International TAX HIGHLIGHTS

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Volume 2, Number 1, February 2023

In This Issue

In some circles, the saying is "Three strikes and you're out." Well, after our first three issues of *International Tax Highlights*, we're still in the game, and I'll venture to call no strikes so far, thanks to the thoughtful and generous contributions of our authors this past year, and to the commitment of our production staff.

We start the new year with a variety of highlights, contributed by an equally thoughtful and generous group of authors. The themes of this issue include the revised EIFEL rules, the pillar 2 global minimum tax, some administrative practice developments, some Canadian and foreign jurisprudence, and some broader thinking on digitalization and data.

With respect to the EIFEL rules, Ken Buttenham and Alex Cook provide a neat overview of the revised proposals released on November 3, 2022. The revised proposals include rules addressing foreign affiliate situations, which are the focus of the more detailed article that follows, by Nathan Boidman and Eivan Sulaiman (in what represents, incidentally, a very nice inter-firm and, indeed, intergenerational collaboration). Ken Griffin then rounds out this theme with a rather penetrating look at the application of these proposals in relation to non-residents that are taxed on a net basis under section 216 in respect of certain Canadian rents or timber royalties.

In This Issue

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There is only one article on pillar 2, by the incredibly dedicated and talented Oleg Chayka, who provides an update on the numerous developments of the last couple of months, including the very recent release, on February 3, of the OECD's so-called administrative guidance on many of the questions that remain regarding the implementation of pillar 2. We continue to await further announcements from Canada on this topic. It is hoped that there will be some news in the upcoming budget.

Samantha D'Andrea then takes us through the international tax elements of the most recent CRA round table, at the 2022 Canadian Tax Foundation annual conference. (How nice it was, by the way, to have an in-person event.) Michael Kandev and Marie-Emmanuelle Vaillancourt, in the next article, likewise address the CRA's round table pronouncements, but they focus more specifically on the CRA's new views regarding the withholding tax treatment of payments for broadcasting rights.

On the jurisprudence front, Pierre J. Bourgeois reviews the recent Quebec income tax case in *Kone*, in which the court rejected the recharacterization (under general principles and under the Quebec GAAR) of a cross-border repo transaction. Anja Taferner and Katia Agazzini cover the recent rejection by the European Court of Justice of "state aid" allegations made by the European Commission against Luxembourg in the *Fiat* case. Both of these decisions will have important implications for Canadian taxpayers.

Kim Maguire and Camille Andrzejewski bravely tackle the theme of the taxation of data-driven transactions, reporting on the discussions in this regard at the 74th Congress of the International Fiscal Association, held in Berlin in September 2022, and providing insight into the Canadian perspective on many of the relevant issues (and a shout-out to Mathieu Champagne and Marie-Emmanuelle Vaillancourt, who had prepared the Canadian report discussed at the congress). This article and many of the items from the CRA round table referred to above provide important reminders that the taxation of data-driven transactions is not just about the imposition of a digital services tax or about other new approaches to taxation under pillar 1. This area of taxation continues to give rise to a number of very interesting and challenging traditional income tax questions.

Finally, Balaji Katlai and Kenneth Keung (in another inter-firm collaboration) remind us that the foreign affiliate dumping rules should not necessarily be viewed as a barrier to establish-new rules and to ensuring that the most beneficial elections are made when the rules are enacted, particularly in an environ-ment where Canadian taxpayers, even before they consider the implications of EIFEL, have to navigate the adjustments imposed by transfer-pricing, thin capitalization, and hybrid mismatch rules.

The EIFEL Proposals and Controlled Foreign Affiliates

The advent, in October 2015, of the OECD/G20-sponsored BEPS action 4—which recommends that both third-party and related-party interest deductions be limited to 30 percent of a taxpayer's earnings before interest, taxes, depreciation, and amortization (EBITDA)—set the stage for the introduction of the excessive interest and financing expenses limitation (EIFEL) rules, which represent what is, perhaps, the most significant shift in more than 50 years in Canadian policy on the treatment of the debt financing of corporations.

Before Canada's major 1971-72 tax reform, there was no limit on the portion of corporate financing that could take the form of interest-bearing resident or non-resident related-party or third-party debt. The tax reform introduced, with subsection 18(4), the relatively reasonable thin capitalization limitations on certain shareholder loans, denying the deduction of interest on the portion of loans made to Canadian corporations by 25 percent or greater non-resident shareholders, to the extent that the debt level exceeded three times their equity investment. Over the next 50 years, there were two reductions in the ratio, first to 2 to 1 and then to the current 1.5 to 1.

Prior to the BEPS action 4 initiative, however, the limitations on interest deductions generally applied only to related-party debt, with few exceptions. A notable exception was the foreign affiliate dumping rules in section 212.3, which result in deemed dividends or paid-up capital reductions when the proceeds of third-party debt (or other sources of cash) are used by a foreign-controlled Canadian corporation to make an investment in a foreign affiliate (FA). Transactions in which foreign-controlled Canadian corporations borrowed to invest in FAs were specifically targeted by section 212.3 because these transactions were perceived as giving rise to base erosion—a result of the fact that the Canadian corporation was entitled to an interest deduction while the dividend income from the FA was often exempt from Canadian tax.

The policy objectives of BEPS action 4 are much broader: they target perceived base erosion that multinational groups are purported to cause by allocating more of their debt (third-party or otherwise) to higher-taxed jurisdictions. The general limitation, under the EIFEL proposals, on interest deductions and other financing expenses in respect of third-party debt represents a significant change in Canadian policy. That the limitation is based on earnings, as opposed to a debt-to-equity ratio, is another significant difference from the concepts that Canadian taxpayers are accustomed to.

Basic Scheme of the EIFEL Proposals

The EIFEL proposals adopt the core recommendations of action 4 by adding new rules to the Act, in proposed sections 18.2 and 18.21, that would generally limit the interest and financing expenses (IFE) otherwise permitted under the Act (after the application of, for example, paragraph 20(1)(c) and subsection 18(4)). The rules do so by denying the portion of those deductions that exceeds the aggregate of (1) 30 percent of the taxpayer's adjusted taxable income (ATI) (which, loosely speaking, represents tax EBITDA that is generally taxable in-come recalculated by adding back CCA and otherwise deduct-ible IFE, among other adjustments); (2) the taxpayer's interest and financing revenues (IFR); and (3) certain amounts from other years or other group entities. "Group ratio" rules in proposed section 18.21 permit, in certain circumstances, a group ratio to apply that may exceed the 30 percent fixed ratio. An exemption from the rules is available for taxpayers that qualify as "excluded entities."

The main operative rule for the EIFEL regime is found in proposed subsection 18.2(2), and its mechanics are important to the discussion that follows. Under proposed subsection 18.2(2), the proportion of the taxpayer's IFE for the year that exceeds the maximum amount that is deductible for the year is determined on the basis of a formula (we will refer to this as the "excess percentage"). A proportionate amount of each IFE of the taxpayer for the year is then denied, on the basis of that excess percentage. For example, if a taxpayer has taxable income (before interest deductions) of $3,000 and interest expense of $2,000, the denied interest under proposed sub-section 18.2(2) would be $2,000 less 30 percent of $3,000 (that is, $900), or $1,100. More precisely, 55 percent (that is, $1,100/$2,000) of each amount included in the taxpayer's IFE (that is, $2,000 of otherwise deductible interest expense) for the year would be denied.

Application of the EIFEL Rules to Controlled Foreign Affiliates

The latest draft legislation to implement the EIFEL rules, released on November 3, 2022, included rules to address FAs (the initial version of the draft legislation was silent on the matter). Under these new rules, when the taxpayer has a controlled foreign affiliate (CFA) that earns foreign accrual property income (FAPI) or incurs a foreign accrual property loss (FAPL) and has IFE or IFR that relates to the FAPI or FAPL, the IFE or IFR of the CFA is included in the calculation of the interest limitation, under proposed subsection 18.2(2), that is applicable to the taxpayer. A separate rule then imposes a limitation on the ability to deduct the CFA's IFE in computing the CFA's FAPI or FAPL. Additional rules may apply where a CFA incurs FAPLs. For simplicity's sake, this article will not address the application of the EIFEL rules in relation to FAPLs.

In computing the IFE of the taxpayer (pursuant to paragraph (j) of the definition of IFE), the taxpayer must include its share (based on its "specified participating percentage") of the relevant affiliate interest and financing expenses (RAIFE) of a CFA, which is, in general terms, the IFE of a CFA that is relevant in computing FAPI.

Similar rules apply to interest income: pursuant to paragraph (g) of the definition of IFR, the taxpayer would include in its IFR its share of any relevant af-filiate interest and financing revenues (RAIFR) of a CFA, which is the IFR of the CFA that is relevant in computing FAPI. Thus, the RAIFE and RAIFR of a CFA must be taken into account in determining the excess percentage for the taxpayer under proposed subsection 18.2(2).

However, proposed subsection 18.2(2) does not apply to deny the portion of the taxpayer's IFE that relates to RAIFE. Instead, in the computation of the amounts of the CFA that are described in subparagraph 95(2)(f.11)(ii) (that is, income from property and certain other amounts included in FAPI), proposed clause 95(2)(f.11)(ii)(D) applies to deny a portion of the RAIFE of the CFA on the basis of the excess percentage determined under proposed subsection 18.2(2) in respect of the taxpayer. For example, if the excess percentage determined in respect of the taxpayer is 20 percent (such that 20 percent of each amount included in the IFE of the taxpayer is denied under proposed subsection 18.2(2)), it follows that in the com-putation of the CFA's FAPI, generally 20 percent of the CFA's RAIFE is also denied under proposed clause 95(2)(f.11)(ii)(D). Proposed amendments to clause 95(2)(f.11)(ii)(A) ensure that proposed subsection 18.2(2) is not applicable in computing income described in subparagraph 95(2)(f)(ii), such that the application of the EIFEL rules to the computation of FAPI is generally governed by proposed clause 95(2)(f.11)(ii)(D).

Illustrative Example

Consider the following example. Canco earns business in-come of $2,500 (before interest deductions and before the inclusion of any FAPI in income) and has interest expense of $1,400. Canco also has a 100 percent owned CFA that has income from property of $1,000 and interest expense of $600, and pays no tax. Accordingly, before the application of the EIFEL rules, Canco would have FAPI of $400 (that is, $1,000 − $600) and Canco's taxable income would be $1,500 (that is, $2,500 − $1,400 + $400). What is Canco's taxable income after the application of the EIFEL rules?

The analysis that follows will show that in the computation of Canco's FAPI, the EIFEL rules will operate to reduce by $950 in aggregate Canco's interest deduction and the interest de-duction of its CFA, thereby increasing Canco's taxable income from $1,500 to $2,450.

By way of overview, Canco's taxable income of $2,450 is equal to the combined income of Canco and the CFA before any interest deductions are taken into account—that amount being $3,500 (that is, $2,500 $1,000), less the maximum interest deduction permitted under the EIFEL rules, which is equal to 30 percent of the combined EBITDA of the taxpayer and the CFA, or $1,050 (that is, $3,500 30 percent). How-ever, the actual mechanics by which we arrive at this amount are more involved.

The excess percentage under proposed subsection 18.2(2) must be determined. This requires a determination of the IFE and ATI of Canco. The IFE of Canco is equal to Canco's inter-est expense of $1,400 plus Canco's share of the RAIFE of the CFA of $600 (that is, a total of $2,000). Next, the taxpayer's ATI must be determined. The definition of ATI is highly complex, but in this example, the computation of ATI is simply the tax-able income (otherwise determined) of $1,500 plus the IFE of $2,000 (that is, a total of $3,500).

Next, proposed subsection 18.2(2) requires that the excess percentage be calculated by a formula. The numerator of the formula is the IFE of $2,000 less 30 percent of ATI, or $1,050 (that is, 30 percent × $3,500), which is $950. This is generally the total excessive expense that will be denied. The denomina-tor in the formula is the IFE of $2,000. Therefore, the excess percentage is 47.5 percent (that is, $1,050/$2,000) and it will then be used in two ways to increase, in the aggregate, Canco's taxable income by $950.

First, under proposed subsection 18.2(2), 47.5 percent of Canco's $1,400 of interest expense (that is, $665) is denied. Second, under proposed clause 95(2)(f.11)(ii)(D), in comput-ing the FAPI of the CFA, 47.5 percent of the RAIFE of $600 (that is, $285) is denied, thus increasing the subsection 91(1) FAPI inclusion from $400 to $685. Those two additions (that is, $665 and $285, or $950 in total) to Canco's taxable income bring the taxable income from $1,500 to $2,450.

The interest deductions denied by the EIFEL rules are add-ed to a new tax account called "restricted interest and finan-cing expense" (RIFE), which is defined in revised subsection 111(8). Canco's RIFE will include both the interest expense of Canco that is denied under proposed subsection 18.2(2) of $665 and Canco's share of the denied interest expense of CFA that is denied under proposed clause 95(2)(f.11)(ii)(D) of $285. In other words, the full amount of the denied expenses of $950 is added to the RIFE of the taxpayer (that is, there is no parallel system applicable at the level of the CFA). RIFE can be carried forward indefinitely and deducted by Canco in future tax years if, very generally, Canco has the capacity to deduct interest under the EIFEL rules in those years.

In computing the adjusted cost base (ACB) of Canco's shares of the CFA, the amount included in Canco's income under subsection 91(1) in respect of FAPI is normally added to avoid double taxation. When that amount is distributed by way of a taxable surplus dividend, it is then deducted under sub-section 91(5) in computing Canco's income in the year of dis-tribution (along with a corresponding reduction to ACB). To maintain the correct relationship between these factors when the EIFEL rules have operated to increase the FAPI from $400 to $685 and there is only cash of $400 to distribute, the addi-tion to ACB under revised subsection 92(1) will be limited to the pre-EIFEL FAPI of $400, and, consequently, any deduction under subsection 91(5) will also be limited to $400.

Similarly, proposed amendments to the definition of "net earnings" in regulation 5907(1) ensure that only the pre-EIFEL FAPI of $400 is added to the taxable surplus of the CFA.

The rules described above generally work to give consistent results when the CFA is only partially owned by the rel-evant Canadian shareholder. For example, if the CFA in the illustration above were only 50 percent owned but the FAPI numbers were doubled, the results would be similar to those in the illustration.

In summary, the EIFEL rules are intended to apply similarly to income earned directly by a Canadian corporation and to FAPI earned by a CFA of the Canadian corporation. However, readers should be aware that the EIFEL rules contain a great deal of complexity that has not been addressed in this article, and that circumstances exist in which the application of the EIFEL rules to CFAs may have unexpected results. For instance, in the example above, if the CFA had incurred a FAPL instead of FAPI, the RAIFE of the CFA would nonetheless be included in the IFE of Canco notwithstanding that the FAPL may not be deductible (and potentially may never be deducted) in computing the income of Canco. Further complexities may arise when the CFA pays foreign income tax (for example, the resulting foreign accrual tax deduction under subsection 91(4) would reduce Canco's ATI). A detailed discussion of these and other issues is beyond the scope of this article.

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