McMillan Binch LLP

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Tax-Efficient Lending into Canada: Dispelling the Myths

International lenders are often reluctant to deal with Canadian borrowers, despite the presence of attractive interest rates. Chilled by the spectre of high Canadian withholding taxes, many investors have chosen not to entertain the prospect of lending funds into Canada.

However, many of the prevailing perceptions of Canada as a punitively high tax jurisdiction are based on outdated misconceptions and plain mistruths. Canadian tax rates are now comparable to those found in many other developed nations. In fact, on average, corporate tax rates in Canada are actually lower than those found in many regions of the United States of America.

This bulletin briefly outlines some strategies that non-resident lenders can use to advance funds to Canadian borrowers without bearing additional Canadian tax costs. While every factual circumstance is unique, the following techniques are frequently used to mitigate, or completely eliminate, the effect of Canadian withholding taxes.

Canadian Withholding Tax

Like most other developed nations, Canada imposes a withholding tax on payments of interest by Canadian borrowers to non-resident lenders (in general, principal amounts can be repaid on a tax-free basis). The statutory rate of Canadian withholding tax levied on an outbound interest payment is generally applied to the gross value of the interest payment, unless the payment qualifies for a withholding tax exemption or treaty relief.

Strategies for Mitigating or Eliminating Canadian Withholding Tax

"Five Year Debt" Exemption

The Canadian *Income Tax Act* (the "**Tax Act**") provides an exemption from withholding tax on payments of interest in respect of certain qualifying debts for which no more than 25% of the outstanding principal is repayable within five years of the initial issuance of the debt. Accordingly, to the extent that a particular debt can be structured to fit within the "long term debt" exemption, no Canadian withholding tax will be levied on any associated payments of interest.

"Foreign Use Debt" Exemption

The Tax Act also provides an exemption from withholding tax in respect of interest payable in a currency other than Canadian dollars to a non-resident lender in respect of certain qualifying obligations entered into by the borrower in the course of carrying on business in a country other than Canada. To the extent that a particular borrowing relates to business activities outside of Canada and otherwise meets the conditions of the "foreign use debt" exemption, no Canadian withholding tax will be levied on any associated payments of interest.

Treaty Rate Reductions

Canada has entered into more than 80 income tax treaties with developed nations around the world (including the United States of America). One of the primary aims of Canada's bilateral income tax treaties is to reduce rates of double taxation. In furtherance of this objective, Canada has generally agreed to reduce the rate of withholding tax levied on outbound interest payments made to residents of countries with which Canada has entered into an income tax treaty. Under most of Canada's income tax treaties, withholding tax rates are reduced to 10% of the gross value of outbound interest payments (assuming a complete exemption is not otherwise available).

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Foreign Tax Credits

Domestic tax legislation in most foreign jurisdictions (including the United States of America) generally provides that recipients of interest paid by a foreign borrower will be entitled to a foreign tax credit in respect of any withholding tax levied on their interest receipts. Provided a non-resident recipient of interest is resident in a jurisdiction which permits taxpayers to fully claim foreign tax credits in respect of foreign withholding taxes, the non-resident will be eligible to reduce its domestic income tax liabilities by the amount of any withholding tax paid in Canada. Therefore, under many circumstances, the imposition of Canadian withholding tax will not ultimately increase a non-resident lender's aggregate income tax burden.

Use of Derivatives and Hybrid Structuring Techniques

The use of derivative instruments has now become a popular means by which non-resident lenders can effectively transfer funds to Canadian borrowers without incurring significant Canadian withholding tax liabilities. Similarly, other hybrid structuring techniques have also been developed to mitigate the negative effects of Canadian withholding taxes. Although the use of derivatives and hybrid structures entail more complicated modes of planning, they still often represent a cost-effective means of reducing Canadian withholding taxes in the context of cross-border lending arrangements.

Lending into Canada: Opportunities Abound

The Canadian market stands as fertile ground for non-resident lenders seeking new financial opportunities. Despite the historical view of Canada as a high tax jurisdiction, many steps can be taken to limit, or completely eliminate, the imposition of withholding tax on interest payments that cross the Canadian border.

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McMillan Binch LLP has extensive experience counselling non-residents on tax-effective means of structuring cross-border lending arrangements. We regularly work with both large financial institutions and boutique venture capital firms to enhance the after-tax return enjoyed by non-resident lenders that wish to explore the Canadian market.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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