

## **Elimination of Canadian Withholding Tax, and a Revised Canada-U.S. Tax Treaty, Create New Opportunities to Securitize Canadian Receivables**

As of January 1, 2008, Canadian withholding tax no longer applies to most arm's length, unrelated party payments of interest. This dramatic change will now finally permit the tax efficient cross-border securitization of billions of dollars of Canadian consumer and corporate receivables in U.S., European and other capital markets throughout the world.

To understand the significance of this development, one must appreciate that few Canadian receivables have been securitized outside Canada since the 1980s:

- For 20 years, Canadian trade receivables, which do not bear interest and therefore did not attract withholding tax, have been transferred to multi-seller ABCP conduits in the U.S., the U.K. and a number of other European countries.
- Five-year Canadian corporate loans, such as small balance commercial mortgage obligations, have been securitized in the U.S. in reliance on a withholding tax exemption for long-term corporate debt (the "5/25 Rule").
- Short-term corporate obligations, such as dealer floorplan loans, have also been funded off-shore free of withholding tax under somewhat complex structures involving the transfer of the loans to Canadian SPEs which then issued five-year notes that complied with the 5/25 Rule.

But, with few exceptions, Canadian consumer receivables have not been securitized outside the country and the cross-border securitization of other interest-bearing receivables has been limited. The main obstacle was Canada's withholding tax regime. Generally, Canada imposed a 25% withholding tax (often reduced by treaty) on interest paid to non-residents. And while it was theoretically possible to utilize the 5/25 Rule for corporate debt to structure a cross-border transaction, the reality of having to fund short-term assets with long-term debt, and the rather complex structuring that was involved, often made this approach unattractive.

However, subject to a few exceptions, the Canadian withholding tax barrier is now behind us. It does not seem overly dramatic to suggest that the repeal of withholding tax will have a transforming effect on where Canadian receivables are securitized. Among other likely scenarios:

- Canadian residential mortgages, auto loans and other consumer assets will begin to access the U.S. securitization market, in much the same way as occurred with Australian residential mortgages after Australia repealed withholding tax for certain international financings.

- U.S. and global enterprises will add their Canadian affiliates' receivables to their securitization platforms to increase volumes, and to streamline the inconsistent documentation and reporting requirements that are endemic to administering multiple programs.
- U.S. and European investors will be attracted to the diversification, strong credit fundamentals and higher spreads offered by Canadian ABS/MBS.
- Canadian ABCP, backed by global-style liquidity facilities from the large Canadian banks, will for the first time be made available to non-Canadian investors.
- With the new exit strategy offered by U.S. and European securitization, international originators can be expected to follow the lead of Capital One, Citibank, CNH, Ford, GMAC RFC, Honda, John Deere, MBNA, Merrill Lynch, Nissan and other global enterprises that have established Canadian financing platforms.

Since withholding tax has ceased to apply to lending facilities as well as securitizations, U.S. and other off-shore lenders are now able to offer cost effective cross-border warehouse and liquidity facilities to Canadian origination and securitization programs.

It should be noted that Canadian withholding tax has not been totally eradicated. It will continue to apply to lease payments, dividends, royalties and certain other cross-border payments, and even the new rules on interest payments will not apply to "participating" interest or interest on certain convertible debt. Interest on non-arm's length and related party debt will also remain subject to withholding tax except for the tax on payments to the U.S. which, as discussed below, will be gradually phased out once the recent amendment to the Canada-U.S. tax treaty is ratified.

The cross-border securitization of Canadian receivables will also be impacted by the September 2007 signing of a long-awaited amendment to the Canada-U.S. tax treaty, which will likely come into force some time in 2008. While the amendment, among other things, will eliminate withholding tax on cross-border interest payments between the two countries, this will be superseded, with respect to payments to unrelated U.S. persons, by the legislation discussed above. However, the amended treaty will also gradually reduce and eventually eliminate Canadian withholding tax on interest paid to related U.S. persons, provided they are residents of the U.S. for the purposes of the treaty and satisfy the treaty's new limitation on benefits (or "LOB") rules.

The relatively complex LOB rules determine which U.S. entities are entitled to rely on the treaty, and will be important when determining whether a U.S. entity's participation in a Canadian securitization will attract Canadian income tax. For those entitled to rely on the treaty, the current rules will continue to apply. They need only avoid structures that give rise to a Canadian "permanent establishment" – a result that is usually not difficult to achieve. However, U.S. entities that do not have treaty benefits will have to avoid "carrying on business in Canada" – a stricter test, especially if the transaction involves a Canadian servicer.

One other positive result of the amended treaty will be to finally accord treaty protection to members of LLCs. Currently, Canadian tax authorities take the position that LLCs (and their members) cannot rely on the treaty unless they have elected to be taxed as corporations. This has been an issue for those U.S. ABCP conduits and other securitization vehicles that are structured as LLCs, since lack of treaty protection subjects them to the stricter "carrying on

business in Canada” test for determining their liability for Canadian income tax. Under the amended treaty, LLCs whose members are able to meet the LOB’s new qualification tests will be entitled to full treaty benefits. Not a perfect solution, but hopefully one that will work for many LLCs.

The amended treaty will come into force when Canada and the U.S. notify each other that they have ratified it. For Canada, that involves passage of an enacting statute, which occurred in December 2007. For the U.S., it means Senate approval, which we expect will take place later this year.

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