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Excessive Interest and Financing Expenses Limitation

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Everyone's Talking About It

The Excessive Interest and Financing Expense Limitation ("EIFEL") regime limits the deduction of interest and other financing costs of affected Canadian corporations and trusts. Here are some answers to your questions in this regard.

When did the rules come into effect?

These rules apply to taxation years beginning on or after October 1, 2023.[1]

What expenses are affected by the restriction?

The restriction applies to a taxpayer's "interest and financing expenses," reduced by its "interest and financing revenues." It therefore applies to the **net amount** of expenses As a result, the interest and financing revenues increase the taxpayer's capacity to deduct these types of expenses.

The rules apply to current as well as capitalized interest expenses and to imputed amounts of interest in respect of certain finance leases. However, interest paid between taxable Canadian corporations that are part of the same group may be excluded by filing a joint election (creditor – debtor). Expenses paid in respect of certain Canadian public-private partnership (PPP) infrastructure projects may also be excluded.[2]

Who are the affected taxpayers?

The rules apply to all corporations and trusts resident in Canada, **other than an "excluded entity"**.

Individuals and partnerships are not covered, but partnerships may be affected indirectly as the rules apply to corporations and trusts that are partners of a partnership that allocates interest and financing income and expenses to them.

Non-residents who elect to pay taxes in Canada under Part I of the *Income Tax Act* (ITA)[3] on real or immovable property located in Canada (or forest royalties) are also subject to these rules.

Interest and financing expenses of controlled foreign affiliates for which a Foreign Accrual Property Income (FAPI) or a Foreign Accrual Property Loss (FAPL) arises from interest income or expenses must be analyzed in detail for purposes of these rules.

This measure essentially targets large corporations, since associated corporations whose consolidated taxable capital does not exceed $50M are automatically excluded. For other corporations, the criteria used to determine whether they are subject to these rules take into consideration all entities related to the taxpayer, which includes not only corporations under common control, but also those controlled by members of the same family (brother, sister, parents, children, parents-in-law, brothers-in-law and sisters-in-law, etc.). Such entities do not normally share sensitive information with each other. It is therefore important to understand the scope of these rules.

[1] The rules may apply to a taxation year that begins before October 1, 2023, and ends after that day if, within the last three years, the taxpayer had a short taxation year to defer the application of these rules.

[2] These expenses are considered "exempt interest and financing expenses."

[3] This election is provided in Section 216 of the ITA.

What are the excluded entities?

The rules **do not apply** to the following corporations and trusts:

- **Small CCPC Exclusion**: A Canadian-controlled private corporations (CCPC) whose taxable capital employed in Canada in the previous year is less than $50M (including that of associated corporations);
- ***De-minimis* Exclusion**: A taxpayer resident in Canada whose net interest and financing expenses (including exempt expenses), within the Canadian group,[4] do not exceed $1M in a taxation year;
- **Domestic Exclusion**: A Canadian-resident corporation or trust or a group consisting exclusively of Canadian-resident corporations or trusts that satisfies all of the following conditions:
  - All or substantially all[5] of each eligible entity of the group's businesses, activities and undertakings are carried on in Canada;[6]
  - The book cost of all foreign affiliate shares held by the Canadian group **and** the fair market value of the assets of all foreign affiliates held by the group do not exceed $5M; [7]
  - No non-resident owns more than 25% (in votes or value) of an entity in the Canadian group; [8]
  - All or substantially all of any eligible group member's interest and financing expenses is payable to persons or partnerships other than a non-arm's length "tax- indifferent" person. [9]

A taxpayer is not subject to the EIFEL rules as soon as one of these three exclusions applies. This analysis must be carried out every year.

What are the eligible group entities?

To qualify an "excluded entity", the *De-Minimis* Exclusion and the Domestic Exclusion take into consideration all the Canadian entities in the group, i.e. all those considered as an "eligible group entity".

Briefly, eligible group entities include the taxpayer (corporation or trust) and all corporations and trusts resident in Canada with which the taxpayer is related or affiliated. A **discretionary trust** is also an eligible group entity of its beneficiaries (corporations or trusts), and *vice versa*.

Finally, two taxpayers are deemed to be eligible group entities with respect to each other when they are eligible group entities with respect to the same third entity.

Related entities

The definition of "eligible group entity" includes related entities, which includes corporations controlled by persons with whom the taxpayer is related by blood or marriage.[10] Accordingly, all corporations controlled by the spouse, parents, children, siblings, parents-in-law, and brothers-in-law and sisters-in-law of a taxpayer could be considered eligible group entities.

The concept of "eligible group entity" is very broad, which can lead to unintended consequences. Thus, to the extent that they are not excluded from the EIFEL rules under Small CCPC Exclusion, the corporation controlled by Brother #1 and the one controlled by Brother #2 may have to exchange information regarding their respective income and expenses, their activities, and the entities with which they are respectively related or affiliated in order to determine whether they are subject to the rules and for the purpose of the certain elections provided therein.

Partnerships

A partnership is not an "eligible group entity" but partners must consider their share of the partnership's interest and financing expenses, as well as the partnership's foreign affiliates, in determining if they are an "eligible group entity" and in making their calculations.

What is the impact of these rules?

For a corporation or trust subject to the rules, the deduction of interest and financing expenses (net of related revenues) is limited to a fixed ratio of tax earnings before interest, taxes, depreciation and amortization ("tax EBITDA"). The fixed ratio is 30% for taxation years that begin after December 31, 2023 (40% for taxation years beginning after September 30, 2023, and before January 1, 2024).

Group Ratio Election

The Canadian members of a consolidated group may elect to use a group ratio, to be allocated among the members, instead of the fixed ratio.[11] If certain conditions are satisfied, with this election, the group members may be able to deduct total expenses that are greater than

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[4] For the purposes of this document, "**Canadian group**" refers to all eligible group entities.

[5] According to tax authorities, "all or substantially all" generally corresponds to 90% or more but this is a matter of facts.

[6] Holding debts or shares of a foreign affiliate does not constitute an activity for these purposes. For example, a Canadian corporation whose sole activity is holding shares of a foreign affiliate is considered to carry out all or substantially all of its activities in Canada.

[7] This value must be calculated based on the participation of the taxpayer (or the taxpayer's group) and only the amount which may reasonably be considered the taxpayer's proportionate share (or that of the taxpayer's group) of the value of the affiliated corporation is considered. This includes foreign affiliates held by partnerships.

[8] **Waring**: If the taxpayer is a trust, this condition is assessed based on the beneficiaries' interest in the trust. Consequently, a non-resident beneficiary of a discretionary family trust could cause the entire group to lose the right to this exclusion, due to the definition of "specified beneficiary" in subsection 18(5) of the ITA. Particular attention must also be paid to non-resident shareholders, since the 25% holding takes into account the shares held by all persons who deal at non-arm's length.

[9] A "tax-indifferent person" is essentially a tax-exempt entity (Crown corporation, pension fund) or a non-resident not subject to tax in Canada. This includes certain investment entities majority-owned by such investors.

[10] Individuals are considered related persons if they are related by blood, adoption, marriage or common-law partnership, which includes parents, grandparents, children, grandchildren, siblings of the individual and their spouse, as well as their respective spouses. Uncles, aunts, nephews, and nieces are not considered related persons. Two corporations are related if they are controlled by the same person or group, or if the person who controls one is related to the person who controls the other. A trust is not generally included among related persons, but it will usually be affiliated with its discretionary beneficiaries and with persons who are affiliated with that beneficiary, such as corporations controlled by the same person and their subsidiaries. A detailed analysis of the group is required.

[11] Essentially, a consolidated group includes several entities resident in Canada, whose ultimate parent and all the entities are fully consolidated in the parent's consolidated financial statements or that would be if the group were required to prepare such statements under International Financial Reporting Standards. This includes financial statements prepared under International Financial Reporting Standards (IFRS) and generally accepted accounting principles of countries including Canada. A trust, not included in the consolidated financial statements, cannot be part of such an election.

the fixed ratio and allocate the deduction capacity where it is most needed.

The group ratio will generally be more interesting than the fixed ratio if net interest expenses paid to third parties with respect to accounting EBITDA are greater than the fixed ratio. However, this must be evidenced in the group's audited consolidated financial statements and the situation must be analyzed annually.

Potential carry-forward of excess capacity

If, in a given taxation year, net interest and financing expenses are less than the maximum amount that the taxpayer may deduct, the excess creates an "excess capacity" for the year, provided that the group did not elect to use the "group ratio".

The excess capacity for a given year must first be used to deduct interest and financing expenses previously denied to the entity. Any interest and financing expenses that are denied because of these rules are therefore carried forward indefinitely since they are automatically deducted against future excess capacity.

The resulting balance, which is the taxpayer's excess capacity after deducting restricted expenses for the year and a preceding year,[12] can then be either:

- Carried forward to any of the next three years to deduct restricted expenses whose deduction would otherwise be denied as a result of these rules (three-year-carry-forward);[13]
- Transferred to a member of the Canadian group (joint election required) so they can use it to deduct their own restricted expenses.[14]

If, in a year, a taxpayer has cumulative unused excess capacity (credit balance), it is required to first use it to deduct its own otherwise denied interest and financing expenses during the year before transferring to another group member.

Example: *In 2025, Canco1 has base deduction capacity of $50M and incurred $15M in restricted expenses. In 2024, it incurred $10M in expenses for which a deduction was denied. Canco1's excess capacity for its 2025 taxation year is $25M, calculated as A –B –C where:*

A	*Base deduction capacity for 2025*	*$50M*
B	*Restricted interest and financing expenses for 2025*	*($15M)*
C	*Restricted expenses carried forward from 2024*	*($10M)*
	Cumulative unused excess capacity for 2025	*$25M*

If Canco1 incurs interest and financing expenses in 2026 which exceed its deduction capacity for the year, it is required to use its unused excess capacity to deduct these expenses.

Transitional Rules Election

For the first year of application of the EIFEL rules, a taxpayer may elect to use the transitional rules, which allow an excess capacity to be determined for each of the three years preceding the first year of application of the EIFEL rules.

The transitional rules election must be made jointly by all corporations and fixed interest commercial trusts that are members of the Canadian group.

What is the purpose of these rules?

The EIFEL rules are part of the global effort to combat tax base erosion, supported by the Organisation for Economic Co-operation and Development (OECD). The purpose of these rules is to limit the amount of interest and other financing expenses Canadian taxpayers may deduct where the amount is considered excessive compared to realized gains.

These rules are intended to counter tax erosion, such as the following situations.

- A Canadian corporation borrows funds in Canada and invests in foreign affiliates' equity. In this situation, the interest paid is deductible in Canada and the dividends received from the foreign affiliates may not be taxable in Canada (for example, if they are paid from the foreign affiliates' exempt surplus).
- A Canadian corporation has a non-resident shareholder who owns at least 25% (in votes or value), borrows funds in Canada and invests the funds in Canadian corporations. The interest is deductible in Canada and the funds enrich the non-resident who might not pay tax in Canada.

Their aim is therefore to limit the transfer of profit out of the country. However, the rules have a broader scope since, for an affected Canadian corporation or trust, the deductibility of all interest and financing expenses incurred will be restricted under these rules, regardless of who these expenses are paid to and what type of income they generate.

Are there other tax rules limiting the deduction of interest?

Paragraph 20(1)(c) of the *ITA* generally governs the deductibility of interest for the purpose of computing taxable income in Canada. It remains the starting point for interest deductibility.

Generally, transfer pricing rules govern the amounts to be reported in Canada on transactions within a multinational group. In a cross-border context, the thin capitalization rules also limit the interest deduction in respect of a corporation's indebtedness to certain non-resident persons, where the corporation's indebtedness to such persons is more than one and a half times the corporation's equity (1.5:1 or 60% debt to 40% equity). These rules continue to apply but amounts for which a deduction is denied due to thin capitalization limitations are excluded from the expenses taken into account for EIFEL purposes.

Conclusion

The EIFEL regime establishes a set of complex rules that will have a significant impact on affected taxpayers. A number of special rules are applicable to partnerships, for example.

Since this is a completely new concept, understanding the resulting challenges is important. Taxpayers subject to these rules should analyze various scenarios and take into account the applicable anti-avoidance rules and the options available to them.

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[12] The resulting balance represents the "**unused excess capacity**."

[13] The amount of excess capacity that is used in this manner is referred to as "absorbed capacity."

[14] The amount so allocated to this entity is referred to as "received capacity."

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