

## Canada's Section 116 System for Nonresident Vendors of Taxable Canadian Property

by Steve Suarez and Marie-Eve Gosselin

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Section 116 of the Income Tax Act (Canada)<sup>1</sup> may apply when a nonresident of Canada disposes of property that is considered to have a significant connection to Canada. The purpose of section 116 and related provisions is to protect Canada's right to tax nonresidents on gains from the disposition of such taxable Canadian property. The system created by these provisions (the 116 system) consists of three principal obligations:

- *Vendor Notification.* The nonresident vendor may be required to notify the Canada Revenue Agency of the disposition.
- *Purchaser Remittance.* The purchaser of the property, whether Canadian or non-Canadian, may be required to remit a specified percentage of the purchase price (usually 25 percent) to the CRA. Such remittance is credited toward the vendor's Canadian tax liability (if any).
- *Vendor Tax Return Filing.* The vendor may be obligated to file a Canadian income tax return for the tax year in which the disposition occurred.

This article<sup>2</sup> analyzes these three obligations and incorporates changes to these rules announced and enacted into law in 2008, as well as subsequent amend-

ments made in 2010 relating principally to the scope of property that comes within the 116 system.<sup>3</sup>

Both nonresidents with Canadian-related property subject to the 116 system and persons (wherever resident) acquiring such property from such nonresidents must be aware that these rules may apply whether or not any gain is realized or any Canadian tax is owing from the disposition by the vendor. Indeed, Canadian counsel frequently advise purchasers and vendors who have ignored the 116 system in the mistaken belief that compliance was not required because no Canadian tax arose from the disposition. The 2008 amendments made several changes to the 116 system intended to reduce compliance obligations when Canadian tax is less likely to be due, especially when gains (if any) on the relevant property are exempt from Canadian taxation under an income tax treaty. Moreover, the narrowing of the "taxable Canadian property" definition (see

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<sup>3</sup>The 2008 federal budget added several amendments to sections 116 and 150 that are generally effective for dispositions occurring in or after 2009: see Bill C-50, Budget Implementation Act, 2008, S.C. 2008, c. 28, sections 14 and 28. For more detail, see Suarez, "Canada's 2008 Budget Is Light on Business Tax Measures," *Doc 2008-4180* or *2008 WTD 40-2*. Moreover, some measures announced in the Mar. 4, 2010, federal budget (which were subsequently enacted into law on July 12, 2010) have significantly amended the definition of "taxable Canadian property." These amendments apply after Mar. 4, 2010, for the purpose of determining whether a property is "taxable Canadian property": see Bill C-9, Jobs and Economic Growth Act, S.C. 2010, c. 12, section 22. For more detail, see Suarez, "Canada's 2010 Budget Heavy with Major Tax Initiatives," *Tax Notes Int'l*, Mar. 22, 2010, p. 1021, *Doc 2010-4813*, or *2010 WTD 45-1*.

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<sup>1</sup>All references herein are to the ITA unless otherwise noted.

<sup>2</sup>This article is based on and updates an earlier article, Suarez and Gaskell, "Canada's Revised Section 116 Regime for Nonresident Vendors," *Tax Notes Int'l*, Jan. 26, 2009, p. 321, *Doc 2008-27299*, or *2009 WTD 16-10*.

Table 1. Summary of the 116 System

Vendor Notification Obligation	Purchaser Remittance Obligation	Vendor Tax Return Filing Obligation
Potentially applicable when nonresident disposes of TCP.	Potentially applicable when TCP is acquired from nonresident.	Potentially applicable where nonresident disposes of TCP.
Not applicable on dispositions of excluded property (for example, publicly listed shares), but for transfers of treaty-exempt property between related parties purchaser must file notice with CRA if vendor does not. Also, notice not required on dispositions of section 116(5.2) property.	Not applicable (1) on acquisitions of excluded property; (2) if purchaser reasonably believes vendor is a Canadian resident after making reasonable inquiry; or (3) if vendor obtains certificate of compliance from CRA. Exception also provided for treaty-protected property if necessary conditions met.	May not apply if all TCP dispositions are excluded dispositions and vendor has no outstanding tax liability.
May apply even if no gain is realized or no tax is payable on the disposition.	Remittance obligation is generally 25 percent of sale price, whether or not vendor realizes any gain or owes tax.	Always applicable where Part I income tax is owing for the year by vendor.
Required if obtaining a certificate of compliance to address purchaser remittance obligation.	Arm's-length purchasers will often insist on certificate of compliance unless there is no material risk, failing which they will withhold required funds from sale proceeds.	Vendor will want to file a tax return and claim a refund if amount remitted by purchaser exceeds vendor's tax owing.
Notification deadline is 10 days after disposition.	CRA comfort letter may suspend remittance due date where vendor has applied for certificate of compliance.	

*infra*) in 2010 has also reduced how frequently 116 system obligations will arise. Even with these amendments, however, the 116 system still has broad application and may apply to a disposition of property even when no Canadian tax is exigible.

The 116 system is complex, and some of the concepts overlap one another. It is helpful to divide the regime into the three basic obligations described herein, analyze each obligation in turn, and then consider how they interact in order to form a compliance system for dealing with dispositions of taxable Canadian property by nonresidents. The principal features of the 116 system are summarized in Table 1.

## I. Background

A nonresident of Canada may be subject to regular Canadian income taxation under Part I of the ITA for any of three reasons:

- the nonresident was employed in Canada;
- the nonresident carried on business in Canada; or
- the nonresident disposed of “taxable Canadian property” (TCP).

The 116 system essentially deals with the third of these bases for taxation and supports Canada’s ability to collect Part I income tax on the disposition of TCP by nonresident vendors (from whom Canadian tax may otherwise be difficult to collect as a practical matter).

When a nonresident disposes of property, the key questions in determining whether Canadian tax arises on the disposition are:

- Was the disposed-of property TCP under the ITA?
- Was there a gain on the property (that is, did proceeds of disposition exceed the nonresident’s cost of the property for Canadian tax purposes plus any costs of disposition) or any other form of income recognition (for example, recaptured depreciation)?
- Is relief from Canadian tax on such gain available to the nonresident under an income tax treaty between Canada and the nonresident’s home country?
- Does the nonresident have realized losses or other Canadian tax attributes that can be used to offset any gains or income from the disposed-of TCP?

Answering yes to the first question is generally sufficient to invoke the 116 system. Relief from compliance with some elements of the 116 system may apply in some situations, in particular when any gains from the property are treaty exempt. Note, however, that the issue of whether the 116 system applies to a particular disposition is quite separate from whether any Canadian tax arises on the disposition. While most Canadian tax treaties significantly reduce the scope of properties that Canada retains the right to tax nonresidents on gains from, the 116 system encompasses *all* TCP (including treaty-exempt property) unless the requirements of any specific exclusion are met. It is therefore essential to understand that 116 system obligations may arise in many situations when no Canadian tax is payable by the vendor.

## A. The Scope of Taxable Canadian Property

The definition of TCP is central to the scope of Canadian taxation of nonresidents and, more specifically, the 116 system.<sup>4</sup> The 2010 federal budget significantly narrowed the scope of the TCP definition by excluding shares of corporations and certain other interests in entities that do not derive their value principally from Canadian real property (directly or indirectly).

The most important forms of TCP are:

- real or immovable property situated in Canada (which for most relevant purposes includes interests in Canadian mining and oil and gas properties and rights to cut timber in Canada);
- most property used in a business carried on in Canada;
- a share of the capital stock of a corporation that *is listed* on a designated stock exchange at the particular time,<sup>5</sup> if at any time during the previous 60 months *both*:
  - 25 percent or more of any class of the corporation's shares were owned by the nonresident vendor, persons not dealing at arm's length with that vendor, or a combination of the vendor and such persons; and
  - more than 50 percent of the fair market value of the share was derived directly or indirectly from Canadian real property (that is, an interest in land situated in Canada, an interest or royalty in a mine or oil field located in Canada, a right to remove timber on Canadian property, or options or interests regarding any of the foregoing)<sup>6</sup>;
- a share of the capital stock of a corporation (excluding a mutual fund corporation) that is *not listed* on a designated stock exchange at the par-

ticular time, if at any time during the previous 60 months more than 50 percent of the fair market value of the share was derived directly or indirectly<sup>7</sup> from Canadian real property;

- an interest in a partnership or an interest in a trust (other than a unit of a mutual fund trust or an income interest in a trust resident in Canada) if at any time during the previous 60 months more than 50 percent of the fair market value of the interest was derived directly or indirectly<sup>8</sup> from Canadian real property; and
- an interest, option, or right regarding any of the foregoing property, whether or not the property exists.

In addition to property that falls within the TCP definition in the ITA, certain properties not falling within that definition may be *deemed* to be TCP by another provision of the ITA. (This is described in more detail in Section I.C of this article.) This typically occurs when a person exchanges TCP for other property on a tax-deferred basis under a specific provision of the ITA that defers recognition of any gain but deems the property received in exchange to be TCP. For example, when a nonresident transfers TCP to a Canadian corporation in exchange for shares of that Canadian corporation under subsection 85(1) of the ITA,<sup>9</sup> such shares are deemed to be TCP of the nonresident for the 60-month period following the exchange.

While this article is focused on the 116 system rather than the scope of Canadian taxation of capital gains derived by nonresidents, a few brief observations can be made:

- The TCP definition as applied to shares of a corporation does not distinguish between Canadian and foreign corporations, meaning that shares of a foreign corporation will constitute TCP if the corporation owns enough Canadian real property (directly or indirectly), notwithstanding the practical enforcement issues associated with trying to tax such foreign shares.
- Because the post-February 2010 TCP definition now more closely matches the property on which

<sup>4</sup>The general definition of TCP is found in subsection 248(1) of the ITA. Certain property is defined as TCP for purposes of some sections of the ITA (including sections 2 and 150) but not section 116. However, in most cases this has no practical implications for our purposes, as most such property is nonetheless included within section 116 through subsection 116(5.2). A few relatively unusual properties are not dealt with in section 116, and are outside the scope of this article.

<sup>5</sup>Designated stock exchanges in Canada include the Toronto Stock Exchange, the TSX Venture Exchange (Tiers 1 and 2), and the Montreal Exchange. Many foreign stock exchanges are also designated, including the New York Stock Exchange and the London Stock Exchange. The Department of Finance maintains a list of designated stock exchanges on its website at <http://www.fin.gc.ca/act/fim-imf/dse-bvd-eng.asp>. For further reference on this topic, see Long, "New Canadian Guidelines for Stock Exchanges," *Tax Notes Int'l*, Oct. 20, 2008, p. 231, *Doc 2008-19111*, or *2008 WTD 206-9*.

<sup>6</sup>Both tests must be met at the same time in order for a share to fall within this branch of the definition. This same two-part test also applies to determine the TCP status of a share of a mutual fund corporation or a unit of a mutual fund trust.

<sup>7</sup>Except if so derived through a corporation, partnership, or trust, the shares or interests in which were not themselves TCP. This exception is meant to prevent anomalous and unintended results such as might occur (for example) if a nonresident owning less than 25 percent of the listed shares of a public company interposed a private holding corporation (that is, the shares of which are not listed on a designated stock exchange) to hold those public company shares. For further discussion, see Suarez, "Draft Legislation Would Fix Nonresident Tax Trap," *Tax Notes Int'l*, Sept. 27, 2010, p. 1009, *Doc 2010-20624*, or *2010 WTD 183-5*.

<sup>8</sup>*Id.*

<sup>9</sup>For a discussion of tax-deferred transfers under subsection 85(1) of the ITA, see Suarez and Wooles, "Ten Essential Elements of Canada's Tax System," *Tax Notes Int'l*, Sept. 8, 2008, p. 825, *Doc 2008-17137*, or *2008 WTD 177-11*.

Table 2. Summary of TCP Status

Property	TCP Status
Shares of corporations listed on a designated stock exchange; shares of mutual fund corporations; units of mutual fund trusts.	TCP if at any time during the preceding 60 months, both: <ul style="list-style-type: none"> <li>the nonresident holder owned more than 25 percent of any class of the corporation's shares or the trust's units (including any shares or units owned by non-arm's-length persons); and</li> <li>more than 50 percent of value of the shares or units was derived (directly or indirectly) from Canadian real property.</li> </ul>
Unlisted shares of corporations (other than mutual fund corporations); interests in partnerships and most trusts.	TCP if at any time during the preceding 60 months more than 50 percent of value of the share or interest was derived from Canadian real property directly or indirectly (other than through a corporation, partnership, or trust the shares or interests of which are not themselves TCP at that time).

Canada retains the right to tax gains in its income tax treaties, in many cases residents of countries that do not have a Canadian tax treaty will now be able to hold investments in Canadian entities without being taxable in Canada on any gains, and without needing to interpose an acquisition vehicle in a treaty country to hold such investments.

- There are often significant differences among Canada's tax treaties. For example, some exclude Canadian real property used in an underlying business in determining whether shares derive their value primarily from Canadian real property, and most generally have a much shorter lookback period for determining whether shares derive their value primarily from Canadian real property (that is, usually one year rather than 60 months). As such, subject to treaty shopping concerns, treaty countries are still often very useful in managing Canadian capital gains taxation, depending on the circumstances.<sup>10</sup>
- The use of a treaty country may also still be desirable when other forms of treaty-advantaged income (for example, dividends, interest, or royalties) may arise, again subject to treaty shopping limitations.

## B. The 50 Percent Fair Market Value Test

The TCP status of shares of a corporation or an interest in a trust or partnership depends on whether more than 50 percent of the fair market value of the share or interest was derived directly or indirectly from Canadian real property during the preceding five years.

<sup>10</sup>For more on the variations among the capital gains articles of Canada's tax treaties (and a discussion of inbound planning into Canada generally), see Suarez, "Canadian Taxation of Mining," *Tax Notes Int'l*, Dec. 13, 2010, p. 867, *Doc 2010-24370*, or *2010 WTD 238-19*.

It is possible for two otherwise identical shares owned by the same person to have a different TCP status depending on when they were issued. For example, a share issued *after* the time that a corporation's equity ceased to derive its value primarily from Canadian real property will not meet the five-year 50 percent value test, even though other (identical) shares issued *before* that time may be caught.

The lookback nature of the 50 percent value test often creates significant practical difficulties, since valuation at any moment in time (let alone over five years) is a matter of opinion. Coming to the conclusion that a share has never derived more than half of its value from Canadian real property over a five-year period can be a challenging exercise, and in many cases taxpayers would be well advised to obtain professional valuation advice.

Quite apart from the uncertainties inherent in any valuation, there are also interpretational uncertainties both as to what constitutes "real property" (for example, whether a particular structure affixed to land considered part of the "real property" under Canadian real property law) and as to the precise application of the legal test. For instance:

- Should the determination be based on the gross assets or the net assets of the entity?
- If computed on a net asset basis, against which assets should the entity's liabilities be allocated (for example, do debts reduce the value of assets that secure the debt or the value of assets acquired with the debt, how is unsecured debt allocated, and so forth)?

Historically, the CRA has adopted a relatively flexible approach in the context of capital gains taxation under article 13 of Canada's tax treaties, which typically limits Canadian taxation of shares of corporations to (or to some subset of) shares that derive their value principally from Canadian real property. In a

technical interpretation issued in 2003,<sup>11</sup> the CRA noted that the relevant OECD commentary on article 13 interpreted the “primarily derived from real property” test as one involving only gross assets, without taking liabilities into account. However, the CRA rejected using a gross assets test as a uniform rule, instead stating that “we feel that one can use the gross asset value method, the net asset value method or any other valuation method that is appropriate in the circumstances.” This 2003 technical interpretation endorsed an answer from a 1984 Round Table in which the CRA stated that it would accept a valuation method that “assigns debt to the assets to which the debt reasonably relates” unless there is evidence of manipulation in contemplation of a share sale.<sup>12</sup>

However, late in 2011 the CRA announced an important change in its administrative policy.<sup>13</sup> Effective for property acquired after 2011 or property disposed of after December 31, 2012, the CRA will apply a “gross assets” test (that is, liabilities are irrelevant) in interpreting both the TCP definition and the comparable test in article 13 of Canada’s tax treaties. An exception will be made for property that is both held by the taxpayer at any time during 2011 and disposed of before 2013, for which the CRA will permit the taxpayer to use the previous, more flexible policy of choosing any reasonable valuation method in applying the TCP definition or the comparable test in article 13. This change in administrative policy is an interesting development, particularly as *prima facie* one might have thought that a test based on the value of the equity of a corporation would inherently reflect both the corporation’s assets and its liabilities.

### C. Timing Issues

The TCP definition (as amended by the 2010 federal budget) applies in determining after March 4, 2010, whether a property is TCP of a taxpayer. Thus, a property that was TCP of a taxpayer before March 4, 2010, under the previous TCP definition may no longer be TCP under the new TCP definition.

The 2010 federal budget also changed the TCP status of shares of a corporation (or interest in a partnership) received on some tax-deferred transfers. The ITA contains specific deeming rules under which the TCP status of a property exchanged for a new property will carry over to the new property in some

circumstances.<sup>14</sup> In other words, shares (or a partnership interest) received as consideration for TCP disposed of in most tax-deferred transfers will be deemed to be TCP, even if those shares (or partnership interest) do not come within the TCP definition.

Before the 2010 federal budget, deemed TCP status applied indefinitely: A property deemed to be TCP to a nonresident would always be TCP to the nonresident. Following the 2010 federal budget, these rules now deem the shares (or a partnership interest) received on a tax-deferred exchange to be TCP only for 60 months following the transfer (assuming they are not already TCP by virtue of falling within the TCP definition).<sup>15</sup>

These deeming rules may produce anomalous results for shares acquired in a tax-deferred transaction before March 5, 2010. For example, if shares (old shares) that were TCP under the pre-March 5, 2010, definition were exchanged before that date for other shares (new shares) that would not otherwise be TCP but to which a deeming rule applies, the new shares continue to be deemed TCP even after March 4, 2010. Based on the wording of the deeming rules, the new shares are deemed to be TCP for 60 months following the date of the transfer, even though neither the old shares nor the new shares would constitute TCP under the new TCP definition (that is, they do not derive more than 50 percent of their value from Canadian real property).<sup>16</sup> It is perhaps somewhat odd that following March 4, 2010, shares of a corporation that have never (before or after that date) satisfied the new TCP definition nonetheless continue to be TCP for up to 60 months because of a deeming rule that applied before March 5, 2010. The

<sup>14</sup>See, e.g., paras. 44.1(2)(c) (small business share rollover), 51(1)(f) (share conversion), 85(1)(i) (transfer of property to a Canadian corporation on a rollover basis), and 85.1(1)(c) (share-for-share exchange); subsection 87(4) (amalgamation); and para. 97(2)(c) (transfer of property to a Canadian partnership on a rollover basis). Note that no similar deeming rule applies in the context of a tax-deferred transfer under section 86 (exchange of shares in the course of a reorganization of share capital) or subsection 88(1) (winding up of a closely owned taxable Canadian corporation).

<sup>15</sup>Although a disposition of “deemed TCP” that is not otherwise TCP is not subject to the section 116 notification requirements, as mentioned below, a nonresident vendor disposing of “deemed TCP” will generally be required to file a Canadian tax return for the year of disposition and pay Canadian tax on any taxable capital gain arising from the disposition, subject to exceptions.

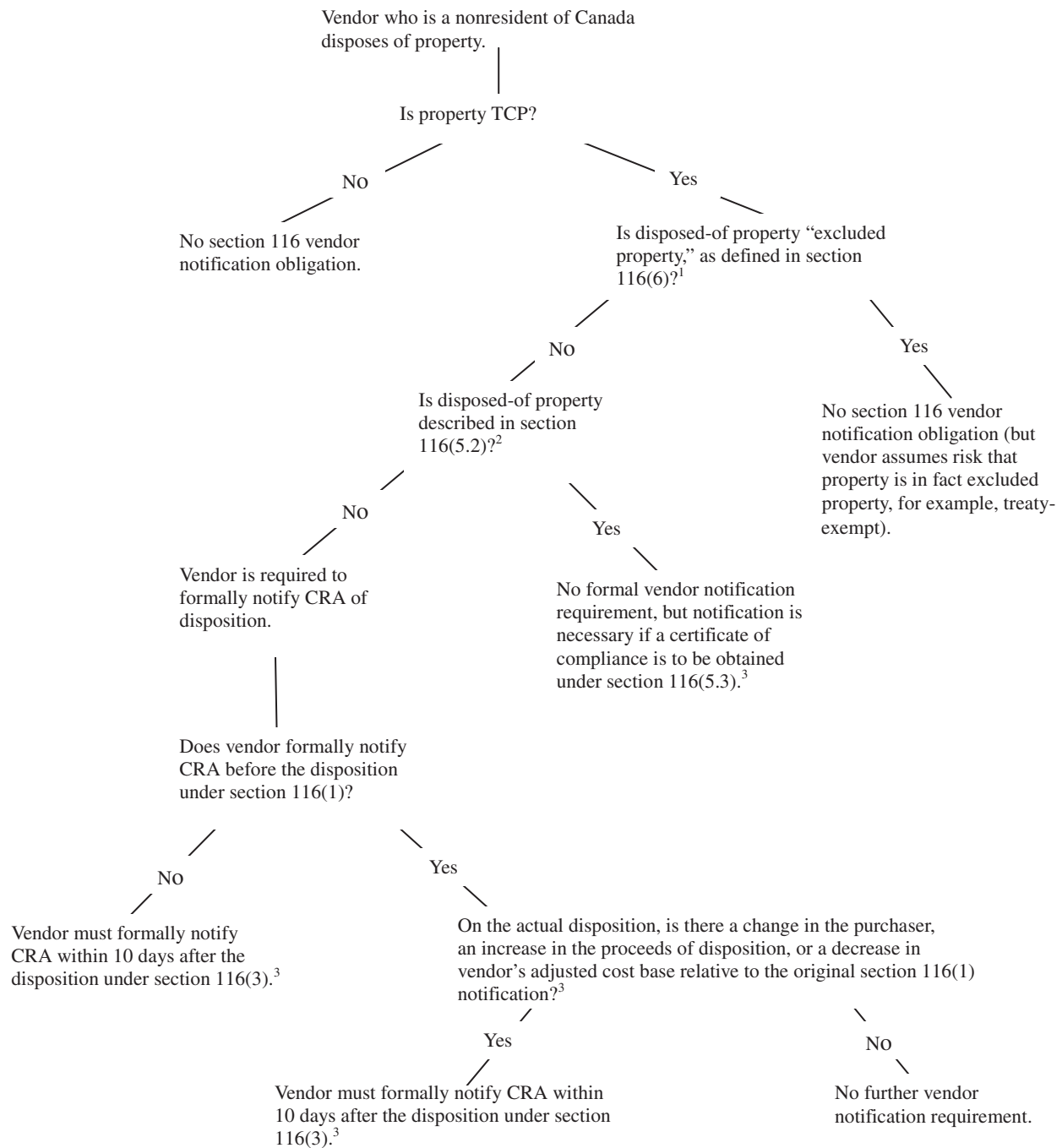
<sup>16</sup>At least one author has expressed the view that the new TCP definition should prevail such that the deeming rules should not apply after March 4, 2010, for tax-deferred transfers that were completed before March 5, 2010, unless the property disposed of at the time of the transfer is TCP under the new definition; see Bowman, “Taxable Canadian Property,” Report of Proceedings of Sixty-Second Tax Conference, 2010 Tax Conference (Toronto: Canadian Tax Foundation, 2011), 32:1-24, 2010. In the article the author indicates his understanding that this proposal has been rejected by the Department of Finance (Canada).

<sup>11</sup>CRA document 2003-0029675, Sept. 5, 2003.

<sup>12</sup>Revenue Canada Round Table, Report of Proceedings of Thirty-Sixth Tax Conference, 1984 Tax Conference (Toronto: Canadian Tax Foundation, 1985), Question 58 at p. 824.

<sup>13</sup>CRA Round Table, Canadian Tax Foundation Annual Conference, Nov. 29, 2011.

**Figure 1. Summary of Vendor Notification Obligation Under Section 116**



<sup>1</sup> Excluded property includes, most notably, (1) shares of a corporation listed on a recognized stock exchange, and (2) a “treaty-exempt property,” being a property any gain from the disposition of which by the vendor would be exempt from Canadian tax under a tax treaty (but if the purchaser and the vendor are related, the purchaser has an obligation to notify the CRA).

<sup>2</sup> Property described in subsection 116(5.2) is a life insurance policy in Canada, a Canadian resource property, real property located in Canada that is inventory, a timber resource property, TCP that is depreciable property or eligible capital property, or an interest or option in any of the foregoing.

<sup>3</sup> To receive a certificate of compliance, vendor may have to provide the CRA with more information and/or payment or acceptable security for tax.

deeming rules effectively extend the broader, pre-March 5, 2010, TCP definition into the post-March 4, 2010, period in which a narrower TCP definition applies.<sup>17</sup>

With this understanding of the TCP concept and its related issues, we can analyze the three elements of the 116 system.

## II. Vendor Notification Obligation

The vendor notification requirement under section 116 is an obligation of the vendor in the case of most dispositions of TCP to provide information about the disposition to the CRA within a specific time frame.<sup>18</sup> Figure 1 summarizes the vendor notification obligation, and the reader may find it helpful to refer to it as a guide when reviewing the discussion that follows.

The vendor's disposition of TCP triggers the requirement of the vendor to notify the CRA. For practical purposes a disposition is a sale or other alienation of a property, including one that is tax deferred such as under subsection 85(1).<sup>19</sup> In some cases a vendor who is not subject to the formal vendor notification obligation will nonetheless voluntarily choose to provide notification of a disposition, as part of the process of dealing with the purchaser's remittance obligation (which is discussed in Section III of this article). The following commentary describes the extent of the vendor's formal obligation to notify the CRA, rather than what the vendor may do voluntarily in any particular situation.

### A. Excluded Property

Not all dispositions of TCP trigger the vendor notification requirement. A disposition of excluded property<sup>20</sup> does not create a notification obligation. Excluded property is typically TCP that is impractical to make subject to the purchaser remittance and vendor notification obligations (such as most publicly listed securities) or property that the purchaser cannot reasonably be expected to know is TCP. For instance, "excluded property" includes property that is TCP solely

because it has been deemed to be TCP under one of the deeming rules applicable to tax-deferred transfers described earlier.<sup>21</sup>

The most important kind of excluded property is shares of a corporation that are listed on a recognized stock exchange. A recognized stock exchange includes a designated stock exchange (described in Section I.A of this article) or any other stock exchange located in Canada or in an OECD member country that has a tax treaty with Canada.<sup>22</sup> Units of mutual fund trusts are also excluded property, as are bonds, debentures, mortgages, and similar obligations. Publicly traded partnership units and publicly traded trust units that are not mutual fund trust units are *not* excluded property. Inventory (other than Canadian real property) of a business carried on in Canada is also excluded property. An option or interest in excluded property is itself excluded property, as is property that does not fall within the TCP definition but has been deemed to be TCP by another provision of the ITA (such as on a tax-deferred exchange, described earlier).

"Treaty-exempt property"<sup>23</sup> is also excluded property. Treaty-exempt property of a nonresident person means "property any income or gain from the disposition of which by the taxpayer at that time would, because of a tax treaty with another country, be exempt from tax under Part I."<sup>24</sup> Hence, no vendor notification is required when any gain on the property is (or would be if there were a gain) treaty exempt. However, when the vendor and the purchaser are "related,"<sup>25</sup> in order for the property to be treaty-exempt property the purchaser must also provide notice to the CRA within 30 days after the acquisition<sup>26</sup> setting out:

<sup>21</sup>For example, shares received in exchange for the disposition of TCP on a tax-deferred transfer, as described earlier in Section I.C of this article.

<sup>22</sup>Definition of the term "recognized stock exchange" in subsection 248(1). A list of Canada's tax treaties can be found on the Department of Finance website at [http://www.fin.gc.ca/treaties-conventions/treatystatus\\_-eng.asp](http://www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp).

<sup>23</sup>Defined in subsection 116(6.1), added to the ITA by the 2008 federal budget amendments.

<sup>24</sup>The term "treaty-protected property" referred to in subsection 116(6.1) is actually defined in subsection 248(1).

<sup>25</sup>"Relatedness" is defined in the ITA; very generally, persons may be "related" by virtue of blood relationship (parent and child), marriage, or legal control (when one corporation has de jure control of another). In some cases rights under an agreement of purchase and sale for a controlling interest in a corporation may cause an otherwise unrelated purchaser and vendor to be deemed to be related.

<sup>26</sup>The CRA has stated that a late-filed notification will not be accepted, meaning that the property will not be considered to be "excluded property"; see Information Circular IC 72-17R6, "Procedures concerning the disposition of taxable Canadian property by nonresidents of Canada — section 116," released Sept. 29, 2011, at para. 28. The CRA has stated that it will notify a taxpayer if the Form T2062C used to make the notification

(Footnote continued on next page.)

<sup>17</sup>The 60-month period may possibly be further extended if additional tax-deferred transfers of "deemed TCP" shares occur in circumstances when a deeming rule applies again.

<sup>18</sup>See subsections 116(1) and (3).

<sup>19</sup>Disposition is defined in the ITA somewhat unhelpfully as including any transaction entitling a taxpayer to proceeds of disposition of the property. Administratively, the CRA takes the position that a shareholder of a corporation that is a party to an amalgamation (a form of tax-deferred merger) of two or more corporations need not notify the CRA when the old shares were TCP and the new shares are deemed to be TCP by subsection 87(4) of the ITA; see Interpretation Bulletin IT-474R2, "Amalgamations of Canadian Corporations," released Jan. 8, 2008, at para. 45. A disposition also includes a redemption, acquisition, repurchase, or cancellation of shares by a corporation.

<sup>20</sup>Defined in subsection 116(6).



- the date of the acquisition;
- the name and address of the vendor;
- a description of the property sufficient to identify it;
- the amount paid or payable for the property<sup>27</sup>; and
- the country whose Canadian tax treaty the non-resident is relying on to exempt the gain from Canadian taxation.

This information is largely similar to that required under the vendor notification obligation. As such, for related parties dealing with treaty-exempt property, in most cases the “treaty-exempt property” component of “excluded property” essentially just gives the parties a choice of having the purchaser or the vendor notify the CRA of the disposition. The purchaser may satisfy this related-party notice requirement by completing and submitting Form T2062C or otherwise providing this information to the CRA.

When the vendor relies on the treaty-exempt property element of the excluded property definition to forgo complying with the vendor notification obligation, the vendor assumes the risk that the property is not treaty exempt. In particular, U.S. vendors relying on the definition of treaty-exempt property must be sure that they are entitled to treaty benefits under the limitation on benefits provisions of the Canada-U.S. income tax treaty. A vendor related to the purchaser must also rely on the purchaser to provide the CRA with the requisite notification on time.

## B. Property in Section 116(5.2)

The vendor need not provide notification to the CRA for disposed-of property described in subsection 116(5.2) of the ITA (herein, “116(5.2) property”). Such property is perhaps best described as an assortment of special types of property the disposition of which may give rise to regular income rather than (or in addition

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has been late-filed, so that the taxpayer is aware that the notification is invalid; see <http://www.cra-arc.gc.ca/tx/nrrsdnts/cmnn/dsp/menu-eng.html>. Otherwise, while the CRA will not generally acknowledge receipt of a Form T2062C, it has stated that it will send a letter acknowledging receipt if specifically requested; see Toronto Centre CRA & Professionals Group Newsletters, 8-2 Vol. 8, No. 2, May 2009, Q5.

<sup>27</sup>When the amount paid or payable for the property includes a contingent or variable component (such as a post-closing adjustment based on net working capital) that is not known until after the filing due date for the purchaser’s Form T2062C, the CRA has stated that a purchaser who has filed the required notice on time will have complied with its obligations if the purchase price shown includes a portion that has been estimated, indicating such on the notice. However, if the final amount turns out to be different from the amount reported, the purchaser should promptly provide a revised notice to the CRA; see CRA document 2009-0347711C6, dated Dec. 8, 2009.

to) capital gains.<sup>28</sup> Such property is not exempted from the 116 system, but is subject to a modified set of requirements. As to vendor notification, the vendor may still choose to notify the CRA regarding a disposition of 116(5.2) property in order to obtain a certificate of compliance, which most arm’s-length purchasers will generally demand as part of meeting their purchaser remittance obligation. (See Section III of this article.) However, in terms of legal compliance with the ITA, there is no vendor notification obligation on dispositions of 116(5.2) property.

## C. Vendor Notification Procedure

When a vendor disposes of TCP that is neither excluded property nor 116(5.2) property, the vendor is required to formally notify the CRA of the disposition. There are two procedures for meeting the vendor notification requirement. Under the first, referred to as a 116(3) notification, the vendor simply waits until the disposition occurs and then within 10 days following sends the CRA the following information:

- the name and address of the purchaser;
- a description of the property sufficient to identify it;
- the amount of the proceeds of disposition received or receivable by the vendor; and
- the adjusted cost base of the property (ACB, or cost for tax purposes) to the vendor immediately before the disposition.

A 116(3) notification has the advantage of requiring only one filing, but because it is made post-disposition it leaves very little time to obtain a certificate of compliance, which can adversely affect the vendor in dealing with the purchaser remittance obligation (as is described in Section II.E of this article).

The more commonly used procedure is a 116(1) notification, in which the vendor provides notification to the CRA *before* the disposition. A 116(1) notification requires the vendor to submit to the CRA information similar to the information in a 116(3) notification, except that the amount shown as the proceeds of disposition is an estimate and the vendor’s ACB of the property is determined at the time of notification.

Often a vendor that provided a 116(1) notification will not have to make a 116(3) notification as well. However, when a 116(1) notification was provided to the CRA, a 116(3) notification must also be filed if:

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<sup>28</sup>116(5.2) property comprises a life insurance policy in Canada, a Canadian resource property, Canadian real property that is held as inventory or otherwise not as capital property, a timber resource property, depreciable property that is TCP, or any interest or option regarding the foregoing. Also, draft legislation released on July 16, 2010, proposes to add eligible capital property that is TCP to the list of 116(5.2) property.

- the actual proceeds of disposition exceed the estimated proceeds reported in the 116(1) notification;
- the vendor's ACB at the time of the disposition is less than the ACB reported in the 116(1) notice; or
- the identity of the purchaser has changed.

If any of these three conditions is met, a 116(3) notification must be made within 10 days after the disposition; otherwise, no further notification is necessary. The 116(1) notification (which is voluntary)<sup>29</sup> gives the vendor more time to obtain a certificate of compliance. (See Section II.E of this article.)

#### D. Procedures and Penalties

A vendor that is required to provide notification must either use the appropriate authorized form<sup>30</sup> or send a letter with required information. In addition to notification, the vendor may be required to provide supporting documentation.<sup>31</sup> The vendor should provide the applicable notification to the CRA office serving the area in which the disposed-of property is located. If there are properties located in several areas and more than one CRA office is affected, the vendor should send the notice to the office that serves the area where the majority of the properties are located.<sup>32</sup>

A separate vendor notification should be filed for each disposition. However, if the vendor disposes of several properties to the same purchaser at the same time and the same form for notification is used for each property, only one notification is required.

<sup>29</sup>The 116(1) notification is voluntary in the sense that the vendor can choose to simply wait until closing and make a 116(3) notification instead.

<sup>30</sup>Form T2062 for a 116(1) or 116(3) notification. For 116(5.2) property, voluntary notification may be provided before or after disposition and the authorized forms are T2062A for Canadian resource or timber resource property, Canadian real property (other than capital property), or depreciable TCP, and Form T2062B for life insurance policies. The requisite forms (as well as the Form T2062C described earlier) are available at <http://www.cra-arc.gc.ca/formspubs/menu-eng.html>.

<sup>31</sup>See the supporting document list in the instructions to forms T2062, T2062A, and T2062B.

<sup>32</sup>See IC 72-17R6, *supra* note 26, at para. 11. Note, however, that in May 2010, the CRA announced that it had established a Regional Intake Centre as a pilot project to improve the processing of applications for certificates of compliance. As a result, the T2062 forms that were formerly sent to the areas serviced by the Toronto North, Toronto Centre, Toronto East, Toronto West, London, Kitchener-Waterloo, St. Catharines, and Thunder Bay Tax Services Offices should now be mailed to the following address: Canada Revenue Agency, P.O. Box 546, London, Ontario, N6A 4W8. See <http://www.cra-arc.gc.ca/tx/nrsdnts/cmnn/dsp/menu-eng.html>, and Toronto Centre CRA & Professionals Group Newsletters, 9-2 Vol. 9, No. 2, May 2010. The CRA has verbally confirmed that the Regional Intake Centre has been quite successful thus far. However, it is not yet clear whether the initiative will be maintained or expanded nationally.

When there is more than one vendor of a property, each vendor must file a separate notification indicating its interest in the property. On dispositions by partnerships, it is the CRA's administrative policy to accept one notification of disposition filed by one partner on behalf of all partners, provided that the filing partner gives a complete listing of the nonresident partners that are disposing of the property together with information about those partners in its notification.<sup>33</sup> This procedure has sometimes proven rather unworkable from a practical perspective, especially for large, widely held partnerships such as private equity funds or other look-through entities, or when the partnership has one or more other partnerships as partners. The typical (if often suboptimal) taxpayer response has often been to insert a foreign entity beneath the partnership to hold the property, assuming that doing so does not create other unmanageable tax issues (in Canada or elsewhere).

Failure to make the required notification is an offense under the ITA, subject to a fine of between \$1,000 and \$25,000, or imprisonment.<sup>34</sup> A vendor that does not provide notice when required may also be assessed a penalty of \$25 a day for each day the notification is late, subject to a minimum of \$100 and a maximum of \$2,500.<sup>35</sup>

#### E. Certificates of Compliance

Closely related to the vendor notification obligation is a procedure whereby the vendor can apply to the CRA for what is colloquially known as a certificate of compliance, or a 116 certificate. Effectively this is done by providing the information necessary to comply with the vendor notification obligation plus any further information or supporting documentation that the CRA may require. Once issued, a certificate of compliance reduces or eliminates the purchaser's obligation to remit a portion of the purchase price under section 116. (See Section III.C of this article.) However, it is the vendor that must apply for a certificate of compliance. As such, while certificates of compliance protect purchasers and relate to the second of the three elements of the 116 system, practically it is vendors that benefit from them (since otherwise most purchasers will withhold from the sale proceeds) and they are effectively an element of the vendor notification requirement. There will be circumstances when a purchaser may not demand a certificate of compliance and vendors may choose not to obtain one, for example:

- when the purchaser is willing to rely on another exception to the purchaser remittance obligation (most typically when the property is publicly listed shares or when the vendor and the purchaser are related); or

<sup>33</sup>*Id.* at para. 10.

<sup>34</sup>Subsection 238(1).

<sup>35</sup>Subsection 162(7).

- when the vendor is willing to simply let the purchaser withhold and remit from the purchase price.

Otherwise, even when the ITA may not formally require vendor notification,<sup>36</sup> it will often be advantageous for the vendor to go through the notification process to obtain a certificate. In particular, when the vendor's Canadian tax owed on the disposition is zero (for example, because no gain is realized or because any gain is treaty exempt) or less than the amount the purchaser is otherwise required to remit to the CRA under the purchaser remittance obligation, a certificate of compliance benefits the vendor by reducing the amount that the purchaser (or at least any arm's-length purchaser) withholds to fund the purchaser remittance obligation.

A vendor obtains a certificate of compliance by taking the steps described above (voluntarily or otherwise) to meet the vendor notification obligation and providing any further information required by the CRA. If the vendor realizes a gain on the disposition that is taxable in Canada, the vendor must also provide payment or security to the CRA on account of its Canadian tax payable. Therefore, in order to receive a certificate of compliance regarding property for which the vendor is taxable on the gain and has provided a 116(1) or 116(3) notification, the payment or security is generally 25 percent of the amount by which the proceeds of disposition exceed the vendor's ACB of the property.<sup>37</sup>

To receive a certificate of compliance for property for which 116(1) notification has been provided, the CRA has traditionally said that notification and payment or security should be provided at least 30 days before the property is actually disposed of to permit time to review the transaction and verify that the vendor's payment or security is adequate. It often takes significantly more than 30 days to obtain a certificate of compliance, although processing time at the new Regional Intake Centre<sup>38</sup> for fully completed requests that are not referred for internal verification (audit) is understood to be averaging about one month.

### 1. Tax Treaty Reliance

When a vendor seeking a certificate of compliance is claiming that Canadian tax owed is reduced or eliminated in reliance on a tax treaty, the information required by the CRA to support the application will be greater than is normally the case. The vendor must

identify the applicable provision of the particular treaty and provide documentation to support the claim that the treaty is applicable. Such documentation would include proof of residence or proof that the gain has been or will be reported in the vendor's country of residence.<sup>39</sup>

In April 2011, the CRA released new forms to be used by a resident of a country with which Canada has a tax treaty who is eligible to receive a treaty-reduced rate of Canadian withholding tax or a treaty exemption on payments from a Canadian resident.<sup>40</sup> By completing the relevant form, a nonresident vendor certifies that it (or its members or stakeholders, in the case of partnerships or hybrids) is:

- a resident of a treaty country;
- the beneficial owner of the payment; and
- entitled to the benefits of the treaty between Canada and the relevant country regarding that payment.

While primarily relevant to Canadian nonresident withholding tax on passive income (for example, dividends, royalties, and so forth), the new forms are also to be used as part of a nonresident vendor's application to the CRA for a certificate of compliance on the disposition of TCP that is "treaty-protected property." While there is currently no statutory requirement mandating their use, the CRA has verbally indicated that the supporting documentation to Forms T2062 and T2062A will be revised to include Forms NR301, NR302, and NR303; and Information Circular IC 72-17R6 (paragraph 29) now asks vendors applying for a certificate of compliance to use these forms "or equivalent information." Therefore, a nonresident vendor requesting a certificate of compliance for the disposition of TCP that is "treaty-protected property" should expect to be asked to submit the appropriate NR301, NR302, or NR303 form.

## III. Purchaser Remittance Obligation

The second fundamental element of the 116 system is an obligation on a purchaser (wherever resident) to remit to the CRA an amount equal to 25 percent of

<sup>36</sup>For example, regarding 116(5.2) property.

<sup>37</sup>For 116(5.2) property, the amount of payment or security is determined based on the rate of tax applicable to the particular taxpayer; see para. 42 of IC 72-17R6, *supra* note 26. A certificate of compliance received as a result of a 116(1) notification is issued under subsection 116(2), while one received as a result of a 116(3) notification is issued under subsection 116(4).

<sup>38</sup>See *supra* note 32.

<sup>39</sup>See the supporting documents list in the instructions to forms T2062, T2062A, or T2062B.

<sup>40</sup>The appropriate form to be used depends on the identity of the nonresident: Form NR301 is intended for use by individuals and corporations, Form NR302 should be provided by partnerships, and Form NR303 deals with hybrid entities. A detailed discussion of these forms is outside the scope of this article. For prior coverage, see Suarez, "Canada Extends Transition Period for Treaty-Reduced Nonresident Withholding," *Tax Notes Int'l*, Feb. 27, 2012, p. 687, *Doc 2012-1864*, or *2012 WTD 38-12*.

the property's purchase price on account of the vendor's Canadian tax liability (unless an exception applies).<sup>41</sup> The rationale for this obligation is that since the vendor is a nonresident and is likely receiving cash or other property over which the CRA has no practical enforcement power, imposing a withholding obligation on the purchaser of Canadian-situs property is the best opportunity for collecting the vendor's Canadian tax (if any).

Since the purchaser remittance obligation relates to the vendor's tax, the 116 system creates a statutory right authorizing the purchaser to withhold from payments made to the vendor any amount the purchaser remits to the CRA on account of the vendor's tax.<sup>42</sup> Thus, it is intended that the purchaser withhold this amount from the sale proceeds rather than actually bear the liability. However, by making the purchaser potentially liable for this amount, the 116 system creates the necessary inducement for the purchaser to actually fulfill its obligation. The ability of purchasers to withhold is an important part of the 116 system, since from a practical perspective it drives the discussion between vendors and purchasers as to how to comply with the 116 system. Withholding from the purchase price is usually a result that vendors wish to avoid, since the remittance obligation amount is computed without regard to the vendor's basis in the property and will typically exceed any Canadian tax payable.

The amount remitted by the purchaser to the CRA is credited toward the vendor's Canadian income tax liability but is not itself a final calculation of Canadian tax owed. If the amount so remitted (together with any other payments or credits made by or on behalf of the vendor) exceeds the vendor's Canadian tax owed, the vendor files a Canadian tax return for the year and claims a refund of the excess.

In general terms, a purchaser of TCP from a nonresident vendor essentially has the following options for addressing the purchaser remittance obligation:

- if the property is "excluded property," the purchaser has no remittance obligation;
- if after making reasonable inquiry the purchaser had no reason to believe that the vendor was a nonresident of Canada, the purchaser has no liability for not remitting;
- if the specific exception for "treaty-protected property" introduced in 2008 applies, there is no purchaser remittance obligation (it appears that in some circumstances if the exception does not in

fact apply but the purchaser believed that it did and exercised reasonable diligence, the CRA will not pursue the purchaser for not remitting — see Section III.D of this article);

- if the vendor obtains and presents the purchaser with a certificate of compliance from the CRA, this relieves the purchaser from a remittance requirement (to the extent of the amount specified in the certificate)<sup>43</sup>; or
- the purchaser can withhold and remit the required amount from the purchase price to satisfy its obligations.

Figure 2 summarizes the relevant questions to answer in determining a purchaser's liability to remit. Note that it is an *acquisition* of TCP *from* a nonresident (as opposed to a *disposition* of property *by* a nonresident) that triggers the purchaser's liability to remit. This is a subtle difference from what invokes the vendor notification requirement, and in some circumstances, the purchaser may have a liability to remit even though the vendor does not have an obligation to provide notification.<sup>44</sup>

#### A. Excluded Property

As with the vendor's obligation to provide notification, the purchaser does not have a liability to remit regarding TCP that is excluded property. A purchaser that does not remit because it believes the acquired property is excluded property bears the risk that the acquired property is not excluded property. This risk may not be significant in some cases; for example, a purchaser is generally able to determine on its own and with a high degree of certainty that a share of a class of a corporation's stock is listed on a recognized stock exchange. The risk is often much greater for other classes of excluded property, such as treaty-exempt property.

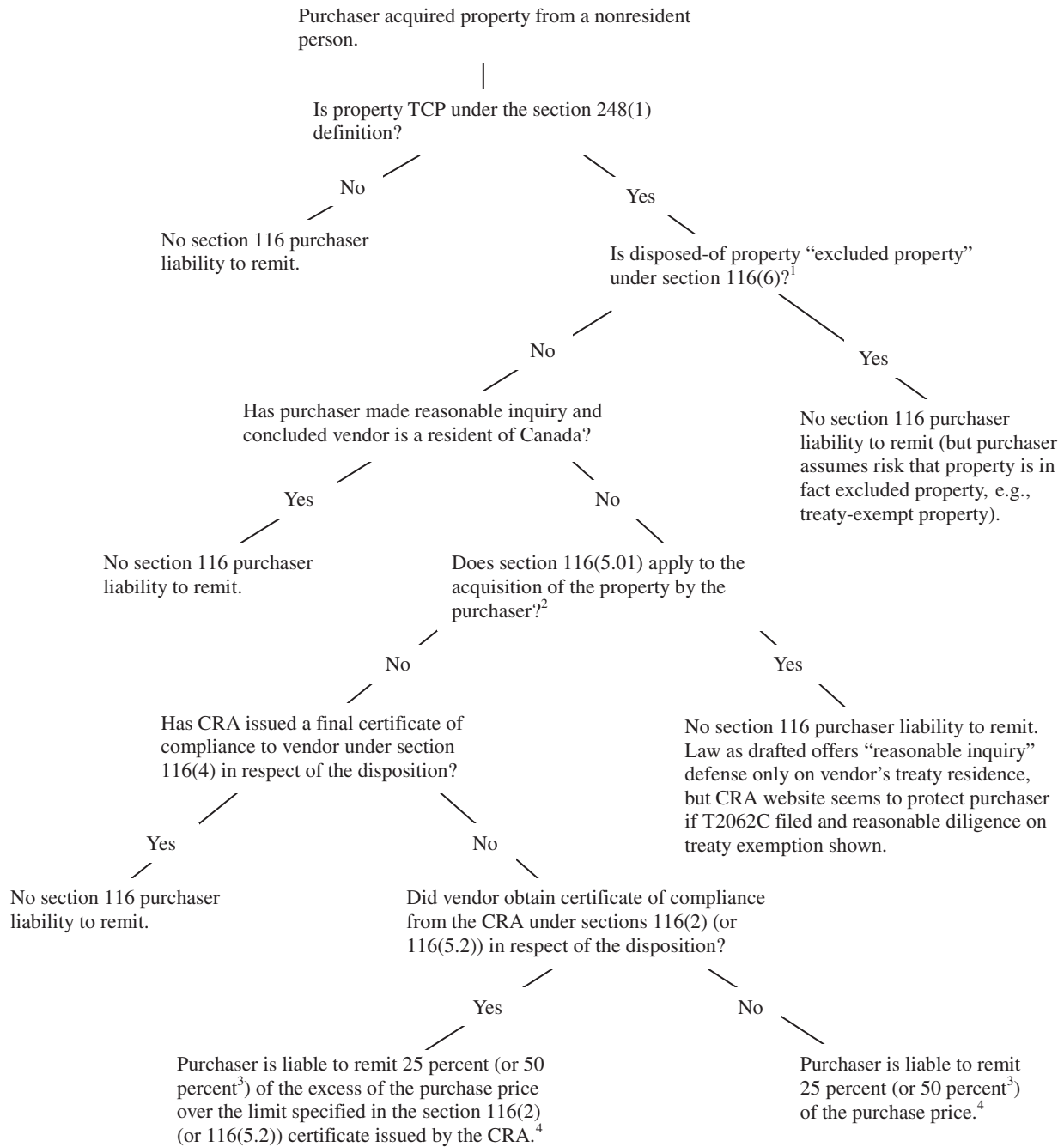
<sup>43</sup>When the vendor has applied for a certificate of compliance but has not yet received it by the date of the sale, a purchaser will often withhold from the purchase price and either release the funds to the vendor once the certificate of compliance has been received if this occurs by the deadline for the purchaser to remit, or continue to hold the funds if the CRA issues a "comfort letter" allowing the purchaser to delay remittance pending issuance of the certificate.

<sup>44</sup>For example, section 51 deems there to be no disposition when shares or convertible debt of a corporation held as capital property are converted into new shares of the corporation. Although the lack of a disposition means that the vendor is not required to provide notification, the CRA believes that the purchaser still acquires TCP from a nonresident and therefore the purchaser may still have a liability to remit. (See para. 40 of IC 72-17R6, *supra* note 26.) In such situations, the purchaser often asks the vendor to provide notification to the CRA and appropriate payment or security to receive a certificate of compliance that will relieve the purchaser of its liability to remit. For another example, see CRA document 2006-020165117, Sept. 21, 2006.

<sup>41</sup>The required remittance amount for 116(5.2) property is 50 percent of the purchase price.

<sup>42</sup>Subsections 116(5) and (5.3). When the purchaser doesn't withhold, these rules also give the purchaser the right to be reimbursed by the vendor for any remitted amounts, although practically it is much easier to simply withholding from the purchase price.

**Figure 2. Summary of Purchaser Remittance Obligation Under Section 116**



<sup>1</sup> Excluded property includes, most notably, (1) shares of a corporation listed on a recognized stock exchange, and (2) a "treaty-exempt property," being a property any gain from the disposition of which by the vendor would be exempt from Canadian tax under a tax treaty (but if the purchaser and the vendor are related, the purchaser has an obligation to notify the CRA).

<sup>2</sup> In order for this exemption to apply, (1) the purchaser must (after making reasonable inquiry) believe that the vendor is resident in a country with which Canada has a tax treaty, (2) the vendor must be exempt from Canadian tax on any gains on the property under that tax treaty, assuming the vendor had such gains and was in fact resident in that other country, and (3) the purchaser must provide required notification to CRA. Relief from remittance is provided in paragraphs 116(5)(a.1) and 116(5.3)(a).

<sup>3</sup> In the case of property described in section 116(5.2).

<sup>4</sup> The purchaser is entitled to deduct such amount from the purchase price. If the CRA has issued a "comfort letter" allowing the purchaser to delay remittance until further notice, this suspends (but does not eliminate) the remittance obligation.

The “treaty-exempt property” element of excluded property has been discussed above regarding the vendor notification obligation. As noted, a party relying on this exception<sup>45</sup> assumes the risk on the issue of whether the vendor is truly exempt from taxation on gains from the property under an applicable tax treaty, and where the purchaser and the vendor are related the purchaser must file the required notification within 30 days after the property is acquired.<sup>46</sup>

If for some reason the treaty exemption does *not* apply, legally the CRA remains entitled to assess the purchaser for not remitting (plus interest and penalties). Would the CRA in fact reassess a purchaser who does not withhold and remit based on an honest but mistaken belief that a treaty exemption applied? There is no certainty on this point, but the answer would appear to be yes, unless the conditions described in Section III.D of this article relating to the treaty-protected property exception apply.

Consequently, as a practical matter we would expect purchasers who are unrelated to the vendor to be willing to rely on the treaty-exempt property element of the excluded property definition only when:

- there is virtually no doubt that the vendor is treaty exempt on gains from the property; and
- the purchaser does not wish to meet (or overlooks) the filing requirement in subsection 116(5.01), discussed below in Section III.D.

At a minimum, most unrelated purchasers will want the additional protection that filing a Form T2062C offers under the treaty-protected property rule in subsection 116(5.01), and in many cases will insist on the vendor obtaining a certificate of compliance to remove all possible purchaser liability.

## B. Reasonable Belief Vendor Is Canadian Resident

A purchaser has no liability to remit if, after making reasonable inquiry, it had no reason to believe that the vendor was a nonresident of Canada. The ITA does not define what constitutes reasonable inquiry. However, the CRA has stated that to satisfy the reasonable inquiry standard the purchaser must take “prudent measures” to confirm the vendor’s residence status and that the purchaser may become liable if, for any reason, the CRA believes that the purchaser could reasonably have known or should have known that the vendor was a nonresident.<sup>47</sup>

Given the CRA’s approach to the reasonable inquiry standard, it is insufficient to merely rely on the fact

<sup>45</sup>That is, a vendor in the case of the vendor notification requirement or a purchaser in the case of the purchaser remittance requirement.

<sup>46</sup>As noted above, the CRA has stated that it will not accept a late-filed notification, with the result that the property will not be “excluded property”; see *supra* note 26.

<sup>47</sup>IC 72-17R6, *supra* note 26, at para. 58.

that no circumstances suggest that the vendor is a non-resident of Canada: Some kind of active inquiry is necessary. Typically, in purchase and sale agreements the purchaser requires the vendor to represent and warrant that it is a resident of Canada for purposes of the ITA, and the general practice is to consider this to be sufficient in the absence of facts that would lead a reasonable person to doubt the accuracy of such representation.

## C. Certificates of Compliance

The most common manner for dealing with the purchaser remittance obligation is for the vendor to obtain and present to the purchaser a certificate of compliance through the vendor notification process, as described in Section II.E of this article. This may occur as part of a 116(1) notification, a 116(3) notification, or a voluntary notification regarding 116(5.2) property.

The purchaser has no liability to remit if the vendor obtained a certificate of compliance as a consequence of a 116(3) notification.<sup>48</sup> If the certificate of compliance was issued as a result of a 116(1) notification or as a result of a notification regarding 116(5.2) property, the purchaser must compare the amount paid or payable to the vendor<sup>49</sup> with the certificate limit specified on the certificate of compliance. If the certificate limit is less than the amount payable by the purchaser to the vendor, the purchaser is liable to remit an amount equal to:

- 25 percent of the difference for TCP that is not 116(5.2) property; or
- 50 percent of the difference for 116(5.2) property.

In many cases in which a 116(1) notification or 116(3) notification has been made, the CRA has not processed the application and issued the certificate of compliance by the time of the purchaser’s remittance due date (30 days after the end of the month in which the purchaser acquired the property). As a result, the CRA has developed a practice of issuing “comfort letters” to the parties, essentially holding the remittance process in abeyance until the CRA’s review is complete. A typical comfort letter is issued by the CRA

<sup>48</sup>Although subsection 116(5) states that the purchaser does not have a liability to remit if the CRA has issued a 116(4) certificate of compliance resulting from a 116(3) notification, the CRA has taken the rather dubious position that a 116(4) certificate issued with incorrect information does not relieve the purchaser from its liability to remit, even if the error is partly the fault of the CRA; see CRA documents 2002-0146345, Nov. 7, 2002, and 2002-0175695, Dec. 5, 2002.

<sup>49</sup>Subsection 116(5) refers to the purchaser’s “cost” in the acquired property. Subsection 116(5.3), which applies to subsection 116(5.2) property, refers to “the amount payable” for the property. In the case of gifts or property disposed of to a non-arm’s-length person for less than fair value proceeds, the references to cost and amount payable are read as “fair market value” of the relevant property: see subsection 116(5.1).

before the remittance due date, and authorizes the purchaser to continue holding the relevant amount (that is, 25 percent of the purchase price for non-116(5.2) property) until further instructed by the CRA. This procedure at least relieves the vendor from having to try and obtain a refund from the CRA of amounts that were remitted but ultimately need not have been had the certificate of compliance been issued sooner. A purchaser that has not received either a certificate of compliance or a comfort letter by the remittance due date and that cannot rely on another exemption (for example, the excluded property or the subsection 116(5.01) exceptions) will typically remit any withheld funds by that date in order to meet the purchaser remittance obligation.

#### D. Treaty-Protected Property Exception

Subsection 116(5.01) relieves a purchaser from the purchaser remittance obligation if the following three conditions are met:

- After reasonable inquiry, the purchaser concludes that the vendor is, under a tax treaty that Canada has with a particular country, resident in that particular country.
- Canada's tax treaty with that particular country exempts the vendor from Canadian taxation of any income or gain from the disposition of that property, assuming for this purpose that the vendor was indeed resident in that particular country under that tax treaty.<sup>50</sup>
- The purchaser provides notice containing specified information to the CRA of its acquisition of the property within 30 days after the date of the acquisition. This information is the same information described in Section II.A of this article, that a purchaser must give to the CRA in order for a vendor who is related to the purchaser to claim relief from the vendor notification requirement on the basis that treaty-protected property is "excluded property."<sup>51</sup>

Subsection 116(5.01) provides the purchaser with a reasonable inquiry defense for the first condition, but *not* for the second condition. A purchaser may be in-

correct about the vendor's country of residence, but if the purchaser made reasonable inquiry as to the vendor's treaty residence and genuinely believes the vendor to be a resident of that treaty country, the purchaser is not disqualified from relying on subsection 116(5.01) as a defense for not remitting.<sup>52</sup>

However, subsection 116(5.01) does not contain any "reasonable inquiry" safe harbor for the other requirements that must be met for the vendor to be treaty-exempt on the relevant property (some of these are reviewed below): If the purchaser is wrong about any element of eligibility for the treaty exemption other than the vendor's fiscal residence, the treaty-exempt property exception does not apply. Therefore, a purchaser that neither remits nor requires the vendor to get a certificate of compliance on the basis that the second condition is met assumes the risk that the vendor may not be treaty-exempt on the property (assuming the vendor's apparent fiscal residence to be correct).

The technical notes to subsection 116(5.01) released by Canada's Department of Finance give two examples of the interplay between the first and second conditions. The examples deal with the Canada-Russia tax treaty, which does not allow Canada to tax a Russian resident's gain on the shares of any corporation that is not resident in Canada; and the Canada-Moldova tax treaty, which allows Canada to tax a Moldovan resident's gain on shares of a nonresident corporation that derives its value principally from Canadian real property.

In the first example provided in the technical notes, a resident of Moldova sells shares of a Moldovan resident corporation that derive their value principally from Canadian real property. After reasonable inquiry, the purchaser believes that the vendor is a resident of Russia. Russia is a country with which Canada has a tax treaty and hence the first condition is satisfied. The second condition is also satisfied because if the vendor *were* resident in Russia (which is what the purchaser's reasonable inquiry led it to believe), the property would be protected by the Canada-Russia treaty. Therefore, subsection 116(5.01) would apply to relieve the purchaser from the purchaser remittance obligation.

In the second example, a resident of Moldova sells shares of a Moldovan resident corporation that derive their value principally from Canadian real property. The purchaser after reasonable inquiry concludes that the vendor is a resident of Moldova, satisfying the first

<sup>50</sup>Expressed another way, all of the conditions necessary for the nonresident to be exempt from Canadian tax on gains from the property under the relevant tax treaty must be met *other than* the fiscal residence condition.

<sup>51</sup>The notice obligation can be satisfied by submitting Form T2062C to the CRA or otherwise providing the CRA with the following information:

- the date the property was acquired;
- the name and address of the vendor;
- a description of the property sufficient to identify it;
- the amount paid (or payable) for the property; and
- the name of the country with which Canada has concluded a tax treaty under which the property is treaty-protected property for the purposes of subsection 116(5.01).

<sup>52</sup>In this context, the CRA has stated regarding nonresidents that were formerly Canadian residents that it would generally consider that standard to have been met when the purchaser obtains from the vendor "signed and sworn declarations by [the nonresident vendors] indicating their country of residence, length of time residing there and proper use of the [relevant] tax treaty"; see Toronto Centre CRA & Professionals Group Newsletters, 8-2 Vol. 8, No. 2, May 2009, Q4.

condition. However, the purchaser also concludes that the shares are treaty-exempt property. This is incorrect because the Canada-Moldova income tax treaty allows Canada to tax the gain on the disposition of shares of nonresident corporations that derive their value principally from Canadian real property. Therefore the second condition of subsection 116(5.01) is not satisfied, regardless of whether the purchaser made reasonable inquiry about the property's treaty-protected status, and subsection 116(5.01) does not apply to relieve the purchaser of its remittance obligation.

There are many situations in which determining whether property is protected by a tax treaty for the purposes of the second condition may be difficult. For example, it may be unclear whether valuable structures affixed to land constitute "real property" under the relevant treaty (that is, fixtures versus chattels). Different treaties also have different eligibility requirements for exemption from gains taxation, some of which are much easier to determine than others:<sup>53</sup>

- In the case of shares of a corporation that might be TCP by virtue of possibly deriving their value primarily from Canadian real property at some point during the previous five years, often the relevant treaty exempts the vendor from Canadian taxation only if it can positively be shown that the shares do not in fact derive their value primarily from (or that the corporation's assets do not consist primarily of)<sup>54</sup> Canadian real property. As noted above regarding making a TCP determination in Section I.B of this article, valuation is a matter of judgment and what role a corporation's liabilities play in making this determination is uncertain.
- Under some treaties Canadian real property used in a corporation's business is excluded in determining whether the corporation's shares derive their value primarily from Canadian real property, making it necessary to determine the extent to which real property is used in the corporation's business and the value of that real property.<sup>55</sup>

<sup>53</sup>For more on these treaty variations, see Suarez, *supra* note 10.

<sup>54</sup>As noted by Bruson and Gamble, "International Tax Update," 2010 British Columbia Tax Conference (Vancouver: Canadian Tax Foundation, 2010), 14:1-24, the CRA acknowledges that when the relevant treaty language uses the term "consist" without any reference to "directly or indirectly," the determination is made based solely on the assets held *directly* by the corporation, without applying a look-through or consolidation approach; see CRA document 2008-030444117, Mar. 23, 2009.

<sup>55</sup>See in this regard CRA document 9506785, Aug. 29, 1995 (cited in Bruson and Gamble, *id.*), where the CRA stated that:

as a general rule, in order for a company to be "actively engaged" in the exploitation of natural resources, the company must be directly involved in the management

(Footnote continued in next column.)

- Certain Canadian tax treaties prevent Canada from taxing gains on shares of corporations that are nonresidents of Canada, making it necessary to determine their fiscal residence.<sup>56</sup>
- In some of Canada's treaties there is a minimum ownership threshold in a corporation's shares in order for a holder to be taxable on gains on those shares.
- Some treaties preserve Canada's right to tax former residents of Canada on gains for a certain period of time after they cease to be Canadian residents.
- It may not be clear whether a particular property forms part of a Canadian permanent establishment of the vendor, so as to be ineligible for treaty relief.

In the case of a vendor resident in the U.S., the purchaser may not be able to determine if the vendor satisfies the limitation on benefits provisions in Article XXIX-A of the Canada-U.S. income tax treaty, and there are restrictions when hybrid entities are involved. Finally, a purchaser will generally be ill-equipped to judge whether on the facts there is any risk of treaty eligibility being denied under the general antiavoidance rule in the ITA or other antiavoidance principles.

Assume that a purchaser chooses not to withhold and remit in reliance on the treaty-protected property exception, after having made reasonable inquiries as to the vendor's residence in a treaty country and having filed the required notice with the CRA within 30 days of the acquisition. If it is subsequently determined that the vendor was not in fact treaty-exempt on the property for some reason other than fiscal residence, what is the purchaser's liability?

Based on statements made on the CRA's website, it would seem that generally the CRA would not assess the purchaser for non-remittance under the following conditions:

- the purchaser filed a Form T2062C (discussed below) regarding the property;
- the purchaser and the vendor are unrelated; and

and daily activities of the exploitation process on a regular, continuous, and substantial basis, and the company's employees must devote time, work, and energy to the exploitation. We contrast this with a passive investor or an investor who is in the business of buying and selling working interests or royalties for speculation purposes without being directly involved in the exploitation of the underlying reserves.

<sup>56</sup>Subsection 250(5) provides that any person who is a resident of another country for purposes of a Canadian tax treaty is deemed to be a nonresident of Canada for purposes of the ITA.



- the purchaser has made every reasonable effort to determine that the property qualifies as treaty-protected property.<sup>57</sup>

Thus, for a purchaser who is unrelated to the vendor, taking positive steps to try to establish the vendor's entitlement to the treaty exemption is beneficial. It is understood that making "every reasonable effort" involves at least following all of the guidance on the Form T2062C applicable to the relevant property.

The certainty of relief offered by the CRA in these circumstances is obviously less than the absolute protection given by a certificate of compliance, and the CRA makes no similar reference to relief in these circumstances in IC 72-17R6. However, the fact that the CRA is willing to make a public statement of this nature certainly makes undertaking reasonable diligence efforts and filing a Form T2062C a plausible alternative to demanding that the vendor obtain a certificate of compliance or just withholding from the purchase price, at least for a purchaser who is unrelated to the vendor. Whether or not a purchaser would be willing to take these extra steps and rely on the subsection 116(5.01) exception of course depends on the facts of each case, including the relative bargaining position of the parties and the extent to which there is doubt as to the vendor's treaty entitlement.

#### 1. Form T2062C

Form T2062C is an officially sanctioned way in which to satisfy the third condition of the new subsection 116(5.01) exception to the purchaser remittance obligation.<sup>58</sup> However, it is relevant to the first and second conditions as well. As to the first condition (rea-

sonable inquiry as to treaty residence), the new form provides an "optional" area for the vendor to certify its agreement with the information provided in the remainder of the form. In the completion instructions on the form, the CRA states that it will "generally accept that the purchaser has made reasonable inquiry if [this optional part of the form] is completed by the vendor or an equivalent declaration is obtained from the vendor."

When the nonresident vendor is a partnership, the CRA has stated that the purchaser should complete one T2062C for each of the partners eligible for treaty relief, indicating the portion of the purchase price that would be in proportion to the partner's share of the gain. For other partners, the purchaser must either withhold from the purchase price or have received a certificate of compliance from the CRA.<sup>59</sup>

When the vendor is a limited liability company that is transparent for U.S. tax purposes, the CRA's position is that the purchaser cannot use a T2062C notice. Even though U.S. resident members of the LLC may be entitled to substantive relief from Canadian taxation via Article IV(6) of the Canada-U.S. treaty, for withholding purposes the CRA views the LLC as the vendor and considers that vendor to be ineligible for treaty relief because it is not a U.S. resident by virtue of not being liable to tax in the U.S.<sup>60</sup> An exception is made administratively only when all of the LLC's members are U.S. residents entitled to benefits under the Canada-U.S. treaty. Otherwise, it appears that the CRA will not entertain requests for treaty relief made on behalf of an LLC's members under subsection 116(5.01) in the same way as is possible via the certificate of compliance process. Accordingly, a purchaser of property from an LLC that is transparent for U.S. purposes would have to withhold on the purchase price or have received a certificate of compliance in order to satisfy the purchaser remittance requirement.

As noted above, various questions must be addressed for a purchaser to conclude that a vendor is treaty exempt regarding a property. The instructions for completing Form T2062C suggest ways of confirming

<sup>57</sup>CRA Notice "Disposing of or acquiring certain Canadian property," available at <http://www.cra-arc.gc.ca/tx/nnrdsnts/cmmn/dsp/menu-eng.html>. See also the following comments made by the CRA at the 2009 Canadian Tax Foundation British Columbia Tax conference:

For the purpose of the treaty-protected status of a property, the tax legislation does not provide any protection to the purchaser. However, the CRA will generally not raise a purchaser liability assessment in situations where the purchaser has made a good faith attempt to determine that the property is in fact treaty protected. A simple statement from the vendor claiming that the property is treaty-protected is not enough to demonstrate good faith. For example: in the case of shares of a Canadian corporation, the purchaser should obtain a declaration from the corporation certifying that the value of the shares is not principally derived from Canadian real property, Canadian resource property or timber resource property. In general, purchasers should carefully review the applicable tax treaty along with the section titled Treaty Protected Property in the general information provided on Form T2062C and follow the guidance provided. We cannot state that we will never raise a purchaser assessment in any particular circumstances. We will have to review each situation on its own merit.

<sup>58</sup>As noted in Section II.A of this article, Form T2062C is also the form that a purchaser of treaty-exempt property from a

(Footnote continued in next column.)

related vendor may use to cause such property to be "excluded property" for purposes of the vendor notification requirement.

<sup>59</sup>CRA document 2009-031737117, dated July 16, 2009. Note that on Form T2062C itself, the CRA recommends that if the gain is only partially treaty-exempt, purchasers of property from partnerships (or hybrids) should withhold 25 percent from the purchase price unless the partnership provides a certificate of compliance.

<sup>60</sup>*Id.* Arguably this conclusion is at odds with the decision of the Tax Court of Canada in *TD Securities (USA) LLC v. the Queen*, 2010 TCC 186, rendered regarding the period predating Article IV(6) of the Canada-U.S. treaty; see Suarez, "Canada Will Not Appeal Ruling on LLC's Treaty Rights," *Tax Notes Int'l*, May 17, 2010, p. 512, *Doc 2010-10461*, or 2010 *WTD 91-2*; and "Canadian LLC Ruling Overturns Long-Standing Policy," *Tax Notes Int'l*, Apr. 19, 2010, p. 199, *Doc 2010-7935*, or 2010 *WTD 69-1*.

whether property is treaty-protected property for the purposes of the second condition of the subsection 116(5.01) exception. The instructions state:

In order to confirm that the property in question is treaty-protected property, you may consider the following:

- For a vendor who is an individual, request information concerning the vendor's residence. Many of Canada's tax treaties contain provisions to limit exemptions when the vendor was previously a resident of Canada. These limitations should be reviewed in conjunction with the vendor's residency information.
- Tax treaties may include limitation on benefits (LOB) provisions that specifically prevent unintended use of treaties by residents of third countries. You may consider having the vendor provide a certification related to the LOB provisions.
- For shares of a Canadian corporation, obtain a declaration from the corporation certifying that the value of the shares is not principally derived from Canadian real property, Canadian resource property, or timber resource property.
- For a capital interest in a Canadian resident trust or a unit of a Canadian resident unit trust, obtain a declaration from the trust that the value of the trust is not principally derived from Canadian real property, Canadian resource property, or timber resource property.

We understand that Form T2062C is being revised to add a certification from the vendor regarding its eligibility for treaty benefits.

### E. Remittance Procedures and Penalties

When no relief from the purchaser remittance obligation applies, any amounts payable by the purchaser must be remitted to the CRA within 30 days from the end of the month in which the property was acquired (for example, November 30 for a property acquired in October). When remitting, the purchaser should give the particulars of the transaction, provide its full name and address along with the full name and address of the vendor, and specify whether the remittance pertains to 116(5.2) property.

A purchaser that does not remit the amount (if any) required under the purchaser remittance obligation is liable to pay that amount as a tax.<sup>61</sup> Such a purchaser is also liable for interest on the unremitted amount and may also be assessed a penalty equal to 10 percent of

the amount that was required to have been remitted.<sup>62</sup> For second and subsequent failures to remit during the same year, or if the failure to remit was made knowingly or under circumstances amounting to gross negligence, the penalty is 20 percent of the amount required to be remitted.<sup>63</sup> There is no statutory time limit for the CRA to assess under these provisions, so this is not a liability that eventually disappears over time.<sup>64</sup>

### F. Managing Purchaser Risk

Purchasers of TCP from vendors to whom they are unrelated are always reluctant to take on any risk relating to the purchaser remittance obligation. This is understandable, given that the obligation relates to someone else's taxes.

The easiest course of action for purchasers is always to simply insist that the vendor obtain and present a certificate of compliance (failing which the purchaser will withhold and remit), as it requires no effort on the part of the purchaser and provides complete relief from liability. However, in many cases vendors will resist doing so and demand that the purchaser not withhold from the purchase price, because they are unwilling to incur the effort and expense of obtaining a certificate of compliance and believe that the property is not TCP or that one or more of the exceptions to the purchaser remittance obligation applies.

The parties' relative bargaining strength is usually the determining factor as to whether the purchaser accepts anything less than the absolute protection of a certificate of compliance. Generally the more uncertainty there is regarding the applicability of an exception to the purchaser remittance obligation, the less likely the purchaser will be to contemplate relying on such exception and the more protection the purchaser will demand from the vendor if no certificate of compliance is obtained.

In these circumstances the parties must address who will bear the risk of the CRA challenging the purchaser for not remitting, acknowledging that even if the purchaser is ultimately successful there is time and expense involved in dealing with the challenge. While the appropriate result will depend on the facts of each case, some general comments may be made in this regard.

The starting point is that the tax in question is the vendor's tax, and as such a purchaser who agrees to take on any material liability should reasonably expect a high degree of vendor cooperation in mitigating the risk associated with not withholding and remitting. This will generally involve the vendor:

<sup>62</sup>Subsection 227(9.3) and para. 227(9)(a).

<sup>63</sup>Para. 227(9)(b).

<sup>64</sup>Subsection 227(10.1).

<sup>61</sup>Subsection 116(5) for most TCP and subsection 116(5.3) for 116(5.2) property.

- providing information necessary for the purchaser to obtain some degree of comfort as to why no purchaser remittance obligation applies;
- accepting some or all of the allocation of risk should the purchaser remittance obligation be found to be in fact applicable for some reason; and
- assisting the purchaser in obtaining the benefit of whatever potential relief from liability the purchaser may be able to obtain outside of the certificate of compliance regime.

For example, to the extent that the vendor is asserting treaty relief as the basis for there being no purchaser remittance obligation, a purchaser would reasonably expect the vendor to complete and provide a Form T2062C in a timely manner and help the purchaser document its diligence efforts, in order to come within the scope of the CRA website statement described in Section III.D of this article, as to when a purchaser who believes a property to be treaty-protected would not be pursued by the CRA for not remitting.

Generally, one would expect a purchaser who agrees not to withhold and remit and who will not be receiving a certificate of compliance to ask for the following from the vendor in the agreement of purchase and sale when the agreement is signed:

- a representation and warranty as to why no purchaser remittance obligation exists (that is, that the vendor is not a nonresident of Canada for purposes of the ITA, or that the subject property is not TCP, or that the property is excluded property or treaty-protected property in relation to the vendor), along with any specific representations supporting the exemption that the CRA would wish to see made to demonstrate the purchaser's reasonable diligence<sup>65</sup>;
- a "bring-down" provision providing that these representations and warranties made at the time of signing will continue to be accurate when the sale is completed, that is, the closing<sup>66</sup>;
- a covenant not to do anything (or omit to do anything) between signing and closing that would cause these representations and warranties to cease to be true at closing;
- a further covenant to provide the purchaser with any information or assistance that it may reason-

<sup>65</sup>See the CRA comments quoted in note 57, *supra*. In the case of treaty-protected property, it is important that the representation fully address all of the requirements necessary for the exception to apply on the facts, for example, that the vendor is the beneficial owner of the property, not merely the legal owner.

<sup>66</sup>Typically there will be a general "bring-down" provision applicable to most or all of the vendor's representations and warranties.

ably require before or after closing related to this issue, in particular as regards dealing with the CRA (including preparing and filing a Form T2062C);

- an indemnity compensating the purchaser for any liability to the CRA (taxes, penalties, and interest) as a result of not remitting the amount otherwise required, plus any costs or expenses involved in dealing with the CRA on this point; and
- a clause ensuring that these representations, warranties, covenants, and indemnities survive the closing and continue indefinitely, given the lack of any time limit for the CRA to assess for noncompliance. In the appropriate circumstances, the purchaser may insist that the indemnity be secured for a period of time (for example, by a holdback of some of the sale proceeds or by a third-party letter of credit).

Identifying and avoiding a noncompliance issue is far better than not withholding and then relying on an indemnity for protection, since trying to pursue a counterparty under an indemnity can be difficult and time-consuming. For this reason, a purchaser will typically want to obtain *before closing* a significant degree of information supporting the vendor's claim that an exception to the purchaser remittance obligation applies. This is especially so when the exception is treaty-based, given the wide range of potential uncertainties involved in claiming treaty relief (discussed in Section III.D of this article) and the need for the purchaser to demonstrate due diligence efforts to come within the CRA's apparent administrative policy offering relief.<sup>67</sup> The result in any case will depend on the circumstances, including the parties' relative bargaining power, the creditworthiness of the vendor, and how much uncertainty exists as to the exception being relied on. Ultimately the allocation of risk is a business decision, with each party requiring informed counsel to assess the degree of risk involved.

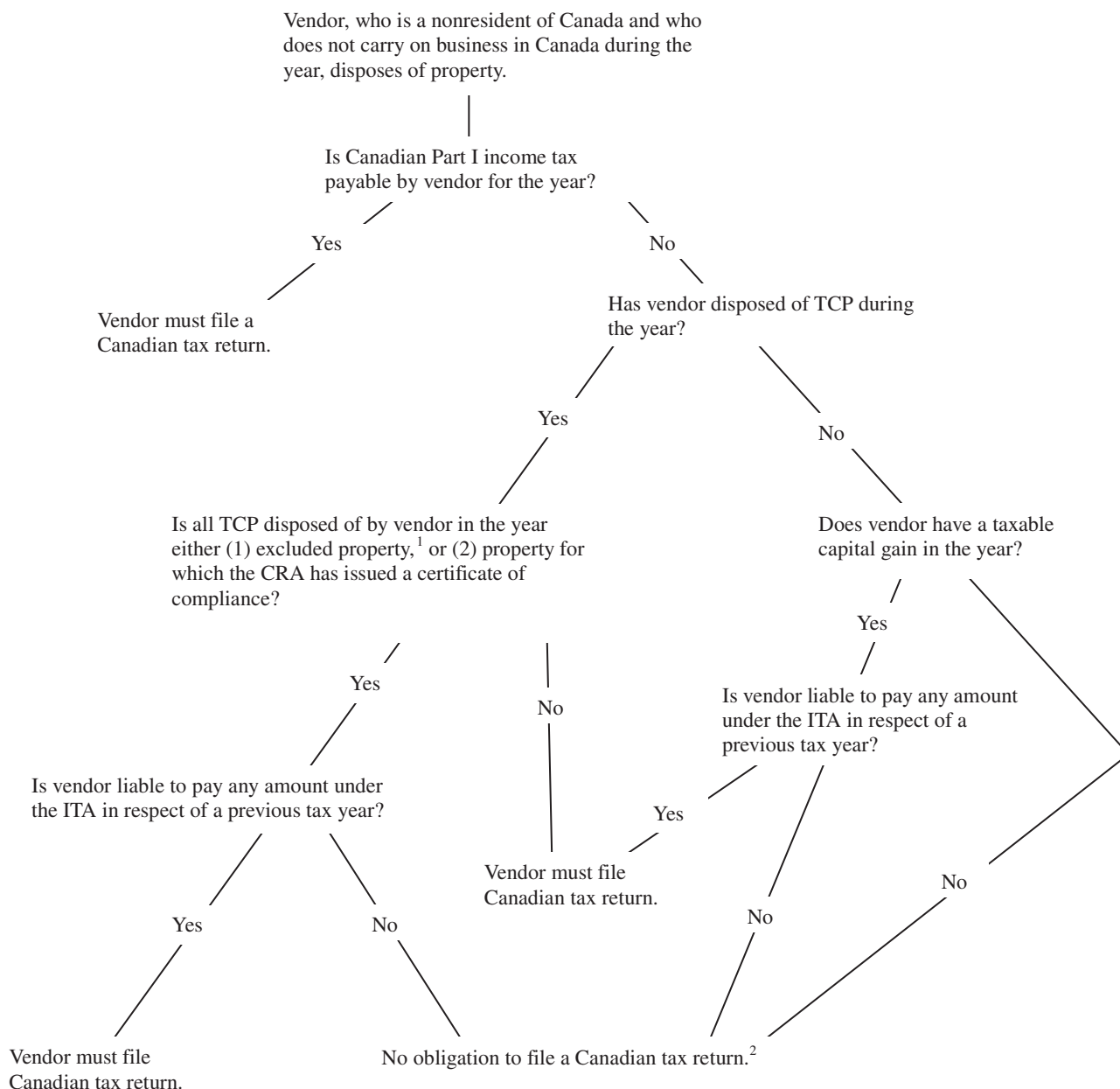
#### IV. Tax Return Filing Obligation

The third element of the 116 system is the vendor's obligation to file a Canadian tax return for the year. Filing obligations for corporations are largely similar although not identical to those for natural persons and trusts; as a result, it is necessary to discuss them separately to some extent. This discussion starts from the position of a person who at no time during the year carries on business in Canada or is resident in Canada.<sup>68</sup> The vendor's requirement to file a Canadian income tax return is summarized in Figure 3.

<sup>67</sup>See *supra* note 57.

<sup>68</sup>Carrying on business in Canada requires a corporation to file an income tax return for the year; see clause 150(1)(a)(i)(B).

**Figure 3. Summary of Vendor Canadian Tax Return Filing Obligation**



<sup>1</sup> Excluded property includes, most notably, (1) shares of a corporation listed on a recognized stock exchange, and (2) a “treaty-exempt property,” being a property any gain from the disposition of which by the vendor would be exempt from Canadian tax under a tax treaty (but if the purchaser and the vendor are related, the purchaser has an obligation to notify the CRA).

<sup>2</sup> A tax return must be filed by a corporation that would owe Part I income tax for the year but for an exemption provided by a tax treaty, unless the treaty-exempted tax arises solely from a disposition of TCP.

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## A. Income Tax Owed for the Year

A nonresident that owes Canadian income tax under Part I of the ITA for a particular year must always file a tax return for that year.<sup>69</sup> A nonresident may have tax payable under Part I of the ITA if, in the current year or a previous year, it carried on a business in Canada, was employed in Canada, or disposed of TCP.<sup>70</sup>

## B. Disposing of TCP in the Year

A vendor that disposes of TCP in a year must file a Canadian income tax return for that year (even if no tax is payable under Part I) unless the disposition was an “excluded disposition.”<sup>71</sup> Four conditions must be satisfied for a disposition to be an excluded disposition, two of which this discussion presupposes have been met:<sup>72</sup>

- the taxpayer is a nonresident at the time of the disposition; and
- there is no tax payable under Part I by the vendor for the current tax year (as noted above, a current-year Part I tax liability always results in a tax return filing obligation).

The following two further conditions must also be met for an excluded disposition to exist:

- all of the TCP disposed of by the vendor in that year must either be excluded property or property for which the CRA has issued a certificate of compliance<sup>73</sup>; and
- the vendor must not be liable to pay any amount under the ITA (whether under Part I or any other part of the ITA) regarding any previous tax year (other than amounts for which the CRA has accepted and holds adequate security).

Unless all four of these conditions are met, a vendor of TCP must file a Canadian tax return.

## C. Taxable Capital Gain in the Year

If the vendor has a taxable capital gain<sup>74</sup> in the year otherwise than from an excluded disposition, it must

file a Canadian tax return.<sup>75</sup> An excluded disposition for this purpose is the same as for a disposition of TCP (described immediately above) and the same four conditions apply.

It will be rare for a taxpayer who has not been required to file a Part I Canadian tax return under any of the previously described rules (that is, a nonresident who does not carry on business in Canada, who has no tax payable under Part I of the ITA for the year, and who has not disposed of any TCP in the year other than through excluded dispositions) to have to file a tax return under the taxable capital gain test. Conceivably, such a nonresident could realize a taxable capital gain on non-TCP and be unable to meet the final condition of the excluded disposition test because of being liable to pay an amount under the ITA for a previous tax year. If such a nonresident does owe Canadian tax for a previous tax year, a strict reading of the ITA would seem to require the nonresident to file a Canadian tax return, even though the taxable capital gain arose on non-TCP, and the nonresident had no taxable connection to Canada nor any income that was taxable in Canada in the current tax year. The tax policy objective of requiring a nonresident to file a return in such circumstances is unclear.

## D. Treaty-Based Returns — Corporations

A corporation (but not an individual) must also file a return if it would owe tax under Part I for the year but for a tax treaty that prevents Canada from taxing the corporation on the relevant income or gain. However, this tax return filing obligation does not arise if the only reason that tax would be owed but for the treaty provision is a disposition of TCP that is “treaty-protected property”<sup>76</sup> of the corporation. Since non-resident corporations are essentially only subject to Part I income tax in a year by virtue of carrying on business in Canada or disposing of TCP in the year or a prior year, it will be rare that a nonresident corporation that does not carry on business in Canada *in the year* would be required to file a tax return for the year on this basis.<sup>77</sup>

<sup>69</sup>Clause 150(1)(a)(ii)(A) for corporations, and subpara. 150(1.1)(b)(i) for individuals.

<sup>70</sup>The possibilities of a vendor having Part I tax payable in the year seem remote when the vendor is nonresident, does not carry on business in Canada, and does not dispose of TCP. Such a situation might occur for natural persons formerly employed in Canada, or if some deductions claimed in a prior tax year are reversed and have consequences for the current tax year.

<sup>71</sup>Clause 150(1)(a)(i)(D) for corporations and subpara. 150(1.1)(b)(iii) for individuals.

<sup>72</sup>Defined in subsection 150(5).

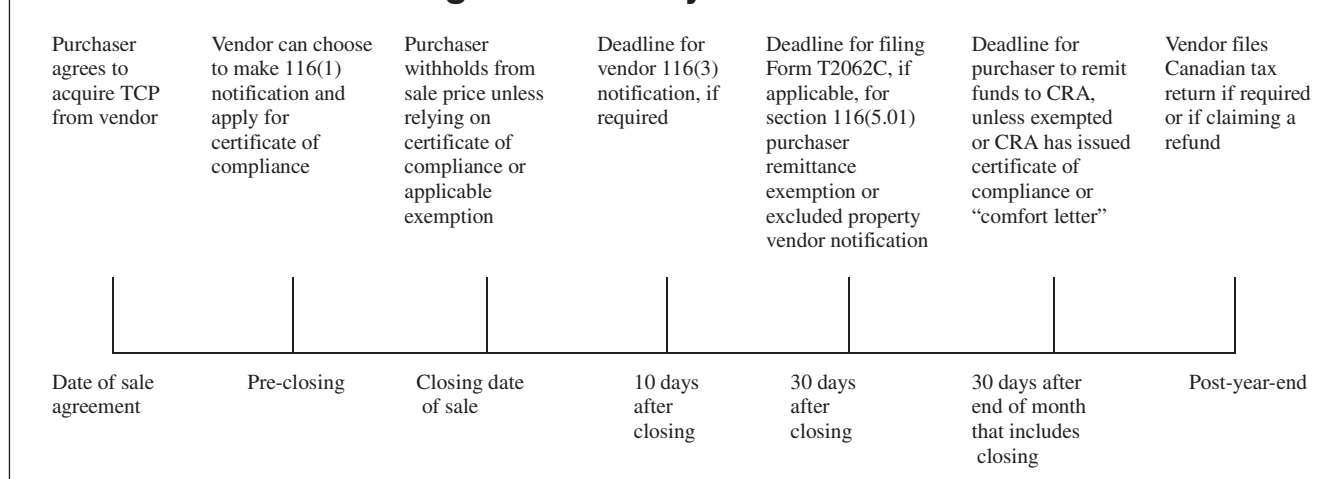
<sup>73</sup>See sections II.A and II.E of this article.

<sup>74</sup>Only 50 percent of capital gains are included in computing income for Canadian income tax purposes. The 50 percent included in income is referred to as a “taxable capital gain.”

<sup>75</sup>Clause 150(1)(a)(i)(C) for corporations and subpara. 150(1.1)(b)(iii) for individuals.

<sup>76</sup>Defined in subsection 248(1) as “property any income or gain from the disposition of which by the taxpayer at that time would, because of a tax treaty with another country, be exempt from tax under Part I.”

<sup>77</sup>This might occur when it has treaty-exempt income for the year as a result of having carried on business in Canada during a prior year.

**Figure 4. 116 System Timeline**

### E. Procedure and Penalties

Tax returns for corporations are due within six months from the end of the tax year, while those for trusts are due 90 days from the end of the year. Natural persons are required to file a tax return for any particular year by April 30 of the following year. (Self-employed persons have until to June 15 to file but must pay any amounts owing by April 30.)

A person who fails to file an income tax return for a tax year when required may be subject to a penalty equal to the total of (a) 5 percent of the person's unpaid Part I tax that is payable for the tax year and (b) 1 percent of the person's unpaid Part I tax payable for the year for each complete month, not exceeding 12 months, for which the return was not filed.<sup>78</sup> In the case of a nonresident corporation that fails to file when required, the penalty is the greater of the amount described in the preceding sentence or \$100 plus \$25 per day for each day the return is not filed, up to a maximum of \$2,500.<sup>79</sup>

### V. Conclusion

The 116 system can be difficult to navigate for non-residents and those acquiring property from them, and there are significant practical challenges that often arise in trying to comply with these rules. The timelines for compliance are fairly tight, and accordingly parties to a transaction that is potentially subject to the 116 system need to have a good understanding of the process (and in particular the deadlines) before they agree to the sale of property, so that they can agree on who will do what and by what date. Figure 4 illustrates what might

occur in the course of a transaction that is subject to the 116 system and the most important deadlines for taking action (not all of which will be applicable in any given case, depending on how the parties propose to comply with the rules).

### Appendix. CRA Section 116 Resources

Information Circular IC 72-17R6, "Procedures Concerning the Disposition of Taxable Canadian Property by Nonresidents of Canada - Section 116," available at <http://www.cra-arc.gc.ca/E/pub/tp/ic72-17r6/README.html>.

Information Circular IC76-12R6, "Applicable rate of part XIII tax on amounts paid or credited to persons in countries with which Canada has a tax convention," available at <http://www.cra-arc.gc.ca/E/pub/tp/ic76-12r6/README.html>.

"Pending updates to IC76-12, *Applicable rate of part XIII tax on amounts paid or credited to persons in countries with which Canada has a tax convention* related to forms NR301, NR302, and NR303," available at <http://www.cra-arc.gc.ca/formspubs/frms/ic76-12r6-eng.html>.

Interpretation Bulletin IT176R2, "Taxable Canadian property — Interests in and options on real property and shares," available at <http://www.cra-arc.gc.ca/E/pub/tp/it176r2/README.html>.

"Disposing of or Acquiring Certain Canadian Property," available at <http://www.cra-arc.gc.ca/tx/nrsdnts/cmmn/dsp/menu-eng.html>.

CRA Forms and Publications, available at <http://www.cra-arc.gc.ca/formspubs/menu-eng.html>.

Contact numbers for the CRA International Tax Services Office (as provided in Toronto Centre CRA & Professionals Group Newsletters, 9-2 Vol. 9, No. 2, May 2010):

<sup>78</sup>Subsection 162(1). There are additional penalties for repeated failure to file a tax return.

<sup>79</sup>Subsection 162(2.1).

## SPECIAL REPORTS

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### *Individuals:*

- 1-800-267-5177 for calls from anywhere in Canada and the U.S.; or
- 1-613-952-3741 for calls from outside Canada or the U.S. (collect calls accepted).

### *Nonresident Corporations:*

- 1-800-561-7761 (Ext. 9144) for calls from anywhere in Canada and the U.S.; or

- 1-613-954-9681 for calls from outside Canada or the U.S. (collect calls accepted).

### *Nonresident Trusts:*

- 1-800-561-7761 (Ext. 9150) for calls from anywhere in Canada and the U.S.; or
- 1-613-952-8753 for calls from outside Canada or the U.S. (collect calls accepted). ◆