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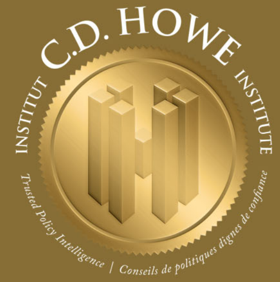

From: Marc André Gaudreau Duval and Marc Pietro Allard

To: The Hon. Chrystia Freeland, Minister of Finance and Eric Girard, Quebec Finance Minister

Date: August 26, 2022

Re: **Canada's New Interest and Financing Expense Deductibility Rules**

New rules limiting the deduction of "interest and financing expenses" to a percentage of earnings before interest, taxes, depreciation and amortization (EBITDA) for Canadian income tax purposes come into force on January 1, 2023.

The Excessive Interest and Financing Expenses Limitation (EIFEL) Rules will:

- affect a significant number of Canadian corporations;
- disproportionally affect capital-intensive industries, such as real estate and infrastructure; and
- apply in addition to existing rules limiting interest deductibility.

In simple terms, the deductibility of net interest and financing expenses of corporations and trusts (that are not excluded) will be limited to a "fixed ratio" of 40 percent of EBITDA for taxation years starting on or after January 1, 2023. The fixed ratio will decrease to 30 percent for taxation years starting on or after January 1, 2024.

The EIFEL Rules also provide for a group ratio applicable to corporate groups that have audited consolidated financial statements and meet certain requirements. The group ratio can, under certain circumstances, be higher than the fixed ratio. However, even with this alternative rule, the interest deductible for tax purposes will be significantly lower than the interest paid.

The EIFEL Rules should not apply to natural persons or to certain "excluded entities", the definition of which is meant to capture (i) small business corporations and trusts, (ii) corporations and trusts with very low amount of net interest and financing expenses in a taxation year; and (iii) corporations and trusts without any foreign affiliate in its corporate group if substantially all of the business of the taxpayer is carried on in Canada, substantially all of its interest and financing expenses are payable to non-tax-exempt entities and no non-resident owns more than 25 percent of the votes or fair market value of the taxpayer.

Taxpayers must take the complexity and formula-driven approach of the new rules into account, as compliance costs will undoubtedly increase. Understandably, the complexity and scope of the new EIFEL Rules have received much criticism.

Some criticism pertains to the EIFEL Rules' disproportionate effect on capital-intensive industries, such as real estate and infrastructure. Limiting deductions for interest and financing expenses will necessarily increase the cost of financing arrangements, thereby reducing the internal rate of return and the overall fair market value of projects in such industries.

Both the OECD and the US have recognized the adverse effects on these industries and, thus, have provided explicit exceptions for such investments. In the absence of similar exceptions in Canada, the EIFEL Rules risk hurting Canada's ability to attract foreign and domestic investment in these industries.

Part of the criticism submitted to the Department of Finance also concerned the fact that these restrictions were so broadly drafted that they may actually impact a significant number of Canadian taxpayers that would not normally expect the rules to apply to them, due to a combination of two reasons:

1. although the rules are intended to address so-called base erosion and profit-shifting by multinational firms, a significant number of Canadian small business corporations and trusts will actually be caught; and
2. although they are anti-avoidance rules in nature, their mechanical application will affect some taxpayers, even if their dealings have no underlying tax-avoidance motivation.

In light of these criticisms, Canada should expand the notion of "excluded entities" to include those disproportionately adversely affected by the new rules, as well as those that are not engaged in any sort of international tax planning aimed at shifting profits to jurisdictions with lower income tax rates.

Moreover, given the dire need for investment in Canadian housing and infrastructure, one would expect the Canadian government to adopt policies that would encourage (and not discourage) such investment. However, following a consultation period during which the Department of Finance received an abundance of submissions from tax professionals criticizing the rules, the department confirmed in May 2022 that they would remain substantially the same. As such, the EIFEL Rules are unlikely to change and Canadians should prepare for a decrease in housing and infrastructure investment due to the increased cost to investors' financing arrangements.

In summary, these rules, which we discuss in more detail in a recent paper, seem to be in direct contradiction with the top priorities of the current government that revolve around affordable housing, renewable energy and a more resilient economy.

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