Tax Law

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2010 Federal Budget Amendments to "Taxable Canadian Property" – Your Questions Answered

It has been over a month since the March 4, 2010 release of the Canadian Federal Budget (the "Budget"). The Budget included proposed amendments that will significantly narrow the definition (the "TCP Definition") of "taxable Canadian property" ("TCP"). As a result, Canada's domestic system for taxing gains realized by non-residents of Canada will be similar to that of the United States: Canadian tax will generally only arise in respect of gains from dispositions of (i) real property situated in Canada and Canadian resource property, and (ii) shares of corporations, and equity interests in partnerships and trusts, where the shares or equity interests derive (or have derived in the previous five year period) more than 50% of their value from real property situated in Canada or Canadian resource property. As a result of this substantive amendment, non-resident vendors will no longer need to obtain Canadian tax clearance certificates in respect of many dispositions of shares of Canadian corporations.

Although the proposed amendments to the TCP Definition are relatively straightforward in concept, a number of questions have arisen with respect to the practical consequences of the new definition.

Relevance of TCP Status

1. What are the consequences to a non-resident of disposing of TCP?

Capital gains realized by a non-resident of Canada on the disposition of TCP are subject to tax in Canada, unless exempted under an applicable tax treaty. If Canadian tax is payable on the disposition (and in some instances even if it is not), the non-resident has an obligation to file a Canadian tax return for the taxation year in which the disposition occurs. In addition, a non-resident that disposes of TCP generally must provide notice of the disposition to the Canadian tax authorities and obtain a tax clearance certificate under section 116 of the *Income Tax Act* (Canada)) (a "Section 116 Certificate"). In the absence of a Section 116 Certificate, the purchaser of the TCP may be required to remit to the Canadian government an amount equal to 25% of the gross purchase price. Certain property, including listed securities, is excluded from the Section 116 Certificate procedures even if it constitutes TCP.

The New TCP Definition

2. What shares are considered to be TCP under the new TCP Definition?

Unlisted shares of corporations will constitute TCP if more than 50% of their value was derived (directly or indirectly) from real property or resource property situated in Canada (or an option in respect thereof) at any time in the five year period preceding the disposition. Similar rules apply to trust units (other than units of mutual fund trusts) and partnership interests.

Listed shares of public corporations will constitute TCP if, at any time in the five year period preceding the disposition:

- more than 50% of the value of the shares was derived (directly or indirectly) from real property or resource property situated in Canada (or an option in respect thereof); and
- the holder (and persons with whom the holder did not deal at arm's length) owned 25% or more of any class of shares of the corporation.

Similar rules apply to shares of mutual fund corporations and units of mutual fund trusts.

Shares of a corporation will not cease to be TCP simply because the underlying real property or resource-property is disposed of by the corporation, even on a taxable basis.

3. Is the residence of a corporation, trust or partnership relevant to the TCP Definition?

No. The residence, place of incorporation or place of formation of a corporation, partnership or trust is not relevant to the TCP Definition. For example, shares of a non-Canadian corporation which satisfy these conditions will constitute TCP; however, certain treaties may apply to exempt gains on such shares from Canadian tax.

4. What other property will constitute TCP?

Other property, including real property situated in Canada, Canadian resource property and property used in a business carried on in Canada, will continue to be TCP. Options in respect of, or interests in, TCP will generally also constitute TCP. It is unclear how the five year look-back rule described above will apply to options to acquire treasury shares where the issuer ceased to be real property based while the option was outstanding.

Where shares which are TCP are disposed of in certain tax-deferred transactions (including amalgamations, conversions and certain share-for-share exchanges), the shares received as consideration will be deemed to constitute TCP for five years following the tax-deferred transaction (or longer, if the new shares themselves satisfy the TCP Definition).

5. Does the new TCP Definition apply to property acquired before the Budget date?

Yes. The new TCP Definition applies to all dispositions that occur after March 4, 2010, regardless of when the property was acquired.

However, it should be noted that certain shares acquired prior to March 4, 2010 may be deemed to constitute TCP, regardless of whether the shares ever derived any part of their value from Canadian real property or resource property. For example, under the prior definition of TCP, shares that were acquired pursuant to certain tax-deferred transactions (such as amalgamations, conversions and certain share-for-share exchanges), were generally deemed to be TCP indefinitely. Under the new rules, this deemed status will continue to apply for a five year period following the particular tax-deferred transaction, regardless of whether the shares derived any of their value from Canadian real property or resource property at the time of the transaction or at any other time. **As a result, shares of a corporation acquired prior to March 4, 2010 may still constitute TCP today, even though the corporation owned no Canadian real property or resource property at any time in the last five years.**

6. Does the change in the TCP Definition affect Canada's tax treaties?

No. A non-resident who is a resident of a country with which Canada has a tax treaty may still be relieved from Canadian tax on a disposition of TCP depending on the existing provisions of the particular treaty. However, the change in the TCP Definition will likely mean that the need to resort to a treaty to claim exemption from Canadian tax should be significantly reduced.

7. How is it determined whether the value of a share is derived directly or indirectly from real property or resource property?

The proposed amendments to the TCP Definition do not provide any guidance as to the meaning of "derived directly or indirectly" in this context. Certain shares of a corporation could conceivably constitute TCP where the corporation does not actually own any Canadian real property or resource property, but where its assets or business operations are indirectly connected to Canadian real property or resource property.

The term "real property" is not defined but takes its meaning from the relevant provincial law. Questions may arise as to whether certain forms of property, such as fixtures, production equipment and certain intangible assets (such as rights and licences to use land in a certain manner), are included in the definition of real property. In addition, there is no guidance as to how liabilities should be taken into account in the valuation of real property for the purposes of the TCP Definition.

Considerations On A Purchase And Sale Of Canadian Shares

8. Do these new rules change the obligations imposed on a purchaser?

Yes and no. A purchaser is still required to withhold and remit 25% of the gross purchase price on the acquisition from a non-resident vendor of shares (and other equity interests) which constitute TCP unless (i) the vendor provides the purchaser with a Section 116 Certificate from the Canada Revenue Agency ("CRA"), or (ii) generally, the purchaser is satisfied that that vendor is entitled to relief from Canadian taxation under an applicable tax treaty. The proposed amendments do not change these obligations. However, they do restrict their practical application by significantly narrowing the circumstances in which shares are TCP.

The 25% withholding requirement does not apply to acquisitions of shares that are TCP solely because of the application of a deeming rule (such as shares acquired on a tax-deferred transaction – see question 4, above). Purchaser withholding is only required on the acquisition of shares which constitute TCP because of current or prior Canadian real property or resource property holdings.

9. Are non-resident vendors still required to file Canadian tax returns?

Generally, a non-resident vendor of TCP is required to file a Canadian tax return unless the vendor first obtained a Section 116 Certificate (or none was required) and no tax is payable by the vendor. A Canadian tax return is not required where the property sold is not TCP. Accordingly, by narrowing the scope of which property constitutes TCP, non-residents will be obliged to file a tax return much less frequently.

10. Who bears the risk of determining whether a share is TCP?

The purchaser. If a sale transaction is completed without a Section 116 Certificate and the purchaser did not withhold and remit, a subsequent determination by the CRA that the shares were TCP (and that no treaty relief was available to the vendor) could result in purchaser liability, including penalties and interest.

Potential purchaser liability under the section 116 regime is not new; however, prior to the 2010 Budget, the purchaser typically protected itself by withholding and remitting unless the vendor obtained a Section 116 Certificate. The new TCP Definition introduces factual uncertainty as to which property may constitute TCP, such that it may not be clear when withholding is required. It remains to be seen which commercial practices will become accepted in the market to manage this risk.

11. How can a purchaser protect itself when determining whether more than 50% of the value of a share is (or has been at any time in the last five years) derived directly or indirectly from Canadian real property or resource property?

The purchaser can undertake due diligence to make its own determination as to whether the subject shares are TCP. This could include:

- detailed enquiries concerning the corporation's assets and liabilities over last the five years;
- a review of historic financial statements, tax returns, minute books and other corporate records; and
- the assistance of third-party valuators.

The purchaser can also negotiate representations and warranties from the vendor, and have these supported with indemnities and security. The viability of this approach will vary depending on the circumstances.

12. Should the purchaser bear the risk that the shares acquired may be TCP?

This will often be a matter of commercial negotiation. Many purchasers may not be willing to bear this risk. If the shares are TCP, any tax owing is a liability of the vendor, and presumably the vendor should bear the risk. However, there are numerous potential scenarios where this factual determination will be unclear or where the information required to make the determination will not be available, especially in light of the five year look-back.

Legislative or administrative responses to these practical issues may emerge, which could include:

- a statutory "due diligence" defence for the purchaser;
- the ability of a purchaser to rely on a vendor's certificate or affidavit stating that the subject shares are not TCP, made "on penalties of perjury" (similar to the U.S. FIRPTA regime); or
- a procedure where the CRA pre-determines whether certain property is TCP.

Considerations For A Non-Resident Acquiring Shares

13. Non-residents were often advised to use a third country blocker entity to acquire Canadian shares. These entities can be cumbersome and expensive to maintain. In light of the changes to the TCP Definition, is a blocker still advisable?

It depends on the circumstances. In situations where it is reasonably certain that the investment is not (and is unlikely to become) Canadian real property or resource property based, a blocker may be unnecessary.

In contrast, where the investment could be TCP under the new rules (or even where there is some uncertainty in this regard), a blocker may be used to minimize filing obligations (including the Section 116 Certificate), especially in situations involving a widely-held investment fund.

A blocker may also be beneficial where the relevant tax treaty provides additional tax relief even where the subject property is TCP. For example, certain treaties provide relief where the shares being sold derive more than 50% of their value from real property in which a business is carried on. A blocker may also be beneficial where a lower dividend withholding rate may be advantageous. As always, consideration must be given to the substance of the blocker and to treaty shopping concerns.

14. When a non-resident acquires a previously issued share of a private Canadian corporation, does it need to enquire as to the history of the share and the prior real property/resource property holdings of the corporation?

Yes. The TCP Definition looks to whether the particular unlisted share held by the non-resident has derived its value from Canadian real property or resource property in the last five years, regardless of whether the non-resident holder owned the share during that prior five year period. However, deemed TCP status will not carry over from one shareholder to another.

15. Can the acquisition of unlisted Canadian shares be structured to minimize the risk of TCP status on a future disposition of those shares?

If the share derives more than 50% of its value from Canadian real property or resource property at the time the non-resident is making the acquisition, the manner in which the non-resident acquires the share generally should not matter (subject to the discussion above concerning blockers).

However, where the share may be considered to be TCP solely because of prior Canadian real property or resource property holdings, the non-resident purchaser may want to consider structuring the acquisition so as to avoid TCP status. For example, the non-resident could consider incorporating a Canadian acquisition company ("Acquireco") to acquire the Canadian target shares from the vendors. The shares of the Acquireco (even if it amalgamates with the target) will not be TCP solely because of any prior real property/resource property holdings in the target. Alternatively, where possible, the non-resident could consider acquiring newly issued treasury shares of the target.

16. When a non-resident makes a share investment in a Canadian corporation, should the non-resident seek additional covenants relating to the future TCP status of the shares?

The answer depends on the ownership interest in the Canadian corporation. Where the non-resident will own a controlling interest in the Canadian corporation, representations and covenants from the corporation or the other shareholders are unlikely to be necessary, as the non resident should be knowledgeable about, and have control over, the real property/resource property holdings of the corporation.

Where the non-resident has a substantial but non-controlling interest in the Canadian corporation, the non-resident should consider requesting regular periodic statements from the Canadian corporation respecting its Canadian real property/resource holdings. It should also consider requesting a covenant that the Canadian corporation will not acquire Canadian real property or resource property without the non-resident's consent and that it will take reasonable steps to ensure that (to the extent possible) shares of the corporation will not at any time derive more than 50% of their value directly or indirectly from Canadian real property or resource property.

In any event, it is recommended that non-resident investors in a Canadian corporation (particularly a private corporation) document the corporation's direct or indirect holdings of Canadian real property or resource property on a regular and continuous basis. This should also assist in demonstrating to a future purchaser of unlisted shares that the shares are not TCP.

17. Non-residents often make investments in unlisted convertible preferred shares of Canadian public corporations. Are there any special TCP considerations applicable to these investments?

Both the preferred shares and the common shares must be tested separately under the TCP Definition. Where the issuing corporation has not had significant Canadian real property or resource property holdings at any time, no TCP concerns should arise.

However, if the shares of the issuer may derive more than 50% of their value from Canadian real property or resource property, a number of issues should be considered. The unlisted preferred shares will constitute TCP, even though the listed common shares that may be acquired on conversion do not comprise 25% or more of the corporation's common share equity and would not constitute TCP if directly acquired by the non-resident shareholder. In addition, where the preferred shares are TCP at the time of conversion, the listed common shares acquired on conversion will be deemed to constitute TCP (regardless of the holder's ownership interest) for a period of five years following the conversion (and for longer, if the common shares themselves satisfy the TCP Definition). If the preferred shares were only TCP because of prior real property holdings, the conversion will restart the five-year clock.

Interestingly, where the investment is in the form of a convertible debenture which would, on conversion, result in the non-resident owning less than 25% of any class of shares of the Canadian company, neither the debenture nor the listed common shares received on conversion will constitute TCP to the holder, even if the corporation has significant Canadian real property or resource property holdings.

Further Questions

18. What should you do if you have any further questions?

Contact any of the following lawyers at Goodmans:

Maureen Berry
mberry@goodmans.ca 416.597.4287

Alan Bowman
abowman@goodmans.ca 416.597.4209

Glenn Ernst
gernst@goodmans.ca 416.597.3770

Neil Harris
nharris@goodmans.ca 416.597.4117

Jon Northup
jnorthup@goodmans.ca 416.597.4228

Mitchell Sherman
msherman@goodmans.ca 416.597.4189

Carrie Smit
csmit@goodmans.ca 416.597.4230

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