

A Happy New Year for Foreign Lenders and their Canadian Borrowers: Withholding Tax to be Eliminated on Most Interest Payments

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On December 14, 2007, The Honourable Jim Flaherty, Minister of Finance, announced that Bill C-28 received Royal Assent. Bill C-28 is the final 2007 budget implementation bill, and includes amendments to the *Income Tax Act* (Canada) (the "Tax Act") which eliminate withholding tax on most outbound interest payments to residents of all countries. The elimination of withholding tax on most interest payments will be effective as of January 1, 2008. The following is a summary of the important features and limitations of these amendments, as well as relevant amendments to the Canada-U.S. Tax Treaty (the "Treaty").

The Tax Act generally provides for a 25% withholding tax on all interest payments paid or payable to a non-resident of Canada. This 25% withholding tax rate is generally subject to reduction by an applicable tax treaty. For full exemption from the withholding tax, most non-resident lenders currently rely upon the "5/25" exemption under the Tax Act. In order to qualify for this exemption, generally, the debt obligation must be (i) issued by a corporate resident of Canada dealing at arm's length with the non-resident lender, and (ii) for a term greater than 5 years, where no more than 25% of the principal amount of the debt is required to be re-paid by the borrower within 5 years (except in certain limited circumstances).

As of January 1, 2008, the "5/25" exemption will be repealed. Instead, non-resident lenders will be able to rely on a much broader exemption from the withholding tax. This broader exemption generally will apply to interest that is paid or payable to a non-resident person with whom the payer is dealing at arm's length. Only interest that is "participating debt interest", regardless of whether the borrowing and lending parties are dealing at arm's length, will continue to be

subject to withholding tax under the Tax Act. Generally, "participating debt interest" includes interest that is contingent or dependent on the use of or production from property in Canada, or that is computed by reference to revenue, profit, cash flow, dividends or other similar criteria.

Generally, in order to determine whether interest that is not "participating debt interest" will qualify for the exemption from the withholding tax, it must be determined whether the parties are dealing with each other at arm's length. Under the Tax Act, related persons are deemed not to deal with each other at arm's length. Related persons include individuals that are connected by blood, marriage, common law partnership or adoption. Members of a controlled corporate group are also treated as related persons. Furthermore, in almost all other cases, it is a question of fact as to whether unrelated persons are dealing with each other at arm's length at a particular time.

Generally, U.S. lenders and Canadian borrowers who do not deal with each other at arm's length currently have the benefit of a reduced withholding tax rate of 10% under the Treaty. However, such non-arm's length parties will soon be able to rely on the Treaty for a greater reduction in the withholding tax rate and eventually a full exemption from it altogether. This would be the result of provisions in the Fifth Protocol (the "Protocol") to the Treaty, which has been signed and is expected to come into effect some time in 2008.

Under provisions of the Protocol, withholding tax on interest payments between non-arm's length parties generally will be phased out over a three year period. The withholding tax rate will continue to be 10% in the first two months after the Protocol is in effect, but then will be reduced to 7% for the remainder of that year. In the second year after the Protocol is in effect, the rate will be further reduced to 4%. The rate will be then eliminated to 0%, in the third and all subsequent years.

These changes both to the Tax Act and to the Treaty will significantly enhance the efficiency of cross-border investment. Specifically, they will serve to improve the competitiveness of non-resident lenders relative to their Canadian counterparts. Canadian borrowers and non-resident lenders, in particular, will be happy start the new year with the benefit of reduced borrowing costs, greater access to foreign debt financing and simplified structuring options.

The elimination of withholding tax for arm's length loans and the eventual elimination of withholding tax on non-arm's length loans by US lenders may create opportunities for non-resident lenders to lend to Canadian borrowers. However, any non-resident lender making a loan to a Canadian borrower should ensure that its activities in Canada do not contravene any Canadian law. In particular, if a non-resident lender is a "foreign bank" within the broad meaning of the term as defined in the *Bank Act* (Canada), (the "Bank Act") it should ensure that its activities in Canada do not amount to engaging in or carrying on business in Canada in contravention of the Bank Act. The provision of a loan by a "foreign bank" to a Canadian borrower would not in and of itself be viewed as such party engaging in or carrying on business in Canada but one must also analyze the nature and extent of the particular loan together with a review of all of the foreign bank's activities in Canada in order to complete the analysis. Generally, if all aspects of the marketing, negotiation, execution and closing of a loan transaction by a foreign bank took place outside of Canada, the foreign bank would not likely be considered to be engaging in or carrying on business in Canada solely by the reason of the loan transaction. Best practice is to obtain specific advice on one's specific set of circumstances in order to determine compliance with the Bank Act.

It would appear that as a result of the foregoing, an immediate impact will be felt in the syndicated loan markets. The elimination of withholding tax in stages will make it competitive for US lenders in particular to participate in syndicated loans and thereby lend to Canada through an office outside of Canada. By participating in this fashion the US lender who joins a syndicate would not be considered to be engaging in or carrying on business in Canada.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation.

If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact us.

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