Host Country CANADA

Richard J. Bennett and Daniel J. Palmer
Borden Ladner Gervais LLP, Vancouver, BC

I. Relevant Canadian tax principles

A. General

Canada generally only taxes nonresidents on capital gains realised of dispositions of capital property that is "taxable Canadian property" (TCP) and is not "treaty-protected property" (TPP).[1] Regardless of any ultimate liability for Canadian capital gains tax, a nonresident who disposes of TCP will in many cases be required to apply to the Canada Revenue Agency (CRA) for a clearance certificate (a "§ 116 Certificate"), prepay an amount on account of Canadian capital gains tax to the CRA, and/or file a Canadian income tax return to report the disposition and calculate any actual tax payable (and, if applicable, claim any resulting overpayment of tax) in respect of it. Each of these aspects is discussed in more detail below.

Under Canadian rules, a taxpayer's capital gain realised on the disposition of a capital property is the amount by which the proceeds of disposition of the property exceed its adjusted cost base (ACB) to the taxpayer and reasonable costs of disposition.[2] One half of the gain is then brought into income as a "taxable capital gain"[3] and taxed at normal rates. The Canadian income tax rate is approximately 43 percent for nonresident individuals and 25 percent for nonresident corporations. Since only 50 percent of a capital gain is generally brought into income, this results in an effective tax rate on the full capital gain of 21.5 percent for individuals and 12.5 percent for corporations.

B. Taxable Canadian property

TCP includes a share of the capital stock of a corporation (other than a mutual fund corporation),[4] an interest in a partnership or a capital interest in a trust where, at any particular time in the 60 month period that ends at that time, more than 50 percent of the fair market value of the share or interest is derived directly or indirectly from one or any combination of:

(1) real or immovable property situated in Canada;

(2) "Canadian resource properties;"[5]

(3) "Timber resource properties;"[6] and

(4) options in respect of the property described in (1) to (3).[7]

A share of a corporation that is listed on a "designated stock exchange"[8] will only be TCP of a nonresident if, in addition to the criteria above being met, 25 percent or more of the issued shares of *any* class of the capital stock of the corporation (not necessarily the listed class) were, at any time in the 60 month period, held by one or any combination of the nonresident and persons with whom the nonresident did not deal at arm's length.[9]

C. Treaty-protected property

Property of a nonresident will be TPP if the taxpayer's income or gain from the disposition of the property would be exempt from tax under Part I of the Tax Act under an applicable tax treaty between Canada and another country.[10]

Canada has an extensive network of bilateral tax treaties, all generally based on the OECD Model Convention. These treaties typically limit Canada's right to tax a nonresident's capital gains to gains arising from the disposition of very specific types of capital property — generally Canadian real property, shares or other securities that derive their value primarily from Canadian real property, and personal property that forms part of a Canadian permanent establishment (PE).[11] All other capital properties are generally exempt from Canadian taxation and are therefore TPP. The relevant treaty must be consulted in each case to determine whether a nonresident's TCP is TPP.

D. § 116 Certificates

1. General

§ 116 of the Tax Act contains a set of rules designed to protect the Canadian tax base by requiring most nonresidents who dispose of TCP to report the disposition to the CRA at the time of the disposition and prepay an appropriate amount on account of the nonresident's ultimate Canadian capital gains tax liability, irrespective of any ultimate liability for Canadian capital gains tax.

The rules function by requiring the nonresident to apply to the CRA for a § 116 Certificate in respect of

the disposition either before,[12] or (and in practice much more commonly) within ten days after,[13] the disposition (subject to penalties for late filing).[14] The application must include required information regarding the disposition, including the proceeds of disposition and the nonresident's ACB in the TCP. The CRA will normally issue the § 116 Certificate upon payment of an amount equal to 25 percent of the amount by which the proceeds of disposition of the property exceed the property's ACB.[15] The nonresident can obtain a refund of any overpayment of capital gains tax by filing a Canadian income tax return as discussed below. If the purchaser fails to obtain a copy of the § 116 Certificate from the nonresident, the purchaser can be liable for tax equal to 25 percent of the *price* that the purchaser pays for the property (*not* 25 percent of the gain).[16] Consequently, a properly advised purchaser of TCP from a nonresident will normally require that 25 percent of the purchase price be withheld at closing, to be paid out on delivery of an appropriate § 116 Certificate.

It should be noted that the fiscal residence of the purchaser is irrelevant to the application of the § 116 Certificate rules — i.e., they apply regardless of whether the purchaser is a resident or nonresident of Canada for purposes of the Tax Act.

2. Excluded Property

The § 116 Certificate rules do not apply to TCP that is "excluded property" (EP). While there are several types of EP, two are relevant for present purposes.

First, any share of a corporation that is listed on a "recognized stock exchange" is EP.[17]

Second, EP includes property that is TPP subject to the additional requirement, if the nonresident and the purchaser are "related" for purposes of the Tax Act, that the purchaser sends a notice (a "TPP Notice") to the CRA within 30 days after the disposition setting out required particulars of the disposition and the name of the country with which Canada has the relevant tax treaty.[18]

In many cases, it may not be clear whether the vendor is a resident of the relevant treaty country. In such cases, compliance with the § 116 Certificate rules is not required if the purchaser concludes "after reasonable inquiry" that the nonresident is resident in the foreign jurisdiction under the relevant tax treaty, the property would be TPP if the nonresident were resident in that jurisdiction, and the purchaser sends a TPP Notice to the CRA (the "Reasonable Inquiry Exception").[19] Although the CRA has issued some guidelines on what constitutes reasonable inquiry, given the uncertainty of the term it is not uncommon for purchasers to refuse to rely on it and instead to require the nonresident vendor to obtain a § 116 Certificate.

It should be noted that a nonresident is still liable for Canadian income tax on capital gains arising from the disposition of TCP that is EP; the EP designation only provides relief from the nonresident's filing obligations and the purchaser's liability under § 116, as described above.

E. Canadian income tax returns

Generally, a nonresident who disposes of TCP in a taxation year is required to file a Canadian income tax return for the year to report the disposition. The deadline for filing is generally April 30 of the year following the disposition year for individuals,[20] and June 30 of the year following the disposition year for corporations.[21]

Notwithstanding the general rule, a nonresident individual or corporation will not be required to file a Canadian income tax return solely because of the disposition of TCP if the disposition is an "excluded disposition." A disposition will be excluded if:

- the nonresident was a nonresident at the time of the disposition;
- the nonresident is not liable for any Canadian income tax as a result of the disposition, and has no outstanding liability for Canadian tax in respect of a previous taxation year; and
- the TCP is EP or the nonresident obtained a clearance certificate in respect of the TCP.[22]

Even if filing is not strictly required, a nonresident may choose to file a tax return to claim a refund for any overpayment of Canadian capital gains tax that the nonresident paid in respect of the disposition under the § 116 Certificate rules or that the purchaser withheld from the purchase price.

II. Forum questions

The answers to the forum questions assume that Host Country is Canada, that ABCCo is a resident of Canada for purposes of the Tax Act, that X is an individual and that X holds or held all ABC stock, HavenCo shares and PQR partnership interests as capital property.

A. Sale of ABC stock

1. Canadian tax consequences (if any) for X on the sale of ABC stock

This part of the response assumes that X is not resident in a jurisdiction with which Canada has a tax treaty and therefore that the ABC stock is not TPP. On this assumption, the tax consequences for X on the disposition of ABC stock will turn on whether the stock is TCP.

Whether X's ABC stock is TCP will in turn depend on whether the shares derived more than 50 percent of their value from Canadian real property at any time in the 60 months preceding the disposition. Whether they did so is not clear on the stated facts, which provide only that ABCCo owns a "great deal" of Canadian real property.

(a). Shares are not TCP

If X's ABC stock did not derive more than 50 percent of its value from Canadian real property in the 60 months preceding the disposition, it will not be TCP, and therefore X should have no liability for Canadian tax or any obligation to file a Canadian income tax return, in respect of the disposition. As a practical matter, unless X can satisfy the purchaser that the shares have not so derived their value, the purchaser

may insist that X comply with the § 116 Certificate rules in order to eliminate any risk to the purchaser of having to pay tax on the transaction. In that case, X would either succeed in obtaining a § 116 Certificate on the basis that no tax is payable or it would fail. In the latter case X would be required to pay 25 percent of X's proceeds of disposition minus X's ACB in the shares to the CRA (or provide acceptable security in lieu of payment) and file a Canadian tax return to determine X's ultimate liability for tax.

(b). Shares are TCP

If X's shares of ABC stock have derived more than 50 percent of their fair market value from Canadian real property at some point in the 60 months preceding the disposition, the shares will be TCP if they are not listed on a designated stock exchange. If the shares are listed on a designated stock exchange, then they would only be TCP if, in addition, one or more of any combination of X and persons with whom X does not deal at arm's length owned 25 percent or more of the shares of any class of shares in ABCCo's stock at any time in the 60 month period. Assuming the shares are TCP, X would be liable for Canadian capital gains tax on the gain on the sale of the ABC Stock at an effective rate of approximately 21.5 percent (i.e., 43 percent of the taxable capital gain).

X will also be required to comply with the § 116 Certificate rules as described above, unless the ABC stock is listed on a "recognized stock exchange." Consequently, if the ABC stock is not so listed, X will be subject to the § 116 Certificate rules and the purchaser of the ABC stock will be liable for 25 percent of the purchase price unless X provides the purchaser with a clearance certificate as described above.

X will be required to file a Canadian income tax return on or before April 30 of the following year, unless the disposition of ABC stock was an "excluded disposition" as described above. X will likely want to file the income tax return, even if it is not strictly required, to claim the difference between X's actual tax liability and any amount that X paid to obtain a clearance certificate, or that the purchaser withheld from the purchase price.

2. Difference in Canadian tax consequences of the sale if Canada has a tax treaty with Foreign Country

This part of the response assumes that X is a resident of a jurisdiction with which Canada has a bilateral tax treaty and is entitled to the benefits of that treaty (a "Treaty Resident").

In this case, X will only be liable for Canadian capital gains tax in respect of any capital gain arising on the disposition if X's shares of ABC stock are TCP and are not TPP. Whether X's ABC Stock is TCP will be determined as described in II.A.1.a., above.

Whether X's ABC stock is TPP will depend on the terms of the particular tax treaty. If the ABC Stock derives its value primarily from Canadian real property as defined in the applicable treaty, it likely will be TPP. If it does not so derive its value, it likely will not be TPP.

Whether or not X's shares of ABC Stock are TPP, X will not be required to comply with the § 116 Certificate rules if the shares are listed on a recognised stock exchange at the time of the disposition. If the shares are TPP but not listed, compliance with the § 116 Certificate rules in many cases will not strictly be required, either because the shares are TPP or because of the Reasonable Inquiry Exception. However, a purchaser who harbours any doubt that the shares are TPP (because of uncertainty as to the extent to which they derive their value from Canadian real property) or that the nonresident vendor is a resident of the relevant jurisdiction for purposes of the relevant tax treaty (and therefore that the Reasonable Inquiry Exception may not be available), may as a practical matter require the vendor to comply with the § 116 Certificate rules with the consequences discussed above.

B. Sale of HavenCo stock

1. Canadian tax consequences (if any) for X on the sale of HavenCo stock

Again, this part of the response assumes that X is not a Treaty Resident.

X's shares of HavenCo will be TCP if they derive their value *directly or indirectly* from the property listed in I.B above. Since HavenCo's only asset is its shares in DEFCorp, X's HavenCo shares should be (or not be) TCP if the shares of DEFCorp are (or are not) TCP of HavenCo. Consequently, X must undertake the same analysis with respect to the shares of DEFCorp as described in II.A.1.a., above with respect to ABC stock.

Once the status of X's HavenCo shares are determined, the tax consequences for X in respect of any capital gain arising on the disposition of the shares will be as described in II.A.1.a., above.

2. Difference in Canadian tax consequences of the sale if Canada has a tax treaty with Foreign Country or the country in which HavenCo is resident

On the assumption that X is a Treaty Resident, the answer should generally be the same as the answer in II.A.2., above.

The tax treaty between Canada and the country of residence of HavenCo, if any, is not relevant to the determination of X's Canadian tax liability.

C. Sale of PQR partnership interest

1. Canadian tax consequences (if any) for X on the sale of his PQR partnership interest

This part of the response assumes that X is not a Treaty Resident.

TCP includes a partnership interest, whether or not listed on a designated stock exchange, that derives its value from the property listed in I.B., above. Thus, the TCP analysis, resulting Canadian income tax analysis and consequences for X on the disposition of his PQR

partnership interest will generally be the same as on a disposition of unlisted shares of a corporation. See II.A.1., above.

Similarly, the application of the § 116 Certificate rules to a disposition of X's PQR partnership interest will generally be as described at I.D., above. In this respect, the PQR partnership interest will be EP if it is listed on a recognised stock exchange.

2. Difference in Canadian tax consequences of the sale if Belgium has a tax treaty with Foreign Country

On the assumption that X is a Treaty Resident, the answer should generally be the same as the answer in II.A.2., above.

D. Difference in Canadian tax consequences if X were a foreign corporation instead of an individual

The only differences should be that the effective Canadian income tax rate on X's capital gains will be 12.5 percent as opposed to 21.5 percent, and that the deadline for filing a Canadian tax return, if required or desired, will be June 30 of the year following the disposition year.

NOTES

[1] § 115(1)(b). All statutory references are to the *Income Tax Act* (Canada) (the "Tax Act"), as currently proposed to be amended, unless otherwise indicated.

[2] § 40(1)(a).

[3] § 38(a). Exceptions to the 50 percent inclusion rate apply to certain specific types of property. These are ignored in this response.

[4] Generally, a mutual fund corporation is a public corporation whose only undertaking is the investing of its funds in property (other than real property) and/or the acquiring, holding, maintaining, improving or managing of any real property that is capital property of the corporation. See § 131(8).

[5] Generally, a "Canadian resource property" is an interest in, a right related to, or a royalty derived from, oil and mineral resources situated in Canada. See § 66(15) "Canadian resource property".

[6] Generally, a "timber resource property" is a right or licence to cut or remove timber from an area in Canada, subject to certain conditions. See § 13(21) "timber resource property".

[7] § 248(1) "taxable Canadian property" (d).

[8] Stock exchanges are designated by the Canadian Minister of Finance under § 262. The list of designated stock exchanges includes many Canadian and foreign exchanges.

[9] § 248(1), "taxable Canadian property" (e).

[10] § 248(1) "treaty-protected property".

[11] See, e.g., OECD Model Convention, Art. 13 and Canada–United States tax treaty, Art. XIII.

[12] § 116(1).

[13] § 116(3).

[14] § 162(7).

[15] § 116(2) or (4). The CRA may also issue a § 116 Certificate if the nonresident provides acceptable security — normally a letter of credit.

[16] § 116(5).

[17] § 116(6)(b). A "recognized stock exchange" includes all "designated stock exchanges," as well as any stock exchange located in Canada or a country with which Canada has a tax treaty.

[18] § 116(5.02), (6)(i) and (6.1).

[19] § 116(5)(a.1), (5.01) and (5.02).

[20] § 150(1)(d).

[21] § 150(1)(a).

[22] § 150(5).

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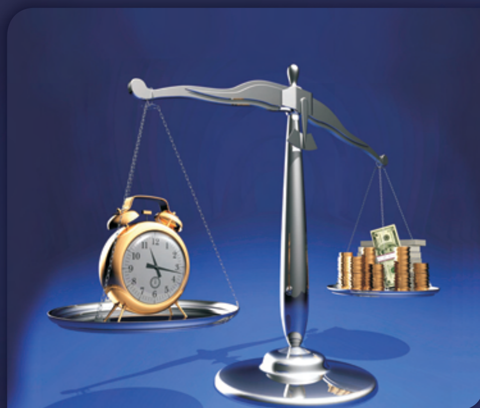

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