Canada makes welcome amendments to the Income Tax Act for EIFEL rules

December 15, 2022

In the Federal Budget tabled on April 19, 2021 (Budget 2021), the Government of Canada announced its intention to introduce legislation to implement limitations on interest deductibility. The relevance of introducing limits on interest deductibility legislation comes from a recommendation from the Organisation for Economic Co-operation and Development's project dealing with base erosion and profit shifting (BEPS Action 4) that Canada has yet to adopt.

Canada introduces income tax and excise tax proposals

On February 4, 2022, the Government of Canada released a package of draft legislative proposals and explanatory notes to implement a number of income and excise tax proposals. The package included the excessive interest and financing expenses limitation rules (the EIFEL rules) in accordance with BEPS Action 4.

Generally, the EIFEL rules, as proposed will limit a taxpayer's ability to deduct interest and financing expenses where such amounts exceed a fixed ratio equal to 30 per cent of tax-adjusted earnings before interest, taxes, depreciation and amortization. The federal government's press release accompanying the EIFEL rules invited taxpayers to provide comments and submissions on the EIFEL rules.

BLG proposed amendments

BLG, on behalf of a Canadian securitization vehicle, reviewed the EIFEL rules as proposed on February 4, 2022, and provided a submission to the department of finance that requested certain amendments be made to the EIFEL rules. BLG proposed amendments to ensure the continued and effective operation of securitization vehicles within Canada's financial sector. On November 3, 2022, concurrent with the Fall Economic Statement 2022, the department of finance released further revised draft legislation and explanatory notes for the EIFEL rules with welcomed changes for securitization vehicles. See "Preparing for the new EIFEL rules in Canada" for general information regarding other taxpayers impacted by the new rules.

Securitization vehicles

A securitization vehicle generally describes a trust or other special purpose entity that is established to facilitate the issuance of securities, typically debt, which is backed by a pool of income producing assets. The goal of most securitization vehicles is to provide liquidity to its “sponsor” by enabling the sponsor to sell the pool of income producing assets to the securitization vehicle in exchange for cash. The securitization vehicle typically finances its acquisition of the pool of income producing assets through the issuance of debt that has an interest rate that generally reflects the anticipated income associated with the pool of income producing assets. This process ensures that the securitization vehicle “runs flat” from an income tax perspective, thus avoiding unnecessary tax leakage.

What does this mean for Canadian taxpayers?

Under the originally proposed EIFEL rules (February 4, 2022), most Canadian securitization vehicles would have been subject to the restriction on interest deductibility by virtue of their issuance of debt and payment of interest to non-residents of Canada and entities exempt from Canadian income tax (referred to as tax-indifferent investors), thus preventing them from running flat from an income tax perspective. However, under the revised proposed EIFEL rules and explanatory notes (November 3, 2022), the three categories of excluded entities (not subject to the EIFEL rules) have been expanded and a sector-specific exemption for Canadian public-private partnerships was also introduced.

Specifically related to securitization vehicles, an entity may now qualify as an excluded entity provided all or substantially all of its interest is paid to persons or partnerships with which it deals at arm’s length, regardless of whether that person is a non-resident of Canada or exempt from Canadian income tax. The EIFEL rules now intend to apply to taxation years beginning on or after October 1, 2023, rather than January 1, 2023, as originally proposed. The deadline for providing comments to The Department of Finance on the revised EIFEL rules is January 6, 2023.

Conclusion

The EIFEL rules represent a material shift in Canadian tax policy and are very technical in nature. Taxpayers with concerns can contact the authors listed below or a member of the BLG Financial Services or Tax Groups with questions or for assistance with submitting comments to the department of finance before January 6, 2023.

By

Robert Nearing

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blg.com

BLG Offices

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749

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