2024 Issue No. 31
29 May 2024

# Tax Alert – Canada

## EIFEL rules and other business income tax measures substantively enacted as part of Bill C-59

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 28 May 2024, amended Bill C-59, *Fall Economic Statement Implementation Act, 2023,* received third reading in the House of Commons and became substantively enacted for Canadian financial reporting purposes.

Bill C-59 implements the majority of the remaining income tax measures from the 2023 federal budget, as well as certain measures from the 2023 fall economic statement (FES) and other previously announced measures. Most notably from a business income tax perspective, Bill C-59 contains the excessive interest and financing expenses limitation (EIFEL) rules, the carbon capture, utilization and storage (CCUS) and clean technology investment tax credits (ITCs), the substantive Canadian-controlled private corporation (CCPC) measure, the hybrid mismatch arrangement rules, and changes to the General Anti-Avoidance Rule (GAAR).

The original (first reading) version of Bill C-59 has subsequently been amended to include a change to the denial of the dividend received deduction by financial institutions. This amendment, which is described in more detail below, was reported by the House of Commons Standing Committee on Finance on 6 May 2024 and adopted on 21 May 2024.

A summary of the business and international income tax measures contained in Bill C-59 is provided below. For a summary of other income tax, indirect tax and digital services tax measures contained in Bill C-59, refer to EY Tax Alert 2023 Issue No. 44, *Bill C-59 to implement certain Budget 2023 and other previously announced measures receives first reading*, EY Tax Alert 2023 Issue No. 52, *Bill C-59 to implement outstanding indirect tax measures receives first reading*, and EY Tax Alert 2023 Issue No. 48, *Digital Services Tax Act has been tabled in the House of Commons*.

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## Business and international income tax measures

Because of the minority status of the federal government, the business income tax measures contained in Bill C-59 are considered substantively enacted (for financial reporting purposes) on 28 May 2024, when the bill passed third reading in the House of Commons.

Bill C-59 includes the following business and international income tax measures:

**EIFEL rules** – Introduction of new earnings-stripping rules to limit the amount of net interest and financing expenses that a corporation may deduct in computing business or property income, or taxable income, to a fixed ratio (or, where certain conditions are met and a consolidated group elects, a higher group ratio) of adjusted taxable income for the year. Adjusted taxable income is essentially taxable income adjusted to, among other things, reverse deductions for interest and financing expenses, capital cost allowance (CCA), resource expenses and terminal losses, and reverse income inclusions for interest and financing revenues, CCA recapture and recovery of certain resource expenses. Adjusted taxable income thus approximates the accounting concept of earnings before interest, taxes, depreciation and amortization (EBITDA) but as determined for tax purposes. Subject to transitional rules, these rules apply in respect of taxation years beginning on or after 1 October 2023. See EY Tax Alert 2023 Issue No. 32, *Finance releases further revisions to EIFEL proposals*, for more information on these rules.

**Hybrid mismatch arrangement rules** – Introduction of new rules to neutralize the effects of hybrid mismatch arrangements, including certain consequential amendments to related provisions. "Hybrid mismatch arrangements" are cross-border tax avoidance arrangements that exploit differences in the income tax treatment of business entities or financial instruments under the laws of two or more countries to produce mismatched tax results (e.g., deduction/non-inclusion mismatches and double deduction mismatches). The new rules are generally consistent with recommendations in the OECD/G20 Base Erosion and Profit Shifting (BEPS) Action 2 Report, with adaptations to the Canadian income tax context, and generally apply in respect of payments between parties that satisfy a relationship test (e.g., related parties or certain specified entities) and payments between unrelated parties under certain structured arrangements designed to produce a mismatch. In general, the rules operate by:

- Denying the deduction of payments made by a taxpayer under a hybrid mismatch arrangement to the extent of the hybrid mismatch amount (i.e., generally, the amount that gave rise to a further deduction in another country or that is not fully included in the ordinary income of a nonresident recipient);
- Requiring the inclusion in income of payments received under a hybrid mismatch arrangement with a foreign deduction component (i.e., where the payment gives rise to a foreign income tax deduction) to the extent of the hybrid mismatch amount; and

- Restricting the deduction of dividends received from a foreign affiliate out of the affiliate's exempt, hybrid, taxable and pre-acquisition surpluses, generally to the extent that a foreign income tax deduction is available in respect of the dividend to the affiliate or certain other entities.

These rules generally apply in respect of payments arising, or dividends received, on or after 1 July 2022. New reporting requirements are introduced for amounts that are subject to the deduction denial rule, income inclusion rule or dividend restriction rule, but only for amounts arising, or dividends received, on or after 1 July 2023. See EY Tax Alert 2022 Issue No. 29, *Proposed hybrid mismatch arrangement rules*, for more information on the original proposals.

**Rate reduction for zero-emission technology manufacturers** – Extension of the temporary reduction in corporate income tax rates for zero-emission technology manufacturing (ZETM) profits by three years, so that the reduced rates will begin to be phased out for taxation years beginning in 2032 and will be fully phased out for taxation years beginning after 2034 (instead of being phased out from 2029 to 2031 under the existing schedule). In addition, eligible activities for purposes of the rate reduction are expanded to include certain nuclear manufacturing and processing activities — namely, manufacturing of nuclear energy equipment, processing of nuclear fuels and heavy water (used for nuclear energy generation), and manufacturing of nuclear fuel rods — effective for taxation years beginning after 2023. A consequential amendment (effective on Royal Assent of Bill C-59) permits the Canada Revenue Agency (CRA) to share a corporation's taxpayer information with the Department of Natural Resources solely for the purpose of determining if a cost is a "ZETM cost of capital" or a "ZETM cost of labour" and if activities are "qualified ZETM activities."

**Tax on repurchases of equity** – Amendments to introduce a 2% tax on the net value of equity repurchases by certain publicly traded entities in Canada, subject to a de minimis rule and applicable in respect of repurchases and issuances of equity that occur after 2023. The tax applies to Canadian resident corporations with shares listed on a designated stock exchange (excluding mutual fund corporations), as well as to real estate investment trusts, specified investment flow-through (SIFT) trusts, SIFT partnerships that have units listed on a designated stock exchange, and certain other publicly traded entities that would be SIFT trusts or SIFT partnerships if their assets were located in Canada. Certain exceptions to the scope of the tax apply, including for debt-like preferred shares and units (referred to as "substantive debt") meeting certain conditions and for shares or units that are issued or cancelled as part of certain types of corporate reorganizations and acquisitions. The tax also does not apply to equity repurchases of less than $1 million in a taxation year (prorated for short taxation years). Certain anti-avoidance rules also apply.

**Dividend deduction for financial institutions** — Introduction of new rules to deny the deduction for intercorporate dividends received from Canadian corporations, where the dividends are received by a financial institution on shares that are mark-to-market property, applicable for dividends received after 2023 and subject to certain exceptions. For these purposes, shares (other than shares of a financial institution) that are tracking property are deemed to be mark-to-market property. Dividends on taxable preferred shares are excluded from the application of the deduction denial rule (unless the shares are tracking property of the financial institution receiving the dividend). In addition, Bill C-59 has been amended to include an additional exception for certain dividends received by an insurance corporation. Specifically, the deduction denial rule will not apply to dividends received on shares (other than shares that are tracking property of the corporation), or that are deemed to be received on units of a mutual fund trust, where the shares or units are held in connection with an insurance contract entered into, issued or acquired in the ordinary course of the corporation's insurance business and the received dividends are identified in the corporation's tax return.

**Substantive CCPCs** – Introduction of the concept of a "substantive CCPC" for the purpose of aligning the tax treatment of investment income earned and distributed by a substantive CCPC with the rules applicable to CCPCs, effective for taxation years ending on or after 7 April 2022, subject to transitional rules for certain loss restriction event transactions entered into before that date. Specifically, a "substantive CCPC" is defined as a private corporation (other than a CCPC) that is controlled, directly or indirectly in any manner whatever, by one or more Canadian resident individuals, or would, if all shares held by Canadian resident individuals were owned by a particular individual, be controlled by that particular individual. Under the amendments, a substantive CCPC is generally taxed in the same manner as a CCPC with respect to investment income (i.e., a federal corporate income tax rate of 38.67% applies to the aggregate investment income of the corporation, of which 30.67% will be refundable), and the aggregate investment income increases the corporation's low-rate income pool. Substantive CCPC status only applies for these purposes, and corporations will continue to be treated as non-CCPCs for other purposes of the *Income Tax Act* (the Act) (e.g., they will not be entitled to the small-business deduction). Related amendments include the introduction of an anti-avoidance rule intended to address transactions or arrangements reasonably considered to be undertaken to avoid the additional 10.67% tax otherwise payable on the aggregate investment income. Other amendments facilitate the administration and enforcement of the new rules, including a one-year extension to the normal reassessment period for consequential assessments of Part IV tax arising from the assessment or reassessment of a dividend refund.

**CCUS ITC** – Amendments to introduce a refundable ITC for businesses that incur qualified expenditures related to CCUS (qualified CCUS expenditures) after 2021 and before 2041. The credit comprises a cumulative CCUS development tax credit (for qualified CCUS expenditures incurred before the first day of commercial operations of a CCUS project) and a CCUS refurbishment tax credit (for qualified CCUS expenditures during the total CCUS project review period). Generally, qualified CCUS expenditures include the cost of acquiring eligible equipment used in qualified CCUS projects. This equipment is generally included in new CCA Classes 57 and 58, which have 8% and 20% declining-balance-basis CCA rates, respectively, and is eligible for enhanced first-year depreciation under the accelerated investment incentive. For qualified CCUS expenditures incurred after 2021 and before 2031, credit rates are 60% for qualified carbon capture expenditures used to capture carbon directly from ambient air, 50% for other qualified carbon capture expenditures, and 37.5% for qualified carbon transportation, storage or use expenditures. These credit rates are reduced by half for eligible expenditures incurred after 2030 and before 2041. Also, the credit rate is reduced by 10 percentage points if certain labour conditions are not met (see "Labour requirements for certain ITCs" below). Certain knowledge sharing and climate risk disclosure requirements apply.

**Clean technology ITC** – Amendments to introduce a 30% refundable ITC for eligible investments in clean technology equipment, applicable for eligible property that is acquired and becomes available for use on or after 28 March 2023. Eligible equipment includes certain property described in CCA Classes 43.1, 43.2 and 56, as well as concentrated solar energy equipment and small modular nuclear reactors, that is situated in Canada and intended for use exclusively in Canada. The credit will be phased out for property that becomes available for use after 2033. Specifically, the credit is reduced to 15% in 2034 and is fully phased out in 2035. The credit rate is also reduced by 10 percentage points if certain labour conditions are not met (see "Labour requirements for certain ITCs" below). A recapture of the credit received will apply if the eligible property is converted to a non-eligible use or disposed of or exported from Canada within 10 years of the date it was acquired. For more information on this new ITC, see EY Tax Alert 2024 Issue No. 6, *Canada's new clean technology investment tax credit*.

**Labour requirements for certain ITCs** – Amendments to introduce labour conditions, including prevailing wage and apprenticeship requirements, for purposes of the new ITCs for clean technology and for CCUS, applicable in respect of specified property prepared or installed on or after 28 November 2023. To receive the maximum tax credit rates under these ITCs, businesses are required to pay a total compensation package that equates to the prevailing wage (generally based on union compensation from the most recent, widely accepted multi-employer collective bargaining agreement or corresponding project labour agreement in the applicable provincial jurisdiction) and ensure that at least 10% of tradesperson hours worked are performed by registered apprentices in Red Seal trades on the preparation or installation of specified property. They must also elect in prescribed form and manner for each installation taxation year to have the applicable regular credit rates apply. If no election is filed or the

labour requirements are not met, the applicable regular credit rate is reduced by 10 percentage points. Failing to meet the labour requirements may also result in non-compliance penalties.

**Exploration and development expenses relating to CCUS** – Introduction of new CCA Classes 59 and 60 for intangible exploration expenses and development expenses related to the storage of captured carbon. Class 59 provides a 100% rate and applies to property acquired after 2021 for the purpose of determining the existence, location, extent or quality of a geological formation to permanently store captured carbon in Canada, including property acquired as a result of undertaking environmental studies or community consultations. Class 60 provides a 30% declining-balance rate and generally applies to property acquired after 2021 for the purposes of drilling, converting or completing a well in Canada for the permanent storage of captured carbon, or for monitoring pressure changes (or other phenomena) in a geological formation in which captured carbon is permanently stored, as well as various rights, licences or privileges acquired for related purposes.

**Critical mineral exploration tax credit and flow-through share regime** – Expansion of the critical mineral exploration tax credit and flow-through share regime to include eligible expenses related to exploration and development activities for lithium from brines. Eligible expenses related to lithium from brines made on or after 28 March 2023 qualify as Canadian exploration expenses and Canadian development expenses.

**Definition of credit union** – Elimination of the revenue test under the definition of "credit union" that is included in the Act and used in the *Excise Tax Act* (for GST/HST purposes), so that credit unions that earn more than 10% of their revenue from sources other than specified sources (such as interest income from lending activities) are no longer excluded from the definition, applicable as of 1 January 2016. This amendment is intended to accommodate how most credit unions currently operate — as full-service financial institutions offering a comprehensive suite of financial products and services.

**General anti-avoidance rule** – Various amendments to modernize and strengthen the GAAR, including:

- **Preamble** – Addition of a GAAR preamble to help address interpretive issues and ensure that the rule applies as intended, by setting out some key considerations relating to the GAAR's intended purpose and operation; the Department of Finance cautions that the preamble does not form a part of the GAAR analytical framework.
- **Avoidance transaction** – Reduction in the threshold for the avoidance transaction test, changing it from a "primary purpose" test to a "one of the main purposes" test.
- **Economic substance** – Addition of an economic substance test to be considered at the "misuse or abuse" stage of the GAAR analysis. Under this provision, a significant lack of economic substance is an important consideration that tends to indicate abusive tax avoidance.

- **Penalty** – Introduction of a penalty equal to 25% of the amount of the tax benefit (including a tax benefit obtained in the form of a deemed payment of Part I tax, such as in the case of a tax credit). The penalty may be avoided if the transaction is disclosed to the CRA, under the mandatory disclosure rules (for reportable transactions or notifiable transactions) or voluntarily (see below). An exception from the penalty is also provided if it can be demonstrated that the taxpayer had relied upon current case law or published administrative guidance or statements (by the CRA or another relevant government authority) in reasonably concluding that the GAAR would not apply to a transaction at the time it was entered into. A reduction of the penalty may also be provided if the gross negligence penalty under paragraph 163(2) of the Act applied in respect of the transaction or series.

- **Reassessment period** – Extension by three years of the normal reassessment period for GAAR assessments unless the transaction had been disclosed to the CRA, either voluntarily (see below) or under the mandatory disclosure rules (for reportable transactions or notifiable transactions).

The GAAR amendments generally apply to transactions that occur after 2023, except that the preamble applies on Royal Assent of Bill C-59 and the penalty provision applies to transactions that occur on or after the date of Royal Assent.

**Voluntary reporting under reportable transaction rules** – Amendments to the reportable transaction rules to allow for a voluntary disclosure of a transaction (or series of transactions) in circumstances where a disclosure would not otherwise be required. These amendments are consequential to the GAAR penalty and reassessment period changes noted above and apply to transactions that occur on or after 1 January 2024.

## Learn more

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