BDO Canada

CROSS-BORDER TAX PODCAST SERIES

Episode 14: An update on Excessive Interest and Financing Expenses Limitation (EIFEL) rules - LIVE in Toronto

Laura Ball:

Mic test. Mic test. Are we live?

Hi, this is Laura Ball.

Jessica Blazejewicz:

And Jessica Blazejewicz.

Laura Ball:

And you're listening to BDO's Cross-Border Tax Podcast live.

Thank you for the warm welcome, everyone. Jessica and I are very excited to present on the new excessive interest in financing expense regime. You're probably asking yourselves why us? Why does Canada have yet another set of very complex rules that are formula driven that we now have to sort through?

Well, Canada is a member of the OECD. We know the OECD over the last decade has been very focused on curtailing the perceived aggressive tax planning that certain multinational organizations utilize. And so, the BEPS Initiative has been developing over the last 10 years. The OECD essentially provides the framework, the rules. And in turn, each country is then left with their own set of rules that they are going to develop, and they put their own spin on each rule. So, what's happened globally now is we have this patchwork of rules for all these different jurisdictions governing interest deductibility and larger multinational organizations are left with this decision of where are we going to invest in the future and where are we going to finance, and even just wrapping their heads around these very complex rules.

However, what we've seen in the legislation as it's been rolled out in the Canadian context is that the rules are far more broad and they impact most businesses that are operating it within the borders of Canada. So, what we like to advise is that assume you're into the rules, unless there's some specific exclusion that might get you out of them. So just a super quick overview and timeline of events. We first caught wind of the rules in budget 2021. And since that time, we've seen three versions of the rules.

The most recent one was released in August of 2023. Consultation period is now over. So, when these rules come into effect, they will have retroactive application back to tax years beginning on or after October 1st, 2023. So if you're doing the mental math, that was about a week and a half ago. I don't have a crystal ball. I don't know when or if the rules will be enacted, but I would say that since Canada has committed to the BEPS Initiatives, and we are part of the OECD, that I do feel strongly that there will be some version of these rules that will be brought into legislation in the very near future.

So how do the rules work? Put very simply, the rules operate to limit the net interest and financing expenses that a company can deduct in the computation of their taxable income to 30% of tax EBITDA. Sometimes you can get a little higher if you can qualify for group ratio relief. That is a tricky one to get into. Jessica is going to cover it in the slides that follow, but the group ratio relief is really there to provide a higher percentage than 30 when you have a group of companies that are very heavily leveraged with external third-party debt.

But I would just forewarn you, they are significantly difficult to get into that group ratio relief, and we're seeing more and more in practice how challenging that is becoming.

So, in terms of order of operations, when you're looking at your group of financial statements, the first question you should be asking yourself is how much interest is in here? And is it otherwise deductible? So is there something else in the income tax act that might be preventing a deduction of this interest anyway?

The second thing you would want to ask yourself is, am I an excluded entity? And we'll discuss that in a little more detail, but that would essentially get you out of the rules altogether if you meet the conditions to be an excluded entity.

And thirdly, you'd want to ask yourself, is this interest in question excluded interest? In other words, is this debt between related Canadian parties and we can elect out of it?

You might be asking yourself and scratching your head, wondering how can yet another set of rules governing interest deductibility co-mingle and exist in our Income Tax Act when we already have so many that we need to worry about and think about on a daily basis? For example, we have our basic foundational principles. You can't deduct interest unless it's incurred to earn income from a business or property.

Jessica Blazejewicz:

Don't forget you've got things like 21E, 21E part 1 when you've got other financing related costs. That might also be captured by these EIFEL rules beyond interest.

Laura Ball:

You got thin cap. Thin cap also restricts interest deductibility.

Jessica Blazejewicz:

You've got back-to-back debt and interest rules there on how it's recharacterized between two parties and possibly a third.

Laura Ball:

Transfer pricing also restricts interest in certain instances.

Jessica Blazejewicz:

And then finally, as our future guest speakers will talk to, if you're doing a transaction with interest, don't forget your mandatory disclosure rules.

Laura Ball:

There's already tons of stuff in the Income Tax Act, but why not add another? So, these interest deductibility rules are actually going to fall behind all of the other rules that already exist. And I think the most relevant example for this group is thin cap. So, if you have interest that's restricted under the thin cap regime, it's denied as a deduction and it's deemed to be a dividend, that interest is not going to be tested again as part of your interest in finances for the purposes of these rules.

So, a very fundamental and important concept definition within these rules is the concept of excluded entity. So, if you meet one of these tests, then you can ignore the rules altogether for that particular year, but it's a year-by-year test, so it's something you need to be mindful of. The first is the small CCPC exception. So that looks at taxable capital employed in Canada of associated groups being less than $50 million.

The de minimis exception looks at a group of eligible entities and their net interest expense. So that's your interest expense less your interest revenues. And if that number falls below $1 million, you don't have to be concerned about these rules. That's very hard to fit into with the way the interest rates are currently today and just general debt levels inside of businesses, but that's the de minimis set for Canada.

And then this domestic exception, again, a very hard exception to meet. There are four prongs within this exception, and all four have to be met.

So, the first one looks at businesses undertakings and activities that carry on all or substantially all of their business in Canada. That's a 90% test.

You can have foreign affiliates, but the book costs of your foreign affiliates must be below $5 million and the underlying assets of the foreign affiliates fair market value must be below $5 million. So again, very low thresholds and that is a greater of test. So, keep that in mind. We'll walk through an example in the coming slides.

You can't have any material non-resident ownership. That looks at a 25% test. So, if you've got non-residents at the top of the chain with 25% or more, then you don't meet the exception.

And lastly, that your interest is not paid to a non-arm’s length tax indifferent investor. So that's a defined term in the legislation. Put a little more simply, it would be interest paid to a non-arm’s length non-resident or even interest paid to a non-arm’s length Canadian resident that maybe falls within section 149 of the Act. So, you're thinking your pension funds, your NPOs or charities or things like that.

So, this is a very straightforward example of the de minimis exception. Obviously, this example assumes that the other exemptions are available. Let's say taxable capital is more than $50 million and they have some foreign business operations. But the key here is that when you're looking at the de minimis exception, you're testing the net interest expense across an eligible group, right? So that is really related or affiliated entities. And in this case, Canco2 has $2 million of interest income. Canco3 has $2.5 million of interest expense. $500,000 net interest expense - you're below a million and therefore the rules don't apply.

This slide touches on one of the prongs of the domestic exception that have to be met. It deals with the all or substantially all test, that all or substantially all of the activity must be carried on in Canada. So, in this example, Canco2 has a foreign unincorporated branch, and this is not an uncommon situation. Where this will be problematic is if, for example, Canco2 is a holding company or has very nominal activity and the branch is substantial in relation to what's transpiring in Canco2, then the domestic exception will not be met and it will in fact taint it for the group.

So maybe a little bit of planning opportunity here. If you have this situation, you could consider incorporating the foreign branches because you are permitted to have foreign affiliates in the domestic exception. So that brings me to my next example.

In this example, we have Canco1 owning 100% of foreign affiliate one and that foreign affiliate has a property with a fair market value of $6 million. In this situation, the test that you look at with respect to foreign affiliates, like I said, is a greater of, and it's a two-prong test. So, you'd look at the book value of the shares of foreign affiliate one in Canco1 if those are over $5 million, and you would look at the value of the property, the fair market value of the property held by foreign affiliate one. Those are over $5 million, and therefore the domestic exception is not met in this instance.

The second example, you might be surprised by the result. The change here is that there's only a 10% ownership interest that Canco2 has in foreign affiliate two, so very minority amount of ownership. However, the rules as they're worded indicate that because foreign affiliate two has property with a fair market value of over $5 million, the domestic exception will not be met, and they basically ignore the ownership percentage that Canco2 has in foreign affiliate two. So it's a bit of a peculiar result, but we'll see if that changes in future updates.

So, this slide, this formula really governs and computes the amount of interest that is limited as a deduction in the computation of taxable income.

So, A, in the formula is your total interest in financing expenses, and then variables B, C, D, and E, those comprise the amount the taxpayer is permitted to deduct. So, the numerator is really your taxpayer's expenses in excess of the allowable deductions and the denominator is really the interest in financing expense for the year.

Like I said, interest in financing expense is variable A. Variable B contemplates the ratio of permissible expenses multiplied by adjusted taxable income.

So that's the 30% ratio that we've been seeing or higher if you elect under group ratio relief multiplied by tax EBITDA. But since there's so many adjustments to that, it's more accurately defined as adjusted taxable income. And then C is your interest in financing revenues. D and E are received and absorbed capacity. We haven't touched on those in the slides yet, but that's essentially when another member of your eligible group could transfer any capacity to you to potentially allow you to make a deduction if there wasn't enough room in the year or if you could carry forward room from a prior year.

The definition of and determining what is interest and financing expense on its own is a fairly extensive exercise.

First, you'd have to look at your deductible interest. So again, that's interest that hasn't otherwise been denied a deduction because of some other section of the Income Tax Act and you exclude excluded interest, which Jessica is going to cover. That financing costs would be included portion of CCA or resource expenditures that relate to interest in financing expenses.

So, if you've got interest that has been capitalized and you are taking CCA in the year that you take the CCA, then that is considered to be interest in financing expenses for these purposes. If you have a lease and it's economically similar to what could otherwise be a loan, then there's specific rules around that as well and those would be captured.

Important to note too, partnerships are not subject to these rules. Rather, the income of the partnership will flow up to the partners. So, if your partnership is incurring interest in financing expenses, then in that case, you'll need to understand how much of that is allocable to you so you can include those numbers in your calculation as well. I bet you're already thinking there's some practical concerns with even doing that. If you envision a 5013 slip, there's nowhere on the slip where it would indicate or inform the partners about the interest in financing expenses of the partnership.

So, in practice, I've seen situations where their side letters or addendums made to partnership agreements such that the partners have the right to be furnished with the information that they need in order to make these calculations.

Interest in financing revenues: they're interest income other than excluded interest.

Guarantee fees. Leases, again, that are economically similar to a loan. Your share of any partnership interest revenue.

And what's not noted on the slide would be something like imputed interest or deemed interest under some other section of the act. So let's say, for example, you've made a ploy election and you have imputed interest, then that should be considered as part of your interest in financing revenues.

So, I'll just go through this slide here before I turn it over to Jessica. There's two examples in this slide. The variables remain the same with one exception.

The adjusted taxable income in the first example is $5 million and the adjusted taxable income in the second example is $10 million, interest expense is $3 million, interest revenue is $1 million, and we've assumed that there's no transferred or absorbed capacity to keep things a little more straightforward.

So, in the first example, the denied interest is calculated by taking 3 million, which is your expense, less 30%, because we don't have group ratio relief to increase it any higher, multiplied by the adjusted taxable income, you add in your interest in financing revenues and divide it by the 3 million of interest expense and you get denied interest of $500,000.

In the alternative calculation, with adjusted taxable income of 10 million, there is no denied interest and that intuitively makes sense because the income threshold has gone up.

So further ado, I'm going to pass it over to Jessica to talk us through some of the more technical nuances in these rules.

Jessica Blazejewicz:

All right, thanks, Laura.

I know the first part of this presentation is probably quite a lot to take in if you haven't started going through the EIFEL rules already, so we're going to stay fairly high level as we get into some of the nuances in the rules, especially as we move into the complexities of going beyond Canada and your group within Canada.

With EIFEL comes a variety of tax attributes. And like other tax attributes that we have, we have to think about our tax provisions going forward. So as many of you might be thinking, "Well, this isn't effective yet, I'll deal with it on my tax return," you do want to start thinking about what are your quarterly reporting’s going to look like. Do you have attributes that you need to set up? Deferred tax assets and liabilities, for example.

So, we'll talk through some of these attributes that you want to be thinking of today as you go forward into the new world of EIFEL.

The first one is what we call restricted interest and financing expenses or RIFE as I'll refer to it as. This is essentially the amount of your interest that has been denied in a particular year. You're denied interest under the current rules as proposed can be carried forward indefinitely. And so, what we're seeing with a lot of clients is there may not be necessarily an EIFEL issue long-term. But for clients who are very forward focused and longer term projects with a time value of money consideration, this is actually quite important on when you're going to actually recover and deduct that interest.

If you've got excess capacity in the future, which we'll talk about in a moment, that's the time you get to deduct that non-deductible interest in the future.

Excess capacity, that is when you calculate your EIFEL and you actually have excess room in a particular year, so you could have had a higher interest expense deduction that year. That amount is eligible for carry forward for three years.

And what they've done with these two attributes combined is essentially try to mimic the non-capital loss carry forwards and carrybacks, except you'll see in something like your non-deductible interest, it's carried forward indefinitely and that three year carryback that you're expected to see, that's coming through your excess capacity mechanism. For both of these attributes, you do want to think about some of the transactions you might be going through in a particular year.

So, for example, windups, amalgamations in Canada, there's transitional rules that allow you to carry those attributes forward. But if you've got, for example, an acquisition of control, something like excess capacity expires. So, there's considerations there that you want to think about depending on what's going on in any particular year.

EIFEL is also permitted loss consolidation, so very much like Canada has always allowed. Even though we file on an individual taxpayer basis, there are mechanisms that are permissible to allow use of interest expense and deductions within a particular Canadian group. This is coming through our concept of excluded interest. So, this is an election that you file to say that intercompany interest financing expenses within your Canadian group can essentially be exempt from EIFEL. And so, for our clients that we're seeing, we're often focusing on what is otherwise cross-border interest deductions because we can manage internally some of the intercompany payments.

One thing to focus on here is you do want to think about your relationships with your Canadian entities and the level of control that you have because that will influence whether you can qualify for these exemptions. Another election that you can opt into, for example, is the pre regime excess capacity. So, for example, this allows you to calculate excess capacity for the three years leading up to the effective date of EIFEL, and you're able to use that going forward in your deduction of interest.

Something to consider if you're looking at this particular regime is you do have to maintain those attributes and restate them, for example, under the 40% permissible limit and the 30% limit going forward. So, it's not an easy exercise - it's actually quite complex.

What about companies that have foreign affiliates, in particular controlled foreign affiliates?

So we know that in our adjusted taxable income, you're going to include all of your FAPI amounts in your income. And so there's these particular definitions that are going to help you adjust and manage interest of your foreign affiliates that are sheltering some of that income, in particular the FAPI income. So, these definitions that are important to those particular businesses out there are your relevant affiliate interest and financing expenses, and your relevant affiliate interest and financing revenues.

So essentially the same concepts that Laura talked about earlier in the domestic context, but these are your interest in financing expenses and revenues that do not otherwise give rise to or are deductible in computing your active business income. So, this is all of your FAPI related interest in financing.

The other concept you want to be cognizant of when you're looking at foreign affiliates is your relevant inter-affiliate interest. So, this is similar to the excluded interest definition, these are inter-affiliate payments that will be captured and they are automatically pulled out of your definitions of relevant affiliate interest and financing expense. So, you don't have to look at those types of amounts.

So, what does this mean to your EIFEL position if you've got controlled foreign affiliates with FAPI income? So essentially, like I mentioned, your FAPI amounts are already included in your adjustable taxable income, but your FAPL amounts, the losses are only included to the extent that they're sheltering FAPI.

So, a number of provisions in these rules are meant to adjust your FAPLs to the extent that they are derived from what we call these IFE of your foreign affiliates.

Again, we've got an election that allows you to scope out your inter-affiliate payments. It's an automatic election. Unlike the excluded interest where you have to file that election, these are automatic. Again, you want to think about similar to upstream loan rules, they may not have a symmetrical impact to both your payor and your recipient affiliate, especially if you've got different ownerships and control levels. So while you think that you might be out, you want to consider where you might have inequity of ownership between the two.

Lastly, I'll just mention that there is an election to forego your FAPLs in exchange for avoiding including your foreign affiliate interest expenses in your IFE of your taxpayer. So, for example, if you have FAPLs, you're not expecting to use them in the future, this might be a good way to go if you've got an adverse EIFEL impact from your foreign affiliates.

So, we've discussed the basics of EIFEL and what that means to a Canadian taxpayer.

So, what relief could be available if, for example, you're getting a denied amount?

So, the Department of Finance had been very clear that they didn't want to put industry specific exemptions in place or anything specific to a particular taxpayer group. And while there are specific areas such as P3s or financial institutions that did get some relief and additional provisions in the rules, I think the mechanism that the Department of Finance put in place here is really the group ratio.

And so, to Laura's point, if you're in an industry that's more highly leveraged, this concept of group ratio is intended to give you an effective rate of interest deduction higher than 30%.

Under these rules, which are quite difficult to qualify for, you're essentially looking at your global interest that's deductible by the group versus the global accounting book income. There is now a 10% uplift. So, it used to be the ratio that you got of external debt to your global income, that was your new ratio. Now it's times 1.1, which you'll see in the next slide.

So, what we're seeing in this particular area is difficulties in defining what a consolidated group looks like. So ultimately, you're looking at groups that are consolidated at an ultimate parent level. And so the rules are quite specific.

What is an ultimate parent? It is essentially the top company where IFRS... International Financial Reporting Standards. There we go. Too many acronyms. It's where that accounting standard would otherwise require you to file a consolidated financial statement.

So, we do have clients that we're seeing that might have consolidated financial statements at a lower level, but it is not the level that would otherwise require financial statements, and it may be higher up. We're also seeing nuances in off balance sheet debt, where you think you do have debt in the group, it might not actually be in your accounting statements because of some of the gap that's being elected.

So, this is essentially the formula for your group ratio. Again, we're finding a lot of difficulty of businesses getting into this exemption, but I won't go into any particular detail.

A couple of things to note, this is elective, so any one member of the Canadian group can elect on behalf of the full group. So, this is something that's quite important when you might be part of a larger group of companies, and you may not have oversight to other related parties. You do want to understand who's filing within the group, whether that's you or maybe it's someone else because they can elect on your behalf.

And there is a requirement for audited statements. We're finding that is also a challenge. It's a new cost to doing EIFEL that a lot of taxpayers were not anticipating.

I won't go into specific details about group ratio, but there's a couple examples here, essentially giving you your 10% uplift on what you would otherwise have in your consolidated group. One thing to note is if globally you are in a loss position, your group ratio is deemed to be nil, so essentially, you're getting almost full capacity to deduct your interest in that particular year.

So, a couple key takeaways. EIFEL applies to all taxpayers unless you meet the definition of an excluded entity, and that's what Laura talked about earlier is meeting one of those criteria. It's complex and where tax used to be a past tense activity where you're doing your tax returns based on the last year, we're now finding EIFEL is forcing taxpayers to project their income and manage future expectations of interest deductibility.

It requires a lot of detailed modeling, so taking projections, understanding what the debt will look like in the future relative to projected income and whether it's deductible, and it's forcing taxpayers to really think about, do you need to do something today to maximize your positions on EIFEL in the future? As we mentioned, there's attributes that can be carried back and forward related to EIFEL. These need to be managed, and they need to be reported in your financial statements.

And lastly, there's group relief that may be available. It's complex. It has additional costs, and so it's something you want to be considering today. Because come January 1, those are the things you're thinking about is what is my budget? What do I need to manage going forward?

So how would you approach EIFEL? Essentially, you want to understand your business, who you're related to in Canada, and who you're related to globally. There are very specific definitions. You need to get a good understanding of knowing where you stand. That includes your ability to figure out if you're an exempt entity, if there's excluded interest within your group by knowing that business in much more detail than you might've previously.

Then you want to move to the calculations and the quantifications. So what is the impact? If I model this out, when is it going to be deductible? What does that do to my bottom line?

The next item that you want to think about is, are there elections I need to be thinking about? Whether it is the excluded interest election or perhaps it is your group ratio that you want to elect into. Those processes take time and they require audits of those consolidated financial statements that might or might not already be underway.

And then lastly, we talked a little bit about financial reporting. That's going to come up sooner rather than later. And then you also have your reporting at year-end with your tax return. There is a prescribed form for EIFEL that is now required to be filed. We don't have insight as to what that would look like, but we know it's coming.

And lastly, as Laura mentioned, these are proposed rules. We don't have a final version that's enacted yet, and so it's an activity where we're staying tuned. What will be in the final version? How different will it look from the versions that we're looking at today?

Disclosure:

This podcast was recorded live in Toronto, Canada on October 12th, 2023.