TaxNewsFlash
Canada

New Interest Expense Rules Have Broad Reach

August 3, 2022
No. 2022-39

Many corporations and trusts will soon 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 are broader than is often assumed. In addition to large multinationals, these rules also apply to trusts and small- and medium-sized corporations, with narrow exceptions. For example, the EIFEL rules could apply in common situations that include corporations and trusts with foreign affiliates, non-resident shareholders or beneficiaries, business carried on outside Canada, or interest paid to tax-indifferent investors.

To prepare for these changes, corporations and trusts should review the EIFEL rules to determine whether they may be affected and model potential impacts, including on after-tax cashflows. Note that these rules, which are proposed to apply to taxation years beginning in 2023, have so far only been released as draft legislation, and a revised version of the rules that could include additional changes is soon expected to be issued for public consultation.

Background
The EIFEL rules apply to corporations and trusts (with certain look-through rules for partnerships). These rules generally limit the amount of net interest expense and financing fees that may be deducted by corporations and trusts for Canadian income tax purposes to a fixed ratio of 30% (40% in the first year of application) of “adjusted taxable income”, subject to certain exceptions and the Group Ratio rule.

The "adjusted taxable income" of a taxpayer, which is generally intended to correspond to its tax adjusted EBITDA, is equal to the taxpayer's taxable income with certain amounts added back (e.g., interest and financing expenses, deductions for tax expenses and capital cost allowance (CCA)) and other amounts subtracted (e.g., interest and financing revenues and untaxed income).

Certain groups may be able to elect to deduct interest and financing expenses using their Group 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% fixed ratio (or 40% in the first year of application). However, the Group Ratio is limited above 40%. The Group Ratio is determined based on the consolidated group's ratio of net third-party interest expense to book earnings before interest, taxes, depreciation and amortization, as determined based on the group's audited consolidated financial statements. To access the Group Ratio rule, each Canadian corporation and trust in the consolidated group must be a taxable Canadian corporation or trust resident in Canada, have the same reporting currency and have the same taxation year as the fiscal period of the ultimate parent of the consolidated group.

The EIFEL rules apply on a taxpayer-by-taxpayer basis, but affected corporations and trusts may make certain elections to transfer their unused capacity to deduct interest to eligible group corporations. The EIFEL rules also provide certain carry-forward rules for unused capacity and denied interest and financing expenses (including the ability to carry forward excess capacity from the three years preceding the year in which the rules take effect). Certain transitional rules are also included.

The EIFEL rules were released by Finance on February 4, 2022 for public consultation. The rules were originally announced in the 2021 federal budget (see *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".

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. Currently, entities may qualify under 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 $15 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 $250,000 or less of net interest and financing expenses in a taxation year, and
- 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, related or affiliated entities):
    - Carries on all or substantially all of each of its businesses in Canada
    - Does not have a foreign affiliate or a non-resident specified shareholder or non-resident specified beneficiary, and
    - Has interest and financing expenses, all or substantially all of which are paid or payable to other than "tax-indifferent investors" such as non-residents (subject to certain exceptions) and tax-exempt persons.

KPMG observations
As currently drafted, the excluded entity exception is surprisingly narrow. However, Finance recently indicated that it was considering the possibility of increasing the Small CCPC Exclusion threshold to $50 million (from $15 million) at the 2022 International Fiscal Association conference on May 17, 2022. Finance has also noted that it is considering increasing the De Minimis Exclusion threshold to better align with the rules in other countries, but did not provide details on what the increased amount may be.

Examples of when the EIFEL rules may apply

The following examples illustrate just some of the situations in which corporations may be subject to these broad rules, as they are currently drafted. The examples below assume that the corporation does not qualify for the Small CCPC and De Minimis Exclusions, and therefore only considers whether the corporation qualifies for the Domestic Exclusion. Although these examples focus on corporations, trusts will also need to consider whether they may be affected these rules.

Example 1 — Nominal foreign affiliate

A Canadian resident corporation (ACo) that is wholly owned by Canadian residents has net interest and financing expenses of more than $250,000. ACo pays all of its interest and financing expenses to fully taxable Canadian resident arm's length lenders. ACo carries on each of its businesses in Canada, but has an inactive foreign affiliate (FA1) with no or nominal assets.

In this case, Aco would be subject to the EIFEL rules since it would not be eligible for the Domestic Exclusion. Specifically, Aco would not qualify for this exclusion because of its interest in FA1, even if FA1 is inactive. Note that ACo would still not meet the requirements for this exclusion if Aco was a member of an eligible group, and the foreign affiliate were

instead held by another member of the eligible group, as no member of the eligible group can have an interest in a foreign affiliate under the Domestic Exclusion.

Example 2 — Business carried on outside Canada

A Canadian resident corporation (BCo) that is wholly owned by Canadian residents has net interest and financing expenses, payable to fully taxable Canadian resident arm's length lenders, of more than $250,000. BCo carries on 15% of its business in the United States. BCo owns all of the issued and outstanding shares of ZCo.

In this scenario, BCo likely would be subject to the EIFEL rules since BCo does not carry on all or substantially all (generally considered by the CRA to be 90% or more) of its business in Canada (i.e., 15% of its business is carried on in the United States). As a result, BCo would not meet the Domestic Exclusion. The EIFEL rules would also apply to ZCo since BCo would be an eligible group entity with respect to BCo.

Example 3 — Specified non-resident shareholders

CCo is a Canadian-resident corporation that has net interest and financing expenses of more than $250,000 that is payable to fully taxable Canadian-resident arm's-length lenders. CCo has three shareholders, including Ms. X, a U.S.-resident who owns 33% of the common shares of CCo. These shares represent more than 25% of CCo in votes or value. DCo is a wholly owned subsidiary of CCo. CCo and DCo carry on business exclusively in Canada and do not have any foreign affiliates.

CCo would be subject to the EIFEL rules in this example since CCo has a specified non-resident shareholder. For the purposes of the EIFEL rules, the term "specified shareholder" generally refers to a person who (alone or together with non-arm's length persons) owns shares that represent 25% or more of the votes or value of the corporation. Since Ms. X owns 33% of the shares of CCo, Ms. X would be a specified shareholder of CCo. As a result, the Domestic Exclusion would not apply. DCo. would also be subject to the EIFEL rules, since CCo is an eligible group entity with respect to DCo.

Example 4 — Tax-indifferent investors

ECo, a Canadian-resident corporation, obtained a syndicated loan from a group of financial institutions, with whom ECo deals at arm's length. ECo has net interest and financing expenses of more than $250,000 paid to the consortium. More than 10% of the interest is paid to non-residents of Canada. FCo is a wholly owned subsidiary of ECo.

In this case, ECo would likely be subject to the EIFEL rules because of the interest paid to the consortium. The non-resident members of the consortium would be viewed as "tax-indifferent investors". As a result, all or substantially (generally 90% or more) of the interest paid or payable by ECo would not be paid or payable to persons other than tax-indifferent investors and the Domestic Exclusion would not apply. The EIFEL rules would also apply to FCo, since ECo is an eligible group entity with respect to FCo.

KPMG observations

Corporations and trusts that determine that they are not an excluded entity will need to carefully review the complex new EIFEL rules to consider whether any of their net interest and financing expenses may be denied. These corporations and trusts should also consider whether they may be able to make elections or designations to minimize the denied interest or financing expenses, as well as whether any existing internal or external financing or other restructuring can or should be implemented before the rules take effect on January 1, 2023.

We can help

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

kpmg.ca

Contact Us | KPMG in Canada Privacy Policy | KPMG On-Line Privacy Policy | Legal

Information is current to August 2, 2022. The information contained in this *TaxNewsFlash-Canada* is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2022 KPMG LLP, an Ontario limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.