



BDO Seidman, LLP
Accountants and Consultants

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Subject:

Canadian Withholding on Arm's Length Interest

International Tax Alert

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Issue

The elimination of Canada's withholding on interest payments between unrelated parties is expected to be accelerated to January 1, 2008.

Affecting

This acceleration potentially affects taxpayers with cross-border lending transactions into Canada.

Details

The Canadian Minister of Finance introduced to the House of Commons a motion to eliminate withholding on interest paid to unrelated lenders. If approved by Parliament, the elimination on withholding on interest would be effective as of January 1, 2008. It is anticipated that the elimination of withholding will no longer be determined by the timing of the ratification of the new U.S.-Canadian Tax Treaty Protocol.

Canadian Withholding on the Interest of Unrelated Loans

Under Part XIII of the Canadian Income Tax Act ("the ITA"), unless an exemption applies, interest paid or deemed paid by a Canadian resident to a non-resident lender is subject to withholding tax. The withholding rate set by Part XIII is 25% on interest payments paid to a non-resident lender. This withholding tax may be reduced by a bilateral tax treaty. The U.S.-Canadian Income Tax Treaty generally reduces the withholding rate to 10% under Article 11. Additionally, under the ITA, there is a "5/25" exemption from withholding tax available to interest paid on loans into Canada that do not mandate repayment of more than 25% of the principal within the first 5 years.

The motion would introduce a new exemption from withholding applicable to interest payments. To qualify for the new exemption, interest payment must be made by a Canadian resident to an unrelated non-resident lender. Without the exemption, such loans may only be exempted from withholding if they satisfy the "5/25" exemption. The

motion does not affect withholding on any other type of cross-border payments, such as rent, royalties, and dividends.

U.S. Planning

An elimination of withholding would allow for greater flexibility in U.S.-Canadian tax structuring. The motion would also free lenders of traditional restrictions commonly imposed on term loans, enabling greater flexibility with both new and existing contract terms.

Taxpayers considering loans into Canada should consider the revised timing of the withholding elimination in connection with any cross-border planning.

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