

## **CROSS-BORDER DEBT FINANCING OF CANADIAN ENTERPRISES A Primer on the 5/25 Exemption from Withholding Tax**

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Canadian enterprises have raised billions of dollars on foreign capital markets. Such markets have provided sources of capital at interest rates and on other terms that are not otherwise available in the domestic Canadian capital market. Generally, the *Income Tax Act* (Canada) (the Act) imposes Canadian withholding tax at the rate of 25% (unless reduced by applicable treaty) on any amount that a Canadian resident pays or credits, or is deemed to pay or credit to a non-resident as, on account or in lieu of payment of, or in satisfaction of interest. This withholding tax is subject to certain exceptions, the most broadly available of which is discussed below.

### **WITHHOLDING TAX COST**

Canadian withholding tax is a very important commercial issue in connection with indebtedness between a Canadian resident borrower and a non-resident lender. It may represent a very significant cost that will make a transaction uneconomic for either the Canadian borrower (Canco) or the non-resident lender (the NR). As a condition of making a loan, the NR typically requires that it will receive interest without a deduction of withholding taxes. Any Canadian withholding tax may add a non-recoverable expense because the NR may not, for a variety of reasons, fully claim the Canadian withholding tax as a foreign tax credit. Accordingly, if withholding taxes are or may be applicable, the NR will likely require that Canco make an additional payment

representing the withholding tax liability. This is typically structured as a gross-up requirement and an indemnity to protect the NR. If an exemption from withholding tax will be relied on, often a high level of comfort (such as a "will" opinion or an advance tax ruling) is required by the NR and Canco.

### **EXEMPTIONS FROM NON-RESIDENT WITHHOLDING TAX ON INTEREST UNDER THE ACT**

There are a limited number of exemptions in the Act for non-resident withholding tax on interest. Several OECD member countries provide exemptions from withholding tax in respect of certain corporate debt. In order to improve access to international capital markets and to reduce financing costs, the Canadian federal government introduced a withholding tax exemption for long and medium term corporate debt effective after June 23, 1975. Subparagraph 212(1)(b)(vii) of the Act (or the "5/25 exemption" as it has become known) was enacted and has been amended on numerous occasions.

This exemption contains numerous requirements which must be satisfied in order to qualify for the exemption. Because of the importance of the exemption, tax advisors have frequently sought the advice of the Canada Revenue Agency (the CRA) or advance income tax rulings from the CRA. Consequently, there has developed a large body of CRA administrative policy with respect to the interpretation of the exemption.

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