

Elimination of Withholding Tax – FAQs

1. When did Canada eliminate withholding tax?

Canada has enacted legislation that eliminated withholding tax on most arm's length (unrelated party) payments of interest made on or after **January 1, 2008**. This applies to **all non-residents of Canada**. In particular, U.S. residents will not have to wait for ratification of the recent amendment to the Canada-U.S. Tax Treaty which will eliminate withholding tax on unrelated party interest payments between residents of those countries.

2. Has Canadian withholding tax on all interest payments been eliminated?

There are certain exceptions. Firstly, payments of interest between non-arm's length parties (including related parties) continue to be subject to withholding tax at the 25% statutory rate, unless an applicable tax treaty either reduces the rate or eliminates the tax. (The elimination of the tax on interest paid to related U.S. persons is discussed below.)

Withholding tax also continues to apply, with some exceptions, to certain types of convertible debt and to "participating" interest – interest that is contingent or dependent on the use of or production from property in Canada, or that is computed by reference to dividends or to profit, cash flow, commodity price or similar criteria.

3. When is interest considered to be paid between persons who do not deal at arm's length?

Persons who are defined as being "related" (in the Canadian *Income Tax Act*) are deemed not to deal at arm's length. This includes members of a controlled corporate group and persons connected by blood, marriage and certain other relationships. In addition, it is a question of fact whether, in any particular circumstances, persons who are not "related" deal at arm's length.

4. Will withholding tax be eliminated on interest paid between parties who are related or otherwise do not deal at arm's length?

An amendment to the Canada-U.S. Tax Treaty was signed on September 21, 2007, and is expected to come into effect sometime in 2008. When this occurs, the rate of withholding tax will be reduced and eventually eliminated on interest paid by Canadians to related U.S. persons, provided they are residents of the U.S. for purposes of the treaty and satisfy the treaty's new limitation on benefits rules. The existing treaty rate of 10% will be reduced to 7% for the whole of the calendar year in which the amendment comes into force, to 4% during the next calendar year, and to zero on January 1st of the following calendar year. Therefore, if the amended treaty comes into force during 2008, the tax will be eliminated on January 1, 2010.

5. Will withholding tax be eliminated on amounts other than interest?

No. Withholding tax will continue to apply to dividends, income distributions from trusts, rent and royalties (subject to existing domestic and treaty exemptions).

6. Is the elimination of withholding tax on arm's length (unrelated party) interest retroactive?

The change applies to interest paid on and after January 1, 2008, even though the applicable agreements or securities were entered into or issued before that date.

7. How will cross-border loans benefit from the elimination of withholding tax on arm's length interest payments?

Under the former rules, most non-Canadian lenders were able to lend to Canadians free of withholding tax only if the borrower and loan satisfied a number of restrictive conditions. Under the new regime, the availability of the exemption does not depend on the status of the borrower or the terms of the loan (so long as it does not provide for "participating" interest or relate to certain types of convertible debt). In particular:

- Borrowers can be Canadian trusts, including REITs
- Borrowers can be individuals
- Borrowers can be partnerships that have one or more non-corporate partners
- Cross-border loans can be on a demand basis and include operating and revolving facilities
- Cross-border loans can have any term
- Cross-border loans can have cash sweep, material adverse change and other non-default provisions that could lead to mandatory repayment
- Events of default need not be measured against what Canadian tax authorities view as being commercially reasonable
- It will be possible to simplify cross-border loan provisions that provide for certain types of mandatory repayments.

8. How will the repeal of withholding tax impact cross-border securitization?

It is for the first time possible to securitize in U.S., U.K., European, Asian and other capital markets, on a straightforward and economic basis, certain types of Canadian receivables and securities, such as:

- Floor plan facilities, conventional commercial loans and other short term corporate obligations
- Commercial mortgages that do not meet the restrictive conditions of the former withholding tax exemption

- All types of consumer obligations, such as residential mortgages, reverse mortgages, credit card receivables, student loans, lines of credit and auto loans.

It is also now possible for non-residents to originate or acquire Canadian loans, such as commercial or residential mortgages, and securitize them outside Canada, either in Canadian-only pools or together with loans in other currencies.

As well, non-Canadian investors are now able to acquire ABCP, ABS or CMBS issued under Canadian securitizations. This could include tranches denominated in U.S. or other non-Canadian currencies, or that are otherwise designed for particular investors.

9. Is it possible to securitize leases or royalties cross-border without withholding tax?

Withholding tax continues to apply to rent and royalties (subject to existing domestic and treaty exemptions). However, it would be possible for Canadian leases or royalties to be transferred to a Canadian SPE, and for the SPE to fund the acquisition by issuing withholding tax-free notes to non-resident term investors or ABCP conduits. In adopting this structure, the Canadian SPE would need to carefully review its Canadian income tax position.


10. What new issues should non-Canadian lenders or investors be aware of?

- They should ensure that their Canadian activities do not subject them to Canadian income taxation on their business profits. Non-residents who are able to rely on a tax treaty with Canada should avoid structures that are deemed to create a Canadian “permanent establishment”. Certain U.S. entities may not be able to rely on the “permanent establishment” test if they cannot meet the new limitation on benefits tests under the amended Canada-U.S. Tax Treaty, which will likely come into force in 2008. U.S. and other non-residents that do not have treaty protection will have to avoid “carrying on business” in Canada – a stricter test that may be more difficult to satisfy where the non-resident appoints a Canadian servicer for its Canadian receivables or has any other agent or employee in Canada.
- Foreign banks and other lenders should structure their Canadian transactions to comply with federal and provincial laws that regulate such entities when they carry on business in Canada.
- Non-Canadian entities should be alert to whether their Canadian-related activities amount to “carrying on business” in Canada for provincial licensing purposes.
- If a non-Canadian’s employees travel to Canada, they should be alert to immigration issues, and to possible exposure of the employees to personal Canadian income tax and of the employer to a requirement to withhold source deductions from the employees’ remuneration.
- If the loan or securitized receivables will be denominated in Canadian dollars, it may be advisable or required to hedge the currency risk.
- A Canadian-law true sale opinion will be required if a Canadian originator transfers receivables cross-border in a rated securitization.

If you have any questions regarding the foregoing, please contact:

| | | |
|-----------------------|--------------|----------------------------------|
| Michael Burke | 416-863-3866 | michael.burke@blakes.com |
| Martin Fingerhut | 416-863-2638 | martin.fingerhut@blakes.com |
| Kathleen Penny | 416-863-3898 | kathleen.penny@blakes.com |
| Michelle Schwartzberg | 416-863-5801 | michelle.schwartzberg@blakes.com |
| Mark Selick | 416-863-2924 | mark.selick@blakes.com |

or any member of our Structured Finance Group or Tax Group.

| | |
|--|--|
| <p>Blakes periodically provides materials on our services and developments in the law to interested persons. To unsubscribe to this e-bulletin, please respond back with unsubscribe in the subject line or contact Blakes Marketing Department at 416-863-3036 or dorothy.byers@blakes.com. Additional information on our privacy practices may be obtained by contacting us at privacyofficer@blakes.com.</p> <p>This e-bulletin is for informational purposes only and does not create a lawyer-client relationship. The transmission of this information does not suggest Blakes or any of its lawyers are practising law of any jurisdiction other than Canada. The information provided in this e-bulletin is summary in nature and does not constitute legal advice. We would be pleased to provide additional details or advise about specific situations if desired.</p> <p>For permission to reprint articles, please contact Blakes Marketing Department at 416-863-2403 or lynn.spencer@blakes.com.</p> <p>© 2008 BLAKE, CASSELS & GRAYDON LLP</p> <p>MONTRÉAL OTTAWA TORONTO CALGARY VANCOUVER NEW YORK CHICAGO LONDON BEIJING</p> |  |
|--|--|