KPMG

TaxNewsFlash

Canada

Finance Revises Interest Expense Limitation Proposals

November 21, 2022
No. 2022-53

Many corporations and trusts will be affected by proposed rules to limit the amount of interest and other financing expenses that businesses may deduct for Canadian income tax purposes. These proposals, known as the excessive interest and financing expenses limitation (EIFEL) rules, generally limit the amount of net interest and financing expenses that may be deducted by affected corporations and trusts. Finance recently released a revised version of these proposals, which narrows their applicability in some cases, provides new rules to address controlled foreign affiliates, and delays their implementation date to taxation years beginning on or after October 1, 2023. Finance is accepting comments on the revised draft legislation until January 6, 2023.

The revised rules, which were released November 3, 2022, provide some welcome changes, but not all of the revisions are relieving, and the rules will still significantly affect many corporations and trusts. Corporations and trusts should review the revisions to the EIFEL rules to determine whether they may be affected and model potential impacts, including on after-tax cashflows, especially due to the recent increase in interest rates. These corporations and trusts should also consider any available elections or designations to maximize allowable interest and financing expenses. In addition, these taxpayers may want to look at whether it makes sense to modify any existing internal or external financing, or undertake restructuring transactions before the rules take effect.

Background
Finance released the draft legislation for the EIFEL rules on February 4, 2022 for public consultation. The rules were originally announced in the 2021 federal budget. For further details, see *TaxNewsFlash-Canada* 2022-39, "New Interest Expense Rules", *TaxNewsFlash-Canada* 2022-05, "Finance Issues Outstanding Interest Expense Rules &

More" and *TaxNewsFlash-Canada* 2021-21, "2021 Federal Budget Highlights). Once these rules are enacted, Canada will join several other countries with similar rules including the U.S., the UK and several countries across the EU that have also introduced rules that are generally consistent with the OECD's 2015 recommendations in its BEPS Action 4 report, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments".

What do the EIFEL rules do?

In general, the EIFEL rules apply to corporations and trusts (with certain look-through rules for partnerships), for taxation years beginning on or after October 1, 2023. These rules generally limit the amount of net interest and financing expenses that may be deducted by corporations and trusts for Canadian income tax purposes to a fixed ratio of 30% (40% if the taxation year begins on or after October 1, 2023 and before 2024) of "adjusted taxable income" (ATI), subject to certain exceptions and the Group Ratio rule.

Affected corporations and trusts

Corporations and trusts may be affected by the EIFEL rules unless they qualify as an excluded entity for a given year. Under the revised proposals, entities may qualify under any one of the following exclusions:

- The Small CCPC Exclusion — This exclusion applies to Canadian-controlled private corporations (CCPCs) that, combined with any associated corporations, have less than $50 million of taxable capital employed in Canada
- The De Minimis Exclusion — This exclusion applies to eligible groups of corporations and trusts resident in Canada that have $1 million or less of aggregate net interest and financing expenses in a taxation year, or
- The Domestic Exclusion — This exclusion may apply to a Canadian-resident corporation or trust so long as that entity, along with any other eligible group entities (generally, Canadian-resident related or affiliated entities):
    - Carries on all or substantially all of its businesses, activities and undertakings in Canada
    - Does not have a "material" foreign affiliate (i.e., the greater of the book cost of all foreign affiliate shares and the FMV of assets held by all foreign affiliates does not exceed $5 million)
    - Does not have a non-resident specified shareholder or non-resident specified beneficiary
    - Has interest and financing expenses, all or substantially all of which are paid or payable to persons or partnerships other than non-arm's length

"tax-indifferent investors" such as non-residents (subject to certain exceptions) and tax-exempt persons. (Previously this condition also restricted amounts paid or payable to arm's length tax-indifferent investors.)

- Does not have more than 25% of the votes or fair market value (FMV) of its shares (in the case of a corporation) held by a partnership, where more than 50% of the FMV of the interests in that partnership are held by non-residents.

KPMG observations
Finance's latest proposals include certain changes to the excluded entity exception in response to submissions to broaden the exception and better target the rules towards larger corporations. Specifically, Finance has increased the taxable capital threshold for the Small CCPC Exclusion to $50 million (from $15 million) and raised the threshold for the De Minimis Exclusion to $1 million or less of net interest and financing expenses (previously $250,000). Further, affected Canadian-resident corporations or trusts who pay more than 10% of their interest or financing fees to arm's-length "tax-indifferent investors", such as non-residents and pension funds, will no longer be automatically disqualified from the Domestic Exclusion. In addition, affected corporations or trusts with "immaterial" foreign affiliates that don't exceed the new $5 million test may also be able to benefit from the Domestic Exclusion (although the test examines both the amount of the investment by the corporation or trust in the foreign affiliate, as well as the value of the affiliate's own property).

Note that Finance previously stated that increasing the De Minimis Exclusion threshold could better align with other countries that have enacted similar rules similar based on the OECD's BEPS Action 4 report. However, Finance's proposed $1 million threshold is still significantly less than certain thresholds that apply in other countries, including the UK (£2 million).

The revised Domestic Exclusion now appears broader, as it removes the requirement that each business must be carried on all or substantially all in Canada. Instead, corporations and trusts must assess whether all or substantially all of their businesses, activities and undertakings are in Canada. However, there remains some uncertainty about how to apply the "all or substantially all" test within this provision. In addition, the revised rules add a new condition that must now be met to qualify for the Domestic Exclusion, in certain cases where a partnership with non-resident partners owns (or has a right to acquire) shares of a corporation in the eligible group.

Types of expenses limited by EIFEL

The EIFEL rules may apply to limit the net amount of "interest and financing expenses" (IFE) otherwise deductible when computing a taxpayer's income. A taxpayer's net IFE is generally its IFE in excess of its interest and financing revenues (IFR). IFE generally includes interest and other deductible financing costs (including capitalized interest and financing expenses that are deducted as capital cost allowance (CCA) or resource expenditure pool claims), imputed interest and certain amounts economically equivalent to interest, among other amounts. A taxpayer that is a partner in a partnership must also include its share of the partnership's IFE. The rules also allow two taxable Canadian corporations to jointly elect for certain interest or lease financing amounts paid between them to be treated as "excluded interest", which is not included in the payor's IFE or payee's IFR, as applicable. This election is generally intended to allow for common loss consolidation transactions undertaken with Canadian corporate groups to remain unaffected by the EIFEL rules. Note that certain conditions must be met to qualify for the election.

Foreign affiliates

The latest proposals now include specific provisions to clarify how the EIFEL rules apply for controlled foreign affiliates (CFA). Specifically, these proposals now require taxpayers to include, in their IFE and IFR, their share of a CFA's "relevant affiliate interest and financing expenses" and "relevant affiliate interest and financing revenue" that are taken into account in determining the CFA's foreign accrual property income (FAPI). The previous draft legislation did not specify how these amounts would be treated.

KPMG observations
Finance's latest proposals make certain adjustments to the types of expenses that are considered IFE. In particular, the portion of CCA or certain resource expenditure pools that a taxpayer claims in the year that is attributable to previously capitalized interest and financing costs is now only considered IFE if it is incurred and capitalized after February 4, 2022. Similar rules also now apply for terminal losses realized in the year, any portion of which is attributable to previously capitalized interest and financing costs. Further, the proposals now reduce IFE by certain amounts received or receivable under or as a result of agreements or arrangements designed to hedge the cost of borrowing.

Finance also adds a new definition for "exempt IFE", which clarifies that IFE incurred as part of Canadian public-private partnership (P3) infrastructure projects that meet certain conditions, is not subject to the EIFEL rules. However, note that exempt IFE is still included for purposes of determining whether the $1 million De Minimis Exclusion is met.

The revised rules also allow more taxpayers to qualify for the excluded interest election, and enhance the benefit of making the election. In particular, the election is now available for amounts paid or received by a partnership provided that, among other conditions, no partnership member is a natural person, a trust or a corporation that is not a taxable Canadian corporation. The election can now also be made for a lease financing amount. However, the election cannot be made where a payer is not a financial institution group entity, and the payee is a financial institution group entity.

These proposals provide that where a proportion of the taxpayer's interest and financing expenses are denied, the same proportion of a CFA's relevant affiliate interest and financing expenses are also denied in computing the CFA's FAPI. That is, there is no separate determination of denied interest when computing FAPI for a taxpayer's CFA.

Fixed Ratio

Under the EIFEL rules, corporations and trusts can only deduct IFEs up to a Fixed Ratio of ATI, subject to certain exceptions and the Group Ratio rule. Generally, a 30% Fixed Ratio applies, but for corporations and trusts with a tax year that begins on or after October 1, 2023 and before January 1, 2024, a 40% Fixed Ratio applies in the first year of application. The ATI of a taxpayer, which is generally intended to correspond to its tax-adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA), is equal to the taxpayer's taxable income with certain amounts added back (e.g., interest and financing expenses, deductions for certain tax expenses and capital cost allowance (CCA)) and other amounts subtracted (e.g., interest and financing revenues and untaxed income).

KPMG observations
The revised rules limit the 40% Fixed Ratio transition period to tax years that begin on or after October 1, 2023 and before January 1, 2024 (instead of tax years that begin on or after January 1, 2023 and before January 1, 2024). As a result of the 40% ratio applying only to taxpayers with taxation years beginning in the last three months of 2023, far fewer taxpayers will have to apply both the 40% and the 30% ratio. Specifically, for calendar-year taxpayers, the EIFEL rules will now begin to apply only as of January 1, 2024 at the 30% rate (i.e., these taxpayers will no longer subject to the 40% transitional rate).

The revised legislation also includes several notable changes to the calculation of ATI, which is no longer reduced by net capital losses until they are claimed to reduce taxable income, but is reduced by foreign accrual property losses (FAPLs) of any of the taxpayer's CFAs, where that FAPL is derived from "net relevant affiliate IFE". ATI also excludes the newly defined "exempt IFE" related to certain P3 infrastructure projects, and now includes addbacks for resource pool expenses along with CCA and terminal losses (other than capitalized IFE). In addition, certain amounts distributed from a trust designated as a taxable dividend are now excluded from ATI.

Group Ratio

Certain groups may be able to elect to deduct interest and financing expenses using their Group Ratio instead of the Fixed Ratio, where certain conditions are met. Under this rule, affected corporations and trusts may use their Group Ratio, which may be higher than the 30% (or 40%) fixed ratio. To determine its Group Ratio, a consolidated group must calculate its ratio of net third-party interest expense to book EBITDA, as determined based on the group's audited consolidated financial statements. Corporations and trusts that are residents of Canada and members of the same consolidated group may elect to allocate amounts to each other under the Group Ratio.

KPMG observations
Finance's revised legislation provides additional relief by relaxing some of the conditions that must be met to access the Group Ratio election. In particular, affected corporations or trusts in a Canadian group are no longer required to have the same tax year or the same reporting currency, and are also allowed to have a relevant financial institution as a group member.

For purposes of computing the Group Ratio, the new rules also provide for a one-time election to exclude fair market value adjustments when computing the group's adjusted book EBITDA.

In addition, the revised legislation removes previously proposed restrictions that limited the Group Ratio where it was above 40%.

Carry-forward rules for denied interest and excess capacity

The EIFEL rules apply on a taxpayer-by-taxpayer basis, but affected corporations and trusts may make certain elections to transfer their excess capacity to deduct interest to eligible group corporations and trusts, in certain circumstances. The EIFEL rules also provide that excess capacity can be carried forward from the three years preceding the year in which the rules take effect, and that previously denied interest expense can be carried forward indefinitely. Certain transitional rules are also included.

To share excess capacity the transferor and transferee must be taxable Canadian corporations or "fixed interest commercial trusts" that are an "eligible group entity". Special rules apply to a "financial institution group entity" and "insurance holding corporation", which are prohibited from transferring their cumulative unused excess capacity outside of their financial group.

KPMG observations

The revised rules provide that previously denied interest expense can be carried forward indefinitely (instead of 20 years, as previously proposed). In addition, for the purposes of transferring excess capacity, Finance has relaxed the conditions so that entities are no longer required to have the same reporting currency. Further, the transferor and transferee can now include "fixed interest commercial trusts" (previously only available to taxable Canadian corporations). In addition, certain financial institutions and insurance holding companies may now be eligible to share unused capacity with other financial institutions group entities, insurance holding companies or special loss corporations under these rules.

Where the transferor designates certain amounts in its election and these amounts exceed its cumulative unused capacity due to a CRA reassessment, the revised rules now provide that an amended election can be made, subject to certain conditions.

Anti-avoidance rules

The revised legislation includes targeted anti-avoidance rules that replace certain broader anti-avoidance rules included in the previous draft. The revised legislation also introduces other anti-avoidance rules to address certain application issues, including to ensure taxpayers do not inflate interest and financing revenues or understate interest and financing expense. In addition, the explanatory notes advise that the general anti-avoidance rule (GAAR) may apply to any transaction that results in an inappropriate increase of interest and financing revenues or a reduction of interest and financing expenses, even if the specific anti-avoidance rules may not otherwise apply.

We can help

The EIFEL rules are complex, and your KPMG adviser can help you determine whether you are subject to new rules and how they may apply to your unique situation. For more details on these rules, contact your KPMG adviser.