Grant Thornton

TAX ALERT

What are the proposed excessive interest and financing expenses limitation (EIFEL) rules?

UPDATED: SEPTEMBER 13, 2022

The Department of Finance (Finance) introduced draft legislation[1] earlier this year for EIFEL. It was initially proposed in Budget 2021, consistent with similar legislative steps taken by other G20 jurisdictions as an outcome of the international "Base Erosion and Profit Sharing" (BEPS) initiative.[2]

Under EIFEL, the tax-deductible amount of "interest and financing expenses" (IFE) for certain corporations and trusts may be restricted as explained below.

The rules are proposed to be effective for taxation years starting on or after January 1, 2023.

Finance announced[3] its intention to release a further revised draft of EIFEL in response to public submissions received during the consultation period.

Who is impacted?

EIFEL would generally apply to corporations and trusts, other than an "excluded entity."

Excluded entities:

- Canadian-controlled private corporations (CCPCs)—which along with any associated corporations—have taxable capital employed in Canada of less than $15 million.
- Groups of corporations and trusts whose aggregate net IFE among their Canadian members is $250,000 or less.
- Certain Canadian corporations and trusts, either alone or in groups, consisting solely of Canadian corporations and trusts that carry on substantially all of their business in Canada provided the following conditions are met:
  - no non-resident is a foreign affiliate of, or holds a significant interest in, any group member, and
  - all or substantially all[4] of the IFE of any group member is payable to persons or partnerships that are not "tax-indifferent investors", defined to include entities exempt from tax and non-residents of Canada.

Status of the proposals

1. Proposed new sections 18.2 and 18.21 of the Income Tax Act.
2. BEPS refers to the Inclusive Framework on Base Erosion and Profit Shifting led by the OECD and the G20 group of nations. EIFEL is based on the objectives recommended under Action 4 of the BEPS project.
3. At the May 17, 2022 Finance Roundtable, 2022 International Fiscal Association Tax Conference.
4. The CRA usually considers the phrase "all or substantially all" to mean 90% or more.

Members of partnerships

When corporations and trusts subject to EIFEL are members of a partnership, they may be indirectly impacted in accordance with their proportionate share of the partnership's income. Under proposed new paragraph 12(1)(l.2) of the Income Tax Act (the Act) accompanying the proposed EIFEL rules, excessive IFE incurred by a partnership is subject to a deemed income inclusion in the hands of the corporation and trust members, rather than being treated as a denied deduction at the partnership level.

Excluded interest

Certain Canadian corporations that are related or affiliated can jointly elect under the proposals to have certain interest payments made by one to the other excluded from the application of EIFEL. The purpose of the election is to ensure that EIFEL would not adversely impact transactions that commonly occur within Canadian corporate groups that allow the losses of one group member to be offset against the income of another group member.

How do the rules work?

If EIFEL is enacted in its current form, an impacted taxpayer's net IFE would generally be limited by a calculation that incorporates a certain "fixed ratio" of their adjusted taxable income.

Period of Application	Fixed Ratio
Taxation years beginning on or after January 1, 2023 and before January 1, 2024 (transitional period)	40%
Taxation years beginning after the transitional period	30%

In certain circumstances an election may be available to use a "group ratio" instead of the fixed ratio, as explained further below.

IFE deduction denial calculation

The core provision of EIFEL is found in proposed subsection 18.2(2) of the Act. It's a mechanical, multi-layered calculation that a taxpayer must work through to arrive at the "excessive" IFE for a taxation year. It works by multiplying the taxpayer's IFE for the taxation year (except amounts incurred through a partnership[5]) by the following formula to arrive at the non-deductible amount of IFE, if any:

(A – (B + C + D + E)) / A

where for the taxation year,

A = taxpayer's IFE

B = taxpayer's "adjusted taxable income" multiplied by the fixed ratio, or taxpayer's allocated group ratio amount

C = taxpayer's interest and financing revenues

D = taxpayer's "received capacity"

E = taxpayer's "absorbed capacity"

Below is a general summary of each of the above elements.

Element A - IFE

Apart from "excluded interest", IFE broadly includes ordinary interest and financing expenditures otherwise deductible under the Act as well as various other items, including:

- interest and financing expenses that were capitalized and deducted as capital cost allowance
- certain amounts paid or payable under certain agreements and arrangements, considered economically equivalent to interest
- interest amounts embedded within certain lease payments
- partnership level IFE attributable to a taxpayer in accordance with its share of partnership income or loss

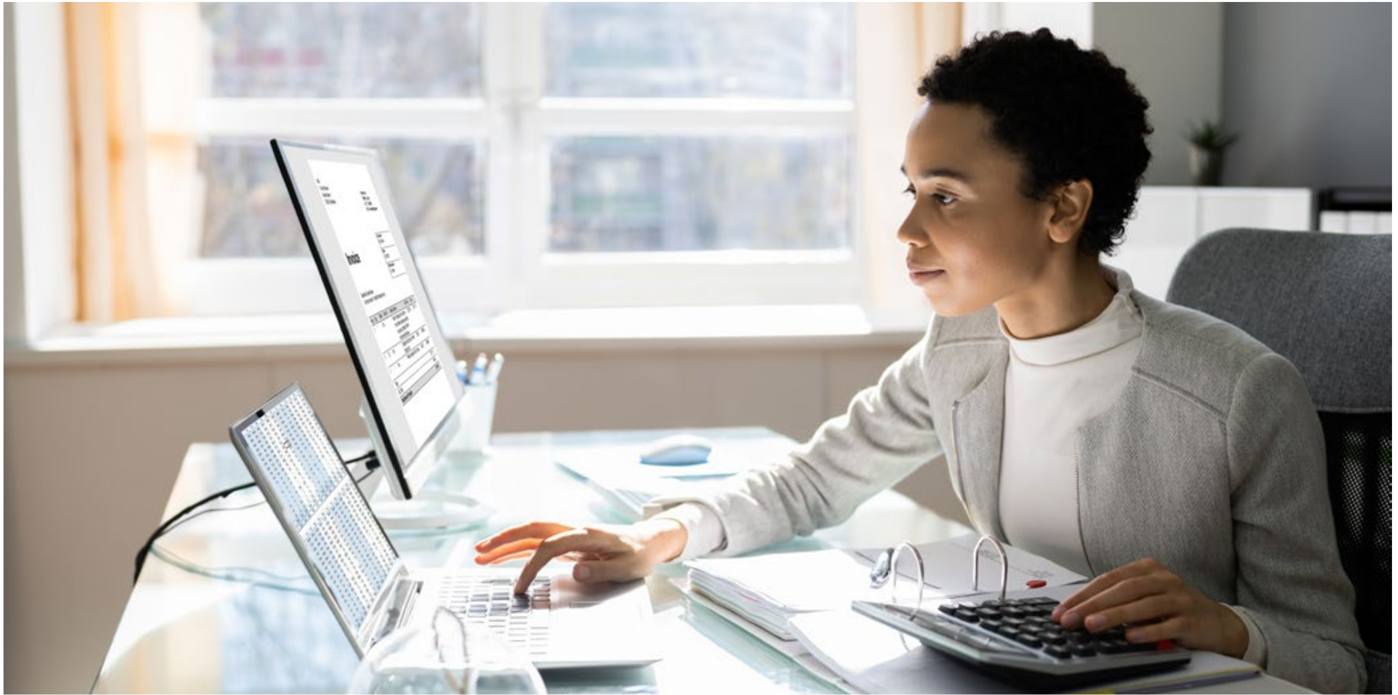
Element B – Adjusted taxable income multiplied by the fixed ratio, or an allocated group ratio amount

Adjusted taxable income generally refers to earnings before interest, taxes, depreciation and amortization ("EBITDA"), calculated for tax purposes as follows:

- Start with taxable income for the taxation year (which already includes any inter-corporate dividend deductions) before considering the EIFEL rules, less applied non- and net- capital losses;
- add back certain amounts, such as IFE, capital cost allowance (including any pro-rata share from a partnership) or trust amounts allocated to beneficiaries, and
- deduct certain amounts, such as interest and financing revenues, foreign source income offset by foreign tax credits or amounts allocated from a trust.

The adjusted taxable income would then be multiplied by the fixed ratio. As previously outlined, the fixed ratio would be 30% or 40% during the transitional period.

5. As previously mentioned, the potential income inclusion related to a partner's share of the partnership's IFE is determined under proposed paragraph 12(1)(l.2).



How is the group ratio amount determined?

Provided certain conditions are met, under the proposal, Canadian members of a consolidated group (and certain deemed "single member groups") of corporations and/or trusts may be eligible to file a joint election to receive an allocated amount based on a group ratio instead of following the fixed ratio method.

The group ratio is calculated as follows:

$$\text{Group ratio} = \frac{\text{Group net interest expense}}{\text{Group adjusted net book income}}$$

The numerator generally comprises the group's net amount of third-party interest expense (calculated using acceptable accounting standards). The denominator is generally the group's consolidated financial statement EBITDA amount as determined using acceptable accounting standards. The group ratio is deemed to be nil where the group does not have an overall positive book EBITDA.

Once the group ratio is determined—subject to certain limitations—the group would calculate the maximum amount of deductible IFE based on the group ratio multiplied by the adjusted taxable income of each of the Canadian group members. The group would then allocate the resulting amount of deductible IFE amongst the group members as part of the election. This potentially allows for the collective deduction capacity of the Canadian group to be allocated to group members that would benefit the most. The group ratio election is made on an annual basis, thus taxpayers may want to model how the group ratio and fixed ratio apply on an annual basis to determine which provides the most favourable treatment.

Element C – Interest and financing revenues

This element includes a broad range of ordinary interest and financing revenues, other than "excluded interest". It also includes other items such as:

- guarantee fees and similar amounts received for the repayment of debt
- amounts received or receivable under certain agreements and arrangements economically equivalent to interest
- certain lease financing amounts
- partnership level interest and financing revenues attributable to a taxpayer in accordance with its share of partnership income or loss

Notably, subsection 18.2(12) appears to exclude interest and financing revenues received from non-arm's length persons unless it is included in computing the IFE of a taxable Canadian corporation or a Canadian resident trust. This would appear to exclude interest earned from loans to foreign affiliates or other non-arm's length non-residents.

Elements D and E – "received capacity" and "absorbed capacity" amounts

These two elements of the formula represent amounts that may allow a taxpayer to deduct net IFE in a taxation year where it would otherwise exceed the maximum allowable deduction under EIFEL.

Element D represents "received capacity" for the taxation year transferred (by way of joint election) to a taxpayer by a fellow Canadian group member entity that had available "cumulative unused excess capacity." A group member's cumulative unused excess capacity for a taxation year is unused excess capacity carryforwards from the three immediately preceding taxation years, plus any excess

capacity it has for the year. Any received capacity must first be applied against a taxpayer's restricted IFE from prior years. Note that certain financial institutions are not allowed to transfer their cumulative unused excess capacity to other financial institution group members.

Element E captures a taxpayer's "absorbed capacity" for the year, comprising its own unused excess capacity carryforwards used in the year to reduce or eliminate denied deductions of IFE. Generally, a taxpayer has excess capacity in a given taxation year when the maximum amount of IFE that it is allowed to deduct under EIFEL exceeds the actual amount of IFE incurred in the year. Cumulative unused excess capacity is the accumulation of a taxpayer's unused excess capacity for the current taxation year and the immediately preceding three taxation years that hasn't been used to deduct the taxpayer's own IFE or transferred to another Canadian group member. When a taxpayer uses the group ratio approach for a taxation year, it is considered to not have excess capacity for that taxation year.

Proposed transitional rules would allow a taxpayer to jointly elect with other corporate group members for the purpose of determining excess capacity for each of the three taxation years (pre-regime years) immediately preceding the first taxation year in which the EIFEL rules will apply.

Carryforwards of denied IFE

If a taxpayer's net IFE are denied under EIFEL, they would be considered "restricted IFE" and could be carried forward (i.e., for use in a future taxation year where there is capacity available) for up to 20 taxation years, subject to the continuity rules outlined further below.

Example scenario

Consider a Canadian corporation (CanCorp) with a December 31 year-end that is not an excluded entity, is not a member of a partnership and has no losses carried forward. For 2025, CanCorp has the following amounts for the year:

- IFE of $4M (which would otherwise be fully tax deductible)
- taxable income before considering EIFEL of $3.5M
- capital cost allowance of $1M
- interest and financing revenues of $500,000

Let's assume there are no amounts other than the above that would impact CanCorp's adjusted taxable income under EIFEL. Let's further assume that CanCorp does not have any amounts of received capacity or absorbed capacity for the year and that CanCorp is not eligible for the group ratio election.

Analysis and Calculations:

Since CanCorp is not an excluded entity, the following calculations would need to be worked through to determine what portion, if any, of the $4M IFE is not deductible under EIFEL:

(A – (B + C + D + E)) / A

- **Element A** = $4M, the amount of CanCorp's IFE
- **Element B** = $2.4M, calculated using the fixed ratio method, as follows:
  - Adjusted Taxable Income = $8M ($3.5M (net taxable income) + $4M (IFE) +$1M (capital cost allowance) - $500,000 (interest and financing revenues))
  - Fixed ratio for 2025 = 30%
  - Element B = $2.4M ($8M x 30%)
- **Element C** = $500,000, the amount of CanCorp's interest and financing revenues
- **Elements D** and **E** are zero, since there are nil amounts of received capacity or absorbed capacity for the year

Plugging the above elements into the EIFEL calculation would result in a denial of $1.1M (27.5%) of CanCorp's IFE, as follows:
= ($4M – ($2.4M + $500,000)) / $4M
= 27.5%

Therefore, the non-deductible portion of the $4M IFE would be $1.1M ($4M x 27.5%).

Result

In this example, CanCorp's taxable income for 2025 would be increased from $3.5M to $4.6M under EIFEL due to $1.1 million of CanCorp's IFE being considered excessive. This $1.1M would become restricted IFE that would generally be carried forward to a future taxation year if there is capacity available in that year, for up to 20 taxation years.

Other considerations

Continuity rules for new tax attributes

Where a corporation goes through an amalgamation or winding-up, its carryforwards of restricted IFE and cumulative unused excess capacity generally would be inherited by the new corporation formed on the amalgamation or the parent corporation in respect of the winding-up.

Furthermore, a taxpayer's restricted IFE carryforward balances generally remain deductible following an acquisition of control if the taxpayer continues to carry on the same business after such time. However, the cumulative unused excess capacity of a taxpayer would no longer be available in post-acquisition taxation years.

EIFEL and other existing rules

EIFEL rules would apply in addition to, and after the application of, existing limitations in the Act regarding the deductibility of interest and financing expenses, such as thin capitalization and transfer pricing rules. Any expenses denied as a tax deduction under such provisions are excluded from a taxpayer's IFE for EIFEL purposes.

Anti-avoidance rules

The proposals contain numerous anti-avoidance rules. For example, an amount may be included in IFE or excluded from interest and financing revenue where a taxpayer tries to avoid this result. Also, the higher 40% fixed rate may be denied where a taxpayer undertakes a transaction to extend the period in which it applies.

Conclusion

The EIFEL rules have not been enacted as of the date of this article. If enacted, the rules would have a significant impact on financing decisions and the tax compliance obligations of certain taxpayers — we can help you navigate them. Contact your local advisor or reach out to us here.

grantthornton.ca

Disclaimer
The information contained herein is general in nature and is based on proposals that are subject to change. It is not, and should not be construed as, accounting, legal or tax advice or an opinion provided by Grant Thornton LLP to the reader. This material may not be applicable to, or suitable for, specific circumstances or needs and may require consideration of other factors not described herein.

Audit | Tax | Advisory
©2022 Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

About Grant Thornton LLP in Canada

Grant Thornton LLP is a leading Canadian accounting and advisory firm providing audit, tax and advisory services to private and public organizations. We help dynamic organizations unlock their potential for growth by providing meaningful, actionable advice through a broad range of services. Grant Thornton LLP is a Canadian member of Grant Thornton International Ltd, whose member and correspondent firms operate in over 100 countries worldwide. A listing of Grant Thornton offices and contact information can be found at: www.GrantThornton.ca