SUBMISSION TO THE DEPARTMENT OF FINANCE FEBRUARY 4, 2022 DRAFT LEGISLATIVE PROPOSALS

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Submitted electronically at: Consultation-Legislation@fin.gc.ca

Following our submission of April 4, 2022, MNP LLP (MNP) is pleased to make a second submission in response to the Department of Finance (the "Department") request for comments on the draft legislative proposals to the *Income Tax Act* ("ITA") and other legislation released on February 4, 2022. We appreciate the opportunity to provide our comments and recommendations.

While we understand that the proposed measures are intended to align with the Base Erosion and Profit Shifting ("BEPS") Action 4 recommendations provided by the Organisation for Economic Co-operation and Development ("OECD"), the proposed excessive interest and financing expenses limitation ("EIFEL") rules add to the complexity of the existing Canadian income tax system and will impact Canadian businesses that do not engage in activities that the recommendations seek to discourage. Our submission addresses the concerns and challenges we anticipate Canadian businesses will face if the proposed EIFEL rules are enacted in their current form.

Our understanding is that the main intent of the proposed EIFEL rules is to prevent tax base erosion in Canada arising from multinational corporate groups with certain financing structures. Specifically, the rules seek to prevent or limit financing structures that have the effect of using domestic borrowing to finance foreign operations, while generating deductions for the financing expenses against Canadian-source income.

Canada already has numerous provisions in place to limit excessive interest and financing expense deductions both from domestic and cross-border perspectives, such as the transfer pricing rules in ITA section 247, the general rule in ITA paragraph 20(1)(c), the thin capitalization rules in ITA subsection 18(4), and the foreign affiliate dumping rules in ITA section 212.3. Given the extensive tax legislation that already exists in Canada, this new set of highly elaborate rules creates even more complexity and uncertainty for Canadian businesses, particularly for Canadian-controlled Private Corporations ("CCPCs").

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Primary Recommendations

To ensure the proposed EIFEL rules appropriately target the intended cross-border financing structures without adversely impacting Canadian businesses incurring domestic borrowing for domestic operations, the following recommendations should be considered.

1. Narrow the scope of the proposed rules to exclude CCPCs that do not contribute to Canadian tax base erosion, or at a minimum, expand the exemption criteria to reduce the number of CCPCs that will be subject to these rules.

2. Provide specific exemptions from the rules for highly leveraged Canadian industries such as agriculture and aquaculture.

Please refer to the detailed recommendations to follow in this submission.

Complexity and Broad Application of the EIFEL Rules to CCPCs

The proposed measures provide a complex and lengthy set of rules to limit the amount of net interest expense deductible in computing a taxpayer's taxable income to a fixed ratio of "adjusted taxable income" ("ATI"), as defined in proposed ITA subsection 18.2(1). There is a significant additional compliance burden created to prepare numerous calculations required under the various formulas in the proposed rules. This level of complexity creates challenges for taxpayers already dedicating significant resources to remain compliant for tax purposes, especially for CCPCs.

While the EIFEL rules attempt to exclude certain entities with the intention of ensuring the new rules are appropriately targeted at significant BEPS risks, many Canadian resident corporations and corporate groups outside of this target group will be affected because of the broadly drafted provisions. For example, a taxpayer would not be considered an "excluded entity" as defined in proposed ITA subsection 18.2(1) if it or any "eligible group entity" has a foreign affiliate (regardless of level of activity) or if it or any "eligible group entity" has a non-resident specified shareholder or beneficiary, as defined in proposed ITA subsection 18(5). An "eligible group entity," as defined in proposed ITA subsection 18.2(1), is generally a corporation or trust resident in Canada that is related to, or affiliated with, the taxpayer at that time. This extremely broad definition will make many Canadian taxpayers not be considered "excluded entities".

This is especially concerning for CCPCs that incur domestic borrowing to fund only domestic operations. For example, a CCPC that borrows for its Canadian business, but also happens to have a foreign affiliate or a non-resident passive shareholder, could inadvertently be subject to the proposed EIFEL rules. This result creates an undue hardship on the taxpayer given that the CCPC is not engaged in the type of financing activity and base erosion targeted by the proposed rules.

Agriculture

The broad application of the EIFEL rules is of particular concern to the agriculture sector. With the rising costs of land, quota and equipment, farms and feedlots are becoming increasingly capital intensive such that even a small family farm can easily exceed the $15 million taxable capital threshold. With expected interest rate increases, the limitations on interest deductibility will increase corporate income taxes, which will reduce overall business competitiveness.

Through a Taxpayer Lens

Dan and Josephine are like many other grain farmers in Canada. They are second-generation farmers in rural Saskatchewan and now have the joy of seeing two of their three daughters, Christine and Theresa, join the family business. Their third daughter, Emily, moved to England last year and became a non-resident of Canada. Emily is not involved in the farm operation. Christine, Theresa and Emily also each own 33 percent of the shares of a related investment holding corporation.

Dan and Josephine feel their current operation is at maximum capacity and are focused on acquiring new land for future growth. This would be supported by $40M of financing at a 2.5 percent annual interest rate, equivalent to $1M of interest per year. Given that grain farms are low margin and capital intensive, Dan and Josephine felt it was prudent to involve their advisor to assist them in evaluating the impact of the newly proposed interest limitation rules, which would be applicable because their non-resident daughter is a 33 percent shareholder of a related corporation. With annual profits of $3M, their advisor indicated that the interest on their bank debt would be capped at 30 percent (or $900,000). This will result in a denial of interest costs of $100,000 annually.

Grain farmers like Dan and Josephine are proud of their ultimate product and accept that they work in an industry that is faced with low margins and high capital investment. The legacy of Dan's and Josephine's family farm is dependent on expansions in order for their girls to be successors. Limiting interest deductibility would significantly increase the cost of their investment through increased taxes. Also navigating the complexity of the rules will create a significant additional administrative burden. As such, it may discourage Dan and Josephine from on-going expansions or updating existing operations.

Real Estate

Real estate is another capital-intensive industry in which Canadian businesses will be adversely impacted by the EIFEL rules. Banks and third-party lenders have their own lending thresholds based on industry standards and therefore normal commercial transactions will be adversely impacted by this tax legislation.

The 2022 Federal Budget included various initiatives to address housing affordability issues in Canada, including measures to help increase housing supply over the next decade. However, the EIFEL rules can inadvertently have the opposite effect, as demonstrated by the example below.

Through a Taxpayer Lens

Brad and Hugh are brothers who are real estate developers. They are 50 percent owners of several real estate companies. With $65M of bank financing, one of their companies with ten full-time employees recently completed the construction of a complex of condominiums in Halifax, Nova Scotia, which are now being rented out. The interest rate on their debt is 2.25 percent, equivalent to $1,462,500 annually. Their annual profits are approximately $4M and to their surprise, their accountant advises them that the interest deduction on their bank debt would be capped at 30 percent, or $1,200,000, because of the newly proposed interest limitation rules. They fall into these rules because they own shares of another corporation that has a 20 percent ownership in a United States (U.S.) company. That U.S. company holds a small condominium in Florida, which was developed 15 years ago and generates minimal rent.

This results in a denial of interest costs of $262,500 annually. This limit in interest deductibility will significantly increase the cost of their investment through additional taxes and will limit Brad and Hugh from investing in similar housing and condominium projects in the future.

An important question remains as to whether these scenarios should fall into the scope of the EIFEL rules as there is no cross-border financing and no erosion of the Canadian tax base taking place. Given that the rules are intended to target significant BEPS risks, it appears that the draft legislation may be too far-reaching and that further exclusions should be considered.

Comparisons with Other Countries

The proposed rules include an exemption for corporate groups and trusts that have aggregate net interest expenses of less than $250,000, whereas general exemption thresholds for similar rules in other countries are significantly higher:

	UK	Germany	France
Net Interest Expense Exemption Threshold*	GBP 2,000,000 *C$3,264,800*	EUR 3,000,000 *C$4,093,200*	EUR 1,000,000 *C$1,364,400*

** C$ shown using average April 2022 exchange rates.*

The U.S. provides additional relief from these rules for specific industries, such as certain real property trades or businesses, farming business and regulated utility trades or businesses.

Additionally, Germany, with the introduction of the new interest deductibility limitations, repealed its existing thin capitalization rules. Germany also has an indefinite carry-forward period for non-deductible interest expenses.

The Department should assess the potential impact of the EIFEL rules on Canada's ability to compete for foreign investment and adjust its rules accordingly to ensure Canada is not disadvantaged.

Recommendations

To align the proposed EIFEL rules more appropriately with OECD recommendations as well the Department's stated objectives of these rules, the recommendations below should be considered.

1. Increase the taxable capital limit in proposed paragraph (a) of the "excluded entity" definition in ITA subsection 18.2(1) to $50,000,000, which would align with the 2022 Federal Budget proposals concerning the small business deduction.

2. Substantially increase the $250,000 exemption amount for aggregate net interest expenses in paragraph (b) of the "excluded entity" definition in ITA subsection 18.2(1) to be more comparable to other countries with similar rules.

3. Broaden the "excluded entity" definition to exclude situations that do not erode the Canadian tax base and to reduce the number of CCPCs that will be subject to these rules. For instance, an exclusion for CCPCs can be added to proposed ITA subparagraphs (c)(ii) and (c)(iii) of the definition. Alternatively, reduce complexity by making the rules applicable to targeted situations.

4. Provide additional exceptions and relief for specific highly leveraged industries such as agriculture and aquaculture, as well as real estate.

5. For the purpose of the calculation of foreign accrual property income ("FAPI") of a foreign affiliate, expressly exclude the EIFEL rules from the computation of a foreign affiliate's income, similar to the thin capitalization rules exclusion currently in ITA subsection 18(8).

6. Consider repealing the thin capitalization rules altogether to eliminate the existing overlap with the proposed EIFEL rules.

7. Similar to the rules in Germany, allow for denied interest expenses to be carried forward indefinitely to allow Canadian businesses to claim a deduction for these legitimate expenses in a year where there is capacity to do so.

8. Allow for cumulative unused excess capacity to be available following a loss restriction event where specific conditions are met, such as those in ITA paragraph 111(5)(b) in respect of certain losses.

9. Have the EIFEL rules applicable only to new borrowings after January 1, 2023 or allow for a two-year transitional period for the rules to not apply to existing debt.

10. Adjust the proposed legislation to address various technical issues, as detailed in the Appendix.

Concluding Remarks

Considering the Department's stated objective of the EIFEL regime, one would expect that these rules would have limited application to most CCPCs, except in situations where a CCPC is clearly incurring interest expense and financing costs that are not commensurate with its Canadian-source income. However, as illustrated above, the current draft legislation will impact CCPCs that do not contribute to Canadian tax base erosion. The draft legislation should be revised to ensure Canadian businesses engaged in domestic activity are not penalized.

MNP is pleased to continue to work with the Government, other members of Parliament and policy makers across Canada to further discuss our observations, comments, and recommendations in this submission.

APPENDIX: TECHNICAL CONCERNS

The following are technical concerns noted from the proposed EIFEL legislation.

- Proposed ITA subsection 18.2(12) specifies that in the context of non-arm's length parties, no amount will be included in interest and financing revenues ("IFR") except to the extent it is included in interest and financing expense ("IFE") of a taxable Canadian corporation or trust that is resident in Canada and subject to Part I tax. While the exclusion of these amounts from IFR increases the net interest and financing expenses by 100%, those revenues would then not be deducted from the calculation of ATI on which the 30% "ratio of permissible expenses" is applied, effectively decreasing the denied expenses by 30% rather than 100%. The results are especially problematic in situations where the interest expense in the entity from which the IFR is received has already been restricted by proposed ITA section 18.2, such as a Canadian branch of a non-resident or in situations where a Canadian taxpayer borrows and subsequently loans to foreign affiliates or other non-arm's length non-residents.

- The definition of IFR does not include FAPI, which can create a net increase in taxable income. Also, the definition of IFR does not include deemed or imputed interest with respect to a pertinent loan or indebtedness election or in accordance with ITA section 17.

- Foreign tax credits under ITA subsections 126(1) and (2) are affected by the amount of the deductible IFE, whereas those same tax credits affect the calculation of the deductible IFE, creating a circularity issue.

- Under proposed ITA section 18.2, "excess capacity", when available after calculating the "ratio of permissible expenses," can be transferred from one group member to another. However with respect to proposed ITA section 18.21, "excess capacity" is not determined on an entity-by-entity basis; instead, total deductible IFE is calculated for the group as a whole and allocated to each member within group ratio amount limits.

- From the above it seems that excess capacity can be transferred to and from trusts within a group (other than mutual fund trusts) in accordance with proposed ITA section 18.21 but not in accordance with proposed ITA section 18.2.

- The election under "excluded interest" in proposed ITA subsection 18.2(1) is currently not available to partnerships or trusts.

- The requirement to file the "excluded interest" election adds an additional administrative burden for taxpayers with limited resources to manage tax compliance.

- Item A in the formula for ATI reduces the taxable income by the total of the taxpayer's non-capital loss and net capital loss for the year. Item B in the formula adds the portion of the taxpayer's non-capital loss for another year deducted under ITA section 111, but only to the extent that this loss can reasonably be considered to relate to the taxpayer's net interest and financing expense deducted in that other year.

This addback in Item B seems to be disproportionate to the reduction in Item A, resulting in double counting of a portion of the loss.

- The reduction to the undepreciated capital cost pool of previously capitalized interest per proposed ITA subsection 18.2(3) for non-deductible interest amounts can create recapture on future disposals of the asset while the interest may never be deducted due to the EIFEL rules.

- The group ratio availability appears to be very restrictive. It excludes local European GAAP and is not available where the entities in the group do not have the same taxation year end, do not use the same functional currency, or are financial institutions. For those groups where the group ratio is available, the required information may be difficult to obtain for large multinational structures.

- The anti-avoidance provisions in proposed ITA subsections 18.2(13) to (15) are very broad and can include transactions that are outside the intended scope of the anti-avoidance rules.