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News Analysis: Further Clarification On Revised Regime for Nonresident Vendors

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News Analysis: Further Clarification On Revised Regime for Nonresident Vendors

In 2008 Canada enacted changes to its rules governing nonresidents' disposition of some Canadian-situs property, called taxable Canadian property (TCP). The rules are intended to protect the Canadian tax base by creating obligations on both the purchaser and the nonresident vendor when TCP is disposed of. There are three obligations:

- Notification: The vendor may have to provide notification of the disposition to the Canada Revenue Agency.
- Remittance: The purchaser of the property, wherever resident, may have to remit a specified percentage of the purchase price (usually 25 percent) to the CRA on account of the vendor's potential Canadian income tax liability. That may be avoided if the vendor obtains a certificate of compliance issued by the CRA under subsections 116(2) or (4) of the Income Tax Act (Canada) allowing the purchaser not to remit any funds or to remit less than what would otherwise be required (for example, if the vendor establishes that no tax is due).
- Filing: The vendor may have to file a Canadian income tax return for the tax year in which the disposition occurred.

In general, these rules (the section 116 system) allow the CRA to review and consider TCP transactions while the sale proceeds remain within its reach for assessment and collection. (For a related analysis, see *Tax Notes Int'l*, Jan. 26, 2009, p. 321, *Doc 2008-27299*, or *2009 WTD 16-10*.)

At a February 11 panel presentation in Toronto on the 2008 revisions to the section 116 system, the CRA addressed questions regarding new subsection 116(5.01), which relieves a purchaser of TCP from liability for not remitting a portion of the sale proceeds to the CRA if three conditions are met:

- after making reasonable inquires, the purchaser must conclude that the vendor is, under a tax treaty that Canada has with a particular country, resident in that country;
- Canada's tax treaty with that country must exempt the vendor from Canadian tax on the gain from the TCP, assuming the vendor was resident in that country under that tax treaty; and
- the purchaser must provide certain information to the CRA within 30 days.

The first condition allows the purchaser some reassurance as to the vendor's treaty residence as long as it makes reasonable inquiries (the due diligence defense). However, the second condition offers no relief to a purchaser who makes reasonable inquiries as to the requirement for the TCP to be treaty-protected property, and who as a result remits no funds to the CRA, believing in good faith that the vendor is treaty exempt from Canadian tax on the sale. The absence of any due diligence defense for the second condition has caused some to question whether any purchaser dealing with an arm's-length vendor would ever take the risk involved in relying on this new exception[1] or would instead simply either require the vendor to obtain a certificate of compliance from the CRA authorizing nonremittance or withhold and remit the required amount to the CRA (forcing the vendor to file a tax return and claim a refund months later).

At the February 11 presentation, the CRA said it will exercise administrative discretion in applying new subsection 116(5.01) in arm's-length transactions. The CRA prefers that this new process be used as an alternative to the certificate of compliance process in low-risk situations in which no Canadian tax seems likely to be payable because of a treaty exemption.

In general, the CRA will not pursue a purchaser of TCP for failing to remit a portion of the purchase price

[1]For example, that treaty benefits are denied to the vendor under a limitation on benefits rule in the treaty or under domestic antiavoidance rules, or that the TCP factually derives most of its value from Canadian property so as to make some treaty exemptions inapplicable.

to the CRA, even if it is ultimately determined that the vendor was not treaty exempt on the property, if:

- the first and third conditions above are met;
- the purchaser has made every reasonable effort to determine if the property is a fully treaty-protected property (TPP) for the vendor (that is, exempt from Canadian income tax); and
- on the basis of such efforts and in good faith, the purchaser believes the property to be TPP for the vendor and, relying on subsection 116(5.01), does not remit to the CRA.

The CRA will consider reasonable efforts to have been made if the purchaser has reviewed the tax treaty and carried out the steps for determining TPP status as suggested by the CRA on the form used to comply with the third condition,[2] which reads as follows:

> 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.

The CRA's willingness to exercise administrative discretion not to pursue good-faith purchasers who make reasonable efforts to determine that property is TPP will go a long way toward encouraging reliance on the new subsection 116(5.01) exception.

In particular, authorizing the use of a certificate from the vendor as to eligibility for treaty benefits under an LOB clause will help address concerns about that aspect of treaty protection. When (as is often the case) the relevant treaty exemption depends on the requirement that the securities being disposed of do not derive more than half their value from Canadian real or resource property, a purchaser's ability to obtain the certificate from the issuing corporation or trust will depend on the facts. While not all corporations and trusts will be willing to provide certification, the CRA's willingness to accept it as evidence of reasonable efforts at least provides another alternative for purchasers (who often will demand that the vendor be the one to make the effort to obtain it).

Presumably there may be other ways in which a purchaser could demonstrate that reasonable efforts had been made to determine that the valuation test had been met (for example, an assessment by a financial advisor). If there is genuine doubt as to whether the shares or trust interests do derive their value primarily from Canadian real property, the CRA recommends purchasers request that the nonresident vendor provide them with a certificate of compliance issued through the existing Form T2062 process.

The CRA statement on reasonable efforts would not appear to put purchasers at risk if they make the reasonable efforts described above and rely in good faith on new subsection 116(5.01), yet the property turns out not to be TPP because something about the vendor's facts causes treaty protection to be denied under domestic antiavoidance rules. That is helpful, as otherwise a purchaser could never be confident as to the vendor's entitlement to treaty protection without detailed knowledge of the vendor's circumstances plus an extensive legal analysis. Obviously, a purchaser who had good reason to believe that the CRA would object to the vendor's claim for a treaty exemption on an antiavoidance basis would be in a different position, not meeting the good-faith element of the CRA's administrative position, and again that purchaser would be well-advised to demand a certificate of compliance from the vendor instead of relying on the new subsection 116(5.01) exception.

One area of concern addressed during the presentation was new Article IV(7) of the Canada-U.S. income tax treaty, implemented last year by the fifth protocol to that treaty, effective beginning in 2010. That provision deems items of income not to be derived by a treaty resident in certain situations involving hybrid entities (that is, viewed as taxpayers in one country and treated as transparent in the other). The CRA confirmed that the provision could affect whether property is TPP to the vendor. Accordingly, purchasers of TCP should exercise particular caution in transactions involving those entities and the Canada-U.S. treaty after 2009, and they should demand a certificate of compliance instead of relying on the new subsection 116(5.01) exception.

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[2]Form T2062C, available from the CRA Web site at http://www.cra-arc.gc.ca/E/pbg/tf/t2062c/README.html.

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One difficult area of interpretation is the interaction of the amendments to the section 116 system with new Article IV(6) of the treaty. The CRA's long-standing position has been that property disposed of by a U.S. limited liability company that is fiscally transparent for U.S. tax purposes will not entitle either the LLC or its shareholders to a treaty exemption on gains, because the LLC is not itself a U.S. resident (it pays no U.S. tax) and because any U.S.-resident shareholders do not own the disposed-of property (Canada does not look through LLCs, unlike partnerships).

New Article IV(6) is meant to provide relief in these circumstances. It is not obvious from the text of the article and the accompanying commentary in the technical explanation to the 2007 protocol regarding Article IV(6) how this provision affects the new subsection 116(5.01) exception. The CRA reportedly is now considering how new Article IV(6) applies to the section 116 process, and it will release guidance later this year.

Finally, the CRA noted that it issues certificates of compliance under the section 116 system. It explained that using other terms, such as ''clearance certificates,'' when dealing with the CRA for this process may create unnecessary delays. Accordingly, it encourages the use of the term ''certificate of compliance'' to describe certificates issued under subsections 116(2) and 116(4).

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