

Tax Law Bulletin

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Withholding Tax on Interest – Some Recent Developments

Elimination of Withholding Tax on Interest Payments to Arm's Length Non-Residents

Bill C-28 was enacted on December 14, 2007 which contained an amendment to the *Income Tax Act* (Canada) to eliminate Canadian non-resident withholding tax on interest (other than "participating debt interest") paid or credited to arm's length non-resident lenders (regardless of their country of residence) with effect from January 1, 2008.

In the federal budget of March 2007, the government announced that withholding taxes in respect of interest payments made to arm's length non-residents would be eliminated upon the coming into force of the Fifth Protocol to amend the Canada-U.S. Income Tax Convention (the "Fifth Protocol"). However, by virtue of the enactment of Bill C-28, arm's length non-resident lenders will no longer be subject to withholding tax on interest payments (other than "participating debt interest") on or after January 1, 2008, regardless of where they reside. Arm's length lenders who are U.S. residents will not need to rely on the relief from withholding tax to be provided by the Fifth Protocol.

The elimination of withholding tax on interest payments should be of benefit to Canadian borrowers as it may reduce the cost of funds since Canadian borrowers will no longer face demands to "gross-up" interest payments to compensate for the imposition of withholding tax. Non-resident lenders might be more inclined to lend to arm's length Canadian borrowers since the impediment of withholding tax has been removed.

Canadian corporate borrowers will no longer be required to structure their cross-border financing to fit within the somewhat stringent conditions imposed by the so-called "5/25" withholding tax exemption on interest paid to arm's length non-residents.

Non-Arm's Length Interest Payments – U.S./Canadian Residents

Canada passed legislation to enact the Fifth Protocol. We are still awaiting the U.S. to ratify the Fifth Protocol. Once the Fifth Protocol comes into effect, the 10% withholding tax on cross-border interest payments passing between non-arm's length persons who are U.S. and Canadian residents will be phased out over a 3-year period as follows:

- 7% during the first calendar year that ends after entry into force;
- 4% during the second calendar year that ends after entry into force; and
- 0% for subsequent years.

There are some exceptions to the exemption from withholding tax to be provided by the Fifth Protocol. The first exception applies in the case of certain participating interest arising in Canada and paid to beneficial owners who are U.S. residents. A second exception applies in the case of interest arising in the U.S. and paid to a beneficial owner who is a Canadian resident that is contingent interest not qualifying as "portfolio interest" under the U.S. portfolio interest exemption. A third exception applies in a situation where, because of a special relationship between the payor and the beneficial owner of the interest payment, the amount of interest being paid exceeds the amount of interest that would otherwise have been paid in the absence of the special relationship (in this case, the "excess" interest payment amount does not benefit from the exemption from withholding tax).

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