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Résumé des questions soumises au ministère des Finances concernant les propositions relatives à la restriction des dépenses excessives d'intérêts et de financement

Le 22 mars 2023

Dans son budget déposé le 19 avril 2021, le gouvernement fédéral a annoncé son intention d'imposer des limites à la déductibilité des intérêts. Selon les documents budgétaires produits, le régime de restriction des dépenses excessives d'intérêts et de financement doit être cohérent avec les recommandations formulées dans le Rapport concernant le BEPS – Action 4, qui propose une approche de type « pratique exemplaire » pour limiter la déductibilité des intérêts et d'autres coûts de financement afin de régler les problèmes de l'érosion de la base d'imposition et du transfert de bénéfices (BEPS). L'objectif de ce régime, tel qu'il est décrit dans le budget fédéral de 2021, est de s'attaquer aux problèmes liés au BEPS qui découlent de la déduction de frais d'intérêts et d'autres coûts de financement excessifs, principalement dans le cas des entreprises multinationales et des investissements transfrontaliers.

Le 4 février 2022, le gouvernement du Canada a publié un projet de propositions législatives portant sur les règles relatives à la restriction des dépenses excessives d'intérêts et de financement. Il a ensuite publié des propositions législatives révisées le 22 novembre 2022.

Lorsque le Comité a fait part au ministère des Finances de ses commentaires au sujet des propositions législatives, des sous-groupes ont été constitués pour examiner certains aspects des propositions. Dans le cadre de ces travaux, le Comité a soulevé des questions et tenu des réunions virtuelles avec les représentants du Ministère. Des membres des sous-groupes ont aussi rencontré des fonctionnaires qui travaillaient sur des aspects précis des propositions législatives.

Le 5 mai 2022, le Comité a déposé un mémoire officiel sur les propositions législatives préliminaires du 4 février. En ce qui concerne les propositions publiées le 22 novembre 2022, le ministère des Finances a annoncé la tenue d'une consultation de 60 jours et, en raison du court laps de temps (qui comprenait la période des Fêtes), le Comité a cherché à lui soumettre le plus de commentaires possible dans le délai imparti. Il n'a donc pas déposé de mémoire officiel.

Le reste du document contient un résumé des commentaires et des recommandations qui ont été transmis au ministère des Finances dans le cadre de la consultation sur les propositions législatives du 22 novembre. Il comporte deux sections : l'une sur les questions liées aux propositions législatives en général et l'autre sur les questions liées aux sociétés étrangères affiliées.

Des membres du Comité mixte et d'autres experts en fiscalité ont pris part aux discussions ayant abouti au résumé et ont contribué à sa rédaction, notamment :

- Bruce Ball – CPA Canada
- David Bunn – Deloitte S.E.N.C.R.L./s.r.l.
- Ian Crosbie – Davies Ward Phillips & Vineberg S.E.N.C.R.L., s.r.l.
- Sarah Chiu – Felesky Flynn LLP
- Ken Griffin – PwC s.r.l./S.E.N.C.R.L.
- Raj Juneja – McCarthy Tétrault S.E.N.C.R.L., s.r.l.
- Dion Legge – Norton Rose Fulbright LLP
- Angelo Nikolakakis – EY Cabinet d'avocats s.r.l./S.E.N.C.R.L.
- Anu Nijhawan – Bennett Jones LLP
- Jim Samuel – KPMG s.r.l./S.E.N.C.R.L.
- Jeffrey Shafer – Blake, Cassels & Graydon S.E.N.C.R.L./s.r.l.
- Mitch Sherman – Goodmans LLP
- Carrie Smit – Goodmans LLP
- Eric Xiao – Ernst & Young s.r.l./S.E.N.C.R.L.

Summary of Issues Identified
(Excluding Foreign Affiliate and Section 216 Issues)

1. Excluded Entity

Siblings and Excluded Entity

To determine if a taxpayer qualifies as an "excluded entity" under the *de minimis* exception (paragraph (b)) or the domestic exception (paragraph (c)), a taxpayer appears to be presumed to have knowledge of the activities and characteristics of every "eligible group entity" in respect of a taxpayer. An "eligible group entity" is defined to include a resident of Canada that is a corporation or trust that is related to the taxpayer.

As siblings are related for most purposes of the Act, the rules as currently drafted presume that a taxpayer that is controlled by an individual has knowledge of the activities and characteristics of each corporation controlled by any of that individual's siblings. As siblings may (and often will) have limited knowledge of each other's business affairs, they may be unable to determine if the "excluded entity" exception applies. We note that being an "eligible group entity" also has corresponding benefits, including the ability to transfer capacity between eligible group entities.

As siblings are deemed not to deal at arm's length for most purposes of the Act by virtue of being related, the rules as currently drafted also disqualify a family corporation from the domestic exception if even an immaterial number (e.g., 1%) of shares are held by a sibling that is a non-resident of Canada.

We suggest it would be appropriate for siblings to be entitled to elect to be unrelated for purposes of determining whether an entity is related for purposes of paragraph (a) of the definition of "eligible group entity" and for purposes of determining whether a person is a "specified shareholder" or "specified beneficiary" for purposes of subparagraph (c)(iii) of the definition of "eligible group entity". Siblings who so elect will also lose the ability to transfer capacity from a Canadian entity controlled by one of them to a Canadian entity controlled by the other.

Recommendation: A sibling should be able to elect to be unrelated to their siblings for purposes determining whether an entity is related to the taxpayer for purposes of paragraph (a) of the definition of "eligible group entity" and for purposes of determining whether a person is a "specified shareholder" or "specified beneficiary" for purposes of subparagraph (c)(iii) of the definition of "eligible group entity".

Impermissible Shareholders and Beneficiaries

We understand that the domestic exception (paragraph (c) of the excluded entity definition) is intended to identify those entities and groups of entities which could pose a significant BEPS risk by virtue of the influence of non-resident shareholders and beneficiaries. In particular, the Department of Finance draft technical notes describe the purpose of the "excluded entity" definition as being "to ensure the new rules are appropriately targeted at significant BEPS risks".

The OECD BEPS Action 4 report describes an entity that poses BEPS risk by virtue of being part of a multinational group that operates in more than one jurisdiction as an entity which "is directly or indirectly controlled by a company, or the entity is a company which directly or indirectly controls one or more other entities".

> BEPS Action 4 Report – 2016 Update at page 37:
>
> 44. As set out in the BEPS Action Plan (OECD, 2013), the deductibility of interest can raise base erosion and profit shifting concerns in both inbound and outbound investment scenarios. Therefore, it is recommended that as a minimum a fixed ratio rule as described in Chapter 6 should apply to all entities which are part of a multinational group.
>
> 45. An entity is part of a group if the entity is directly or indirectly controlled by a company, or the entity is a company which directly or indirectly controls one or more other entities. A group is a multinational group where it operates in more than one jurisdiction, including through a permanent establishment.

The domestic exception, as currently drafted, disqualifies an entity from being an "excluded entity" if that entity or any eligible group entity in respect of the taxpayer has a "specified shareholder" or "specified beneficiary" that is not resident in Canada. An entity is also disqualified if (i) a partnership holds 25% or more of the votes or value of a corporate entity or 25% or more of the value of a trust entity and (ii) that partnership has 50% or more non-resident partners (the "**No 50% NR Partnership Requirement**").

The no "specified shareholder", no "specified beneficiary" and No 50% NR Partnership Requirement (collectively, the "**Subparagraph (c)(iii) Requirements**") can cause an entity to qualify or not qualify as an "excluded entity" arbitrarily in circumstances which are equivalent from a BEPS risk perspective.

Example 1. A wholly domestic public corporation (e.g., $100MM market capitalization), Canco, has a small (e.g., $5MM value) wholly owned subsidiary, Subco. A non-resident investor purchases 25% of the shares of Subco for cash. This share purchase causes the entire Canco group to cease to qualify under the domestic exception. If, in the example, the non-resident investor instead subscribes for the shares of Subco indirectly through a Canadian resident subsidiary, then Canco's excluded entity status would not be affected.

Example 2. Expanding on Example 1, if Subco were to have two separate non-resident investors who each subscribe for 12.5% of the shares of Subco, Canco's excluded entity status would not be affected. However, if in the example, the relationship between the two non-resident investors was determined to be a partnership, then the entire Canco group would cease to qualify under the domestic exception.

Example 3. A similar arbitrary result flows from an example where a domestic corporation, FamCanCo, is held by ten family members in equal shares. One of the family members happens to emigrate from Canada, perhaps unbeknownst to certain other family members, causing FamCanCo to be disqualified from the domestic exception. Even if the non-resident family member were to hold the shares in FamCanCo indirectly through a Canadian subsidiary, that Canadian subsidiary would be an "eligible

group entity" in respect of FamCanCo such that FamCanCo should still not qualify under the domestic exception.

To avoid these seemingly arbitrary and inequitable results, and to align the Canadian rules with the OECD BEPS Action 4 Report, we suggest it would be appropriate to replace the Subparagraph (c)(iii) Requirements with a 50% ownership requirement that includes direct and indirect ownership. We suggest it would be appropriate for an entity to be disqualified from the domestic exception where a non-resident person, either alone or together with other non-arm's length non-resident persons, own more than 50% of the votes or more than 75% of the value, either directly or indirectly through intervening corporations, trusts or partnerships, of the taxpayer or an eligible group entity in respect of the taxpayer. The 50% voting threshold aligns with the well understood *de jure* control concept and the 75% value threshold aligns with the threshold in section 256.1.

Applying the foregoing suggested rule to Examples 1 through 3, CanCo is treated consistently based on equivalent BEPS risk and FamCanCo is, we suggest, treated appropriately.

Importantly, when considering Example 1, choosing the 50% voting threshold also causes Subco to be disqualified from the domestic exception when a non-resident acquires control of Subco which should also be the moment at which Subco ceases to be an eligible group entity in respect of Canco. We suggest that this symmetry is appropriate and consistent with the OECD BEPS Action 4 Report – that is, once Subco ceases to be controlled by Canco and is controlled by a non-resident person, it poses a BEPS risk and so long as Canco is never controlled by a non-resident investor in Subco, Canco does not pose a sufficient BEPS risk.

Recommendation: The requirements in subparagraph (c)(iii) of the definition of "excluded entity" in proposed subsection 18.2(1) be replaced with a requirement that no non-resident person, either alone or together with other non-arm's length non-resident persons, own more than 50% of the votes or more than 75% of the value, either directly or indirectly through intervening corporations, trusts or partnerships, of the taxpayer or an eligible group entity in respect of the taxpayer, at any time in the particular year.

<u>Domestic Exception – Property owned by Foreign Affiliate</u>

The domestic exception in paragraph (c) of the excluded entity exception does not apply if the group has investments in one or more foreign affiliates, unless the greater of the book cost of all foreign affiliate shares held by the group and the fair market value of the assets of all foreign affiliates held by the group does not exceed $5,000,000.

Currently, when testing the fair market value of shares, the language refers to "…the shares of the capital stock of a foreign affiliate of the taxpayer, or an eligible group entity in respect of the taxpayer…" and when testing the fair market value of property, the language refers to "…the fair market value of all property of a foreign affiliate of the taxpayer or of an eligible entity in respect of the taxpayer." While it seems clear that this is intended to mean the shares/property of a corporation that is (i) a foreign affiliate of the taxpayer or (ii) a foreign affiliate of an eligible group entity in respect of the taxpayer, it could also be read as (i) the shares/property of a foreign affiliate of the taxpayer or (ii) the shares/property of an eligible group entity in respect of the taxpayer.

Recommendation: The language in (c)(ii) item B(A) should be clarified to read: "…the shares of the capital stock of a foreign affiliate of the taxpayer, or <u>of a foreign affiliate of</u> an eligible group entity in respect of the taxpayer…" and the language in (c)(ii) item B(B) should be clarified to read: "…all property of a foreign affiliate of the taxpayer or <u>of a foreign affiliate of</u> an eligible group entity in respect of the taxpayer."

<u>Paragraph 251(5)(b)</u>

Certain aspects of the excluded entity concept are applied with reference to the particular taxpayer and any other eligible group entity in respect of the particular taxpayer. The definition of eligible group entity includes, *inter alia*, a corporation that is related to the taxpayer.

Pursuant to paragraph 251(5)(b), where a person has a right to acquire shares of the capital stock of a corporation, the person is deemed to have the same position in relation to the control of the corporation as if the person owned the shares at that time.

This can lead to inappropriate results in certain cases. For instance, if a corporation agrees to sell a subsidiary to a purchaser, that purchaser becomes related to that subsidiary and all other related corporations while the agreement is outstanding. That purchaser may then preclude the selling corporate group from being excluded entities, which does not seem consistent with the policy of the rules. Also, as a practical matter, it is unlikely that the selling group would have sufficient information with respect to the purchaser group to be able to determine the impact of the excluded entity status of the selling group.

We believe it would be appropriate for paragraph (a) of the definition of eligible group entity to be read without reference to paragraph 251(5)(b). The anti-avoidance rule in proposed subsection 18.2(9) should be sufficient to ensure that this cannot be used to gain an advantage under the EIFEL rules (although consideration could be given to having the anti-avoidance rule apply not only where a corporation becomes or ceases to be an eligible group entity, but also where the corporation is structured not to be an eligible group entity from the start).

It should also be noted that if our recommendations above regarding impermissible shareholders and beneficiaries is not adopted and the current reference to specified shareholder and specified beneficiary remains, the same concerns would apply for the purposes of applying these terms, as defined in subsection 18(5), as both terms include provisions which deem rights to acquire shares (or, in the case of a trust, rights to acquire an interest as a beneficiary in the trust) to have been exercised. As such, if the concept of specified shareholder and specified beneficiary were to remain, it would be appropriate to have these terms apply based on current ownership alone – not rights to acquire an ownership interest.

Recommendation: Paragraph (a) of the definition of eligible group entity should be read without reference to paragraph 251(5)(b). Similarly, if the concept of specified shareholder and specified beneficiary are retained, these terms should be applied based on current ownership alone – not rights to acquire an ownership interest.

2. Adjusted Taxable Income

Excess Non-Capital Losses

As noted in our Prior Submission, there may be situations where a taxpayer has taxable income in a particular taxation year and sufficient non-capital losses in another taxation year to reduce that particular year's taxable income to nil; however, as a consequence of the application of proposed section 18.2, the taxpayer may need to carry back or carry forward losses in excess of that taxable income (determined before the carry back or carry forward) in order to result in no taxable income in the particular year. This is because the carry back/forward may change the ATI in the particular year, which can affect the quantum of interest deductible in the particular year. The example provided in our Prior Submission is as follows:

> … assume the taxpayer has a non-capital loss in 2025 of $2,329 (determined without regard to proposed subsection 18.2(2)), which is reduced to $1,429 because it cannot deduct $900 of IFE. If the taxpayer could carry back the $1,429 non-capital loss to 2024, the taxpayer's resulting taxable income (determined without regard to proposed subsection 18.2(2)) in 2024 would be a non-capital loss of $429. The 2024 ATI would then be $1,571 (-$429 + $900 + $1,100) (assuming none of the loss carry back is added to ATI under Variable B(h)). $471 of IFE would be deductible in 2024, with $429 becoming a RIFE. This would result in taxable income in 2024 of nil ($3,000 - $471 - $1,100 - $1,429). Although a $1,429 non-capital loss is carried back (which is larger than the otherwise determined 2024 taxable income of $1,000), $429 of this loss is effectively converted to RIFE.

The same result occurs with a loss carry forward, where the taxpayer may need to carry forward a loss which is greater than the particular year's taxable income (determined before the loss carry forward). The only situation where the loss carry back or carry forward equals the taxable income otherwise determined in the particular taxation year is where the add-back to ATI under Variable B(h) is the full amount of the loss.

In order to permit the carry back or carry forward of losses sufficient to fully offset taxable income in another taxation year, it should be clarified that Variable (A)(D)(a) can be a negative number (negative taxable income) in determining ATI where there is a loss carry back or carry forward. Without this, it appears that a smaller loss carry forward or carry back may be sufficient to result in no taxable income in the particular taxation year. This would result because Variable A(D)(a) of ATI would be nil (not a negative number) resulting in higher ATI and higher deductible interest, such that a lower loss carry forward or carry back would be required to result in nil taxable income.

The carry back/forward of losses, and the effect on ATI, is not intuitive and is quite complicated to determine, especially where there may be losses in multiple years with different percentages for the purposes of Variable B(h).

Recommendation: The Explanatory Notes should provide examples of loss carry forwards and carry backs, illustrating the effects on ATI and interest deductibility. In particular, it should be clarified that taxpayers may carry back/forward losses in excess of taxable income (otherwise determined), and

that Variable A (D)(a) of the definition of ATI can be a non-capital loss created from the carry forward or carry back of losses (provided that this does not result in an actual non-capital loss in the taxation year to which the non-capital loss is carried forward or carried back (after the application of section 18.2)). Consideration should also be given to whether section 18.2 or 111, or the applicable tax return schedules, need to be revised to facilitate this.

Treatment of RIFE

Under the proposed EIFEL regime, interest which is not deductible under proposed section 18.2 becomes RIFE. In some ways, RIFE is a tax attribute which is similar to a non-capital loss, in that RIFE can be carried forward and can offset future income in certain circumstances. In our Prior Submission, we noted examples where the provisions of the Act should be amended to treat RIFE in a manner similar to non-capital losses.

Recommendation: Where not otherwise dealt with in the EIFEL regime, certain provisions of the Act should be amended to treat RIFE in a manner consistent with non-capital loss carryforwards. Specific recommendations in this regard include the following:

- ***The definition of "commercial debt obligation" in subsection 80(1) should be amended to include section 18.2 as one of the sections referenced at the end of that definition (i.e., such that the fact that interest may not be deductible due to the application of section 18.2 does not preclude the debt from constituting a "commercial debt obligation").***

- ***The definition of "relevant loss balance" in subsection 80(1) should be amended to include a debtor's RIFE in the computation of the losses that are available to offset a taxpayer's "forgiven amount".***

Subsections 80(2) – 80(11) should be amended to enable a taxpayer to apply a "forgiven amount" to reduce a RIFE balance (particularly if a "commercial debt obligation" is treated as suggested above). Given the similarity of RIFE to non-capital loss carryforwards, it appears that such reduction should occur mandatorily after the reduction of the taxpayer's non-capital losses.

It must also be recognized, however, that RIFE is a more difficult attribute for a taxpayer to utilize than non-capital loss carryforwards. In particular, while a non-capital loss can be used in any future taxation year where the taxpayer has positive taxable income, RIFE can only be utilized where the taxpayer has positive income and has excess capacity (or received capacity) under the EIFEL regime. In that respect, the provisions of the Act may need to be amended to deal with RIFE in a slightly different manner. One example relates to the utility of RIFE in the context of a loss restriction event of the taxpayer. Under proposed subsection 111(5), a RIFE carryforward of a taxpayer will survive a loss restriction event only to the extent that the interest is sourced to income from a business and the taxpayer continues to carry on the same business following the loss restriction event. We note that interest expense is often sourced to income from a property (*e.g.,* borrowed money used to acquire shares) and, in that circumstance, RIFE would, under the proposed rules, be extinguished on a loss restriction event. While non-capital losses from property are also extinguished on a loss restriction event, such losses can be applied to increase the tax cost of property under paragraph 111(4)(e), whereas this is not true of RIFE under the current proposals. It is not clear that this treatment of RIFE is equitable.

Recommendation: Consideration should be given to whether RIFE should be excluded from the loss restriction event limitations. Alternatively, if it is determined to be appropriate that such limitations should apply to RIFE, consideration should be given to alternative mechanisms potentially applicable to RIFE. For example:

- ***If it is appropriate that RIFE be subject to loss restriction event limitations, should RIFE be streamed to the same business or the same property?***

- ***Should RIFE be an attribute available to a taxpayer, under a mechanism similar to paragraph 111(4)(e), to shelter designated gains from capital property?***

Application of proposed subparagraph 87(2.1)(a.1)(ii) to a wind-up

Where an amalgamation has taken place, subparagraph 87(2.1)(a.1)(ii) has a continuity rule for the IFE and IFR of the predecessors in determining the add-back to the amalgamated corporation's ATI under variable B(h). In particular, it appears that where corporations with losses amalgamate, there is an add-back to the amalgamated corporation's ATI under variable B(h) where the losses were derived from IFE of a predecessor. Based on our review, it appears that a similar rule does not apply under section 88 where a subsidiary with a loss derived from IFE is wound up into its parent.

Recommendation: The rules in section 88 should be amended to provide for a rule similar to subparagraph 87(2.1)(a.1)(ii).

3. Subsection 18.2(4): Capacity sharing between a Canadian branch of a foreign entity and a Canadian subsidiary within the same corporate group

Because of regulatory reasons a foreign bank will generally carry on its Canadian banking business through a Canadian branch that is an "authorized foreign bank" and will carry on its Canadian securities broker dealer business through a Canadian corporation. Both the Canadian branch and the Canadian securities broker dealer will be subject to the EIFEL rules and both will be a "financial institution group entities". However, proposed paragraph 18.2(4)(b) only permits cumulative unused excess capacity to be transferred where the transferor and transferee are either a taxable Canadian corporation or a fixed interest commercial trust throughout its taxation year. We see no policy reason for not allowing the transfer of excess capacity between the Canadian branch and the Canadian corporate securities dealer.

Similar issues exist with respect to capacity sharing between a Canadian branch of a foreign entity and a Canadian subsidiary within the same corporate group, or a Canadian branch of a foreign entity and a Canadian branch of another foreign entity within the same corporate group.

Recommendation: The EIFEL rules be amended to allow capacity transfers between Canadian corporation and Canadian branches of foreign corporations that are part of the same overall group (i.e., common control).

4. Anti-Avoidance Rules

Paragraph 18.2(13)(a)

The Explanatory Notes state that paragraph 18.2(13)(a) is intended to address transactions where, for example, a taxpayer receives an interest payment directly or indirectly from a non-controlled foreign affiliate, and the interest payment is deductible in computing the affiliate's FAPI. The Explanatory Notes state that these transactions raise integrity concerns in that, if they were to result in IFR (or reduce IFE), this could effectively convert amounts that would otherwise have been included in an affiliate's taxable surplus or reduced an affiliate's taxable deficit – and thus could ultimately have resulted in an increase to the taxpayer's ATI on a subsequent distribution from the affiliate – into IFR, while the affiliate's interest expense would not be included in computing the taxpayer's IFE.

We note that this provision can also apply in circumstances where there is no such conversion of taxable surplus and ATI into IFR.

Example

A taxpayer invests in shares of a non-CFA in a joint venture project. The taxpayer and the other shareholders of the affiliate are required to make loans to the affiliate to fund its investments. The taxpayer borrows from external lender in order to make a loan to the affiliate. The affiliate is subject to a high rate of income tax in the foreign jurisdiction and as a result, the affiliate will have sufficient underlying foreign tax such that a taxable surplus dividend paid by the affiliate to the taxpayer would be fully sheltered by a deduction under paragraph 113(1)(b) and would not be included in the taxpayer's ATI. In these circumstances, it would seem appropriate to include the interest payment, which is foreign sourced interest income that is being brought into the Canada tax net, in IFR so that the taxpayer can deduct its interest expense paid to the external lender.

Recommendation: Paragraph 18.2(13)(a) be amended such that it is does not apply to transactions described above.

Paragraph 18.2(13)(b)

Proposed paragraph 18.2(13)(b) provides that a particular amount that would otherwise be included under variable A of the definition of IFR or variable B of the definition of IFE must not be so included if the particular amount is received or receivable by the taxpayer (or a partnership of which it is a member) from:

(i) a non-arm's length person that is not subject to the EIFEL regime by reason of being an excluded entity or a natural person, or from a non-arm's length financial institution group entity, if the taxpayer is not a financial institution group entity or an insurance holding corporation; or

(ii) a partnership, any member of which is described above.

According to the Explanatory Notes, this provision is intended to ensure the integrity of the EIFEL rules in two ways: (i) by preventing payments between non-arm's length persons and partnerships from

increasing the recipient's capacity to deduct IFE (by generating IFR) where the payer is indifferent to any corresponding increase in their IFE because they are not subject to the EIFEL rules: and (ii) by preventing payments between non-arm's length financial institutions and non-financial institutions from circumventing the restriction on capacity transfers between such persons in paragraph 18.2(4)(c).

Although we continue to believe that interest which is included in income for general income tax purposes (and therefore is subject to taxation under Part I) should be included in IFR, we accept in principle the underlying basis of the foregoing restrictions in the context of these limited non-arm's length transactions. However, we believe that this provision has the potential to overreach in certain situations involving partnerships because it may not take into account a member's proportionate interest in a particular partnership. The construct of the provision, and insertion of the words "in whole or part", seems to suggest that the entire amount received from a partnership may be denied IFR treatment even if only a small portion of the partnership is owned by a person listed above.

For example, assume that a taxable Canadian corporation which is subject to the EIFEL rules (Canco) receives interest income from a partnership. Canco is wholly owned by Person A, an individual. One of the partners of the partnership is Person A's sibling, who is a 10% limited partner of the partnership (i.e., a natural person who does not deal at arm's length with Canco). The remainder of the partners could be entities which are related to Canco which themselves are subject to the EIFEL rules, or they could be individuals or entities that deal at arm's length with Canco (it should not matter in the latter case whether such persons are subject to the EIFEL rules or not). Pursuant to proposed paragraph 18.2(13)(b), it appears that the full amount of interest income received by Canco from the partnership will not be included in IFR because the amount is received from a partnership a member of which is a non-arm's length person that is a natural person (i.e., Person A's sibling). A full denial of the interest inclusion in Canco's IFR is not appropriate in these circumstances because this rule is focused solely on asymmetrical treatment between non-arm's length persons. Where the other partners deal at arm's length with Canco, this provision is not intended to affect Canco whether or not these persons are subject to the EIFEL rules. Similarly, where the other partners are non-arm's length with Canco but are subject to the EIFEL rules, their percentage of the interest expense of the partnership will be included in their IFE so a denial of IFR treatment is not appropriate to that extent because there is no asymmetrical treatment.

Recommendation: The amount of interest income subject to this rule should be limited "to the extent" the associated interest expense of the partnership is attributable to the member(s) of the partnership which cause the application of the rule in the first place, in this example Person A's sibling (such that only 10% of the interest income would be denied IFR treatment to Canco).

<u>Paragraph 18.2(13)(c)</u>

Canco is a CRIC and part of a multinational group that owns shares of two CFAs, NR Finco and NR Holdco. NR Holdco in turns owns 100% of NR Opco, a disregarded LLC. Canco borrows externally from a third party bank and makes investments in the equity of NR Finco. NR Finco uses the cash from this equity financing to make an interest-bearing loan to NR Opco (the "NR Opco Loan"). The NR Opco Loan qualifies as a "Cap B" loan pursuant to clause 95(2)(a)(ii)(B).

Canco is expected to have restrictive interest and financing expenses. In order to comply with the EIFEL rules, NR Finco distributes the NR Opco Loan to Canco with the sole purpose of including the interest payment from NR Opco in its IFR.

Our concern is the wording of subparagraph 18.2(13)(c)(i) is not clear and could apply to deny the inclusion of the interest payment received by Canco in its IFR on the basis that the interest expense of NR Opco is not included in Canco's IFE but it is deductible against NR Opco's active business income. We understand that subsection 18.2(13) is not intended to deny the inclusion in Canco's IFE of the interest payment received by Canco from NR Opco as Canco undertakes transaction to comply with the EIFEL rules. In addition, there is some concern that the same interpretative issue may arise if Canco simply makes a loan to NR Opco.

Recommendation: We recommend that subsection 18.2(13) be amended such that it is does not apply to transactions described above. We also recommend that the Explanatory Notes provide examples where subsection 18.2(13) is not intended to apply.

5. Other issues

Subsection 18.2(1) – Definition of "Insurance holding company"

The definition of "insurance holding company" in proposed subsection 18.2(1) references subsidiary wholly owned-corporation under subsection 87(4.1). However, it appears that this reference should be replaced with a reference to subsection 87(1.4).

Exempt interest and financing expenses

The definition of "exempt interest and financing expenses" requires that a borrower entered into an agreement with a public authority to design, build and finance, or to design, build, finance, maintain and operate, real or immovable property owned by a public sector authority. In certain cases, the public sector authority that has contracted with the borrower to design, build and finance, or to design, build, finance, maintain and operate a particular infrastructure project may not own an interest in the underlying real property on which the infrastructure is located. For example, long-term care homes are often entirely or partially funded by provincial or territorial governments, and potentially a borrower could be contracted to design, build, finance, maintain and operate a long-term care facility by a province. However, in certain provinces, many or all of the long-term care facilities will not owned by the province but instead by independent entities – some of whom may be operated on a not-for-profit basis. It is unclear why the ability to qualify as "exempt interest and financing expenses" requires the particular property to be owned by a public sector authority, as it would result in seeming inconsistencies between borrowers who are engaged by a public sector authority to design, build, finance, maintain and operate an infrastructure project in one province that owns the underlying property, whereas in other provinces the EIFEL rules would apply to the borrower as a private entity – particularly a not-for-profit entity – owns the underlying property.

Similarly, in certain infrastructure projects, ownership of the underlying property that the borrower has been contracted to design, build, finance, maintain and operate may only pass to the public sector

authority at certain predetermined milestones when approvals (by engineers, etc.) have occurred. In such cases, the public sector authority does not become the owner of the particular property until such time as ownership passes, meaning the public sector authority may not be the relevant owner at the time the interest is incurred by the borrower. As such, the nature of the contract and the timing at which ownership of the underlying property transfers to the public sector authority could result in inconsistencies in the application of the EIFEL rules.

Recommendation: The requirement in the "exempt interest and financing expenses" definition that the underlying property be owned by a public sector authority should be removed, or at minimum, expanded to include situations where the underlying property is owned by either a public sector authority or a not-for-profit entity. Also, the definition should be amended to address situations where ownership of the underlying property passes to the public sector authority or not-for-profit entity, as the case may be, at a later date (such as at completion of the building phase).

Cash flow and insolvency concerns

As noted in our Prior Submission, the EIFEL proposals can result in cash flow issues and potentially unexpected and inequitable insolvency situations. Consider the following example which has been slightly modified from that used in the Prior Submission. Assume that a taxpayer has earnings of $1,000 and arm's length interest expense owed to a 25% shareholder (being a "specified non-member") of $900. The taxpayer is profitable, although a significant portion of net revenues services debt. The debt is owing to a 25% shareholder but is on arm's length terms and conditions. Without application of the EIFEL regime, the taxpayer would pay tax on its taxable income of $100. Under the proposed rules, this taxpayer will have ATI of $1,000 (assuming no other ATI adjustments apply), and will only be permitted to deduct $300 of interest. The revised taxable income will be $700. Assuming a 26.5% tax rate, this results in a tax liability of $185.50. This taxpayer does not have sufficient cash to pay both its tax liability and its third party interest. This can result in insolvency situations in otherwise profitable businesses simply because the taxpayer is highly levered, which leverage may have been put in place well before the new rules were released, or is the only feasible way for the taxpayer to raise capital. An issue would also arise under the group ratio rule, because the interest is paid to a "specified non-member" even though on arm's length terms.

We note that the Act contains other adjustments to avoid insolvency events in appropriate circumstances. For example, section 61.3 permits an offset from the income inclusion otherwise arising under the debt forgiveness rules so as to avoid an insolvency event. A similar mechanism could be considered within the EIFEL regime where, for example, an interest deduction would not be denied to the extent that such denial would result in the taxpayer becoming, solely as a result of the denial and the increased tax liability resulting therefrom, unable to meet its obligations as they become due.

Recommendation: We recommend that additional consideration be given to the possibility of the EIFEL rules leading to an insolvency event and to providing appropriate relief in such circumstances.

Indexation

Consider whether the amounts set out in the rules should be subject to specific indexation.

Summary of Issues Identified Related to Foreign Affiliates

Overall/Introductory Comment

The introduction of the EIFEL rules is one of the more complex, and far reaching, changes to the *Income Tax Act* in many years. This complexity increases dramatically in the context of considering the interaction of the EIFEL rules with the foreign affiliate regime. While our submission touches on some considerations that we have identified to date, our submission is not intended to be exhaustive. In this regard, we believe that it is quite likely that many more considerations and/or potential issues will be identified over the coming months, or even years, as the tax community becomes more familiar with the EIFEL rules and their application to real-life situations.

Relevant Affiliate Interest and Financing Revenue and Expense ("RAIFE" and "RAIFR")

We understand that it is intended that a controlled foreign affiliate's RAIFE and RAIFR essentially be the amount that would be, for purposes of computing FAPI, the affiliate's interest and financing expenses ("IFE") and interest and financing revenues ("IFR") if the affiliate were considered a taxpayer resident in Canada (and thus subject to the EIFEL rules). However, as currently drafted it appears that a controlled foreign affiliate's IFE that is deductible in computing its income (loss) that is re-characterized under paragraph 95(2)(a), or interest described in clause 95(2)(a)(ii)(D) that is paid by the affiliate to another affiliate (and thus is not deductible in computing the FAPI of the payer affiliate), could still be included in computing RAIFE despite the active business treatment of such amounts. Although such amounts are not included in computing FAPI of the payer affiliate, those amounts are still relevant in computing an amount described in paragraph 95(2)(f), which is one of the conditions (in the definition of "relevant affiliate interest and financing expenses" in proposed subsection 18.2(1)) for the inclusion of a controlled foreign affiliate's IFE in computing the affiliate's RAIFE.

Recommendation:

We recommend that the rules be clarified to exclude from RAIFE any IFE of a controlled foreign affiliate that is (i) included in computing its income or loss from an active business under paragraph 95(2)(a); and (ii) not included in computing its FAPI by virtue of that amount constituting, to the recipient of the interest, income from an active business under clause 95(2)(a)(ii)(D). For example, these clarifications might include a change to the definition of RAIFE to include a "paragraph 95(2)(a) carveout" similar to that which is currently included the definition of RAIFR, with additional changes potentially being required in the case of interest expense paid or payable to another affiliate that meets the requirements of clause 95(2)(a)(ii)(D).

RAIFE and FAPLs

Under the current draft, RAIFE can arise where the affiliate otherwise has no revenues that would be included in computing its FAPI, or IFE that exceeds those revenues. This can occur on a temporary basis or on a permanent basis. It would be temporary, for example, where the affiliate's revenues are cyclical; or permanent, for example, where the affiliate's IFE relates to a source that consists of shares of another affiliate that are excluded property. Either way, to the extent that the affiliate's IFE has not sheltered a FAPI inclusion, the resulting FAPL may never be available to the taxpayer. Nevertheless, the resulting

RAIFE would be pooled with the taxpayer's IFE and can result in a denial of deductions at the taxpayer level even where the taxpayer on a stand-alone basis would not exceed the 30% threshold. In addition, the RAIFE would also give rise to "restricted interest and financing expenses" ("RIFE") to the taxpayer, which the taxpayer could potentially use in the future against Canadian earnings, even though it could not have used the FAPL. In effect, this approach results in the importation of FAPL, which seems inconsistent with the scheme of the Act.

Recommendations:

- ***We recommend that RAIFE be limited to the lower of the affiliate's net IFE (after its IFR) and the amounts (other than IFR) of relevant positive items included in computing its FAPI.***

- ***As a related point, the future use of a FAPL could be treated as the use of any net IFE embedded in that FAPL.***

With these two changes, the approach reflected in the current draft would seem to operate as intended.

RAIFE and RAIFR

The current draft provides for the concept of "excluded interest", on an elective basis. There is no equivalent in the foreign affiliate context. This can cause consequences that may be unintended. For example, this can cause a transformation of non-IFR into RAIFR, or it can result in the creation of RAIFE which does not correspond to the true IFE in the foreign affiliate network.

Recommendations:

- ***We recommend that a concept be introduced to serve some of the functions of "excluded interest" in the foreign affiliate context – call it "relevant affiliate excluded interest" or "RAEI".***

- ***RAEI would be the appropriate percentage of the amount of the affiliate's net IFE that is paid or payable to another foreign affiliate of the taxpayer, or of an eligible group entity in respect of the taxpayer, adjusted for the proportion of the taxpayer's (or eligible group entity's) appropriate percentage in the recipient affiliate. It the taxpayer had the same percentage in both the payer affiliate and the recipient affiliate, the full amount of the interest payment would be RAEI, which would be treated in respect of the taxpayer (and any relevant eligible group entity) as a shifting of non-IFR between the affiliates. If the taxpayer had varying percentages in the payer affiliate and the recipient affiliate, then only a portion of the interest payment would be treated as RAEI. Mechanically, for example, if the taxpayer had a 100% percentage in the payer affiliate and a 40% interest in the recipient affiliate, then 60% of the affiliate's net IFE would be RAIFE (and would not give rise to RAIFR in the recipient affiliate) and 40% would be RAEI, which would be treated in respect of the taxpayer (and any relevant eligible group entity) as a shifting of non-IFR between the affiliates.***

We would recommend that this treatment would apply on an automatic basis rather than on an elective basis, to reduce administrative complexity.

Foreign Affiliates and Partnerships

Overview of Rules

Pursuant to the definition of "taxpayer" in proposed subsection 18.2(1), a partnership is not a taxpayer for purposes of the EIFEL rules. As a result, IFE incurred at the level of a partnership is attributed to its partners under paragraph (h) of variable A of the definition of "interest and financing expenses", and may result in an income inclusion to one or more of the partners under proposed paragraph 12(1)(l.2).

More specifically, paragraph (h) of variable A of the definition of "interest and financing expenses" includes in a taxpayer's IFE its share of the IFE of a partnership of which the taxpayer is a member. This amount includes IFE described in paragraphs (a) to (g) of variable A that are deducted in computing the income of a partnership, as well as the RAIFE of a controlled foreign affiliate of a partnership (as described in paragraph (j) of variable A). As a result, a partner of a partnership that is subject to the EIFEL rules will generally include, in computing its IFE, its share of the RAIFE of a controlled foreign affiliate of the partnership that is included in computing the affiliate's FAPI vis-à-vis the partnership.

In regards to the computation of FAPI of a foreign affiliate of a taxpayer, a proposed amendment to clause 95(2)(f.11)(ii)(A) provides that the income or loss from property, and a non-active business, of the affiliate be determined without regard to proposed subsection 18.2(2). Furthermore, the explanatory notes indicate that since no amount is separately determined in respect of the affiliate under proposed subsection 18.2(2), proposed paragraph 12(1)(l.2) does not apply to include an amount in the affiliate's FAPI in respect of the IFE of a partnership of which the affiliate is member.

However, where a portion of the taxpayer's IFE for a taxation year is denied under proposed subsection 18.2(2), a corresponding portion of the RAIFE of a controlled foreign affiliate of the taxpayer is denied, under proposed clause 95(2)(f.11)(ii)(D), for purposes of computing that affiliate's FAPI vis-à-vis the taxpayer. According to the explanatory notes for proposed subsection 18.2(2) and proposed subclause 95(2)(f.11)(ii)(D)(II), the same proportion is also applied in determining the amount included under proposed subclause 95(2)(f.11)(ii)(D)(II) in computing the FAPI of a controlled foreign affiliate in respect of its share of the IFE of a partnership of which it is a member.[1]

Assuming that our understanding of the above mechanics is correct, it appears that, in the context of a "top tier" partnership structure (e.g., Canco owns an interest in a partnership which owns a controlled foreign affiliate), proposed clause 95(2)(f.11)(ii)(D) would not be applicable to restrict, or deny, any IFE that is included in computing the controlled foreign affiliate's FAPI vis-à-vis the partnership because the partnership is not a taxpayer for purposes of proposed subsection 18.2. Rather, any "excess" RAIFE of a controlled foreign affiliate of a partnership would be separately determined at the partner level (and, depending upon the facts, could potentially result in an income inclusion to the partner under proposed paragraph 12(1)(l.2)).

[1] This income inclusion is effectively akin to the amount that would otherwise be determined under proposed paragraph 12(1)(l.2) had the foreign affiliate partner of the partnership been subject to proposed subsection 18.2(2).

Observations/Recommendations:

Below are some additional preliminary observations/recommendations based on our initial review of the draft legislation.

- ***The interaction of partnerships with the foreign affiliate regime is notoriously complex and can give rise to many interpretational issues and/or technical issues.***

  - ***We recommend that one or more examples be included in the explanatory notes that illustrates the application of the EIFEL rules in a situation where a partnership owns a foreign affiliate, including "top tier" and "lower tier" (i.e., a partnership interposed between two controlled foreign affiliates) partnership structures.***

- ***As currently drafted, it is not clear to us as to how the EIFEL rules apply in a "lower tier" partnership structure in which a partnership is interposed between two controlled foreign affiliates. For example, assume that (i) Canco wholly owns two controlled foreign affiliates ("CFA1" and "CFA2"); (ii) CFA1 and CFA2 own all of the partnership interests in a limited partnership ("LP"); (iii) LP wholly owns a controlled foreign affiliate ("CFA3"); and (iii) CFA3 incurs interest expense that is otherwise deductible in computing its FAPI vis-à-vis LP (with such FAPI then being allocated to CFA1 and CFA2 and ultimately included in computing the taxable income of Canco). Because LP is owned by CFA1 and CFA2 (instead of Canco) and the foreign affiliate "look through" rule in section 93.1 do not apply for purposes of proposed subsection 18.2(2) or for purposes of computing FAPI, it seems that CFA3 would have no RAIFE (or RAIFR) that is elevated to Canco.[2] Such a result seems to arise because LP is not a taxpayer for purposes of the EIFEL rules (pursuant to the definition of "taxpayer" in proposed subsection 18.2(1)) and proposed subclause 95(2)(f.11)(ii)(A) provides that subsection 18.2(2) does NOT apply for purposes of computing FAPI income or loss of a foreign affiliate. Similarly, while proposed clause 95(2)(f.11)(ii)(D) provides for a proportionate disallowance of RAIFE for purposes of computing the FAPI of a controlled foreign affiliate where a portion of the taxpayer's IFE for the year is denied, it is not clear how this proposed clause can apply for purposes of computing the FAPI of CFA3 given that it is only a controlled foreign affiliate of Canco for the limited provisions described in subsection 93.1(1.11) (which generally do not apply for purposes of computing FAPI as the LP is viewed as the taxpayer for those purposes).***

  - ***We recommend that changes be made to clarify the application of the EIFEL rules in a situation where a partnership is interposed between two controlled foreign affiliates.***

- ***In a situation where a "top tier" (or "lower tier") partnership structure is not wholly owned by a taxpayer group, it appears that additional burdens or complexities could arise. For example, assume that (i) a Canadian corporation ("Canco") that is subject to the EIFEL rules owns a minority interest (e.g., 10% or less) in a partnership ("LP") that might or might not have a presence in***

[2] In contrast, certain components (e.g., variables E(b) and Z.2) of the definition of "adjusted taxable income" in proposed subsection 18.2(1) clearly contemplate the inclusion of a FAPL or RAIFE of a controlled foreign affiliate of a partnership that is owned by a controlled foreign affiliate of the taxpayer.

Canada; and (ii) LP owns a controlled foreign affiliate ("CFA") that earns FAPI (and incurs interest expense that is otherwise deductible in computing that FAPI). Notwithstanding that Canco only has an indirect minority interest in CFA (and that CFA might not even be a foreign affiliate, let alone a controlled foreign affiliate, of Canco had it instead directly owned shares of CFA), the effect of the structure is such that LP becomes a "FAPI aggregator" in the sense that CFA is required to compute its FAPI vis-à-vis LP, with that FAPI being allocated by LP to its partners.

While such a structure has significant administrative and compliance burdens/challenges under existing law from the perspective of both the CRA and taxpayers, these burdens/challenges are potentially magnified due to the proposed treatment of RAIFE and RAIFR of controlled foreign affiliates. For example, in order to comply with the proposed EIFEL rules, it would be necessary for LP to provide sufficient additional information to its partners, even minority ones such as Canco, to allow the partners to compute their IFE. Given the increased administrative burden to the partnership, it is possible that a partnership (particularly one that does not have any significant Canadian resident shareholders) may not provide a minority partner with sufficient information regarding the RAIFE of the controlled foreign affiliate(s) of the partnership to allow that partner to compute its IFE and potential income inclusion under proposed paragraph 12(1)(l.2).

- ***We recommend that a de minimis exception be included to ease the compliance and enforcement burden faced by taxpayers and the CRA in these types of structures.***

- ***The foreign affiliate regime currently includes a number of potential technical issues that could prevent paragraph 95(2)(g) from applying to deem nil (under the mechanics of subsection 93.1(5) and/or paragraph 95(2)(g.03)) foreign exchange gains (losses), as computed vis-à-vis the Canadian currency, otherwise arising on certain indebtedness between (i) a partnership and a foreign affiliate; and (ii) two foreign affiliates where there is a partnership interposed between those affiliates.***

  - ***Based on our understanding that the EIFEL rules currently contemplate the inclusion of foreign exchange gains (losses) in the determination of IFE and IFR (even if those gains (losses) are on account of capital), it becomes increasingly important that these potential technical issues be addressed on a timely basis. As a result, we recommend that these potential technical issues be addressed as part of the enactment of the EIFEL rules.***

Excluded Entity

In general, a Canadian-resident taxpayer qualifies as an excluded entity, under paragraph (c) of the definition of "excluded entity" in proposed subsection 18.2(1), if the taxpayer is a standalone entity or a member of a group that consists exclusively of Canadian-resident taxpayers, provided certain conditions are met, including:

(i) the particular taxpayer and all other group members carry on all or substantially all of their businesses, undertakings and activities in Canada; and

(ii) the group's foreign affiliate holdings, if any, are *de minimis*, meaning the greater of the book cost of all foreign affiliate shares held by the group and the fair market value of the assets of

all foreign affiliates held by the group does not exceed $5,000,000.

Observations/Recommendations:

Regarding the condition in subparagraph (c)(i), we assume that it is not the intention for the mere ownership, by the taxpayer or another group member, of the indebtedness, or shares, of a foreign affiliate (or other foreign property) to cause this requirement to not be met. For example, assume that a Canadian holding company's ("Cdn Holdco") only property is the shares and/or debt of a foreign affiliate. Given that subparagraph (c)(ii) of the definition of "excluded entity" specifically contemplates the ownership of the shares of a foreign affiliate, it would seem reasonable that the location of Cdn Holdco's "business, undertaking and activities" should not be determined based on the mere ownership of foreign property. However, the explanatory notes do not provide any interpretive guidance regarding the phrase "businesses, undertakings and activities".

- ***We recommend that this holding company situation, and more broadly what is intended by the phrase "businesses, undertakings and activities", be clarified in the explanatory notes to the definition of "excluded entity".***

Another aspect of the conditions in subparagraph (c)(i), is that the taxpayer and each other member of the group must meet the "all or substantially all" requirement. As a result, the business, undertaking or activity of an insignificant member of the group could result in this condition not being met, even if there is a commercial or legal reason for segregating the business, undertaking or activity in a particular group member.

- ***We recommend that this condition be determined on a group, as opposed to a member by member, basis.***

Regarding the condition in subparagraph (c)(ii), in the case of a foreign affiliate that is not wholly owned by a taxpayer, or a taxpayer group, it is not entirely clear, for purposes of the $5M test, if the determination of book value and/or fair market value should be determined only by reference to the taxpayer's (or taxpayer group's) ownership interest in the affiliate.

- ***We recommend that this condition be clarified in a manner such that it is based on the group's ownership interest in a foreign affiliate.***

We also note that an "eligible group entity" can include an entity controlled by a sibling of a person that controls the taxpayer, even if there is no material economic relationship between the taxpayer and the other entity. Another example would be where an investment fund manager manages two economically separate investment partnerships and one of them is purely Canadian while the other may hold foreign investments. The entities held under the purely Canadian investment partnership could be disqualified from "excluded entity" status because both partnerships are controlled by general partnership entities that are related because they are both controlled by the investment manager, even though the two partnerships represent truly separate investor pools and investment footprints.

- ***We recommend that "eligible group entity" should be defined in a manner that is focused on commonality of economic interests rather than all cases of technical relatedness.***

Treatment of Foreign Accrual Tax ('FAT")

Paragraph (g) of the definition of IFR includes an amount equal to the RAIFR of a CFA multiplied by the taxpayer's specified participating percentage in the CFA, less any amount deducted under subsection 91(4) in respect of FAT that is applicable to the RAIFR. In other words, only the "net" FAPI inclusion relating to the RAIFR of a CFA is factored into the IFR of the taxpayer.

The comments below consider a few different scenarios regarding the treatment of FAT and whether the outcome(s) that arise are appropriate.

CFA versus directly earned

As a preliminary matter, we note that a different approach has been taken for the treatment of FAT incurred by a CFA as compared to foreign taxes that are incurred directly by a taxpayer. In particular, if a taxpayer earns interest income directly, suffers foreign tax, and claims a foreign tax credit ("FTC"), the full amount of the interest income is included in IFR. The FTC is factored into the ATI definition, not the IFR definition. This is true regardless of whether the foreign tax incurred by the taxpayer is withholding tax or income tax – for instance, by virtue of the taxpayer earning interest income through a foreign branch.

In the case of withholding tax, we recognize the importance of excluding foreign withholding tax when computing the IFR of a taxpayer in respect of interest income earned directly by the taxpayer, as this is necessary in order to facilitate situations where external debt is borrowed in Canada for commercial reasons and then advanced to foreign subsidiaries. In such cases, if the IFR inclusion for the taxpayer was reduced by any foreign withholding tax suffered by the taxpayer in respect of the interest income, the taxpayer would not be able to deduct the all of the IFE on the external debt, even though the taxpayer is simply borrowing to on-lend in a manner that is intended to be facilitated by the EIFEL rules. As such, it is important that any FTC arising from foreign withholding tax incurred by a taxpayer in respect of IFR earned directly by the taxpayer continue to be factored into the ATI definition and not the IFR definition. However, for consistency, we suggest that consideration be given to providing similar treatment for any withholding tax incurred by a CFA in respect of RAIFR earned by the CFA. This could be done by only reducing RAIFR by the portion of any subsection 91(4) deduction that relates to income or profits taxes, other than withholding taxes.

In the case of foreign income tax, we note that the application of the EIFEL rules can be very different where interest income is earned by a CFA as compared to being earned through a foreign branch. Assume, for instance, that a Canadian company ("Canco") has a wholly-owned foreign subsidiary that earns $100 of interest income and suffers $25 of foreign income tax, with no "net" FAPI being attributed to Canco because the FAPI inclusion is fully offset by a FAT deduction. In this case, there would be no amount included in the IFR or ATI of Canco. Now, for comparison, assume that Canco instead has a foreign branch that earns $100 of interest income and suffers $25 of foreign income tax, with the Canadian tax otherwise payable by Canco with respect to the interest income being fully offset by a FTC. In this case, Canco would have IFR of $100 and a reduction to ATI of $100, and would therefore have

greater capacity to deduct IFE relative to the scenario where the interest income is earned by a CFA. It is not clear if these two varying outcomes are intended from a policy standpoint. If so, then it would be helpful to explain this in the explanatory notes. If it was not intended, then consideration could be given to providing similar treatment for foreign income taxes incurred (i) by a CFA and (ii) by a taxpayer directly vis-à-vis a foreign branch.

Recommendation:

We recommend that there be greater consistency between the treatment of foreign taxes incurred directly by a taxpayer and foreign taxes incurred by a CFA of a taxpayer. If different outcomes are intended from a policy perspective, we suggest that an overview of the intended differences be provided in the explanatory notes. For greater certainty, we believe it is important that any FTC of a taxpayer that relates to foreign withholding taxes suffered by the taxpayer with respect to directly earned IFR continue to be addressed in the ATI definition, and not the IFR definition, as this is necessary to ensure that a taxpayer can borrow money in Canada and on-lend to its foreign subsidiaries (i.e., on a back-to-back basis) without creating any EIFEL limitations.

Canadian withholding taxes

As currently drafted, the RAIFR of a particular CFA is reduced by any amount that is deducted under subsection 91(4) in respect of FAT that is applicable the RAIFR. FAT includes, among other things, any income or profits tax paid by the particular CFA, and therefore includes any Canadian withholding taxes suffered by the CFA – for instance, on an upstream loan to Canada. This is necessary to ensure that double tax does not arise when a CFA suffers Canadian withholding tax on FAPI which is later repatriated to its Canadian parent company via dividends.

However, in the context of the EIFEL rules, it is inappropriate in our view to reduce the RAIFR of a CFA by an amount that is deducted under subsection 91(4) in respect of Canadian withholding taxes.
To illustrate, assume that a wholly-owned CFA of a Canadian company ("Canco") makes an interest-bearing upstream loan to Canco, with the interest payments from Canco to the CFA being subject to a 25% Canadian withholding tax. From a policy perspective, we would expect this scenario to be neutral from an EIFEL perspective since there is IFE (in Canada) and corresponding IFR (in a wholly-owned CFA), and the only "tax" that is suffered by the CFA is Canadian withholding tax. However, under the rules as currently drafted, Canco would have $100 of IFE and no IFR since the RAIFR of the CFA would be fully offset by a FAT deduction, being the grossed-up deduction for the 25% Canadian withholding tax suffered by the CFA.

Recommendation:

We recommend that a specific exclusion for Canadian withholding tax be included, such that any reduction to the amount of RAIFR that is included in the IFR definition is limited to the subsection 91(4) deduction with respect to FAT other than any tax paid to the government of Canada or to the government of a Canadian province or territory.

Inter-affiliate transactions

The definition of IFE includes the RAIFE of a CFA multiplied by the taxpayer's specified participating percentage in the CFA. Similarly, the definition of IFR includes the RAIFR of a CFA multiplied by the taxpayer's specified participating percentage in the CFA. However, this amount is reduced by any amount deducted under subsection 91(4) in respect of FAT that is applicable to RAIFR. We believe this can lead to inappropriate outcomes in the case of inter-affiliate transactions.

Assume, for instance, that a Canadian company ("Canco") has two wholly-owned CFAs ("CFA 1" and "CFA 2"). CFA 1 and CFA 2 are both resident in a country with a 25% corporate income tax rate. CFA 1 carries on an investment business and earns non-interest FAPI. CFA 2 carries on an active business. For commercial reasons, CFA 2 advances funds to CFA 1 on an interest-bearing basis, which are used by CFA 1 in its investment business. The interest paid from CFA 1 to CFA 2 is deductible in computing the FAPI of CFA 1 and is included in the computing the FAPI of CFA 2.

In this case, ignoring the inter-affiliate loan, the activities at the CFA level would have no EIFEL implications for Canco (i.e., CFA 1 earns FAPI but it is fully offset by a FAT deduction, and CFA 2 earns active business income). However, the inter-affiliate loan gives rise to EIFEL implications since (i) the interest expense incurred by CFA 1 is RAIFE and is therefore included in IFE of Canco and (ii) the interest revenue income by CFA 2 is RAIFR but is not included in the IFR of Canco since it is fully offset by a FAT deduction. As such, there would be a net IFE inclusion for Canco by virtue of the inter-affiliate loan, even though it has not eroded the Canadian tax base. In other words, the RAIFE in this case has simply reduced FAPI that would not otherwise have been subject to tax in Canada given that CFA 1 pays foreign income tax at 25%.

Recommendation:

To the extent our recommendations above regarding the exclusion of inter-affiliate loans are adopted (i.e., the RAEI concept described above), there should be no concerns as the RAIFE and RAIFR would both be excluded, and therefore there would be no net IFE inclusion for Canco. However, to the extent that inter-affiliate loans are not excluded either automatically or by election, then we believe relief should be available for scenarios like the one described above. In particular, the RAIFR arising from an inter-affiliate loan should only be reduced by a FAT deduction with respect to the RAIFR to the extent that the interest expense is deductible in computing non-interest FAPI that would otherwise be subject to tax in Canada, when taking into account the FAT that would otherwise have been payable by the debtor FA has the inter-affiliate loan not been made.