

## OWNERSHIP STRUCTURES FOR NON-CANADIAN Investors in Canadian Real Estate

JEFFREY TROSSMAN



Jeffrey Trossman  
Tel: 416.863.4290  
E-mail: jeffrey.trossman@blakes.com

A non-Canadian investor's after tax return from an investment in Canadian real estate will depend vitally on the legal structure through which the real estate is acquired and held. This article summarizes some of the tax considerations arising with alternative structures.

### FACTORS TO CONSIDER

The appropriate structure will vary from case to case depending upon several factors, including:

- Status of the non-Canadian investor. In particular, some U.S. tax exempt entities can benefit from specific exemptions in the Canada-U.S. Tax Treaty. Different considerations arise for investors that are organized as limited liability companies (LLCs), and for taxable investors.
- Nature of the real property investment. The Canadian tax system draws a fundamental distinction between assets held as long-term investments (i.e., capital assets) and trading assets. A lower capital gains rate applies to dispositions of capital assets. Also, an important distinction is drawn between "business income" and "property income".
- Province in which the real property is located. In recent years, the disparity in provincial tax rates has grown, as some provinces, notably Alberta, have reduced corporate tax rates significantly,

while others have either not reduced rates, or made more modest reductions. This disparity may affect tax planning as it relates to real estate investments.

### ALTERNATIVE LEGAL STRUCTURES

The most common legal structures used by non-Canadian investors in Canadian real estate are trusts and corporations. Each of these is discussed below.

**TRUST.** An increasingly common legal structure for investment in Canadian real estate is the trust.

**NON-CANADIAN TRUST.** In particular, a U.S. or other non-Canadian investor will frequently decide to utilize a U.S. "grantor trust" (or offshore trust) as the vehicle through which an investment in Canadian real estate is made.

Generally speaking, where the investor has acquired a Canadian rental property, the overall income tax rate on rental income will be minimized by using such a trust, even if no other tax planning is done. This is illustrated in the chart at the end of this article.

Furthermore, under current federal and provincial tax laws, trusts are not subject to the capital taxes which are generally imposed on corporations.

Another advantage of a trust is that the "thin capitalization" rules in the Canadian *Income Tax Act* do not apply to trusts. These rules generally restrict the deductibility of interest on certain related party cross-border debt incurred by corporations unless a specific debt-to-equity test is met. As this rule does not apply to trusts, it is generally possible to capitalize trusts with a greater percentage of debt than would be permitted with a corporation.

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## Ownership Structures for Non-Canadian Investors in Canadian Real Estate

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The tax treatment of a non-Canadian trust holding Canadian real estate will depend to some extent on whether the income is classified as "business income" or "property income". The Canada Revenue Agency (CRA) will look to a number of criteria to determine whether income from a rental operation should be classified as business income or property income. In general, many factors are considered, including the extent of the services provided to tenants. If a building is rented *en bloc* with the landlord providing only basic maintenance of the building, heat and air conditioning, income from the rental operation is considered property income. The facts of each case must be considered to determine the appropriate classification of rental income.

Where rental income is classified as property income, this will generally result in a lower tax rate. Furthermore, interest on properly structured related party cross-border debt of the trust will not be subject to Canadian withholding taxes. In appropriate cases, relatively high leverage ratios will enable the owner to significantly reduce the effective tax rate.

However, it is also important to note that the Canadian tax rules do not permit any carry forward or carry back of losses incurred by a non-Canadian trust earning property income.

If a non-Canadian trust is used, there will be some additional compliance burdens to consider. First, unless a discretionary waiver is obtained from the Canadian tax authorities, tenants are technically required to withhold 25% of each gross rental payment and remit that amount to the Canadian tax authorities on account of the tax liability of the non-Canadian trust. There is an election that can be made to be taxed on a net rather than gross basis which will mitigate this withholding, though it will be difficult to entirely avoid it if the trust is earning property income. Furthermore, at the time of sale, the trust will have to apply to the CRA for a "section 116 certificate". Without such a certificate, the purchaser will withhold 25% of the purchase price on account of the trust's capital gains tax liability. The process of obtaining such a certificate can be managed, but in recent years, it is typical to find that the CRA is backlogged with these applications, and therefore a long lead time is recommended.

Finally, with a non-Canadian trust, it is important to ensure that all mortgage debt is held by Canadian lenders. The "5-

year" debt exception usually relied upon to avoid Canadian withholding tax on such debt applies only to corporate borrowers, and not to trusts.

### CANADIAN DOMESTIC TRUST

In some cases, a Canadian domestic trust has been used by foreign investors to acquire and hold Canadian real property. Generally speaking, the overall tax rate will be higher than that applicable to a non-Canadian trust. However, such a trust will not be subject to capital taxes or the "thin capitalization" rules. In certain circumstances, a tax exempt investor may be able to achieve a reduced overall tax rate by using a domestic trust by taking advantage of specific exemptions contained in a tax treaty, such as Article XXI of the Canada-U.S. Tax Treaty.

In all cases involving the use of trusts, it is quite important to obtain Canadian tax advice at the outset. Every situation is different. Furthermore, the Canadian tax system is extremely form-driven, and, as a consequence, the tax results in any case can be particularly sensitive to the wording of the relevant legal documents.

### CORPORATION

Despite the recent popularity of trusts, it is still quite common to see corporations as the vehicle of choice for foreign investors in Canadian real estate. Corporations are well known and well understood by most investors. They offer the most comprehensive and reliable form of limited liability, which is often an overriding concern.

The overall tax rate applicable to an investor who uses a corporation to invest in Canadian real estate will typically be higher than that applicable to an investor who uses a trust. In addition, as noted above, the corporation will typically be subject to federal and applicable provincial capital taxes, although in many markets these can be passed on to tenants in the form of additional rent. Furthermore, the "thin capitalization" rules will effectively require that the corporation be capitalized in a manner that respects the specific debt-to-equity ratio set out in the Canadian *Income Tax Act*. It is to be noted however that these rules do not apply to bank debt and other loans from unrelated parties.

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It is typical for an investor to utilize a Canadian domestic corporation. A Canadian domestic corporation will be less onerous than a non-Canadian trust from a compliance perspective. Tenants will not be required to withhold from their rental payments. On a future exit, the purchaser will not withhold tax from the purchase price, and there will be no need to obtain a "section 116" certificate from the Canadian tax authorities.

A U.S. investor may find it advantageous to use a Canadian "unlimited liability company" (ULC) formed under the laws of Nova Scotia or Alberta. A ULC is a "hybrid" entity – it is treated as a corporation for Canadian tax purposes, but is usually fiscally transparent for U.S. tax purposes (in other words, it is treated as either a partnership or a disregarded entity for U.S. tax purposes). By using a ULC to hold Canadian real estate, a U.S. investor may be able to reduce its overall effective tax rate.

## LIMITED PARTNERSHIP

The trust or corporate structure can often be combined with a limited partnership. This is most commonly used in a joint venture situation.

If the current owner of the property intends to retain an interest, such owner will typically request that a limited partnership be used so that the property can be contributed into the limited partnership on a tax deferred basis. It is important to note that the Canadian tax rules permit such a tax deferred transfer only where all of the participants in the limited partnership (including any non-resident investors) have participated through a Canadian resident vehicle (such as a domestic trust or a domestic corporation). In many cases, this will effectively limit the choice of vehicles available to a non-Canadian investor.

It is also important to note that Canada currently takes a different view of LLCs than does the U.S. In particular, while LLCs are generally characterized as partnerships for U.S. tax purposes, they are treated as corporations for Canadian tax purposes. Furthermore, the Canadian tax authorities take the view that no treaty benefits are available to an LLC. This will be the case even where all of the members of the LLC are U.S. taxable corporations or individuals. This anomaly very frequently leads to a need for advance tax planning to avoid later problems.

## CONCLUSION

A non-Canadian investor's after tax return from an investment in Canadian real estate can depend vitally on the legal structure used. Many factors will need to be considered in order to determine the appropriate structure in a given case. Furthermore, the Canadian tax rules tend not to remain static, and therefore structures that might have been optimal many years ago can sometimes be supplanted by newer structures that adapt to and take advantage of changes in the tax environment.

Attached is simplified chart illustrating 2005 tax rates for an investment in Canadian real estate situated in the Province of Ontario. These rates are illustrative only, and are generally based on the most conservative assumptions. They also assume that the owner has done no tax planning to reduce the effective tax rate.

As indicated in this article, many factors and tax planning opportunities will arise in each particular case, and these will ultimately determine the overall effective tax rate.

Summary of Tax Rates for an Investment in Ontario Rental Property - 2005 <sup>1</sup>				
	U.S. Grantor Trust	Ontario Trust	U.S. LLC	Ontario Corporation
Rental Income classified as Property Income	42.9%	52.0%	46.5%	52.4%
Rental Income classified as Business Income	46.4%	52.0%	52.4%	52.4%
Capital Gain on Sale	21.5%	26.0%	23.2%	38.7%

<sup>1</sup> Assumes that all after-tax amounts are distributed and no tax planning such as internal debt financing to reduce effective rate. Also assumes the investor has no treaty protection (e.g., LLC). Rates vary by province and from year to year.



Kathleen Penny

Tel: 416.863.3898 E-mail: kathleen.penny@blakes.com

Kenneth Snider

Tel: 416.863.5844 E-mail: kenneth.snider@blakes.com

# CROSS-BORDER DEBT FINANCING OF CANADIAN REAL ESTATE – THE 5/25 EXEMPTION FROM WITHHOLDING TAX

KATHLEEN PENNY AND KENNETH SNIDER

Foreign lenders and capital markets have provided sources of capital for Canadian real estate financing at interest rates and on other terms that are not otherwise available from Canadian lenders and investors.

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 to a non-resident as, on account or in lieu of payment of, or in satisfaction of interest. The same Canadian withholding tax applies if a non-resident of Canada pays interest on debt secured by Canadian real estate and the interest is deductible in computing net income subject to tax under the Act. 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 to a non-resident lender secured by Canadian real estate. It may represent a very significant cost that will make a transaction uneconomic for either the borrower (Realco) or the non-resident lender (NR). As a condition of making a loan, 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 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, NR will likely require that Realco make an additional payment representing the withholding tax liability. This is typically structured as a gross-up requirement and an indemnity to protect 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 NR and Realco.

## 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. 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.

## STATUS OF REALCO

The provision states that for the 5/25 exemption to apply the interest must be payable by a corporation resident in Canada. The CRA has confirmed that the exemption is available to a non-Canadian corporation that is deemed to be resident in Canada with respect to payments of interest, for example in the case of debt secured by Canadian real estate where the interest is deductible in computing net income of the borrower corporation that is subject to Canadian income tax. Also, the CRA has stated that interest paid to NR under an obligation that otherwise satisfied the requirements is not disqualified from the exemption simply because the borrower is a partnership, all the members of which are corporations resident, or deemed by the Act to be resident, in Canada.

## BACK-TO-BACK LOANS

The requirement that Realco be a corporation or partnership of corporations is a major restriction, precluding the exemption where the borrower from NR is a trust (including a REIT), an individual or a partnership with non-corporate partners. Several recent tax rulings released by the CRA have ruled favourably on back-to-back loan situations, in which NR lends to a corporation, and the corporation on-lends to the non-corporate borrower on virtually the same terms. These include an important ruling that the Canadian general anti-avoidance rule will not be applied to deny the exemption. In each case, the taxpayers had to convince the CRA that there were commercial reasons why the loan transaction was structured in this manner, including reasons why the indirect borrower benefited from access to foreign capital.

The indirect borrowers that have obtained such rulings from the CRA to date include several limited partnerships (the cross-border loan was made to the corporate general partner, and it on-loaned to the limited partnership), a securitization trust sponsored by a Canadian corporation (which formed a new Canadian corporation to borrow cross-border and on-lend to the trust) and, most recently, a partnership of which the main

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partner was a business trust owned by a public income fund (the business trust incorporated a wholly-owned subsidiary corporation to borrow cross-border and on-lend to the partnership).

There has not yet been a ruling on a back-to-back loan involving a REIT. The recently announced "moratorium" on the issuance of advance income tax rulings to flow-through entities may temporarily preclude any partnership or trust from obtaining a ruling on any type of tax issue. At the present time, CRA is imposing the moratorium very broadly, including to rulings related to the financing of flow-through entities.

### STATUS OF LENDER

There is no requirement as to the legal personality or status of the lender or the lender's residency.

### ARM'S LENGTH RELATIONSHIP

The interest must be payable to a person dealing at arm's length with Realco. If Realco is a partnership, NR must deal at arm's length with each member of the partnership. Persons who are related for purposes of the Act are deemed not to be dealing at arm's length, and otherwise it is a question of fact whether persons are dealing at arm's length.

### INTEREST PAYABLE

The 5/25 exemption is available for "interest payable by a corporation resident in Canada". Therefore, an amount that is payable in lieu of interest, which is not in fact interest and is not deemed by the Act to be interest, may be subject to withholding tax yet will not qualify for the exemption. Similarly, interest which is paid or credited but which is not "payable" will not qualify for the exemption. An amount becomes payable only if the taxpayer has an unconditional legal liability to pay and the amount of the liability is certain. The CRA takes the position that "payable" means accrued and owing and therefore prepaid interest is not eligible for the exemption.

An amount that is deemed by the Act to be a payment of interest will qualify for the exemption if the related debt qualifies. Examples include certain standby or commitment fees, guarantee fees and original issue discount.

### TERMS OF REPAYMENT – THE 5/25 REQUIREMENT

Paragraph 212(1)(b)(vii) of the Act requires that under the terms of the obligation or any agreement relating thereto, the borrower may not under any circumstances, subject to the exceptions discussed below, be obligated to pay more than 25% of the principal amount of the obligation, within five years from the date of issue, subject to the exceptions discussed below. Consequently, interest on a demand loan will not qualify for the exemption. Similarly, revolving loan facilities generally do not qualify for the exemption.

An obligation which otherwise qualifies for the exemption is not disqualified because Realco has discretion to voluntarily prepay more than 25% of the principal amount within five years of the date of issue.

NR and Realco must be certain as to when the five-year period commences. This period commences when the loan is advanced and not when the loan documentation is signed. If the loan contemplates multiple advances, compliance with the 5/25 requirement is normally achieved by ensuring that the loan matures no earlier than five years from the date of the last advance. While the wording of the exemption likely requires the maturity date of the loan to be greater than five years from the date of advance, the CRA has accepted a maturity date of exactly five years from the date of advance.

The CRA has confirmed that for a loan denominated in non-Canadian currency, the 5/25 requirement can be tested in that currency, so that foreign exchange fluctuations would not by themselves result in loss of the exemption provided that required repayments are expressed in that same currency.

Special issues in connection with the 5/25 requirement can arise in connection with cash reserve or deposit accounts that the lender requires the borrower to establish. The CRA's view is that an obligation to repay more than 25% of a loan may exist if the borrower is required to irrevocably place more than 25% of the principal amount with an independent trustee or third party, notwithstanding any limitations on the lender's ability to access these funds before a defined event of default.

A requirement for temporary cash collateral, for example during a period of low cash flow, does not appear to violate this rule, as long as there are reasonable prospects that the funds will be released to the borrower, and the funds are not expected to be

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tied up long enough to create an "economic compulsion" to prepay. Similarly, subject to the same caveats, reasonable cash reserves for the purpose of funding insurance premiums, real property taxes, tenant inducements, capital expenditures and the like are normally acceptable. With the possible exception of cash reserves to pay insurance premiums and taxes, the funds would have to be held by a third party, e.g., in a blocked bank account of a bank unrelated to the lender, not by the lender.

### EXCEPTIONS FROM THE 5/25 REQUIREMENT

There are certain circumstances in which Realco may be obligated to pay more than 25% within five years, without loss of the exemption. The permitted circumstances for payment of more than 25% within the first five years are:

- (i) in the event of a failure or default under the terms of the agreement;
- (ii) if the terms of the obligation or any agreement relating thereto become unlawful or are changed by virtue of legislation or by a court, statutory board or commission;
- (iii) if the person exercises the right under the terms of the obligation or any agreement relating thereto to convert the obligation into, or exchange the obligation for, a "prescribed security", or
- (iv) in the event of the death of the lender.

### EVENTS OF FAILURE OR DEFAULT

The question of what is a permissible event of failure or default for the purpose of the 5/25 exemption has been the subject of considerable analysis by tax advisors and the CRA. Any condition which would require repayment of the principal of the debt is not necessarily viewed as a permissible event of failure or default for purposes of the exemption. Defining the events of default, the occurrence of which would require immediate payment of the principal of the debt, is a vitally important commercial issue, and there may be tension between what may be viewed as commercially reasonable and what is needed to qualify for the exemption. In some instances, there will be a conflict between the commercial objectives and the objective that the interest qualify for the exemption. The expression "event of a failure or default" in subparagraph 212(1)(b)(vii) has not been judicially considered. Accordingly, the administrative policies of the CRA in respect of what it considers a permissible event of default provide very important guidance to taxpayers.

The CRA has published many statements regarding what it considers to be an acceptable event of default. Any particular event of default must be examined carefully. The CRA's view is that in order to be acceptable for purposes of paragraph 212(1)(b)(vii), an event of failure or default must (i) have commercial reality; (ii) be beyond the control of the lender; and (iii) not be contrived.

Other relevant positions of the CRA include the following:

- Cross-default provisions may be acceptable if the default of the other party impairs the security for the obligation and the lender does not have discretion to trigger the default.
- Events that are the consequence of an act by persons not party to the agreement, such as governments, regulatory bodies, or courts, who are under no obligation pursuant to the agreement, cannot generally be considered "failure or default under the ... terms of agreement." For example, a change in internationally recognized interest rates or commodity prices is not, in and by itself, an event that is a "failure or default under the ... terms of agreement."
- In this context, the expression "terms of agreement" can be interpreted to mean "terms of the obligation or any agreement relating thereto".

Thus, in analyzing cross-default provisions, if the default is by a person other than Realco which affects the security Realco has provided or Realco's creditworthiness, such a default should constitute an acceptable event of default of Realco. Defaults of material subsidiaries having this effect will generally be regarded as permissible events of default. Similarly, a default by the guarantor of Realco's debt and its material subsidiaries should also be generally acceptable. Defaults or acts of the parent (if not a guarantor) may not be acceptable events of default of Realco unless it is clear that they affect Realco's creditworthiness or security.

NRs often require that they be entitled to accelerate the repayment of a debt in the event of a change of control of Realco because control of Realco may be a very important credit risk factor. Fortunately, the CRA has adopted the position that where a loan agreement states that a change of control of the borrower is an event of default, such event is generally considered a permitted event of default. Caution should be exercised in determining whether the particular change of control clause is

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acceptable in the circumstances. For example, the CRA has accepted clauses designed to identify changes in voting control or changes in the ability to appoint the board of directors.

It is often desirable to draft a change of control provision so as to avoid triggering cross defaults. To accomplish this in a manner that satisfies the requirements of the withholding tax exemption, the loan agreement will typically provide that a change of control is not, of itself, an event of default. Instead, the change of control would initiate a "triggering event" whereby Realco would be obligated to offer to prepay the loan. Failure to make the offer to prepay would constitute an event of default, which would trigger repayment. The CRA has accepted this as a valid mechanism. Other "triggering events" have been accepted by the CRA, such as a material asset sale and a failure to maintain a minimum level of EBITDA.

The policy of the CRA concerning events of failure or default has continued to evolve. One contentious issue is whether a "material adverse change" is an acceptable default. If the determination of whether such a change has occurred is stated to be in the opinion of the lender, the CRA's view is that this gives the lender an unacceptable level of control over whether the debt will become due, and makes the 5/25 exemption unavailable. The more objectively and precisely the clause is worded, the more likely it is to be acceptable to the CRA.

### EXCLUDED INTEREST

Where all or any interest payable on an obligation is contingent or dependent upon the use or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or by any other similar criterion or by reference to dividends paid or payable to shareholders of any shares of a corporation, the interest is deemed not to be interest for the purpose of the exemption. Consequently, all the interest payable under a "participating" real estate loan will not qualify for the 5/25 exemption.

The question has arisen whether the timing of interest payments is dependent on the criteria referred to above and would disqualify the interest for the exemption. The CRA has confirmed that where interest amounts are fixed and payable pursuant to a legal obligation to pay interest at a fixed rate, the fact that the timing of the interest payments is variable will not prevent the

exemption from applying. All unpaid interest should be due no later than the due date of the obligation.

### CHANGES IN TERMS OF DEBT OBLIGATIONS AND NOVATION

The terms of debt obligations are often amended, either because such amendments are contemplated by the loan documentation or Realco requires an accommodation. Where the changes to the debt are significant, the CRA may take the position that there has been a disposition of the debt obligation in consideration of a new debt obligation. The administrative views of the CRA in respect of changes in terms of a debt obligation that result in a disposition are very contentious. Any amendment to the terms of a debt, the interest on which qualifies for the exemption, should be carefully reviewed. Also, some instances there may be a novation of the debt obligation resulting in the termination of the old debt and the creation of a new debt. A novation will arise when the debt is being assumed and the lenders provide a release to the original borrower. The Act does, however, contain a saving provision where a corporation in financial difficulty issues a new debt (a "replacement obligation") in exchange or substitution for an obligation that meets the 5/25 exemption. In certain cases, the replacement obligation will be deemed to have been issued on the date the original obligation was issued, thus preserving the 5/25 exemption (if the replacement debt otherwise satisfies its requirements).

If there has been a disposition of the debt obligation and the issuance of a new debt obligation as a result of significant amendments or a novation, consideration must be given to whether interest on the "new" debt obligation qualifies for the exemption. For instance, if there was such a disposition and issuance, the exemption would not apply if the term of the "new" loan did not comply with the 5/25 requirement discussed above. A recent case illustrates the importance of this point. In *General Electric Capital Equipment Finance Inc. v. The Queen*, the Court considered whether the 5/25 exemption was available after a series of amendments to certain notes. The Court stated that the fundamental terms of the particular notes were the identity of the debtor, the principal amount, the interest rate and the maturity date. All but one of these (the principal amount) had been changed. The result was that, in view of the Court, the terms of the notes were so materially altered that a new obligation was created. The new obligation did not meet the requirements of the 5/25 exemption.



Joel Shafer  
Tel: 416.863.2944  
E-mail: joel.shafer@blakes.com

# DISPOSITIONS BY NON-RESIDENTS OF CANADIAN REAL PROPERTY – TAXATION & COMPLIANCE REQUIREMENTS

JOEL SHAFER

## DOMESTIC TAX RULES

A non-resident is liable to tax in Canada on income from a variety of domestic sources. Included among these is income from a business carried on in Canada and taxable capital gains from the disposition of “taxable Canadian properties” other than “treaty-protected properties”. Taxable Canadian property includes, among other assets, real or immovable property situated in Canada, property used or held by the taxpayer in a business carried on in Canada and a share of the capital stock of a corporation resident in Canada that is not listed on a prescribed stock exchange. Also included in the definition is a share of the capital stock of a non-resident corporation (not listed on a prescribed stock exchange) if at any time during the preceding five-year period the fair market value of the taxable Canadian property owned by it is greater than 50% of the fair market value of all of its properties and more than 50% of the fair market value of the share is derived directly or indirectly from a combination of assets including real or immovable property situated in Canada.

## TREATY-PROTECTED PROPERTIES

The OECD Model Convention contemplates that gains derived by a resident of a contracting state from the alienation of immovable property situated in the other contracting state may be taxed in the latter jurisdiction. Similarly, gains derived by a resident of a contracting state from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other contracting state may also be taxed in the latter state. Gains from the alienation of any property other than that specifically referred to is taxable only in the state of which the taxpayer is a resident.

Canada has entered into a broad network of bilateral tax conventions that generally follow the OECD Model Convention and that may protect a non-resident from Canadian tax on capital gains that would otherwise be taxable under domestic legislation. The most obvious situation in which treaty protection would be available is a disposition by a resident of a treaty jurisdiction of shares of a Canadian corporation that do not derive more than 50% of their value directly or indirectly from immovable property situated in Canada. Some, but not

all, of the tax treaties to which Canada is a signatory go further than the OECD Model Convention and define immovable property for purposes of treaty protection so as not to include, in determining whether the shares of a corporation derive more than 50% of their value from real property situated in Canada, real property (other than rental property) in which the business of the company is carried on. For example, this extended exemption is to be found in Canada’s tax convention with the United Kingdom but, as of yet, is not included in the convention with the United States.

## COMPLIANCE REQUIREMENTS

In order to ensure collection of tax owing, a non-resident who disposes of most types of taxable Canadian property (the prime exception being shares listed on a prescribed stock exchange) is required to apply for and obtain a tax clearance certificate. This requirement to complete the tax clearance process is imposed whether or not there is a gain from the disposition and whether or not a treaty exemption applies.

The necessary documentation must be filed by the vendor with the Canada Revenue Agency (CRA) prior to or within 10 days immediately following the disposition and must set out details of the transaction including the identification of the parties, a description of the property, the anticipated proceeds of sale, a computation of the resultant gain or loss and a statement as to whether the transaction is at arm’s length or between related parties. The CRA will, after processing the notice, determine the amount of tax, if any, that is payable and negotiate appropriate arrangements for payment of tax or the posting of security. It will then issue a certificate indicating the disclosed proceeds of sale (in the case of a notice filed prior to disposition) or a statement that all tax owing has been paid (in the case of a notice filed post closing).

To enforce this requirement, the purchaser is obligated to obtain from the vendor a copy of the certificate issued by CRA confirming that the appropriate notification procedure has been completed and setting forth the maximum price that may be paid by the purchaser without any withholding requirement (or, where the notification has been filed after the date of disposition, confirming that no amount need be withheld from the purchase price).

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The purchaser is authorized and required to withhold from the consideration paid to the vendor an amount equal to 25% (or 50% in the case of depreciable and certain other property) of the amount by which the purchase price exceeds the limit set out in the CRA certificate. If no certificate has been provided at closing, the purchaser is required to withhold 25% (or 50% as applicable) of the purchase price. Any amount that has been so withheld must be remitted to CRA by the 30th day of the month following the month in which the closing occurs.

If the purchaser disregards these requirements and fails to withhold as set out above, the purchaser is itself liable to pay an amount equal to what it ought to have withheld. Any amount withheld by the purchaser, or paid by it as a consequence of its failure to require production of the appropriate clearance certificate, is credited to the vendor on account of any tax for which it may be liable. The vendor may, upon filing a tax return, claim a refund of any excess of the amount paid on account over its actual tax liability. The purchaser is entitled to recover from the vendor any amount it has been required to pay as a consequence of failure to comply with the procedures described above, but enforcement of this right may be a difficult matter.

Where no certificate is available at closing, or where the certificate indicates a purchase price less than the amount actually payable by the purchaser, the necessary deduction from the proceeds of sale will typically be held in escrow until the date on which it must be remitted to CRA. This raises the issues of identifying the appropriate escrow agent and negotiating the terms of an escrow agreement describing the circumstances in which the funds may be dispersed and to whom.

In the event an amount has been withheld and no certificate is available by the date on which the funds must otherwise be remitted to CRA, it may be possible to obtain a "comfort letter" from CRA confirming that remittance may be delayed without penalties until the tax clearance procedure has been completed. While there does not appear to be a legislative basis for relying on such a comfort letter, it is common practice to do so.

### TAX RETURN

Where there has been a disposition of taxable Canadian property, the vendor is required to file a return of income for the year in which the disposition occurs and report the results of the transaction whether or not tax is payable.



Kenneth Snider  
Tel: 416.863.5844  
E-mail: kenneth.snider@blakes.com

## U.S. TAX-EXEMPT ORGANIZATIONS INVESTING IN CANADIAN REAL ESTATE

KENNETH SNIDER

U.S. tax-exempt organizations considering a potential debt or equity investment in respect of Canadian real estate should focus at an early stage on Canadian tax planning.

The investment may take a variety of forms, including 100% equity ownership, participating as a minority or majority joint venture partner, or a mortgage loan. The transaction will fundamentally affect the planning. Structuring the investment to take advantage of Article XXI of the Canada U.S. Tax Convention (the Convention) will be a fundamental objective.

A few preliminary points should be borne in mind. A non-resident of Canada is taxable on income from carrying on business in Canada and on capital gains from the disposition of "taxable Canadian property" under Part I of the *Income Tax Act* (the Act) subject to the application of a tax treaty. Taxable Canadian property is broadly defined and includes real property situated in Canada; a share of the capital stock of a corporation resident in Canada that is not listed on a prescribed stock exchange; a share that is listed on a prescribed stock exchange if certain ownership tests are satisfied, and interests in certain partnerships and trusts that own taxable Canadian property.

Consequently, if rental income earned by a non-resident was considered income from carrying on a business in Canada it would be taxable under Part I. The Convention, like other of Canada's tax treaties, does not provide any general relief from tax on income and gains from real estate. In contrast to Part I, certain amounts paid or credited to a non-resident including rent (that is considered income from property and not income from business), dividends and interest are subject to withholding tax at the rate of 25%, subject to possible reduction or exemption under the Convention. There is an election that can be made by the non-resident to be taxed on a net basis in respect of rental income at the applicable rate in Part I instead of being subject to a withholding tax on the gross rent.

### ARTICLE XXI OF THE CONVENTION

There are two different exemptions from tax under the Act in Article XXI of relevance to U.S. tax-exempt organizations. First, income derived by a religious, scientific, literary, educational or charitable organization shall be exempt from tax in Canada if it is resident in the U.S. for purposes of the Convention but only to the extent that such income is exempt from U.S. tax. Subject to the qualification discussed below, this exemption will apply to taxes payable under Part I and withholding tax under Part XIII of the Act.

Second, subject to the same qualification discussed below, dividends and interest derived by:

- a trust, company, organization or other arrangement that is a resident of the U.S., generally exempt from U.S. income taxation in a taxable year and operated exclusively to administer or provide pension, retirement or employee benefits; or
- a trust, company, organization or other arrangement that is a resident of the U.S., generally exempt from U.S. income taxation in a taxable year and operated exclusively to earn income for the benefit of an organization referred to in subparagraph (a);

shall be exempt from tax under the Act in that taxable year.

Because the second exemption only applies to interest and dividends subject to Part XIII withholding tax, a U.S. pension does not qualify for any income tax relief in respect of operating income, or recapture and capital gains. Consequently, "substituting" interest (subject to the possible application of the thin capitalization rules in the Act) and dividends for these types of returns from real estate will be important in order to take advantage of the exemption.

An important qualification is that the two exemptions in Article XXI shall not apply with respect to the income (a) from carrying on a trade or business or (b) from a "related person" that is not also an exempt organization as discussed below.

### LOOK THROUGH APPROACH FOR PARTNERSHIPS

Where the recipient of interest or dividends is a partnership of the U.S. pension funds or other entities otherwise qualified for the benefits of Article XXI, CRA has confirmed that it will look through the partnership to each member and grant or withhold the exemption based on the member's proportionate interest in the partnership.

### RELATED PERSONS

The restriction in respect of income from a "related person" is very important to consider. The expression is not defined in the Convention for purposes of Article XXI. CRA has considered the meaning of "related person" and whether it has the same meaning as defined under the Act, and whether a similar look-through mentioned above will be applied in determining a member's "related person" status under Article XXI of the Convention.

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## U.S. Tax Exempt Organizations Investing in Canadian Real Estate

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CRA has noted that in accordance with the *Canadian Income Tax Conventions Interpretation Act*, that term has, except to the extent the context otherwise requires, the meaning it has for purposes of the Act. Where a person is a member of a partnership, the CRA will look through to the members in determining whether a particular member is related to the person from which the income is derived and whether Article XXI of the Convention is applied in respect of that member.

As one would expect, the term "related person" is broadly defined in the Act. In summary, the definition turns on a person having legal control of a corporation or the right to acquire control. For instance, a U.S. exempt organization that owned in excess of 50% of the voting shares of a corporation owning Canadian real estate would generally be related to the corporation and would not be entitled to the benefit of Article XXI. There are special considerations in respect of "related persons" and trusts.

### PARTICIPATING DEBT

Participating debt should be considered to deal with reducing taxable income of the entity owning the real estate resulting from increased rents (and decreasing capital cost allowance). The "5/25 exemption" restricts the availability of the withholding tax exemption where interest is linked to a variable participation in the borrower's profits or cash flow. However, the Article XXI exemption should be available in respect of participating interest provided that the payment falls within the definition of "interest" in the Convention. Article XI(4) of the Convention provides as follows:

"The term 'interest' as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage, and *whether or not carrying a right to participate in the debtor's profits ...* as well as income assimilated to income from money lent by the taxation laws of the Contracting State in which the income arises ..." [*Italics added*]

With proper crafting of the participating loan instrument, it is possible to design an instrument whose payments qualify both as deductible interest under the Act (subject to the possible application of the thin capitalization rules in the Act) to the payor and interest eligible for the benefits under Article XXI.

### COMPLIANCE CONSIDERATIONS

The Act imposes a withholding and remittance obligation on the Canadian resident in respect of certain amounts paid or credited to a non-resident regardless of a treaty exemption. As an administrative matter, the Article XXI exemption cannot override the payor's withholding obligations under Part XIII of the Act. Information Circular IC 77-16R4 authorizes Canadian payors to rely upon the CRA's published list of treaty exempt investors under Article XXI. In order for the payor to avoid liability for tax, penalties and interest for failure to withhold and remit tax in respect of payments to an organization described in Article XXI(1) and (2), the payor should withhold unless the organization is listed. Tax exempts would also want to avoid being subject to withholding by not being listed and applying for a refund. Paragraph 78 of Information Circular IC 77-16R4 describes the application process for tax exempts to be listed in CRA's annual publication of exempt U.S. organizations.

With respect to nominees that hold the security, CRA has stated that in the case of a security held in the name of a nominee (including an approved special nominee) for an organization or trust to which a letter of exemption under Article XXI is issued, the Canadian payor is obliged to withhold tax from any payment on the security unless CRA has provided the payor with written authorization to refrain from doing so for payments on the specific security (i.e., name of issuer, serial number, denomination and date of issue of the share or bond certificate) in question. Reference should be made to Information Circular IC 77-16R4 for instructions regarding obtaining authorization.

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Kenneth Snider

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