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TaxNewsFlash

Canada

EIFEL Rules — Finance Further Revises Proposals

August 14, 2023
No. 2023-30

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 newly revised version of these proposals that, among other changes, clarifies how the EIFEL rules apply to controlled foreign affiliates (CFAs), introduces a 10% up-lift for groups that elect to use the Group Ratio and notes that taxpayers will be required to file a new prescribed form along with their tax return with respect to the deductibility of their interest and financing expenses. These revised rules, which were released August 4, 2023, are proposed to be effective for taxation years beginning on or after October 1, 2023. Finance is accepting comments on the revised draft legislation until September 8, 2023.

Corporations and trusts should review the latest revisions to the EIFEL rules to determine whether they may be affected and model potential impacts, including on after-tax cashflows. These corporations and trusts should also consider any available elections or designations to maximize allowable interest and financing expenses on a group-wide basis. 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 draft legislation for the EIFEL rules on November 3, 2022 for public consultation that included revisions from the previous draft legislation released on February 4, 2022. The rules were originally announced in the 2021 federal budget. For

further details, see *TaxNewsFlash-Canada* 2022-53, "Finance Revises Interest Expense Limitation Proposals", *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".

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. Corporations and trusts may be affected by the EIFEL rules unless they qualify as an excluded entity for a given year or can exclude certain interest and financing expenses relating to public-private partnership infrastructure projects. Special rules apply to financial institutions to generally restrict their ability to share excess capacity with non-financial institution group entities.

For further details of these rules, see *TaxNewsFlash-Canada* 2022-53, "Finance Revises Interest Expense Limitation Proposals".

Relevant inter-affiliate interest

Finance's revised proposals clarify the treatment of interest between CFAs, which the rules now refer to as relevant inter-affiliate interest. Generally, for the interest to be relevant inter-affiliate interest, it 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. In particular, the rules include a formula for determining how much of the relevant inter-affiliate interest should be included in a CFA's relevant affiliate interest and financing expenses or relevant affiliate interest and financing revenues.

KPMG observations
Although this new change seems similar to the "excluded interest" concept for domestic interest payments, it's important to note that the relevant inter-affiliate interest rules are not elective, nor do they create a symmetrical outcome to the payer and recipient affiliates in all cases.

Relevant affiliate interest and financing expenses and revenues

The revised rules clarify that only amounts that are deductible in computing income or loss in determining FAPI are included in computing the relevant affiliate interest and financing expenses. In particular, the revisions provide that amounts that are deductible in computing deemed active business income under paragraph 95(2)(a) or amounts paid or payable under financing structures described in clause 95(2)(a)(ii)(D) and treated as nil in computing FAPI, are not included. Similarly, these rules state that only amounts that are actually included in computing FAPI are included in relevant affiliate interest and financing revenues.

FAPL election

The revised proposals allow taxpayers to elect to have all or a portion of a controlled foreign affiliate's otherwise deductible interest and financing expenses to not be deductible in computing the taxpayer's income or loss from property, a business other than an active business, or a non-qualifying business. As a result of this election, the elected amount would not be included in the affiliate's relevant affiliate interest and financing expenses or the Canadian taxpayer's interest and financing expenses, and therefore this amount will not affect the taxpayer's interest deduction capacity in Canada. In addition, this election will reduce the affiliate's foreign accrual property losses (FAPL) by the elected amount which the CFA can then not use to offset foreign accrual property income (FAPI).

Group ratio "up-lift"

Finance has introduced a 10% up-lift for certain groups that elect to use the group ratio. Under the revised proposals, once the consolidated group determines its group ratio amount (group net interest expense divided by group adjusted net book income), that amount is subject to a 10% "up-lift" determined by multiplying the group ratio by a factor of 1.1. Finance explains that this change, which is in line with the BEPS Action 4 Report, is intended to mitigate against book-tax timing differences that may arise from the group ratio calculation.

Pre-regime loss election

In the revised proposals, Finance introduces an election that allows taxpayers to elect to classify a non-capital loss arising in a taxation year that ends before February 4, 2022 as a "specified pre-regime loss". Where this election is made, 25% of the amount of the non-capital loss deducted by the taxpayer in the year will be added back under Variable B of the formula to calculate adjusted taxable income (ATI), in lieu of otherwise determining the portion of the loss derived from interest and financing expenses and other amounts relevant to the loss year. Finance advises that this election is intended to ease compliance for non-capital losses incurred for taxation years that ended before the release of the initial draft EIFEL rules.

KPMG observations
Taxpayers with non-capital losses from taxation years ending before February 4, 2022 will want to pay particular attention to the effects of claiming such a loss on the ATI of the entity claiming the loss, both with and without the specified pre-regime loss election.

New prescribed form

Finance's revised proposals now provide that affected corporations and trusts must file a new annual prescribed form on the deductibility of its interest and financing expenses. This form must be filed each year with its tax return. Where taxpayers do not file this form as required, the CRA can extend the normal reassessment period as long as the reassessment is related to the application of the EIFEL rules.

Relief for public-private partnership infrastructure projects

In the revised proposals, Finance has expanded the exemption for certain interest and financing expenses of Canadian public-private partnership infrastructure projects. In particular, the rules now exclude borrowings on property owned by a public sector authority or another public sector authority, or in which the public sector authority or another public sector authority has a leasehold interest in or an option to acquire the property, where amounts are borne directly or indirectly by such public sector authority. In addition, the exclusion extends to borrowings on all property. Previously, this exclusion only applied to borrowings on property owned by a public sector authority, and to only real or immovable property).

Additional changes

The revised proposals also include other changes to:

- Replace the definition of "Insurance Holding Corporations" with the new broader definition of "Financial Holding Corporations" for purposes of transferring excess capacity

- Ensure that where the income of a partnership is zero, the partner's proportionate share of interest and financing expenses and interest and financing revenues can still be determined, consistent with other provisions of the Act

- Add new elements of ATI for losses in connection with exempt interest and financing expense activities and for certain amounts deducted as tax credits or received as government assistance but reduced the cost or capital cost of certain properties

- Amend the definition of eligible group entity to exclude trust interests that are not a fixed interest, as defined in subsection 94(1)

- Revise the definition of ultimate parent to clarify the ultimate parent where the top entity in the organizational structure is the Crown or entities referred to in paragraphs 149(1)(c) to (d.6)
- Narrow the definition of a single member group to only Canadian resident taxpayers, for purposes of the group ratio election
- Simplify the group ratio election and the pre-regime capacity election by having these elections filed by any Canadian group member (in the case of the group ratio) and any eligible pre-regime group entity in respect of the taxpayer (in the case of the pre-regime capacity election)
- Clarify that windings up in the pre-regime period give rise to carryover of certain EIFEL attributes for windings up that begin in any taxation year rather than just those beginning on or after October 1, 2023
- Revise the definition of commercial debt obligation for purposes of the debt forgiveness rules such that the definition is to be determined without regard to the EIFEL rules.

We can help

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