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Draft Legislation Would Fix Nonresident Tax Trap

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COUNTRY DIGEST

Draft Legislation Would Fix Nonresident Tax Trap

Canada's Department of Finance on August 27 released draft legislation to enact various measures arising out of initiatives announced in the 2010 federal budget. The legislation includes — among other things — proposed changes to the scope of taxable Canadian property (TCP) on which nonresidents must pay Canadian capital gains tax. (For the consultation document, see *Doc 2010-19176* or *2010 WTD 168-10*; for the proposals, see *Doc 2010-19177* or *2010 WTD 168-11*.)

The 2010 federal budget significantly narrowed the scope of TCP, effective after March 4, 2010. (For prior coverage, see *Tax Notes Int'l*, Mar. 22, 2010, p. 1021, *Doc 2010-4813*, or *2010 WTD 45-1*.) In general terms, the situation before the 2010 budget was as follows:

- shares of a Canadian corporation that were not listed on a designated stock exchange were always TCP;
- shares of a non-Canadian corporation that were not listed on a designated stock exchange could be TCP if at some point during the preceding 60 months, the corporation itself owned sufficient TCP and more than 50 percent of the value of those shares was derived (directly or indirectly) from Canadian real property (that is, an interest in land situated in Canada, an interest or royalty in a mine or oil field located in Canada, or a right to remove timber on Canadian property);
- shares of a Canadian corporation listed on a designated stock exchange would be TCP to a nonresident holder only if, at any time during the preceding 60 months, that nonresident owned 25 percent or more of any class of the corporation's shares, including for this purpose any shares held by someone dealing at non-arm's-length with the nonresident (the 25 percent-plus test); and
- shares of a non-Canadian corporation listed on a designated stock exchange would be TCP to a nonresident holder only if those shares met both the 25 percent-plus test and if, at some point during the preceding 60 months, the corporation itself owned sufficient TCP, and more than 50 percent of the value of those shares was derived (directly or indirectly) from Canadian real property.

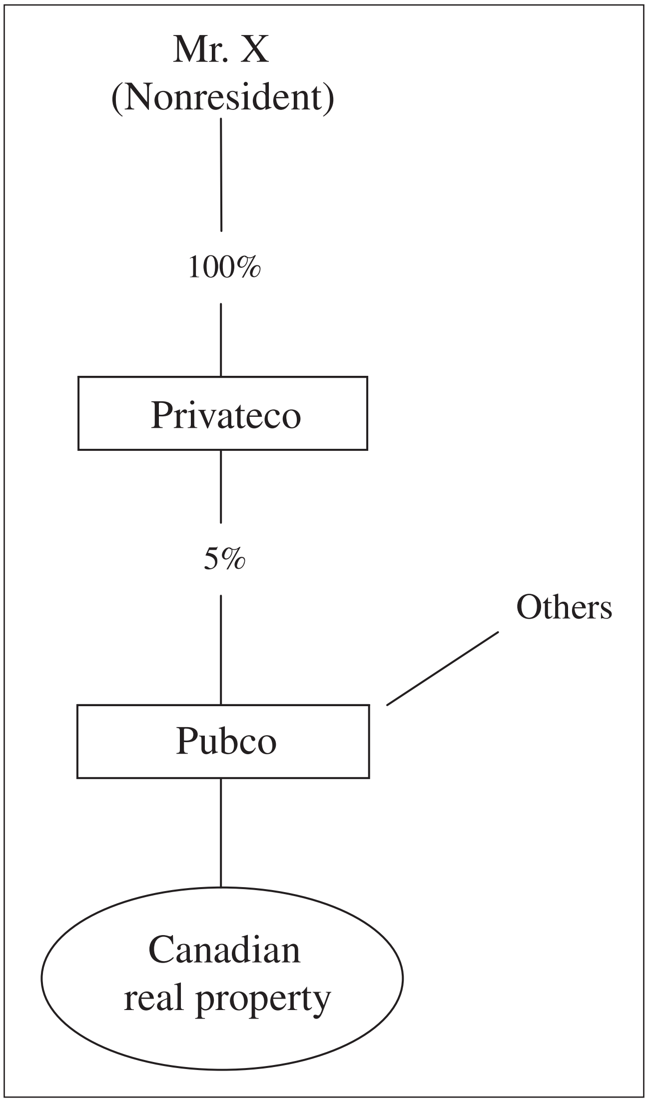
The 2010 budget proposed to narrow the scope of TCP, essentially by raising the TCP threshold for shares of Canadian corporations to make it the same as for non-Canadian corporations. Under the 2010 budget proposal:

- shares of a corporation (whether Canadian or foreign) not listed on a designated stock exchange would be TCP only if, at some point during the preceding 60 months, they derived more than 50 percent of their value, directly or indirectly, from Canadian real property (the 50 percent-plus test); and
- shares of a corporation (whether Canadian or foreign) that are listed on a designated stock exchange would be TCP only if both the 25 percent-plus test and the 50 percent-plus test are met.

Publicly traded shares are much less likely to constitute TCP because they benefit from an extra threshold (the 25 percent-plus test) before becoming TCP. When combined with the ''directly or indirectly'' condition of the 50 percent-plus test, this creates the potential for anomalous results.

For example, consider the following situation: Privateco, whose shares are held entirely by Mr. X (a nonresident of Canada), owns a single asset — namely, 5 percent of the publicly traded shares of Pubco, a company with significant holdings of Canadian real property. The Pubco shares meet the 50 percent-plus test (that is, at some point in the preceding 60 months, more than 50 percent of their value was derived from Canadian real property).

The Pubco shares are not TCP to Privateco because the 25 percent-plus test is not met. Similarly, if Mr. X held the Pubco shares directly, those shares would not be TCP because the 25 percent-plus test would not be met. However, because Mr. X's shares of Privateco are not publicly listed, the 25 percent-plus test does not apply to his holding of those shares, which meet the 50 percent-plus test by virtue of deriving more than 50 percent of their value from Canadian real property, indirectly, via Privateco's holding of Pubco shares. This produces the anomalous result of causing the insertion



of a private holding company between a nonresident and a non-TCP investment to create TCP, even though the sole property held by the private holding company is not itself TCP.

The August 27 release fixes that problem by amending the 50 percent test for shares of a corporation (other than a mutual fund corporation) that are not listed on a designated stock exchange as well as for interests in partnerships and most trusts, effective after March 4, 2010. Specifically, any such share or interest will not be TCP unless, at some point during the preceding 60 months, more than 50 percent of the value of the share or interest was derived directly or indirectly from Canadian real property other than through a corporation, partnership, or trust, the shares or interests in which are not TCP at that time.

Based on the facts of this example, because the shares of Pubco are not TCP and because it is only through the non-TCP shares that the Privateco shares derive more than 50 percent of their value from Canadian real property, those Privateco shares should not meet the revised 50 percent-plus test and will not constitute TCP to Mr. X.

The table sets out the current TCP tests, taking the amendment included in the August 27 release into account. ◆

Summary of TCP Status

Property	TCP Status
Unlisted shares of corporations (other than mutual fund corporations); interests in partnerships and most trusts	TCP if at any time during the preceding 60 months more than 50% of value of the share or interest was derived from Canadian real property (other than through a corporation, partnership, or trust, the shares or interests of which are not themselves TCP at that time)
Shares of corporations listed on a designated stock exchange; shares of mutual fund corporations; units of mutual fund trusts	TCP if at any time during the preceding 60 months, both: 1) the nonresident holder owns more than 25% of any class of the corporation's shares or the trust's units (including any shares or units owned by non-arm's-length persons); and 2) more than 50% of value of the shares or units is derived from Canadian real property