The Canadian Government released its 2008 Budget on February 26, 2008. The Budget is relevant to non-Canadian investors, in that it is intended to simplify the tax filing procedures imposed when they sell property that is deemed to have a source in, or generally a “nexus” to, Canada. This property is labelled “taxable Canadian property” (“TCP”) and the tax filing procedures are imposed under section 116 of the Canadian Income Tax Act (the “Act”).

1. The current tax regime for property sales by foreign vendors

Many vendors who are not Canadian residents are surprised to find that they are required to satisfy Canadian tax certification procedures in advance of their sale of TCP, failing which the purchasers are obligated to withhold tax on a portion of the sale proceeds. In addition, these non-Canadian resident vendors are required to file Canadian tax returns to report the disposition, even if the proceeds are exempt from Canadian taxation. These reporting procedures have been the source of much complaint by international investors.

a) General Requirements for a section 116 certificate

Under section 116 of the Act, a non-Canadian resident vendor who disposes of TCP must notify the Canada Revenue Agency (“CRA”) of the sale transaction. The notification can either be submitted by that vendor prior to the disposition of the TCP or up to 10 days following the disposition. The purpose of this notification process is to provide the CRA with an opportunity to evaluate the quantum of Canadian income tax, if any, that would be triggered by the sale. After processing the application, the CRA will issue to the non-Canadian vendor a compliance certificate (the “section 116 certificate”) that identifies a specific dollar amount threshold. If the CRA were satisfied that the vendor is either not subject to Canadian income tax or has remitted instalments to cover the tax liability, then the amount recorded on the Section 116 certificate would equal the proposed sale price of the TCP.

If the vendor does not pursue the certification process or if the section 116 certificate issued by the CRA provides for a dollar amount threshold that is less than the actual sale price, the purchaser must withhold and remit to the CRA a portion of the purchase price.\(^2\) In this case, the withholding tax functions as an instalment of the vendor’s ultimate Canadian tax liability. The purchaser would be motivated to withhold the requisite amount of tax since it does not want to

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\(^1\) The Québec Government announced in its March 2008 Budget that it will harmonize its provincial tax reporting for “Taxable Québec Property” with the changes announced by the Federal Government.

\(^2\) The withholding tax is generally set at 25% of the amount by which the sale price exceeds the section 116 certificate limit. In some cases, such as the sale of depreciable property, the withholding rate is set at 50% of the excess amount. All such withholding tax must be remitted within 30 days following the month in which the sale transaction occurred.
be exposed to any potential tax liability. It follows that the vendor must apply for a section 116 certificate if it wishes to avoid the imposition against it of Canadian withholding tax.

The definition of TCP includes a lengthy list of items for which Canada taxes non-Canadian resident vendors on the gains or income generated from the sale, such as:

- shares of a Canadian company that is not listed on a designated stock exchange (i.e., private company shares);

- shares of a Canadian company listed on a designated stock exchange (i.e., public company shares) if the non-Canadian vendor or persons not dealing at arm’s length to that vendor held more than 25% of any class of shares at any time within 60 months preceding the sale;

- a unit of a unit trust other than a mutual fund trust; and

- a unit of a mutual fund trust if the non-Canadian vendor or persons not dealing at arm’s length to that vendor held more than 25% of the issued units at any time within 60 months preceding the sale.

Many of Canada’s tax treaties ensure that a non-resident vendor is not subject to any Canadian taxation on the sale of most types of TCP. The principal types of TCP that are ineligible for treaty relief are real property situated in Canada, Canadian resource property and shares that derive their value primarily from such real or resource property. At the time that a vendor applies for a section 116 certificate, the CRA permits non-Canadian resident vendors to identify the tax treaty provision relieving them from Canadian taxation that otherwise would apply.

b) The exemption from the section 116 certification procedures

The Act currently excuses a non-Canadian resident vendor from the requirement to apply for a section 116 certificate on the sale of TCP in only two limited circumstances.

i. The excluded property exception

The first exemption from the section 116 certification process arises when the property qualifies as “excluded property”. Excluded property is generally intended to be a subset of TCP, and includes all shares listed on a designated stock exchange, a unit of a mutual fund trust, as well as a bond, debenture, or similar obligation. The excluded property provision acknowledges that the purchaser may not have the ability to determine the identity of the vendor selling the particular property, and therefore, the section 116 certification process would be too difficult to enforce.

ii. The reasonable inquiry exception

The Act also exempts Canadian-resident vendors of TCP from having to apply for a section 116 certificate. When a purchaser has made a “reasonable inquiry” and believes that the vendor was a Canadian resident, no tax withholding is required under section 116. The reasonable inquiry threshold is usually fairly easy for the purchaser to satisfy. The purchase and sale agreement would typically include a representation made by the
vendor that it is “not a non-resident of Canada.” In any event, the purchaser could often do its own due diligence as it could, for example, review the vendor’s articles of incorporation to verify that the vendor was incorporated in Canada.

c) Tax return filings requirements

Regardless of whether a non-Canadian resident vendor obtains a section 116 certificate confirming that the sale proceeds are exempt from Canadian withholding tax and regardless of whether the property is excluded property, the non-Canadian resident vendor must still file a Canadian tax return at the end of the year and report the disposition of the TCP. It follows that the section 116 certificate only represents a confirmation that no withholding tax instalments arose on the sale transaction, and is not a final assessment that no Canadian tax was owing on the transaction. In filing the tax return, the non-Canadian resident vendor would formally claim the benefit of tax treaty to exempt the sale proceeds from Canadian income tax, or alternatively could report that no Canadian tax was due on the transaction if the TCP were being sold at a loss. A final assessment that no Canadian tax was due would only be made upon a review by the CRA of the vendor’s income tax return for the year.

2. Budget Proposals to Expand Exemption from section 116 Certification

The 2008 Budget proposes three legislative changes to the Act to streamline and simplify compliance with the section 116 application process. These changes will only apply to dispositions of TCP that occur after December 31, 2008.

a) Expanded exemption for applying for a section 116 certificate

The first change under the 2008 Budget will exempt a non-Canadian resident vendor of TCP from the requirement to apply for a section 116 certificate, provided that a tax convention between Canada and the vendor’s jurisdiction of residence relieves the imposition of any Canadian income tax. However, if the TCP is being sold to a related person, then under the 2008 Budget the purchaser must still provide a notice to the CRA within 30 days of the disposition. The notice would contain information on both the transaction and the identity of the vendor, but would be a much less onerous process as compared to the current section 116 certification process.

In isolation, the exemption from applying for a section 116 certificate would not relieve the non-Canadian resident vendor from subsequently filing a Canadian tax return. However, one of the 2008 Budget measures, as noted in paragraph c.), may provide an exemption from the tax return filing requirements.

b) Expansion of withholding tax remittance exemptions

The second change will exempt a purchaser of TCP from being required to collect and remit withholding tax on the sale proceeds payable to a non-Canadian resident vendor. In order to be exempt from these withholding tax requirements arising on the sale of TCP, all of the following conditions must be satisfied:
• after a reasonable inquiry, it becomes clear that the vendor is resident in a country that has entered into a tax treaty with Canada;

• the property would be treaty-protected property of the vendor, if the vendor were resident in that particular treaty country. Treaty-protected property is defined under the Act to mean property whose sale proceeds would be exempt from Canadian income tax due to a tax treaty entered into between Canada and the vendor’s country of residence; and

• the purchaser must send a notice setting out basic information about the transaction to the CRA within 30 days of the purchase date. The information to be submitted will include the acquisition date, the name and address of the non-Canadian vendor, a description of the property, the amount paid by the purchaser for the property, and the country of residence of the vendor.

c) Exemption from filing a Canadian tax return

The 2008 Budget will exempt non-Canadian resident vendors of TCP from filing Canadian income tax returns for any taxation year if the following criteria are satisfied:

• the non-resident has no tax payable under Part I of the Act for the taxation year. Part I of the Act generally refers to the sections dealing with employment income, capital gains and profits or losses for the year from Canadian business operations;

• the non-Canadian resident vendor is not currently liable to pay any amount under the Act in respect of any previous taxation year (other than an amount for which the CRA has accepted, and holds, adequate security); and

• each TCP disposed of by the non-resident in the year is either "excluded property" under section 116 of the Act (which will now include the treaty-protected property), or a certificate under section 116 of the Act has been issued in respect of the property to the non-resident.

3. Analysis of the 2008 Budget changes

Before the 2008 Budget measures were announced, the administrative burdens attributable to the section 116 certification process were frequently criticized, particularly by international private equity investors and venture capital funds. One primary criticism was that the non-Canadian resident vendor was compelled to obtain a section 116 certificate for its TCP sales (provided that the TCP did not qualify as excluded property), even if the vendor was ultimately exempt from Canadian income taxes by virtue of a tax treaty. Moreover, the application for a section 116 certificate involved much paperwork.

The many investors who have been hoping for significant relief from the section 116 filing requirements will be disappointed with the proposed amendments.
a) Impact on Section 116 filings

While the 2008 Budget measures may eliminate the requirement for the non-Canadian resident vendor to obtain a section 116 certificate, the conditions associated with this relieving measure shift almost all of the tax collection liability onto the purchaser. Therefore, the purchaser will have the primary due diligence obligation to ensure that a non-Canadian resident vendor is eligible for the new exemptions under section 116 of the Act. This may be difficult to achieve, since the rules for determining whether property is treaty protected are complex and are based on facts that may be solely within the vendor’s domain. In many cases, it would not be possible for the purchaser to make such a determination. The proposals do not provide the purchaser with a due diligence defence if it incorrectly determines that no withholding tax was due on the sale proceeds. Many purchasers will be unwilling to accept any liability pertaining to the withholding tax.

It is extremely unlikely that an arm’s length purchaser would (or could) rely solely on representations to be made vendor in the purchase and sale agreement that it would be eligible for the section 116 filing exemptions. A purchaser would also not be amenable to accepting an indemnity, except possibly from the limited number of extremely “blue-chip” and highly credit-worthy corporations.

If the purchaser is unwilling to rely on representations and indemnities being provided by the non-Canadian resident vendor, the only recourse would be for the vendor to continue to apply for a section 116 certificate despite the introduction of the 2008 Budget measures. A continued reliance by the purchaser on the section 116 certificates would seem to undermine these measures.

However, many purchase transactions are structured as non-arm’s length transactions occurring within a related group. For example, the non-Canadian resident shareholder of a private Canadian company may have a need to transfer its share ownership to an affiliated company. Such purchasers would likely to accept the risks of using the 2008 Budget measures, as the tax exposure would still remain within the related group. Accordingly, these non-arm’s length purchasers should be comfortable in accepting the representations and indemnities being provided by vendors.

Based on our informal discussions with legislative drafters at the Department of Finance, the Department is anticipating that most arm’s-length purchasers will continue to demand that a section 116 certificate be provided. As a consequence, we believe that the section 116 amendments were mainly intended to ease the compliance burden arising in non-arm’s length transactions. The CRA has been experiencing significant backlogs in processing section 116 certificates. Since related party transactions represent a significant portion of the CRA’s workload in issuing section 116 certificates, eliminating these applications should enable the CRA to expedite applications from arm’s length parties and reduce its processing backlogs.

b) Impact on the tax filings

The proposed legislative amendment exempting the filing a Canadian tax return appears straightforward. It acknowledges that if the TCP sale proceeds were treaty protected, the non-
Canadian resident vendor would not need to file a Canadian income tax return. However, the vendor must be certain that the sale proceeds are, in fact, treaty protected. This creates an issue similar to that being evaluated by the purchaser, namely, whether the property is exempt from Canadian income tax by virtue of a tax treaty. Where there is uncertainty, the non-Canadian resident vendor would likely want to file a protective Canadian tax return and forego the supposed relief available under the 2008 Budget Measures.

4. **Conclusions**

The proposed amendments to the section 116 filing procedures are only a partial measure to address deficiencies in the application process for section 116 certificates. The primary objective for the amendments appears to be to reduce tax filings that are made on related party transactions. In very limited circumstance, the purchaser would also be amendable to accepting an indemnity from a credit worthy vendor. However, for most arm’s length sale transactions there will be little change in the Canadian tax filing procedures currently pursued by the parties.