tax notes international

Volume 53, Number 4 ■ January 26, 2009

Canada's Revised Section 116 Regime for Nonresident Vendors

by Steve Suarez and David Gaskell

Reprinted from *Tax Notes Int'l*, January 26, 2009, p. 321

PRACTITIONERS' CORNER

Canada's Revised Section 116 Regime for Nonresident Vendors

by Steve Suarez and David Gaskell

Section 116 of the Income Tax Act (Canada) (the Act) applies when a nonresident of Canada disposes of types of property that are considered to have a strong 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 Canadian-situs property. The system created by these provisions (the 116 system) gives rise to three principal requirements:

- **Notification.** The nonresident vendor may be required to provide notification of the disposition to the Canada Revenue Agency.
- **Remittance.** The purchaser of the property, wherever resident, may be required to remit a specified percentage of the purchase price (usually 25 percent) to the Receiver General of Canada on account of the vendor's Canadian income tax liability.
- **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 discusses these three obligations and, in particular, considers recent changes to these rules announced in the 2008 federal budget and enacted into law in 2008 (generally effective for dispositions occurring in or after 2009).[1]

Nonresidents with Canadian-situs property subject to the 116 system or persons (wherever resident) acquiring such property from such nonresidents must appreciate that these rules may apply whether or not any gain is realized or any Canadian tax is owed from the disposition by the vendor. The 2008 federal budget added many amendments to section 116 and the provisions governing the filing of a Canadian tax return that are intended to offer some relief, especially when gains on the relevant property are exempt from Canadian taxation under a bilateral tax treaty. However, despite these amendments section 116 still has broad application and may apply to property that gives rise to a gain exempt from tax in Canada by virtue of a bilateral tax treaty.

I. Background

A nonresident of Canada may be subject to regular Canadian income taxation under Part I of the Act 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).

Section 116 attempts to ensure that Canada can collect Part I income tax on the disposition of TCP by nonresident vendors, whose Canadian tax liabilities may otherwise be difficult to enforce.

The definition of TCP is obviously an important consideration that affects the scope of Canadian taxation of nonresidents and, more specifically, the 116

[1] *See* Steve Suarez, ''Canada's 2008 Budget Is Light on Business Tax Measures,'' *Doc 2008-4180* or *2008 WTD 40-2*.

system.[2] TCP is property that is considered to have a strong nexus with Canada. Some of the most important kinds of TCP include:

- real property situated in Canada;
- a share of the capital stock of a corporation resident in Canada that is not listed on a designated stock exchange[3] (that is, a private corporation);
- a share of the capital stock of a nonresident corporation that is not listed on a designated stock exchange if at any time during the previous 60 months:
  - — more than 50 percent of the fair market value of all of the property of the nonresident corporation was made up of TCP and certain Canadian resource properties; and
  - — more than 50 percent of the fair market value of the share was derived directly or indirectly from TCP and certain Canadian resource properties;
- a share of the capital stock of a Canadian-resident corporation that is listed on a designated stock exchange if at any time during the previous 60 months, the taxpayer, together with persons not dealing at arm's length with the taxpayer, owned 25 percent or more of the issued shares of any class of the corporation's shares;
- a share of the capital stock of a nonresident corporation listed on a designated stock exchange if at any time during the previous 60 months:
  - — more than 50 percent of the fair market value of all of the property of the nonresident corporation was made up of TCP and certain Canadian resource properties;
  - — more than 50 percent of the fair market value of the share was derived directly or indirectly from TCP and certain Canadian resource properties; and
  - — the taxpayer, together with persons not dealing at arm's length with the taxpayer, owned 25 percent or more of the issued shares of any class of the corporation's shares;
- a capital interest in a trust (other than a unit trust) resident in Canada;
- most property used in a business carried on in Canada; and
- an interest or option in respect of any of the foregoing property.

It is noteworthy that the Act includes in the definition of TCP shares of foreign corporations that own sufficient amounts of certain Canadian-situs property, in spite of the practical enforcement issues associated with trying to tax such foreign shares.

While most Canadian tax treaties greatly restrict the scope of properties that Canada retains the right to tax nonresidents regarding gains thereon, the 116 system encompasses all TCP (whether or not treaty exempt) unless specifically excluded. It is therefore essential to understand that the 116 system may apply in many situations when no Canadian tax is in fact payable by the vendor.

II. Vendor Notification

The vendor notification requirement under section 116 is an obligation on the vendor to provide information to the CRA within a specific time frame. While in general terms the vendor notification requirement can be described as applying on some dispositions of TCP, it is somewhat more complicated than this. The vendor notification requirement is summarized in Figure 1, and the reader may find it helpful to refer to this as a guide when reviewing the discussion that follows.

The vendor's disposition of TCP is the initial triggering event for the requirement of the vendor to notify the CRA. The scope of TCP has been described previously. For practical purposes a disposition is a sale or other alienation of a property, including those that are tax deferred such as section 85 nonrecognition or rollover transfer.[4] In many cases a vendor not subject to a

---

[2]The general definition of TCP is found in subsection 248(1) of the Act. Certain property is defined as TCP for purposes of some sections of the Act (including sections 2 and 150) but not section 116. However, in the vast majority of 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.

[3]Designated stock exchanges in Canada include the Toronto Stock Exchange, the TSX Venture Exchange, and the Montreal Exchange. A large number of foreign stock exchanges are also designated, including the New York Stock Exchange and the London Stock Exchange. *See* subsection 248(1) and section 262 of the Act. The process for designation of a stock exchange is described by the Department of Finance in News Release 2008-049, dated July 2, 2008. For further reference on this topic, see Stacy Long, ''New Canadian Guidelines for Stock Exchanges,'' *Tax Notes Int'l*, Oct. 20, 2008, p. 231, *Doc 2008-19111*, or *2008 WTD 206-9*.

[4]Disposition is defined 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 Act; *see* Interpretation Bulletin IT-474R2, ''Amalgamations of Canadian Corporations,'' released Jan. 8, 2008, at para. 45.

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. The comments that follow should thus be read as delineating the extent of the vendor's formal obligation to notify the CRA, rather than what will necessarily occur in any given situation.

A. Excluded Property

Not all dispositions of TCP trigger the vendor notification requirement. Disposition of excluded property[5] does not create a notification obligation. Excluded property is generally TCP that is either impractical to make subject to a notification requirement (such as most publicly listed and widely traded securities) or property that the purchaser is unlikely to be aware is TCP.

The most important kind of excluded property is shares of a corporation that are listed on a recognized stock exchange.[6] A recognized stock exchange is a designated stock exchange or any other stock exchange located in Canada or in an OECD member country that has a tax treaty with Canada. Units of some types of trusts are also excluded property, but publicly traded partnership units and some publicly traded trust units are not. Inventory (other than land or some resource properties) of a business carried on in Canada is also excluded property.

The 2008 budget amendments created a new category of excluded property called treaty-exempt property, which is defined in subsection 116(6.1) 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.''[7] Hence, no vendor notification is required when any gain on the property is (or would be if a gain existed) treaty exempt. However, when the vendor and the purchaser are related, a further requirement for property to be treaty-exempt property is that the purchaser must provide notice to the CRA within 30 days of the acquisition setting out:

- the date of the acquisition;
- the name and address of the vendor;
- a description of the property sufficient to identify it;
- the amount paid for the property; and
- the country under whose tax treaty with Canada the nonresident is treaty exempt from Canadian taxation on gains on the property.

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 new ''treaty-exempt property'' expansion 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 new Form T2062C.

When the vendor relies on the new treaty-exempt property element of the excluded property definition to forgo complying with the vendor notification obligation, the vendor will be assuming 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 new limitation on benefits provisions of the Canada-U.S. income tax convention, as recently modified by the fifth protocol. A vendor related to the purchaser must also rely on the purchaser to provide the CRA with the requisite notification in 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 Act (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 capital gains.[8] 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 provide notification regarding 116(5.2) property in order to receive a clearance certificate, which most purchasers (or at least most arm's-length purchasers) will generally demand. However, in terms of compliance with the Act, 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 CRA of the disposition. There are two procedures for meeting the vendor notification requirement. Under the first, a 116(3) notification, the vendor simply waits until the disposition occurs and then within 10 days sends the CRA the following information:

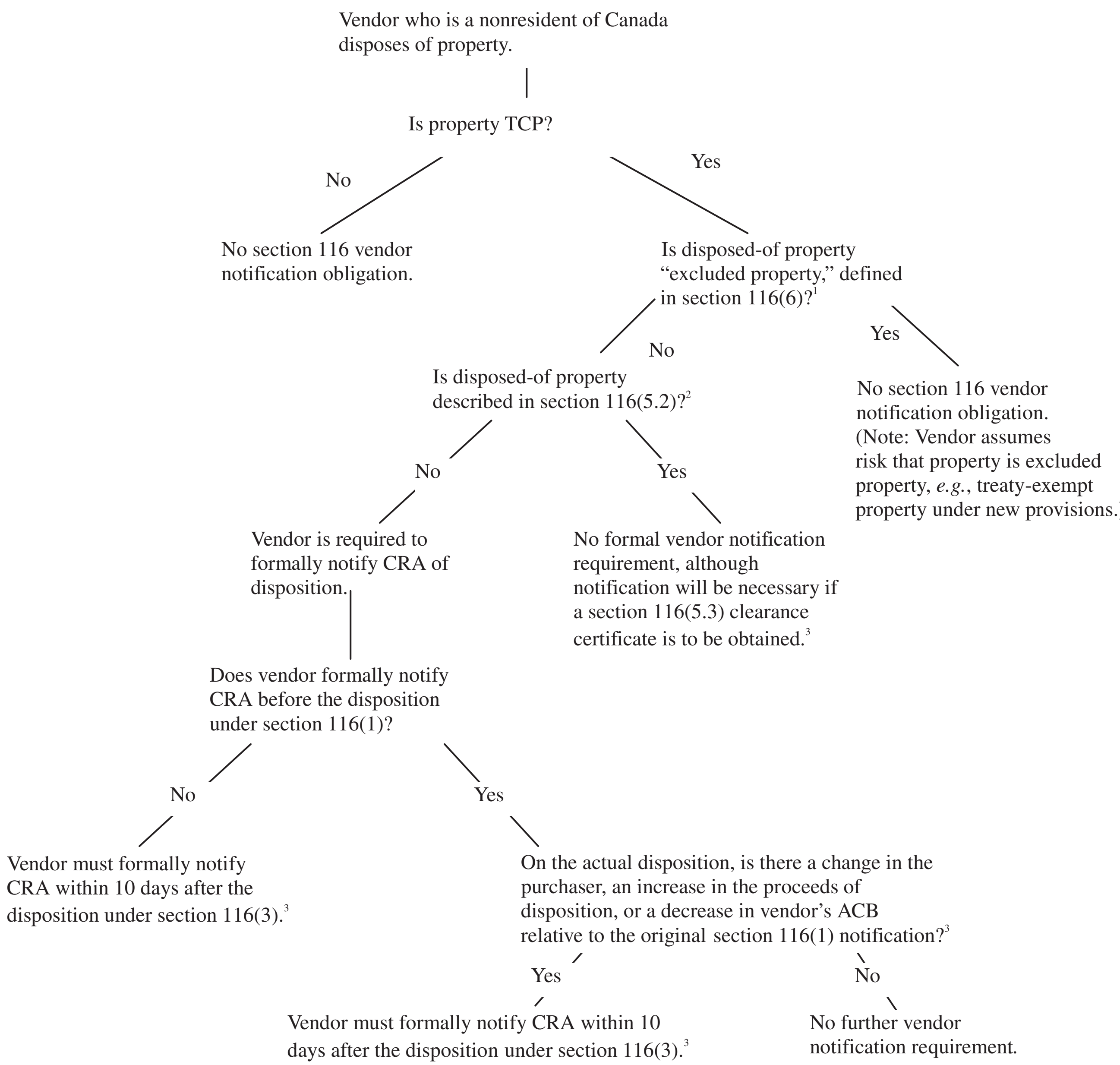
[5] Defined in subsection 116(6).

[6] Excluded property is defined in subsection 248(1).

[7] The definition of treaty-exempt property in subsection 116(6.1) actually refers to ''treaty-protected property,'' which is defined in subsection 248(1). The quote above is from the definition of treaty-protected property.

[8] 116(5.2) property comprises depreciable property or eligible capital property that is TCP, 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, or any interest or option regarding the foregoing.

Figure 1. Summary of Vendor Notification Obligation Under Section 116



[1]Excluded property includes, most notably, (1) shares of a corporation listed on a recognized stock exchange, and (2) under the 2008 federal budget amendments, a property vendor would be exempt from Canadian tax on any gains on under a tax treaty. (If purchaser and vendor are related, purchaser has an additional obligation to notify the CRA.)

[2]Property described in section 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, depreciable property that is TCP, or an interest or option in any of the foregoing.

[3]To receive a clearance certificate, in addition to notification, vendor may have to provide a payment to the Receiver General or furnish the CRA with acceptable security.

- the identity of the purchaser;
- a description of the property sufficient to identify it;
- 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 postdisposition, it leaves very little time to obtain a clearance certificate and thereby has negative implications in terms of the purchaser remittance obligation and how it affects the vendor.

The second, more commonly used procedure is for the vendor to provide notification to the CRA *before* the disposition (a section 116(1) notification). In a 116(1) notification the vendor must submit information to the CRA similar to the information in a 116(3) notification except the proceeds of disposition are estimated proceeds of disposition and the ACB is the ACB at the time of notification.

In many cases, a vendor that provided 116(1) notification will not also have to provide 116(3) notification, but under some circumstances both are required. A 116(3) notification must be filed if:

- 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 are met, a 116(3) notification is required within 10 days after the disposition; otherwise, no further notification is necessary. The 116(1) notification (which is voluntary)[9] gives the vendor more time to obtain a clearance certificate. (See Section II.E below.)

D. Procedures and Penalties

A vendor that is required to provide notification must either use the appropriate authorized form[10] or send a letter. In addition to notification, the vendor may be required to provide supporting documentation.[11] 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.[12]

Separate vendor notifications should be filed regarding 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 for all the properties.

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 CRA 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.[13] This procedure has often proven rather unworkable from a practical perspective, especially for large, widely held partnerships such as private equity funds or other look-through entities, or in situations 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 Act, subject to a fine of between $1,000 and $25,000, or imprisonment.[14] 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, with a minimum of $100 and a maximum of $2,500.[15]

E. Clearance Certificates

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 clearance

[9]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.

[10]Form T2062 for a 116(1) or 116(3) notification. For 116(5.2) property, 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) can be found at the CRA's Web site, *available at* http://www.cra-arc.gc.ca/formspubs/menu-eng.html.

[11]*See* the supporting document list in the instructions to forms T2062, T2062A, and T2062B.

[12]Information Circular IC 72-17R5 at para. 11, ''Procedures concerning the disposition of taxable Canadian property by nonresidents of Canada — section 116,'' released Mar. 15, 2005.

[13]*Id.*

[14]Subsection 238(1).

[15]Subsection 162(7).

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 clearance certificate reduces or eliminates a purchaser's otherwise applicable obligation to remit a portion of the purchase price under section 116 of the Act (that is, the second element of the 116 system). However, it is the vendor that must apply for any clearance certificate. As such, while clearance certificates are for the benefit of 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 purchase price) and they are effectively part of the vendor notification requirement. There will be circumstances when a purchaser may not demand a clearance certificate 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 likely when the vendor and the purchaser are related); or

- when the vendor is willing to simply let the purchaser withhold and remit from the purchase price (for example, if the vendor's actual Canadian tax liability exceeds the amount withheld).

Otherwise, however, even when the Act may not formally require vendor notification,[16] it will often be advantageous for the vendor to do so. 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 clearance certificate benefits the vendor by reducing the amount that the purchaser (or at least any arm's-length purchaser) will withhold from the purchase price to fund the remittance.

As noted, a clearance certificate is obtained by a vendor by taking the steps described above (voluntarily or otherwise) to meet the vendor notification obligation and providing any further information required by the CRA. When tax is owed on the disposition, the vendor must also provide payment to the Receiver General or security to the CRA on account of the vendor's Canadian tax payable. To receive a clearance certificate regarding property for which the vendor 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.[17]

When the vendor is claiming that Canadian tax owed is reduced or eliminated because of special circumstances (for example, reliance on a tax treaty), the information required by the CRA to support the application will be greater than is normally the case.[18] If the vendor is relying on a tax treaty, 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 items such as proof of residence or proof that the gain has been or will be reported in the vendor's country of residence.[19] Tax officials in the vendor's country of residence may provide certificates that assist with this documentation.

To receive a clearance certificate for property for which 116(1) notification has been provided, the CRA has traditionally said 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. In practice, however, a clearance certificate is rarely received in less than three months, and in some cases has taken up to a year.[20] One of the principal objectives of the 2008 federal budget amendments to the 116 system is to reduce the clearance certificate backlog by creating new exceptions that taxpayers (and in particular related parties) will rely on as an alternative to requesting clearance certificates. The degree to which this initiative is likely to be successful is discussed below.

III. Purchaser Liability to Remit

The second fundamental element of the 116 system is the creation of an obligation on a purchaser, wherever resident, to remit to the CRA an amount equal to a portion of the purchase price on account of the vendor's Canadian tax liability. The rationale for the purchaser's remittance obligation is that, since the vendor is a nonresident and is likely receiving cash or other

[16] For example, regarding 116(5.2) property.

[17] For 116(5.2) property, the amount of payment or security is determined through negotiation with the CRA. A clearance certificate 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).

[18] Vendors of treaty-exempt property will still often wish to apply for a clearance certificate because of the purchaser's remittance obligation and ability to withhold from the purchase price.

[19] *See* the supporting documents list in the instructions to forms T2062, T2062A, or T2062B.

[20] For example, see CRA document 2006-0185642C6, dated Sept. 11, 2006.

property over which the CRA has no practical enforcement power, it makes sense to demand compliance from the person acquiring the Canadian-situs property.

Since the purchaser remittance obligation is for the vendor's tax, the 116 system creates a statutory right for the purchaser to withhold from any payments the purchaser makes to the vendor any amount remitted by the purchaser to the Receiver General on account of the vendor's tax.[21] Thus, it is intended that the purchaser withhold this amount from the sale proceeds rather than to 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.

The amount remitted by the purchaser is credited toward the vendor's Canadian income tax liability but is not itself a final calculation of Canadian tax owed. If amounts so remitted (together with any other payments or credits made by or on behalf of the vendor) exceed the vendor's Canadian tax owed, the vendor can file a Canadian tax return for the year and claim a refund of any excess. The relevant series of issues to be addressed in analyzing a purchaser's liability to remit is summarized in Figure 2.

An acquisition of TCP from a nonresident (as opposed to a disposition of property by a nonresident) is the trigger for 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.[22]

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 with some kinds of excluded property; for example, it is generally possible for a purchaser 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 greater for other classes of excluded property, such as treaty-exempt property.

The new treaty-exempt property element of excluded property has been discussed above regarding the vendor notification obligation. As noted, a party relying on this new amendment assumes the risk on the issue of whether the property really is exempt from gains under an applicable tax treaty, and a filing requirement exists for related-party transactions. Therefore, when the purchaser acquires property that the vendor is treaty protected on *and* the parties are unrelated, the new treaty-exempt property element of excluded property will prevent any purchaser liability for nonremittance from arising even if no notification is provided to the CRA.

A purchaser that acquires property it believes to be treaty exempt does not have to rely exclusively on this expansion of the excluded property definition as a basis not to remit. New subsection 116(5.01) also provides relief from the purchaser remittance obligation when the property is treaty exempt and offers the further benefit of a limited safe harbor provision (but also has a filing requirement for all purchasers, not just related parties). As such, practically we would expect reliance on the new treaty-exempt property element of the excluded property definition to be limited to situations involving unrelated parties when the property is clearly treaty exempt, and the parties don't wish to meet (or overlook) the filing requirement in new subsection 116(5.01).

B. Reasonable Belief Vendor Is Canadian Resident

A purchaser has no liability to remit if, after making reasonable inquiry, it believed the vendor was a resident of Canada.[23] The Act contains no definition of 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

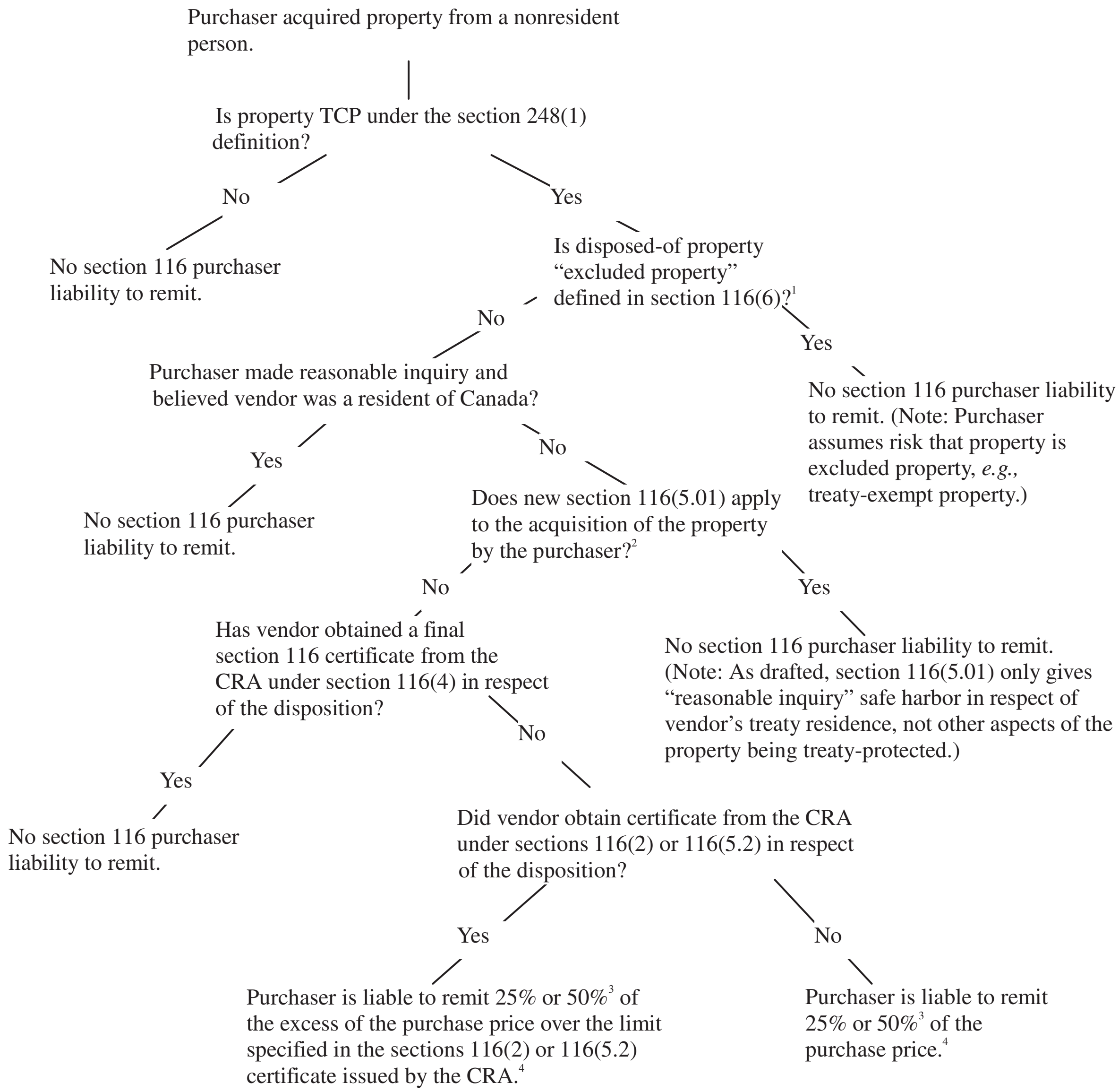
---

[21]Subsections 116(5) and (5.3). When the purchaser doesn't withhold, these rules also allow the purchaser to seek reimbursement from the vendor for any remitted amounts, although practically this is much more difficult to accomplish than simply withholding from the purchase proceeds.

[22]For example, section 51 deems that there is no disposition when certain property is converted into shares of the capital stock of a 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. 34 of IC 72-17R5.) In such situations, the purchaser often asks the vendor to provide notification to the CRA and appropriate payment or security to receive a clearance certificate that will relieve the purchaser of its liability to remit. For a different example of when there is an acquisition of TCP but no disposition, see CRA document 2006-0201651I7, Sept. 21, 2006.

[23]The Act phrases this in the negative: ''after reasonable inquiry the purchaser had no reason to believe that the nonresident person was not resident in Canada'' (para. 116(5)(a); *see also* para. 116(5.3)(a)).

Figure 2. Summary of Purchaser Liability to Remit Under Section 116



[1]Excluded property includes, most notably, (1) shares of a corporation listed on a recognized stock exchange, and (2) under the 2008 federal budget amendments, a property vendor would be exempt from Canadian tax on any gains on under a tax treaty. (If purchaser and vendor are related, purchaser has an additional obligation to notify the CRA.)

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

[3]In the case of property described in section 116(5.2), the requirement to remit under section 116(5.3) is 50% of the purchase price (or if a section 116 certificate was obtained from the CRA under section 116(5.2), 50% of the amount (if any) by which the purchase price exceeds the limit specified in the section 116(5.2) certificate issued by the CRA).

[4]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.

believes that the purchaser could reasonably have known or should have known that the vendor was a nonresident.[24]

Given the CRA's approach to reasonable inquiry, it is not sufficient to merely rely on the fact that no circumstances suggest that the vendor is a nonresident 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 section 116, and in most cases this is sufficient.[25]

C. The New Treaty-Protected Property Exception

As a consequence of the 2008 federal budget amendments, new subsection 116(5.01) creates an exception to the purchaser remittance obligation, which applies if three conditions are met:

1) after reasonable inquiry, the purchaser must conclude that the vendor is, under a tax treaty that Canada has with a particular country, resident in that particular country;

2) Canada's tax treaty with that particular country must exempt the vendor from Canadian Part I taxation of any income or gain from the disposition of that property, assuming that the vendor was indeed resident in that particular country under that tax treaty; and

3) the purchaser must provide notice containing specified information to the CRA of its acquisition of the property within 30 days after the date of the acquisition.[26]

Subsection 116(5.01) provides a reasonable inquiry safe harbor for condition 1, but not for condition 2. A purchaser may be incorrect about the vendor's country of residence, but if the purchaser made reasonable inquiry as to the vendor's treaty residence, the purchaser may still be able to rely on subsection 116(5.01) as a basis for not remitting any money to the Receiver General.[27] In determining whether the property is treaty protected in condition 2, however, the Act states that all of the other requirements necessary for the property to be exempt from Canadian taxation on gains in the hands of the vendor must exist, assuming that the vendor was fiscally resident in the particular country described in condition 1. A purchaser that neither remits nor requires the vendor to get a clearance certificate on the basis that condition 2 and the other requirements of the new subsection 116(5.01) exception are met therefore assumes the risk that the property's treaty status has not been properly determined.

The technical notes to subsection 116(5.01) released by the Department of Finance give two examples of the interplay between conditions 1 and 2. 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 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 derives its 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 condition 1 is satisfied. Condition 2 is also satisfied because if the vendor *was* resident in Russia (which is what the purchaser's reasonable inquiry led it to believe), the property would be protected by the 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 derives its value principally from Canadian real property. The purchaser after reasonable inquiry concludes that the vendor is a resident of Moldova, satisfying condition 1. However, the purchaser also concludes that the shares are treaty-exempt property. This is incorrect because, under the Canada-Moldova income tax convention, Canada can tax the gain on the disposition of shares of nonresident corporations that derive their value principally from Canadian real property. Therefore condition 2 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 the acquisition.

---

[24] IC 72-17R5 at para. 50.

[25] Subsection 250(5) provides that any person who is a resident of another country under the provisions of a tax treaty between Canada and that other country is deemed to be a nonresident of Canada for purposes of the Act.

[26] This notice applies in all cases, unlike the notice requirement in the new treaty-exempt property element of the excluded property definition described earlier, which applies only to related parties. The notice must set out the following:

- the date of the acquisition;
- the name and address of the vendor;
- a description of the property sufficient to identify;
- the amount paid 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).

The notice obligation can be satisfied by submitting Form T2062C.

[27] In the context of the Canada-U.S. tax treaty, as recently modified by the fifth protocol, reasonable inquiry as to treaty residence could require taking the new antihybrid rules in Article IV(7) into account, once that provision becomes operative.

There are many situations in which determining whether property is protected by a treaty for the purposes of condition 2 may be difficult. In particular, the purchaser may not be able to determine if the vendor satisfies the new limitation on benefits provisions in Article XXIX A of the Canada-U.S. income tax convention, as recently modified by the fifth protocol. Another example is shares of a Canadian corporation. Most of Canada's tax treaties exempt nonresidents from Canadian tax on gains from a Canadian corporation's shares if the shares do not derive their value principally (that is, more than 50 percent) from Canadian real property. Valuation being a question of judgment, it will not always be clear whether the shares of any particular Canadian corporation derive most of their value from underlying assets that are Canadian real property and are therefore not treaty protected.

D. New Form T2062C

New Form T2062C released by the CRA in late 2008 is an officially sanctioned way in which to satisfy condition 3 of the new subsection 116(5.01) exception to the purchaser remittance obligation. However, it is relevant to conditions 1 and 2 as well. As to condition 1 (reasonable 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.'' In spite of the qualifier ''generally'' (which we understand is largely directed at situations when the purchaser knows or should know that the vendor's declaration is false), this formally approved mechanism is helpful to purchasers seeking to ensure that they have met the reasonable inquiry standard on the question of treaty residence.[28]

In the instructions to Form T2062C, the CRA paraphrases the wording of subsection 116(5.01) as providing a reasonable inquiry defense only on the question of treaty residence, and not as to any other element of whether property is treaty protected. However, it is noteworthy that the instructions on completing the form suggest ways of confirming whether property is treaty-protected property for the purposes of condition 2 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 believe that despite the strict wording of subsection 116(5.01), as a practical matter the CRA is likely to exercise its administrative discretion *not* to pursue purchasers that rely on the new subsection 116(5.01) exception after having made reasonable good-faith inquires as to both treaty residence *and* treaty-protected property status (and who file Form T2062C on time).

If condition 2 of subsection 116(5.01) is strictly interpreted so as to leave the purchaser liable if the property turns out not to be treaty-protected property, *irrespective of whether good-faith reasonable inquiries were made on this issue*, as a practical matter this will reduce the scope of the exception to situations involving related parties. Purchasers generally view section 116 compliance as the vendors' issue, and will typically withhold and remit unless there is no risk to them for not doing so. The simplest ways of eliminating risk to the purchaser are withholding from the purchase price and remitting, or requiring the vendor to get a clearance certificate. This is what happens in the vast majority of arm's-length transactions.

Only in relatively unusual circumstances are arm's-length purchasers willing to accept any risk at all of being found not to have complied with the purchaser remittance obligation, and their advisers will invariably tell them to demand a clearance certificate or withhold and remit unless there is a clear legislative or CRA administrative basis for doing otherwise. If the CRA does

[28]Presumably a formal representation by the vendor as to treaty residence in the purchase and sale agreement should also suffice, although this is not clear. In particular, the CRA's reference to an ''equivalent declaration'' from the vendor seems to suggest that the vendor would need to attest to all of the factual matters on the Form T2062C, not just treaty residence, although practically we would think that a vendor declaration limited only to treaty residence should also be adequate evidence of reasonable inquiry on this point.

not clearly signal its intention to administer the new subsection 116(5.01) exception to protect purchasers who rely in good faith on reasonable inquiries made as to treaty-protected property status, there will be very few arm's-length purchasers that will use it as an alternative to the clearance certificate process. When the vendor has an unusually high degree of bargaining power, it is possible that in some circumstances the purchaser might rely on subsection 116(5.01) and accept a representation and warranty from the vendor that it is resident in a country and that the property is treaty-protected property under the applicable tax treaty between Canada and that country. A well-advised purchaser would also insist on an indemnity from the vendor for any loss or damages should it turn out that the property was not treaty exempt to the vendor. However, trying to claim on an indemnity is often costly and time-consuming with no guarantee of success, so purchasers may only be willing to rely on an indemnity when the vendor is viewed as extremely reliable, and even then not very often. For these reasons, unless the CRA publicly indicates its willingness to allow purchasers to rely on good-faith reasonable inquiries as to treaty-protected property status, only related-party purchasers are likely to use subsection 116(5.01) as an alternative to filing for a clearance certificate.

We understand, however, that the CRA wants the new subsection 116(5.01) exception to be a viable alternative not only in related-party situations. To do that the CRA will need to give taxpayers meaningful comfort that if they act reasonably and in good faith to come within the object and spirit of this new exception, they will not be at risk; otherwise, advisers will simply counsel their clients to demand a clearance certificate. We would therefore expect the CRA to assure taxpayers who conduct themselves appropriately that they need not clog up the clearance certificate process with applications in situations when reasonable inquiries lead them to believe that the vendor's gain on the property would be treaty exempt and the notice requirements in subsection 116(5.02) are complied with.[29]

We hope that the CRA makes some more formal statement of its willingness to exercise administrative discretion in favor of purchasers that make good-faith reasonable inquiries as to treaty-protected property status in the manner suggested in the instructions to Form T2062C. If this occurs, the subsection 116(5.01) exception will be a viable alternative to the clearance certificate process in many situations. Otherwise, we would expect that virtually all arm's-length purchasers will continue to insist that vendors obtain a clearance certificate, and in practice the subsection 116(5.01) exception will be limited to related-party transactions.

E. Clearance Certificates

By far the most common manner for dealing with the purchaser remittance obligation is for the vendor to obtain and present to the purchaser a clearance certificate as a result of having gone through the vendor notification process. This may be as a result of a 116(1) notification, 116(3) notification, or voluntary notification regarding 116(5.2) property.

The purchaser has no liability to remit if the vendor obtained a clearance certificate as a consequence of a 116(3) notification.[30] If the clearance certificate 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[31] with the certificate limit on the clearance certificate. 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.

When no clearance certificate is issued and none of the exceptions to the purchaser remittance obligation apply, the purchaser must remit a percentage of the gross purchase price. This is usually a result that vendors wish to avoid, since the amount is computed without regard to the vendor's basis in the property and will typically be withheld from the vendor's proceeds.

[29]This would be consistent with the CRA's administrative position on the applicable rate of withholding taxes on amounts paid or credited to persons in countries with which Canada has a tax convention, as described in Information Circular 76-12R6, ''Applicable Rate of Part XIII Tax on Amounts Paid or Credited to Persons in Countries with Which Canada has a Tax Convention,'' released Nov. 2, 2007. In that document (at para. 4), the CRA states that it is the payer's responsibility to withhold and remit Part XIII withholding tax at the appropriate rate and the payer is liable to the Crown for any deficiency. However, when the payer is uncertain of the payee's treaty residence, the payer can request that the payee submit a certificate described in the information circular and the ''lower [treaty] rate of withholding tax, in accordance with a tax convention, can be applied.''

[30]Although subsection 116(5) states that the purchaser does not have a liability to remit if the CRA has issued a 116(4) certificate (that is, a clearance certificate 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.

[31]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'': subsection 116(5.1).

The required remittance amount is 25 percent of the purchase price for TCP that is not 116(5.2) property, and 50 percent of the purchase price for 116(5.2) property.

F. Remittance Procedures and Penalties

Any amounts payable by the purchaser must be remitted to the Receiver General 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 remittances pertain to 116(5.2) property.

In the vast majority of cases in which a 116(1) notification or 116(3) notification has been made, the CRA has not processed the application and issued the clearance certificate by the time of the purchaser's remittance due date. As a result, the CRA has developed a practice of issuing ''comfort letters'' to the parties, essentially holding the remittance process in abeyance pending finalization of the CRA's review. A typical comfort letter is issued by the CRA 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 mechanism at least prevents 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 clearance certificate process been more timely. A purchaser that has not received either a clearance certificate or a comfort letter by the remittance due date and that cannot rely on another exemption (for example, excluded property or the new subsection 116(5.01) exception) will typically withhold and remit by that date, and doing so satisfies the purchaser remittance obligation.

A purchaser that fails to remit the amount called for by the purchaser remittance obligation and that cannot rely on an exception to this obligation is liable to pay that amount as a tax.[32] 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.[33] 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.[34] 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.[35]

IV. Vendor Canadian Tax Return

The third element of the 116 system is the obligation to file a Canadian tax return for the year. This obligation was, to some extent, narrowed by the 2008 budget amendments to the 116 system. 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.[36] The vendor's requirement to file a Canadian income tax return is summarized in Figure 3; again, it may prove useful to the reader to use it as a guide to the discussion that follows.

A. Income Tax Owed for the Year

A nonresident that owes Canadian income tax under Part I of the Act for a particular year is always obliged to file an income tax return for that year.[37] A nonresident may have tax payable under Part I of the Act if, in the current year or a previous year, it carried on a business in Canada, was employed in Canada, or disposed of TCP.[38]

B. Disposing of TCP

A vendor that disposes of TCP must file a Canadian income tax return (even if no tax is payable under Part I) unless the disposition was an ''excluded disposition.''[39] There are four conditions that must be satisfied for the disposition to be an excluded disposition, two of which are presupposed to have been met:[40]

- 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).

[32]Subsection 116(5) for most TCP; subsection 116(5.3) for 116(5.2) property.

[33]Subsection 227(9.3) and para. 227(9)(a).

[34]Para. 227(9)(b).

[35]Para. 227(10.1).

[36]Carrying on business in Canada requires a corporation to file an income tax return for the year (clause 150(1)(a)(i)(B)).

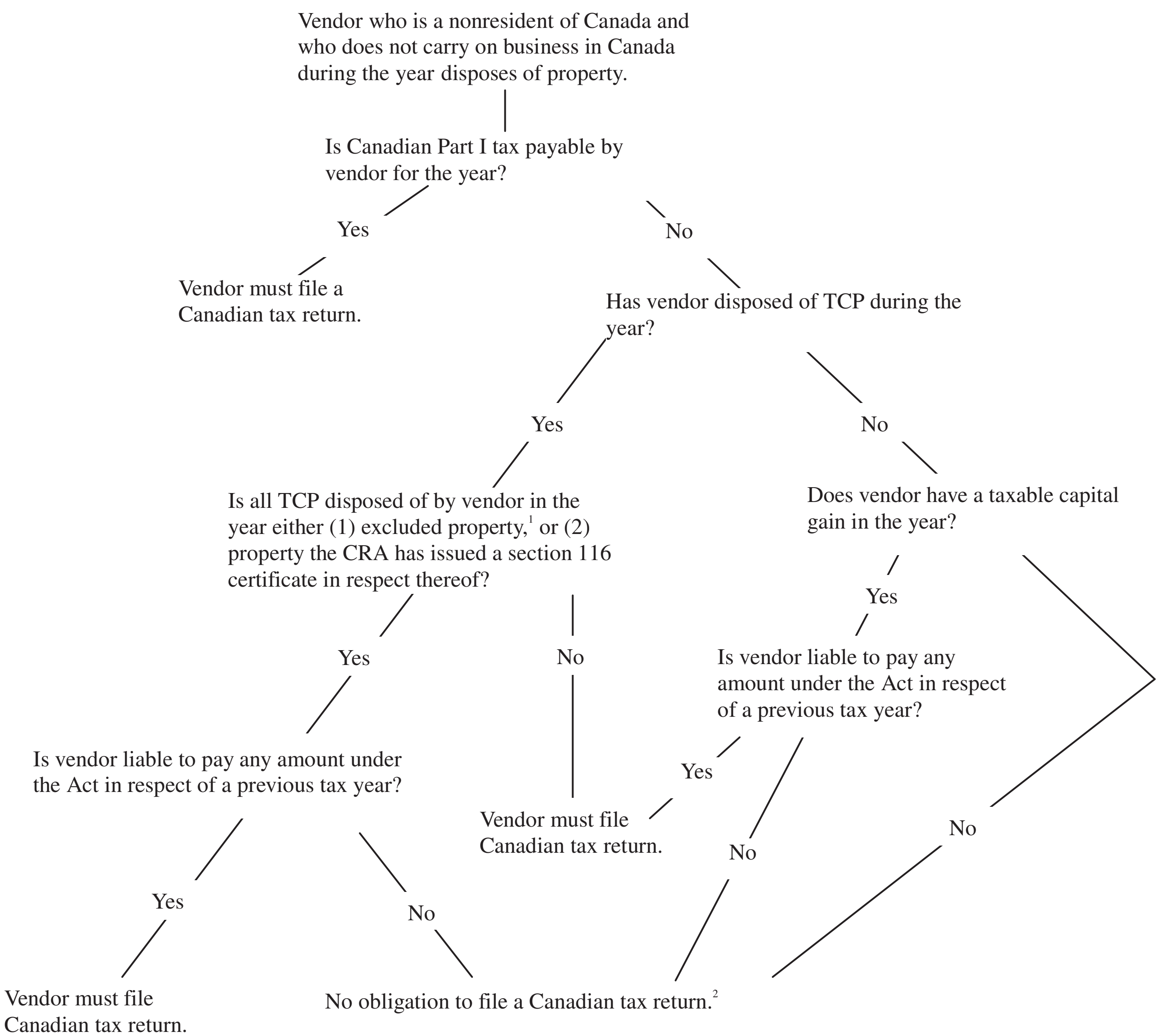
[37]Clause 150(1)(a)(ii)(A) for corporations, and subpara. 150(1.1)(b)(i) for individuals.

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

[39]Clause 150(1)(a)(i)(D) for corporations, and subpara. 150(1.1)(b)(iii) for individuals.

[40]Defined in subsection 150(5).

Figure 3. Summary of Vendor Obligation to File Canadian Tax Return



[1]Excluded property includes, most notably, (1) shares of a corporation listed on a recognized stock exchange, and (2) under the 2008 federal budget amendments, a property vendor would be exempt from Canadian tax on any gains on under a tax treaty. (If purchaser and vendor are related, purchaser has an additional obligation to notify the CRA.)

[2]A tax return would have to be filed by a corporation that would owe Part I income tax for the year but for relief provided by a tax treaty, unless the exempted tax arises solely from the disposition of TCP.

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

- all of the TCP disposed of by the vendor in that year must either be excluded property[41] or property for which the CRA has issued a clearance certificate; the clearance certificate may result from a 116(1) or 116(3) notification or relate to subsection 116(5.2) property; and
- the vendor must not be liable to pay any amount under the Act (whether under Part I or any other part of the Act) regarding any previous tax year.[42]

Unless all four of these conditions are met, a disposition of TCP is not an excluded disposition and the vendor must file a Canadian tax return.

C. Taxable Capital Gain

If the vendor has a taxable capital gain[43] in the year otherwise than from an excluded disposition, it must file a Canadian tax return. 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 not carrying on business in Canada, who has no tax payable under Part I of the Act for the year, and 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 Act regarding a previous tax year. If such a nonresident does have Canadian tax owed for a previous tax year, a strict reading of the Act would seem to require a Canadian tax return to be filed even though the taxable capital arose on non-TCP (that is, outside Canada) and the nonresident had no connection to Canada and no income that was taxable in Canada in the current tax year. Both the utility and the enforceability of requiring a nonresident to file a return in such circumstances seem rather dubious as a matter of tax policy.

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 obligation does not apply if the only reason that tax would be owed but for the treaty provision is a disposition of TCP that is treaty-protected property[44] of the corporation. Since nonresident 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 is required to file a tax return for the year on this basis.[45]

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 any tax returns due by April 30 of the following year.

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, for which the return was not filed.[46] In the case of a nonresident corporation that fails to file, 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.[47]

V. Conclusion

The 116 system can be difficult to navigate for nonresidents and those acquiring property from them. There are also significant practical challenges that often arise in trying to comply with these rules. The timelines for effecting compliance are fairly tight, and as such, parties to a transaction 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

[41] *See* Section II.A above.

[42] Other than amounts for which the CRA has accepted and holds adequate security.

[43] 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.

[44] 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.''

[45] 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.

[46] Subsection 162(1). There are additional penalties for repeated failure to file a tax return.

[47] Subsection 162(2.1).

Figure 4. A 116 System Timeline

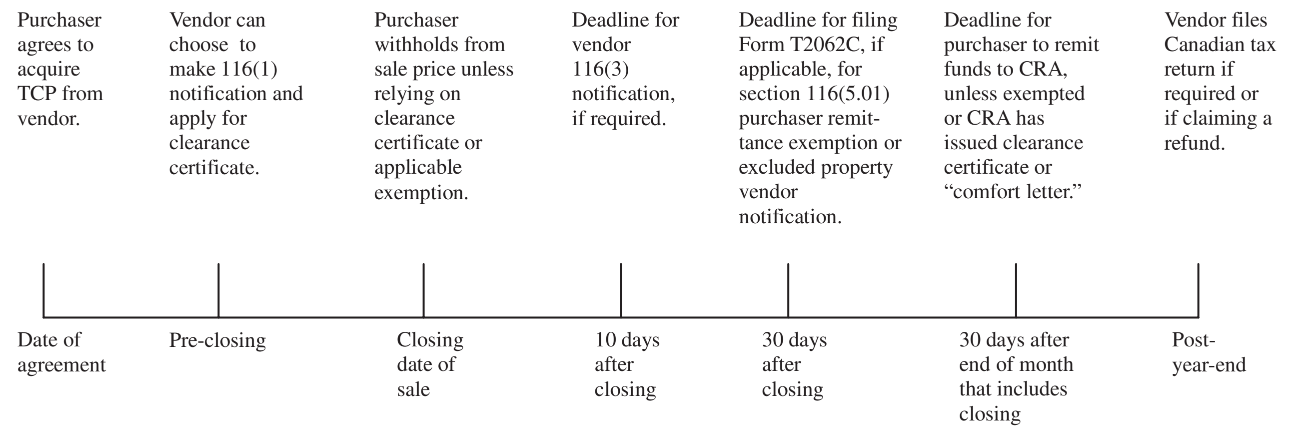


Table 1. Summary of 116 System

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.	Not applicable on acquisitions of excluded property, or if purchaser reasonably believes vendor is a Canadian resident after making reasonable inquiry.	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 on the disposition or no tax is payable.	Arm's-length purchasers will typically insist on clearance certificate unless there is clearly no risk, failing which they will withhold from sale proceeds.	Always applicable where Part I income tax is owing for the year.
Required if obtaining a clearance certificate to address purchaser remittance obligation.	New exception for treaty-protected property may provide a viable alternative to clearance certificates, depending on how the CRA administers it (if strictly, then likely limited to related-party transactions).	Vendor will want to file and claim a refund if amount remitted by purchaser exceeds vendor's tax owing.
	Basic remittance obligation is 25% of sale price unless reduced or eliminated by clearance certificate, whether or not vendor realizes any gain.	
	CRA comfort letter may delay remittance due date.	

be applicable in a given case, depending on how the parties are proposing to effect compliance with the rules).

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 created and described herein, and then to consider how they interact in order to form a compliance system for dealing with dispositions of Canadian-situs property by nonresidents. This article describes the three key components of the 116 system, the principal features of which are summarized in Table 1. ◆