

BULLETIN

November 26, 2007

SECURITIES & CORPORATE FINANCE LAW**Removal Of Canadian Withholding Tax On Interest**

effective January 1, 2008

by Albert J. Hudec

The surprise announcement by Canadian Finance Minister John Flaherty that legislation will be passed to eliminate Canadian withholding tax on arm's length cross-border interest payments effective January 1, 2008 creates major business opportunities for foreign financial institutions in the Canadian cross-border securitization market.

Until recently, it was expected that Canada would eliminate withholding tax only on a country by country basis as other countries agreed to reciprocate, starting with amendments to the Canada-U.S. tax treaty expected to be implemented sometime next year. The unexpected announcement, which was buried to amendments to a detailed *Ways and Means Motion* tabled on November 13, 2007, makes it clear that Canada now intends to act unilaterally without insisting on reciprocity.

The door is now open for foreign institutions to finance the full spectrum of securitization programs originated in Canada. Previously, cross-border securitization financings were mostly limited to five-year corporate loans and non-interest bearing trade receivables. Securitizations of shorter-term Canadian corporate obligations (such as dealer floor plans) and Canadian consumer receivables have been financed outside of Canada only in a few instances using complex and convoluted structures involving the funding of short term obligations with five year notes.

Upon enactment of the changes, international originators of securitization products will be able, for the first time, to include shorter-term corporate obligations as well as Canadian-originated residential mortgages, auto loans and other consumer assets, in their non-Canadian securitization vehicles. Also, international securitization originators who have previously used separate Canadian financing platforms for their Canadian assets will now be able to eliminate the inefficiencies of administering multiple programs and standardize documentation by including their Canadian assets in their international securitization platforms.

Furthermore, the recent (August 2007) collapse of the \$35 billion independent or non-bank asset-backed commercial paper market has created opportunities in Canada for foreign sponsors of securitization vehicles, particularly in market niches not serviced by the traditional banks. This includes smaller deals involving traditional asset classes such as residential mortgages and auto loans and leases; deals involving issuers outside of the Greater Toronto Area; and transactions involving new or innovative asset classes such as commercial mortgages, personal credit lines, non-investment grade receivables, insurance premiums, mutual fund management fees, non-conventional residential and auto loans and credit arbitrage securitizations.

Under Canada's old rules, a 25 per cent rate of withholding (reduced to 10 per cent by treaty in some cases) was imposed on most cross-border interest payments, except where the loan qualified for the exemption from Canadian withholding tax available under the so-called "5/25 Exemption" pursuant to subparagraph 212(1)(b)(vii) of the *Income Tax Act* (Canada) (the "ITA"). Under the 5/25 Exemption, the borrower could not be required absolutely or contingently to repay more than 25 per cent of the principal amount of the loan in the first five years unless there has been an event of failure or default.

Accessing the 5/25 Exemption required lenders and borrowers to comply with a myriad of CRA administrative requirements relating to a wide range of matters including repayment schedules, permissible events of default, MAC and MAE clauses, conversion and anti-dilution features, the use of excess cash and cash sweeps, cash collateral requirements, permitted cross defaults, change of control provisions and events triggering repayment obligations; together with matters such as assignments, participations and novations.

Many of these arcane requirements were at odds with typical control and risk sharing provisions in loan documentations between borrowers and commercial lenders.

Although the legal profession's knowledge of the arcane rules governing eligibility for the 5/25 Exemption is now obsolete, sophisticated legal advice will continue to be required to ensure that cross-border securitization activity does not result in "carrying on business in Canada" (for institutions from non-treaty jurisdictions) or in the deemed establishment of a "permanent establishment" in Canada (for institutions from treaty jurisdictions), which would result in the imposition of Canadian income tax; and that it does not infringe federal and provincial rules regulating the carrying on of business in Canada by foreign banks and insurance companies.

For further details or to receive a copy of a more detailed discussion paper contact Al Hudec at ajhudec@davis.ca.



For more information, please contact:

Al Hudec, CFA
604.643.6463
ajhudec@davis.ca

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For more information, please contact:

Edmonton	Edward Boomer	David J. Stratton, Q.C.
	780.429.6823	780.429.6804
	eboomer@davis.ca	dstratton@davis.ca

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