The Joint Committee on Taxation of
The Canadian Bar Association

and

Chartered Professional Accountants of Canada

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May 5, 2022

Trevor McGowan
Director General
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Ottawa, ON K1A 0G5

Email: Consultation-Legislation@fin.gc.ca

Dear Mr. McGowan:

Subject: Excessive Interest and Financing Expenses Limitation Proposals

This submission sets out comments of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada ("Joint Committee") with respect to the Excessive Interest and Financing Expenses Limitation proposals that were included as part of the draft legislation that was released on February 4, 2022.

The Joint Committee gratefully acknowledges the willingness of Finance to engage in open discussions concerning these measures, and it is our hope that our dialogue will continue.

Members of the Joint Committee and others in the tax community participated in the discussion concerning this submission and contributed to its preparation, including:

- Bruce Ball – CPA Canada
- David Bunn – Deloitte LLP
- Ian Crosbie – Davies Ward Phillips & Vineberg LLP
- Sarah Chiu – Felesky Flynn LLP
- Ken Griffin – PwC LLP
- Raj Juneja – McCarthy Tétrault LLP
- Dion Legge – Norton Rose Fulbright LLP
- Angelo Nikolakakis – EY Law LLP
- Anu Nijhawan – Bennett Jones LLP
- Jim Samuel – KPMG LLP
- Jeffrey Shafer – Blake, Cassels & Graydon LLP
- Mitch Sherman – Goodmans LLP
- Carrie Smit – Goodmans LLP
- Eric Xiao – Ernst & Young LLP

If it would be helpful, members of the Committee would be pleased to discuss the issues in more detail.

Yours very truly,

David Bunn
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Ian Crosbie
Chair, Taxation Section
Canadian Bar Association

Cc:

- Shawn Porter, Associate Assistant Deputy Minister, Tax Legislation, Department of Finance

Submission of the Joint Committee on Taxation of The Canadian Bar Association and Chartered Professional Accountants of Canada
February 4, 2022 Draft Legislation on the Excessive Interest and Financing Expenses Limitation ("EIFEL") Regime

INTRODUCTION

This submission sets out our comments and recommendations on the Draft Legislation released on February 4, 2022 relating to the proposed addition of the excessive interest and financing expenses limitation ("EIFEL") regime to the *Income Tax Act* (Canada) (the "Act").

The 2021 Federal Budget indicated that the EIFEL regime is intended to be consistent with the recommendations in the BEPS Action 4 Report,[1] which outlines a suggested "best practice approach" to limiting the deductibility of interest and other financing costs to address base erosion and profit shifting ("BEPS") concerns. The objective of the EIFEL regime, as described in the 2021 Federal Budget, is to address BEPS issues arising from taxpayers deducting excessive interest and other financing costs, principally in the context of multinational enterprises and cross-border investments.

The BEPS Action 4 Report recognizes that achieving an effective solution to BEPS concerns must be balanced by the need for an approach that is reasonably straightforward for groups and tax authorities to apply. In the Canadian context, where the EIFEL regime is proposed as an overlay to the existing rules in our system addressing the treatment of interest and related expenses in a number of different circumstances and ways, it is especially important to find the right balance. The existing rules include a number of detailed, complex and interrelated provisions, none of which are proposed to be simplified or repealed in connection with the introduction of the EIFEL regime. These include, *inter alia*, the general interest deductibility rule in paragraph 20(1)(c), the thin capitalization rules in subsections 18(4) to (8), the transfer pricing rules in section 247, and the foreign affiliate dumping rules in section 212.3. We believe it is important that the Canadian system be as coherent, cohesive and straightforward as possible, and the EIFEL regime should be designed with this in mind.

We also believe that the EIFEL rules should not place Canadian multinational enterprise groups, and other Canadian groups, at a competitive disadvantage relative to their peers, either from an administrative perspective or from a substantive perspective.

In the balance of this submission, we provide our comments and recommendations on certain key elements of the EIFEL regime. Given the complex nature of the proposed rules and the limited consultation period, we have focused our comments on key areas with broad impact. As a result, this submission does not exhaustively address all aspects of the rules or potential issues that have been raised in respect of the rules. For instance, we generally have not commented on

[1] OECD (2017), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

industry-specific considerations, although we understand that various industry associations will be making separate submissions on these matters. We would be pleased to engage with you on such matters at the appropriate time.

LIST OF TERMS AND ACRONYMS

The following terms and abbreviations have been used in this submission:

ACB	Adjusted cost base
ATI	Adjusted taxable income
BEPS	Base erosion and profit shifting
CCA	Capital cost allowance
CCPC	Canadian-controlled private corporation
CDE	Canadian development expenses
CEE	Canadian exploration expenses
COGPE	Canadian oil and gas property expenses
CRA	Canada Revenue Agency
CRIC	Corporation resident in Canada
EBITDA	Earnings before interest, taxes, depreciation, and amortization
EIFEL	Excessive interest and financing expenses limitation
FAPI	Foreign accrual property income
IFE	Interest and financing expenses
IFR	Interest and financing revenues
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
RIFE	Restricted interest and financing expenses

COMMENTS

The EIFEL regime reflects a fundamentally new approach in the Canadian context to the deduction of interest and other financing expenses by taxpayers to whom the rules relate. Given the proposed rules will form a fundamental component of the structure of the Act, it is important that they are introduced in a fully-developed form. We appreciate the opportunity to provide input to the drafting of these rules and hope that you will find the following comments useful. As we hope will be apparent, they are the product of a significant amount of work by a large number of the members of the Committee.

In order to provide structure for our comments, we have broken them down into the following topic areas.

1. Effective Date and Transitional Rules
2. Excluded Entities
3. Excluded Interest
4. Adjusted Taxable Income
5. Interest and Financing Expenses

6. Interest and Financing Revenues
7. Excess Capacity
8. Transfer of Cumulative Unused Excess Capacity
9. Anti-Avoidance Provisions
10. Foreign Affiliates
11. Group Ratio
12. Relevant Financial Institutions
13. Section 216
14. Other Issues

Within each topic area we discuss conceptual aspects of the rules based on our understanding of the overriding policy objectives of the proposals. The conceptual aspects may be found in the proposed legislation and explanatory notes[2] or in some cases may, in our view, be missing from those materials. We then also discuss certain technical issues with respect to aspects of the draft legislation that are relevant to the particular topic. In some cases there are connections between different topics, meaning that comments in respect of one topic may be affected by or relate to comments in respect of a different topic.

1. Effective Date and Transitional Rules

The EIFEL regime is intended to apply to taxation years beginning on or after January 1, 2023. This is consistent with statements in the 2021 Federal Budget, which also indicated that draft legislation was expected to be released for comment in the summer of 2021. Due to unforeseen developments, including the election called in August 2021 and resulting delays, draft legislation was not in fact released for comment until February 2022. Given a consultation period that runs until May 5, 2022 and the range and complexity of the issues involved, it is reasonable to expect that a near-final package of legislation will not be available until later this summer at the earliest.

If the effective date for the EIFEL regime remains as currently proposed, it will be challenging, at best, for many taxpayers to appropriately adjust their affairs and meet that deadline. The complexity of the rules and their application mean that affected taxpayers will need to expend significant efforts to understand the consequences of the rules to their organizations, and the changes necessary to comply with the new rules may be difficult or impossible to effect prior to the effective date given that they may involve changes to the fundamental capital structure of the relevant entities which may, in many cases, have international implications and require renegotiation with third parties. The BEPS Action 4 Report noted that "…it is expected that a country introducing a fixed ratio rule and group ratio rule would give entities reasonable time to restructure existing financing arrangements before the rules come into effect."[3] The announcement of the intention to introduce an earnings-stripping rule in the 2021 Federal Budget did not provide taxpayers with the level of information necessary to act at that time, and they were obliged to wait for more particularity in the proposals. And even now, given the range of possible changes to the draft rules prior to implementation, taxpayers are not fully able to plan

[2] Explanatory Notes of the Legislative Proposals Relating to Income Tax Act and Other Legislation, Department of Finance (Canada), page 113.
[3] BEPS Action 4 Report, *supra* note 1, paragraph 194.

their path forward. We do not believe that the existing effective date for the rules provides entities with reasonable time to restructure.

While we recognize that the EIFEL regime contemplates a "transitional year" with a fixed ratio of 40% rather than 30%, such transitional relief was proposed at a time when draft legislation was expected to be released well in advance of the transitional year. The 40% ratio presumably was intended to recognize that some time was needed to transition to the new regime given both the complexity of the issues and the potential legal impediments. However, a provision intended to give adequate time for undertaking transactions that may be difficult to effect within what was expected to be an 18-month period does not address the much greater difficulties taxpayers will face with a very short implementation period. In our view events have overtaken the adequacy of this transitional relief.

Further, we would like to emphasize that any taxpayers who have borrowed external debt in Canada may not be able, under the terms of the relevant loan agreements, to restructure the existing external debt without incurring significant penalties or fees, assuming it can be restructured at all. This concept was acknowledged in the BEPS Action 4 Report. While grandfathering was not listed as a specific requirement, it was identified as an acceptable method of providing transitional relief:

> A country may also apply transitional rules which exclude interest on certain existing loans from the scope of the rules, either for a fixed period or indefinitely. In this case it is recommended that these transitional rules are primarily restricted to interest on third party loans entered into before the rules were announced.[4]

Recommendations

1.1. Given the lengthy delay in the release of the draft legislation, and the short period of time that will exist between the issuance of near-final rules and the end of the year, we recommend that the effective date of the rules be deferred, and that the proposed rules only take effect for taxation years beginning on or after January 1, 2024. Any decision regarding deferral (or not) should be announced as soon as possible – a deferral announcement made in December (for example), while surely welcome, would not relieve taxpayers from having to attempt to restructure and incur related costs/penalties, perhaps needlessly.

1.2. Given the challenges and, in many cases, prohibitive costs associated with restructuring external debt, we recommend that grandfathering relief be provided for debt obligations owing to arm's length persons that (i) cannot be repaid or cannot be repaid without incurring material penalties or fees and (ii) existed prior to April 19, 2021, being the date of the 2021 Federal Budget when the intention to introduce a new earnings-stripping rule was first announced. To ensure the grandfathering relief is not inappropriately extended, we recommend that an existing debt obligation that qualifies for grandfathering relief be deemed to lose its

[4] Ibid, paragraph 195.

grandfathered status if it is significantly modified, including any extension to its normal repayment date.

2. Excluded Entities

As noted above, we understand that the EIFEL regime is intended to be consistent with the recommendations in the BEPS Action 4 Report and intended to apply principally in the context of multinational enterprises and cross-border investments.

The BEPS Action 4 Report indicates that BEPS risks may arise in three basic scenarios:

- Groups placing higher levels of third party debt in high tax countries;
- Groups using internal loans to generate interest deductions in excess of the group's actual third party interest expense; and
- Groups using third party or internal financing to fund the generation of tax-exempt income.[5]

In recognition that only certain entities and situations pose a material BEPS risk, the BEPS Action 4 Report recommends that entities which pose a sufficiently low BEPS risk be excluded from the rules:

> While the main policy goal of the best practice approach set out in this report is to address base erosion and profit shifting using interest, it is recognised that certain entities may pose a sufficiently low risk that excluding them from a fixed ratio rule and group ratio rule would be appropriate. Excluding these entities from the fixed ratio rule and group ratio rule would mean that a best practice approach can focus on entities which pose material base erosion and profit shifting risk, reducing compliance costs for other entities. Reducing the number of entities covered would also reduce the costs of administering a rule and would allow a tax authority to focus its resources on entities which pose the greatest risk.[6]

Under the EIFEL rules, an entity which qualifies as an "excluded entity" as defined subsection 18.2(1) is not subject to the interest limitation in subsection 18.2(2). In the Explanatory Notes for the definition of "excluded entity", these are described as entities that generally do not pose significant BEPS risks. While the inclusion of an "excluded entity" concept is welcome, we are concerned that the ability to qualify as an "excluded entity" is overly narrow. As such, we believe that many entities which pose a sufficiently low BEPS risk will nevertheless be required to comply with EIFEL rules, leading to unnecessary compliance costs for taxpayers (who must comply with the rules) and diverting resources of the CRA, who must administer the rules, away from entities which pose the greatest risk.

[5] Ibid, page 13 in the executive summary.
[6] Ibid, paragraph 54.

As currently drafted, there are three separate categories within the definition of "excluded entity":

- Paragraph (a): CCPCs with a sufficiently low level of taxable capital employed in Canada (referred to herein as the "small CCPC exception");
- Paragraph (b): groups with total net IFE of $250,000 or less (referred to herein as the "*de minimis* exception"); and
- Paragraph (c): groups that carry on all or substantially all of their business in Canada, do not have any foreign affiliates, do not have any specified shareholders or specified beneficiaries who are non-resident persons, and pay all or substantially all of their IFE to persons other than tax-indifferent investors (referred to herein as the "domestic exception").

Each category is discussed separately below, as well as an additional category that warrants consideration: securitization vehicles.

Small CCPC Exception

The small CCPC exception applies to a CCPC that, together with any associated corporations, has taxable capital employed in Canada of less than $15 million, being the top end of the phase-out range for the small business deduction at the time the draft EIFEL legislation was released. It was indicated in the Explanatory Notes that these entities are relieved from the application of the EIFEL rules because they are Canadian controlled and their operations are of a relatively small scale.[7]

Following the release of the EIFEL rules, it was announced in the 2022 Federal Budget that the government intends to increase the top end of the phase-out range for the small business deduction to $50 million of taxable capital employed in Canada. It was noted that phasing out access to the small business deduction too quickly can discourage some businesses from continuing to grow and create jobs.

Recommendation

2.1. Given that the phase-out range for the small business deduction is being increased from $15 million of taxable capital employed in Canada to $50 million, we recommend that the threshold for the small CCPC exception in the "excluded entity" definition also be increased to $50 million of taxable capital employed in Canada.

[7] Explanatory Notes, *supra* note 2, page 113.

De Minimis Exception

The *de minimis* exception applies to a taxpayer which, together with other Canadian group members, has total net IFE of $250,000 or less. The inclusion of a *de minimis* exception is consistent with the recommendations in the BEPS Action 4 Report:

> Countries may . . . introduce a *de minimis* threshold to exclude low risk entities from the scope of the fixed ratio rule and group ratio rule. It is recommended that such a threshold should be based on the total net interest expense of all entities in the local group . . . .
> A *de minimis* threshold based on net interest expense should be relatively simple to apply and would ensure that highly-leveraged entities are required to apply a general interest limitation rule regardless of their size. A country should set the level of a *de minimis* threshold to reflect a number of factors, including the local economic and interest rate environment, as well as relevant tax or legal considerations. This may be reviewed and updated periodically to reflect changes in these factors.[8]

Threshold

While the inclusion of a *de minimis* exception is welcome, we are concerned that the proposed threshold of $250,000 is quite low relative to many other countries that have introduced earnings-stripping rules in response to the BEPS Action 4 Report. We note, for instance, that Germany, France and the UK have adopted thresholds of €3 million, €3 million and £2 million, respectively. These thresholds are significantly higher than the $250,000 currently envisioned under the EIFEL rules. We understand that the $250,000 threshold is essentially a proxy for $5 million of debt with a 5% interest rate. Given that the purpose of a *de minimis* exception is to exclude from the application of the EIFEL rules any entities that pose a sufficiently low BEPS risk, we believe that a higher threshold should be considered. One alternative is to align our threshold with other jurisdictions to be consistent with international norms. For instance, when converted to Canadian dollars based on current exchange rates, the thresholds in Germany, France and the UK are in the range of $3 million to $4 million. Another alternative is to align our threshold with other Canadian tax policies. For instance, given that the top end of the phase-out range for the small business deduction is being increased to $50 million of taxable capital employed in Canada, and given that our thin capitalization rules generally permit a debt-to-equity ratio of 1.5 to 1, the threshold could be set at $1.5 million, which is equivalent to $30 million of debt with a 5% interest rate.

Safe Harbour vs. Hard Cap

We also note that the thresholds referred to above for Germany, France and the UK are safe harbour amounts as opposed to hard caps. More specifically, the deduction limit is equal to the <u>higher</u> of (i) the particular threshold (€3 million or £2 million, as the case may be) and (ii) 30% of tax EBITDA. There are several benefits to this approach. First, a safe harbour provides equal footing between taxpayers, whereas a hard cap can provide materially different results for similar

[8] BEPS Action 4 Report, *supra* note 1, paragraphs 55 and 56.

taxpayers. Consider, for example, two separate Canadian entities, one of which has total net IFE slightly above the threshold and the other has total net IFE slightly below the threshold. Under a safe harbour approach, the implications would be similar for both entities, whereas under a hard cap approach the first entity would be fully subject to the EIFEL rules and the second entity would be outside of the EIFEL rules. Second, it would seem that a hard cap can discourage growth. For instance, if a small but highly-leveraged entity has total net IFE below the threshold, it may choose not to pursue a growth opportunity that would involve taking on additional debt, as the incremental IFE could cause all of the entity's IFE to potentially be subject to the interest limitation.

Relevant Financial Institutions

As an additional point for the *de minimis* exception, we note that the exclusion of IFR of a RFI under B(ii) of paragraph (b) does not seem appropriate, unless the IFE of the RFI are also excluded. We believe the exclusion leads to an overly narrow scope for the *de minimis* exception, especially since the definition of RFI is extremely broad, as discussed elsewhere in this submission. Consider, for example, the scenario where an entity in the group is an investment corporation with IFR of $250,000 and IFE of $250,000. If the IFR is excluded from the *de minimis* test, the threshold would be crossed and the group would not meet the *de minimis* test, even if there is only a modest amount of IFE elsewhere in the group. If the IFR of a RFI are to be excluded, then it would be appropriate, in our view, to only exclude such revenues to the extent that they exceed the IFE of the RFI. Applying this suggested modification to the above scenario, there would be no net IFR to exclude.

Subsection 18.2(12)

Finally, as discussed elsewhere in this submission, the proposed rule in subsection 18.2(12) is problematic in that it excludes an amount from IFR unless the amount is included in computing the IFE of a taxable Canadian corporation, or trust that is resident in Canada, that is subject to tax under Part I. IFR received from other persons (e.g., foreign affiliates, other non-resident persons, etc.) is not included. We believe it is important that all IFR be included for purposes of the *de minimis* test.

Recommendations

We recommend that the following changes be made to the *de minimis* exception:

2.2. The current threshold of $250,000 should be significantly increased to better align with international norms and with other Canadian tax policies.

2.3. The threshold amount should be a safe harbour rather than a hard cap, with interest only being denied to the extent that it exceeds the <u>higher</u> of (i) the threshold amount and (ii) the permitted ratio of tax EBITDA.

2.4. The exclusion under B(ii) of paragraph (b) should be limited to the amount by which the IFR of the RFI exceeds the IFE of the RFI.

2.5. The *de minimis* threshold should be applied without reference to subsection 18.2(12).

Domestic Exception

The domestic exception applies to groups that carry on all or substantially all of their business in Canada, do not have any foreign affiliates, do not have any specified shareholders or specified beneficiaries who are non-resident persons, and pay all or substantially all of their IFE to persons other than tax-indifferent investors. This is a welcome exception, as it allows entities that pose little base erosion risk to be excluded from the complexity of the EIFEL rules. That said, we believe the domestic exception can be fine-tuned to ensure it is not overly narrow.

Business Activities

As currently drafted, it is necessary for all or substantially all of "each" business of the taxpayer and "each" eligible group entity in respect of the taxpayer to be carried on in Canada throughout the year. This could be problematic, for instance, if a particular business that is a relatively minor portion of the group's overall activities is carried on outside of Canada. Consider the scenario where a group carries on several businesses, all of which are carried on exclusively in Canada, with the exception of one minor business line (representing well less than 10% of the group's overall business activities) that has a U.S. sales branch representing more than 10% of the activity for that particular business line. Given that all or substantially all of one minor business is not carried on in Canada, the domestic exception would not be available. It would be appropriate, in our view, to base the "all or substantially" all requirement on the overall business activities carried on by the taxpayer together with all eligible group entities in respect of the taxpayer, rather than testing each business and each eligible group entity separately.

Foreign Affiliates

The domestic exception does not apply if the taxpayer or any eligible group entity in respect of the taxpayer has a foreign affiliate at any time in the year. The BEPS Action 4 Report recognizes that most material BEPS risks are posed by entities that are part of multinational groups, and describes an entity as being part of a multinational group if it is directly or indirectly controlled by a company, or if it directly or indirectly controls one or more other entities.[9] As such, it would be more appropriate in our view to limit the disqualification from the domestic exception to situations where a corporation is a controlled foreign affiliate of the taxpayer or any eligible group entity in respect of the taxpayer.

Further, unlike the business activities requirement, there is no "all or substantially all" requirement; the mere existence of a foreign affiliate (or controlled foreign affiliate, if the recommendation above is adopted) at any time in the year prevents the domestic exception from applying. This could be problematic in a number of situations. For instance, a dormant foreign affiliate could be indirectly acquired as part of an acquisition where it is not possible to wind up for some period of time because of foreign jurisdiction delays. Also, a foreign affiliate may be necessary for legal or commercial reasons, such as to serve as a collection agent for customers in

[9] Ibid, paragraph 45.

a particular jurisdiction, but with only a nominal amount of income being retained by the foreign affiliate. It would be appropriate in our view to include an "all or substantially all" requirement for foreign affiliates similar to that currently proposed for business activities. In other words, the domestic exception would apply provided that all or substantially all of the overall business activities of the group are carried on in Canada.

At minimum, an exception should be made for foreign affiliates with limited assets and limited income, such as an appropriate upscaling of the dormant or inactive threshold that the CRA applies for T1134 reporting purposes.

Specified Shareholders and Specified Beneficiaries

An entity cannot qualify under the domestic exception, as currently drafted, if it or any eligible group entity in respect of the taxpayer has a specified shareholder or specified beneficiary who is a non-resident person. Given that most material BEPS risks are posed by entities that are part of multinational groups, as discussed above, we suggest that disqualification from the domestic exemption not be based on the mere existence of a specified shareholder, but rather on whether the entity is controlled by a non-resident corporation. For consistency, in the case of trusts, disqualification could be limited to situations where there is a "majority interest beneficiary" who is a non-resident person.

We understand that the policy concern sought to be addressed with the current requirement in the domestic exception may be more narrowly limited to circumstances where interest or financing expenses are paid to a non-resident person that is a specified shareholder or specified beneficiary. To address this more narrow concern, we suggest it would be appropriate to allow an entity to have a specified shareholder or specified beneficiary that is a non-resident, provided there is no material IFE paid by the entity, or any Canadian entity dealing not at arm's length with the entity, to that specified shareholder or specified beneficiary, either directly or indirectly.

As currently drafted, concerns have been raised that certain family-owned businesses could be impacted, for instance, where four siblings each hold 25% of the shares of a corporate group that operates exclusively within Canada, but one of the siblings resides outside of Canada for non-tax reasons. Similar issues can arise for family trusts where one of the beneficiaries resides outside of Canada. These concerns can be addressed with the modifications suggested above.

Interest and Financing Expenses

The domestic exception does not apply unless all or substantially all of the IFE of the taxpayer and each eligible group entity in respect of the taxpayer are paid or payable to persons or partnerships that are not tax-indifferent investors (i.e., including non-resident persons, tax-exempts, discretionary trusts and trusts or partnerships where more than 10% of the interests in the trust or partnership are held by non-residents, tax-exempts or discretionary trusts). It is not clear to us why payments made to persons exempt from tax under section 149 (e.g., Canadian charities) should disqualify an entity from the domestic exception. Given the other requirements under the domestic exception, and particularly the requirement related to specified shareholders and specified beneficiaries, it is not clear to us whether this additional requirement is necessary.

This requirement could be problematic, for instance, where a purely domestic corporate group has publicly issued debt. As the debt is publicly traded, from time to time, a portion of this debt may become held by non-resident persons or by Canadian tax-exempts without the debt issuer's knowledge. If this requirement is retained, then we suggest there be a carve-out for publicly traded debt (e.g., by deeming any interest on publicly traded debt to be paid to a person that is not a tax-indifferent investor).

This requirement also may be overbroad in circumstances where the recipient of the IFE is a tax-indifferent investor that is a trust or a partnership. For example, if 11% of an entity's IFE is paid to a partnership that has an 11% non-resident partner, the entity will be disqualified from the domestic exception when only 1.21% of the IFE is ultimately allocable to a non-resident recipient. If this requirement is retained, then we suggest it would be appropriate to modify the requirement by allowing a "look through" of the trust or partnership in paragraphs (d) and (e) of the definition of "tax-indifferent investor" in subsection 248(1) to any entities described in paragraphs (a) to (c) of that definition in determining whether the "all or substantially all" requirement has been met.

Also, we note that paragraph (b) of the definition of "tax-indifferent investor" does not exclude a non-resident person earning interest income through a Canadian permanent establishment. It would be appropriate to exclude such persons from the definition of "tax-indifferent investor" when applying the "excluded entity" definition.

Finally, as this requirement is currently worded, it is not clear whether the requirement is to be applied to the eligible group entities viewed together or to each eligible group entity separately. If this requirement is retained, it would be appropriate, in our view, to base the "all or substantially all" requirement on the overall IFE of the taxpayer together with all eligible group entities in respect of the taxpayer, rather than testing each eligible group entity separately.

Recommendations

We recommend that the following changes be made to the domestic exception:

2.6. The requirement that all or substantially all the business activities be carried on in Canada should be based on the group's overall business activities; this modification is required in order to ensure that taxpayers do not lose access to the domestic exception because less than substantially all of an insignificant business is carried on in Canada.

2.7. The mere existence of a foreign affiliate should not cause a taxpayer to lose access to the domestic exception. A taxpayer should only lose access to the domestic exception if there is an investment in a controlled foreign affiliate, and only if the activities of the controlled foreign affiliate result in less than "all or substantially all" of the group's overall activities being carried on in Canada. At minimum, an exception should be made for foreign affiliates with limited assets and limited income, such as an appropriate upscaling of the dormant or inactive threshold that

the CRA applies for T1134 reporting purposes. Consideration should also be given to excluding temporary foreign affiliates – entities that are present only for a certain limited period during the taxation year.

2.8. In terms of shareholder composition, a taxpayer should only lose access to the domestic exception if it is a corporation (or a corporation is an eligible group entity in respect of the taxpayer) and (i) it (or that corporation) is controlled by a non-resident corporation, or (ii) it (or that corporation) has a non-resident specified shareholder and a material portion of its IFE is paid or payable to the specified shareholder, either directly or indirectly. Similarly, a taxpayer should only lose access to the domestic exemption if it is a trust (or a trust is an eligible group entity in respect of the taxpayer) and (i) it (or that trust) has a non-resident majority interest beneficiary, or (ii) it (or that trust) has a non-resident specified beneficiary and a material portion of its IFE is paid or payable to the specified beneficiary, either directly or indirectly.

2.9. Given the other requirements in the domestic exception, consideration should be given to removing the requirement that all or substantially all IFE be paid to persons who are not tax-indifferent investors. If this requirement is to remain, then at minimum, it should not be necessary for all or substantially all IFE in respect of publicly traded debt to be paid to persons other than tax-indifferent investors. Also, consideration should be given to adding a look-through test for payments to partnerships and trusts that are tax-indifferent investors when determining whether all or substantially all IFE have been paid to persons other than tax-indifferent investors. This "all or substantially all" requirement should be based on the group's overall IFE. Finally, IFE received by a non-resident tax-indifferent investor as part of a Canadian permanent establishment should not have a negative impact.

Securitization Vehicles

There is another category of taxpayers that warrants consideration under the excluded entity concept: securitization vehicles. Securitization vehicles are special-purpose vehicles that are used for securitization purposes, and whose assets consist of receivables, mortgages and similar financial assets. Securitization is a long-established and widespread financing technique, which reduces the cost of capital for Canadian businesses and allocates credit risk efficiently.

A securitization vehicle may be established by a Canadian business itself or by a financial institution. Once established, a securitization vehicle issues debt obligations in the market to investors under a private placement or public offering and uses the proceeds to purchase financial assets from a Canadian business. The securitization vehicle earns a nominal profit each year.

Concerns have been raised that certain portions of the revenue of a securitization vehicle consists of amounts (such as membership fees and early repayment premiums) which may not qualify as IFR, and for that reason (and for other reasons) certain securitization vehicles may not qualify as excluded entities. To address this concern, we suggest that a new category be added to the

definition of "excluded entity" that would include any entity that has been established for the sole purpose of securitizing financial assets. Alternatively, as discussed elsewhere in this submission, the definition of "interest and financing revenues" could be expanded to include the various types of ancillary income earned by a typical securitization vehicle.

Recommendation

2.10. A new category should be added to the "excluded entity" definition to ensure that securitization vehicles are not inappropriately impacted by the EIFEL rules.

3. Excluded Interest

The proposed EIFEL rules would deny a deduction in computing income in respect of excess IFE, calculated after deducting IFR. Thus, the component parts of IFE and IFR are central to the application of the test. The "excluded interest" definition excludes certain amounts of interest from both IFE and IFR where it applies, making such amounts irrelevant for this aspect of the EIFEL rules. The status of excluded interest also affects the calculation of ATI and various items to which ATI is relevant.

Simplifying the wording of the definition, excluded interest is interest payable by a corporation to another corporation that is, throughout the accrual period for the interest, in respect of a debt owed by the payer to the payee, where throughout the relevant period both corporations are taxable Canadian corporations and the payee is an "eligible group corporation" in respect of the payer. In order for the definition to apply, an election must be filed. An eligible group corporation, in respect of a corporation resident in Canada (the payer), means a corporation resident in Canada that is related to the payee (ignoring paragraph 251(5)(b)), or that would be affiliated with the payee if section 251.1 were read without the definition of "controlled" in subsection 251.1(3).

Scope of the Rule

The Explanatory Notes indicate that the excluded interest provision was included in the proposed EIFEL rules principally to ensure that the EIFEL rules do not negatively affect corporate transactions that are often undertaken within Canadian corporate groups to allow the losses of one group member to be offset against the income of another group member. In a common form of these transactions, a group member (the "Payer") borrows money from another group member (the "Payee") to acquire fixed-dividend preference shares in the capital of a group member. Under the EIFEL rules, the Payer's IFE will include the interest it pays on the related party debt, but its IFR will not include the dividends it receives. In addition, because the Payer's only income is often dividends on the preference shares, which are deductible in computing taxable income under subsection 112(1), its ATI often will be nil. Accordingly, under proposed subsection 18.2(2), the Payer will be precluded from deducting any of the interest it pays to the Payee. If the excluded interest election is made, the Payer will have no IFE and subsection 18.2(2) will not apply to deny its interest deduction. Correspondingly, the Payee will not include this interest in its IFR. This avoids the unnecessary additional complexity of using the excess capacity transfer mechanism to avoid the application of subsection 18.2(2) to the Payer.

The emphasis on facilitating these loss-shifting transactions is understandable given their important role in the Canadian income tax system in allowing an indirect form of income and loss consolidation in the absence of group tax reporting. But there is nothing particular to these items of income and expense that distinguishes them from interest payments relating to other intra-group transactions that may result in negative consequences under (or additional complexity from having to apply the other rules in) proposed subsection 18.2(2). In either case, such consequences or complexity would not be appropriate from a policy perspective when both sides of the transaction are taken into account. In these cases as well as in connection with loss-shifting transactions it is appropriate to allow the "backing-out" of these transactions for purposes of the IFE and IFR definitions to avoid where possible the necessity of relying on the excess capacity transfer mechanism to deal with intra-group transactions (as well as avoiding any other unforeseen difficulties or complications). Accordingly, in our view it is appropriate that the excluded interest provision deal not only with facts that arise in typical loss-shifting transactions (inter-corporate loans) but that they also encompass factual circumstances that may arise in connection with other intra-group transactions. This observation by itself does not lead to specific recommended statutory amendments. Rather, it informs our view that the following observations are relevant in considering the proper scope and operation of the excluded interest provision.

Nature of Eligible Entities

Notably, the excluded interest provision applies only to payments where both parties are corporations. However, corporate groups may contain partnerships and trusts within their structure that have members or beneficiaries that are, directly or indirectly, all eligible group corporations. There is nothing inherent in the nature of partnerships or trusts that should exclude them from the application of the excluded interest provision in such situations.

Consider the following example. Canco 2 is undertaking a real estate development venture and elects to do so through a limited partnership of which Canco 3 is the general partner. There are no other partners. Both Canco 2 and Canco 3 are eligible group corporations in respect of Canco 1. This arrangement might be undertaken to facilitate tax integration (subject to the usual limitations on at-risk amounts, etc.) while preserving separate limited liability, or to facilitate a future syndication of the project to third parties who would acquire limited partnership interests. Canco 4, also an eligible group corporation in respect of Canco 1, provides development and operating financing to the partnership. To protect its investment, Canco 4 advances the funds by way of interest-bearing debt. In this circumstance, there should be no policy difference in considering the application of the excluded interest provision than if Canco 2 had developed the project directly, with financing from Canco 4. In either case, it would be appropriate for the excluded interest provision to be available.

We understand that the Department may have concerns with the application of the excluded interest provision to partnerships or trusts that have members or beneficiaries that are not themselves eligible group entities (either directly or indirectly through partnerships or trusts). However, without extending the policy scope of the excluded interest provision beyond that of

the above example there are other circumstances in which it would be appropriate to permit the excluded interest provision to apply to a partnership or trust.

Consider the following example. A joint-venture development project is undertaken between two unrelated groups, each as to 50%. The project is undertaken through a limited partnership to preserve limited liability for the joint-venturers while allowing the income and loss of each joint-venturer from the project to be integrated with its corporate income and loss (subject to the usual limitations on at-risk amounts, etc.). Each joint-venturer funds its 50% contribution to the cost of the project in large part with loans from a corporation that is an eligible group corporation in respect of the joint-venturer. For commercial reasons, the loans would be in proportion to their 50-50 ownership and on matching terms. In this case allowing the excluded interest provision to apply would be appropriate from a policy perspective, as the two joint-venture groups are not "sharing" tax attributes between themselves.

Nature of Eligible Payments

As the term excluded interest suggests, the excluded interest provision applies only in respect of payments of interest, notwithstanding that IFE and IFR include many items that are not interest. It is likely that a rule applying to interest will suffice for many or most situations. However, it would not apply to any related hedging costs associated to the loan. And it would exclude arrangements other than loans that also can be used for loss-consolidation. For example, a sale and lease-back transaction among eligible group corporations can be used as a form of loss-shifting, in the form of rental payments. While IFE and IFR include lease financing amounts, there is no regime similar to the excluded interest provision that will apply to such intra-group transactions. Both of these circumstances bear a great deal of similarity to the circumstances encompassed by the currently proposed excluded interest provision.

Canadian Resident Individuals

The EIFEL rules are applicable to a privately-held Canadian corporation that does not qualify as an "excluded entity" as described above. Generally, interest paid on a loan from a Canadian-resident individual (other than certain trusts) by such a corporation should not present issues of the sort that the EIFEL restrictions are intended to counter. Interest in respect of such loans leaves the corporate system, but if paid to a Canadian-resident taxable individual generally is received by a taxpayer subject to tax at a higher rate than the rate applicable to the corporate tax deduction, and no BEPS concerns should arise. The framework of the excluded interest provision requires reciprocity (both IFE and IFR of group members are affected) which would not be satisfied in the case of loans from individuals. However, comparable rules applicable to loans from Canadian-resident individuals could closely resemble the excluded interest provision. In particular, interest on loans from related/affiliated Canadian resident individuals in appropriate circumstances could be allowed to qualify for "excluded interest" treatment to avoid adverse results that could otherwise arise. Although such loans could in some cases be modified to become non-interest bearing, to avoid a potential "one-sided" limitation on corporate deductibility, in other cases doing so could expose the individual lender to adverse implications under the income attribution or "stop-loss" rules, for example.

Recommendations

3.1. **The excluded interest provision should be expanded to apply where either or both of the parties to a loan are partnerships, all of the members of which are, directly or indirectly, eligible group corporations, and where either or both of the parties to a loan are trusts, all of the beneficiaries of which are, directly or indirectly, eligible group corporations. Consideration should be given to ways in which the rules can be further adjusted to accommodate circumstances such as the joint-venture example above. Also, as discussed elsewhere in this submission, we recommend that the excluded interest provision be made applicable in appropriate circumstances in the foreign affiliate context.**

3.2. **The excluded interest provision should be extended to payments other than interest. In particular, hedging payments between eligible group members that relate to excluded interest loans and lease financing amounts should be encompassed and consideration should be given to expanding the rule further. Indeed, it is not clear to us why the provisions should not extend to all IFE/IFR amounts.**

3.3. **Rules comparable to the excluded interest provision should be available for interest paid by a corporation resident in Canada to an individual resident in Canada (other than a disqualified trust) who is related to the corporation (determined without reference to paragraph 251(5)(b)) or would be affiliated with it, if section 251.1 were read without the definition of "controlled" in subsection 251.1(3).**

Procedural Comments

The proposed excluded interest provision requires that an election be made in respect of "an amount of interest". It appears to be intended that the interest in respect of each particular debt requires a separate election, although this is not entirely clear. The election requires that the amount of the debt be specified as well, which does not appear to easily accommodate a debt with a fluctuating balance, or one that is partially repaid during a year.

Where the scope of the proposed excluded interest provision is conceived of as relating to loss-shifting transactions, it can be anticipated that there will be a limited number of loans and interest amounts, so that separate elections may not be unduly onerous. Likewise, it may be that loan balances will not often fluctuate in such arrangements. But, as noted above, there is no reason for the excluded interest provision to be limited to this circumstance, and it may be that in other circumstances in which the application of the provision is appropriate a large number of loans or fluctuating loan balances could be involved. There is no obvious reason to establish an election mechanism in respect of such transactions that will be administratively burdensome.

Paragraph (b) of the definition requires that the payer and payee meet certain conditions at the time of payment of the interest covered by the election, but the condition is paragraph (c) could require that the election be filed prior to that time (for example, where the interest has become payable but remains unpaid). It is not clear whether it is intended that no election be allowed in such circumstances. The condition in paragraph (c) also refers to the taxation year in which the

amount of interest “became payable”. It is not clear how the excluded interest rules are intended to apply in a situation where interest accrues during the term of the debt but becomes due only after a number of years (or at maturity, for example). Although the interest (other than any “compound” interest portion) would normally be deductible each year as it accrues, and would therefore be affected by the limitation rules in section 18.2 for those years, an excluded interest election could not be made in respect of an “early year” of the debt until a subsequent year when the interest is actually paid or becomes payable. Furthermore, in such a case it would appear that the amount of interest covered by the election could relate to multiple taxation years. It is not clear how the parties would apply the rules in section 18.2 for such early years prior to the filing of an election. More generally, it does not appear that the amount of interest to be specified in an election would always relate to only one taxation year of either the payer or payee, for example where the parties have taxation years ending on different dates. The rules should presumably require the election to identify the portion of the amount that relates to each relevant taxation year of the payer and payee.

Recommendations

3.4. The requirement in the excluded interest election that the amount of the debt be specified should be clarified to take into account fluctuations in loan balances during the course of the year, whether because the loan is a “revolver”, there has been a partial repayment, or for any other reason.

3.5. A single “blanket” election should be permitted (but not required) in respect of all excluded interest for a year between any two (or more) eligible group members.

3.6. The election mechanism should be modified to address the issues noted regarding the filing conditions that must be satisfied and the treatment of interest accruing for a year in which the interest has not yet become payable.

4. Adjusted Taxable Income

The definition of ATI in proposed subsection 18.2(1) is intended to reflect a "tax EBITDA" concept, which is similar to earnings without reduction for items on capital account (including, for example, interest and CCA). ATI is set out in a formula, which is based on a taxpayer's Part I taxable income as adjusted for certain items. A number of these adjustments may, however, give rise to inappropriate or unexpected results, some of which are noted below.

Treatment of Losses

As currently drafted, variable A in the ATI formula is a taxpayer's taxable income for the year (determined without regard to proposed subsection 18.2(2)), reduced by the amount of the taxpayer's non-capital loss for the year (determined without regard to proposed subsection 18.2(2)) and by the amount of the taxpayer's net capital loss for the year. This can lead to anomalous results including the double reduction of ATI in certain circumstances, as outlined below.

Treatment of Non-Capital Losses

Converting Non-Capital Losses to RIFE

Variable A in the ATI definition will be a negative amount where the taxpayer realizes a non-capital loss in the year (determined without regard to proposed subsection 18.2(2)). If the ATI (after adjusting for variables B and C) is still negative, none of the IFE will be deductible. This non-deductibility will, in turn, reduce the non-capital loss realized in the year (or result in taxable income), and will result in RIFE. This treatment in effect converts a non-capital loss into a RIFE.

In the scenario where the non-deductibility of interest results in taxable income, this could mean that a taxpayer with losses will nevertheless be required to pay tax. We note that the BEPS Action 4 Report[10] notes this risk and suggests that it be reduced.

A RIFE is a tax attribute similar to a non-capital loss, and in many circumstances an otherwise available non-capital loss will be converted into a RIFE. As a result, provisions of the Act will need to be amended to treat RIFE similar to non-capital losses.

Recommendation

4.1. RIFE should be treated throughout the Act in a manner similar to non-capital losses (where not otherwise dealt with in the proposals). For example, section 80 should be amended to enable taxpayers to apply a "forgiven amount" to reduce a RIFE balance. As a related comment, the definition of "commercial debt obligation" in section 80 should be expanded to include a reference to section 18.2.

Non-Capital Loss Carry Back or Carry Forward

Where a taxpayer carries back or carries forward a non-capital loss realized in a particular taxation year to another taxation year, that carry back or carry forward can change the IFE previously deductible in that other taxation year.

For example, assume that in 2024 a taxpayer has earnings of $3,000, IFE of $900 and CCA of $1,100. It therefore has taxable income of $1,000 ($3,000 - $900 - $1,100) and ATI of $3,000 ($1,000 + $900 + $1,100), and the taxpayer can therefore deduct all of its interest expense ($900). Further assume that in 2025 the taxpayer realizes a $1,000 operating loss, has IFE of $900 and claims no CCA. The taxpayer has a non-capital loss in 2025 of $1,900 (determined without regard to proposed subsection 18.2(2)), which is reduced to $1,000 under the EIFEL regime as it has no ATI and thus cannot deduct the $900 of IFE. The taxpayer chooses to carry back the $1,000 non-capital loss from 2025 to 2024. If all $1,000 is carried back, the taxpayer's revised taxable income (determined without regard to proposed subsection 18.2(2)) for 2024 becomes nil. This results in revised ATI in 2024 of $2,000 (nil + $900 + $1,100), as there is no add-back in paragraph (g) of variable B (because the 2025 IFE was not deductible). As a result, only $600 of IFE (30% of $2,000) is deductible in 2024, resulting in the taxpayer having revised

[10] Ibid, paragraph 77.

2024 taxable income of $300 after application of the EIFEL regime. The result is that, in effect, only $700 of the 2025 loss is utilized and the remaining $300 becomes a 2024 RIFE.

The above example becomes even more complicated in the scenario where some of the 2025 non-capital loss which is carried back to 2024 is attributable to deductible interest expense and is thus added back in paragraph (g) of variable B.

This complicated system will require substantial professional time to determine the appropriate loss amount to be carried back or carried forward, as applicable, particularly as the *prima facie* position of many taxpayers would be to carry back or carry forward the maximum loss possible. Significant professional time will also be required to compute and maintain the various accounts. As noted above, this puts smaller or less sophisticated taxpayers, who may not be excluded entities, at a disadvantage and also requires them to incur significant costs to ensure compliance. This example illustrates the inequities that can arise where the "excluded entity" concept is unduly narrow.

Recommendation

4.2. As discussed in detail above, the universe of excluded entities should be expanded, such that only larger more sophisticated taxpayers need to work within these complicated rules.

Carry Back or Carry Forward of Excess Non-Capital Losses

There may also be situations where a taxpayer has taxable income in a particular year, and sufficient non-capital losses in another year, such that if the taxpayer was permitted under section 111 to carry back or carry forward losses in excess of the taxable income in the particular year, this would result in no taxable income in the particular year. Expanding on the example above, assume the taxpayer has a non-capital loss in 2025 of $2,329 (determined without regard to proposed subsection 18.2(2)), which is reduced to $1,429 because it cannot deduct $900 of IFE. If the taxpayer could carry back the $1,429 non-capital loss to 2024, the taxpayer's resulting taxable income (determined without regard to proposed subsection 18.2(2)) in 2024 would be a non-capital loss of $429. The 2024 ATI would then be $1,571 (-$429 + $900 + $1,100), and $471 of IFE would be deductible in 2024, with $429 becoming a RIFE. This would result in taxable income in 2024 of nil ($3,000 - $471 + $1,100 - $1,429). Although a $1,429 non-capital loss is carried back (which is larger than the otherwise determined 2024 taxable income of $1,000), $429 of this loss is effectively converted to RIFE.

Recommendation

4.3. It should be clarified that variable A of the definition of ATI can be a non-capital loss created from the carry forward or carry back of losses, provided that this does not result in an actual non-capital loss in the taxation year to which the non-capital loss is carried forward or carried back. Consideration should also be given to whether section 111 needs to be revised to facilitate this.

Treatment of Net Capital Losses

Net Capital Loss Carry Forward

The treatment of net capital losses in the definition of ATI can lead to a double reduction of ATI. In particular, if the taxpayer has a current year net capital loss, that net capital loss will reduce the taxpayer's ATI in that year under paragraph (b) of variable E of the definition. If that net capital loss is used to offset a taxable capital gain in a future taxation year, the taxpayer's taxable income in that future year will also be reduced by virtue of the application of this capital loss, resulting in a double reduction of ATI in respect of the net capital loss.

For example, assume that, in 2024, a taxpayer has $1,000 of earnings, $300 of interest expense and a $200 net capital loss from the sale of a capital asset. The taxpayer's taxable income (before application of the proposed EIFEL regime) is $700 ($1,000 - $300) and the net capital loss will not reduce its tax payable in 2024 (since no capital gain has been realized). In this scenario, the ATI of the taxpayer in 2024 will be only $800 ($700 + $300 - $200), with the result that only $240 of the interest will be deductible and $60 will be a RIFE. In 2025, assume that the taxpayer has another $1,000 of earnings, $300 of interest expense and a $200 taxable capital gain from the sale of a capital asset. The 2024 net capital loss is carried forward and applied against the taxable capital gain. The taxpayer's 2025 taxable income (determined without regard to proposed subsection 18.2(2)) is $700 (the taxable capital gain is offset by the net capital loss carried forward) and its ATI is $1,000 ($700 + $300). The result is that the taxpayer can deduct the full $300 of 2025 IFE but cannot deduct the $60 RIFE from 2024. In this example, the taxpayer had aggregate cumulative earnings of $2,000, $600 of interest expense and no net capital gain or loss, but it still cannot deduct all of the interest expense. In effect, the capital loss has reduced the ATI twice, once when realized and once when applied. If the capital gain had instead been realized in 2024 instead of 2025, the taxpayer's 2024 and 2025 ATI would have each been $1,000, for an aggregate ATI of $2,000; instead because of the timing of the recognition of the capital gain, the taxpayer's aggregate ATI will be only $1,800.

Net Capital Losses Never Used

There may be situations where a taxpayer's net capital loss is never used. The net capital loss will reduce ATI in the year of realization, although the taxpayer may never benefit from this loss. For example, the taxpayer may not realize taxable capital gains sufficient to utilize its net capital losses. The adverse effect of this rule can be compounded where there is a loss restriction event - the taxpayer may realize significant inherent capital losses under paragraph 111(4)(d) which losses will reduce ATI in that year even though such losses are not able to be used in a year ending after the loss restriction event. This can result in a significant loss of interest deductibility in a taxation year ending as the result of a loss restriction event.

Net Capital Loss Carry Back

There may also be situations where a taxpayer carries back a net capital loss to offset a taxable capital gain realized in a prior taxation year. In such a situation, the ATI in the earlier year was increased by the taxable capital gain, but is then retroactively reduced. For example, a taxpayer

could have $800 of earnings, $300 of interest expense and a $200 taxable capital gain in 2024, resulting in $700 of taxable income and $1000 of ATI. All interest would be deductible. In 2025, the taxpayer has $1,200 of earnings, $300 of interest expense and a $200 net capital loss, which net capital loss is carried back to 2024. The net capital loss carried back will reduce the ATI in 2024 to $800, and only $240 of the interest expense will be deductible. The remaining $60 of interest expense will be RIFE. In 2025, the ATI will be $1,000 (as it is reduced by the net capital loss realized in that year). The $300 of 2025 interest will be deductible but the undeducted interest from 2024 will still not be deductible. This is the result notwithstanding the fact that, in 2024 and 2025, the taxpayer had $2,000 of earnings, $600 of IFE and an offsetting $200 taxable capital gain and net capital loss.

Recommendation

4.4. To avoid double counting of a capital loss, a net capital loss realized by a taxpayer should only reduce the taxpayer's ATI in the taxation year in which the taxpayer's taxable income (determined without regard to proposed subsection 18.2(2)) is reduced by virtue of the deduction of a net capital loss (whether as a result of a loss carry forward or loss carry back).

Terminal Losses

A taxpayer will realize a terminal loss under subsection 20(16) where, at the end of a taxation year, it has no depreciable property of a particular class and there is an excess amount in that class as set out in paragraph 20(16)(a). Such a terminal loss arises directly from the fact that there is "unused" capital cost; if this capital cost were instead deducted under paragraph 20(1)(a), it would have been added back to ATI under variable B of the formula. Accordingly, a terminal loss should also be added back in determining ATI.

Recommendation

4.5. Variable B in the ATI formula should include an addback for an amount deducted by the taxpayer in computing its income for the year under subsection 20(16). Similarly, there should also be an addback where a partnership realizes a terminal loss.

Variable B Addback of Resource Pool Deductions

As noted above, paragraph (b) of variable B of the ATI formula adds back to a taxpayer's ATI any deductions under paragraph 20(1)(a) (i.e., CCA). This is consistent with the BEPS Action 4 Report which recommends that the interest deduction limitation be based on a fixed ratio of earnings before interest, taxes, depreciation and amortization.[11] The basis for the BEPS Action 4 recommendation in this regard was that the exclusion of significant non-current expenses (depreciation of fixed assets and amortization of intangible assets) would allow a better representation of a taxpayer's ability to pay interest. The addback does not currently include a consideration of other non-current expenditures of a taxpayer. In particular, it is noted that

[11] Ibid, paragraph 86.

taxpayers in the natural resource sector have, in addition to depreciation and amortization, depletion.

Similar to the tax regime governing CCA, the Act permits taxpayers to deduct amounts for capital items in the form of resource pools (COGPE, CDE, CEE, foreign exploration and development expenses, and foreign resource expenses). Given that the "tax EBITDA" concept is intended to refer to earnings without reduction for items on capital account, resource pools should be treated consistently with CCA. As such, the ATI formula should contain an addback for any such claims.

We understand, based on our preliminary conversations with the Department, that a concern arises to the extent that resource pools include amounts that would otherwise be deductible on a current basis and that there is a view that such current expenses should not be added back to ATI. In this regard, we note that CCA classes may also contain what would otherwise be considered to be current expenses and, in that respect, different treatment as between CCA and resource pools is not appropriate.[12]

In any event, if there is such a concern, it could potentially be addressed through a mechanism where the addback was limited to a fixed ratio of resource pools (based on an understanding that the excluded portion would be a proxy for otherwise current expenses) or where amounts which would otherwise be deductible under section 9 (if it were not for their inclusion in resource pools) were excluded from the addback. In any such scenario, given the inherent complexities of such an approach we recommend further consultation with relevant industry groups to develop a mechanism which is efficient for both taxpayers and the CRA.

Recommendations

4.6. Deductions from resource pools should be treated consistently with CCA deductions. As such, variable B of the ATI formula should contain an addback for deductions made under any of subsections 66(4), 66.1(2) or (3), 66.2(2), 66.21(4), 66.4(2), 66.7(1), (2), (2.3), (3), (4), or (5). The addback for these amounts would also be consistent with the carve-out in paragraph (a) of variable B of the ATI formula for amounts described in paragraph (c) of the definition of IFE (which includes resource pool amounts).

4.7. It is not clear to us that a policy concern should exist with respect to the inclusion of otherwise current expenses. However, if there is such a concern, further consultations should be undertaken with the applicable industry groups to develop a mechanism to exclude such amounts from the addback which is efficient for both taxpayers and the CRA.

Variable B Addback for Certain Losses

Paragraph (g) of variable B of the ATI formula adds back the portion of a non-capital loss for another taxation year that is deducted by the taxpayer under paragraph 111(1)(a), to the extent

[12] For example, where capital property is manufactured or built for a taxpayer's own use.

that the loss arose from amounts deducted by the taxpayer in the other year in respect of its IFE (net of IFR) for the other year or under paragraph 111(1)(a.1) as a RIFE from a previous year. As per the Explanatory Notes, this addback is consistent with the addback under paragraph (a) of variable B in respect of a taxpayer's IFE for a year. Certain anomalies can arise, however.

Carry Forward of Pre-Effective Date Non-Capital Losses

Many taxpayers will have realized non-capital losses in taxation years prior to 2023 (or other delayed effective date), particularly during the pandemic years. As an overall point, we note that the EIFEL rules lack clarity both on the treatment of pre-2023 loss balances which may be carried forward to impact taxable income in post-2023 taxation years and on the treatment of that portion of the pre-2023 loss that relates to pre-2023 IFE. We have assumed, however, that, as drafted, pre-2023 losses would reduce ATI in the same manner as all other non-capital losses. If a taxpayer carries pre-2023 non-capital losses forward to later taxation years when the proposed EIFEL regime is applicable, that carry forward will reduce taxable income in those future years, thereby reducing ATI (except to the extent such losses arose from net interest expense, assuming that IFE is considered to exist prior to the Effective Date, which should be clarified). This is effectively a retroactive application of the proposed EIFEL regime.

For example, assume that a taxpayer has $1,000 of earnings and $300 of IFE in 2024. In this case, the taxpayer's taxable income is $700 and, assuming no other items in ATI, the taxpayer's ATI is $1,000. In the result, the taxpayer should be permitted a deduction of the full IFE. If, however, the taxpayer carried forward a non-capital loss from 2022 (which is not attributable to IFE), this will reduce the taxpayer's ATI and therefore interest deductibility in 2024. This seems unfair and contrary to the policy of the EIFEL regime, which is to ensure that, *from and after 2023*, the IFE deducted does not exceed more than 30% of earnings.

It is also counterintuitive that, in the above example, the taxpayer's ATI in 2024 is reduced where the non-capital loss carry forward was sourced from business operations, where the taxpayer had little or no net interest expense in the pre-2023 taxation years. In contrast, however, ATI in 2024 would not be reduced where the taxpayer was highly levered in pre-2023 years and the non-capital loss carry forward was therefore sourced from interest expense.

Non-Capital Losses from Variable B Items

Consistent with the policy behind paragraph (g) of variable B, the addback in that provision should be extended to include the portion of a non-capital loss for another taxation year that is deducted by the taxpayer under paragraph 111(1)(a) to the extent of any amounts deducted by the taxpayer in the other year that would otherwise have been added back in that other year under variable B. This would include IFE, CCA, amounts in respect of resources expenses (as per our recommendation above), partnership amounts described in paragraphs (c) or (d) of variable B, and amounts deducted under any of paragraph 110(1)(k) or 111(1)(a.1) or subsection 104(6). For example, without the addback for the portion of a non-capital loss arising from previously claimed CCA, a taxpayer would be better off not claiming CCA to create a loss. Assume in 2024 that a taxpayer has earnings of $1,000, IFE of $300 and claims CCA of $1,200, resulting in a non-capital loss (determined without regard to proposed subsection 18.2(2)) of $500. The 2024

ATI is $1,000 and all interest is deductible. In 2025, the taxpayer has earnings of $1,000, IFE of $300, and claims only $200 of CCA, resulting in taxable income of $500 (determined without regard to proposed subsection 18.2(2)). The ATI for 2025 is $1,000 and all interest is deductible. If the $500 non-capital loss from 2024 is carried forward, the ATI in 2025 is reduced to $800 (nil + $300 + $200 + $300), and only $240 of interest is deductible. If, instead, the taxpayer had claimed only $700 of CCA in 2024 and claimed the additional amount of $500 of CCA in 2025, all interest would have been deductible in 2025.

Recommendations

4.8. To avoid the retroactive application of the proposed EIFEL regime in respect of pre-effective date losses, the addbacks contemplated in variable B of the definition of ATI should be expanded to include all pre-effective date non-capital loss carry forwards. This could, for example, be accomplished by adding the following as paragraph (f.1):

> ***an amount deducted by the taxpayer under paragraph 111(1)(a) in computing its taxable income for the year, in respect of the taxpayer's non-capital loss for a taxation year prior to the first taxation year to which subsection 18.2(2) applied to the taxpayer.***

4.9. Paragraph (g) of variable B should be extended so that the addback includes the portion of a non-capital loss for another taxation year that is deducted by the taxpayer under paragraph 111(1)(a) to the extent that the loss arose from any amounts deducted by the taxpayer in the other year that would otherwise have been added back in that other year under variable B. This could, for example, be accomplished by amending clause (ii)(A) of variable K to provide as follows:

> ***the amount by which the total amount deducted in computing the taxpayer's income for the other taxation year in respect of any amount described in paragraphs (a) to (f) above, for the other taxation year exceeds the interest and financing revenues of the taxpayer for the other taxation year, or***

4.10. Similarly, it should be clarified that the amount described in paragraph (d) of variable B includes amounts in respect of fiscal periods of a partnership ending prior to the effective date of these rules.

4.11. Following on our recommendations under the headings "Terminal Losses" and "Variable B Addback of Resource Pool Deductions" above, clause (ii)(A) of variable K should also include reference to the amended paragraph, permitting addbacks for terminal losses and resource pools.

Issues Concerning Trusts

Variable C of the ATI formula reduces a taxpayer's ATI by, in effect, reversing income inclusions for various amounts that are included in income under variable A (by virtue of being

included in computing a taxpayer's taxable income). Paragraph (e) of variable C reduces ATI by an amount included in a taxpayer's income under subsection 104(13) (i.e., income of a trust that became payable in the trust's year to a beneficiary). This reduction is intended, as per the Explanatory Notes, to reflect that this amount is effectively included in the ATI of the trust by virtue of the addback for subsection 104(6) amounts under paragraph (f) of variable B. However, this approach may give rise to inappropriate results in certain circumstances.

As currently drafted, paragraph (e) of variable C does not appropriately treat taxable dividend income of a trust allocated to a corporate beneficiary which is subject to a designation under subsection 104(19). Where a taxable dividend received by a trust on a share of a taxable Canadian corporation is allocated to a corporate beneficiary and subject to a designation by the trust under subsection 104(19), the corporate beneficiary would include the dividend amount in its income under subsection 104(13) and then claim an offsetting deduction in computing taxable income under subsection 112(1). Accordingly, the corporate beneficiary would have no net taxable income related to the dividends (consistent with the Explanatory Notes), however paragraph (e) of variable C requires the beneficiary to deduct the amount of the dividend in computing ATI, resulting in a reduction of ATI notwithstanding that the dividend amount was not actually included in taxable income.

More generally, we question whether, from a policy perspective, it is appropriate to reduce the ATI of a taxpayer on account of amounts included in the taxpayer's income for the year under subsection 104(13). As currently drafted, the draft legislation would not permit beneficiaries subject to the EIFEL regime (i.e., beneficiaries which are trusts and corporations) to include fully taxable income from a trust in determining the amount of IFE that the beneficiary is entitled to deduct. We understand from the Explanatory Notes that the reduction in ATI is intended to reflect that this amount is effectively included in the ATI of the trust. However, there may be situations where trust beneficiaries have IFE, but the underlying trust does not have any IFE or has IFE less than 30% of its ATI.

For example, investors in mutual fund trusts may have IFE but the mutual fund trust may itself have no indebtedness. Alternatively, the trust could have ATI more than 3.33 times the amount of its IFE, such that it has excess ATI. Under the new rules, the ATI of the mutual fund trust, which is fully taxable to its beneficiaries, is not available to permit maximum deductions of IFE. In addition, it is common for certain mutual fund trusts (such as real estate investment trusts and private mutual fund trusts) to structure investments through tiered trust structures where an upper-tier trust incurs interest-bearing debt that is used to invest in a lower-tier trust that earns income. As currently drafted, the EIFEL rules would not permit the upper-tier trust to include the subsection 104(13) income from the lower-tier trust in determining its ATI, resulting in the IFE of the upper-tier trust being non-deductible. This is an inappropriate outcome in our view.

Recommendations

4.12. Paragraph (e) of variable C should exclude an amount deductible by the beneficiary under subsection 112(1) to the extent that it relates to an amount included in the beneficiary's income under subsection 104(13).

4.13. Trusts should be able to allocate their excess ATI to their beneficiaries pro rata in accordance with the amounts of trust income for the year made payable to the beneficiaries pursuant to subsection 104(13). This could, for example, be accomplished through amending paragraph (f) of variable B such that the ATI of a trust would be increased by an elected proportion of its subsection 104(6) deductible amounts (instead of the full amount of the subsection 104(6) amounts) and paragraph (e) of variable C would also be amended such that the beneficiaries' ATI would be reduced by the corresponding proportion of their subsection 104(13) income inclusions. As a related point, trusts should be able to designate to their beneficiaries, pro rata in accordance with the amounts of trust income for the year made payable to the beneficiaries pursuant to subsection 104(13), an amount of their IFR to be treated as IFR of the beneficiaries.

Paragraph 12(1)(l.2) and Circularity

ATI is based on taxable income, which is determined without regard to proposed subsection 18.2(2). Paragraph (f) of variable C of the ATI formula reduces ATI by an amount included under proposed paragraph 12(1)(l.2) in computing the taxpayer's taxable income for the year. However, under variable B of proposed paragraph 12(1)(l.2), the amount under that provision cannot be determined without reference to proposed subsection 18.2(2) which is based on ATI. This leads to circularity. In addition, it is not clear that the paragraph 12(1)(l.2) income inclusion would be included in taxable income in variable A of ATI; if it is not so included, the reduction of ATI under paragraph (f) of variable C would be inappropriate.

Recommendation

4.14. The bracketed words in variable A should be revised to be "(determined without regard to subsection 2 or paragraph 12(1)(l.2))", and paragraph (f) of variable C should be struck. If paragraph (f) of variable (C) is retained, we believe the reference in paragraph (f) to "taxable income" should be replaced by "income", as inclusions under section 12 are to "income" and not "taxable income".

Paragraph 12(1)(l.2) and Regulation 1100(11)

There appears to be a technical issue where a partnership carries on a highly leveraged Canadian real estate rental business. As an example, consider a limited partnership ("LP") that owns Canadian rental properties and borrows from an arm's length Canadian bank. LP's interest expense exceeds its rental income before any CCA deduction. Pursuant to Regulation 1100(11), LP may not claim any CCA since such a deduction would increase its losses. LP allocates the

losses to its 99.99% limited partner ("Partner A"). Partner A does not have any other assets or liabilities.

Under the proposed EIFEL rules, paragraph 12(1)(l.2) would include an amount in Partner A's income in respect of its share of the IFE of LP if Partner A's total IFE (consisting of IFE of LP in this example) for the year exceeds the amount of such expense that Partner A is permitted to deduct, as determined under subsection 18.2(2). Where the amount under paragraph 12(1)(l.2) exceeds the losses allocated to Partner A by LP, it will result in net income to Partner A. It appears there is no mechanism to allow LP or Partner A to claim LP's available CCA to offset the income inclusion. Note that if Partner A were to carry on the rental business directly, subsection 18.2(2) would deny the RIFE, but Partner A would be able to claim CCA to reduce its income and the excessive IFE would be carried forward. It would appear that the only option available to LP A would be to not claim the interest expense and claim CCA instead, but the interest deduction would be permanently lost. This is an inappropriate outcome in our view.

Recommendation

4.15. In light of the above, it is recommended that the rules be revised to provide a mechanism to allow LP or Partner A to claim a deduction equivalent to the available CCA such that Partner A does not have net income as described above together with protective measures to ensure that there is no double deduction of CCA (e.g. some sort of notional recapture mechanism).

4.16. More generally, consideration should be given to the interaction of the EIFEL rules with the at-risk rules and basis adjustment rules for partnerships.

5. Interest and Financing Expenses

Treatment of Hedging Gains included in Variable B of the IFE definition

Net gains from "hedging" activities, which relate to debts in respect of which amounts such as interest expense are included in IFE, are deducted in computing a taxpayer's IFE for the year. However, where the taxpayer is subject to a limitation under proposed subsection 18.2(2), the limitation does not apply to reduce amounts included in income in respect of such gains. Given that hedging gains represent, in an economic sense, a reduction to the related IFE amounts, this lack of reduction seems inappropriate.

The formula in subsection 18.2(2) (i.e., (A-(B+C+D+E))/A) calculates the portion (as a percentage) of amounts included in IFE that are disallowed as a deduction in computing income for the year. Variable A is the taxpayer's IFE (which includes any reduction in IFE for hedging gains by virtue of the ("A-B") formula in the IFE definition). However, the preamble to 18.2(2) applies this portion (%) to amounts described in "paragraphs (a) to (f) or (h)" in the IFE definition - there is no adjustment for amounts described in variable B of the IFE definition.

Consider the following example:

Assume a taxpayer has ATI of $100 for the year, $100 of otherwise deductible interest expense for the year, $20 of hedging gains included in income for the year related to borrowings, and a ratio of permissible expenses of 40% for the year. The proportion under subsection 18.2(2) for the year would be calculated as follows:

> A in the formula is $80 ($100 of interest expense (paragraph (a) of A in the definition of IFE) less $20 hedging gain in B of the definition of IFE)
>
> B in the formula is $40 (ATI of $100 x 40% ratio of permissible expenses)
>
> C in the formula is $0 (no IFR)
>
> D in the formula is $0 (no received capacity)
>
> E in the formula is $0 (no absorbed capacity).

Therefore, the proportion is ($80 - $40) / $80 or 50%, and the provision should operate to deny a deduction for 50% of the "net" IFE amount for the year of $80, or $40.

The subsection applies, however, to deny a deduction for 50% of the amounts in paragraphs (a) to (f) or (h) of A in the definition of IFE, which is 50% of $100, or $50.

A more fundamental issue exists for a partnership that has a hedging gain in respect of a debt, or a hedging loss in respect of a receivable, because the partnership amounts in paragraph (g) of variable A in the definition of IFE (and in paragraph (e) of variable A of the definition of IFR) do not have the equivalent of a variable B (and the variable B for IFE and IFR do not include the taxpayer's share of amounts related to a partnership). In addition, the partnership income inclusion amount in proposed paragraph 12(1)(l.2) only includes amounts from paragraph (g) of variable A of the definition of IFE.

Recommendation

5.1. The amounts currently described in variable B of the definition of IFE should be moved to paragraph (d) of variable A of the definition, and paragraph (d) should be allowed to be a positive or negative amount. The preamble to subsection 18.2(2) should then be modified to require that "no deduction <u>or inclusion</u> shall be made in respect of any amount . . . that would . . . be deductible <u>or includable</u> in computing that income….". Similar modifications should be made to the various provisions dealing with the taxpayer's share of partnership amounts, to address amounts covered by variable B of the definitions of IFE and IFR for other taxpayers, and to adjust the partnership income inclusion provision in paragraph 12(1)(l.2) accordingly.

6. Interest and Financing Revenues

The EIFEL rules limit the amount of "net" IFE (being the taxpayer's IFE net of its IFR) that may be deducted in computing a taxpayer's income to no more than a fixed ratio of tax EBITDA (subject to the group ratio rules). As such, the definition of IFR (which determines what can be netted against IFE) is an important concept. As currently drafted, the definition of IFR includes interest income and certain other financing-related income and gains, to the extent that these amounts are included in the taxpayer's income for the year.

It is not entirely clear, as currently drafted, whether amounts that are included in a taxpayer's income as imputed interest income fall within the definition of IFR. This includes, *inter alia*, imputed interest income arising under: subsection 12(9) (prescribed debt obligations); section 16.1 (leasing property), section 17 (no or low interest loans); section 17.1 (PLOI elections); and subsection 247(2) (transfer pricing adjustments). Similarly, under the proposed hybrid mismatch arrangement rules, amounts included in income under proposed section 12.7 (especially in situations where proposed subsection 18.4(9) applies in respect of a no or low interest loan, but arguably in other cases as well) should be included in IFR, and we think it might also be appropriate to include foreign affiliate dividends in IFR to the extent the section 113 deduction is restricted by proposed subsection 113(5) (on the basis that the deduction is being restricted because the dividend is treated as a deductible payment, similar to interest, in the payer jurisdiction). Given the policy objectives of the EIFEL rules, we believe such amounts should be included in the definition of IFR. In principle, it should not matter whether an amount that is included in a taxpayer's income represents actual interest income or notional/imputed interest income. If it was intended that such amounts fall within the definition of IFR as currently drafted, it would be helpful to include a statement to this effect in the Explanatory Notes.

Also, as discussed in greater detail below under the "Foreign Affiliates" heading, we believe that FAPI interest revenue should be included in the definition of IFR (and, similarly, that FAPI interest expense should be included in the definition of IFE). This is consistent with the recommendations in the BEPS Action 4 Report: "Where . . . CFC income includes interest income or expense, the country should consider including the interest in the calculation of the parent's net interest expense and excluding that interest from the calculation of the parent's EBITDA."[13] In principle, it should not matter whether interest revenue is earned directly by a taxpayer or indirectly through a controlled foreign affiliate and included in the taxpayer's income as FAPI. We understand that there are concerns that including FAPI interest revenue in a taxpayer's IFR could give rise to inappropriate results in certain cases; however, we believe such concerns can be adequately addressed when incorporating the EIFEL rules into the foreign affiliate regime, as described under the "Foreign Affiliates" heading. It would be unfair and inappropriate in our view to exclude FAPI interest revenue from the definition of IFR.

Further, as discussed under the "Excluded Entities" heading, concerns have been raised that certain portions of the revenue of a securitization vehicle may not qualify as IFR. For instance, where credit cards are securitized, the trust would earn interest and other amounts, including (a) cheque return fees, rush card fees, and overlimit fees, (b) annual membership fees, (c) cash advance fees, balance transfer fees and cash-like transaction fees, (d) inactive account fees, (e)

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[13] BEPS Action 4 Report, *supra* note 1, paragraph 203.

statement reprint fees, and (f) interchange fees. Where residential mortgages are securitized, the trust would earn interest and early repayment premiums. If the recommendation to add a new category to the "excluded entity" definition to address securitization vehicles is not adopted, then we believe the definition of IFR should be amended to include the various types of ancillary income earned by securitization vehicles.

Recommendations

6.1. The definition of IFR should be modified to include imputed interest income, including, *inter alia*, amounts arising under subsection 12(9), section 16.1, section 17, section 17.1 and subsection 247(2) (to the extent the transfer pricing adjustment relates to interest income). If it was intended that such amounts fall within the definition of IFR as currently drafted, this should be clarified in the Explanatory Notes. Similarly, amounts arising under proposed section 12.7 or restricted under proposed subsection 113(5) should be included in the definition of IFR.

6.2. As discussed elsewhere in this submission, FAPI interest revenue should be included in a taxpayer's IFR and excluded from the calculation of ATI, unless another approach with similar effect is chosen, such as including in the taxpayer's ATI an amount equal to the grossed-up unused capacity arising at the foreign affiliate level.

6.3. If our earlier recommendation to add a new category to the "excluded entity" definition to address securitization vehicles is not followed, then we recommend that the definition of IFR be amended to include the various types of income earned by a typical securitization vehicle.

7. <u>Excess Capacity</u>

In situations where a taxpayer has capacity to deduct IFE in excess of its actual IFE, the differential is added to the taxpayer's "excess capacity" for the year and can be claimed by the taxpayer in a subsequent year as "absorbed capacity" or transferred to another Canadian group member. The Explanatory Notes describe a taxpayer's excess capacity as a measure of the amount by which the taxpayer's "capacity" for deducting IFE under the EIFEL rules, generated by its own taxable income and IFR for the year, exceeds the amount of its actual IFE for the year plus its carry forward of RIFE from previous years.

The specific formula is as follows:

$A – B – C$

where[14] A = the amount determined by the formula D x E + F

where D = the ratio of permissible expenses for the year

E = the taxpayer's ATI for the year

[14] The description of each variable has been simplified for ease of reference.

F = the amount determined by the formula G – H x I

where G = the taxpayer's IFR for the year

H = the ratio of permissible expenses for the year

I = the lesser of:

(i) the amount by which the IFR of the taxpayer for the year exceeds the IFE of the taxpayer for the year, and

(ii) either (A) if the ATI of the taxpayer for the year would, in the absence of section 257, be a negative number, the absolute value of the negative number, or (B) in any other case, nil

B = the taxpayer's IFE for the year

C = the amount deductible by the taxpayer under paragraph 111(1)(a.1) in the year.

When applying the above formula to a taxpayer with $300 of IFR, no IFE and no other sources of income or loss (i.e., ATI of nil), the taxpayer would have excess capacity of $300, which could be carried forward for future use or transferred to another Canadian group member. This makes sense, conceptually, since the taxpayer could have deducted $300 of IFE in the year (assuming the ratio of permissible expenses for the year is 30%), if such IFE had been incurred by it (i.e., based on $300 of IFR, which provides for 100% deduction capacity).

While the intent of the excess capacity concept seems clear, we believe the formula has been drafted in a way that that can lead to inappropriate results in certain cases, particularly where the taxpayer has IFR and negative ATI (for instance, due to an operating loss). This is because of variables H and I of the formula which provide for a reduction if (i) the taxpayer has net IFR for the year and (ii) the taxpayer would have negative ATI for the year if the definition allowed negative ATI to be read as the absolute value of the amount that would be its negative ATI (i.e., as if section 257, which deems a negative number arising under an algebraic formula to be nil, did not apply). To illustrate, assume the same example as above, but with the taxpayer having negative ATI of $1,000, in addition to IFR of $300. In this case, the taxpayer's excess capacity for the year would be limited to $210, rather than $300 as determined above:

= (D x E + (G – H x I)) – B - C

= (30% x nil + ($300 – 30% x $300)) - nil – nil

= $210

This is an inappropriate outcome in our view, as the taxpayer could have deducted $300 of IFE in the year if such IFE had been incurred by it, notwithstanding the fact that it had negative ATI. In other words, the taxpayer had the capacity to deduct $300 of IFE in the year, yet the amount of excess capacity generated for the year is only $210. As such, the amount that can be transferred to another Canadian group member would be limited to only $210. Similarly, the amount that can be carried forward by the taxpayer and claimed as "absorbed capacity" in a future year would be limited to only $210. The differential of $90 would not be recognized unless and until the taxpayer's non-capital loss of $700 (i.e., $1,000 - $300) is used to reduce taxable income in subsequent year.

The Explanatory Notes describe the reduction under variables H and I as being necessary because, absent the reduction, the negative ATI for the year would not be appropriately reflected in its deduction capacity. An illustration of the reduction is provided in the Explanatory Notes in the commentary to the "excluded interest" definition.

While we understand that the intention of the reduction and how it works mechanically, we do not believe it provides the appropriate result. For instance, if one group member has IFR of $300 and negative ATI of $1,000 (as described above) and another has IFE of $300, it would only be possible for the first member to transfer $210 of capacity to the second member, which seems unfair and contrary to the policy of the EIFEL regime.

Recommendations

7.1. Variables H and I of the definition of "excess capacity" should be removed from the definition to ensure that capacity resulting from a taxpayer's net IFR is not inappropriately deferred when a taxpayer has negative ATI.

7.2. As a consequential amendment, we recommend that the definition of "adjusted taxable income" be amended to provide an addback for the amount of any net IFR that was factored into a non-capital loss from a prior year that is being claimed by the taxpayer in the current year.

8. Transfer of Cumulative Unused Excess Capacity

Proposed subsection 18.2(4) provides an election that allows a taxable Canadian corporation (the "transferor") to transfer all or a portion of its cumulative unused excess capacity to another taxable Canadian corporation (the "transferee") provided certain conditions are met. The Explanatory Notes state that the intention of this transfer mechanism is to accommodate misalignments between IFE and ATI among Canadian group members that could result in some group members exceeding the permitted fixed ratio under the EIFEL rules, and other group members having ratios below the permitted fixed ratio.

Subparagraph 18.2(4)(b)(iii) – the Same Tax Reporting Currency Requirement

The condition in subparagraph 18.2(4)(b)(iii) requires that both the transferor and transferee have the same tax reporting currency[15] throughout their respective years. We believe that the requirement that the transferor and transferee have the same tax reporting currency throughout the year prevents the stated policy objective of subsection 18.2(4) from being achieved.

As an example, consider a taxable Canadian corporation ("Can Holdco") that is the parent of two taxable Canadian corporations: Aco and Bco.

- Can Holdco, Aco, and Bco are all eligible group corporations in respect of one another and none of the entities are RFIs[16].

- Can Holdco is the external borrower in the group that obtains financing from third party banks in order to fund the operations of Aco (through internal loans) and Bco (through equity contributions).

- Aco is an operating company and carries on an active business in Canada. Aco's tax reporting currency is the Canadian dollar.

- Bco is an operating company and carries on an active business in Canada. Bco has significant number of customers located in the United States and these customers represent the majority of Bco's customer base. As a result, Bco has elected to use the US dollar as its tax reporting currency[17] in order to reflect the commercial reality of its business and manage any foreign exchange issues.

Under the rules in subsection 18.2(4) as currently drafted, Bco would be prohibited from transferring any cumulative unused excess capacity to Can Holdco or Aco. In our view, this result prevents the policy objective noted above from being achieved.

We note that the CRA has issued rulings in the past where taxpayers undertook in-house loss utilization transactions to transfer losses from one entity to another entity within the related/affiliated corporate group that has a different tax reporting currency (see, for example, CRA document #2019-0794891R3). In our view, permitting capacity transfer between taxpayers with different tax reporting currencies would be consistent with the long-standing policy on loss consolidation. Further, we believe that guidance should be provided to taxpayers and CRA that the proposed EIFEL rules are not intended to affect similar in-house loss utilization transactions to promote certainty and predictability.

We recognize that a mechanism may be needed in such circumstances to ensure that currency fluctuations, in and of themselves, do not create excess capacity where none would otherwise exist. If such a control can be put in place, it is difficult to see how the underlying policy

[15] As defined in subsection 261(1) of the Act.
[16] As defined in proposed subsection 18.2(1) of the Act.
[17] Under paragraph 261(3)(b) of the Act.

objectives of the capacity-sharing rules are being harmed by permitting a transfer of cumulative unused excess capacity in such a circumstance.

Recommendations

8.1. The transfer mechanism under proposed subsection 18.2(4) should be revised to accommodate misalignments between net IFE and ATI among taxable Canadian group members that have different tax reporting currency.

8.2. Guidance should be provided to taxpayers and the CRA that the proposed EIFEL rules are not intended to affect in-house loss utilization transactions between Canadian group members with different tax reporting currencies.

<u>Subparagraphs 18.2(4)(b)(i) and (ii) – Taxable Canadian Corporation vs. CRIC</u>

The condition in subparagraph 18.2(4)(b)(i) requires that the transferor and transferee are both taxable Canadian corporations[18] throughout their respective taxation years while the condition in subparagraph 18.2(4)(b)(ii) requires that the transferor and transferee are eligible group corporations[19] in respect of each other at the end of their respective taxation years. As defined in subsection 18.2(1), an eligible group corporation in respect of a particular CRIC is another CRIC that is at that time either (i) related (otherwise than because of a right referred to in paragraph 251(5)(b)) to the particular corporation, or (ii) would, at that time, be affiliated with the particular corporation if section 251.1 were read without reference to the definition "controlled" in subsection 251.1(3). Per the Explanatory Notes in respect of paragraph 18.2(4)(b), these conditions are intended to ensure the transferor and transferee are members of the same corporate group.

In our view, it is unclear why subparagraph 18.2(4)(b)(i) requires the transferor and transferee to be taxable Canadian corporations while subparagraph 18.2(4)(b)(ii) requires that the transferor and transferee be CRICs. Furthermore, this inconsistency does not appear to have any relation to the policy intent of ensuring the transferor and transferee are members of the same corporate group as we believe the CRIC requirement alone is sufficient to achieve this objective.

Recommendation

8.3. The transfer mechanism under proposed subsection 18.2(4) should be revised to accommodate misalignments between net IFE and ATI among taxable Canadian group members that are CRICs (i.e., not only taxable Canadian corporations).

<u>Trusts</u>

Pursuant to the conditions in subparagraphs 18.2(4)(b)(i) and (ii), it appears that all trusts have been excluded from the rules that allow the transfer of cumulative unused excess capacity. It is not clear to us why trusts should be excluded from these rules given that trusts that are part of a

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[18] As defined in subsection 89(1) of the Act.
[19] As defined in proposed subsection 18.2(1) of the Act.

corporate group typically have characteristics similar to those of a corporation. The exclusion of trusts from the excess capacity transfer rules will result in misalignments between net IFE and ATI among Canadian group members that include trusts that could result in some group members exceeding the permitted fixed ratio under the EIFEL rules, and other group members having ratios below the permitted fixed ratio. While the group ratio rules cover a trust that is an eligible group entity, we understand that those rules are designed for a different purpose, contain a different set of conditions and do not appear to provide the same relief that is intended under the excess capacity transfer rules.

Recommendation

8.4. The transfer mechanism under proposed subsection 18.2(4) should be revised to accommodate misalignments between net IFE and ATI among Canadian group members that include trusts. We would be pleased to work with the Department to discuss possible modifications to the rules including any limitations that may need to be put in place.

Financial Institutions

The condition in proposed paragraph 18.2(4)(c) precludes any RFI from sharing any cumulative unused excess capacity with any other eligible group corporations, as financial institutions are expected to often have excess capacity because their regular business activities can result in IFR exceeding IFE. However, the result of this exclusion can be to deny the interest deduction within a group where there is a mismatch between IFE in some entities and IFR in other entities that arises for commercial or regulatory reasons not connected with tax planning. The OECD's Action 4 Report acknowledges many of the issues involved with different approaches to applying a fixed ratio rule to groups that include banking and insurance businesses in particular.[20] Further, we understand that many other countries have no special rules for financial institutions within their earning-stripping regimes.

Consider, for example, a group with a taxable Canadian holding company ("Can Parent") as the parent entity, with a number of subsidiaries that are mostly RFIs. For regulatory and other commercial reasons, it may be desirable (or required) to have Can Parent borrow debt either privately or by accessing the public markets, with such borrowed funds invested as equity in the RFI subsidiaries. In such a case, Can Parent would be expected to have little to no ATI, with the result that most or all of its interest deduction would be denied. This is arguably not the right policy outcome, as the debt in question has been incurred entirely to support the business of RFI subsidiaries that each, on their own, have more than sufficient capacity.

Similar distorting effects can result within groups whose members are exclusively financial institutions but that have differing levels of IFE and IFR, respectively.

[20] BEPS Action 4 Report, *supra* note 1, at paragraphs 518 and following.

Recommendation

8.5. Consideration should be given to modifying the transfer mechanism in subsection 18.2(4), or to providing an alternative, to relieve the distortions that can otherwise arise by not permitting any RFIs to share cumulative unused excess capacity. Potential measures could include the ability for RFIs to share capacity with other RFIs and with other related group entities in a similar or related business, or in situations where separate legal entities are required for regulatory reasons. In that context, consideration should be given to the ability to elect to deem holding companies that have minimal economic activity and whose assets comprise mostly shares of RFIs to themselves be RFIs for purposes of participating in this limited capacity sharing.

Paragraph 18.2(4)(e)

Pursuant to paragraph 18.2(4)(e) and as stated in the Explanatory Notes, all of the transferor's transfers for a taxation year are invalid if the total of the transferred capacity amounts designated by the transferor in elections for the year exceeds its cumulative unused excess capacity for the year. As a consequence, all of the amounts of received capacity otherwise accruing to the transferees under those elections would be nullified. This would be the case even if the excess is a nominal amount.

The Explanatory Notes further state that, to accommodate situations where a reassessment results in an over-transfer (e.g., by increasing the amount of the transferor's IFE for its taxation year in which the transfer election was made), paragraphs 18.2(4)(d) and (f) provide for the filing of an amended election. The ability to file an amended election is provided for the sole purpose of allowing taxpayers to alter the amount designated in the election in cases where a reassessment results in a change in the transferor's cumulative unused excess capacity, or in the transferee's RIFE; it is not intended to be used for retroactive tax planning.

While the ability to file an amended election is helpful, in our view, the elections should not be automatically rendered invalid as a result of any excess described above and a different mechanics should be provided. The calculation of the unused cumulative excess capacity is complex. It is unreasonable that any excess, however immaterial it may be, would result in the denial of all elections of the transferor, in particular where taxpayers have made reasonable efforts to determine the applicable amounts. In addition, where the transferor or a transferee has been disposed off as part of an ordinary commercial transaction and is no longer part of the group, filing an amended election may not be readily available to the parties, which could result in significant complexity and uncertainty for taxpayers that undertake ordinary commercial transactions.

Recommendation

8.6. We recommend that paragraph 18.2(4)(e) be modified such that capacity transfer elections of a transferor are not automatically invalidated by virtue of any excess

described above. We would be pleased to work with the Department to discuss possible modifications to the rules.

9. Anti-Avoidance Provisions

General

Subsections 18.2(12) to (15) contain a series of provisions which are intended to support the integrity of the EIFEL rules. Subsection 18.2(12) is aimed at preventing a non-arm's length group of taxpayers from obtaining a net benefit for the group by entering into transactions amongst themselves that result in asymmetrical tax treatment under the EIFEL rules. Subsections 18.2(13) to (15) are more broadly drafted purpose based anti-avoidance rules which appear to address planning related to the character of income and expense amounts under the EIFEL rules and the status of an entity as an excluded entity.

We recognize that complicated and formulaic provisions, such as the EIFEL rules, may provide a scope for inappropriate taxpayer planning, and that it is reasonable to seek to curtail such planning from the outset of the rules (rather than waiting for it to emerge in practice over time). However, for the reasons set out below, we have significant concerns with the overly broad nature of the provisions as currently drafted. In particular, our primary conceptual concern, especially in relation to subsections 18.2(13) to (15), is that the absence of any notion of abuse in these specific provisions makes it extremely difficult for taxpayers, and the CRA, to delineate between acceptable planning undertaken to comply with the rules and planning designed to inappropriately circumvent the rules. In our view, a fundamental premise underlying these anti-avoidance provisions should be that legitimate commercial transactions – whether deliberately raising share capital without giving rise to IFE, or making an investment in debt which gives rise to IFR as opposed to an alternative form of investment – should be respected for the purposes of the EIFEL rules unless there is an abusive element inherent in the planning.

The BEPS Action 4 Report contemplates that the EIFEL rules should be supported by targeted anti-avoidance rules.[21] In particular, paragraph 171 states that interest deductibility rules should be "…supported by targeted rules to counteract planning undertaken by groups to reduce the impact of these rules,…". That said, paragraph 172 of the report stipulates that the risk of such planning may be addressed by "…standalone rules, specific provisions within the [EIFEL rules] or by other tax rules (such as, for example, a country's general anti-avoidance rule)".

Paragraph 171 of the report also notes a limited number of specific risks that should be addressed including, for example, the conversion of interest expense into a different form of deductible expense or the conversion of other taxable income into a form that is economically equivalent to interest. It is noteworthy that the report contains only a narrow list of specific targeted risks that should be addressed through anti-avoidance provisions, and suggests that these integrity measures may be incorporated into the EIFEL rules in a number of different ways including through existing general anti-avoidance provisions. [22] Conceptually, then, there is nothing unique or special about the EIFEL rules to suggest that a code of specific targeted measures is

[21] Ibid, paragraphs 20 and 171.
[22] Ibid, paragraph 173.

necessarily to be preferred over placing reliance on the General Anti-Avoidance Rule in Section 245 of the Act to address abusive planning.

Subsection 18.2(12)

Proposed subsection 18.2(12) provides, in general terms, that no amount received or receivable by a taxpayer in a particular year from a non-arm's length person or partnership may be included in IFR except to the extent that the amount is contemporaneously included in IFE to the payor. According to the Explanatory Notes, this provision is intended to ensure the integrity of the EIFEL rules by requiring symmetry in treatment between non-arm's length parties.

We accept in principle that a group of related Canadian entities should not be able to "game" the EIFEL rules by entering into non-commercial asymmetrical transactions the only ostensible purpose of which is to inappropriately improve the overall application of the rules to the group. However, we believe that asymmetry in and of itself cannot be the only guiding principle, and that this provision should accommodate the normal tax results of ordinary commercial transactions. Furthermore, we note that the BEPS Action Item 4 Report does not appear to explicitly include a recommendation that countries consider enacting a similar type of rule to address symmetry. If the government believes that such a provision is necessary, the scope of this provision should be restricted to certain targeted situations. Such an approach would also seem to be consistent with the recommendation of paragraph 171 of the BEPS Action Item 4 Report. Some of our more specific concerns relating to this provision are described below.

In particular, IFR received or receivable by a taxpayer from a non-arm's length non-resident should be included in the determination of IFR. We believe the inclusion of such income is appropriate from a policy perspective, and consistent with the recommendations of BEPS Action Item 4 Report, because it increases a taxpayer's taxable income, or reduces its loss, and is beneficial to the Canadian economy (i.e., foreign source income is being captured by the Canadian tax net). Furthermore, such an inclusion of foreign source interest (and similar types of income) is appropriate regardless of whether that income is received from a foreign affiliate, a controlled foreign affiliate, or other non-resident. While we acknowledge that there could be, at least in certain circumstances, potential policy concerns associated with the inclusion of interest (and similar types of income) earned from foreign affiliates (e.g., inappropriate creation of deduction capacity), any such concerns should be alleviated if the EIFEL rules apply for purposes of computing FAPI of a foreign affiliate with appropriate modifications, as discussed in detail under the "Foreign Affiliates" heading below.

Even in a wholly domestic context, it appears that this rule, as currently drafted, could give rise to inappropriate results from a technical and policy perspective unless it is drafted in a more restrictive manner.

For example, assume that a taxable Canadian corporation (Canco 1) receives interest income from a partnership. Although one of the partners (e.g., a general partner and/or significant (say, 51%) limited partner) of the partnership is a taxable Canadian corporation (Canco 2) that does not deal at arm's length with Canco 1, the remainder of the partners deal at arm's length with Canco 1. Assume further that: (i) the other arm's length partners comprise one or more individuals, non-residents or tax-exempts; (ii) the partnership is formed to develop and own a rental real estate project (for example, a shopping centre or an apartment building, which will be held as capital property by the partnership); and (iii) during the construction phase of the project, and prior to the receipt of permanent financing on the completed project, Canco 1 agrees to loan funds on commercial terms to the partnership to fund construction costs.

These construction costs, including interest on the loan, will be capitalized into the cost of the project for tax purposes and the interest component will constitute IFE under paragraph (c) thereof, but only in future years when capital cost allowance on the project is claimed. Pursuant to subsection 18.2(12), it appears that the interest income received by Canco 1 (and on which it is immediately taxable) will not be included in IFR for the year because the amount is not included in IFE to the partnership (and its partners) for the year in which the interest is paid or payable.

This result does not seem to be appropriate. Although there is asymmetrical treatment under the EIFEL rules, this is no different than the asymmetrical treatment of the amounts generally for tax purposes (giving rise to immediate taxation of the interest receivable but a deferred deduction of the interest payable). Second, leaving aside this timing issue, it appears that 49% of the interest received by Canco 1 will never form IFR (again, even though the interest is immediately taxable to Canco 1) because that amount is never deductible in computing the IFE of a taxable Canadian corporation or a trust resident in Canada. The transaction in this example reflects a legitimate commercial transaction that is not motivated by any attempt to circumvent the EIFEL rules and in our view, there is no obvious reason why the normal tax results of this arrangement need to be changed for the purpose of applying the EIFEL rules.

Subsections 18.2(13) and (14)

In general terms, subsection 18.2(13) provides that any amount, that is not included in IFE, must be so included if one of the purposes of the transaction, event or series is to avoid an IFE inclusion. Subsection 18.2(14) essentially works in the opposite manner, by excluding an amount from IFR where one of the purposes of the transaction, event or series is to create an IFR inclusion in order to obtain a tax benefit.

Our fundamental difficulty with these provisions relates to the broad and vague manner in which they are drafted, and the low threshold for application created by the "one of the purposes" test. Although the Explanatory Notes elaborate on these provisions somewhat, the discussion seems mostly to reinforce the breadth of these provisions, without providing any substantive guidance or examples of specific planning that is intended to be captured by the provisions (or, of equal importance, the nature of planning to comply with the EIFEL rules which should not be caught). While we expect that the Department would agree that the intention of these provisions is meant to be more narrow in focus, perhaps to apply to certain forms of inappropriate character

conversion, the Explanatory Notes do not state this specifically and the words of the provisions themselves are readily applicable to ordinary, including "self help", transactions. The examples below highlight these challenges, and support our position noted above that only abusive transactions should be subject to these rules.

We would also note that the definitions of IFE (paragraph (d)) and IFR (variable B) themselves already appear to contain broadly drafted provisions which appear to contemplate economic equivalence.

Example 1

Purchaser, a corporation resident in Canada ("CRIC"), borrows money from a third party bank and purchases the shares of Target, another CRIC, from an arm's length person. Purchaser and Target cannot be amalgamated due to commercial reasons. Post closing, in order to push debt into Target, Purchaser transfers the shares of Target to a new subsidiary ("Cansub") in exchange for shares of Cansub and an interest-bearing promissory note ("Cansub Note"). Cansub and Target are then amalgamated.

Our concern is that the broad wording of subsection 18.2(14) would allow the CRA to assert that one of the purposes of the transaction noted above is to increase Purchaser's IFR for the year (i.e., interest revenue earned on the Cansub Note) in order to obtain a tax benefit (i.e., to allow Purchaser to increase its interest deductibility room under the EIFEL rules). The above example represents a fairly common form of post-acquisition structuring that is undertaken in the context of a third party share acquisition wherein debt is pushed down into a target operating company given the lack of any tax consolidation rules in Canada.

Example 2

ACo, a CRIC, has IFE that is denied under subsection 18.2(2). ACo plans to make an investment in BCo, also a CRIC. The investment options available to ACo are either debt (in the form of an interest-bearing loan to BCo ("BCo Loan")) or preferred shares of BCo. The economic returns earned by ACo under both alternatives are expected to be substantially similar. ACo chooses to invest in debt, as opposed to preferred shares, specifically because the interest income will increase its IFR.

Our concern is that the broad wording of subsection 18.2(14) would allow the CRA to assert that one of the purposes of structuring all or a portion of the investment in BCo as debt financing rather than equity financing in the scenario above, would be to increase ACo's IFR for the year (i.e., by the interest revenue earned on the BCo Loan) in order to obtain a tax benefit (i.e., to allow ACo to increase its interest deductibility room under the EIFEL rules). In our view, this type of decision (or the similar decision to raise equity instead of debt financing, even for the principal purpose of avoiding IFE) should not be subject to the anti-avoidance provisions.

Example 3

Canco is a CRIC and part of a multinational group that includes two foreign affiliates, NR Finco and NR Opco. The financing structure of the multinational group, prior to the application of the EIFEL rules is as follows: Canco borrows externally from a third party bank and makes investments in the equity of NR Finco. NR Finco uses the cash from this equity financing to debt finance NR Opco by way of an interest-bearing intercompany loan ("NR Opco Loan").

The multinational group is restructured in order to onshore the interest income earned by NR Finco and comply with the EIFEL rules. Namely, NR Finco distributes the NR Opco Loan to Canco such that the interest income earned on the NR Opco Note is now earned directly by Canco which increases Canco's IFR and the Canadian tax base.

Our concern is that the broad wording of subsection 18.2(14) would allow the CRA to assert that one of the purposes of the restructuring noted above is to increase Canco's IFR for the year (i.e., interest revenue earned on the NR Opco Loan that is now directly held by Canco) in order to obtain a tax benefit (i.e., to allow Canco to increase its interest deductibility room under the EIFEL rules). From a policy perspective, the onshoring of interest income should not offend the underlying policy intent of the EIFEL rules as it increases the Canadian tax base. As such, this result does not seem to adhere to the policy intent behind the EIFEL rules as it penalizes the onshoring of interest income and prevents taxpayers from engaging in self-help transactions in order to arrange their affairs in such a way as to comply with the EIFEL rules both technically and in policy. The broad wording of subsection 18.2(14) creates meaningful uncertainty in this regard.

Example 4

Profitco 1 and Profitco 2 are taxable Canadian corporations that are profitable. Lossco is a taxable Canadian corporation with non-capital loss carry forwards. Lossco has external debt on which it pays interest. Profitco 1, Profitco 2 and Lossco are all eligible group entities in respect of one another and are all part of the same Canadian group. The group enters into a loss consolidation arrangement as follows: Profitco 1 and Profitco 2 form a partnership ("Profitco Partnership"). Profitco Partnership obtains a daylight loan from a third party bank and uses the cash received to subscribe for preferred shares of Lossco. Lossco uses the cash received on the subscription to make a commercially reasonable interest-bearing loan ("IB Loan") to Profitco Partnership and it repays the daylight loan. As the IB Loan is a loan between a corporation and a partnership, a joint election is not available to treat the interest paid by Profitco Partnership to Lossco as excluded interest.

Our concern with respect to the above example is that the broad wording of subsection 18.2(14) may allow the CRA to assert that one of the purposes of entering into the loss consolidation arrangement was to increase Lossco's IFR (i.e., the interest revenue earned by Lossco on the IB Loan) in order to obtain a tax benefit (i.e., to allow Lossco to increase its interest deductibility room under the EIFEL rules). This result is particularly unreasonable as the loss consolidation arrangement undertaken is fully sanctioned by the CRA and commonly used in related and affiliated groups where there are multiple profitable entities. However, as the arrangement includes the use of a partnership, the excluded interest election that is meant to facilitate such loss consolidation arrangements is unavailable.

Example 5

Corporation A, a CRIC, owns a partnership interest in Partnership A. Partnership A earns business income (not IFR) but also incurs IFE which is allocated to its partners, including Corporation A. Corporation A will be offside the EIFEL rules in 2023 and subsequently by virtue of this allocated IFE. Corporation B, an eligible group corporation in respect of Corporation A, has excess capacity. As a commercial matter, the group is indifferent as to whether the partnership interest is owned by Corporation A or Corporation B, and it would be possible for Corporation A to transfer the partnership interest to Corporation B on a rollover basis, if necessary. The group decides that the partnership interest should be transferred to Corporation B to avoid the complexities noted above with subsection 18.2(4).

Our concern in respect of the above example is that the use of the phrase "any amount" in the preamble of subsection 18.2(13) and the broad purpose test contained in the subsection may allow the CRA to assert that the application of subsection 18.2(13) would cause the IFE incurred by Partnership A to be allocated to Corporation A even after Corporation A has disposed of its partnership interest and is no longer legally entitled to any partnership allocation from Partnership A. Furthermore, it appears that the same IFE would also be included in the calculation made by Corporation B following the transfer, and it does not seem that subsection 248(28) would necessarily resolve this double counting issue. In our view, there is no mischief with this transaction, even if the requirements of subsection 18.2(4) would not permit a transfer of excess capacity. There is nothing which mandates that this investment must continue to be owned by Corporation A, and Corporation B will have all of the legal rights and obligations associated with this investment following the transfer.

<u>Subsection 18.2(15)</u>

Subsection 18.2(15) applies for the purposes of the definition of "excluded entity," and deems a person or a partnership to be a tax-indifferent investor in relation to a taxpayer where amounts are paid or payable to the person or partnership as part of a transaction, event or series one of the purposes of which is to avoid an amount of IFE being paid by the taxpayer to a tax-indifferent investor. Although the wording of this provision is also quite broad, at least the Explanatory Notes contain two specific examples of the mischief underlying this provision, relating to back-to-back arrangements and coupon stripping.

Example 6

Aco is a corporation resident in Canada. Aco has outstanding debt owing to a tax exempt, a tax-indifferent investor, which causes Aco not to be an excluded entity for the purposes of the EIFEL rules. Aco wishes to refinance this debt so that it can qualify as an excluded entity. Aco borrows from a Canadian bank and repays the debt owing to the tax-exempt entity.

There is concern that the broad wording of subsection 18.2(15) may allow the CRA to assert that one of the purposes of the transaction described above is to avoid the IFE being paid or payable to a tax-indifferent investor and the Canadian bank is therefore deemed to be a tax-indifferent investor in respect of Aco.

Recommendations

9.1. We believe that the GAAR should be sufficient to prevent the type of abusive planning that subsection 18.2(12) is intended to address. However, if the Department believes that a specific targeted provision is necessary, we believe that it must specifically permit interest received from non-residents to be included in IFR, and that it must be drafted in a manner that properly accounts for timing mismatches and the breadth of the rules (particularly in a partnership context). As noted above, we do not believe as a general premise that asymmetry of treatment under the EIFEL rules is necessarily wrong in principle where that asymmetry is consistent with the application of normal tax rules and/or arises from legitimate commercial transactions.

9.2. In relation to subsections 18.2(13) to (15), we recommend that these provisions be removed from the EIFEL rules and reliance should instead be placed on the GAAR to support the integrity of the EIFEL rules. There is much discussion about these rules, and this should provide a reasonable benchmark for a determination of whether specific planning is abusive in any particular circumstance. If this recommendation is not accepted, we believe that these provisions should be re-drafted with a much narrower focus, including a misuse or abuse component, and that specific examples should be included in the Explanatory Notes to provide guidance to taxpayers. We would be pleased to work with the Department to begin to formulate guidance which seeks to establish the proper line between acceptable planning to comply with the rules and inappropriate circumvention of the rules.

10. <u>Foreign Affiliates</u>

The EIFEL rules, as currently drafted, do not include any provisions specific to foreign affiliates, nor is there any commentary included in the Explanatory Notes regarding foreign affiliates. We understand the details on how to incorporate the EIFEL rules into the foreign affiliate regime are still under consideration, and that feedback on this area is welcome during the consultation period.

In our view, the general construct for incorporating the EIFEL rules into the foreign affiliate regime should, at minimum, address the following fundamental areas:

- Although the EIFEL rules should apply, with appropriate modifications, for purposes of computing FAPI, these rules should not apply for purposes of computing active business income, including where paragraph 95(2)(f) applies to compute deemed active business income; and

- Amounts included in a taxpayer's income as FAPI should be included in the taxpayer's ATI, except where the amounts are FAPI interest revenue or expense, in which case the FAPI interest revenue or expense should be included in the taxpayer's IFR or IFE, as the case may be, and excluded from the calculation of ATI.

Each of these concepts is discussed in more detail below. In addition, there are various other foreign affiliate issues that warrant additional consideration, some of which are discussed below. We would be pleased to work with the Department on these concepts, including potential issues and considerations, in more detail.

Active Business Income

As noted, we believe it is important that the scope of the EIFEL rules be limited to the computation of FAPI, and not apply for purposes of computing a foreign affiliate's active business income or deemed active business income.

Generally, under subparagraphs (a)(i) and (ii) of the definition of "earnings" in Regulation 5907(1), the earnings of a foreign affiliate from an active business carried on by it are computed in accordance with the tax laws of the country in which the foreign affiliate is resident or the country in which the business is carried on. However, under subparagraph (a)(iii) of that definition, where a foreign affiliate is not required to compute its income or profit under the tax laws of the country in which it is resident or the country in which the business is carried on, the earnings of the foreign affiliate are computed using Canadian tax rules, as if the foreign affiliate were resident in Canada, but without reference to certain provisions such as the thin capitalization rules in subsection 18(4). This would be the case, for instance, if a foreign affiliate were resident and carrying on business in a country that does not impose tax or if the foreign affiliate is a disregarded entity for foreign tax purposes (e.g., a disregarded U.S. limited liability company).

Similarly, under paragraph (b) of the definition of "earnings", together with the income computation rules in paragraphs 95(2)(f) and (f.11), the earnings of a foreign affiliate from an active business are computed as if the foreign affiliate were resident in Canada. Such earnings are also determined without reference to certain provisions such as the thin capitalization rules in subsection 18(4).

If the EIFEL rules were to apply for the purposes of computing a foreign affiliate's earnings from an active business, the exempt (or taxable) earnings and thus exempt (or taxable) surplus of the foreign affiliate would be artificially inflated, either temporarily or permanently, in scenarios where the amount of interest expense incurred by the foreign affiliate exceeds the amount permitted to be deducted under the EIFEL rules in respect of a particular taxation year, as the earnings of the foreign affiliate would only be reduced by the deductible portion. Assume, for instance, that a foreign affiliate ("FA Opco") is carrying on an active business that generates tax EBITDA of $100 and incurs third party interest expense of $40. If the EIFEL rules were to apply, the amount of interest expense that is deductible in computing the earnings of FA Opco would be limited to $30 (assuming a ratio of permissible expenses for the year of 30%), thereby resulting in exempt (or taxable) earnings and thus exempt (or taxable) surplus of $70 rather than

$60 with such difference potentially being permanent in the absence of a provision similar to Regulation 5907(2)(j).

Further, in the case of interest, or similar amounts, paid or payable by one foreign affiliate to another that would otherwise qualify as deemed active business income under paragraph 95(2)(a), any portion of the interest expense that is not deductible by the payor affiliate by virtue of the EIFEL rules may no longer qualify as deemed active business income of the payee affiliate and instead give rise to FAPI, which is an inappropriate result in our view. To illustrate, assume the same example as above, but with FA Opco having been financed with an internal loan from another foreign affiliate ("FA Finco") rather than third party debt. If the EIFEL rules were to apply for purposes of computing the earnings of FA Opco and resulted in a permanent denial of $10 of interest expense, in the absence of a provision similar to Regulation 5907(2)(j) then only $30 of the $40 of interest expense incurred by FA Opco would be deductible, thereby artificially inflating the exempt (or taxable) earnings of FA Opco by $10, as discussed above, and resulting in $10 of the $40 of interest income earned by FA Finco being FAPI rather than deemed active business income.

In principle, the EIFEL rules should have no impact on the computation of earnings from an active business, nor should the EIFEL rules impact whether an amount of interest, or similar amount, paid from one foreign affiliate to another foreign affiliate qualifies as deemed active business income.

Recommendation

10.1. Subparagraph (a)(iii) and paragraph (b) of the definition of "earnings" in Regulation 5907(1) should be amended to provide that the earnings of a foreign affiliate are to be computed without reference to section 18.2. In addition, the language in the preamble to paragraph 95(2)(a) should be amended to clarify that it is to be applied without reference to section 18.2.

Impact of FAPI on Deduction Capacity in Canada

As indicated above, we believe amounts included in a taxpayer's income as FAPI should be included in the taxpayer's ATI, except where the amounts are FAPI interest revenue or expense, in which case the FAPI interest revenue or expense should be included in the taxpayer's IFR or IFE, as the case may be, and excluded from the calculation of ATI.

This view is consistent with the recommendations in paragraph 203 of the BEPS Action 4 Report:

> Where a country applies CFC rules alongside interest limitation rules, CFC income which is subject to tax on the parent company may be included in the calculation of the parent's EBITDA when applying the fixed ratio rule and group ratio rule. Where this CFC income includes interest income or expense, the country should consider including the interest in the calculation of the parent's net interest expense and excluding that interest from the calculation of the parent's EBITDA.

It would be inappropriate, in our view, for FAPI interest revenue and expense to be treated in the same manner as other types of FAPI and included in ATI rather than IFR and IFE. To illustrate, assume a taxpayer incurs $100 of interest expense in Canada, and a controlled foreign affiliate of the taxpayer earns $100 of interest income from arm's length parties, which is included in the taxpayer's income under subsection 91(1). If the FAPI interest revenue were included in ATI rather than IFR, then only $30 of the interest expense incurred by the taxpayer would be deductible, leaving the taxpayer with $70 of taxable income even though there has been no net interest or financing expense incurred from an economic standpoint. However, if the FAPI interest revenue were included in IFR rather than ATI, as recommended in the BEPS Action 4 Report, then the interest expense incurred by the taxpayer would be fully deductible, which is the appropriate outcome in this case. In principle, when determining a taxpayer's net IFE, it should not matter whether the interest revenue was earned directly by the taxpayer or indirectly through a controlled foreign affiliate and included in the taxpayer's income as FAPI.

At the same time, we understand that there are concerns that including FAPI interest revenue in a taxpayer's IFR could give rise to inappropriate results in certain cases, insofar as other types of FAPI that would otherwise be included in a taxpayer's ATI could be converted into FAPI interest revenue, thereby increasing the taxpayer's capacity to deduct interest. For instance, assume a controlled foreign affiliate ("CFA1") earns $100 of non-interest FAPI that is included in the taxpayer's income under subsection 91(1). Such amount would be included in the taxpayer's ATI which would increase its capacity to deduct interest by $30 (i.e., $100 x 30%). However, if CFA1 was financed with a loan from another controlled foreign affiliate ("CFA2") and paid interest of $30 to CFA2, there would be $70 of net FAPI for CFA1 and $30 of FAPI interest revenue for CFA2, which would increase the taxpayer's capacity to deduct interest to $51 (i.e., ($70 x 30%) + ($30 x 100%)). We agree that having a different capacity to deduct interest in these two scenarios is inappropriate.

However, in our view, the incremental capacity that results in the above example does not arise from the FAPI interest revenue of CFA2 being included in IFR, but rather from the net FAPI of CFA1 being included in ATI, even though the capacity to deduct interest at the CFA1 level has been fully used. The same increase in deduction capacity would occur, for instance, if CFA1 were financed with external debt rather than an internal loan and paid $30 of interest to arm's length parties rather than to CFA2. In that case, $30 of interest would be deducted at the CFA1 level, and the remaining $70 of net FAPI would be included in the taxpayer's ATI, which would provide capacity to deduct additional interest of $21 at the taxpayer level (i.e., $70 x 30%), meaning $51 of capacity overall: $30 at the CFA1 level and $21 at the taxpayer level. We believe the duplication of deduction capacity in this case is an unintended outcome, but one that exists nevertheless within the EIFEL regime unless appropriate modifications are made.

We can envision several potential approaches that might provide the appropriate result of including FAPI interest revenue in IFR rather than ATI, without allowing for inappropriate increases in deduction capacity. We recognize that this is a complex area and that many different fact patterns will need to be analyzed to ensure the results make sense under each of those fact patterns. However, to illustrate the general concept of the various approaches, we use the following example. Assume a Canadian corporation ("Canco") owns all the shares of two

controlled foreign affiliates ("CFA1" and "CFA2"). Canco has $100 of directly-earned ATI and incurs $50 of external interest expense. CFA1 has non-interest FAPI of $40 prior to consideration of related interest expense of $9 that was incurred on a loan payable to CFA2. CFA2 has $9 of FAPI interest revenue on the loan receivable from CFA1 and has no other sources of income or expense. Conceptually, if there were no foreign affiliates in the group and all income was earned by Canco directly, there would be $140 of ATI and the capacity to deduct $42 of interest (i.e., $140 x 30%), with the remaining $8 of interest being carried forward.

The first approach is to attribute FAPI (excluding any FAPI interest revenue and expense) to the taxpayer, which would be included in ATI, and then separately attribute any FAPI interest revenue and expense to the taxpayer, which would be included in IFR and IFE. In this case, Canco would be attributed $40 of FAPI (excluding FAPI interest revenue and expense) and would also be attributed $9 of FAPI interest revenue and $9 of FAPI interest expense. The net result in this case would be an increase to ATI of $40, and an increase to both IFR and IFE of $9 each which would effectively offset. As such, Canco would have a total ATI of $140 (i.e., $100 of directly-earned ATI plus $40 of FAPI) and would have capacity to deduct $42 of interest, with the remaining $8 of interest being carried forward. Under this approach, it seems that inter-affiliate loans would not artificially increase deduction capacity, as both the FAPI interest revenue and FAPI interest expense would be attributed to the taxpayer. At the same time, FAPI interest revenue that is not deductible in computing FAPI from other sources would give rise to IFR, which is appropriate (for instance, interest from third parties, or interest from related parties other than foreign affiliates). Further, any capacity that has been used at the foreign affiliate level would not give rise to incremental deduction room at the taxpayer level, which is also appropriate. For instance, if a controlled foreign affiliate had $100 of non-interest FAPI prior to consideration of related third party interest expense of $30, the taxpayer would be allocated $100 of ATI and $30 of IFE, meaning no incremental capacity to deduct interest would be created at the taxpayer level.

The second approach is to exclude FAPI from the calculation of ATI in the first instance. Instead, capacity would be computed at the foreign affiliate level and the taxpayer's ATI would be increased by the grossed-up amount of unused capacity at the foreign affiliate level multiplied by the taxpayer's participating percentage in the foreign affiliate. The gross-up factor would be equal to the amount of unused capacity divided by the ratio of permissible expense (which for all years, other than the transitional year, would be 1/30% or 3.3333). Under the example above, CFA1 would have unused capacity of $3 (i.e., $40 of ATI x 30%, less $9 of IFE) and CFA2 would have unused capacity of $9 (i.e., $9 of IFR). As such, Canco's directly-earned ATI of $100 would be increased by $40, being the $3 of unused capacity of CFA1 multiplied by the gross-up factor 3.3333 (i.e., $10) plus the $9 of unused capacity of CFA2 multiplied by the gross-up factor 3.3333 (i.e., $30). Similar to the previous example, it is not anticipated that inter-affiliate loans could be used to artificially increase deduction capacity, nor could any capacity that has been used at the foreign affiliate level give rise to incremental deduction room at the taxpayer level.

The third approach is similar to the second approach, in that FAPI would be excluded from the calculation of ATI and, instead, capacity would be computed at the foreign affiliate level. However, unlike the second approach, the unused capacity would not be automatically included

in the taxpayer's ATI based on a gross-up factor. Rather, the ability to transfer capacity would be extended so that unused capacity of a controlled foreign affiliate of a Canadian corporate taxpayer could be transferred to the taxpayer or to another Canadian corporation with which the taxpayer does not deal at arm's length. In effect, under this approach, a FAPI-earning controlled foreign affiliate would be treated similarly to a Canadian corporate member of the group. Turning to the example above, CFA1 would have unused capacity of $3 (i.e., $40 of ATI x 30%, less $9 of IFE) and CFA2 would have unused capacity of $9 (i.e., $9 of IFR) and each could designate that its capacity transfer be transferred to Canco. As a result, Canco would have a total capacity of $42, which would include $30 of capacity based on its directly-earned ATI of $100 (i.e., $100 x 30%) plus $3 of capacity transferred from CFA1 and $9 of capacity transferred from CFA2. Consistent with the previous example, it is not anticipated that inter-affiliate loans could be used artificially increase deduction capacity, nor could any capacity that has been used at the foreign affiliate level give rise to incremental deduction room at the taxpayer level.

Recommendations

10.2. Amounts included in a taxpayer's income as FAPI should be included in the taxpayer's ATI, except where the amounts are FAPI interest revenue or expense, in which case the FAPI interest revenue or expense should be included in the taxpayer's IFR or IFE, as the case may be, and excluded from the calculation of ATI.

10.3. Alternatively, consideration could be given to excluding all FAPI from the taxpayer's ATI and instead determining unused capacity at the controlled foreign affiliate level, and then either (i) including in the taxpayer's ATI an amount equal to the grossed-up unused capacity at controlled foreign affiliate level or (ii) allowing a controlled foreign affiliate of a Canadian corporate taxpayer to transfer unused capacity to the taxpayer or to another non-arm's length Canadian corporation.

10.4. If neither of these recommendations is adopted, then at minimum any FAPI interest revenue earned by a controlled foreign affiliate should be included in the taxpayer's IFR unless it has been deducted in computing the non-interest FAPI of another controlled foreign affiliate.

<u>ACB and Taxable Surplus</u>

It would be helpful to clarify the intended impact of the EIFEL rules on the ACB and taxable surplus balances of FAPI-earning controlled foreign affiliates. If a FAPI-earning controlled foreign affiliate incurs interest beyond the EFIEL limits, the interest deduction would be limited to the amount permitted under the EIFEL rules, and any excess amount would be included in the taxpayer's income as FAPI. By virtue of the denied interest deduction, the taxpayer would have a higher ACB in the shares of the controlled foreign affiliate than it would otherwise have, which could lead to a capital loss if the affiliate were to be sold to a third party or wound-up. It is not clear whether this result in intended. To illustrate, assume a Canadian corporation ("Canco") owns all the shares of a controlled foreign affiliate ("CFA1"). CFA1 earns non-interest FAPI of $100 and incurs $50 of external interest expense, thereby generating cash of $50. For FAPI

computation purposes, the interest deduction would be limited to $30, leaving CFA1 with net FAPI of $70 and taxable surplus of $70. Canco would have an income inclusion under subsection 91(1) of $70 and the ACB of its shares in CFA1 would increase by $70 under subsection 92(1). If Canco were to sell the shares of CFA1 to a third party or if CFA1 were wound-up into Canco, it appears that a capital loss could be recognized by Canco in the amount of $20, being the difference between the increase in the ACB of its shares in CFA1 ($70) and the increase in the net assets of CFA1 ($50). Similar outcomes can arise outside of the EIFEL rules (for instance, where a FAPI-earning controlled foreign affiliate incurs non-deductible expenses, such as 50% of meals and entertainment); however, it would seem that this outcome may be amplified once the EIFEL rules are introduced.

Recommendation

10.5. If the outcome described above is not intended, consideration could be given to having the ACB increase under subsection 92(1) be determined without reference to subsection 18.2. However, in that case, it would be appropriate to include a similar carve-out that ensures subsection 18.2 does not apply for surplus purposes either, as it would be inappropriate to limit the ACB increase without limiting the taxable surplus increase in an equivalent way.

Upstream Loans

Under the EIFEL rules as currently drafted, inappropriate outcomes arise if a controlled foreign affiliate makes an interest-bearing upstream loan to its Canadian parent corporation or to another non-arm's length Canadian corporation. In particular, it appears that interest expense at the taxpayer level would be included in IFE and subject to the interest limitation rules while the FAPI interest revenue that arises at the foreign affiliate level would be included in ATI, not IFR. As such, absent other income or expenses, only 30% of the interest expense incurred by the taxpayer would be deductible, while 100% of the corresponding FAPI inclusion would be taxable.

To ensure that inappropriate results do not arise in the case of upstream loans, we suggest that upstream loans from a controlled foreign affiliate to a Canadian corporation be eligible for "excluded interest" treatment. Alternatively, and depending upon the approach adopted for the treatment of the interest income of a controlled foreign affiliate (e.g., included in the IFR of the taxpayer, etc.,), a rule similar to, but appropriately broader in scope than, the existing one in subsection 18(8) could be introduced such that interest expense incurred by a Canadian corporation is excluded from the EIFEL rules to the extent the interest income is included in the income of the corporation (or another non-arm's length Canadian person) under subsection 91(1).

Recommendations

10.6. Upstream loans from a controlled foreign affiliate to a Canadian corporation should be eligible for "excluded interest" treatment.

10.7. Alternatively, a rule similar to, but appropriately broader in scope than, the existing one in subsection 18(8) could be introduced to provide that interest expense incurred by a Canadian corporation is excluded from the EIFEL rules to the extent the interest income is included in the income of the corporation (or another non-arm's length Canadian person) under subsection 91(1).

Excluded Interest

The EIFEL rules allow two Canadian corporations to jointly elect that one or more interest payments made by one corporation to the other be excluded from the interest limitation under subsection 18.2(2). In our view, it would be appropriate to have a similar concept for loans between two FAPI-earning controlled foreign affiliates. For instance, assume CFA1 is carrying on an investment business and CFA2 makes an interest-bearing loan to CF1 to finance its investment business, with the interest expense of CFA1 exceeding 30% of its tax EBITDA. It would be appropriate in these circumstances to allow CFA1 and CFA2 to treat the interest payments on the inter-affiliate loan as "excluded interest".

Recommendation

10.8. The concept of "excluded interest" should be expanded to apply to loans between two controlled foreign affiliates, and also to loans between Canadian corporations and controlled foreign affiliates – at minimum, in the case of upstream loans, as discussed above.

Capacity Transfers

The EIFEL rules allow a Canadian corporation to transfer all or a portion of its cumulative unused excess capacity to another Canadian corporation that is a member of the same corporate group. In our view, it would be appropriate to have a similar rule that allows one FAPI-earing controlled foreign affiliate to transfer its cumulative unused capacity to another FAPI-earning controlled foreign affiliate. For example, assume CFA1 and CFA2 are both carrying on investment businesses, with the investment business of CFA1 being highly leveraged and the investment business of CFA2 having no leverage. It would be appropriate in these circumstances to allow CFA2 to transfer its cumulative unused excess capacity to CFA1.

Recommendation

10.9. The election in subsection 18.2(4) to transfer cumulative unused excess capacity between Canadian corporations should be expanded to allow for similar capacity transfers between two controlled foreign affiliates and also, potentially, between Canadian corporations and controlled foreign affiliates.

Loans to Foreign Affiliates

As described under the "Anti-Avoidance Provisions" heading above, there should be no restriction under subsection 18.2(12) for IFR received from foreign affiliates, nor from other

non-resident persons. While we acknowledge that there could perhaps be, at least in certain circumstances, potential policy concerns associated with the inclusion of interest (and similar types of income) earned from foreign affiliates (e.g., inappropriate creation of deduction capacity), any such concerns should be alleviated if the EIFEL rules apply for purposes of computing FAPI of a foreign affiliate with appropriate modifications.

Recommendation

10.10. As discussed above, we believe that GAAR should be sufficient to prevent the type of abusive planning that subsection 18.2(12) is intended to address. However, if the Department believes that a specific targeted provision is necessary, we believe that it should specifically permit interest received from non-residents (including foreign affiliates) to be included in IFR.

11. Group Ratio

As described in the Explanatory Notes, the group ratio rules allow a taxpayer to deduct IFE in excess of the fixed ratio, provided (in general) that the taxpayer is a member of an accounting consolidated group whose ratio of net third-party interest expense to book EBITDA exceeds the fixed ratio and the group is able to demonstrate this based on audited consolidated financial statements. The "consolidated group" is defined in subsection 18.21(1) as an ultimate parent and all the entities that are fully consolidated in the parent's consolidated financial statements, or that would be if the group were required to prepare such statements under IFRS. Under proposed subsection 18.21(5), the group ratio rules can also in certain cases apply to a single entity.

Conditions for the Application of Group Ratio Rules

Subsection 18.21(2) sets out the main conditions for the application of the group ratio rules. A number of concerns have been expressed in relation to these conditions.

Status of Canadian Group Members

Under subparagraph 18.21(2)(a)(i), each Canadian group member must be, throughout the relevant taxation year, either a taxable Canadian corporation or a trust resident in Canada. Thus, where a corporate member of the group is resident in Canada but not incorporated in Canada, the group is unable to access the group ratio rules.

Second, where a corporate member of the group is exempt from taxation under Part I of the Act, the group is unable to access the group ratio rules. It is unclear how the existence of corporate member of the group that is exempt from taxation under Part I of the Act could result in consequences that are adverse to the purpose of these rules. Tax-exempt corporations do not pose a risk of taking on excessive leverage because of tax considerations. While they may tend to hold interest-income generating assets to a greater degree than certain taxable corporations, this can only disproportionately reduce the group net interest expense of the consolidated group. On the other hand, it is conceivable that a group could disproportionately allocate capacity to taxable members, given that exempt members would be indifferent in this regard. If that is the

concern, it would be conceivable that this could be addressed without a complete disqualification of the group – perhaps by having a mandatory priority allocation to an exempt member up to its specified interest income. We would also note that the presence of a tax-exempt non-resident member of the group would not preclude the group from accessing the group ratio rules. The same should be true where there is a tax-exempt member of the group that is resident in Canada.

Third, it is not clear why a non-resident corporation or trust should not be permitted to access the group ratio rules in respect of its taxable income earned in Canada. In that respect, the general approach under the Act is to treat a non-resident corporation in a manner that is analogous to the treatment of a resident of Canada. That approach is also generally required under Canada tax treaties – for example, under Article XXV(5) of the *Canada-United States Income Tax Convention*, which is consistent with Article 24(3) of the *OECD Model Tax Convention*.

Fourth, a somewhat similar condition applies under subparagraph 18.21(2)(b), which requires that no Canadian group member be a RFI. Here, too, it is unclear how the existence of member of the group that is a RFI could result in consequences that are adverse to the purpose of these rules. Many of these entities tend to have net interest income, which would reduce the group net interest expense of the consolidated group. On the other hand, where the overall group is in a net interest income position, a meaningful group ratio cannot be determined based on the group adjusted net book income. However, conceptually, it seems difficult to understand why this should preclude the group from accessing some form of group ratio rule – perhaps based on a different type of ratio, such as a measure of debt-to-equity, or debt-to-assets. We note that the OECD Action 4 Report contemplates the use of an "equity escape" rule.[23] Such an approach would also address many of the concerns described further below in relation to the group ratio definition.

The definition of RFI includes a mutual fund corporation and a mutual fund trust (paragraphs (k) and (m)). It is unclear why a group that includes such an entity should not be able to access the group ratio rules. Where, for example, such an entity is a parent entity and holds a subsidiary that is not a RFI, the group's indebtedness may have been issued at the level of the parent. In such a case, it would be possible under subsection 18.2(4) for the subsidiary to transfer capacity to the parent, but the group would not be able to access the group ratio rules, such that transferable capacity would be limited to the amounts determined under the fixed ratio, which could be far lower than the group's natural ratio, which seems inappropriate.

Taxation Year of Canadian Group Members

Under subparagraph 18.21(2)(a)(ii), each Canadian group member must have a taxation year that is the same period as the relevant period of the ultimate parent of that consolidated group. This presents two difficulties. First, this condition would disqualify the entire Canadian group if a single member of that group has a different taxation year from the other members of that group (which could occur in the event of reorganization such as an amalgamation or winding-up). Second, this would disqualify the entire Canadian group even if all the members of the Canadian group had the same taxation years, if that does not match relevant period of the ultimate parent of that consolidated group.

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[23] Ibid, paragraphs 118 and 155, and Annex C.

While it is understandable that such period differences can create compliance and administrative challenges, it seems difficult to understand why the group should be disqualified in principle. There are other areas in the Act where "stub period" issues can arise, as well as areas in which period differences are addressed in contexts involving income attribution – such as with partnerships and controlled foreign affiliates. We submit it is readily conceivable that such differences could also be addressed in the context of the group ratio rules. We would also note that such differences are not a barrier to capacity transfers under subsection 18.2(4) as currently drafted.

Tax Reporting Currency of Canadian Group Members

Under subparagraph 18.21(2)(a)(iii), each Canadian group member must have the same tax reporting currency (within the meaning assigned by subsection 261(1)) throughout their respective taxation years. This is also a condition to the capacity transfer rules under subparagraph 18.2(4)(b)(iii), as currently drafted. As noted in that context, we submit that such a requirement is overly restrictive and inconsistent with the policy objectives of the EIFEL regime. Moreover, we would anticipate that the tax reporting currencies of most Canadian group members of foreign-based MNE groups would be different from the currency in which the accounts of the overall consolidated group would be prepared. Thus, currency translation issues would normally be an unavoidable aspect of applying the group ratio rules. While differences in the tax reporting currencies among the Canadian group members may give rise to an additional layer of complexity, this would normally be merely incremental. The functional currency rules in section 261 were adopted because of important policy and practical reasons, and contain a number of safeguards. It is submitted that Canadian group members should not be put to the choice of forgoing either the benefits of the functional currency rules or of the group ratio rules.

Recommendation

11.1. In light of the above, it is submitted that the conditions to the application of the group ratio rules in paragraphs 18.21(2)(a) and (b) should be replaced with the condition that each Canadian group member is, at the end of its taxation year, either a corporation resident in Canada or a trust resident in Canada, or a non-resident corporation or trust in respect of its taxable income earned in Canada.

Group Net Interest Expense

The group net interest expense is reduced by the amount described in element B, which is the total of all amounts each of which is an amount determined, in respect of a specified non-member of the group, by the formula E – F, where:

> E is the portion of the amount of the specified interest expense of the group for the period that is paid or payable to the specified non-member, and
>
> F is the portion of the amount of the specified interest income of the group for the period that is received or receivable from the specified non-member.

This approach seems to determine net results separately for each specified non-member of the group, which can produce inappropriate consequences where specified interest expense is paid or payable to one specified non-member, while specified interest income is received or receivable from another specified non-member. In such a case, on a net basis, the group would be in the same position as where an equal amount of specified interest expense and specified interest income is paid to and received from the same specified non-member. However, since each member of the group may have different means and needs with respect to its liquidity, it seems inappropriate to require an entity-by-entity approach to netting.

Recommendation

11.2. In light of the above, it is submitted that the netting contemplated by element B should be computed on a group-wide basis, which would be achieved if that element were drafted as follows:

> **B is the amount determined by the formula**
>
> $$E - F$$
>
> **where**
>
> **E is the portion of any amount of the specified interest expense of the group for the period that is paid or payable to a specified non-member of the group, and**
>
> **F is the portion of any amount of the specified interest income of the group for the period that is received or receivable from a specified non-member. (dépenses nettes d'intérêts du groupe)**

<u>Group Ratio of the Consolidated Group</u>

The principal concern that has emerged with respect to the calculation of the group ratio of the consolidated group is the "cap" that results from paragraphs (b) and (c). Where the group ratio is 40% or lower, the group ratio under paragraph (a) is the natural group ratio, determined as the group net interest expense of the consolidated group for the relevant period, over the group adjusted net book income of the consolidated group for the relevant period. Where the group ratio exceeds 40%, the rules in paragraphs (b) and (c) progressively limit the group ratio to an unnatural ratio, that is lower than the natural ratio, with an ultimate cap of 100%, which is reached where the natural ratio is 260%.

The Explanatory Notes[24] suggest that this approach is intended to account for the possibility that some group members may have negative book EBITDA. However, these limitations cannot be justified on this basis where no group members have negative book EBITDA. For example, if

[24] At page 96.

the natural ratio is 80%, the group ratio will be 55%, as indicated in the Explanatory Notes.[25] It is readily conceivable in certain industry sectors that such a ratio, or an even higher ratio, is perfectly consistent with an arm's length leverage ratio. Where this is the case, those taxpayers would be penalized, and even possibly forced to pay tax in the absence of true economic profit.

Where the group adjusted net book income of the consolidated group for the relevant period is nil or negative, paragraph (d) provides that the group ratio is nil. However, in such a case, under subsection 18.21(3), the allocated group ratio amount would be the lower of the group net interest expense of the consolidated group in respect of the year, and the total of all amounts each of which would, in the absence of section 257, be the ATI of a Canadian group member for the year. This could be 100% of the aggregate ATI of the Canadian group members for the year. Where the group adjusted net book income of the consolidated group for the relevant period is $1, again the allocated group ratio amount could be 100% of the aggregate ATI of the Canadian group members for the year, because 100% would be the cap under paragraph (c) of the group ratio definition, which would then allow such an allocation under subsection 18.21(3), assuming that the natural ratio were at least 260%.

This concern is particularly troubling in the context of a purely Canadian group, which is not composed of excluded entities and thus must rely on the group ratio rules. While we understand the complexities associated with designing a mechanism to account for actual losses within a consolidated group, it is difficult to understand why the existence of losses should be presumed, or why this possibility should be addressed by such an assumption. The BEPS Action 4 Report contemplates the possibility of adopting a different type of ratio in situations where a ratio based on the group net interest expense of the consolidated group for the relevant period, over the group adjusted net book income of the consolidated group for the relevant period, may give rise to inappropriate results, such as an "equity escape" rule.[26] We note that, with respect to foreign-based MNE groups, the EIFEL rules contemplate the continued application of the thin-capitalization rules in subsection 18(4) and related provisions, which are based on a ratio of debt-to-equity. Thus, such an approach would not be foreign to Canadian practices.

Recommendation

11.3. In light of the above, it is submitted that consideration be given to revising the group ratio definition to eliminate the caps contemplated by paragraph (b) and (c), and to providing for a mechanism that would account for actual losses within a consolidated group without presuming the existence of losses, with a view to better approximating the natural leverage ratio of the group. This could include providing for an "equity escape" rule, which could allow Canadian group members to deduct IFE based on the higher of, on the one hand, their allocation of a ratio based on the group net interest expense of the consolidated group for the relevant period, over the group adjusted net book income of the consolidated group for the relevant period; and, on the other hand, their allocation of a ratio based on debt-to-equity or debt-to-assets.

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[25] At page 142.

[26] BEPS Action 4 Report, *supra* note 1, paragraphs 118 and 155, and Appendix C.

Allocated Group Ratio Amount

With respect to the determination of the allocated group ratio amount under subsection 18.21(3), the principal concern that has emerged is the potentially punitive effects of the feature that deems the allocation to be nil if it exceeds the aggregate allocation capacity, even by $1. This concern is compounded by the lack of any provision for making an amended election under subsection 18.21(2), unlike under subsection 18.2(4). Thus, for example, if a calculation error is made, or if there is a redetermination of the amount of a Canadian group member's adjusted taxable income, this could have the effect of defeating the entire allocation of all Canadian group members.

Recommendation

11.4. In light of the above, we recommend that consideration be given to introducing a mechanism that would reduce the aggregate allocation to the aggregate allocation capacity instead of simply defeating the allocation. This could take the form of allowing the Canadian group members to make an amended election under subsection 18.21(2), or even just to make a supplementary election to reallocate only any excess allocation(s), with appropriate safeguards.

Excess Capacity

We note that the definition of "excess capacity" precludes any such amount where the group ratio election is made. While this may not be problematic in many situations, we believe that further consideration should be given to this element of the EIFEL rules to ensure that it does not result in outcomes that are inappropriate. We have conducted some preliminary work in this regard and we believe that such further consideration is warranted, at least with respect to certain situations.

Recommendation

11.5 We recommend that further consideration be given to permitting "excess capacity" to arise where a group election is made.

12. Relevant Financial Institutions

Scope

The EIFEL rules as currently drafted impose significant consequences if an eligible group entity is a RFI. These consequences include the inability to transfer capacity from the RFI to other members of the group, the inability for members of the group to access the group ratio and the exclusion of revenue of RFI entities in determining whether the *de minimis* exclusion applies to allow a group entity to qualify as an "excluded entity".

The Explanatory Notes describe the entities intended to be included in the RFI definition as follows:

> In general terms, the taxpayers included as "relevant financial institutions" are ones that may have net interest income because their regular business activities involve the lending of money, dealing or investing in indebtedness, or other financing transactions.[27]

The purpose of the constraints placed on a corporate group which includes an RFI is described in the Explanatory Notes:

> A relevant financial institution is subject to certain constraints under sections 18.2 and 18.21, in order to address anomalies associated with applying these rules in respect of corporate groups that include such institutions. In particular, the nature of financial institutions' regular business activities is such that their interest income often exceeds their interest expense. These constraints are intended to ensure that this net interest income cannot be used to shelter the interest expense of other members of the relevant financial institution's group from the limitation under subsection 18.2(2). [Emphasis added.][28]

The BEPS Action 4 Report noted that significant regulatory and commercial considerations reduce the risks posed by banking and insurance groups[29] and also acknowledged that because banks and insurance groups are typically net receivers of interest income, rules which apply to limit net IFE will have no impact on banking and insurance groups.[30] The report suggests that non-regulated entities which carry out quasi-banking or other financial activities where there are no regulatory restraints, or to investment vehicles whether or not regulated, should continue be subject to the regular interest limitation rules.[31]

The BEPS Action 4 Report includes the following description of banks and insurance companies that potentially warrant special consideration in the interest limitation rules:

> Although banks and insurance companies are engaged in very different businesses, in both cases third party interest income is vitally important to ensure a group's profitability and liquidity. For most banks, interest income and expense are largely operating items and play a role which is broadly comparable with revenue and cost of sales for entities in non-financial sectors. For insurance companies, interest income is a major form of investment income used to meet insurance liabilities as they fall due. In both cases, the nature of interest is fundamentally different to that for most other businesses, where interest income is linked to the treasury function of managing a group's net debt. [Emphasis added.][32]

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[27] At page 126. See also at page 97: "Financial institutions would be expected to often have excess capacity because their regular business activities tend to result in interest income exceeding their interest expense."
[28] At page 126.
[29] BEPS Action 4 Report, *supra* note 1, at pages 14, 15 and 172.
[30] Ibid, page 43.
[31] Ibid, page 80.
[32] Ibid, page 175 (paragraph 487).

The BEPS Action 4 Report then proceeds to discuss how a country might choose to address the BEPS risk posed by a group that includes a bank or an insurance company.[33]

We understand that the appropriateness of the consequences imposed on a group with an eligible group entity that is an RFI, particularly in light of existing Canadian restrictions and regulations on these entities, are being addressed by finance industry groups.

We are further concerned that the definition of RFI as currently drafted includes entities whose regular business activities do not involve the lending of money, dealing or investing in indebtedness, or other financing transactions with arm's length entities. While banks (paragraph (a)), credit unions (paragraph (b)) and insurance corporations (paragraph (c)) are generally understood to have the earning of interest as their regular business activities, many of the entities currently listed in the definition of RFI do not. A person authorized under the laws of Canada or a province to carry on the business of offering its services as a trustee to the public (paragraph (d)) and a registered security dealer (paragraph (e)) do not generally have as their main business activities the lending of money, dealing or investing in indebtedness, or other financing transactions.

Recommendations

12.1. Consultations should be undertaken with the applicable finance industry groups to ensure the appropriateness of the consequences imposed on a group with an eligible group entity that is an RFI, particularly in light of existing Canadian restrictions and regulations on these entities.

12.2. Given that the purpose of the definition of RFI is to identify entities whose regular business activities involve the lending of money, dealing or investing in indebtedness or other financing transactions with arm's length entities, we suggest it would be appropriate to modify the definition to remove certain entities – in particular, paragraph (d) (professional trustees), paragraph (e) (registered security dealers), paragraph (k) (mutual fund corporations) and paragraph (m) (mutual fund trusts). Further consideration should be given to the treatment of the entities listed in paragraph (i) (investment corporations) and paragraph (j) (mortgage investment corporations). If these entities are to remain in the definition, at the very least, we suggest it would be appropriate to modify the definition of RFI to provide that an entity will not be a RFI unless the principal purpose of its business is to earn income from the lending of money, trading or dealing in indebtedness or other financial transactions with arm's length entities.[34]

[33] Ibid, page 184.

[34] A similar test currently exists in paragraph 95(2)(l) of the Act. The terms "lending of money", "trading or dealing" and "trading or dealing in indebtedness" have been used elsewhere in the Act.

13. Section 216

The EIFEL regime does not specifically address taxpayers that elect to file tax returns under section 216 ("section 216 filers") in respect of rent on real property (or a timber royalty) in Canada. This creates uncertainty.

Section 216 provides that a section 216 filer is liable to pay tax under Part I for the year as though the non-resident person were a person resident in Canada. This would suggest that a section 216 filer should apply the EIFEL regime as if it were a person that is resident in Canada.

However, when the thin capitalization rules were amended to apply to non-resident trusts and corporations specific language was included in the amendments to contemplate section 216 filers premised on the position that such taxpayers would be considered to be persons not resident in Canada: see paragraph (c) of the definition of "equity amount" in subsection 18(5).

Given the specific language in the thin capitalization rules to address section 216 filers, the lack of similar language in the EIFEL regime creates uncertainty on how the EIFEL regime is intended to apply to these non-residents. In addition, we expect that the application of the EIFEL regime will better align with the section 216 rules where the section 216 filers are treated as a non-resident person for the purposes of the EIFEL regime.

In addition, other modifications to the EIFEL regime are required to address section 216 filers. The points that should be addressed are:

1. ATI is reduced by a "non-capital loss" and a "net capital loss". A section 216 filer is not entitled to deduct non-capital losses or net capital losses in its income by virtue of paragraph 216(1)(c) and, as such, these concepts are generally not relevant to section 216 filers. A section 216 filer could have income or loss, or a net capital loss, for the year from a business or property that is not included in the section 216 return, but the existing definitions of these terms in subsection 111(8) are not similarly limited for a section 216 filer. Accordingly, a modification is required in applying the EIFEL regime to provide that only a non-capital loss to the extent arising from deductions permitted in the computation of income under section 216 should be relevant for the purposes of computing ATI of a section 216 filer.

2. Pursuant to paragraph 216(1)(c), a non-resident person is not entitled to deductions in computing taxable income. The purpose of paragraph 216(1)(c) is, in part, to prevent a section 216 filer from deducting non-capital losses of other years. The concern is that paragraph 216(1)(c) will also deny the deduction of RIFE under proposed paragraph 111(1)(a.1). This is inappropriate.

   The premise of the EIFEL regime is to allow for the deduction of IFE that are otherwise deductible under the Act (including after the application of the thin capitalization rules) in the taxation year if there is sufficient ATI and, to the extent there is insufficient ATI, to provide for a carry-forward of the excess in the form of RIFE which can be deducted in a subsequent year when there is excess capacity. IFE represent the cost of funding the

underlying real property, regardless of whether the person is a 216 filer or another taxpayer. In fact, IFE is similar to CCA which represents the cost of property and can be deducted in a particular year to the extent permitted with the balance carried forward and deducted in subsequent years when permitted. Amendments should be made to paragraph 212(1)(c) to permit the deduction by a section 216 filer of the portion of RIFE for a year representing denied IFE that did not create or increase a loss for the year.

Recommendation

13.1. Given the unique nature of income tax filings pursuant to section 216 and the related issues and concerns outlined above, we recommend that further consideration be given to the rules in order to accommodate section 216 filers and we would be pleased to discuss our suggestions with you.

14. Other Issues

Cash Flow Issues

Highly levered taxpayers may face significant cash flow issues as a result of the application of these rules. For example, assume that a taxpayer has earnings of $1,000 and interest expense owed to third parties of $900. The taxpayer is profitable, although a significant portion of net revenues services debt. Without application of these rules, the taxpayer would pay tax on its taxable income of $100. Under the proposed rules, this taxpayer will have ATI of $1,000 (assuming no other ATI adjustments apply), and will only be permitted to deduct $300 of interest. The revised taxable income will be $700. Assuming a 26.5% tax rate, this results in a tax liability of $185.50. This taxpayer does not have sufficient cash to pay both its tax liability and its third party interest. This can result in insolvency situations in otherwise profitable businesses simply because the taxpayer is highly levered, which leverage may have been put in place well before the new rules were released, or is the only feasible way for the taxpayer to raise capital. This result would arise even if the group ratio rule was applicable, unless our recommendations in that regard were adopted. As currently structured, assuming that paragraph (a) of the definition of "group ratio" was 90%, the group ratio would be 57.5%, such that the taxpayer would only be permitted to deduct $575 of interest, resulting in taxable income of $425 and a tax liability of $112.63. Therefore, even relying on the group ratio rule, the taxpayer does not have sufficient after-tax cash to pay its third party interest. This example also further supports our recommendations above, in respect of the need for grandfathering rules.

Similarly, taxpayers who are not highly levered but whose businesses face a revenue decline in future years due to market factors, may find themselves in this situation. In the example above, that taxpayer may have projected over $3,000 of annual earnings which would have permitted full deductibility of the interest expense. If earnings fall to $1,000 due to unexpected market factors, the business is still profitable however the taxpayer does not have sufficient cash to pay both its Canadian tax liability and its third party interest expense, driving it to an otherwise avoidable insolvency event.

Recommendations

14.1. Consistent with Recommendation 1.2 above, we recommend that grandfathering relief be provided for debt obligations owing to arm's length persons that (i) cannot be repaid or cannot be repaid without incurring material penalties or fees and (ii) existed prior to April 19, 2021.

14.2. In addition, we recommend that additional consideration be given to the possibility of the EIFEL rules leading to an insolvency event, and appropriate relief in such circumstances.

Definition of Taxpayer

In proposed subsection 18.2(1), several new definitions apply for the purposes of the EIFEL rules. We noted that a "taxpayer" is specifically defined to not include a natural person or a partnership. Given that many references to a taxpayer are used throughout the Act, we are concerned that redefining such a common term could cause confusion. Also, it is common in electronic tax services to provide links to underlying definitions, and the use of such a common term may create the potential for erroneous links.

Recommendation

14.2. We recommend that a more specific term be used in the rules, such as "relevant taxpayer", to avoid confusion.

Use of Formulas

While reviewing the draft legislation, we noted that the structure of some of the formulas did not include the use of parentheses. For example, the following formula is used in paragraph (g) of the IFE definition:

$$C \times D/E - F - G$$

Recommendation

14.3. Although the use of parentheses is not strictly needed from a mathematical perspective, it may avoid confusion if that reference (and any other similar references) are adjusted to include parentheses.