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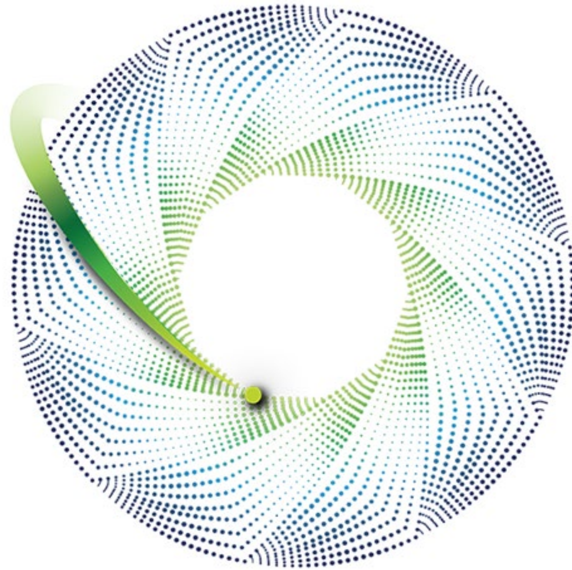

Canadian Tax & Legal Alert

Finance releases long-awaited draft proposals limiting deductibility of interest and financing expenses

March 15, 2022

Context

On February 4, 2022, the Department of Finance Canada released its long-awaited draft legislation to implement the earnings stripping rules previously announced in Budget 2021.[1] The rules are intended to limit the amount of interest and financing expenses (net of interest and financing revenues) that may be deducted by corporations and trusts for Canadian tax purposes based on a permissible percentage (40% in 2023, and 30% in 2024 onwards) of such taxpayers' earnings before interest, taxes, depreciation and amortization (EBITDA), as determined using Canadian tax principles. Referred to as the Excessive Interest and Financing Expenses Limitation (EIFEL) rules, the proposed measures are broadly in line with the general framework for the legislation that was announced in last year's federal budget, as well as the approach set out by the Organization for Economic Cooperation and Development (OECD) in its report on Action 4 of its Base Erosion and Profit Shifting (BEPS) initiative.

[1] The earnings stripping rules comprise just one component of a significant package of numerous other proposals, including measures concerning mandatory disclosures, trust reporting, and immediate expensing of certain capital costs incurred by small and medium sized businesses.
Taxpayers are invited to submit comments on the draft legislation up until May 5, 2022.

However, a careful reading of the rules does reveal several surprising and counter-intuitive implications. Perhaps most notably, while the measures have been described as being aimed principally at multinational organizations and cross-border investments, the EIFEL rules can also apply to purely domestic taxpayers with no foreign operations in respect of third-party debt owed to non-resident persons. Moreover, even organizations with only a minimal presence outside of Canada can find themselves fully subject to the rules and all of their complexity.

Deloitte's Perspective

The introduction of the EIFEL rules represents the end of an era in which Canadian businesses have had a competitive advantage relative to their counterparts around the world in respect of debt incurred to finance global expansion. Because dividends received from foreign operating subsidiaries are often received free of Canadian tax, permitting Canadian multinationals to borrow to earn such dividends provided an additional way to reduce the tax burden otherwise imposed on Canadian earnings.

Going forward, it will no longer be possible to fully offset Canadian earnings with interest and financing expenses, thus resulting in additional tax costs which will erode the ability of Canadian businesses to invest in domestic and global expansion. Organizations projecting future growth should still be able to achieve significant benefits through tax-efficient cross-border financing structures, though the complexity associated with such structuring will certainly increase as a result of the introduction of the EIFEL rules, as well as other tax changes across the globe.

As discussed in further detail below, even groups with operations exclusively within Canada will need to pay careful attention to the EIFEL rules, as depending on their situations, they too may find that the deductibility of their borrowing costs is adversely affected.

While the EIFEL rules contain a number of mechanisms intended to prevent adverse outcomes in situations not involving cross-border investments, the nuances and complexity inherent in the rules mean that organizations may need to undertake detailed modelling in order to avoid unpleasant surprises in how the rules apply in practice.

It is relevant to note that the EIFEL rules do not include any grandfathering for existing debt, notwithstanding that the BEPS Action 4 Report upon which the rules are based contemplated the possibility of countries excluding interest on existing loans from the scope of the rules for either a fixed period of time or indefinitely. While certain transitional relief has been provided, it will nevertheless be challenging for many organizations to adjust their existing capital structures prior to the new rules taking effect, including the costs associated with restructuring existing debt, which can often be significant.

Overview of the EIFEL rules

The remainder of this alert provides an overview of the draft proposals and offers additional insight into both the technical mechanics as well as the broader implications for Canadian businesses overall.

Fixed ratio rule

The core of the EIFEL rules is the so-called fixed ratio rule which limits the amount of net interest and financing expenses that a Canadian-resident corporation, trust, or partnership of which such corporations or trusts are members, or a non-resident earning taxable income in Canada may deduct in computing its taxable income to no more than a specified ratio of

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"adjusted taxable income." Adjusted taxable income is essentially a measure of EBITDA computed with reference to Canadian tax principles. For example, amounts in respect of deductible interest and capital cost allowance, among other items, are added back to taxable income as otherwise determined.

The fixed ratio is defined as the "ratio of permissible expenses." For most years and for most purposes, a taxpayer's ratio of permissible expenses is 30%. To facilitate the transition to the EIFEL rules, however, the ratio is set at 40% for any taxation year of the taxpayer that begins in the 2023 calendar year. The ratio is applied to the adjusted taxable income of each separate corporation within a group, meaning that distortions can arise in situations where disproportionate amounts of interest-bearing debt are located in entities with insufficient earnings as determined on a standalone basis. Non-deductible interest and financing expenses may be carried forward for up to 20 years, and unused deduction capacity may be carried forward to permit the deduction of future interest and financing expenses incurred in the next three years.

To provide relief in situations where there is sufficient adjusted taxable income, but spread across multiple entities, the rules provide the ability to transfer deduction capacity between eligible group corporations (defined as related or affiliated corporations) or, where certain conditions are met, to elect to exclude certain amounts of intragroup interest from the rules altogether. Notably, the election to exclude intragroup interest is only available for loans between two related or affiliated corporations; but not, for instance, for loans between a corporation and a partnership all the members of which are related or affiliated corporations.

Affected taxpayers

As noted above, the EIFEL rules are broader in scope than multinational organizations with interest expense in Canada on debt that has been used for financing cross-border investments. The rules, as drafted, provide no industry or sector specific carve-outs to accommodate businesses who are, by nature, more reliant on leverage. Rather, the rules incorporate a group ratio rule (discussed further below) which is intended to provide relief where an organization can demonstrate that its global operations are, in aggregate, dependent on additional amounts of third-party debt.

The rules do provide for "excluded entities", which generally comprise:

- Canadian-controlled private corporations (CCPCs) with aggregate taxable capital amongst associated entities of less than $15 million;
- Groups with aggregate net interest and financing expenses of $250,000 or less are excluded from the scope of the rules – notably, this de minimis threshold is much lower than the level set by the United Kingdom (£2 million) and by most European Union member states (€3 million), meaning far more Canadian groups with modest levels of net interest and financing expenses will be subject to the earnings stripping limitation and required to bear the associated compliance costs;
- A third class of exempt taxpayers also exists, though in practice, it may prove difficult for many Canadian businesses to meet the necessary conditions to qualify for this exemption. To be exempt, a Canadian group must carry on all or substantially all of its business in Canada, must have no foreign affiliates (even dormant ones), and must have no non-resident shareholder who, together with non-arm's length persons, owns shares with 25% of the votes or value in respect of the issuer. Finally, such groups must pay all or substantially all of their interest and financing expenses to taxable, Canadian-resident persons.

Thus, a mid-sized Canadian business with a U.S. subsidiary providing minimal after-sales support would be in scope, as would a purely domestic Canadian corporation with publicly traded debt that is held, in part, by non-residents. Similarly, a Canadian business controlled by a foreign private equity fund would be in scope, regardless of whether any cross-border debt exists. Even a family-owned business could be in scope if a particular family member were to reside outside of Canada, regardless of whether that family member has any direct involvement or ownership interest in the business.

While being in scope of the EIFEL rules does not necessarily mean that an organization will be subject to further restrictions on the deductibility of interest, it does mean that such organizations will be required to analyze their situation under this complex set of rules, and will need to take great care in attempting to obtain relief through the various capacity transfer and group ratio mechanisms.

Computational considerations

While at first glance, limiting deductible interest expenses to a fixed ratio of adjusted taxable income may seem to be a fairly simple concept, the underlying computations and the manner in which relevant terms are defined can lead to unexpected results. Here are some examples:

- The computation of adjusted taxable income permits an add-back for capital cost allowance. However, since no add-back is provided for capital costs which qualify as resource expenditures, taxpayers in the resource sector may find themselves at a distinct disadvantage when seeking to deduct interest and financing costs.

- In years where loss carryforwards are used to reduce taxable income to nil, all else being equal, only the permissible ratio (40% or 30%, as applicable) of net interest and financing costs will be deductible for that taxation year, meaning that additional loss carryforwards, in an amount equal to the non-deductible portion of such interest and financing expenses, will need to be claimed to prevent a current year tax liability. In effect, this fact pattern accelerates the use of non-capital loss carryforwards, and indefinitely defers the deduction of excess interest and financing expenses unless earnings growth is expected to outpace growth in financing costs in the foreseeable future.

- The definition of interest and financing revenues does not appear to include deemed or imputed interest income, such as in situations where a Canadian taxpayer makes a pertinent loan or indebtedness (PLOI) election to avoid the application of the shareholder loan or foreign affiliate dumping rules on loans to related non-residents, or where notional interest income is included in income under section 17 of the ITA.

- Further, the definition of interest and financing revenues does not include interest income earned by a controlled foreign affiliate (CFA) and included in a Canadian taxpayer's taxable income as foreign accrual property income (FAPI). Notably, this is contrary to the BEPS Action 4 Report which suggested that countries should consider including such income in the calculation of a taxpayer's net interest expense. The decision not to include such income may give rise to a mismatch in certain situations, for instance, where a foreign affiliate earns interest income in respect of an upstream loan to the Canadian taxpayer. While the interest income may be fully taxable as FAPI, the corresponding interest expense may be only partially deductible, depending on facts and circumstances. Thus, instead of merely preventing base erosion, the EIFEL rules can give rise to a net increase in taxable income in this type of situation.

- In addition to traditional interest and financing fees, the definition of interest and financing expenses also includes amounts in respect of capitalized interest, requiring taxpayers to separately track the portion of capital cost allowance claims and deductions in respect of resource expenditures that is comprised of interest and financing expenses.

Group ratio rule

In situations where a taxpayer's net interest and financing expenses exceed the fixed ratio for a given year, the group ratio rule permits an additional deduction to the extent that the taxpayer is able to demonstrate that the ratio of the consolidated group's net third-party interest expense (referred to in the rules as "group net interest expense" or "GNIE") to the consolidated group's book EBITDA (referred to in the rules as the "group adjusted net book income" or "GANBI") exceeds the fixed ratio. In such cases, the consolidated group can elect to determine its deductible amount of interest and financing expenses based on the group's actual ratio multiplied by the adjusted taxable income of the Canadian group members, subject to certain limitations. The group then has flexibility to allocate this deductible amount among the Canadian group members as required.

For these purposes, both GNIE and GANBI are based on figures reported under acceptable accounting standards (defined to include IFRS, US GAAP, and GAAP in a short list of other jurisdictions). More specifically, GANBI is computed by adding amounts for book depreciation, interest expense, and income tax expense to consolidated net income. Additionally, gains and losses in respect of the disposition of fixed assets, as well as charges for fixed asset impairment are backed out of net income when computing GANBI.

The rules allow a standalone entity to avail itself of the group ratio rule as well, in order to provide relief in situations where the entity's business is, by nature, subject to increased interest expenses by virtue of being more reliant on external financing.

However, the group ratio rule does not provide perfect relief. Notably, since this ratio is based on GAAP rather than tax figures, situations may arise in which the group ratio fluctuates from year to year, despite a relatively stable ratio of interest and financing expenses to taxable income. In particular, amounts in respect of stock-based compensation, or unrealized foreign exchange gains and losses may significantly impact the group ratio, potentially inflating or restricting a taxpayer's deduction capacity for a given year. Most notably, however, in situations where the group ratio exceeds 40%, only a portion of expenditures in excess of 40% of adjusted taxable income will be deductible. For example, a taxpayer with a group ratio of 60% will only be permitted to deduct net interest and financing expenses of up to 50% of adjusted taxable income. A taxpayer with a group ratio of 80% will only be able to deduct net interest and financing expenses in an amount equal to 55% of adjusted taxable income.

The choice of whether to rely on the group ratio or not is made annually by filing a joint election by all eligible group entities. Where the group opts to rely on the group ratio, no deduction capacity otherwise determined for the year under the fixed ratio rule may be transferred between entities, nor can any deduction capacity, whether computed under the fixed or group ratio, be carried forward to a future year.

Not all taxpayers will be eligible to rely on the group ratio rule based on the provisions as drafted. In particular, for the group ratio to apply, the consolidated financial statements must be audited, all eligible group entities must have the same taxation year-end and must use the same functional currency for tax purposes.

Further, the group ratio rule is not available in situations where a Canadian group member is a relevant financial institution, which is broadly defined to include more than banks and insurance corporations. This could conceivably limit access to the group ratio rule in unexpected ways, such as a group that self-insures certain risks using a Canadian captive insurance company.

Other items of note

The EIFEL rules contain a number of other complexities and nuances of which taxpayers should be aware, such as:

Excess capacity. While the rules permit deduction capacity to be transferred between eligible group members, such transfers are required to be accomplished by way of an annual election. If a taxpayer attempts to transfer capacity in excess of the amount actually available, the entire transfer is invalidated. Similarly, if a taxpayer inadvertently transfers more capacity than the recipient requires, the excess is lost and can no longer be claimed by any taxpayer in any future year. Additionally, capacity derived from interest and financing revenues may be reduced for a year in which the transferor has net operating losses.

Capacity transfers. Capacity can only be transferred between eligible group members that have the same tax reporting currency meaning, for instance, that capacity cannot be transferred from one corporation that uses the Canadian dollar as its functional currency for Canadian tax purposes to another group corporation that uses the US dollar as its functional currency for Canadian tax purposes. Further, capacity cannot be transferred from a relevant financial institution (which, as noted, is broadly defined) to another group corporation.

Foreign affiliates. The rules as drafted do not contain any specific carve-outs for foreign affiliates required to compute earnings in accordance with Canadian tax principles. Thus, surplus balances may be unexpectedly reduced or inflated by virtue of the impact of interest and financing expenses, despite the complete absence of any erosion of the Canadian tax base.

Transitional rules. As part of the transitional rules, a taxpayer can elect, jointly with its other corporate group members, to have special rules apply for the purposes of determining the excess capacity of the taxpayer (and each group member, if any) for each of the three taxation years (referred to as the "pre-regime years") immediately preceding its first taxation year in respect of which the EIFEL rules apply (i.e., the first taxation year beginning on or after January 1, 2023). This transitional rule, in effect, allows electing taxpayers a three-year carry-forward of their excess capacity, if any, for pre-regime years.

Anti-avoidance measures. The draft legislation contains anti-avoidance measures intended to discourage taxpayers from undertaking steps to attempt to defer the impact of these rules through a change in year-end. The threshold for the application of these anti-avoidance rules is incredibly low, with the EIFEL rules being deemed to apply earlier if "one of the reasons" for a transaction can reasonably be considered to be the deferral of the application of the rules or an attempt to increase deduction capacity. By comparison, many other anti-avoidance rules use language such as "one of the main reasons" or reference "the primary purpose."

Anticipated changes to the draft legislation. There are also several aspects of the draft rules which appear to give rise to unintended outcomes that might be expected to be corrected once the legislation is finalized. In particular:

- Losses appear to be double counted for purposes of computing adjusted taxable income, and thus, deduction capacity. More specifically, losses reduce capacity in the year incurred, as well as the year in which they are ultimately utilized.
- Certain of the anti-avoidance measures appear to be overly broad. For example, one measure is intended to prevent taxpayers from including amounts that would not otherwise be included in interest and financing expenses or interest and financing revenue, as the case may be, if the amounts arise in the course of a transaction or series of transactions one of the purposes of which is to obtain a tax benefit. As currently drafted, these measures could seemingly apply to transactions that are consistent with the intended application of the rules, such as liquidating a foreign affiliate into its Canadian parent such that the offshore interest income is now within the Canadian tax net.

In scope interest revenues. Similarly, the draft legislation includes an anti-avoidance measure that excludes from interest and financing revenues any amounts that are not received from a non-arm's length person, unless that person is a taxable Canadian corporation or a trust resident in Canada. This means, for instance, that a Canadian corporation borrowing to on-lend to a related non-resident corporation (such as a foreign affiliate) could be subject to an interest limitation, even though the Canadian corporation has no (or nominal) net interest expense.

How can Deloitte help you?

Our multidisciplinary team of professionals can help you understand these rules, how they may impact your organization and how to address them.

If you have questions on any of the above, please reach out to your Deloitte advisor or any of the individuals noted on this alert.

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