

ASSET EQUIPMENT FINANCE/LEASING

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PRACTICE AREA DEFINITION

Asset/equipment finance and leasing is 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.

RECENT DEVELOPMENTS OF IMPORTANCE

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According to the Canadian Finance and Leasing Association (a prominent industry organization that represents participants in this industry), the asset-based financing and leasing industry in Canada finances as much as 25 per cent of annual new investment in machinery, equipment and commercial vehicles in Canada. Approximately 60 per cent of the industry's customers are small to medium-sized businesses. 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.

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 asset-based loans (ABLs), which are loans secured by inventory and accounts receivable rather than equipment. There is also a growing need for 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 business unless the 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. 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 and excise 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. A taxpayer can elect to treat locomotives acquired after February 27, 2000 as exempt property (at a CCA rate of 13 per cent as opposed to 15 per cent if no election is made). 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 have an impact on capital account, and losses (if any) would 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

Canada levies a withholding tax of 25 per cent (reduced in many circumstances under Canada's bilateral tax treaties) on payments of interest and rent made by Canadians to non-residents of Canada. 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.

Canada also has an exemption from withholding tax on interest (referred to as the “5/25 exception”). The 5/25 exception applies if the loan is between arm's-length parties, the term of the obligation is greater than five years and no more than 25 per cent of the principal amount of the obligation may be required to be repaid within five years except through the failure or default of the borrower. The 5/25 exception is not well-suited to assets that depreciate quickly or to credits on which principal is repaid quickly. Moreover, the 5/25 exception is limited to corporate borrowers and cannot be used by a trust. Consequently, if a trust structure is used, any borrowing must be from Canadian lenders, otherwise a withholding tax will be imposed on the interest payments. The Canada Revenue

Agency (CRA) has issued several advance tax rulings that have permitted the use of indirect finance entities to allow for the 5/25 exception for partnerships and trusts that finance infrastructure assets. The choice between selecting a trust or a corporation as a lessor is based primarily on withholding tax, calculated according to the source of funds (i.e., non-resident or Canadian lender), and on capital taxes (see below).

Canada and the United States recently renewed their interest in completing a revised Canada-US Tax Convention ("Treaty"). It is expected that they will agree to exempt payments of interest by Canadians to US treaty residents from withholding tax on arm's-length debt. The timing of this is uncertain (perhaps as early as a July 1, 2008 implementation date), but it is expected to permit cross-border loans to Canadian entities free of withholding tax. This would also broaden the current exemptions in the Treaty for certain conditional sale contracts for goods sold to Canadians. This may permit greater financing for Canadian assets into US securitization arrangements and may also permit loans to finance Canadian equipment (particularly vehicles). The treaty exemptions will have a significant effect on access to cross-border capital for asset-based finance.

Goods and Services Tax

Canada levies a value-added goods and services tax (GST) at the rate of 6 per cent (reduced from 7 per cent on July 1, 2006) on most goods and services provided in Canada. 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 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 (e.g., GST, provincial retail sales tax and provincial capital tax), as well as eligibility for relief from withholding tax. There has been considerable uncertainty regarding this characterization since the CRA withdrew Interpretation Bulletin IT-233R, *Lease Option Agreements*. The CRA revoked the bulletin because it believed that certain Supreme Court of Canada cases dictated that a more formalistic approach should be taken. However, we believe that the case law supports an approach that acknowledges that certain legal relationships (such as "lease" or "loan" or "sale") have certain legal elements that must exist

between the parties before a court will conclude that such a relationship exists. A mere label is not sufficient.

Hybrid Structures for US Leases or US

Assets into Canada

Hybrid structures allow consolidation of a Canadian lessor with a US resident so that the US resident may claim "ownership" of the assets for US tax purposes. The entity, however, qualifies as a Canadian resident, including in respect of Canadian withholding tax on rent. This allows a US lessor to offer Canadian lessees benefits from domestic Canadian leases that mirror the results that would have occurred had the lessor been a direct US entity. It also allows a US operating entity to own a Canadian asset. Hybrid structures are available to a lessor that is a ULC. ULCs are eligible for the US "check the box" rules and thus can be treated as a partnership or sole proprietorship for US tax purposes. Due to the unlimited liability aspect of the ULC, US participants would typically use a US limited liability flow-through entity to be the sole shareholder of the ULC. Note that Canadian law restricts "foreign banks" from directly owning Canadian entities, including ULCs, without regulatory compliance.

Hybrid structures are especially attractive for non-exempt assets (there is no competing domestic lease market for these assets), because the lease can be structured as an operating lease for capital tax purposes, and the lessor (being a Canadian entity) can offer to make the section 16.1 election with the lessee.

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

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 Quebec), however, continue to levy a similar tax. Ontario entered into an agreement with the federal government to have the federal government administer Ontario's corporate taxes, including the capital tax. As part of that initiative, on December 13, 2006, 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 gradually reduce the capital tax rate until its elimination for taxation years beginning after 2011. 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. This preference for the use of trusts in single-purpose entity structures are likely to continue until both federal and provincial capital taxes are eliminated completely.

Although the LCT is now eliminated for federal purposes, the existing policy for LCT will be relevant to Ontario commencing in 2009. In particular, the application of capital tax to leases and to back-to-back debt will adopt the federal rules. 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. Ontario has introduced legislation that would reduce

this liability. Similar initiatives continue in other provinces. 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

On November 25, 2005, *An Act To Establish the Wage Earner Protection Program Act, To Amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and To Make Consequential Amendments to Other Acts* (Bill C-55) was passed, but the date on which it will be proclaimed into force has not yet been determined. When proclaimed into force, Bill C-55 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 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.

Further amendments to the BIA and CCAA were proposed in a government motion tabled on December 8, 2006. One of the proposed amendments to the changes contemplated in Bill C-55 would require approval by the trustee in bankruptcy prior to disclaiming a lease in respect of personal property. However, parliamentary debate on this motion has not yet commenced, nor is there a projected timetable for these amendments to be drafted in bill form. Furthermore, the Standing Senate Committee on Banking, Trade and Commerce responsible for reviewing Bill C-55 has not discussed the bill or any proposed changes in committee since November 2005. ■

LEADING PRACTITIONERS

RESEARCH

During the course of 2006 we contacted 98 respected practitioners in this field. We requested that they complete detailed questionnaires describing their practices and identify who in their opinion were the leading firms and practitioners. Sixty-eight kindly did so providing us with a response rate of 69.4 per cent. The survey results are as set out in the league tables below.