EIFEL CAN APPLY TO PRIVATE ENTERPRISES TOO

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Introduction

In recent years, the OECD has made a concerted effort to encourage countries to reduce tax incentives. One such initiative is the push to have countries reduce the deductions available for interest paid to persons who do not pay tax in the source country on such interest income. Canada has proposed to implement this idea through legislation known as the Excessive Interest and Financing Expenses Limitation ("EIFEL"). In general, a taxpayer caught by these rules will be limited to an interest deduction equal to 30% of "adjusted taxable income" for taxation years beginning on or after January 1, 2024.

The Department of Finance released a draft of the EIFEL rules on August 4, 2023. That draft has not been enacted as of the time of writing. It is expected that the final version of the EIFEL rules will resemble that draft closely. For some taxpayers with taxation year beginning on or after October 1, 2023, these rules, if enacted as proposed, are applicable already. Despite the stated overall intent of the OECD initiative on which the EIFEL rules are based, a taxpayer who is subject to EIFEL will be limited in its deduction in respect of all its interest and financing expense, not just those paid to non-resident persons or in respect of financing that generates tax-exempt income.

Many Canadian advisors of large multi-nationals are well-versed in the EIFEL rules. But practitioners who work exclusively with private businesses may still be unfamiliar with them. Canadian private companies, especially those in capital-intensive businesses, can be subject to the EIFEL rules. Most private businesses do not prepare audited consolidated financial statements and, as such, if EIFEL applies, cannot access the more advantageous group ratio method. For these private businesses, their interest and financing expenses will be limited to 30% of EBIDTA (or "adjusted taxable income" as defined in the proposed legislation).

The article focuses on situations where private businesses could find themselves subject to the EIFEL rules.

To whom does EIFEL apply?

The EIFEL rules apply to a "taxpayer" that is not an "excluded entity". For this purpose, a "taxpayer" does not include a natural person. Accordingly, EIFEL should not apply in the computation of a natural person's income, regardless of his or her residency. The EIFEL limitation applies only to corporations and trusts (and partnerships, to the extent of a corporation's or trust's share of the partnership's interest and financing expense).

A taxpayer will be exempt from EIFEL if it qualifies as an "excluded entity". Many components of this determination require looking at all entities within a related/affiliated group under a new definition called "eligible group entity". Speaking generally, an eligible group entity is any person related or affiliated with a taxpayer, but taking only *de jure* control into consideration while disregarding options and rights described under paragraph 251(5)(b)[1]. A discretionary trust is also an eligible group entity of its beneficiaries and *vice versa*.

There are three ways a taxpayer that is a Canadian-resident corporate or trust can qualify as an "excluded entity":

I. The '*Small CCPC Exclusion*' - a CCPC that, together with associated corporations, had total taxable capital employed in Canada of less than $50,000,000 for the last tax year that ended in the preceding calendar year;

II. The '*De-minimis Exclusion*' - a corporation or trust that, together with other eligible group entities, has $1,000,000 or less of ***net*** interest and financing expense for the particular tax year (in other words, the entity is excluded from EIFEL if the group's total "interest and financing expense" does not exceed the group's total "interest and financing revenues" by more than $1,000,000);

III. The '*Domestic Exclusion*' - a corporation or trust that meets these four conditions throughout the particular year:

1. all or substantially all of the businesses and all or substantially all of the undertakings and activities of the taxpayer and all its eligible group entities are carried on in Canada;
2. neither the total book cost of all foreign affiliate shares nor the total fair market value of the gross assets of all foreign affiliates of the taxpayer and all its eligible group entities exceeds $5,000,000;
3. no person or partnership is:
    a. a non-resident "specified shareholder" or "specified beneficiary" of the taxpayer or of any eligible group entity, or
    b. a partnership that, generally speaking, is more than 50% owned, directly or indirectly, by non-residents and that holds 25% or more of either votes or value of the taxpayer or an eligible group entity; and
4. all or substantially all of the interest and financing expenses of the taxpayer and of each eligible group entity is paid or payable to persons who are not "tax-indifferent" (meaning that, for purposes of the Act, they do not care if they receive such interest--for example, a non-resident is considered "tax-indifferent") and who do not deal at arm's length with the taxpayer or any eligible group entity.

As long as **one** of the three exclusions (Small CCPC Exclusion, *De-Minimis* Exclusion, Domestic Exclusion) applies, a taxpayer is not subject to EIFEL. This means that EIFEL should not apply to the vast majority of Canadian private businesses, but there will be some private businesses that will fail all three Exclusions. Below are some common ways a private business can fall offside each of the three exclusions unwittingly.

Common scenarios causing a taxpayer to fail the Small CCPC Exclusion:

- the associated group has taxable capital of more than $50,000,000. At the risk of over-simplification, if the entities in an associated group have book equity and outside financing totalling more than $50,000,000, they probably have taxable capital over that amount. Private businesses in capital-intensive industries such as real estate, manufacturing and car dealerships can cross over this $50,000,000 threshold easily;
- a discretionary family trust owns more than 25% of a class of shares of a corporation that has significant taxable capital. Other corporations owned by the trust's beneficiaries may be associated with the trust's corporation under paragraph 256(1.2)(f). The third-corporation association deeming rule in subsection 256(2) and the additional deeming rules in subsections 256(1.3) and (1.4) exacerbate this contagion

effect. This could lead to EIFEL applying to CCPCs that genuinely are small businesses, just because they are caught by these expanded concepts of association (moreover, the newly expanded trust disclosure requirement will make it easier for the Canada Revenue Agency to find these association connections).

Common scenarios causing a taxpayer to fail the De-Minimis Exclusion:

- at today's interest rates, it is not difficult to exceed $1,000,000 in total net interest and financing expense in a year. For example, a $12,000,000 mortgage loan at 9% interest compounded monthly carries interest of more than $1 million. Furthermore, "interest and financing expenses" are not limited to interest expenses but include paragraph 20(1)(e) financing expenses, CCA deductions and terminal losses that are reasonably attributable to historically capitalized interest and financing expense, as well as notionally calculated interest components of lease payments, among other amounts;
- in recent years, insurance products that are combined with leverage have become commonplace (generally know as an "immediate financing arrangement"). A typical arrangement involves the policy owner using the life insurance policy's cash surrender value as collateral security for a loan. Such arrangements could provide for large interest deductions by a corporation or trust, which could cause taxpayers to fall offside this *De-Minimis* Exclusion (and at the same time, the borrowing increases taxable capital, making the corporation more likely to fail the Small CCPC Exclusion);
- the $1,000,000 limit is shared among all the eligible group entities. Taxpayers need to review carefully the new definition of "eligible group entity" when making this determination. One saving grace is that an eligible group entity does not include a natural person or a non-resident person, so interest on personal debts and interest expense of a foreign entity do not have to be considered.

Common scenarios causing a taxpayer to fail the Domestic Exclusion.

- a corporation can have some activities outside Canada and still qualify for the full small business deduction and for "small business corporation" status because those tests require only that the corporation carries on the business in Canada or primarily in Canada. The Domestic Exclusion introduces a more stringent test: not only are all or substantially all of the businesses required to be carried on in Canada all or substantially all of the "undertakings and activities" must be carried on in Canada. Therefore, a corporation that carries on business in Canada but carries on some "undertaking and activities" outside Canada could fail the Domestic Exclusion (or, put another way, it will fail if their Canadian undertakings and activities are not "substantially all" of their global undertakings and activities);
- many large Canadian businesses have corporate subsidiaries outside Canada. If an eligible group entity has a foreign affiliate (meaning, speaking generally, owning more than 10% of any class of shares) and the foreign affiliate's gross assets have a fair market value totalling more than $5,000,000, the whole eligible group falls offside the Domestic Exclusion (fortunately, because an eligible group entity does not include a natural person, a family member owning a foreign affiliate personally will not make the group fail the Domestic Exclusion, but if the family member used a Canadian corporation to hold a foreign affiliate then that could cause the group to fail the Domestic Exclusion because that Canadian holding corporation could be an eligible group entity);
- for private businesses that are closely held by a family, a departure from Canada of any one shareholder or of any one beneficiary of a family trust could mean that there is a non-resident "specified shareholder" or "specified beneficiary" under the broad definitions of those terms in subsection 18(5). This would cause the eligible group to fail the Domestic Exclusion.

Conclusion

The EIFEL rules are a headache not just for large multi-nationals; they might affect more than a handful of Canadian private businesses. It is not too late for advisors to scour their client list for those that might fail all three of the Exclusions and hence fail to be excluded entities. Advisors will need to educate impacted clients on how the EIFEL rules affect their businesses (and watch their inevitable shell-shocked expression once they learn of EIFEL's scope and impact). One of the more pressing items will be planning for an eligible group to elect to take advantage of three years' worth of "pre-regime" cumulative unused excess capacity, as this election must be filed with the Minister on or before the earliest tax return's due date for the first regime year of any eligible pre-regime group entity.

Advisors of Canadian private business and their clients are already overwhelmed dealing with UHT filings, the new enhanced T3 reporting and disclosure requirements and many other recent changes to the accounting, banking and tax landscape. Unfortunately, the complicated EIFEL rules deepen the quagmire. For businesses impacted by the EIFEL rules, the additional tax resulting from the EIFEL limitation could impact cash flow significantly and cause a hefty increase in compliance costs.

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[1] All statutory references are to the *Income Tax Act*, RSC 1985, c. 1 (5th Supp.), as amended and proposed to be amended as of the date hereof (the "Act").