

Preparing for the new EIFEL rules in Canada

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On Nov. 3, 2022, the Government of Canada released revised [proposed legislation](#) and [explanatory notes](#) for the new excessive interest and financing expenses limitation (EIFEL) rules, first introduced in the 2021 federal budget. The department of finance is accepting comments on the proposed [EIFEL rules](#) until Jan. 6, 2023.

What you need to know about the proposed EIFEL rules

The proposed EIFEL rules are intended to implement the Organisation for Economic and Co-operation and Development (OECD) [base erosion and profit shifting recommendation](#). The intention of the EIFEL rules is to limit base erosion by limiting interest and financing deductions to a proportion of earnings (BEPS Action 4). Generally, Canada's EIFEL rules limit interest deductions by capping interest and financing expenses (IFE) net of interest and financing revenues (IFR) to 30 per cent of adjusted taxable income (ATI) for taxation years starting on or after Jan. 1, 2024.

The EIFEL rules are very complex and preparing revenue and expense models in 2023 is recommended. For non-Canadian purchasers acquiring control (over 50 per cent of voting shares) of Canadian entities, the EIFEL rules may change the economics of related-party debt or share financing.

Notable changes in November 2022

- The transitional rate of 40 per cent as the fixed ratio (rather than 30 per cent) is applicable for taxation years, after Sept. 30, 2023 (instead of Dec. 31, 2022) and before Jan. 1, 2024.
- Expansion of the definition of "excluded entity", thereby broadening the number of taxpayers not subject to the EIFEL rules:
 - Canadian-controlled private corporations and any associated corporations with taxable capital employed in Canada of less than \$50 million (increased from \$15 million), which aligns with the amount at which the small business deduction is fully phased out.
 - For a particular taxation year, corporations or trusts that are part of a group where the Canadian members have total IFE (net of IFR) for the year of \$1 million (up from \$250,000) or less.
 - A taxpayer resident in Canada that meets the following requirements:

- All or substantially all of the group members' business, undertakings, and activities are in Canada.
- Any ownership interest in a foreign corporation does not exceed a de minimis value of \$5 million.
- No person or partnership that is a non-resident owns over 25 per cent of the votes or value of any group entity.
- All or substantially all of the IFE of a taxpayer are paid to persons or partnerships that are not tax-indifferent investors (generally, tax exempt entities like pension plans and non-residents) that do not deal at arm's length with the taxpayer.
- [Introduction of a sector-specific exemption for Canadian public-private partnerships, which impacts securitization vehicles](#)
- Inclusion of provisions that account for foreign accrual property income (FAPI) and foreign accrual property loss (FAPL) of a controlled foreign affiliate (CFA) of a Canadian corporation or trust. Essentially, the IFE and the IFR of a CFA will be included in the IFE and IFR, respectively, of the Canadian taxpayer proportional to its interest held in the CFA, less any foreign tax paid in the case of the IFR.
- Certain anti-avoidance rules are included to prevent improper understatement of IFE or inflation of IFR.

EIFEL rules basics

The operative provision of the EIFEL rules is found in new subsection 18.2(2) of the [Income Tax Act](#) (Canada) (the Tax Act), which limits the amount of IFEs that a taxpayer may deduct in computing its income for a taxation year based on a prescribed formula. Generally, the formula deducts from a taxpayer's IFE four sources of "capacity", which increases the amount of IFE that can be deducted from income.

These sources of capacity are:

1. A fixed ratio (30 per cent) of ATI
2. IFR for the year
3. "Absorbed capacity" for the year
4. "Received capacity" for the year

While not provided for in the formula, an additional fifth source of capacity is restricted interest and financing expenses (RIFE), which is deductible from taxable income similar to non-capital losses, capital losses and dividends.

Although the EIFEL rules only apply to corporations and trusts, the rules can impact partnerships because IFE and IFR of a partnership are attributed pro rata to partners that are corporations or trusts. This is similar to the way in which the thin capitalization rules apply to partnerships.

Further, although the thresholds for what constitutes an "excluded entity" have been increased, CCPCs and trusts with taxable capital employed in Canada over \$50 million or IFE net of IFR over \$1 million are still subject to the EIFEL rules.

Exclusions

As described above, certain entities are excluded from the application of the EIFEL rules. In addition, certain interest is also excluded if an election is made between two members of the same corporate group for interest paid from one to the other. Generally, this election is permissible in circumstances involving loss consolidation or income balancing transactions. Amounts that are excluded interest are not included in IFE or IFR, limiting their ability to shelter any IFE or increase any excess capacity.

Capacity

Conceptually, a taxpayer may not deduct any IFE unless it has capacity to make such a deduction in computing its income from a business or property or in computing its taxable income. In particular, there are five sources of capacity that permits a taxpayer to deduct IFE in a particular taxation year. These sources of capacity allow for annual fluctuations in income for a particular taxpayer as well as transfers of capacity within a corporate group.

1. Adjusted taxable income and fixed ratio

One of the sources of capacity that allows a taxpayer to deduct its IFE in a taxation year results from multiplying the taxpayer's fixed ratio for the year by its ATI for the year. ATI is similar to earnings before interest, taxes, depreciation and amortization (EBITDA) but using tax, instead of accounting, concepts. The starting point for ATI is taxable income after specified deductions (e.g., dividends and losses under section 111), that is then adjusted by adding back certain deductions for IFE to reverse their impact on ATI as well as reversing specified income inclusions.

Unless a taxpayer's taxation year begins after Sept. 30, 2023 and before Jan. 1, 2024, the transitional fixed ratio of 40 per cent will not be applicable, and a taxpayer is generally subject to the 30 per cent fixed ratio. Any attempts to shorten a taxation year in the three taxation years immediately preceding Oct. 1, 2023 will be subject to an anti-avoidance rule, resulting in the fixed ratio being 30 per cent if it can be reasonably considered that one of the purposes was to defer the application of the 30 per cent fixed ratio.

Taxpayers may elect to use the group ratio rules to increase the fixed ratio if the taxpayer can demonstrate that the consolidated group in which it files its financial statements has a net third-party expense to EBITDA ratio exceeding 30 per cent. The group ratio rules are complicated and rely heavily on accounting terms, so it will be important for a taxpayer's financial accounting and tax professionals to work closely to ensure the requirements are met.

2. Interest and financing revenue

A taxpayer's IFR for the year is one of the sources of capacity that allows a taxpayer to deduct its IFE for the year. IFR generally includes interest revenue, imputed interest revenue on leases, guarantee fees and other similar amounts.

3. Absorbed capacity

A taxpayer's absorbed capacity is the lesser of 1) the carry forward of cumulative unused excess capacity (CUEC), a pool of capacity accrued from the three immediately

preceding taxation years in which the maximum amount that the EIFEL regime permits the taxpayer to deduct for the year was not fully utilized, and 2) the amount of IFE deduction that would otherwise have been denied in the year. Each year, an amount of excess capacity that could have been deducted if more IFE was incurred is added to CUEC. The legislation uses the term absorbed capacity (rather than CUEC or excess capacity) to build in an ordering rule that requires a particular taxpayer to use amounts of its CUEC to offset any denied IFE from that particular year before transferring CUEC to another group entity. On an acquisition of control, CUEC expires.

4. Received capacity

Generally, a taxpayer may jointly elect with another Canadian-resident corporation or trust that is related, affiliated or in certain types of enumerated relationships with the taxpayer, to transfer all or a portion of its CUEC balance to the corporation or trust (received capacity). The ability to transfer CUEC may be beneficial when one taxpayer has insufficient IFE amounts to fully utilize their sources of capacity. Instead of generating CUEC balances that it will not use, it may transfer that valuable tax attribute.

5. Restricted interest and financing expense

A taxpayer's RIFE for a particular taxation year is the amount of IFE that is not deductible by the taxpayer for the particular taxation year as a result of the EIFEL rules. The [new proposed paragraph 111\(1\)\(a.1\)](#) of the Tax Act provides that a taxpayer may deduct from its taxable income the RIFE from any taxation year preceding the particular taxation year, to the extent of the taxpayer's "excess capacity" for the particular taxation year. On an acquisition of control, RIFE is carried forward and may be deducted to the extent of income from the same or a similar business, provided the taxpayer continues to carry on the business to which the RIFE relates.

6. Pre-regime years

Additional rules are included in the EIFEL regime that allows for taxpayers to calculate their excess capacity in the three taxation years immediately preceding the coming into force of the EIFEL rules. Under these rules, a taxpayer may jointly elect with other group members to calculate their three-year carryforward of excess capacity arising in the pre-regime years.

Takeaways

Corporations and trusts that pay or receive interest should:

- Determine if they are excluded entities.
- Calculate their capacity, determine whether they will have denied IFE deductions and undertake planning to minimize the negative impact.
- Consider whether to use a group ratio rather than the legislated fixed ratio.
- Consider calculating pre-regime capacity.
- Before implementing any planning, carefully review the anti-avoidance rules to ensure that any proposed tax planning is not caught.

For inbound transactions involving the acquisition of Canadian entities, assuming there is an acquisition of control by a non-resident:

- Because historical CUEC expires, RIFE will be the only available amount that may be deducted.
- If a Canadian entity is in a loss position or has immaterial taxable income (e.g., a pre-revenue technology company with immaterial IFE and limited fixed asset depreciation to add-back for ATI), non-resident purchasers may be indifferent to related-party debt or equity financing because the Canadian entity will not have capacity to support the interest deduction.
- The new rules regarding FAPI and FAPL will not typically be relevant because Canadian entities with foreign affiliates usually transfer their foreign affiliates to their non-resident parent corporation immediately following the acquisition to avoid the foreign affiliate dumping rules.

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