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ASSET EQUIPMENT FINANCE/LEASING

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PRACTICE AREA DEFINITION

The asset equipment finance and leasing practice area is related to the financing of equipment, vehicles and related assets by way of specific asset-based priority financing, primarily through leases, but also through conditional sales contracts, secured loans or securitizations. It is a broad practice area encompassing the financing of large-ticket assets such as aircraft, ships, railcars, locomotives, industrial machinery and oil and gas equipment through to small-ticket assets such as office equipment, light manufacturing equipment and cars and trucks. Transactions are often complex and multidisciplinary, involving cross-border leases, sale leasebacks, securitizations or asset-based loans, and require contributions from lawyers with knowledge of the commercial, regulatory, tax and finance components of the transaction, particularly where there is an international dimension, accounting dimension or regulatory constraint. Please note that the Directory has separate sections for CORPORATE FINANCE; DERIVATIVE INSTRUMENTS; INSOLVENCY & RESTRUCTURING; and INVESTMENT FUNDS & ASSET MANAGEMENT.

RECENT DEVELOPMENTS OF IMPORTANCE

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The year 2007 has seen significant change to the asset-based financing and leasing environment, including the elimination of withholding tax on arm's-length debt (other than participating interest) as well as collateral effects of the credit crisis affecting securitizations and the ability of many financial intermediaries to obtain credit. While many of the credit providers are large financial institutions, such as banks, credit unions and insurance companies,

a substantial number are manufacturers' financing companies or smaller regional independent finance and/or leasing companies whose access to capital will be affected by these changes.

Asset/equipment finance and leasing represents a significant alternative source of business capital. Moreover, it typically relies upon cash flow-based credit analysis over a particular asset rather than "net worth" lending, traditionally provided by banks. There is a substantial market for equipment loans as well as for asset-based loans (ABLs), which are loans secured by inventory and accounts receivable. This segment also provides project finance solutions for infrastructure, including power assets (hydro, wind, gas turbines, nuclear and alternative fuels), hospitals, toll roads and transportation. Traditionally, advice to this market has focused on the relationship between the lender/lessor and the asset user (i.e., on implementation of asset-based finance products), but finance companies and lessors often use specialized securitization financing to reduce their cost of providing asset-based finance products. Asset-based financing (as well as securitization) is highly dependent upon a complex and sometimes conflicting set of tax and accounting rules.

The structure of the Canadian finance and lease market is strongly influenced by financial services regulation and tax considerations. This article surveys the Canadian asset-based financing environment, highlighting uniquely Canadian issues and identifying recent developments.

CANADIAN ISSUES

Financial Services Regulations

The *Bank Act* (Canada) provides that Canadian banks are not permitted to undertake the business of leasing consumer automobiles or any asset leasing unless the asset lease is a "financing lease" as defined in the *Bank Act* (Canada). Accordingly, the automobile lease industry has been dominated by manufacturers' financing companies and smaller fleet lessors (typically operated by independent auto dealers) rather than banks. Further, banks have not generally been able to offer "operating" leases to consumers for leased assets. Banks can offer a form of operating lease whereby residual value guarantees are purchased to offset a substantial portion of the equipment risk, thereby resulting in a finance lease to the bank. Smaller industrial entities provide operating leases by taking residual value and remarketing risk for specific assets. Smaller financing entities often do not have as ready access to capital as larger financial institutions, which results in operating leases being relatively expensive (unless credit can be obtained from pension funds, insurance companies or through a securitization of a portion of the financing). Although banks are not permitted to directly engage in this type of leasing, they typically make credit available to vehicle leasing companies, often on a non-recourse basis.

There is also an increasing desire for US-style monoline insurers and residual value providers to offer services to Canadian customers, banks and other large financial institutions to permit more cost-effective access to asset-backed financing. Financial guarantee insurance or credit wraps are generally not permitted to be provided by regulated insurers in Canada. Moreover, there are significant impediments to foreign unlicensed insurers who provide financial guarantee insurance to Canadian assets or projects. In addition, insurance premium taxes, sales taxes, excise taxes and withholding taxes can apply to such products. Recently, several asset-based project financing transactions have used financial guarantee insurance. This development may lead to other forms

of financial guarantee/credit wraps being available on equipment loans and equipment-based securitization transactions.

Tax Rules Applicable to Leasing

The Canadian tax system generally provides tax incentives to encourage the purchase of goods by allowing an owner of an asset to claim depreciation expenses (known in Canada as “capital cost allowance,” or CCA) calculated on a declining balance basis at rates established for particular classes of assets (subject to a half-year convention in the year of acquisition). In secured loan or conditional sale financings, the borrower acquires the goods and, as owner, obtains the benefit of CCA. For many borrowers, however, there may be only marginal benefit from the CCA because, for example, they operate on a break-even basis, have losses or are exempt from tax. Leasing often results in lower after-tax cost of financing for these borrowers because lessors who obtain the benefit of CCA as owners usually use part of the CCA benefit to subsidize rent charges.

To eliminate the CCA benefit to lessors on certain types of assets, Canada adopted the “specified leasing property rules.” These rules effectively bifurcate the lease market into small-ticket leasing of “exempt assets” and the leasing of all other assets that are non-exempt. In general, a lessor of exempt assets obtains tax incentives for its assets, whereas a lessor of non-exempt assets does not. Exempt assets include general purpose office furniture and office equipment, including computers (which have a value per item of less than \$1 million), residential equipment such as furniture, appliances, televisions, furnaces and hot-water tanks, passenger vehicles, vans, pickup trucks, truck/tractors for hauling road freight, and rail cars. Non-exempt assets constitute the remainder, such as industrial machinery, vessels, energy generation assets, oil and gas equipment, flight simulators and telephone switching assets.

A lessor of exempt assets is entitled to full CCA. A lessor of non-exempt assets is limited to a CCA deduction equal to the lesser of (i) full CCA and (ii) the notional amount of principal it would receive if the lease were treated as a loan of an amount equal to the fair value of the leased property, with interest at a prescribed rate based on long-term Government of Canada bond rates. For most non-exempt assets, the amount of notional principal is much lower than the amount of depreciation that would otherwise be deductible, so there is little, if any, net present value tax benefit for a lease of a non-exempt asset. For leases to poor credits (whose lease rate exceeds the prescribed rate), there may still be a net present value benefit to a lessor. Generally, the specified leasing property rules do not apply to lessees for the purposes of determining the deductibility of rental payments; the lessee is treated as paying rent.

Leases of non-exempt assets at lease rates lower than the prescribed rate (which may occur if the lessee is of substantial credit quality (i.e., investment grade) can result in “phantom income” to a lessor because the higher prescribed rate will treat less of the rent payment as principal and almost all as interest. This can be particularly problematic if the lessor is a special-purpose entity. In addition, US-dollar leases can create phantom income because CCA is calculated in constant Canadian dollars, but rent and interest are reported in Canadian-dollar equivalents and, therefore, vary with currency effects. Currency effects may also be treated as on capital account, and losses (if any) may not be deductible against lease income.

Specified Leasing Property Rules and Section 16.1 Election

A unique rule applies to lessees of non-exempt assets that can provide ownership benefits without passing ownership to the lessee. If the lessee and lessor make an election under section 16.1 of the *Income Tax Act* (Canada) (Tax Act) (a so-called section 16.1 election), the lessee is treated as the owner of the equipment (but only for the purpose of calculating its income for tax purposes) and is entitled to treat the rent payments as a blend of principal and deductible interest. To make a valid section 16.1 election, the lessor and lessee must deal at arm’s length and the lessor must be a resident of Canada or a non-resident carrying on business through a permanent establishment in Canada that is not tax-exempt. However, only the portion of the rent payment that is not considered to be a principal repayment can be deducted. Making the section 16.1 election does not affect the tax position of the lessor. Section 16.1 elections are made extensively by lessees, and many lessors have lease programs and documents developed to facilitate such terms.

Withholding Tax on Interest and Rents

As of January 1, 2008, interest paid or credited to a non-resident on arm’s-length debt (other than participating interest) will be exempt from Canadian withholding tax. Participating interest will remain subject to Canadian withholding tax (other than for certain types of “fully exempt interest,” which generally means Canadian government and quasi-government debt, certain mortgages and sales agreements relating to property outside Canada, interest paid or payable to certain prescribed international organizations and agencies and certain securities lending arrangements).

Canada will continue to impose withholding tax on non-arm’s-length interest (other than fully exempt interest) except to US residents (as described below).

Non-resident lenders are now able to offer withholding tax-exempt loans of any term to Canadians and will be able to lend to trusts and partnerships (without having to use complex lending structures or having to obtain advance tax rulings from the Canada Revenue Agency, or CRA). This will significantly reduce the nuisance of peculiar commercial terms inserted into cross-border loans to ensure that they meet Canada’s former domestic exemption for five-year corporate debt (the “5/25 Exemption”). These changes are also expected to facilitate the use of many new products for Canadians, including financial guarantee insurance on a broader range of loans than exist today, and to facilitate the securitization of Canadian-origin financial assets in US and other foreign capital markets.

Canada still levies a withholding tax of 25 per cent (reduced in many circumstances under Canada’s bilateral tax treaties) on payments of rent made by Canadians to non-residents of Canada. Consequently, there will be an incentive to structure cross-border arrangements as loans rather than leases, including through conditional sale contracts. In certain circumstances, Canada also imposes withholding tax on payments by non-residents to other non-residents if the payment is for the use of or the right to use property in Canada. Withholding taxes are a significant factor in determining the legal structure of a transaction – that is, it depends on whether the lessor is Canadian and whether debt is raised wholly in Canada or wholly or partly outside Canada. Withholding taxes also affect the cost and availability of credit insurance. A Canadian lessor receiving rent from a Canadian is not subject to withholding tax, but the lessor is taxable. Thus, a Canadian lessor

will likely be used for any lease transaction involving a Canadian lessee unless a withholding tax exemption applies.

Canada has exemptions from withholding tax on rent payments for aircraft and for payments to US residents on some computer software, resulting in a number of cross-border lease financing transactions for such assets. US lessors of other types of property can avoid being subject to withholding tax by operating in Canada through an unlimited liability company (ULC) under the laws of either Nova Scotia or Alberta, which becomes the tax owner of the property. The lease payments are not subject to withholding tax because they are made to a Canadian resident. Since ULCs are treated as disregarded entities for US tax purposes, the US owner would still be in the position for US taxes as if it had purchased the assets directly.

Goods and Services Tax

Canada levies a value-added goods and services tax (GST) at the rate of 5 per cent (reduced from 6 per cent on January 1, 2008) on most goods and services provided in Canada. The GST generally applies to lease payments. In most commercial situations, the tax is fully recoverable through input tax credits. However, where government sector participants are involved, sale-leaseback transactions can give rise to unrecovered amounts from these taxes. This is a significant impediment to public/private infrastructure finance projects. Most financial products (loans and other forms of credit) are exempt from GST, but the credit provider is generally not permitted to obtain input tax credits on its input costs to provide exempt financial products.

In addition, dealing with unregistered non-residents may present problems where GST is payable but the appropriate party cannot recover the GST. The CRA adopted a revised policy expanding the circumstances in which it considers a foreign lessor to carry on business in Canada for GST purposes. Policy P-051R2 entitled *Carrying on Business in Canada* provides examples relating to leases that provide, among other things, that a sale-leaseback of property to a non-resident lessor constitutes that the lessor's carrying on business in Canada if the property is delivered in Canada. Foreign lessors should carefully review this policy.

Lease Characterization

The characterization of a lease as being a "true lease," as opposed to a "loan," is an important issue in determining the amount and timing of taxes applicable to lessors and lessees (i.e., GST, provincial retail sales tax and provincial capital tax), as well as eligibility for relief from withholding tax.

Securitizations

Finance companies involved in asset/equipment finance often carry out securitizations to reduce their cost of providing asset-based finance products. Securitizations involving secured loans or conditional sale contracts are generally structured to result in a sale of a pool of secured loans or conditional sale contracts to a bankruptcy remote special purpose vehicle that funds such purchase with the proceeds from the issuance of highly rated debt. Such transactions can be structured to be either on-balance sheet or off-balance sheet for the seller/originator of the secured loans or conditional sale contracts.

Securitizations involving leases in Canada tend to be more complicated than securitizations involving secured loans or conditional sale contracts because of several, often competing, tax and legal parameters. A typical securitization involves the sale of a financial asset. In the context of a lease transaction, the financial asset is the lease receivable that generally has no tax cost. The lessor also owns a non-financial asset in the form of the leased property

that generally has tax cost. The principal tax constraint is that if a lessor merely sold its lease rights (i.e., the right to receive future rents) to obtain funds, it would realize an immediate inclusion in its income equal to the proceeds of sale without any offsetting deduction or reduction of cost. This effectively accelerates the recognition of what would have been future rental income. The lessor could still retain the beneficial ownership of the physical asset and would remain entitled to CCA.

To avoid accelerating income, lease securitization transactions are structured so that the lease payments received by the lessor/owner are treated as prepaid rent, not as proceeds of disposition of the leases themselves. In general, prepaid rent must itself be brought immediately into income; however, a deduction of a reasonable reserve in respect of future rent periods is allowed as a deduction. Two structures allow for this to be accomplished: the sale/sale leaseback and the concurrent lease.

RECENT DEVELOPMENTS

New Protocol to Canada-US Tax Treaty

On September 21, 2007, Canada and the United States entered into a Protocol to amend the Canada-US Income Tax Convention (1980) (the Treaty). The Protocol will enter into force on the day on which both Canada and the United States have notified each other that they have ratified the Protocol. Canada has already ratified the Protocol but the United States has not. The Protocol provides that Canadian withholding tax on interest paid or credited to a US resident that is related or deemed to be related to the payer will be eliminated over a three-year period, commencing the first calendar year ending after the Protocol enters into force. The Protocol provides that interest paid or credited to a US resident that is not related, or deemed to be related, to the payer will be exempt from withholding tax.

Special Treatment for Related Interest Paid to US Residents

Interest paid to a US resident that is related, or deemed to be related, to the payer will still be subject to withholding tax (currently limited to 10 per cent under the Treaty) but at a reduced rate of 7 per cent in the first year ending after the entry into force of the Protocol and 4 per cent in the second year ending after such time.¹ Thereafter, no Canadian withholding tax will be imposed on interest paid to a US resident.

Unreasonable Interest

The Protocol contains a limitation that allows Canada to continue to tax interest to the extent it exceeds the amount that would have been agreed upon in the absence of a special relationship between the payer and the beneficial owner or between both of them and some other person.

Participating Interest

The Protocol provides that the exemption from Canadian withholding tax on interest will not apply to interest determined with reference to receipts, sales, income, profits or other cash flow of the payer or a related person; to any change in the value of any property of the payer or a related person; or to any dividend, partnership distribution or similar payment made by the payer to a related person. The rate of withholding under the Treaty for these amounts will be 15 per cent. Thus, participating interest will still be subject to tax even under the Protocol.

Carrying on Business

Non-resident lenders may still be subject to Canadian tax in respect of loans made to Canadians if such lenders are considered to be

carrying on business in Canada through a permanent establishment in Canada. A non-resident lender who engages in certain types of loans may risk being considered to be carrying on business in Canada. For example, it may be difficult for a non-resident to make residential mortgage loans (which are usually originated by a branch network or broker network) directly to Canada. Even if the loans are purchased after they are originated, the degree of activity that may be required to service those loans may cause a non-resident to be considered to be carrying on business in Canada regardless of the exemption of such loans from Canadian withholding tax. Each situation will need to be reviewed. A US lender desiring to invest in Canadian loans may choose to lend to a Canadian conduit that will hold the loans and service them at the conduit level, thus avoiding a permanent establishment in Canada and becoming subject to Canadian taxes.

Treaty to Apply to LLCs

The Protocol also included amendments that will clarify the application of the Treaty to flow-through entities such as LLCs (which under current Canadian law would not be eligible for the benefit of the Treaty). Depending on the circumstances, these rules should be reviewed to determine the eligibility of a particular lender for the benefit of the Treaty and for the possible application of relief thereunder from Canadian withholding tax.

Rents Still Subject to Withholding Tax

The Protocol does not affect Canadian withholding tax on rents. Thus, payments of rent (which are dealt with under the royalty article of the Treaty) will continue to be subject to withholding tax. Conditional sale-put structures that are economically similar to leases may be attractive alternatives.

Thin Capitalization Rules Will Continue to Apply

Canada's domestic thin capitalization rules will continue to apply to interest paid to "specified non-residents," which may reduce the deductibility of interest paid to a "specified non-resident."

Capital Taxes

Canada no longer levies the federal "large corporations tax" (LCT) and thus the cost of borrowing has been reduced, as has the tax bias of using single-purpose corporations for large capital financings. Many of the provinces are also reducing or eliminating capital taxes. Several Canadian provinces (including Ontario and Québec), however, continue to levy a similar tax. Ontario introduced legislation to replace the Ontario capital tax with the now repealed federal capital tax provisions. In addition, Ontario has announced that it will eliminate capital taxes for companies primarily engaged in manufacturing and resource activities effective January 1, 2008 and that it will accelerate the currently scheduled capital tax rate cuts reducing Ontario capital tax rates until the elimination of Ontario capital tax in 2010. Where capital taxes apply, they are generally imposed on the corporation's taxable capital used in Canada. "Taxable capital" generally means the amount of a corporation's total liabilities and owners' equity. Most single-purpose entity structures are designed to reduce the amount of income taxes payable, so that capital taxes can be a significant additional unrecovered cost for the transaction. Since capital taxes are not levied on trusts, trusts are often the preferred form of entity.

Although the LCT is now eliminated for federal purposes, the existing policy for LCT will be relevant to Ontario commencing in 2009. In IT-532, *Part 1.3 Tax on Large Corporations*, the CRA stated that the determination of whether a transaction is a lease or a sale is to be made by using a legal test, not an accounting test, to identify whether the lessor or lessee is subject to capital tax. IT-532 also provides that

an appropriate use of financial instrument offset accounting may allow netting of certain amounts to reduce the overall carrying value of an obligation for LCT purposes. Case law conflicts regarding the application of capital tax and the characterization and determination of amounts for accounting purposes.

Superpriority Rules

In several recent insolvency situations, the CRA has asserted that it can use the superpriority garnishment powers under the *Tax Act* to garnish proceeds due to lessors, not just for outstanding rental arrears but for the value of the leased assets that the lessor is attempting to recover. Generally, the superpriority rules allow the CRA to garnish amounts due to secured creditors where the CRA is owed amounts for employee source deductions, withholding taxes, the employer and employee portions of Canada Pension Plan and Employment Insurance premiums, and GST (in some circumstances).

Vicarious Liability

A large publicized motor vehicle settlement brought the issue of tort liability for lessors sharply into focus and galvanized the industry to lobby in Canada for specific exemptions from liability. Several provinces have or are enacting legislation that would reduce this liability. These initiatives are similar to the US initiatives to bar vicarious liability in every state.

Changes to Bankruptcy and Insolvency Laws: Aircraft

On February 24, 2005, the *International Interests in Mobile Equipment (aircraft equipment) Act* (Mobile Equipment Act) received royal assent in Canada. The purpose of the Mobile Equipment Act is to implement the *Convention on International Interests in Mobile Equipment* and the *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment* (Protocol). The Mobile Equipment Act makes a number of changes to the *Bankruptcy and Insolvency Act* (Canada) (BIA) and the *Companies' Creditors Arrangement Act* (Canada) (CCAA), resulting in allowing a lessor of "aircraft objects," to exercise its remedies in insolvency proceedings unless (i) after commencement of insolvency proceedings, the debtor protects and maintains the equipment in accordance with the applicable agreement; and (ii) within 60 days of the commencement of the insolvency proceedings, the debtor (a) remedies all defaults under the applicable agreement (other than insolvency defaults), and (b) agrees to perform its obligations (other than insolvency defaults) under the applicable agreement both during and after the insolvency proceedings and continues to perform such obligations without further default (other than insolvency defaults).

The Protocol came into force on March 1, 2006, but will not be in force in Canada until the first day of the month following the expiration of three months after Canada's formal ratification. As of the date of writing this article, Canada had not yet ratified the Protocol.

Changes to Bankruptcy and Insolvency Laws:

Lease Disclaimer

Bill C-12, an *Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*, received royal assent on December 14, 2007. The effect of Bill C-12 was, among other things, to make amendments to the omnibus bankruptcy amending legislation, known as C-47, which received royal assent on November 25, 2005; however, C-47 has still not yet been proclaimed in force. When proclaimed into force, C-47 (as amended by Bill C-12) will make certain changes to the BIA and CCAA, which, if implemented in their current form, would permit a debtor under the BIA or CCAA, with the approval

of the trustee in bankruptcy or monitor, as applicable, to disclaim a lease of personal property regardless of whether it is the lessee or lessor. In addition, the CCAA would be amended to prevent the non-debtor party to an agreement from terminating or amending an agreement solely on the basis that an order under the CCAA has been made in respect of the debtor. The effect of these changes will be problematic for the existing structures used in Canadian lease securitization transactions.

In approving Bill C-12, the Senate reaffirmed its intention to hold hearings on C-47 (as amended by Bill C-12) in 2008 prior to C-47 becoming proclaimed into force. As of the date of writing this article, no date has been set for proclaiming C-47 into force. ■

1. The Protocol uses the term "related" rather than the domestic test for "non-arm's length." The Protocol, its exhibits and the Treaty contain deeming rules for the definition of "related."
