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January 31, 2023

The Honourable Chrystia A. Freeland, P.C., M.P.
Deputy Prime Minister and Minister of Finance
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario K1A 0G5
Canada

Via email

Re: Proposed Excessive Interest and Financing Expenses Limitation

Dear Minister Freeland:

On behalf of Tax Executives Institute, Inc. ("**TEI**"), I am pleased to share our comments on the revised draft legislative proposals released on November 3, 2022 (the "**Revised Draft Legislation**"), to implement new limitations on the deduction of business interest expense.[1] These proposed amendments are referred to as the Excessive Interest and Financing Expenses Limitation ("**EIFEL**"). We appreciate that the Department of Finance took into consideration many of the comments made in TEI's May 6, 2022, submission in response to the initial draft legislative proposals released on February 4, 2022.[2] While many issues have been addressed in the most recent Revised Draft Legislation, the rules continue to be highly complex. We appreciate the opportunity to provide further comments and respectfully urge the Department of Finance (the "**Department**") to consider our comments when finalizing the legislation before its introduction in Parliament. TEI would also be pleased to further discuss these comments with the Department.

About TEI

TEI was founded in 1944 to serve the professional needs of in-house tax professionals. Today, the organization has 57 chapters across North and South America, Europe, and Asia, including four chapters in Canada. Our approximately 6,500 members represent 2,800 of the world's leading companies, many of which

[1] Dep't Fin. Can., *Legislative Proposals Relating to the Income Tax Act,* (Nov. 3, 2022)

[2] Dep't Fin. Can., *Legislative Proposals Relating to Income Tax Act and Other Legislation,* cls 56-64 (Feb. 4, 2022)

either are resident or do business in Canada. Over 15% of TEI's membership comprises tax professionals who work for Canadian businesses in a variety of industries across the country. The following recommendations reflect the views of TEI as a whole but, more particularly, those of our Canadian constituency.

As the preeminent association of in-house tax professionals worldwide, TEI is dedicated to the development of sound tax policy, compliance with and uniform enforcement of tax laws, and minimization of administration and compliance costs to the mutual benefit of government and taxpayers. TEI is committed to fostering a tax system that works—one that is administrable and with which taxpayers can comply in a cost-efficient manner. The diversity, professional training, and global viewpoints of our members enable TEI to bring a balanced and practical perspective to the legislative proposals discussed herein.

1. Implementation Timing and Transition

The Revised Draft Legislation, if enacted, is expected to come into effect for taxation years beginning on or after October 1, 2023, and introduces several rules and definitions intended to limit the deduction of excessive interest and other financing expenses.[3] While the revised proposals address many key issues raised by TEI and the delayed effective date provides taxpayers more time to prepare for the EIFEL rules, companies still do not know the final details and the legislation will need to be tabled in Parliament where it may be subject to further amendments. Compliance with this legislation will be complex and will require changes to business plans, therefore, it is essential that companies have all the details of the final legislation and sufficient time to prepare.

Recommendation 1: If the enactment is delayed beyond March 2023, then the implementation date should be shifted accordingly to provide taxpayers sufficient time to appropriately undertake any restructuring and develop compliance requirements.

The Revised Draft Legislation proposes a 40% transition relief, which is expected only to apply for taxation years that begin before January 1, 2024. Postponing the implementation date for the EIFEL rules provides companies with a reasonable amount of time to adapt to the new interest limitation rules; however, given the high inflationary environment, this may preclude companies from restructuring at this time and could result in significant costs for some companies. Providing transition relief to all companies would help mitigate some of the costs while companies undertake any restructuring.

Recommendation 2: Provide 40% transition relief for all taxation years beginning on or after October 1, 2023, and begin on or before September 30, 2024.

The application of the EIFEL rules will significantly increase the effective cost of companies' current debt. Business cases addressing the new EIFEL rules were based on the relevant tax implications at the time of the initial proposed legislation. Similarly, corporate decisions to use third-party debt to

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3 Dep't Fin. Can., *Legislative Proposals Relating to Income Tax Act*, (Nov. 3, 2022)

finance domestic and international operations were made having regard to the prevailing market conditions at that time. Since that time, interest rates have significantly increased and have made it apparent that debt financing is now, and may continue to be, far more expensive than it has been in recent years. In view of the current interest rate environment, restructuring long-term third-party debt may be cost prohibitive. In addition, higher interest rates will cause even more interest to be non-deductible in a particular year.

<u>Recommendation 3</u>: Given the impediments to the efficient restructuring of existing debt obligations, an exemption for interest expense derived from existing debt obligations on or before February 4, 2022, should be provided in any legislation to implement the EIFEL rules.

2. <u>The FAPI Regime and the Inclusion in Determining Relevant Interest and Financing Expenses</u>

The Revised Draft Legislation expands the EIFEL rules to include in a taxpayer's interest and financing expenses and revenues, the interest and financing expenses/revenues of controlled foreign affiliates that are relevant in determining foreign accrual property income ("**FAPI**") of such affiliates. Given that most jurisdictions have adopted the recommendations in the OECD BEPS Action 4 report, the risk that foreign affiliates are deducting interest in excess of the EIFEL rule limitations should be low. Moreover, given the complexity of the EIFEL rules and the fact that the "FAPI regime is regarded as one of the most complex tax schemes, with hundreds of definitions, rules, and exceptions that shift regularly"[4], the EIFEL rules should not be applied to foreign affiliates (just as the thin capitalization rules in subsection 18(4) are not applicable in accordance with clause 95(2.11)(f.11)(ii)(A)).

<u>Recommendation 4</u>: The EIFEL rules should not be applied in computing FAPI of controlled foreign affiliates given that the EIFEL risk related to a controlled foreign affiliate's FAPI is low and the significant complexity involved in applying the EIFEL regime to the FAPI regime. The EIFEL risks associated with foreign affiliates could be analyzed in the future and the rules could be amended at that time, but for now, the FAPI regime should not be included in the EIFEL rules.

If the Department decides the EIFEL rules should be applied to foreign affiliates, the following are some recommendations on amendments to the rules.

a. Foreign Accrual Property Loss

Very generally, the EIFEL rules apply to restrict interest expenses of a Canadian corporation ("**Canco**") where a controlled foreign affiliate ("**CFA**") of Canco uses borrowed money for the purpose of earning foreign accrual property income ("**FAPI**"). In contrast, the EIFEL rules do not apply where a CFA uses borrowed money to earn active business income. An anomalous result arises where a CFA holding company ("**Holdco**") uses borrowed money to fund a foreign subsidiary that carries on an active business ("**Opco**"). Specifically, the EIFEL rules may apply solely because the money is borrowed by Holdco rather than Opco. This is particularly inappropriate where, consistent with a CRA view from

4 *Canada v. Loblaw Financial Holdings Inc.*, 2021 SCC 51

2017,[5] Holdco does not claim an interest expense in respect of the borrowed money under paragraph 20(1)(c), and therefore does not claim a deduction in computing FAPI.

The definition of "adjusted taxable income" in draft subsection 18.2(1) subtracts the foreign accrual property loss ("**FAPL**") of a taxpayer's CFA to the extent that the FAPL is derived from net relevant affiliate interest and financing expenses. A CFA's relevant affiliate interest and financing expense is generally the amount that would be its interest and financing expense if the affiliate were considered a taxpayer resident in Canada (and thus subject to section 18.2) for purposes of computing its FAPI. The definition "interest and financing expenses" includes amounts paid or payable as, on account of, in lieu of payment of, or in satisfaction of, interest that is deductible for a particular year regardless of the particular provision of the *Income Tax Act* (Canada) under which it is deductible or whether claimed for the year (other than certain discretionary deductions in respect of mainly capitalized interest and financing expenses).

In the 2017 technical interpretation, the Canada Revenue Agency ("**CRA**") considered a scenario where a corporation ("**Canco**") resident in Canada had a CFA ("**FA1**") that was a holding company. FA1 borrowed $100 from an arm's length party ("**Bank**") at an interest rate of 10% and used the proceeds to acquire shares of another CFA ("**FA2**"), which were excluded property. The CRA stated that "if FA1 does not have any other amounts to be included in the computation of FAPI, the interest deduction for the interest paid or payable to the Bank would result in a FAPL in respect of FA1." Moreover, the CRA held that "it is our view that Canco is not required to deduct the interest expense paid or payable by FA1 to the Bank when computing FAPI of FA1, since paragraph 20(1)(c) is a discretionary deduction, the preamble of which provides that an amount 'may be deducted'."

As noted above, the relevant interest and financing expense includes the discretionary deductions under paragraph 20(1)(c) even if FA1 does not claim the deduction. Since the relevant interest and financing expense is included in Canco's interest and financing expense, it increases the proportion of denied interest to Canco. For example, if Canco would otherwise be able to deduct interest expenses of $30 to earn business income of $100, Canco would be denied 17.5%[6] of that interest expense where no interest deduction was claimed by FA1 (and thus no FAPL) because of the $10 relevant interest and financing expense of FA1. A larger proportion (25%[7]) of Canco's interest expenses would be denied if FA1 has a FAPL from claiming the interest deduction of $10 in respect of the payment to the Bank.

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[5] CRA Document No. 2017-0738081E5 "Interest expense of foreign affiliate holding company" (June 5, 2018).

[6] The proportion is determined by the formula (A – B) / F where Variables C, D and E are nil in subsection 18.2(2). Variable A is Canco's interest and financing expenses, which is $30 + $10 = $40. Variable B is 30% x Canco's adjusted taxable income, which is $70 + $40 = $110 (since FAPL is nil). Variable F is determined under paragraph (b), which is $30 + $10 = $40. Therefore, the proportion denied is equal to (40 – 30% x 110) / 40 = 17.5%.

[7] The adjusted taxable income would be $70 – $10 + $40 = $100 resulting in the proportion denied being equal to (40 – 30% x 100) / 40 = 25%.

Recommendation 5: The definition of relevant interest and financing expense should exclude amounts incurred by a CFA that are not actually deducted in computing FAPI/FAPL.

b. Active business under paragraph 95(2)(a)

The definition of "relevant affiliate interest and financing revenues" in draft subsection 18.2(1) expressly excludes amounts that are re-characterized as income or loss from an active business under paragraph 95(2)(a) because only amounts that are actually included in computed FAPI are included in relevant affiliate interest and financing revenues. Similarly, the relevant interest and financing expenses only applies to amounts that are included in computed FAPI (i.e., amounts referred to in paragraphs 95(2)(f)(i) and (ii)).

Since the Draft Legislation is intended to limit the amount of net interest expense as described in Budget 2021, reciprocity is required for interest expenses and revenues. Amounts that are re-characterized as income or loss from an active business under paragraph 95(2)(a) should be treated consistently, and a clarifying change is required to ensure such amounts are excluded from the definition of "relevant interest and financing expenses" in subsection 18.2(1).

Recommendation 6: The definition of relevant interest and financing expense should expressly exclude an amount included in computing a foreign affiliate's income or loss from an active business under paragraph 95(2)(a).

3. Capital Projects: Effect on Rates of Return

There continues to be some concern with respect to financing costs for capital projects related to the time before the project is in service. The rules, as amended, would cause the interest that is incurred prior to income being generated on a particular project to be restricted in later years. This would apply to all companies that are subject to the rules, including those that are primarily doing business in Canada.

The issue arises because denied interest expense in early years of construction is included in a restricted interest and financing expenses ("**RIFE**") pool (in accordance with paragraph 111(1)(a.1)) instead of the non-capital loss pool (in accordance with paragraph 111(1)(a)). When income is generated from the project in a later year, the interest deduction is limited to 30% of EBITDA, which could cause a project to be taxable earlier than it would be under the current rules. The concern here is that, because of the additional cash tax payable earlier, the project may not meet the taxpayer's required internal rate of return ("**IRR**"). In cases where these projects are beneficial to Canada (for example, large capital projects supporting green energy), this could have a detrimental effect on the construction of these projects.

An additional concern from a Canadian competition perspective for large multinational companies is the decision-making process regarding where to deploy their capital. If the interest limitation rules in Canada are so restrictive that they affect the IRR of a project, companies may choose to invest their capital in other countries.

Recommendation 7: Allow interest incurred prior to in-service dates that is currently included as RIFE carried forward in accordance with paragraph 111(1)(a.1) to be included in non-capital losses carried forward in accordance with paragraph 111(1)(a).

4. Foreign Ownership and Domestic Exception

The revised rules address an exception for groups that have minimal activities outside of Canada and no material foreign ownership. This exception is revised to include foreign affiliate holdings up to a *de minimis* threshold of $5 million of either book cost of the shares of the foreign affiliate or the fair market value of all the assets of the foreign affiliates. This exception was not contemplated in the original rules, so we welcome this concept of allowing a certain amount of foreign investment before a group is subject to the EIFEL rules.

The $5 million threshold may be quite low for many large multinational groups in Canada. Therefore, we would suggest that it may be more appropriate to incorporate a percentage calculation instead. This would then address groups of varying sizes, which we believe would be more equitable.

Recommendation 8: The concept of "all or substantially all" (which is generally interpreted to be 90% or more) should be applied to allow a Canadian group to own shares of foreign affiliates up to 10% of its book cost or own assets of foreign affiliates up to 10% of its fair market value before the EIFEL rules apply.

5. Financial Institutions

a. Definition of "insurance holding corporation"

The definition of "insurance holding corporation" in the Revised Draft Legislation has a requirement that qualifying value can only be attributed to an insurance corporation which is a subsidiary wholly-owned corporation (within the meaning of subsection 87(1.4)[sic]). This requirement is overly restrictive, as there are many circumstances in which an underlying insurance corporation is not wholly owned. In determining whether the value of a corporation is primarily attributable to shares or indebtedness of one or more insurance corporations, we respectfully submit that insurance corporations that are within the corporation's control should be included in that determination.

Recommendation 9: The definition of "insurance holding corporation" should be amended such that a corporation will qualify as an insurance holding corporation if the fair market value of its capital stock is primarily attributable to any combination of shares or indebtedness of one or more insurance corporations that are controlled directly or indirectly by it.

b. Financial Institution Group Entity ("FIGE") and the Transitional Rules

In computing the group net excess capacity amount described in subparagraph (d)(vi) of the transition rules, the excess capacity and excess interest of a FIGE is not included. The effect of this is that

a FIGE will have little or no opening cumulative unused excess capacity in its first year in which section 18.2 applies.

Given that FIGEs are allowed to transfer their cumulative unused excess capacity to other FIGEs, Special Purpose Loss Corporations ("**SPLCs**"), and Insurance Holding Corporations ("**IHCs**"), they should be within the scope of the transition rules. Absent such a change, such entities would be at a disadvantage to other industries and groups. Moreover, the excess interest incurred by an IHC or SPLC in pre-regime years will significantly reduce the amount of group net excess capacity without the ability to utilize the excess capacity of FIGEs in the group. Given that the excess interest of an IHC or certain SPLCs is tied to the operations of its FIGEs, this does not produce the correct result.

Recommendation 10: In determining group net excess capacity in the transition rules to section 18.2, we propose that FIGEs, IHCs, and SPLCs are subject to separate transition rules and should be treated as a separate group from all other eligible group entities within a group. In effect, FIGE, IHC, and SPLC Group entities would compute their excess capacity, excess interest, and group net excess capacity as a separate group and such entities would then be allowed to make an election to treat a component of such group net excess capacity as their cumulative unused excess capacity arising from their pre-regime years.

6. Election to Transfer Excess Capacity

Pursuant to paragraph 18.2(4)(e) of the Revised Draft Legislation, an election to transfer excess capacity can be rendered invalid if the total of all amounts of transferred capacity exceeds the total of the transferor's cumulative excess capacity for the year. Accordingly, an election may be considered invalid if it is later determined by the taxpayer that there was an inadvertent (even nominal) excess of transferred capacity – which respectfully seems overly punitive.

Recommendation 11: We recommend that paragraph 18.2(4)(e) be removed as a condition for making a valid election and replaced with a provision which would deny an amount of transferred capacity to the extent that the transferor's transferred capacity in a year exceeds the transferor's cumulative excess capacity for the year.

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TEI appreciates the opportunity to provide input on the Revised Draft Legislation and would be pleased to discuss further with Department officials as they work to finalize the legislation before its introduction in Parliament. The preceding comments were developed jointly by a cross-industry working group of concerned TEI members under the aegis of TEI's Canadian Income Tax Committee, whose chair is Steve Saunders. Should you have any questions about TEI's submission, please do not hesitate to contact Mr. Saunders at 403-801-4657 or steve.saunders@atco.com.

Respectfully submitted,

Wayne G. Monfries
International President
TAX EXECUTIVES INSTITUTE