

DEBT PRODUCTS BULLETIN

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BUDGET 2007 - ELIMINATING NON-RESIDENT WITHHOLDING TAX ON INTEREST: WHAT WILL IT MEAN FOR PARTICIPANTS IN THE CANADIAN CORPORATE DEBT MARKET?

On March 19, 2007, Federal Finance Minister Jim Flaherty presented his second national budget. One of the most significant announcements in Budget 2007 was the proposed elimination of withholding tax on interest payments made by Canadian taxpayers to arm's length non-resident lenders. The eventual elimination of this withholding tax may create more opportunities for foreign 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. For example, if the non-resident lender is a "foreign bank" within the broad meaning of that term as defined in the *Bank Act* (Canada), 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* (Canada) (see comments below).

BACKGROUND

Under the *Income Tax Act* (Canada), non-resident lenders are generally subject to a 25% tax on the gross amount of interest they collect from Canadian resident borrowers. Non-resident lenders that are entitled to the benefits of an income tax treaty are generally subject to a reduced rate of 10% on such interest payments. The law requires the Canadian borrower to withhold the tax from payments made to the lender and remit the tax to Canada's taxing authority, the Canada Revenue Agency. Withholding tax can be a significant factor in structuring transactions and can influence whether debt is raised wholly in Canada or wholly or partly outside Canada.

WITHHOLDING TAX

The *Income Tax Act* (Canada) currently provides a limited number of exemptions for non-resident withholding tax on interest payments. One of the most significant exemptions is the "5/25 exemption" that generally applies if a loan is between arm's-length parties, the term of the obligation is greater than five years and no more than 25 per cent of the principal amount of the loan is required to be repaid within five years (except through the failure or default of the borrower). However, the utility of the 5/25 exemption is limited because it applies only to long and medium-term debt and it does not apply in the case of revolving credit.

In practice, where a withholding tax exemption is not available, withholding tax on interest payments is an additional financing cost, which is either borne by the non-resident lender, or passed on to the Canadian borrower by means of a "gross-up" clause in the loan document. The "gross-up" clause basically requires the borrower to pay additional interest to compensate for the withholding tax. This can represent a significant transaction cost to the parties and it can make transactions with non-resident lenders less competitive than transactions with domestic lenders.

ELIMINATING NON-RESIDENT WITHHOLDING TAX ON INTEREST

Contingent on the implementation of the proposed withholding tax exemption in a new Canada-U.S. income tax treaty discussed below, Budget 2007 proposes to eliminate the withholding tax on interest paid to all arm's length non-residents. It should be noted that the elimination of the withholding tax on interest payments made to arm's length non-resident

lenders (regardless of their country of residence) is still several years away.

With respect to U.S. lenders, Budget 2007 announced that Canada and the U.S. have agreed in principle on major elements of an updated tax treaty between the two countries under which withholding taxes on interest payments between arm's length persons (that are eligible for treaty benefits) will be eliminated as of the first calendar year following the entry into force of the relevant treaty changes. The entry into force of an updated tax treaty may also be several years away. Tax treaties enter into force only after both countries pass laws adopting the treaty. For example, the current tax treaty between Canada and the United States was signed September 26, 1980 but did not come into force until August 16, 1984. Further, rumours of a new tax treaty between the two countries have been discussed for a number of years; it is unclear when the updated tax treaty will be finalized.

The proposed changes will be welcomed by both non-resident lenders and Canadian borrowers. The result in many cases will be to lower the cost of borrowing for Canadian borrowers that borrow from non-resident lenders. The change should also facilitate greater access to foreign debt financing by Canadian borrowers and may introduce additional competition in the Canadian corporate debt markets. However, non-resident lenders contemplating greater access to the Canadian market should take note of several factors: the proposed changes will likely not be effective in the near term, and Budget 2007 does not eliminate all of the obstacles for non-resident lenders that want to lend into Canada – there are regulatory restrictions that should not be overlooked.

REGULATORY RESTRICTIONS ON A “FOREIGN BANK” CARRYING ON BUSINESS IN CANADA

Under the *Bank Act* (Canada), a “foreign bank” shall not engage in or carry on business in Canada except as authorized by the Act (ie. through a foreign bank subsidiary or an authorized foreign branch or some other approved entity). The term “foreign bank” is broadly defined in the Act to include any entity that is called a bank or that is regulated as or like a bank. It also includes any entity that controls a foreign bank and any entity that provides financial services and is affiliated with a foreign bank.

This prohibition against engaging in or carrying on business in Canada would not prohibit a foreign bank from making a loan to a Canadian borrower as long as the nature and extent of all the foreign bank's activities in Canada do not amount to engaging in or carrying on business in Canada. Whether a foreign bank would be considered to be engaging in or carrying on business in Canada by reason of making a particular loan to a Canadian borrower would depend on all the surrounding circumstances. Some of the factors that could be relevant include: how the relationship between the foreign bank and the Canadian borrower arose; where the documentation was negotiated and executed; and where the transaction was closed. Generally, where all aspects of the marketing, negotiation, execution and closing of a loan transaction by a foreign bank took place outside Canada, the foreign bank would not be considered to be engaging in or carrying on business in Canada solely by reason of that loan transaction.

OPPORTUNITIES AND IMPACTS

The area where the proposed elimination of non-resident withholding tax on interest will likely have the greatest impact, and creates the greatest opportunity, is in the market for participants in syndicated loans. The changes will make it more competitive for non-resident lenders to participate in syndicated loans and thereby lend directly into Canada through an office outside of Canada. A non-resident lender that participates in a syndicated financing transaction generally would not be considered to be engaging in or carrying on business in Canada solely by reason of its participation in the syndicated transaction.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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