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The EIFEL Rules – A Significant Reduction to Interest Deductions

RICHTER CFO SERIES

OCTOBER 13, 2022

TORONTO
181 Bay St., #3510
Bay Wellington Tower
Toronto ON M5J 2T3
T 416.488.2345

MONTRÉAL
1981 McGill College, #1100
Richter Tower
Montréal QC H3Z 0G6
T 514.934.3400

CHICAGO
200 South Wacker, #3100
Chicago IL 60606
T 312.828.0800

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THE EIFEL RULES –
A SIGNIFICANT REDUCTION
TO INTEREST DEDUCTIONS

JENNA SCHWARTZ

LL.B., B.C.L.
Vice President, Tax | Richter
T 514.934.3487
jschwatrz@richter.ca

VÉRONIQUE ALARY

CPA
Senior Manager, Tax | Richter
T 514.934.3446
valary@richter.ca

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PHIL NADLER

CPA
Partner, Tax | Richter
T 514 934.8672
pnadler@richter.ca

LORNE RICHTER

CPA
Partner, Tax | Richter
T 514 934.3590
lrichter@richter.ca

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Agenda

1. Overview of Proposed Limitation on Interest and Finance Expenses
2. Will Your Business Be Subject to these Rules?
3. Planning Alternatives

Section 1 –
Overview of Proposed Limitation on Interest and Finance Expenses

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Announced in Budget 2021

Included under "International Tax Measures"

- Text suggested it could apply to domestic situations

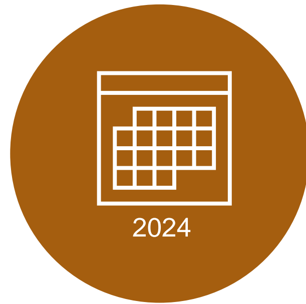
Based on OECD BEPS proposals relating to:

- Interest paid from Canada to low tax jurisdictions
- Use of debt to finance non-taxable investments (i.e. foreign affiliates)
- Canada bearing too much of a multinational group's debt

Draft Legislation

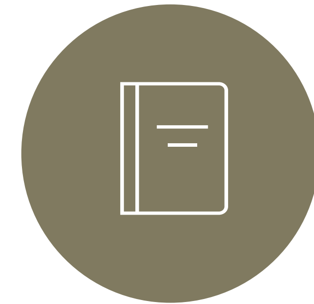
Issued
Feb. 4, 2022

Generally, starting
with year-ends
on Dec. 31, 2023



2024 for all
other year-ends

Rules are complex
and broad –
domestic groups
impacted



Found in 18.2
of the Income
Tax Act, ff.

Basic Rule

- No deduction of interest and financing expenses (other than “excluded interest”) in excess of permissible ratio of “EBITDA”

  - 40% in 2023
  - 30% thereafter

- Applies to corporations and trusts (taking into account their interests in partnerships, joint ventures and co-ownerships)

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Basic Rule (cont'd)

- Possible transfer of "capacity" between related corporations and group election to simplify filings in consolidated groups
- Possible three-year "carryback" and 20-year carryforward of excess expense
- Does not apply to "Excluded Entity"

- Applies if any member of the eligible group entity is subject to the rules.

Eligible Group Entity

- **Corporation or trust resident in Canada**
  - Related or Affiliated with taxpayer
  - Trust of which the taxpayer is discretionary beneficiary
  - Where taxpayer is a trust, a discretionary beneficiary of the taxpayer

- Can include entities that you are not aware of

- Includes entities that were not created for business purpose (i.e.: Foreign personal properties)

1. Will have a major impact on real estate and private equity funds.

2. No grandfathering of existing interest and financing expenses.

3. Extremely complex rules – a professional tax advisor should be consulted!

4. **Rules are still “proposed” yet are in effect very soon**
   → Short timeline to plan

5. **What is the overall policy objective?**
   → Fairness to Canadian entities with no cross-border payments
   → Non-business family situations may trigger the rules
   → Arbitrary distinction between foreign and domestic shareholders

Section 2 –
Will your Business be Subject to These Rules?

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Excluded Entity

A

CCPC with “associated” entities having total taxable capital <$15M

- Finance Canada is considering an increase to $50M

B

Total net interest and financing expenses of entity and all “eligible group entities” <$250,000

- Finance Canada considering an increase to this threshold

Excluded Entity (cont'd)

Taxpayer resident in Canada who meets the following four conditions

1. Each eligible group entity must carry on all or substantially all **(generally, 90%+) of its business in Canada**
2. No investment in a foreign affiliate by **any** eligible group entity.
3. No eligible group entities can have a "specified non-resident shareholder" or "specified non-resident beneficiary".
4. **All or substantially all (generally, 90%+)** of the interest paid by each eligible group entity are **not** paid to "tax-indifferent investors".

Excluded Entity (cont'd)

Taxpayer resident in Canada who meets the following four conditions

1. **Each eligible group entity must carry on all or substantially all (generally, 90%+) of its business in Canada.**

TIP: If your business files foreign tax returns, it is possible that you carry on business outside Canada.

Excluded Entity (cont'd)

Taxpayer resident in Canada who meets the following four conditions

2. **No investment in a foreign affiliate by any eligible group entity.**

TIP: The requirement to file form "T1134 – Information Return Relating to Controlled and Non-Controlled Foreign Affiliates" signifies the presence of a "foreign affiliate".

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Excluded Entity (cont'd)

Taxpayer resident in Canada who meets the following four conditions

3. No eligible group entities can have a "specified non-resident shareholder" or "specified non-resident beneficiary"

- A "specified non-resident shareholder" is a shareholder that generally own 25% or more of the shares of the entity.
- Either alone or together with persons with whom he/she is not dealing at arm's length.

TIP: A non-resident that is the beneficiary of a discretionary trust is likely a "specified non-resident beneficiary".

Excluded Entity (cont'd)

Taxpayer resident in Canada who meets the following four conditions

4. **All or substantially all (generally, 90%+) of the interest paid by each eligible group entity are not paid to "tax-indifferent investors".**
   - "tax-indifferent investor" includes the following:
     - Non-taxable entities
     - Non-residents
     - Canadian resident discretionary trusts
     - Partnerships that have any of the above as members and trusts that have any of the above as beneficiaries.

Insights

1

Many entities will have to rely on the four-condition test.

2

The four-condition test is extremely difficult to meet.

To illustrate, any of the following occurring in any group entity will result in failure of the test:

- A loan from a foreign bank
- A right in an agreement granted to your sibling (when he/she was a resident of Canada) to acquire 25% of the shares in a Canadian corporation, and that sibling has now left Canada.
- One of your kids is a beneficiary of your discretionary family trust and has since left Canada.
- Owning a foreign company for personal purposes. *(ex: A personal use condo in Florida).*

Detailed Calculation

No deduction of interest and financing expenses to the extent of following proportion

=(A − (B + C + D + E))/A

A – interest and financing expenses
B – adjusted taxable income X ratio of permissible expenses
C – interest and financing revenues
D – received capacity for the year in excess of amount deducted in the year under 111(a.1) against prior year carryforward
E – absorbed capacity [transitional rule which permits carryforward of excess room from the three years preceding the enactment of the rules]

Adjusted Taxable Income

Roughly approximates EBITDA

Total of A + B – C

A = taxable income (positive amount) or non-capital loss for the year (negative amount)
B = interest and financing fees + CCA deduction
C = interest and financing revenues

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Examples

Example 1 – Base Case

FACTS –

- Taxable income before considering rules **$100,000**
- CCA deduction **$100,000**
- Interest expense **$200,000**

Basic example showing the impact of the rules.

Example 1 – Base Case (cont'd)

FACTS –

- Taxable income before considering rules **$100,000**
- CCA deduction **$100,000**
- Interest expense **$200,000**

Adjusted taxable income = **$400K**
($100K + $100K + $200K)

Interest denial proportion = **20%**
($200K-($400K X 40%))/$200K

Interest expense denial = **$40,000**
$200,000 X 20%

Deductible interest = $160,000
$200,000 – 40,000

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Example 2 – Non-Capital Loss

FACTS –

- Taxable income before considering rules **($100,000)**
- CCA deduction **$100,000**
- Interest expense **$200,000**

This case shows the impact of having a non-capital loss for a specific year.

Ratio of interest denied is significantly increased.

Example 2 – Non-capital Loss (cont'd)

FACTS –

- Taxable income before considering rules **($100,000)**
- CCA deduction **$100,000**
- Interest expense **$200,000**

Adjusted taxable income = **$200K**
($-100K + $100K + $200K)

Interest denial proportion = **60%**
($200K-($200K X 40%))/$200K

Interest expense denial = **$120,000**
$200,000 X 60%

Deductible interest = $80,000
$200,000 – $120,000

Example 3 – Interest Income

FACTS –

- Taxable income before considering rules **$100,000**
- CCA deduction **$100,000**
- Interest expense **$200,000**
- Interest Income **$200,000**

This case shows the benefit of having interest income.

Interest income will decrease, dollar for dollar, the amount of interest expenses that would otherwise be denied.

Can result in full interest deduction.

Can create excess capacity.

Example 3 – Interest Income (cont’d)

FACTS –

- Taxable income before considering rules **$100,000**
- CCA deduction **$100,000**
- Interest expense **$200,000**
- Interest Income **$200,000**

Adjusted taxable income = **$200K**
($100K + $100K + $200K - $200K)

Interest denial proportion = **0%**
($200K-(($200K X 40%)+$200K))/$200K

Interest expense denial = **$0**
$200,000 X 0%

Deductible interest = $200,000
Excess capacity = $80,000

Section 3 –
Planning Alternatives

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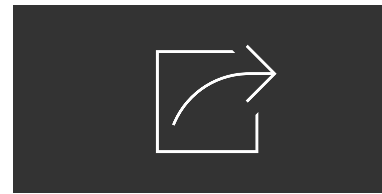
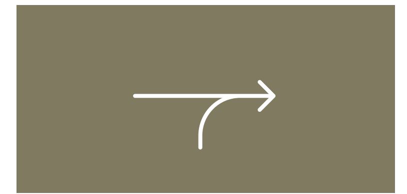
1. Excess and Transferred Capacity
2. Excluded Interest
3. Group Ratio

1. Excess/Transferred Capacity





Election by two taxable Canadian corporations

Must be eligible group corporations for the year

Same reporting currency

Transfer of cumulative excess capacity [unused room to deduct interest] from one corporation to the other

Allows for dealing with "misalignment" in corporate groups

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2. Excluded Interest

- Interest paid between two corporations in same eligible group are not subject to rules
- Payer and payee corporation must be taxable Canadian corporations
- Requires election

- Does not apply to trusts or partnerships.

3. Group Ratio

Certain groups that prepare consolidated audited financial statements may qualify for the “Group Ratio” regime.

- In general, such groups may use a percentage of EBITDA which is greater than 30%/40%.
- Given the strict criteria, it is not anticipated that most owner managed groups will qualify.
- If, however, once computations are run, there is significant disallowed interest, this option should be considered.

CONCLUSION AND DISCUSSION

QUESTIONS AND COMMENTS

COMING SOON AT RICHTER

CFO Webinar Series

TBD 2023

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CONTACT US

TORONTO
181 Bay St., #3510
Bay Wellington Tower
Toronto ON M5J 2T3
T 416.488.2345

MONTRÉAL
1981 McGill College, #1100
Richter Tower
Montréal QC H3Z 0G6
T 514.934.3400

CHICAGO
200 South Wacker, #3100
Chicago IL 60606
T 312.828.0800

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