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May 6, 2022

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

Re: Proposed Excessive Interest and Financing Expenses Limitation

Dear Minister Freeland:

On behalf of Tax Executives Institute, Inc. ("**TEI**"), I am pleased to submit our comments on the draft legislative proposals released on February 4, 2022, to limit the amount of interest and other financing expenses that businesses may deduct for income tax purposes.[1] These proposals were initially described in the federal budget documents tabled in the House of Commons on April 19, 2021 ("**Budget 2021**"),[2] on which TEI provided preliminary comments on December 29, 2021.[3] We appreciate the opportunity to comment on the new draft legislative proposals and respectfully urge the Department of Finance (the "**Department**") to consider our comments when finalizing the legislation before its introduction in Parliament. As always, TEI would welcome the opportunity to discuss any of our comments in further detail with Department officials, either in person or by telephone.

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

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

[2] Dep't Fin. Can., Budget 2021, Annex 6, *Tax Measures: Supplementary Information* (Apr. 19, 2021)

[3] Letter from Mitchell S. Trager, Int'l President, Tax Exec. Inst., to Hon. Chrystia A. Freeland, P.C., M.P., Deputy Prime Minister & Minister of Fin., Dep't of Fin. Canada (Dec. 29, 2021). https://www.tei.org/advocacy/submissions/tei-comments-proposed-interest-deductibility-limits-canadian-budget-2021

Connect. Engage. Impact.

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 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. Background of the Proposed Limitations on Interest and Financing Expenses

On February 4, 2022, the Department released for public comment a package of draft legislative proposals (the "**Draft Legislation**") to implement certain tax measures that were announced in Budget 2021. The package included proposed amendments to the *Income Tax Act* (Canada) (the "**Tax Act**") that, if enacted, would limit deductible net interest expense of certain corporations and trusts to a percentage (i.e., fixed ratio) of adjusted taxable income ("**ATI**") as described in below. The proposed amendments are referred to as the Excessive Interest and Financing Expenses Limitation ("**EIFEL**") rules and are intended to be consistent with the Action 4 Report under the OECD/G20 Base Erosion and Profit Shifting ("**BEPS**") Project.[4] BEPS Action 4 addresses concerns about base erosion arising from the deduction of excessive interest and other financing costs for income tax purposes. The Action 4 Report limits the amount of deductible net interest expense (i.e., interest expense, including payments economically equivalent to interest, as well as other financing-related expenses, less interest and financing-related income) to a fixed ratio of earnings before interest, taxes, depreciation, and amortization ("**EBITDA**").[5]

The Draft Legislation, if enacted in its current form, would be effective for taxation years beginning on or after January 1, 2023, and introduce several rules and definitions intended to limit the deduction of excessive interest and other financing expenses.[6] In particular, the Draft Legislation would:

- apply to interest and financing expenses incurred by Canadian-resident corporations, trusts, partnerships of which such corporations or trusts are members, or non-residents earning taxable income in Canada;

[4] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update, OECD/G20 Base erosion and Profit Shifting Project* (2017), http://dx.doi.org/10.1787/9789264268333-en (hereinafter the "**Action 4 Report**").
[5] *Action 4 Report*, http://dx.doi.org/10.1787/9789264268333-en
[6] Dep't Fin. Can., *Legislative Proposals Relating to Income Tax Act & Other Legislation,* cls. 56-64 (Feb. 4, 2022)

- not apply to:
  - Canadian-controlled private corporations ("**CCPCs**") with aggregate taxable capital amongst associated entities of less than $15 million;
  - groups with aggregate net interest and financing expenses of $250,000 or less; or
  - a Canadian group carrying on all or substantially all of its business in Canada, which does not have any foreign affiliates, and does not have any non-resident shareholders who, together with non-arm's length persons, own shares with 25% of the votes or value of the issuer, provided that the group pays all or substantially all of its interest and financing expenses to taxable, Canadian-resident persons;
- limit the deduction of net interest and financing expenses to 30% of ATI for taxation years beginning on or after January 1, 2024 (40% of ATI for taxation years beginning on or after January 1, 2023, but prior to January 1, 2024);
- define ATI as taxable income for the year or, in the case of a non-resident, its taxable income earned in Canada, in either case adjusted to add back any deductions claimed in computing taxable income in respect of interest and financing expenses, certain tax expenses, and capital cost allowance and to subtract any income inclusions for interest and financing revenues, untaxed income (including foreign source income in respect of which a foreign tax credit is claimed in Canada) and certain other amounts;
- define interest and financing expenses to include interest paid or payable and may include certain financing costs, such as capitalized interest claimed as deductions in respect of capital cost allowance or added to certain resource expenditure pools, amounts paid or payable, or losses incurred, that can reasonably be considered to be part of the cost of funding, expenses under certain hedging or funding derivatives or agreements meant to charge what is not technically interest but economically similar to interest, and imputed interest in respect of certain leases;
- define interest and financing revenues to include certain interest income, guarantee and similar fees, certain lease revenues, and certain amounts earned in relation to loans made or financing provided by a taxpayer;
- permit unused excess capacity to be transferred between eligible group members that have the same tax reporting currency;
- permit use a group ratio if the consolidated group's ratio of book net interest expense to EBITDA exceeds the fixed ratio;
- allow taxpayers to carry over interest and financing expenses denied under the rules for up to 20 taxation years; and

- apply anti-avoidance measures may apply if it can reasonably be considered that one of the reasons for undertaking a transaction was to obtain a deferral of the application of the rules or an attempt to increase deduction capacity.

The EIFEL rules are intended to address BEPS concerns arising from taxpayers deducting excessive interest and financing costs and these rules may apply in addition to existing provisions of the Tax Act such as thin-capitalization, transfer pricing rules, foreign affiliate anti-dumping rules, and other rules. TEI's comments and recommendations regarding the EIFEL rules are set forth immediately below.

2. Complexity of Canadian Rules Relative to Other Countries' Approaches

In our letter of December 29, 2021, TEI strongly encouraged the Department to look at the competitiveness of the overall tax system when drafting the proposed interest limitation rule. Our comments in that letter remain pertinent as neither the legislation nor the accompanying explanatory notes[7] considered making adjustments to Canada's other interest limitation rules.

We draw the Department's attention to the Action 4 Report on targeted rules,[8] which states that specific rules should be based on specific risks not remediated by general rules along with specific anti-avoidance rules that reinforce the overall EBITDA interest limitation.[9] We note the Draft Legislation addresses several of the rules in paragraphs 171 and 173 of the Action 4 Report.

Recommendation #1: TEI's view continues to be that, instead of adding new limitations on top of current interest limitations, Canada should assess the overall policy and articulate what additional interest limitations measures, if any, are required in addition to the Draft Legislation and the accompanying anti-avoidance measures contained therein.

3. Application of the EIFEL Rules to Existing Debt and Inability to Restructure

The lack of transition relief in the Draft Legislation would significantly reduce a taxpayer's ability to continue to deduct ordinary and reasonable interest expense under the current rules, which in turn may adversely impact Canadian businesses.

Whether by design or effect, the EIFEL rules would penalize Canadian-controlled multinational companies, which have existing borrowings at the Canadian parent level, if they are not able to either (i) "push down" existing borrowings to foreign operating subsidiaries, or (ii) recapitalize investments in foreign affiliates to convert existing equity investments into debt. As described in more detail below, even if Canadian controlled multi-national companies can overcome legal and regulatory impediments to "push down" existing borrowings or restructure existing investments, the commercial and tax costs of doing so will be prohibitive.

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[7] *See* Dept. of Fin. Can., *Explanatory Notes of Legislative Proposals Relating to the Income Tax Act and Other Legislation*, (Feb. 4, 2022) (hereinafter "**Explanatory Notes**").
[8] *Action 4 Report*, paragraphs 168-173.
[9] *Ibid.* at paragraph 169.

There are significant commercial reasons why Canadian-controlled multinational enterprises borrow at the parent company level, including: borrowing rates and terms from lenders, depth of capital markets, transaction costs, availability of audited financials, and regulatory considerations. It is typically inefficient to break up debt financing among individual business segments or jurisdictions because the parent company generally has the best market relationship to obtain the most favourable financing.

The EIFEL rules may be based on the erroneous assumption that Canadian-controlled multinationals can, within a short period of time, revise their capital structures by recapitalizing foreign affiliates (to increase deductible borrowing by those affiliates) and de-lever the parent company. There are many legal, regulatory, and tax impediments that may prevent Canadian parent companies from efficiently restructuring corporate borrowings with foreign affiliates or converting existing equity investments into debt.

Consider the following:

- In cases where a Canadian parent company has borrowed funds to invest in or acquire a foreign affiliate, it typically is neither permissible nor feasible—under commercial terms or legal obligations governing the parent or its affiliates—to push down existing debt into foreign affiliates. Significant break fees, such as make-whole payments or prepayment penalties, may be triggered. Taxpayers may not be able to easily restructure certain debt instruments (e.g., hybrid debt that receives equity treatment from a credit rating agency, but is debt for tax purposes, can be issued only by the Canadian public parent company). Additionally, current financial arrangements would need to be considered, including restrictive distribution covenants in loan agreements and existing commercial agreements.

- There are foreign currency exchange implications of unwinding financing arrangements or recapitalizing an equity investment in a foreign affiliate. These implications could be financially significant (e.g., where a Canadian parent company has hedged its foreign exchange exposure based on a certain term of its external debt and the debt is now required to be repaid early to address tax law changes).

- Dividend distributions may be subject to foreign withholding tax if the business has current earnings and profits. For example, distributions from a U.S. corporation are generally treated as sourced first from current and accumulated earnings and such amounts may be subject to U.S. withholding tax. Thus, it may be prohibitive or costly to push down corporate borrowings or change existing equity investments into loans to foreign affiliates if such changes result in a dividend distribution. In addition, there are prohibitive rules in some jurisdictions where debt refinancing could cause the new debt not to qualify for transitional provisions (e.g., refinanced debt to the United States could be subject to the new final regulations regarding the treatment of certain interests in corporations as stock or indebtedness under section 385 of the U.S. Internal Revenue Code of 1986 (as amended)).

- Foreign tax laws may not allow a foreign affiliate to deduct, in computing the affiliate's income for tax purposes in its jurisdiction of residence, interest expense on borrowed funds

used to return capital or pay dividends to its Canadian parent. Recapitalizing existing debt, however, generally requires a new borrowing to repay capital with new interest expense in the local country.

- Foreign corporate laws may impose limits on the ability to make distributions in the foreign jurisdiction.

- There are some cases where regulatory requirements may penalize companies for borrowing in foreign jurisdictions, such as the United States, as opposed to Canada. For example, capital adequacy tests imposed by the Office of the Superintendent of Financial Institutions are designed in a manner to encourage Canadian financial institutions to borrow in Canada even where the funds are used for foreign expansion. Borrowing in the foreign jurisdiction would translate into an unfavorable impact in the financial institution's solvency ratio.

Recommendation #2: Given these impediments to the efficient restructuring of existing debt obligations, we respectfully urge the Department to provide an exemption for interest expenses derived from existing debt obligations in any legislation to implement the EIFEL Proposals, including from any refinancing of such arrangements.

Such a "grandfathering" exemption has been provided under the BEPS Action 4 domestic law measures of nine OECD members in the European Union and is also consistent with the explicit recommendations in the Action 4 Report:

> [A] country may exclude interest on existing loans from the scope of rules, either for a fixed period or indefinitely. This may be particularly relevant for third party loans which form part of a group's regulatory capital, as these loans are often long dated and there may be substantial penalties if they are repaid early. In any case, these "grandfathering" rules should only apply to loans entered into before interest limitation rules are announced and should cease to apply if a loan is subsequently re-financed or if the terms of the loan are significantly modified, to the extent this results in an increase to the tenor of the loan, the principal of the loan or to the rate of interest that applies.[10]

The EIFEL rules are expected to be effective for taxation years beginning on or after January 1, 2023. Final legislation implementing any EIFEL proposals is not expected until later in 2022 following the completion of the Minister of Finance's consultation process. Moreover, Budget 2022 has proposed adoption of the OECD's Pillar 1 and Pillar 2 recommendations. Given such a short timeframe, there may not be adequate time for taxpayers to address many of the punitive consequences of the application of the EIFEL rules—particularly if taxpayers are not able to quickly restructure their existing financing arrangements for the reasons described above—as well as adequately respond to the various upcoming legislative proposals in Budget 2022. Companies have followed the evolution of interest deduction limitations implemented by other OECD members but were unable to plan for the EIFEL rules as draft legislation was needed to understand implementation details. The rules implemented by other OECD

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[10] *Action 4 Report*, paragraph 539.

members, moreover, have varied and the lack of tax consolidation in Canada created further uncertainty in anticipating draft legislation. In addition, the draft legislation was originally to be released for public consultation in late summer / early fall of 2021, which would have provided the Department adequate time to implement final legislation consistent with Canadian tax policy and address the numerous issues identified by advisors, taxpayers and the Department itself.

Recommendation #3: The effective date of application of the EIFEL rules should be deferred by one year, such that they would begin to apply to taxation years beginning on or after January 1, 2024.

4. **Public Infrastructure and Large Capital Projects**

The EIFEL rules do not contemplate the provision of any sectoral exemptions like those found in the tax laws of Canada's trading partners. It would be inappropriate to apply, for example, the proposed earnings-stripping rule to limit the deductibility of interest expense related to large capital projects, including public infrastructure projects ("**P3 projects**"). P3 projects and other large capital projects in Canada would be substantially affected by the proposed rules. The financial models prepared for these projects generally reflect operating losses in early years and profitability in later years as construction is completed. By their very nature, public infrastructure and other large capital projects require substantial initial capital outlays to build and, in many cases, large ongoing capital outlays to maintain. These long-term projects (20–30 years or more), have evolving risks throughout their development and construction lifecycles, and are generally undertaken by a consortium of unrelated parties. Limiting the ability of these businesses to deduct their project-related interest expenses would not only frustrate the public policies promoting such investments but also make Canada an outlier among its trading partners.

Recommendation #4: Implications to large-scale infrastructure projects should be reviewed to ensure the EIFEL rules do not negatively impact such projects and consideration should be given to provide such projects an exception to the EIFEL rules.

5. **Interest Expense and Revenue Definition**

a. Interest and Financing Revenue

Subsection 18.2(12) of the Draft Legislation excludes amounts received or receivable from non-arm's-length non-residents (i.e., amounts received from related foreign parties) from the definition of interest and financing revenue. No policy explanation was provided by the Department for this exclusion. This rule restricts the inclusion of interest income earned by Canadian taxpayers from loans made to foreign affiliates, which may disallow interest expense without offsetting interest income. This is particularly the case when such loans are funded by the Canadian taxpayer's debt, which itself is subject to the EIFEL rules. Further, deemed or imputed interest income in cases where a Canadian taxpayer makes a pertinent loan or indebtedness ("**PLOI**") election to avoid the application of the shareholder loan or foreign affiliate dumping rules on loans to related non-residents or notional interest income under section 17 of the ITA, are not included in the definition of interest and financing revenue.

Foreign-source, non-arm's length interest revenue is already within the scope of Canadian transfer pricing rules and subject to restrictions under applicable foreign tax laws. Additionally, many countries have adopted some version of BEPS Action 4, including large countries such as the United States, United Kingdom, Germany, South Korea, India, and Nigeria.[11] Other countries, such as China and Australia, currently use a balance sheet approach similar to Canada. In these cases, the residence country of the paying entity imposes its own rules to ensure any deductible interest expense is not excessive.

Implementing the rule set forth in subsection 18.2(12) of the Draft Legislation would eliminate the viability of Canadian entities participating in a global cash pool, at least where the entity is a net lender. Not being part of such a cash pool directly increases Treasury costs for the Canadian company.

Recommendation #5 The definition of interest and financing revenue should include interest income received or receivable from non-arm's length non-residents and any deemed, imputed, or notional interest income included in taxpayer's income.

b. Foreign Accrual Property Income

Interest income earned by a controlled foreign affiliate and included in a Canadian taxpayer's taxable income as foreign accrual property income ("**FAPI**") is not included in the definition of interest and financing revenue under the EIFEL rules. This omission may result in a net increase in taxable income, particularly where a foreign affiliate earns interest income in respect of an upstream loan to a Canadian taxpayer. In that case, FAPI is fully taxable, yet the interest expense may only be partially deductible. The Action 4 Report recommended countries consider including such income as interest and financing revenue, thus allowing for an offset against interest and financing expenses subject to the proposed EIFEL rules:

> 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.[12]

Including FAPI interest revenue and expense in ATI rather than as interest and financing revenue or interest and financing expense is inappropriate.

Recommendation #6: Amounts included in taxpayers' income as FAPI interest revenue should be included in the definition of "interest and financing revenue" and excluded from the calculation of ATI.

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[11] The OECD website https://qdd.oecd.org/subject.aspx?Subject=ILR provides a summary description of the rules adopted in these and other countries, which are compliant with or similar to the rules of BEPS Action 4.

[12] *Action 4 Report*, paragraph 203. 3.

6. Capital Leases

The definition of "lease financing amount'" in subsection 18.2(1) of the Draft Legislation requires that capital lease interest be calculated based on prescribed income tax rules. However, Canadian taxpayers who report financial results under either international financial reporting standards ("**IFRS**") or U.S. generally accepted accounting principles ("**GAAP**") are required to calculate lease interest under those rules (i.e., IFRS 16 or accounting standards codification topic ("**ASC**") 842). Therefore, this rule would require taxpayers to track leases under both accounting and tax rules, duplicating effort and risking errors.

Recommendation #7: To reduce the administrative complexity of the new rules, the Draft Legislation should allow taxpayers to elect to use lease financing amounts as determined for statutory accounting purposes if these amounts are included in audited financial statements under IFRS or U.S. GAAP.

7. Definition of Excluded Interest – Partnerships

Under the Draft Legislation, interest and financing expenses and revenues do not include "excluded interest", thereby taking such amounts outside the ambit of the EIFEL regime. The Explanatory Notes indicate this is principally – though not exclusively – not intended to negatively impact loss consolidation transactions commonly undertaken within Canadian corporate groups, which rely on the deductibility of interest expense. TEI supports this approach. In the absence of a consolidated tax reporting or loss transfer regime under the *Income Tax Act*, it is critical that the EIFEL regime not adversely impact the ability of affiliated corporate groups to effect loss consolidation through in-house transactions.

TEI submits, in addition, that the scope of what constitutes excluded interest should be broadened to include interest arising on indebtedness between a corporation and partnership and on indebtedness between partnerships.

While broadening the exclusion to apply to partnership interest expense and revenue may be considered to be irrelevant to the principal objective of corporate group loss consolidation, it is common for Canadian corporate groups to operate through a wholly-owned subsidiary partnership. For corporate groups with such partnerships, a loss consolidation transaction may be more efficiently implemented by making an interest-bearing loan to or from a partnership rather than from corporation to corporation. Accordingly, broadening the definition would facilitate permutations on typical in-house loss consolidation transactions and ease the ongoing inefficiencies encountered by corporate groups due to the absence of a formal consolidated tax reporting regime.

TEI submits the inclusion of partnership indebtedness within the scope of the definition would also help alleviate some degree of the monitoring and compliance burden associated with the application of the Draft Legislation, particularly the complexities associated with the transfer of excess capacity within groups under proposed subsections 18.2(4)-(10). The exemption for excluded interest, which applies regardless of whether the underlying indebtedness was motivated by in-house loss consolidation purposes, offers a much more practical, simplified path to managing the application of the EIFEL rules

to indebtedness within corporate groups. There does not seem to be any reason in principle to foreclose access to the relief afforded by the definition solely because the interest arises on a debt obligation to which a partnership is a debtor and/or creditor, so long as all the interest revenue and expense arising in the relevant period on the obligation is included in the calculation of income of corporations within the group.

Recommendation #8: The definition of "excluded interest" should include interest arising on indebtedness between a corporation and partnerships and on indebtedness between partnerships, provided that:

- ***the membership of the partnership(s) is comprised of "taxable Canadian corporations" that are "eligible group corporations" in respect of the relevant taxpayer throughout the relevant fiscal period(s) of the partnership(s) in which the interest arises; and***
- ***all members of the partnership(s) are included in the joint election contemplated in paragraph (c) of the excluded interest definition.***

8. Definition of Adjusted Taxable Income

a. Treatment of Losses

The starting point for the computation of ATI under the Draft Legislation is a taxpayer's taxable income for the year ("D" in the calculation of ATI) as otherwise determined, less the amount of current year losses, both non-capital and capital (the "E" in the calculation). The difference of these components can be either positive or negative. Accordingly, if a taxpayer incurs a loss in the current year, the difference will be negative, given that taxable income in this case would be nil, and the deduction of the loss would result in a negative balance, as illustrated below. As a result of the operational formulas in the definition, a current year loss effectively reduces ATI for that year.

Example #1 – Current year loss	
Net income before interest income / expense	5,000
Interest income	5,000
Interest expense	(15,000)
Taxable income (loss)	(5,000)
Computation of ATI	
Taxable income (D)	---
Current year loss (E)	5,000
D – E = A	(5,000)
Interest expense (B)	15,000
Interest income (C)	5,000
ATI = A + B – C	**5,000**

In a subsequent year when the carried-over loss is applied, the computation of ATI is adjusted, but only in respect of the portion of the loss that relates to excess interest expense arising in the prior year. If 100% of the prior year's loss relates to excess interest expense, the formula included in the definition of ATI functions appropriately and adds 100% of the loss to the current year's ATI. This is the appropriate outcome as 100% of the loss reduced ATI in the prior year.

However, if all or a portion of the loss realized in the prior year related to operational activities and not to excess interest expense, only a portion or none of the loss would be included in ATI in the year it is used. This is inappropriate given the reduction of ATI by the balance of the loss in the year it is realized, and the reduction of taxable income (and potentially no adjustment to ATI) in the year it is claimed.

Recommendation #9: Adjust the definition of ATI to ensure that losses are treated appropriately at both points in time – the year of realization and the year of utilization.

b. Add-Back for Depreciation and Amortization Amounts

Under the Draft Legislation, capital cost allowance deducted pursuant to paragraph 20(1)(a) in computing income for the taxation year of a taxpayer would be added back to the calculation of the taxpayer's ATI. Deductions claimed by a taxpayer in respect of the following "resource pools" would not be added back:

- Cumulative Canadian oil and gas property expense ("**CCOGPE**");
- Cumulative Canadian exploration expense - including Canadian renewable and conservation expenses - ("**CCEE**");
- Cumulative Canadian development expense ("**CCDE**");
- Cumulative foreign resource expense ("**CFRE**");
- Foreign exploration and development expenses ("**FEDE**"); and
- Successored CCOGPE, CCEE, CFRE, and CCDE.

From an industry perspective, the overwhelming majority of capital expenditures incurred by resource extraction sector taxpayers are either included in the undepreciated capital cost of an applicable class of depreciable capital property or in the foregoing resource pools. Depending on the nature of the resource asset held by an entity, the overwhelming majority of capital expenditures could be added to the entity's resource pools. For example, consider the acquisition cost of developed conventional oil and gas production assets in Western Canada, which would typically be substantially weighted towards

resource pools over undepreciated capital cost under the 80/20 rule of thumb for the allocation of purchase price for such assets.[13]

TEI submits that maintaining/not reversing the deduction of resource pool claims in the determination of ATI is inconsistent with the rationale for adopting EBITDA as the baseline for determining interest deductibility thresholds. The OECD has indicated that the choice of EBITDA is beneficial in that it excludes two major non-cash costs in a typical income statement, better guiding the ability of an entity to meet its obligations to pay interest.[14] It is also a measure of earnings often used by lenders in deciding how much interest expense a borrowing entity can reasonably bear.[15] By not adjusting for an entity's resource pool claims, the resulting ATI may grossly understate the entity's borrowing capacity, unduly restricting the ability to deduct interest and financing expenses when incurred.

Based on our understanding of recent informal discussions between the tax community and the Department, the approach taken in the Draft Legislation with respect to resource pool claims was intentional. We also understand this approach may have been guided by an assumption that a significant portion of costs included in resource pools are costs that would otherwise be deductible on a current basis in computing income in the absence of the resource pool regime (e.g., salary and wages). TEI believes these assumptions are unwarranted. For example, the costs added to an oil and gas producer's CCOGPE or CFRE for acquisitions of mineral leases and other drilling rights are strictly costs for the acquisition of intangible property, which, in the absence of the resource pool regime, would invariably be capital outlays made with a view of earning income for the enduring benefit of the producer's business. Similarly, the acquisition cost of mineral rights by a mining sector participant included in the participant's CCDE or CFRE would also not include material components of otherwise currently deductible costs.

While there may be a greater likelihood of inclusion of otherwise currently deductible costs in resource pools when incurred while developing resource assets (as opposed to acquiring rights to exploit resources), the blanket approach taken in the proposed definition of ATI fails to consider that a significant portion of development-related costs included in resource pools would not otherwise be currently deductible. To clarify, the approach taken fails to recognize that significant components of development-related costs would, in the absence of the resource pool regime, be truly capital in nature. In the context of oil and gas sector development, significant outlays must be made to acquire drilling materials and to obtain the use of equipment to drill wells to exploit underlying resources. If analogous material and equipment rental costs are incurred in the construction of depreciable capital property, it is submitted that those costs would be included in the capital cost of the particular property and deducted to the

[13] If a vendor and purchaser agreed to a purchase price of $100 million for a parcel of developed conventional oil and gas production assets, the vendor and purchased would likely agree to allocate 80% of the purchase price to the underlying mineral exploitation rights, which would constitute COGPE, with the remaining 20% allocated to tangible assets, which would likely constitute Class 41 depreciable capital property

[14] *Action 4 Report*, paragraph 78.

[15] *Ibid.*

extent permitted under paragraph 20(1)(a), and would, therefore, be added back in the computation of ATI as currently constructed.

TEI submits that the lack of an "add-back" for resource pool claims in the calculation of ATI penalizes the resource extraction sector industry, when compared to other capital-intensive industries, simply because a significant component of its capital expenditure profile is dealt with under the Tax Act outside of the capital cost allowance regime.

Recommendation #10: The calculation of adjusted taxable income be altered to include the add-back the deduction of "subdivision e" resource pool claims. TEI invites the Department to engage in further discussions with industry to resolve the foregoing concerns with respect to the approach taken in the proposed legislation to the determination of adjusted taxable income.

9. Excess Capacity Transfer

Subsection 18.2(4) of the Draft Legislation provides the conditions that must be satisfied to elect to transfer cumulative unused excess capacity between two taxable Canadian corporations. The requirement in paragraph 18.2(4)(b) provides:

> (b) the transferor and the transferee
>
> (i) are taxable Canadian corporations throughout their respective taxation years,
>
> (ii) are eligible group corporations in respect of each other at the end of their respective taxation years, and
>
> (iii) have the same tax reporting currency (within the meaning assigned by subsection 261(1)) throughout their respective years; [emphasis added]

a. Same Tax Reporting Currency Requirement

It is not clear why, from a tax policy perspective, the proposals limit the transfer of cumulative unused excess capacity between corporations that have the same tax reporting currency. We perceive this to be an unintended result of the Draft Legislation and request the Department to amend this rule accordingly. We note that cumulative unused excess capacity could simply be converted using the relevant spot rate (as defined in subsection 261(1)) to avoid placing corporate groups that have entities with different functional currencies at a disadvantage.

Recommendation #11: Allow transfer of unused excess capacity regardless of tax reporting currency; allow use of relevant spot rate to convert unused excess capacity at the time of transfer.

b. Limiting Capacity Transfer to Corporations

To make the election under proposed subsection 18.2(4), both corporations must be "eligible group corporations" – defined in proposed subsection 18.2(1) as certain corporations resident in Canada and that are related or affiliated. From a tax policy perspective, it is unclear why this rule is limited to corporations – and does not allow the transfer of cumulative unused excess capacity between a

corporation and a commercial trust that is otherwise treated under the Income Tax Act (Canada) in a manner similar to a corporation.

Recommendation #12: The definition of "eligible group corporation" be amended to refer to "eligible group entity" – and that the definition specifically include commercial trusts to all the transfer of cumulative unused excess capacity between such a trust and a corporation (and not only between corporations).

10. Carryforward of Denied Expenses

Interest and financing expenses denied under the EIFEL rules may be carried forward for up to 20 years in computing taxable income. The carryforward is allowed to the extent a taxpayer has "excess capacity" for a subsequent taxation year, or to the extent it has "received capacity" because of having received a transfer out of the cumulative unused "excess capacity" of a group member.

The 20-year carryforward approach differs significantly from the approach applied by several EU member states and the United States, which allow unused interest expense to be carried forward indefinitely. We request the Department to amend the carryforward period such that interest and financing costs denied under the EIFEL rules may similarly be carried forward indefinitely. We note that such an indefinite carry forward would be consistent with the treatment of capital losses (which may also be carried forward indefinitely) and would provide greater flexibility – particularly for industries that engage in long-term capital-intensive projects.

Recommendation #13: Allow indefinite carry forward of denied interest and financing expenses.

11. Financial Institutions

The Draft Legislation prohibits a relevant financial institution ("**RFI**") from transferring its cumulative unused excess capacity ("**CUEC**") to eligible group corporations ("**EGCs**"). This prohibition is inconsistent with the approach taken by other jurisdictions, is overly restrictive, and will produce punitive and inappropriate results in a variety of circumstances.

The proposed rules are inconsistent with the approaches taken by other G20/OECD member countries in their implementation of the OECD's suggested common approach outlined in the Action 4 Report. For example, the United Kingdom, Germany, and the United States do not include any special rules or carve outs for RFIs in their interest limitation rules. Thus, RFIs in those jurisdictions are entitled to share capacity and/or be treated the same as taxpayers in any other sector.

As Canada's proposed approach is inconsistent and more restrictive than the approach taken by the majority (if not all) of the other countries that have adopted BEPS Action 4 recommendations, if changes are not made to the proposed rules to remove the restrictions on the sharing of CUEC by RFIs, Canadian taxpayers would be at a significant competitive disadvantage when compared to taxpayers in other jurisdictions.

a. Holding Companies

The Explanatory Notes state that financial institutions would be expected to have excess capacity because their regular business activities tend to result in interest income exceeding their interest expense, and this restriction on sharing CUEC is intended to ensure such net interest income cannot be used to shelter the interest and financing expenses of other members of the financial institution's group. However, the broad limitation on the ability for RFIs to share CUEC with any and all EGCs ignores that for regulatory, commercial, or other reasons, an RFI's business operations may be carried out or supported through multiple EGCs.

RFIs may prefer or be required to issue regulatory capital out of a "single point of entry" through a holding company at the top of the group. Limiting the ability of an RFI to share CUEC with a holding company produces an inappropriate result especially when the interest and financing expenses of the holding company are incurred specifically to fund the operations of the RFI in a commercially efficient manner and / or to follow regulatory requirements.

For the Canadian insurance industry, these holding company structures were historically implemented upon demutualization. These holding companies raise regulatory debt capital from the public, as an RFI subsidiary would not typically issue debt to the public directly. Under the proposed rules, interest and financing expenses of the holding company may be disallowed to the extent that the holding company and any other EGC in the related group do not have any CUEC. This produces an inappropriate result as any CUEC of the RFI cannot be transferred to the holding company, even though the interest and financing expenses of the holding company may be incurred specifically to fund the operations of the RFI in a commercially efficient manner, following regulatory requirements. In other words, interest paid on external debt to fund the operations of an RFI may not be deductible, which would ultimately lead to a significant cost to the group and a disadvantage compared to entities that are not structured in the same manner as, for example, financial institution groups (including many banks) where there is no holding company and the RFI is the entity that also issues capital to the market. This would have the effect of placing many Canadian insurance groups at a competitive disadvantage when compared to certain banking and other groups.

b. Interest Income

In paragraph 5 of their discussion draft regarding the impacts of BEPS Action 4 on the insurance and banking sector, the OECD states:

> [f]or 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.[16]

The Explanatory Notes acknowledge this, stating in effect that financial institutions earn substantial amounts of interest income as part of their regular business activity.[17] These commentaries acknowledge that an RFI's interest income is a fundamental component of its business income comparable with revenue and cost of sales of a non-RFI. However, a non-RFI can include a portion of its business income in its CUEC (i.e., by multiplying its ratio of permissible expenses with its adjusted taxable income), while an RFI is unable to share any portion of its business income with EGCs under the proposed rules. This puts groups with RFIs at a significant disadvantage compared to groups without an RFI.

Recommendation #14: The proposed rules should be amended to include either of two alternatives:

1. ***To counter the inequality of the proposed tax rules in Canada versus elsewhere, the draft rules should be amended to eliminate the restriction on RFI's in their ability to transfer CUEC to other EGCs; or***

2. ***All arm's length interest and financing expenses incurred by holding companies that directly hold the shares of an RFI should be excluded from the definition of interest and financing expenses or, alternatively, the RFI should be allowed to transfer its CUEC to the particular holding company up to an amount that would fully eliminate any amount of interest and financing expenses of the holding company denied under proposed subsection 18.2(2). This would be consistent with (and a required improvement over) the OECD's proposed measure in paragraph 56 of their discussion draft regarding the impacts of BEPS Action 4 on the insurance and banking sector (issued 28 July 2016). In particular, the OECD recommends that "[w]here a country applies the fixed ratio rule to a local group excluding banks and insurance companies, it should consider excluding some or all of the third-party interest expense on regulatory capital from the net interest expense subject to the rule."; <u>and</u>***

   For purposes of sharing CUEC by an RFI with other EGCs, the computation of an RFI's excess capacity would be adjusted by amending the definition of adjusted taxable income in such a way that it does not remove the RFI's interest and financing expenses or interest and financing revenues. Similar amendments would need to be made to other parts of these rules. An RFI should then be permitted to share its CUEC with any EGCs on the basis that its CUEC should be measured by this revised method of computing adjusted taxable income multiplied by the ratio of permissible expenses. The reference to an RFI in paragraph 18.2(4)(c) would be removed.

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[16] *Id.* at paragraph 487.
[17] Explanatory Notes at page 126.

12. Anti-Avoidance Rules

The Draft Legislation includes anti-avoidance rules in proposed subsections 18.2(13), (14) and (15). Proposed subsection 18.2(14) would cause an amount included in interest and financing revenues to not be so included if it can reasonably be considered that one of the purposes of the transaction (or event/series) that gave rise to the amount is to increase the taxpayer's interest and financing revenues for the year to obtain a tax benefit. It is difficult to imagine a scenario where the increase of a taxpayer's income would be a tax benefit, other than perhaps when such income would reduce otherwise non-deductible interest and financing expenses.

This anti-avoidance rule is, however, very broadly worded. There are many situations that may arise where interest and financing expenses in Canada will be reduced as a result of business decisions and also where debt and equity investments may be refinanced and restructured. Therefore, it should be clarified that these types of business transactions and reorganizations are not subject to this anti-avoidance rule. For example, a Canadian parent company may determine that its leverage is too high in Canada compared to leverage in a foreign affiliate. In that case, it may decide to lend funds to that foreign affiliate, with the foreign affiliate repaying capital to the Canadian parent company. This transaction would result in interest income being earned by the Canadian parent company that would reduce its net interest and financing expenses. This should not be considered an anti-avoidance transaction as the Canadian parent is, in fact, doing exactly what the proposed EIFEL legislation is encouraging: ensuring that the Canadian tax base is not reduced by excessive interest and financing expenses.

Recommendation #15**: The **Department should consider removing this anti-avoidance provision or provide guidance surrounding situations where the provision would and would not apply. Moreover, as subsection 18.2(14) includes a reference to the general anti-avoidance provision in subsection 245(1), it may be superfluous. In fact, we ask the Department to consider whether specific anti-avoidance rules are required for any of the Draft Legislation as the current general anti-avoidance rule in section 245 should apply.

13. Definition of Excluded Entity – De Minimis Threshold

Paragraph (b) of the proposed definition of "excluded entity" in the Draft Legislation provides that a taxpayer is exempt from EIFEL deductibility restrictions in a particular taxation year if it is part of a group whose Canadian members have total net interest and financing expenses for the year of $250,000 or less. The Explanatory Notes further state that such taxpayers are excluded from the application of the EIFEL rules because they do not have significant net interest and financing expenses on a group-wide basis.

TEI agrees that the EIFEL rules should not apply in these circumstances and supports the exclusion of entities with *de minimis* interest and financing expenses. However, TEI recommends that the threshold in paragraph (b) be significantly increased from the proposed $250,000 amount to maintain parity with other jurisdictions and to reduce compliance burdens associated with the proposed rules. An

increased threshold would be consistent with the de minimis threshold adopted by other jurisdictions for purposes of BEPS Action 4.

For ease of reference, below is a summary of selected jurisdictions that have adopted a de minimis threshold for the application of comparable BEPS Action 4 interest deductibility limitations:

Jurisdiction	Threshold in Local Currency[18] (in millions)	Threshold in Canadian Dollars[19] (in millions, rounded to nearest CAD 0.1 million)
Belgium	EUR 3.0	CAD 4.0
Croatia	EUR 3.0	CAD 4.0
Denmark	DKK 22.3	CAD 4.1
France	EUR 3.0	CAD 4.0
Germany	EUR 3.0	CAD 4.0
India	IRP 10.0	CAD 0.2
Japan	JPY 20.0	CAD 0.2
Mexico	MXN 20.0	CAD 1.3
Netherlands	EUR 1.0	CAD 1.3
Norway	NOK 25.0	CAD 3.6
United Kingdom	GBP 2.0	CAD 3.2

Recommendation #16: Having regard to the thresholds applicable in other comparable developed economies, TEI submits that an increase to the excluded entity threshold from the proposed $250,000 to $2,000,000 would be appropriate.

14. Group Ratio Rules

a. Same Taxation Year Requirement

Section 18.21 of the Draft Legislation permits a taxpayer to elect to use a "group ratio" for determining the threshold for deductible interest and financing expenses (the "**Group Ratio Rules**"). One of the conditions that must be satisfied for taxpayers to use the Group Ratio Rules is that each Canadian group member must have the same taxation year. Canadian public corporations, however, often own a group of related Canadian companies where one or more of those companies have historically had a different year-end. Differing year-ends of related group companies may arise for a

[18] Data derived from PricewaterhouseCoopers LLP, *PwC Tax Summaries,* April 1, 2022 (Worldwide Tax Summaries Online (pwc.com)).

[19] Conversion to Canadian dollars done using Bank of Canada exchange rates for April 1, 2022, except for Danish kroner to CAD, which was calculated with reference to exchange rate provided by Danmarks Nationalbank on April 1, 2022.

variety of business reasons (e.g., due to acquisitions or reorganizations which truncate a taxation year) that have nothing to do with tax considerations in general, or the EIFEL rules in particular.

Recommendation #17: Canadian groups including companies with different year-ends coming into the application of the EIFEL rules should be grandfathered such that they would have the ability to apply the Group Ratio Rules. There should also be a mechanism to permit companies in the group to undergo reorganizations without jeopardizing the ability to use these rules.

b. Electing Application of Group Ratio Rules Each Year

The Draft Legislation requires Canadian corporate groups to make a joint election to use the group ratio each year. However, there is no clear guidance as to whether such groups can elect a different methodology each year, and what the resulting implications to a taxpayer would be in respect of its excess capacity limits. For example, if a taxpayer uses the fixed ratio methodology in Year 1 and has excess capacity available, but then in Year 2 makes a group ratio election, what happens to the availability of the cumulative unused excess capacity limits and carry forwards that were available to the taxpayer in Year 1?

Recommendation #18: The Draft Legislation should provide guidance as to how the rules in proposed section 18.21 are intended to apply in cases where it is used every year to determine interest deductibility thresholds under proposed section 18.2.

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TEI appreciates the opportunity to provide our input on the Draft Legislation and would welcome further engagement 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 Patricia Likogiannis. If you have any questions about TEI's comments, please contact Ms. Likogiannis at (905) 431-4565 or patricia.likogiannis@gm.com.

Respectfully submitted,

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