

Withholding Tax on Interest— Welcome Changes for 2008 and Beyond

Withholding tax on interest paid or credited on debts owing to non-residents may be reduced, and in many cases eliminated, as a result of:

- Bill C-28, *Budget and Economic Statement Interpretation Act, 2007*¹; and
- the Fifth Protocol to amend the *Canada-United States Tax Convention* (the Treaty).

Some experts believe that the changes will lower borrowing costs for Canadian companies by increasing the supply of lenders and reducing administrative burdens.

New Domestic Tax Legislation

Before Bill C-28, a Canadian payer was required to withhold and remit tax of 25% of any interest paid or credited (or deemed paid or credited) to a non-resident, subject to certain exceptions for so-called 5-year debt, and a reduced tax rate available under an applicable income tax treaty (usually between 10% and 15%). Bill C-28, which received royal assent on December 14, 2007, eliminates withholding tax on interest paid or credited after December 31, 2007, to a non-resident lender with whom the payer deals at arm's-length (e.g., a foreign financial institution), except on "participating debt interest" as defined in the *Income Tax Act*.

In other words, under domestic legislation, withholding tax still applies to interest payments made to a related non-resident lender, even if the commercial terms of the loan agreement (including the interest rate) are based on arm's-length principles that satisfy Canadian transfer pricing rules.

The Protocol

The Fifth Protocol was signed by Canada and the United States on September 21, 2007, and is expected to be ratified in 2008. The Treaty currently reduces the tax rate on cross-border interest payments to residents of the other country to 10%. If those payments are to related parties, the Fifth Protocol proposes to reduce and eventually eliminate withholding tax, with certain exceptions, such as "contingent interest" arising in the United States and "participating interest" arising in Canada. (The Protocol would also eliminate withholding tax on payments to unrelated lenders; however, because Bill C-28 has amended domestic law for payments made to arm's-length non-residents, this change is not addressed in this *Tax Memo*.)

Under the Protocol, tax on interest paid or credited to related lenders will be eliminated over three years, as follows:

- the 10% withholding tax rate will be reduced to 7% for the portion of the calendar year between the date the exemption becomes effective and the end of the year;
- the 7% rate will be reduced to 4% for the immediately following calendar year; and
- tax will be eliminated for subsequent calendar years.

1. The full title is: *An Act to implement certain provisions of the budget tabled in Parliament on March 19, 2007 and to implement certain provisions of the economic statement tabled in Parliament on October 30, 2007.*

The rate reduction will become effective for amounts paid or credited on or after the first day of the second month after the Protocol is ratified. For example, if ratification occurs in July 2008, amounts paid or credited to related persons on or after September 1, 2008, will be subject to the reduced rate of withholding tax of 7%. The rate reduction may become effective sooner, because the Canadian Department of Finance has indicated that, if the Protocol is ratified in 2008, the first reduction would apply retroactively to amounts paid or credited after December 31, 2007.

Until the Protocol is ratified, it is uncertain when the lower rates will be effective. Accordingly, Canadian taxpayers are advised to continue to withhold 10% on interest paid or credited to related U.S. lenders. A refund will be available if the reductions are applied retroactively and the proper administrative steps are taken.

Loan agreements with related U.S. companies should be reviewed and consideration given to delay the payment of interest until after the Protocol is ratified.

For Help

To discuss the effect of these changes on your particular situation or other non-resident tax issues, please contact your PricewaterhouseCoopers adviser or any of the following individuals.

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