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DELIVERED VIA EMAIL

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Dear Mesdames / Sirs:

Submissions of Lawson Lundell LLP on the November 3, 2022 Draft Legislation Pertaining to the Excessive Interest and Financing Expenses Limitation ("EIFEL")

We acknowledge again the invitation by the Department of Finance for submissions from taxpayers on the proposed EIFEL rules under the *Income Tax Act* (the "**Act**"). They are indeed complex and the continued engagement with taxpayers is important and appreciated.

Technical Compliance

There are two technical matters with regards to the "excluded entity" test that we wish to raise, addressing taxpayer circumstances that we believe are not uncommon as a commercial matter and merit technical amendments under the proposed rules.

(a) Partnerships[1] *and Arm's length Concept*

For purposes of the excluded entity test, the definition of tax-indifferent investor captures non-resident persons and tax-exempt persons but also includes a partnership where more than 10% of the fair market value of the partnership is held, directly or indirectly through one or more trusts or partnerships, by any combination of non-resident persons or tax-exempts.

The concept of a "tax-indifferent investor" was introduced as part of draft legislation under the April 2016 Budget to address dividend rental arrangements and synthetic equity arrangements. Such rules have different policy objectives and operating provisions than those under the draft EIFEL rules. In particular, the relationship that matters under the dividend rental/synthetic equity arrangement rules is whether a group of tax-indifferent investors are "affiliated". In this regard, the Act prescribes rules for affiliation with partnerships in section 251.1. The Act does

[1] We are aware of submissions having been made regarding trusts as tax-indifferent investors and the low 10% threshold so we have not addressed in our submission except to note that the introduction of an arm's length exception highlights an internal conflict between such a low 10% threshold in the tax-indifferent investor definition and the policy of exempting arm's length debt.

not set out rules of general application for determining when a taxpayer and a partnership deal at arm's length.

- Recommendation: For purposes of the excluded entity test,

  - the tax-indifferent investor definition be read without reference to paragraph (d),

  - a look-through rule for payments of interest to partnerships be introduced to allow taxpayers to have greater certainty with respect to applying the arm's length test, and

  - consideration be given to substituting the arm's length test with a prescriptive shareholding test, similar to the specified non-resident shareholder rules under the current thin-capitalization rules that taxpayers are already familiar with.

(b) Eligible Group Entity and Partnership

With respect to the inclusion of eligible group entities in evaluating a taxpayer's excluded entity status, we note the following circumstances. Two taxpayers (that have common majority investors) are indebted under separate loan arrangements to arm's length, non-resident lenders (mainly financial institutions). For solely commercial reasons (i.e., to achieve efficiencies, including better interest rates, by combining the separate loan arrangements under one common set of security, guarantee and loan terms), the two taxpayers became jointly held by a single limited partnership that continues to be owned by the same majority investor group. The new partnership then acquired the outstanding original debts from the arm's length, non-resident lenders and issued debt of the partnership in exchange.

Prior to the consolidation of the taxpayers under and debts in the new partnership, each taxpayer would have been able to directly account for interest payments to the non-resident lenders as payments to arm's length persons in testing its excluded entity status. As a result of now being owned by a partnership, because partnerships are not currently contemplated in the eligible group entity definition, the taxpayer would not be permitted to account for interest paid by the partnership to arm's length non-residents in testing its excluded entity status.

- Recommendation: For purposes of the excluded entity test, the definition of an eligible group entity should include a partnership where all or substantially all of the votes and value of the taxpayer are owned by the partnership.

Policy Objectives of Action 4

Tax Exempts Not Part of Action 4

As a final matter, although the latest draft of the EIFEL rules has addressed various points raised by taxpayers regarding the scope of the rules, they do not fully address the consistent concern raised by taxpayers that the rules go beyond the objectives of the OECD's BEPS Action 4.

Action 4 is a base erosion measure (i.e., leakage of tax revenues outside Canada) that aims to "limit base erosion through the use of interest expense to achieve excessive interest

deductions…".[2] In the case of interest payments by Canadian resident taxpayers to Canadian resident tax exempts, **no** erosion of the Canadian tax base occurs.

Furthermore, as noted in our first submission dated April 28, 2022 (see attached), we are unaware of any other country that has included or is proposing to include, in the implementation of Action 4, a domestic thin capitalization rule.

- Recommendation: The EIFEL rules be limited to interest payments to non-resident persons.

Again, we appreciate the opportunity to make the above submissions and thank you for your time and consideration of them.

Yours very truly,

LAWSON LUNDELL LLP

[2] https://www.oecd.org/tax/beps/beps-actions/action4/

APPENDIX A

APRIL 28, 2022 SUBMISSION OF LAWSON LUNDELL LLP

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Dear Sirs / Mesdames:

Submissions of Lawson Lundell LLP on the February 4, 2022 Draft Legislation pertaining to the Excessive Interest and Financing Expenses Limitation ("EIFEL")

We appreciate the opportunity to provide comments on the February 4, 2022 draft legislation setting out the new EIFEL regime (the "**Draft Legislation**"). We expect that others will comment at length on the technical aspects of the Draft Legislation. We restrict ourselves in this submission to a key policy matter. The Draft Legislation is intended to implement Canada's response to the OECD's BEPS Action 4, Limitation on Interest Deductions ("**Action 4**"). In summary, we submit that the Draft Legislation is overbroad: it does more than is necessary to implement the recommendations of Action 4, to the detriment of Canadian corporate borrowers and Canadian resident tax-exempt lenders.

Action 4 is a base erosion measure: at its core, it aims to "limit base erosion through the use of interest expense to achieve excessive interest deductions…".[1] The EIFEL rules will generally apply to standalone Canadian-resident corporations and trusts where interest and financing expenses are payable to a "tax-indifferent investor", as that term is defined in subsection 248(1) of the *Income Tax Act* (Canada). A tax-indifferent investor includes a non-resident, as one might expect in the context of a base erosion rule, but also includes a tax-exempt *resident* lender. The predominant tax-exempt lenders in Canada are registered pension plans.

No erosion of the Canadian tax base occurs when a registered pension plan (or a trust or partnership in which such plan invests) lends to a Canadian resident. Under Canada's approach to pension funding, pension contributions are generally deductible, income earned in a registered pension plan is tax-deferred, and pension payments are taxable (known as the E-E-T model).[2] This model is common to around half of OECD member countries.[3]

[1] https://www.oecd.org/tax/beps/beps-actions/action4/
[2] For "Exempt, Exempt, Taxable".
[3] https://www.oecd.org/finance/private-pensions/Tax-treatment-of-retirement-savings-Policy-Brief-1.pdf

Furthermore, in discussions with colleagues in other OECD countries, we are unaware of any other proposal to include, in the implementation of Action 4, a domestic thin capitalization rule.

Combined with the low *de minimis* rules (in the proposed definition of “excluded entity”), we are concerned that the EIFEL rules as drafted will unnecessarily burden Canadian corporate borrowers, putting them at a disadvantage compared with other OECD countries.

Canadian resident tax-exempt lenders would also be adversely impacted by the Draft Legislation. Compared with Canadian taxable investors, a loan by a Canadian resident tax-exempt lender may be sufficient to cause the borrower to cease to be an “excluded entity” under the Draft Legislation.

Canada could meet its commitment to Action 4 by restricting the application of the EIFEL rules to debt owing to non-resident lenders. In our view, this would be a principled approach.

Yours very truly,

LAWSON LUNDELL LLP

Lawson Lundell LLP