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Canadian Withholding Tax Eliminated on Interest Payments to Unrelated U.S. Lenders

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As of January 1, 2008, withholding tax is no longer payable on most interest payments made by Canadian borrowers to arm's-length lenders, including lenders that reside in the United States. Amendments to Canada's *Income Tax Act* have opened the door to the Canadian borrower market for U.S. lenders by reducing the cost of borrowing and allowing for more efficient structuring of cross-border investments. U.S. lenders that have previously lent to Canadian borrowers under the old rules may want to restructure their existing credit facilities in light of these changes.

Under the old rules, unless an exemption was available, amounts paid as interest by a Canadian borrower to a non-resident unrelated lender were generally subject to withholding tax at a rate of 25%, or less if one of Canada's bilateral tax treaties applied (treaties with the United States and the United Kingdom, for example, reduced the rate to 10%). The so-called 5/25 exemption eliminated all withholding tax (except on participating interest¹) for corporate borrowers on term loans provided not more than 25% of such loan could be payable within five years of its origination. No such exemption existed for revolving or other short-term loans. Accordingly, U.S. lenders to Canadian borrowers were subject generally to a 10% withholding tax on interest paid in respect of revolving loans and, to claim the 5/25 exemption, special structuring in respect of term loans was required to avoid withholding tax altogether.

The new rules eliminate withholding tax (except on participating interest) on all types of loans by arm's-length lenders to Canadian borrowers: term, revolver, swing-line and other short-term credit facilities. Withholding tax on income assimilated to interest, such as guarantee fees charged for cross-border guarantees, has also been eliminated. Under the Fifth Protocol to the Canada-U.S. tax treaty, it is also proposed that withholding tax be eliminated on non-participating interest paid to related U.S. lenders, to be phased in over a two-year period once the protocol is enacted.

These changes in the tax laws present tremendous opportunity for U.S. lenders in the Canadian borrower markets. Borrowers need no longer be corporations to be eligible for the exemption to withholding tax; short-term and revolving credit facilities are now free from withholding tax, and long-term credit facilities need not be structured to include peculiar commercial terms to ensure compliance with the 5/25 exemption. These changes will also facilitate the introduction of new products to Canada, including financial guarantee insurance on a broader range of loans than previously existed and the securitization of Canadian-origin financial assets in U.S. and other foreign capital markets. 

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¹ Interest computed directly or indirectly by reference to the profits of the borrower.