. The transferee files an information return (described in new subsection 18.2(5)) for the calendar year in which the transferee's taxation year ends. This information return must be filed on or before 30 June after the end of the respective calendar year.

There is also an ordering rule setting out that absorbed capacity or transferred capacity is to be applied on a first-in, first-out basis (i.e., the unused excess capacity for the relevant years is to be applied first to the earliest year, then to the next year, etc.).

Eligible group corporation: Only corporations that are "eligible group corporations" in respect of one another are eligible to treat an interest payment between them as excluded interest or to elect under new subsection 18.2(4) to transfer excess capacity from one to the other.

For these purposes, eligible group corporations in respect of a particular corporation resident in Canada, at any time, mean another corporation resident in Canada that (i) is, at that time, related to the particular corporation (other than by way of a right referred to in paragraph 251(5)(b)), or (ii) would, at that time, be affiliated with the particular corporation if section 251.1 were read without reference to the definition of *controlled* in subsection 251.1(3).

Carryforward of denied IFE: IFE that is denied under new subsection 18.2(2) (and amounts included under new paragraph 12(1)(l.2) in respect of a member's share of denied partnership IFE, which is not discussed herein) may be carried forward up to 20 years. Such "restricted IFE" may not be carried back, although the effect of carrying forward cumulative unused excess capacity for 3 years permits a substantively similar result.

The carryforward of restricted IFE is provided for under new paragraph 111(1)(a.1). This deduction is permitted in two scenarios and in the following order. First, a taxpayer may deduct its own restricted IFE to the extent of its excess capacity for the year. Second, a taxpayer may deduct amounts to the extent that another eligible group corporation transferred cumulative unused excess capacity to the taxpayer. The taxpayer's unused capacity must be used up before it may receive transferred 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. As discussed above, a taxpayer's cumulative unused excess capacity for a taxation year is determined based on the excess capacity for the year and the three immediately preceding years. 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.

Very generally, the transitional rules are designed so as to determine each amount that is the "group net excess capacity" for each pre-regime year. Though the mechanics are complex, in its very simplest terms, the group net excess capacity requires a determination, for each relevant pre-regime year, of the "excess interest" or "excess capacity otherwise determined" for each eligible group corporation. The group net excess capacity for a pre-regime year is generally the amount by which the total of all such excess capacity otherwise determined for the pre-regime year exceeds the total of the excess interest for the pre-regime year for those eligible group corporations. However, actual results may be different than as described given nuances and complexities. Once the group net excess capacity for each pre-regime year is determined, one condition (among others) for filing a valid election is that this amount must then be allocated among the eligible corporate groups as part of the election itself. In other words, amounts must be known and disclosed as part of the election for it to be a valid election.

Of note, the group must 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 year in which the 30% ratio applies). As such, two sets of calculations will be required.

Determining whether a taxpayer may benefit from filing this joint election will require modelling and analysis.

Group-ratio rules

If all of the conditions in 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 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. It may be noted that while there are similarities and interactions between the Fixed-Ratio Rules and the Group-Ratio Rules, there are key differences and the two rules are distinct from each other.

The conditions to be eligible to file a group election under subsection 18.21(3) for a particular taxation year include:

a. Each Canadian group member:

   i. Is, throughout the year, either a taxable Canadian corporation or a trust resident in Canada;

   ii. Has a taxation year that is the same period as the relevant period of the ultimate parent of that consolidated group; and

   iii. Has the same tax reporting currency (within the meaning assigned by subsection 261(1)) throughout their respective taxation years.

b. No Canadian group member is a relevant financial institution.

c. The consolidated financial statements of the consolidated group for the year are audited.

d. The Canadian group members:

   i) Jointly elect in prescribed form and manner in respect of the year;

   ii) File the joint election on or before the earliest filing due-date of a Canadian member for the year; and

   iii) Allocate, in that election, an amount in respect of the "allocated group ratio amount" to each Canadian group member (to be discussed).

Group adjusted net book income: For these purposes, the group book EBITDA is defined in subsection 18.21(1) as the "group adjusted net book income". This is the denominator in the group ratio determination. The group adjusted net book income is calculated by the formula [A-B].

Variable A in the formula generally includes the group's net income as reported in the consolidated financial statements of the group, plus the following amounts that are included in those statements:

- Income tax expense;
- The amount of specified interest expense, which is defined to mean interest expense plus adjustments for items such as capitalized interest, guarantee fees, standby fees and arrangement fees or similar fees or amounts determined, plus any similar amounts that were included in the determination of net income or loss of an equity-accounted entity. However, excluded from specified interest expense are amounts for dividends otherwise included as interest expense for the year;
- All amounts for depreciation or amortization of an asset, as well as any impairment or write-off of an asset or a loss on the disposal of such asset; and
- Any of the above items included in the determination of the income or loss of an equity-accounted entity, to the extent of the consolidated group's share of that income or loss.

Variable B is, essentially, the inverse of those items listed above, including income tax recovery, specified interest income, amounts for gains on disposals of (depreciable) assets and the group's proportionate share of such amounts for an equity-accounted entity.

Group net interest expense: The numerator for the Group-Ratio Rules is defined to be the group net interest expense. Group net interest expense is defined to generally be the amount by which the consolidated group's specified interest expense exceeds the specified interest income for the period, with adjustments to deduct any portion of the specified interest expense (or add back specified interest income) that is paid or payable to (or, in the case of income, received or receivable from) specified non-members. For this purpose, "specified non-member" of a consolidated group means a particular person or partnership that does not

deal at arm's length with a group member, or where the group members have rights to 25% of the votes and value of the person or partnership.

Group ratio: The group ratio is, in the first instance, the percentage determined by dividing the group net interest expense by the group adjusted net book income for the relevant period. If that percentage is 40% or less, then the group ratio is that percentage. However, if that percentage exceeds 40%, there is a progressive grind to the group ratio. If the percentage is greater than 40% but not greater than 60%, the group ratio would be 40% plus 50% of the amount by which that percentage exceeds 40%. If the percentage is greater than 60%, then the group ratio would be 50% plus 25% of the amount by which that percentage exceeds 60%.

Allocated group ratio amount (AGRA): When a joint election is filed, taxpayers must allocate amounts to members of the group to permit IFE deductions for each such member. However, the total amount that may be allocated may not exceed the AGRA. The primary charging provision in the group ratio rules, subsection 18.21(3), requires that taxpayers first determine and allocate out to all group members the AGRA of the group. AGRA (which is not a defined term) represents the maximum amount of IFE for all group members that may be deducted without restrictions for the taxation year. If that total amount allocated exceeds the AGRA, then the amount allocated to each member is deemed to be nil (thus resulting in the group having no ability to deduct any IFE).

The AGRA that may be allocated to the Canadian group members is the least of the following amounts:

a. The total of each amount that is a Canadian group member's ATI multiplied by the group ratio of the consolidated group, where ATI has the meaning assigned by subsection 18.2(1);

b. The group net interest expense of the consolidated group; and

c. The total of the ATI, determined without reference to section 257, of each group member. (The override of section 257 is to ensure that losses of group members are deducted from total ATI.)

In this sense, unlike the Fixed-Ratio Rule, there is no requirement to determine the "excess capacity" for any particular group member and then separately transfer excess capacity of one particular group member to another. Rather, the total amount of IFE that may be deducted for the group (i.e., the AGRA) is determined and as part of the joint election is merely allocated out to each member in that election itself. No group member should have restricted IFE to the extent that the AGRA allocated to that member is less than that member's net IFE. Part of the reason for this rather streamlined approach is that if an election under subsection 18.21(3) is made for a year, unused excess capacity for each member is deemed to be nil for the year. However, restricted IFE, if any, may be carried forward. Further, if the total AGRA otherwise exceeds the net IFE of the group for the year, any restricted IFE from a prior year my be applied in the year (up to the amount of that excess).

It may be noted that if any two members of the Canadian group have a different tax-reporting currency, the Group-Ratio Rules cannot apply. This is presumably intended to be a parallel rule to the rule in section 18.2 restricting the transfer of unused excess capacity between

group members with a different tax-reporting currency. However, a key distinction between the Fixed-Ratio Rules and the Group-Ratio Rules is that, whereas under the Fixed-Ratio Rules there is no ability for trusts within a group to transfer or receive excess capacity, the mechanics of the Group-Ratio Rules do effectively permit the transfer of excess capacity to or from trusts within the Canadian group.

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