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Finance releases further revised EIFEL rules

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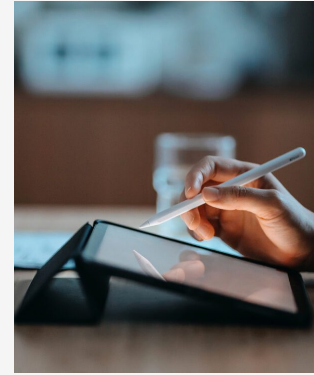

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Osler's National Tax Group has been following these developments closely. See our Updates on the draft tax legislation package, the global minimum tax and clean energy tax credits.

Introduction

The Department of Finance (Finance) released further revised draft legislation and explanatory notes for the proposed excessive interest and financing expenses limitation (EIFEL) rules on August 4, 2023 (the Revised Proposals). The revisions respond to submissions to Finance in response to both (i) the original draft legislation released on February 4, 2022 (the Original Proposals) and (ii) the revised draft legislation released on November 3, 2022 (the Previous Proposals).

The deadline for comments on the Revised Proposals is September 8, 2023.

The proposed EIFEL rules contain limitations intended to address the deduction of interest and financing expenses (IFE), net of interest and financing revenues (IFR), that are considered to be excessive compared to earnings — or, more specifically, that exceed a fixed ratio equal to 30% (or 40%, for taxation years that begin before January 1, 2024) of tax-adjusted earnings before interest, taxes, depreciation and amortization (EBITDA), also known as "adjusted taxable income" (ATI).

This Update provides a summary of the key adjustments to the proposed EIFEL rules in the Revised Proposals. For an overview of the Original Proposals and the Previous Proposals, see the Osler Update on the Original Proposals and the Osler Update on the Previous Proposals.

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Adjusted taxable income

As defined, ATI means the taxpayer’s taxable income (Variable A) as adjusted for 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.

The Revised Proposals contain several changes to the definition of ATI. Certain significant changes are further described below.

Pre-regime carried forward losses

Under the proposed EIFEL rules, paragraph (h) of Variable B provides an add-back where a taxpayer claims a deduction in a year in respect of a non-capital loss carried forward from another taxation year (the taxpayer’s loss year). Paragraph (h) of Variable B generally allows the taxpayer to add back the portion of a non-capital loss deducted under paragraph 111(1)(a) only to the extent that the non-capital loss was derived from IFE or other amounts described in Variable B in the taxpayer’s loss year, and requires a reduction to the extent that the non-capital loss included IFR earned in that taxpayer loss year. Accordingly, for a loss carried-forward from a pre-regime tax year, the Previous Proposals would have required taxpayers to compute their IFE and IFR for years prior to the release of the EIFEL rules, adding significant complexity and compliance burdens on taxpayers.

To address this additional compliance, the Revised Proposals provide a simplified computation in respect of pre-regime non-capital losses carried forward, which a taxpayer may elect to use instead of paragraph (h) of Variable B. A taxpayer may elect to classify a non-capital loss arising in a taxpayer loss year that ends before February 4, 2022 as a “specified pre-regime loss” (February 4, 2022 corresponds to the release date of the Original Proposals). As a result of this election, new paragraph (i) of Variable B will apply instead of paragraph (h), to fix the add-back at 25% of the amount of the non-capital loss from the taxpayer’s loss year which is carried-forward and deducted by the taxpayer in the year under paragraph 111(1)(a). In other words, new paragraph (i) seems to permit a “flat” 25% of such non-capital loss to be added back under Variable B, regardless of what portion of such loss would have been derived from IFE or other amounts described in Variable B.

The explanatory notes to the Revised Proposals indicate that “this election is intended to ease compliance in respect of non-capital losses for taxation years that ended before the release of the initial draft legislation of the EIFEL rules”. To maximize ATI, taxpayers should carefully review how the flat 25% add-back under paragraph (i) would compare to the add-back computed under paragraph (h) (i.e. whether the portion of the non-capital loss derived from IFE or other amounts described in Variable B would be more or less than 25%).

Add-backs for certain investment tax credits and certain forms of government assistance

The Revised Proposals contain two new elements (add-backs) in Variable B, which may have the impact of increasing a taxpayer's ATI, and consequently its capacity to deduct IFE.

Newly-proposed paragraphs (l) and (m) of Variable B provide add-backs for certain amounts that are not included in income under paragraphs 12(1)(t) or 12(1)(x).

Paragraph 12(1)(t) generally includes investment tax credits (ITCs), including the newly-proposed credits for carbon capture, utilization and storage (CCUS) and clean technology, in income. Similarly, paragraph 12(1)(x) includes certain forms of government assistance in income.

To the extent such amounts are included in income, they are included in ATI under Variable A, and would accordingly already contribute to a taxpayer's ability to deduct IFE. However, paragraphs 12(1)(t) and (x) do not include in income amounts that reduce the cost or capital cost of certain properties, and such amounts therefore would not otherwise be included in ATI.

Under the Revised Proposals, paragraphs (l) and (m) include these amounts in ATI (that is, even when such amounts are not included in computing income under Part I). The explanatory notes indicate that 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

The definition of IFR is a very important concept for taxpayers since every dollar of IFR allows a taxpayer to deduct a corresponding dollar of IFE.

A taxpayer's IFR are reduced by amounts described in Variable B of the definition of IFR.

The Revised Proposals contain a new element of Variable B, paragraph (c), which reduces an amount otherwise included in a taxpayer's IFR, to the extent the amount is effectively sheltered from Canadian tax by virtue of a credit or deduction in respect of foreign taxes (other than foreign withholding taxes). The explanatory notes explain that, as a result, where a Canadian parent company borrows funds and on-lends to a foreign subsidiary, which in turn pays interest to the Canadian parent that is subject to foreign withholding tax, the reduction under new paragraph (c) generally does not apply in respect of the withholding tax.

Excluded entities – Persons or partnerships who are tax-indifferent

A taxpayer that qualifies as an "excluded entity" is exempt from the application of the EIFEL rules, subject to a specific anti-avoidance rule in proposed subsection 18.2(14). Under the Previous Proposals, a taxpayer resident in Canada may qualify as an excluded entity where it meets certain conditions, including that all or substantially all of a group's IFE are paid or payable to persons or partnerships that are not "tax-indifferent investors", as defined in subsection 248(1). Under the Revised Proposals, this condition is modified to instead refer to persons or partnerships that are not "tax-indifferent", a new defined term in proposed

subsection 18.2(1).

The definition of “tax-indifferent” is similar but more relaxed compared to “tax-indifferent investor”. The definition of “tax-indifferent investor” includes partnerships and trusts of which more than 10% of the fair market value of all interests are held by certain tax-indifferent investors (such as tax-exempt entities and non-residents). Under the Revised Proposals, the definition of “tax-indifferent” would only include trusts and partnerships of which more than 50% of the fair market value of all interests are held by tax-indifferent persons or partnerships.

Additionally, the definition of “tax-indifferent” does not include certain Canadian trusts of which any of the interests of a beneficiary is not a “fixed interest”, as defined in subsection 251.2(1), whereas the definition of “tax-indifferent investor” includes such trusts. This change addresses an issue which existed under the Previous Proposals, in that a group including such a trust could have failed to qualify as an excluded entity even if there was no connection outside Canada.

Group ratio – 10% “up-lift”

The Previous Proposals contain an alternative regime under which, if certain conditions are satisfied, Canadian group members can elect for a “group ratio” to apply instead of the 30% fixed ratio (or the transitional 40% fixed ratio). The group ratio rules are generally intended to provide relief for groups operating in sectors that are typically highly-leveraged.

Under the Revised Proposals, the “group ratio” otherwise determined is subject to a 10% “up-lift” by multiplying the group ratio by a factor of 1.1. In the explanatory notes to the Revised Proposals, Finance explains that, as recommended in the BEPS Action 4 Report, the 10% “up-lift” is intended to mitigate against book-tax timing differences that may arise from the group ratio calculation.

“Financial institution group entities”

The Previous Proposals allowed “financial institution group entities” to transfer excess capacity to other “financial institution group entities” or, subject to certain limitations, “insurance holding corporations” or “special purpose loss corporations” within the same group. The definition of “insurance holding corporation” has been replaced with “financial holding corporation”, which is a new defined term in the Revised Proposals. The definition of “financial holding corporation” generally encompasses corporations that fell under the previous definition of “insurance holding corporation”, as well as corporations the fair market value of which is primarily attributable to any combination of shares or indebtedness of certain “financial institution group entities”.

Section 216 filers

Generally, section 216 allows certain non-residents who receive payments in respect of rent on real or immovable property (or a timber royalty) in Canada to elect to pay tax under Part I of the ITA, as though the taxpayer were a resident in Canada. The Previous Proposals did not address how non-resident taxpayers that elect to file tax returns under section 216 (section 216 filers) would be required to apply the EIFEL rules. For example, it was unclear whether a section 216 filer would be considered a person resident in Canada for purposes of the EIFEL rules such that it could, for example, qualify as an “excluded entity”. Furthermore, since section 216 filers cannot claim deductions for the purposes of computing taxable income, it

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appeared that section 216 filers would not be able to deduct restricted IFE in a subsequent year even if the section 216 filer has excess capacity.

Under the Revised Proposals, pursuant to proposed paragraph 216(1)(e), a section 216 filer cannot qualify as an "excluded entity", "eligible group entity" or "fixed-interest commercial trust", as these terms are defined in subsection 18.2(1), and would also not be eligible to apply the group ratio rule in section 18.21. In this regard, the Revised Proposals generally confirm that section 216 filers are subject to the EIFEL rules. In addition, the explanatory notes to the Revised Proposals clarify that section 216 filers would continue to be subject to the rules in paragraphs 216(1)(a) to (d) in applying the EIFEL rules, and consequently that paragraph 216(1)(c) would prevent section 216 filers from deducting restricted IFE under paragraph 111(1)(a.1).

FAPI and FAPL rules – updates

The Previous Proposals provided rules regarding how FAPI and FAPL will be incorporated into the EIFEL rules. In brief, the "relevant affiliate interest and financing expenses" (RAIFE) and "relevant affiliate interest and financing revenue" (RAIFR) of a taxpayer's controlled foreign affiliate (CFA) are imputed to the taxpayer based on its "specified participating percentage" in respect of the CFA. For additional details on these rules, see the Osler Update on the Previous Proposals.

'Relevant inter-affiliate interest'

The Revised Proposals contain new rules which apply in respect of interest amounts which are paid between CFAs (a new concept called relevant inter-affiliate interest). This new definition is relevant in determining what portion of the amount of interest is excluded and what portion of that amount is included in determining both the payer affiliate's RAIFE and the recipient affiliate's RAIFR.

The rules regarding "relevant inter-affiliate interest" are highly technical and are described in greater detail below. The explanatory notes contain a numerical example of these rules, which is available here.

"Relevant inter-affiliate interest" of a CFA is essentially an amount of interest that is paid or payable by the CFA to, or that is received or receivable by the CFA from, another CFA of the taxpayer. An amount of interest is only considered "relevant inter-affiliate interest" if it would, absent new subsection 18.2(19), be included in the payer affiliate's RAIFE and the recipient affiliate's RAIFR. In general terms, this means the amount must be interest that, in the absence of the EIFEL rules, would be deductible in computing the FAPI of the payer affiliate, and that is included in computing the FAPI of the recipient affiliate.

Under the Revised Proposals, new subsection 18.2(19) provides rules for determining the portion of "relevant inter-affiliate interest" that is included in a CFA's RAIFE or RAIFR. The explanatory notes indicate that the concept of "relevant inter-affiliate interest" is similar to the "excluded interest" election available for certain interest payments between taxable Canadian corporations, but 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.

The inclusion in RAIFE for "relevant inter-affiliate interest" is determined by the formula A + B.

Variable A is in turn determined by the formula (C – D) x E / C, where:

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C is the total of the specified participating percentages of the taxpayer and any eligible group entity in respect of the payer affiliate.

D is the total of the specified participating percentages of the taxpayer and any eligible group entity in respect of the recipient affiliate, and

E is the amount of the “relevant inter-affiliate interest”.

The explanatory notes describe Variable A as “essentially the portion of the relevant inter-affiliate interest that can be regarded as eroding the tax base by reducing an income inclusion in respect of FAPI which “occurs where the total of the specified participating percentages … in respect of the payer affiliate, of the taxpayer and any eligible group entities in respect of the taxpayer (each referred to in this commentary as a relevant taxpayer) exceeds the total of the specified participating percentages, in respect of the recipient affiliate, of relevant taxpayers”.

According to the explanatory notes, “the portion of the relevant inter-affiliate interest that can be seen as reducing the subsection 91(1) income inclusion in this manner is included in the relevant affiliate interest and financing expenses of the payer affiliate. In contrast, the remaining portion is excluded, subject to variable B.”

Variable B is the lesser of (i) the amount of the “relevant inter-affiliate interest” and (ii) the result determined by the formula (F – G) x E / H, where:

E is the amount of the “relevant inter-affiliate interest”.

F is the payer affiliate’s RAIFR for the year.

G is the amount that would be the payer affiliate’s RAIFE for the year if it had no “relevant inter-affiliate interest” for the year, and

H is the total of all “relevant inter-affiliate interest” amounts that would be included in the payer affiliate’s RAIFE absent this new rule.

According to the explanatory notes, the addition of Variable B in the payer affiliate’s RAIFE ensures that the payer affiliate must treat the “relevant inter-affiliate interest” as RAIFE to the extent these would offset against “net RAIFR” (being essentially RAIFR less RAIFE if there were no “relevant inter-affiliate interest” for the year, or F – G above). The formula above allocates a portion of the net RAIFR *pro rata* to each amount of “relevant inter-affiliate interest” of the payer affiliate for the year.

The inclusion in RAIFR for “relevant inter-affiliate interest” is determined by the formula B x C / D, where:

B is the amount included in the payer affiliate’s RAIFE under Variable B (see above).

C is the total of the specified participating percentages of the taxpayer and any eligible group entity in respect of the payer affiliate, and

D is the total of the specified participating percentages of the taxpayer and any eligible group entity in respect of the recipient affiliate.

As explained in the explanatory notes, if the payer affiliate does not have net RAIFR for the year, none of the “relevant inter-affiliate interest” will be included in the recipient affiliate’s

RAIFR, even if a portion of the "relevant inter-affiliate interest" is included in the payer affiliate's RAIFE by virtue of Variable A. If the payer affiliate has net RAIFR, the portion of the "relevant inter-affiliate interest" included in the recipient affiliate's RAIFR is equal to the portion of the payer affiliate's net RAIFR that is allocated to the "relevant inter-affiliate interest" under Variable B (see above) as adjusted to reflect the total specified participating percentages of relevant taxpayers in respect of the payer affiliate and the recipient affiliate. The explanatory notes indicate that this "ensures the payment of the relevant inter-affiliate interest does not inappropriately convert net relevant affiliate interest and financing revenues of the payer affiliate into FAPI that does not have that character in the hands of the recipient affiliate".

FAPL election

A foreign affiliate's FAPL can only be applied against its FAPI, and not against the Canadian taxpayer's own income. Consequently, there are cases where a FAPL may never actually be used to reduce Canadian taxable income. However, IFE underlying a FAPL are nonetheless included in a CFA's RAIFE, which are attributed to the Canadian taxpayer and can negatively impact its ability to deduct its own IFE. This issue often arises, for example, where a CFA holding company uses borrowed money to acquire shares of a subsidiary.

To address this issue, the Revised Proposals contain a new election by which a Canadian taxpayer may elect in respect of all or a portion of a foreign affiliate's otherwise deductible IFE, such that the elected amount is not deductible in computing its income or loss from property, a business other than an active business, or a non-qualifying business. Specifically, the election has two effects:

- First, the elected amount is not included in the affiliate's RAIFE, and thus is not included in the Canadian taxpayer's IFE and will not impact that taxpayer's interest deduction capacity.
- Second, the affiliate's FAPL is reduced by the elected amount (such that the CFA can not use the amount to offset FAPI).

Administrative rules – updates

New prescribed form for EIFEL filing

New subsection 18.2(18) under the Revised Proposals requires taxpayers to file a prescribed form with their tax return for the year, containing certain prescribed information relating to the deductibility of their interest and financing expenses.

Extended reassessment period

Under proposed paragraph 152(4)(b.9), where a taxpayer fails to file this prescribed form, or files an incomplete form, the normal reassessment period is extended. The Minister may reassess within four years (in the case of most corporations) or three years (in the case of most trusts) from the date on which the taxpayer files the prescribed form containing the information as required in subsection 18.2(18), in effect, delaying the commencement of the reassessment period until the required information is provided. In other words, the three or four year extended period for reassessment only starts once the taxpayer files the properly completed prescribed form.

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Election for transferring excess capacity

Under subsection 18.2(4) of the proposed EIFEL rules, taxpayers who belong to an eligible group have the option to make an election to transfer what is known as "cumulative unused excess capacity" to other members of the group. Generally speaking, a taxpayer's excess capacity refers to the amount by which their permitted deduction for IFE exceeds the actual IFE incurred during the year.

Under the Revised Proposals, proposed paragraph 18.2(4)(d) is modified to clarify that it is only the transferor of the excess capacity that is required to file the election in respect of the transfer, which would facilitate the filing process where a single transferor transfers excess capacity to multiple transferees.

If you have any questions or require additional analysis on the EIFEL rules, please contact any member of our National Tax Department.