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Canada Releases Revised Draft Legislation on New Interest Deductibility Rules

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The Department of Finance (Canada) (Finance) has released revised draft legislation on the proposed rules regarding excessive interest and financing expenses limitation (EIFEL).

The revised draft legislation, released on November 3, 2022, contains several significant updates to Finance's initial draft legislation. However, a number of interpretive issues remain unresolved.

Briefly, the EIFEL rules limit the deduction, for income tax purposes, of "interest and financing expenses" of corporations and trusts (that are not "excluded entities") to a fixed percentage, or "fixed ratio," of earnings before interest, taxes, depreciation and amortization (EBITDA).

With one exception for certain public-private partnership financings, the rules do not contain sector-specific exemptions. Instead, eligible corporate groups may elect to compute the impact of the rules on the basis of a "group ratio" rule as an alternative to the fixed ratio. *Importantly, the group ratio now appears to be more beneficial for most taxpayers, since the "grind" that reduced the group ratio under the previous version of the draft legislation is no longer present.*

Before we delve into the notable changes contained in this revised legislation package, it is important to note that the effective implementation of the EIFEL rules has been postponed. Instead of applying to taxation years beginning on or after January 1, 2023, the EIFEL rules will now apply to taxation years *beginning on or after October 1, 2023*, to limit the deductibility of net interest and financing expenses of corporations and trusts (that are not "excluded entities") to a fixed percentage of 40% of EBITDA. For taxation years that begin on or after January 1, 2024, the limitation will be equal to a fixed percentage of 30% of EBITDA.

More details are available in our initial bulletin on the proposed legislation.

Notable Changes to the Proposed Legislation

Broadening Exemptions: Changes to Excluded Entities

The EIFEL rules will not apply to taxpayers that qualify as excluded entities. Finance has broadened the definition of excluded entities in response to criticism that the definition in the initial draft legislation was too narrow.

The revised draft legislation provides relief from the EIFEL rules for the following entities:

- Canadian-controlled private corporations, and any associated corporations, with less than C$50 million (instead of C$15 million) of taxable capital employed in Canada;
- taxpayers (corporations and trusts) resident in Canada with less than C$1 million (instead of C$250,000) of net interest and financing expenses in a taxation year; or
- taxpayers (corporations and trusts) resident in Canada if
  - substantially all of the businesses, undertakings and activities of the taxpayer's group are carried on in Canada;

- no non-resident person or partnership (i) owns more than 25% of the votes or fair market value of the taxpayer, or (ii) is a partnership with more than 50% of its fair market value held by non-residents, and the property of the partnership includes more than 25% of the votes or fair market value in the taxpayer or an eligible corporate group member; and
- substantially all of its interest and financing expenses are payable to persons or partnerships that are *not "tax-indifferent investors" (e.g., non-residents or tax-exempt entities) that do not deal at arm's length with the taxpayer* or a corporate group member of the taxpayer. Under the previous version of this rule, a taxpayer would cease to be an excluded entity if interest and financing expenses were payable to *any tax-indifferent investor, including arm's-length parties*. As well, the EIFEL rules include an *anti-avoidance rule* that deems a person or partnership to be a non-arm's-length tax-indifferent investor if an amount of interest and financing expenses is paid or payable to the person or partnership (as part of a transaction or event or series thereof) and it can reasonably be considered that one of the main purposes of the transaction, event or series is to avoid the amount being paid or payable to a non arm's-length tax-indifferent investor.

Public-Private Partnership Exemption

In response to criticism that the EIFEL rules would affect Canadian public-private partnerships (PPPs) involved in infrastructure projects, Finance has added a new carve-out for "exempt interest and financing expenses." This exemption will generally apply to exclude third-party interest and financing expenses incurred for borrowing or financing as a result of an agreement with a Canadian "public sector authority," to design, build and finance, or to design, build, finance, maintain and operate, *real or immovable property owned by the public sector authority*.

Public sector authorities include, but are not limited to, the federal government, provincial governments, municipalities, Crown corporations (and corporations largely owned by Crown corporations) and registered charities that are school authorities, public colleges, universities or hospital authorities.

The PPP exemption does not appear to be available where real or immovable property on which the project is located is not owned by the public sector authority that is required to make payments to the borrower of the relevant debt. It is unclear why the particular public sector authority making the payments is also required to hold an interest in the underlying real or immovable property. We hope this will be broadened before the legislation becomes final. The PPP exemption is also not available where the interest is paid to persons that have a direct or indirect equity interest in the borrower.

Rules for Financial Institutions

The revised EIFEL rules provide a definition of "financial institution group entity," (FIGE). Generally, a FIGE includes an entity whose principal business consists of lending money, dealing in indebtedness and involved in other financing-related activities (e.g., banks and credit unions).

Two restrictions are imposed on FIGEs:

- The interest and financing revenues of FIGEs are excluded in the determination whether a taxpayer has less than C$1 million of net interest and financing expenses for the purpose of qualifying as an excluded entity.
- A FIGE can transfer only its "cumulative unused excess capacity" (i.e., its capacity for deducting interest and financing expenses under the EIFEL rules) to another FIGE or, under certain limitations, to an insurance holding corporation or a special purpose loss corporation.

In the previous draft of the legislation, a group with one or more FIGEs was generally unable to access the group ratio. This limit is no longer contained in the legislation, so FIGE groups may now access the group ratio.

Foreign Affiliates

The initial draft legislation of the EIFEL rules did not address the application of the rules to controlled foreign affiliates (CFA) of Canadian taxpayers, specifically with respect to the rules on foreign accrual property income (FAPI). In a nutshell, the revised draft legislation provides that a Canadian taxpayer must

- include its proportionate share of the interest and financing expenses and revenues of its CFAs that are relevant in computing its FAPI;
- determine whether a percentage of its interest and financing expenses is non-deductible; and
- apply that percentage to deny the deduction of interest and financing expenses in computing FAPI from its CFA.

The EIFEL rules do not otherwise appear to affect the determination of surplus balances or the adjusted cost base of shares of a CFA.

Anti-Avoidance Rule 18.2(13): Interest and Financing Revenues and Expenses

The revised EIFEL rules provide for three distinct anti-avoidance rules that will prevent a taxpayer's

- interest and financing revenues from being inflated; or
- interest and financing expenses from being understated.

If the rule applies to an amount, the amount is either not included in the computation of the taxpayer's interest and financing revenues or not deducted from the computation of the taxpayer's interest and financing expenses.

The three situations addressed by the rules are the following:

- The taxpayer earns interest and financing revenue that is deductible in computing the FAPI of a non-controlled foreign affiliate corporation. The purpose of the rule is to ensure that a taxpayer cannot convert a taxable surplus dividend into interest and financing revenues for purposes of the adjusted taxable income definition (i.e., the EBITDA definition used in the EIFEL rules).
- The taxpayer earns interest and financing revenues from *a non-arm's-length person that is an excluded entity, a natural person, a FIGE* (unless the taxpayer is a FIGE or an insurance holding corporation) or a partnership in which one or more members is such a person.
- One of the main purposes of a transaction, event or arrangement (or series thereof) that a taxpayer undertakes is to either increase the amount of interest and financing revenues or decrease the amount of interest and financing expenses, while not increasing its income. The focus is on whether it is *reasonable* to consider that one of the main purposes is to obtain this effect. For example, a taxpayer may receive an amount of interest from a tax-indifferent investor, thereby increasing its interest and financing revenue, and then pay a service fee back to the tax-indifferent investor of the same amount, which reduces its income while not adjusting its interest and financing revenue.

These anti-avoidance rules are more targeted than the previous version of the legislation, which denied any interest and financing revenue received by a taxpayer from any non-arm's-length person that was not a taxable Canadian corporation or a trust.

Group Ratio Rules

The EIFEL rules include a group ratio rule that provides qualifying taxpayers with an elective alternative regime to calculate the amount of their deductible interest and financing expenses. Essentially, provided that certain conditions are satisfied, Canadian taxpayers can elect to use the group ratio to compute the EIFEL limitation *in lieu* of the 30% fixed ratio rule. The group ratio rule is intended to provide relief to groups that are highly leveraged with third-party debt. Although the rules have been broadened from the previous version of the legislation, they may not provide relief for many taxpayers.

In general terms, the group ratio is the *net third-party interest expense of the group/group accounting EBITDA* (based on the consolidated financial statements of the group). The group ratio rule does not apply to provide relief in respect of debts paid to non-arm's-length persons or to persons that own or have a right to acquire more than 25% of the equity interests of the taxpayer and are not part of the group.

Each of the following must be satisfied to qualify for the group ratio rule:

- The taxpayer must prepare audited consolidated financial statements for the group, which includes the ultimate parent. This may require taxpayers that had not previously prepared audited financial statements to undertake the cost and expense of an audit.
- Each Canadian group member must elect to apply the group ratio rule for the relevant period.

Previously, the rule required that each Canadian group member have the same year-end and reporting currency. This is no longer required. However, the group ratio rule still does not apply to non-residents of Canada that may be subject to the EIFEL rules. It is unclear why these entities are excluded.

Under the group ratio rule, the total amount that may be allocated across group members is limited to the least of

- the group ratio multiplied by the aggregate adjusted taxable income of all the Canadian group members;
- the group net interest expense of the consolidated group; and
- the aggregate adjusted taxable income of the Canadian group members net of losses of the Canadian group members for each year.

The final limitation may mean that the group ratio does not provide relief to a Canadian group that has some members with taxable income and others with losses.

Other Technical Updates

- **Resource property**. The revised rules provide adjustments to the computation of both interest and financing expenses and adjusted taxable income to take into account deductions from resource property pools.
- **Excess capacity**. The revised rules now enable eligible group entities with different reporting currencies to transfer "excess capacity."
- **Carry forwards**. Restricted interest and financing expense can now be carried forward indefinitely (a change from the 20 years under the original proposals).
- **Late-filed election**. The revised EIFEL rules enable taxpayers to late-file an election made to transfer "cumulative unused excess capacity" or an election to allocate a group ratio amount.

Our Insights

Broadening the scope of taxpayers that will be exempt from the EIFEL rules is a welcome revision to the original draft legislation. However, the definition of "excluded entities" remains narrow and could make Canada a less competitive jurisdiction. For example:

- The *de minimis* threshold is far below the thresholds adopted by other jurisdictions with similar rules (Germany and France both have a €3-million threshold and the United Kingdom has a £2-million threshold).
- The expression "businesses, undertakings and activities" is very broad and appears to encompass undertakings beyond mere "business activities." Thus, certain businesses with substantial foreign undertakings are unlikely to qualify, even if those foreign undertakings are not substantial when compared to the domestic activities.

The group ratio now appears to be more beneficial for most taxpayers, since the grind that reduced the group ratio under the previous version of the draft legislation is no longer present. However, taxpayer must incur the cost of preparing audited consolidated financial statements for the group, including the ultimate parent, to benefit from the group ratio. Tax-to-accounting differences may also prevent certain taxpayers from fully benefiting from the relief offered by the group ratio rules.

The revised EIFEL rules still do not address their disproportionate impact on certain capital-intensive industries, such as real estate or non-PPP infrastructure projects. Although the PPP exemption is a welcome carve-out to the rules (given that it should promote investment in major infrastructure projects on which private and public sectors partner together), it remains to be seen whether Canada will adopt similar explicit exceptions for all real estate and infrastructure investment as is the case in the United States. Failure to do so may see investors increase investment outside Canada and reduce investment in Canada.

- Generally, the amendments touching specifically on the foreign affiliate regime are consistent with Canada's approach to the thin-capitalization rules (i.e., the other rule limiting interest deductibility in the international context). Although consistency in tax legislation is always welcome, taxpayers should note that these changes add considerable complexity and will further increase compliance costs.
- New anti-avoidance provisions will require taxpayers to further scrutinize transactions, events and arrangements if *one of the main purposes* can reasonably be considered to manipulate the amount of interest and financing expenses that can be deducted. In other words, *taxpayers may be victims of the new EIFEL anti-avoidance provisions* even if transactions were not contemplated to avoid the application of the EIFEL rules.
- The proposed rules do not address any of the ambiguities in the application of the rules to non-residents of Canada that elect to file a 216 return in respect of their net rental income from Canadian real or immovable property. For example, it is unclear how such a taxpayer is intended to compute "adjusted taxable income." In addition, non-residents are unable to utilize the group ratio.

Finance Canada has opened a new public consultation period during which submissions may be made regarding the revised EIFEL rules. The deadline for submissions is January 6, 2023. We will continue to monitor and communicate in future bulletins developments regarding the EIFEL proposals.

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