

CANADIAN SECURITIZATION UPDATE

Capital Tax Elimination – Implication for Cross-Border Securitization

As announced in its May 2nd budget speech, the federal government has enacted legislation that eliminates the federal capital tax, retroactive to January 1, 2006. **The elimination of this tax will facilitate the cross-border securitization of various classes of Canadian leases and interest-bearing receivables, both consumer and corporate, on a tax effective basis.** This results from the interplay between Canadian withholding tax on the one hand, and federal and provincial capital taxes on the other.

It has long been recognized that Canada's withholding tax regime creates a significant hurdle to securitizing leases or interest-bearing receivables in foreign capital markets. Subject to a number of exceptions, a basic 25% withholding tax applies when interest or rent is paid to a non-resident. Although this rate is frequently reduced under a bilateral tax treaty, it rarely falls below 10%, and generally represents too great an economic burden to justify off-shore securitization.

In this regard, we have been able to structure cross-border securitizations of interest-bearing Canadian loans on a withholding tax-free basis where the loans are designed to satisfy the three basic criteria of a statutory withholding tax exemption:

- The borrower is a corporation or partnership of corporations – rather than an individual, trust, or partnership with one or more non-corporate partners.
- With limited exceptions (including acceptable events of default), mandatory repayments in the first five years do not exceed 25% of the amount of each loan.
- The loan structure and the parties' relationship reflect that they are unrelated and act at arm's length.

We have been also able to adapt this long-term corporate debt exemption to structure off-shore securitizations for trusts and short-term loans without attracting withholding tax:

- In one transaction, a Canadian special purpose corporation purchased a revolving pool of demand floor plan loans, and issued five year tranching notes to U.S. and European investors.
- In another, a Canadian special purpose corporation borrowed five-year funds from a U.K. ABCP conduit, and on-lent the proceeds to a Canadian securitization trust that held corporate obligations.

These structures had to deal with a number of complex issues, including early amortization events under the Canadian securitization that did not match the events of default of the corresponding cross-border loan, the Canadian tax authority's policies with respect to back-to-back loan structures, entity level tax issues affecting the Canadian securitization vehicle, and the desire to achieve off-balance sheet funding.

While these structures allow corporate loans to be securitized cross-border without withholding tax, they have not been utilized for leases or consumer assets. This stems from a "capital tax" imposed by certain provinces and, until recently, the federal government. This tax applies to the liabilities and capital of most corporations, but is offset by an allowance for a corporation's holding of loans made to other corporations. It is for this reason that capital tax must be taken into account when a Canadian SPV issues notes to off-shore investors to fund a pool of leases or consumer loans, but can generally be disregarded where the securitized assets comprise solely corporate loans.

The federal capital tax rate was originally set at .225%. It has been declining since 2004, and was to have been eliminated in 2008. However, the early enactment of the federal budget proposals accelerated the process, and the tax has been fully revoked retroactive to January 1, 2006.

As to provincial capital tax, each province has its own regime. Some provinces have never imposed or have eliminated the tax, while in others it ranges from .3% to .6%. However, a corporation will only be subject to a provincial capital tax if it has a "permanent establishment" in that province, which will generally depend on the location of its head office, other business locations, and certain types of employees and agents (including some types of servicers of securitized assets). If a servicer or other agent is an independent person acting in the ordinary course of its own business (i.e., a true third party servicer), its presence in a particular province does not generally create a permanent establishment of the principal. Depending on the facts and circumstances of a particular securitization, it should be possible to design an SPV so that it only has a permanent establishment in a province that does not impose capital tax. By doing so, it would be possible to structure a cross-border securitization of pools of leases or non-corporate loans (such as auto loans, residential mortgages, credit card receivables and loans to REITs) on a basis that avoids both withholding tax and capital tax.

If you have any questions with respect to the foregoing, please contact:

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