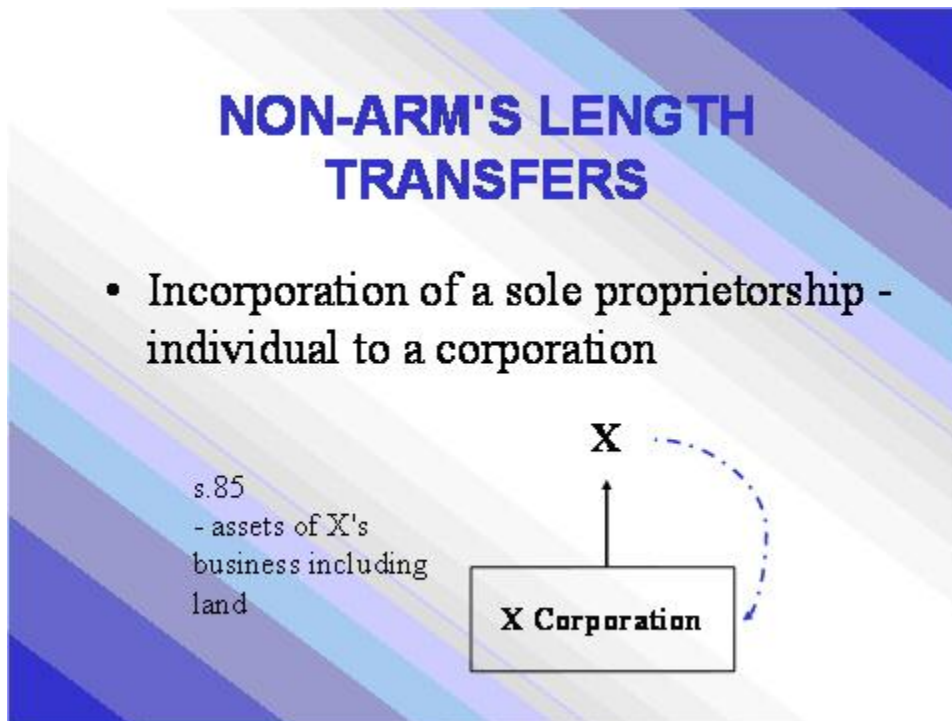


Tax Consequences of Different Types of Transfers and Different Business Transactions

by Joan E. Jung, Tax Partner
Minden Gross LLP, a member of MERITAS Law Firms Worldwide.
(Excerpts from materials presented at an Ontario Bar Association seminar on September 18, 2007)

Non-Arm's Length Transfers



Incorporation of a Sole Proprietorship – Individual to a Corporation

(a) Income Tax Considerations:

- Assume assets of sole proprietorship include real property (land and building)
- Individual will be deemed to dispose of assets of sole proprietorship at fair market value [section 69, ITA]
 - If there is no accrued gain in respect of land and no potential recapture (fair market value of building does not exceed its undepreciated capital cost), then land and building may be transferred for a promissory note
 - to avoid triggering any accrued gain or recapture, transfer pursuant to subsection 85(1), ITA
- Requirements for transfer pursuant to subsection 85(1), ITA
 - to avoid triggering any accrued gain transfer to a “taxable Canadian corporation”
 - can be either federally or provincially incorporated

- term “Canadian corporation” speaks to residence and incorporation in Canada [subsection 89(1), ITA]
 - share consideration required; at least one share or a fraction thereof
 - common shares will suffice unless other shareholders introduced
 - non-share consideration (“boot”) limitations
 - to avoid triggering gain on transfer, boot cannot exceed “cost” (in the generic sense) or technically, adjusted cost base of capital property (i.e., land) and undepreciated capital cost of depreciable property (i.e., building)
 - examples of “boot”:
 - assumed mortgage or other liabilities
 - promissory note
 - problem if outstanding mortgage exceeds above
 - consider allocating balance of mortgage to other assets, e.g., accounts receivable
- Only applies to the transfer of “eligible property” [subsection 85(1.1), ITA]
 - real property but only if held as capital property, i.e., not held as inventory
- Addition to stated capital is relevant to determination of paid-up capital for tax purposes
 - subsection 24(3), OBCA may permit the addition to stated capital to be suppressed (i.e., less than the fair value of consideration received by the corporation)
 - if stated capital is not suppressed, then subsection 85(2.1), ITA effectively “grinds” paid-up capital to an amount calculated as the aggregate elected amount (for purposes of subsection 85(1), ITA) less the amount of non-share consideration
 - lack of correlation between stated capital and paid-up capital can sometimes cause confusion in subsequent reorganization transactions
- Form T2057, joint election by transferor and transferee
 - elected amount generally deemed to be transferee corporation’s cost of acquired property and the transferor’s cost of shares, subject to modification where there is non-share consideration
 - due date
 - the earlier tax return due date for either transferee or transferor for its/his/her taxation year which includes the date of transfer

(b) Land Transfer Tax Considerations:

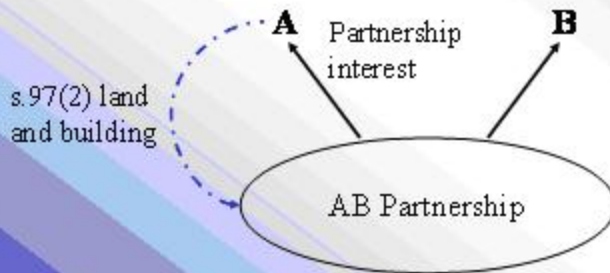
- Land transfer tax is payable unless exemption available
- Family business corporation exemption R.R.O. 1990, Regulation 697 (“Regulation 697”), section 3
 - registered conveyance to a “family business corporation” (defined in subsection 1(1), Regulation 697 with reference to owners of the shares of the corporation)
 - four conditions:

- prior to conveyance, land used “predominantly” in an active business operated exclusively by an individual or individuals who are “members of the family” [extended definition in subsection 1(1), Regulation 697] of a transferor
 - land conveyed for principal purpose of allowing the continued operation of such business on the land
 - in the taxation year ending following the date of registration of the conveyance, the corporation qualifies for the small business deduction for income tax purposes
 - in the taxation year ending following the date of registration of the conveyance, the corporation earns at least 75% of its gross income from an active business carried on in Canada
- because the last two of the above conditions cannot be determined until the end of the taxation year
 - security for the land transfer tax must be posted or the land transfer tax is paid with a view to obtaining a refund later
 - file Initial Family Business Affidavit LT100 including an undertaking to provide information within nine months after the end of the corporation’s taxation year which ends following registration to satisfy the Ministry that the prerequisites for the exemption are satisfied
 - at that time, Affidavit regarding Conveyance to Family Business Corporation LT101 is filed
 - if Ministry satisfied that the prerequisites for the exemption have been satisfied, the security is returned or the land transfer tax, if previously paid, is refunded
- See *Upper Valley Dodge Chrysler Ltd. v. Cronier Estate*, 2005 Carswell Ont 4433 (Ont. CA), as an example of the strict interpretation of the prerequisites to above family business corporation exemption. In this case, M was the sole shareholder and officer of the corporation which carried on a car dealership business. M also owned the land upon which the business was carried on. M transferred the land to the corporation and claimed exemption from land transfer tax on the basis of the family business corporation exemption. The Minister of Finance reassessed to deny the exemption. Although M was successful at first instance at the Ontario Superior Court of Justice, the Ontario Court of Appeal upheld the reassessment. Using a strict interpretation of the regulatory exemption which requires, inter alia, that the land be used predominantly in the operation of an active business which was operated exclusively by an individual, the Court of Appeal held that the corporation was not an individual and although M controlled the corporation, the regulation did not provide for control as a factor in determining the operator of the business.

Non-Arm's Length Transfers

NON-ARM'S LENGTH TRANSFERS

- Transfer to a partnership



Transfer to a Partnership

(a) Income Tax Considerations:

- Tax deferred transfer (rollover) may be available depending on the nature of the partnership
 - is it a "Canadian partnership"? [subsection 102(1), ITA]
 - all members must be residents of Canada for tax purposes
 - if a tiered partnership, then "Canadian partnership" definition requires all members of the other partnership to also be residents of Canada for tax purposes
 - does not relate to the jurisdiction of formation of the partnership
 - can be a limited partnership or a general partnership
 - if not a "Canadian partnership", taxable transfer with recognition of gain/recapture on transfer of real estate depending on consideration received
 - if it is a "Canadian partnership", subsection 97(2), ITA rollover
- Requirements for transfer pursuant to subsection 97(2), ITA
 - what may be transferred?
 - in the case of real property, both inventory and capital property
 - contrast to subsection 85(1), ITA transfer to corporation which only permits transfer of real property which is held as capital property
 - consideration must include partnership interest, whether because transferor becomes a partner or in the case of an existing partner which transfers real property to the partnership, there is an addition to the partner's capital account

- same limitations as apply to subsection 85(1), ITA transfer to corporation relating to “boot” although in this case, this means limitations on the quantum of consideration other than partnership interest
- Form T2059, joint election by transferor and partnership
 - due date is the earliest tax return filing date for the transferor and any member of the transferee partnership for the year which includes the date of transfer
 - signed by one member of the transferee partnership who has authority to act for the partnership
 - authorizing document should be included with Form T2059 upon filing
 - such authorization could be documented by partnership resolution or in the transfer agreement
- where other partners are non-arm’s length, partnership agreement should contain a deferred tax clause whereby the gain and recapture that was deferred upon the transfer of the real estate into the partnership is allocated to the transferor for tax purposes

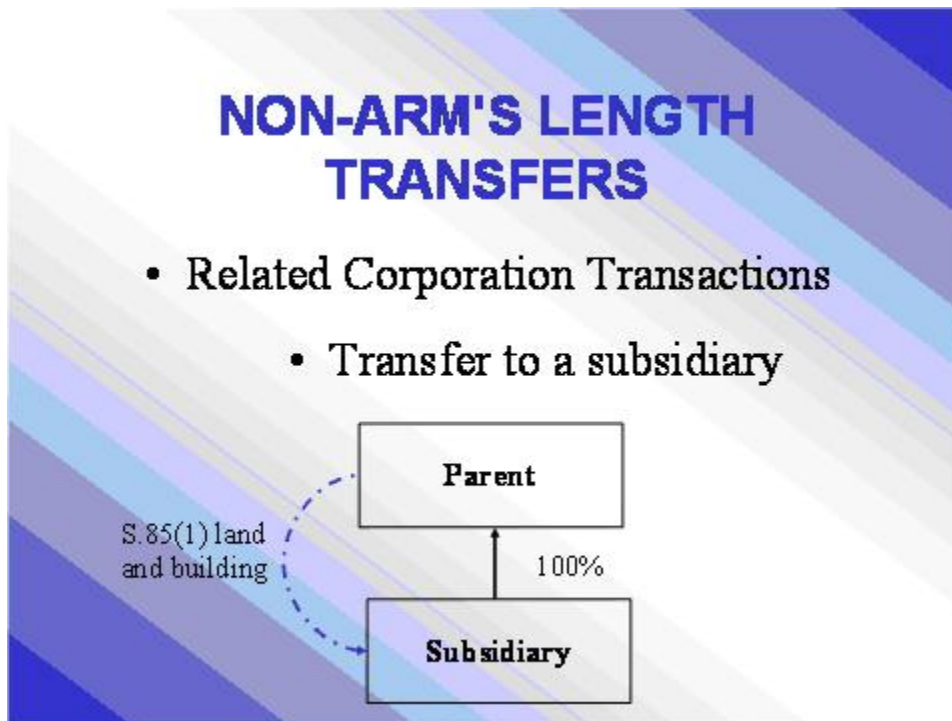
(b) Land Transfer Tax Considerations:

- LTTA does not specifically deal with the transfer of real estate to a partnership
 - Assuming an unregistered transfer, one must rely on the administrative position of the Ministry of Finance as set out in “A Guide for Real Estate Practitioners”, “Land Transfer Tax and the Treatment of Unregistered Dispositions of a Beneficial Interest in Land” (“Guide”) [available at www.rev.gov.on.ca]
 - Ministry of Finance considers each partner to have a beneficial interest in the property of the partnership so that a disposition of land to a partnership represents a conveyance to the partners in proportion to their partnership interests
 - Example: If A transfers Greenacre and B transfers Blackacre to a partnership of which they are each entitled to 50% of the profits, based on the administrative position set out in the Guide, the Ministry of Finance would consider A to have disposed of a 50% beneficial interest in Greenacre and B to have disposed of a 50% beneficial interest in Blackacre with resultant land transfer tax
 - It should be noted that application of the Ministry’s administrative position means that a transfer of partnership interest may also attract land transfer tax
 - above is arguably incorrect on the basis of section 23, Partnerships Act, R.S.O. 1990, c.P.5, as amended or subsection 7(2), Limited Partnerships Act, R.S.O. 1990, c.L.16, as amended which characterizes a transfer of an interest in a partnership which owns real property as a transfer of personal property
- Partnerships Act** - “Where land or any heritable interest therein becomes partnership property, unless the contrary intention appears, it is to be treated as between the partners, including the representatives of a deceased partner, and also as between the heirs of a deceased partner and his or her executors or administrators as personal or movable and not real or heritable estate.”
- Limited Partnerships Act** - “A limited partner’s interest in the limited partnership is personal property.”
- De minimis exemption in regulations, O.Reg. 70/91
 - states that section 3, LTTA (being the charging provision for unregistered dispositions of a beneficial interest in land) does not apply to a disposition of a beneficial interest in

land “if it is an interest of a partner in a partnership and if the person acquiring the interest would not be entitled, during the fiscal year of the partnership in which the disposition was made, to a percentage of profits of the partnership, assuming the partnership had profits to distribute, that exceeds by more than 5 per cent the percentage of profits to which the person would have been entitled at the beginning of the fiscal year”

- administratively interpreted by the Ministry of Finance in the Guide to mean an increase of up to 5 % in each partnership fiscal year, measured by profit entitlement
 - Example: Assume that A and B are the 50:50 partners of AB Partnership in Year I and C becomes a 5 % partner in Year II. Although C would be considered to have acquired a 5% beneficial interest in the underlying real estate of the partnership, no land transfer tax is exigible by virtue of the de minimis exemption. In Year III, C could acquire another 5% interest in the partnership and the de minimis exemption would apply again

Non-Arm's Length Transfers



Related Corporation Transactions

Transfer to a Subsidiary

(a) Income Tax Considerations:

- Same considerations as “Incorporation of Sole Proprietorship – Individual to a Corporation”
- Consider use of subsection 85(1), ITA

(b) Land Transfer Tax Considerations:

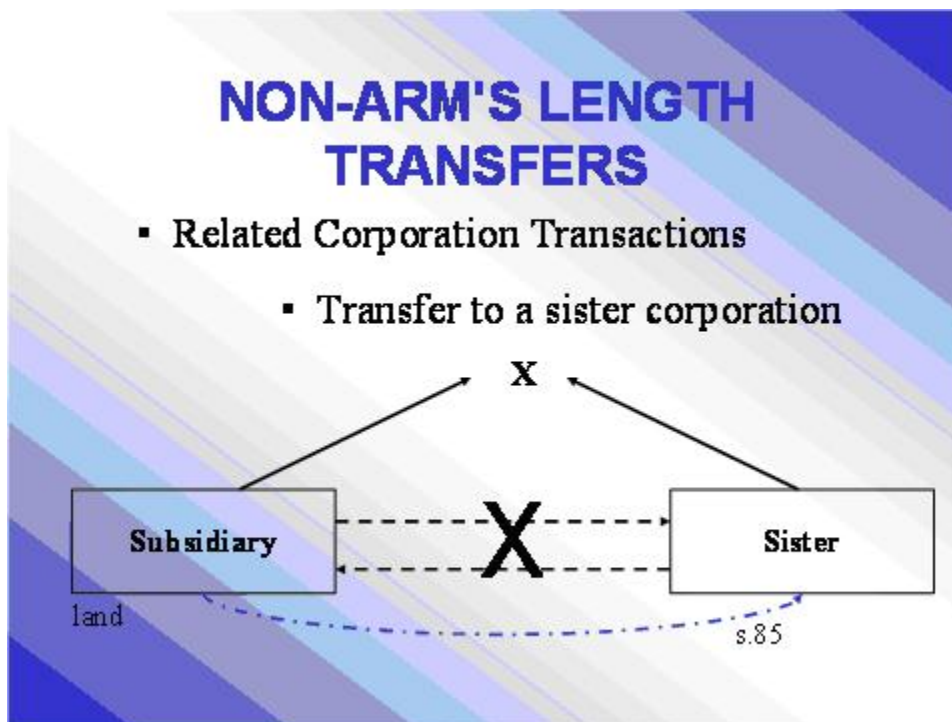
- Planning may involve a combination of “Transfer of title only to Trustee for Same Beneficial Owner” (discussed later in these materials) and subsection 3(9), LTFA

- Overview of subsection 3(9), LTTA
 - since 1989, a transfer of a beneficial interest in land has attracted land transfer tax (subject to available exemptions)
 - subsection 3(9), LTTA effectively provides an exemption applicable to certain corporation to corporation transfers
 - note that technically, this is not an exemption but rather a deferral of the land transfer tax which is cancelled after three years provided certain requirements are satisfied at that time
 - prerequisites to application for deferral of land transfer tax pursuant to subsection 3(9), LTTA
 - only applies to a transfer of beneficial interest, i.e., an unregistered transfer
 - transferor corporation and transferee corporation must be “affiliates” as defined in subsection 3(14) and (15), LTTA
 - Examples:
 - One corporation is controlled by the other corporation
 - Each corporation is controlled by the same person
- Within 30 days after the disposition, submit to the Ministry of Finance:
 - “Return on the Acquisition of a Beneficial Interest in Land”
 - copy of the agreement of purchase and sale
 - acceptable security for the land transfer tax otherwise payable plus an estimate of interest for 3 years
 - letter of credit either automatically renewable annually or with a expiry date 39 months from date of application
 - “Application and Undertaking for the Deferral of Tax pursuant to subsection 3(9)”
 - terms of undertaking
 - for a period of at least 36 consecutive months following the date of disposition
 - transferor corporation and transferee corporation will continue to be affiliates
 - the beneficial interest in land in question will continue to be owned by the particular transferee corporation or by another corporation which is an affiliate of both transferor and transferee
 - no instrument has been registered evidencing the disposition
 - Minister will be notified of any disposition or registration which occurs within the 36 month period
 - further information will be provided as requested by the Minister
- Application is reviewed by the Ministry, including the amount recorded as value of the consideration and if the application is accepted, a letter is issued which states that the land transfer tax is deferred on condition that:

- the terms of the undertaking are satisfied
- no instrument of any kind evidencing disposition is registered on title
- Cancellation of the tax requires that the Minister be satisfied that the terms of the undertaking have been satisfied and that no conveyance or instrument evidencing the disposition of the beneficial interest in land has been registered:
 - satisfying the terms of the undertaking:
 - shortly before the expiry of the 36 month period, the Ministry shall request documentation that the conditions of the undertaking have been met. Requested documentation typically includes:
 - affiliation chart that reflects the position of the transferor and transferee at the date of disposition and at any time where there was a name change, amalgamation or dissolution of relevant corporations
 - affidavit of a director or officer of transferor corporation and transferee corporation that:
 - the two corporation have remained affiliates
 - includes a narrative description to augment the affiliation chart in describing how the corporations are affiliated
 - statement that the beneficial ownership of the lands has not changed since the date of disposition
 - certified copies of the current shareholders registers and ledgers and directors ledgers of the transferee corporation and transferor corporation
 - details of the voting rights attached to the issued and outstanding voting shares of the corporations
 - copies of the abstracts for the particular property (including deleted and undeleted instruments) from the date of disposition to the end of the 36 month period
 - copies of all instruments registered after the date of disposition which relate to the particular property
 - no conveyance or instrument evidencing the disposition of the beneficial interest in land have been registered:
 - definition of “conveyance” in subsection 1(1), LTTA: “...*includes any instrument or writing by which land is conveyed and includes a final order of foreclosure under any mortgage or charge affecting land and a caution or notice of any kind in writing signifying the existence of any instrument or writing by which land is conveyed*”
 - definition of “notice of any kind” in subsection 1(1), LTTA: “*includes a recital or reference made in any registered instrument*”
 - note new subsection 3(13.1), LTTA (in force December 20, 2006) applicable to the determination of whether a conveyance or instrument evidencing the disposition of the beneficial interest in land has been registered as a prerequisite to the deferral [subsection 3(9), LTTA] and the cancellation [subsection 3(11), LTTA]: “...*the registration of a conveyance of legal title to the land to the beneficial owner of the land or a trustee for the beneficial owner is deemed to be a conveyance which evidences the disposition of a beneficial interest in land.*”

- above amendment seems to counter the results of Toronto Dominion Bank v. Ontario (Minister of Revenue) 39 RPR 149 (Ont. CJ) and 932292 Ontario Inc. v. Ontario (Minister of Finance) 1998 CarswellOnt 3578 (Ont. CA), both of which involved registrations after a transfer of beneficial interest involving a subsection 3(9), LTTA deferral of land transfer tax
- If the Ministry of Finance is satisfied that the terms of the undertaking have been met and no conveyance or instrument evidencing the disposition has been registered, a letter is issued cancelling the land transfer tax and returning the security
 - Note: notwithstanding the cancellation, if a conveyance is registered which evidences the disposition of the beneficial interest in land, land transfer tax may be assessed [subsection 3(13), LTTA]
 - In a recent letter from Ministry of Finance returning the security and cancelling the previously deferred tax, the Ministry makes express reference to the foregoing: *“We wish to remind you that the above cancellation of tax does not, in any way, exempt from tax, the registration of any conveyance which may result from this disposition.”*
- Subsection 5(8), LTTA imposes an obligation on a person who holds a legal interest in trust for any other person (i.e., a bare trustee) who becomes aware of a disposition of a beneficial interest in land to file a return setting out particulars of the disposition
 - above seems redundant if the transferee actually files the “Return on the Acquisition of a Beneficial Interest in Land”

Non-Arm's Length Transfers



Transfer to a Sister Corporation

Assumption: sister corporation is controlled by the same person controlling the transferor corporation

(a) Income Tax Considerations:

- As transferor corporation and transferee corporation (sister) are non-arm's length, the transfer is deemed to occur at fair market value with resultant tax consequences [section 69, ITA]
- The property could be transferred to the transferee corporation by means of a subsection 85 (1) transaction
 - if so, then transferor will own shares of transferee corporation
- If the desired structure is that the transferor corporation should not own shares of transferee corporation, then a "spin-out" reorganization may be possible pursuant to paragraph 55(3)(a), ITA
 - typically planned using a series of section 85(1) transactions and a reorganization of the share capital of the transferor corporation and certain share redemptions so that at the end of the series of transactions, transferor does not own shares of the transferee corporation (sister)
- Detailed technical requirements beyond the scope of these materials

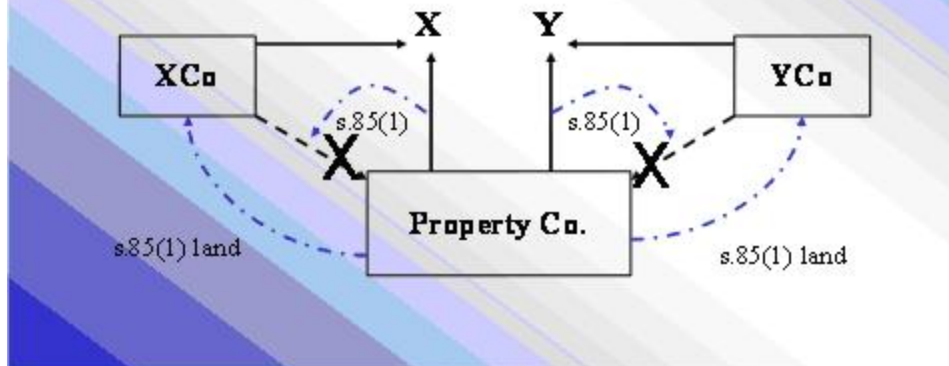
(b) Land Transfer Tax Considerations:

- Land transfer tax applies
- Planning to manage land transfer tax
 - assume that Transferor is the legal and beneficial owner of Greenacre
 - transferor transfers title to Greenacre to Sister as bare trustee for Transferee (see "Transfer of title only to Trustee for Same Beneficial Owner" discussed later in these materials)
 - transferor transfers beneficial ownership of Greenacre to Sister, with result that legal and beneficial ownership merge in Sister
 - deferral of land transfer tax pursuant to subsection 3(9), LTTA

Non-Arm's Length Transfers

NON-ARM'S LENGTH TRANSFERS

- Related Corporation Transactions
 - Butterfly Reorganization



Butterfly Reorganization

(a) Income Tax Considerations:

- A divisive reorganization of the assets of a corporation to its shareholders or where the shareholder is an individual, to a corporation owned by such individual
- Governed by paragraph 55(3)(b), ITA
- Typically involves a series of subsection 85(1), ITA transactions; share capital reorganizations; redemptions
- Complex and beyond the scope of these materials

(b) Land Transfer Tax Considerations:

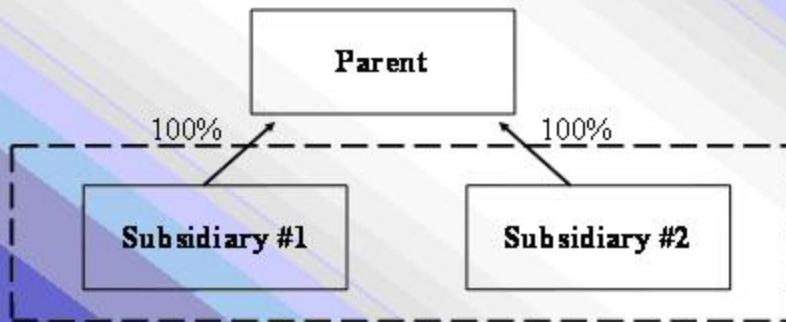
- Assuming that no conveyances are registered in respect of the real estate transferred on a divisive basis to the shareholders, an exemption from land transfer tax is available pursuant to O.Reg. 70/91, section 2
- Transferee files "Application and Declaration for the Exemption of Land Transfer Tax pursuant to Ontario Regulation 70/91" with the Ministry of Finance which includes:
 - a "Return on the Acquisition of a Beneficial Interest in Land"
 - copy of any ruling obtained from the CRA or if no ruling was obtained, a copy of a solicitor's or accountant's opinion setting out the transaction and stating that subsection 55(2), ITA would have applied but for paragraph 55(3)(b), ITA
- If it is subsequently determined by the CRA or the Ministry of Finance that the transactions were not within the paragraph 55(3)(b) "butterfly" provisions, then land transfer tax is payable

Non-Arm's Length Transfers

NON-ARM'S LENGTH TRANSFERS

- Related Corporation Transactions

- Amalgamation



Amalgamation

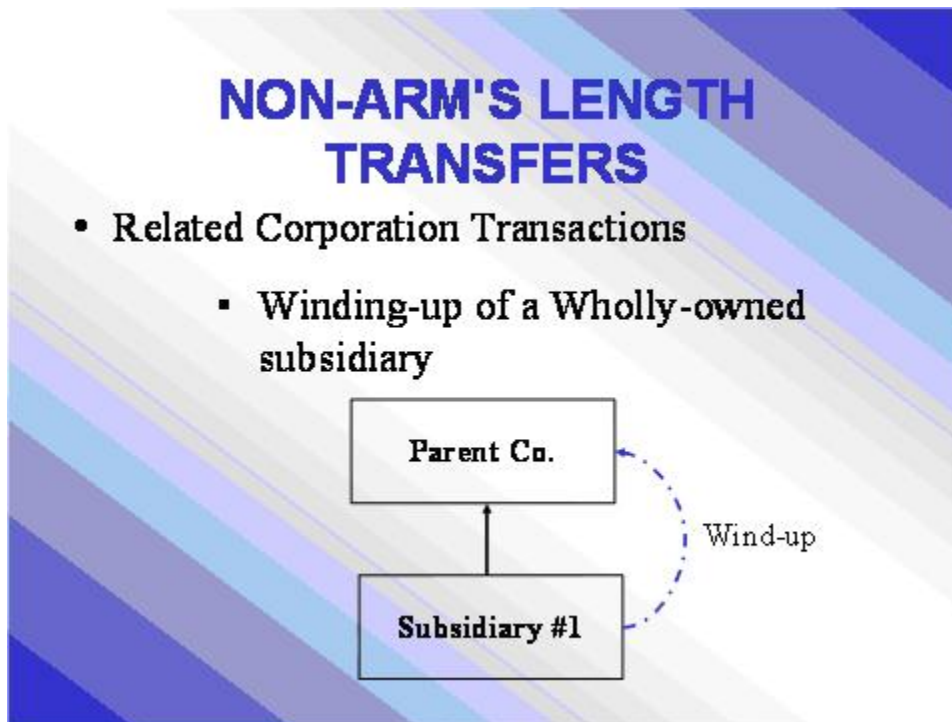
(a) Income Tax Considerations:

- ITA does not expressly cross-reference to a statutory amalgamation pursuant to section 174, Business Corporations Act (Ontario), R.S.O 1990, c.B.16, as amended ("OBCA") or section 181, Canada Business Corporations Act, R.S.C. 1985, c.C-44, as amended ("CBCA")
- Amalgamation is defined in subsection 87(1), ITA as a merger of two or more taxable Canadian corporations to form one corporate entity in such a manner that:
 - all of the property of the predecessor corporations immediately before the merger becomes property of the new corporation by virtue of the merger
 - all of the liabilities of the predecessor corporations immediately before the merger become liabilities of the new corporation by virtue of the merger
 - all of the shareholders who owned shares of any predecessor corporation immediately before the merger, receive shares of the new corporation because of the merger
- Provided that the foregoing is satisfied:
 - no disposition of land by Subsidiary #1 upon amalgamation with Subsidiary #2
 - rollover of tax basis to Amalco [section 87, ITA]
 - adjusted cost base of land to Subsidiary #1 becomes adjusted cost base of land to Amalco
 - capital cost and undepreciated capital cost of depreciable property (building) becomes capital cost and undepreciated capital cost of depreciable property (building) to Amalco

(b) Land Transfer Tax Considerations:

- Not considered to be a conveyance of land [Ontario Tax Bulletin LTT 3-2000, April 2000, paragraph 2]

Non-Arm's Length Transfers



Winding-up of a Wholly-owned Subsidiary

(a) Income Tax Considerations:

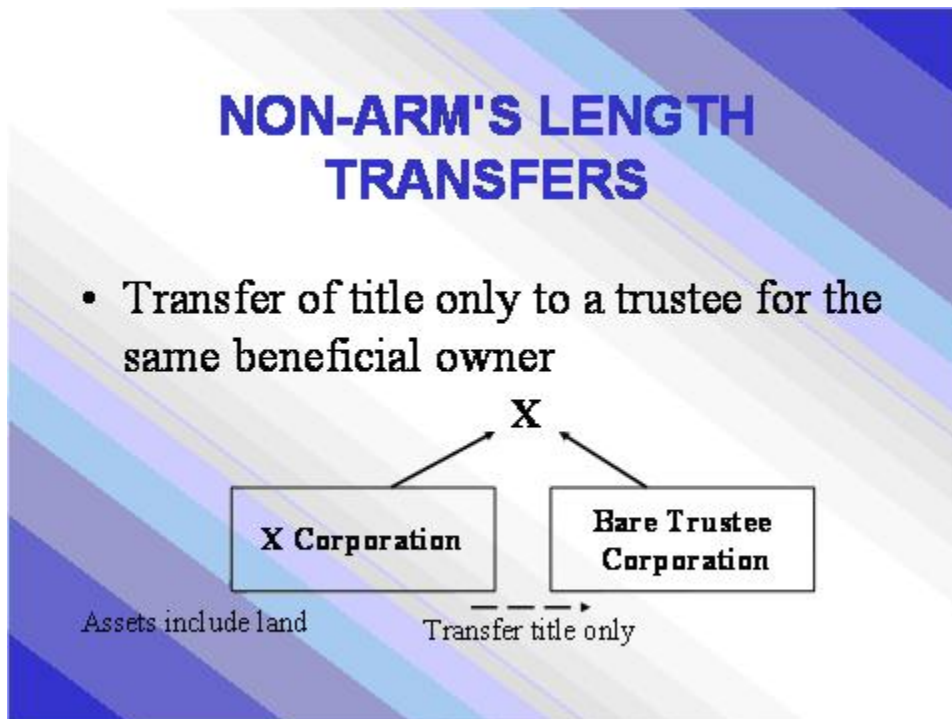
- “Winding up” is not defined in the ITA. Generally considered to include a voluntary dissolution under section 193, OBCA or section 210, CBCA
- Are both the subsidiary (to be wound up) and parent “Canadian corporations” under ITA?
 - if not, the wind-up triggers a taxable disposition to the subsidiary of its assets at fair market value
- If yes, are at least 90% of the shares of each class of shares of the subsidiary owned by the parent with the remaining shares held by arm’s length persons?
 - if not, the wind-up triggers a taxable disposition to the subsidiary of its assets at fair market value
 - if yes, then wind-up is governed by subsection 88(1), ITA
 - although subsidiary corporation disposes of its real property upon the winding-up there are deeming rules in subsection 88(1), ITA whereby:
 - subsidiary is deemed to dispose of property at cost amount
 - parent is deemed to acquire at same

(b) Land Transfer Tax Considerations:

- If conveyance registered to transfer property from Subsidiary to Parent, land transfer tax applies

- Planning to manage land transfer tax:
 - consider using combination of “Transfer of title only to Trustee for Same Beneficial Owner” (discussed later in these materials) and the deferral mechanism in subsection 3(9), LTTA
 - assume Subsidiary is the legal and beneficial owner of Greenacre and it is intended that Subsidiary will be wound up and dissolved. All of Subsidiary’s shares are held by Parent.
 - Subsidiary transfers title only to Greenacre to Parent as bare trustee for Subsidiary. Procedures for transfer to trustee for the same beneficial owner should be followed
 - on the winding-up, Subsidiary transfers beneficial ownership of Greenacre to Parent
 - Subsidiary and Parent are “affiliates” as Subsidiary is controlled by Parent
 - Application for deferral of LTT is submitted pursuant to subsection 3(9), LTTA
 - although Subsidiary shall presumably dissolve prior to the end of the 36 month period from the date of disposition, it is deemed to continue to exist and to continue to be an affiliate of the corporation which acquired the beneficial interest (i.e., Parent) pursuant to subsection 3(12), LTTA

Non-Arm's Length Transfers



Transfer of Title Only to Trustee for Same Beneficial Owner

(a) Income Tax Considerations:

- Not a “disposition” [paragraph (e) of “disposition” in subsection 248(1), ITA]

- No income tax consequences

(b) Land Transfer Tax Considerations:

- Registered conveyance with NIL value of consideration
- Supplement affidavit required (see “Guide to the Requirements to Evidence NIL value of consideration for Conveyances Involving Trusts”)
- Land Transfer Tax Affidavit should be completed showing NIL consideration and the following in section 5:

“Beneficial owner to trustee: The transfer is from the beneficial owner to the trustee for the same beneficial owner”

Business Transactions

Foreclosure

(a) Income Tax Considerations:

- Section 79, ITA applies to determine the tax consequences to debtor where a creditor acquires or reacquires beneficial ownership of property from the debtor as a consequence of the debtor’s failure to pay principal or interest on debt owed by the debtor to the creditor
 - referred to as a “surrender of property” in subsection 79(2), ITA
 - note that the above acquisition or reacquisition of property essentially must arise as a result of the debtor’s default, not in anticipation of the debtor’s failure to pay
- Section 79.1, ITA applies to determine the tax consequences to the creditor
- In the case of foreclosure:
 - debtor disposes of the property for deemed proceeds of disposition calculated based on an algebraic formula in subsection 79(3), ITA. In the simplest situation of foreclosure with a first mortgage only, the debtor or mortgagor’s deemed proceeds of disposition will generally equal to the unpaid principal amount plus accrued and unpaid interest on the debt owing to the creditor.
 - deemed proceeds to the debtor/mortgagor also includes:
 - any other debt (principal plus accrued and unpaid interest) of the debtor which ceases to be owing by the debtor as a consequence of the foreclosure
 - where the property surrendered was security for other debt which ranked in priority, the unpaid amount (including accrued and unpaid interest) of such other debt, e.g., where second mortgagee forecloses, the balance of the first mortgage is included in the calculation of deemed proceeds
 - generally, the creditor/mortgagee’s cost of the acquired or re-acquired property will be equal to its cost of the particular debt plus outlays or expenses to protect the creditor’s interest in the particular property

(b) Land Transfer Tax Considerations:

- Special deeming rule to determine “value of the consideration” [subsection 1(1), LTTA] upon a final order of foreclosure being the lesser of:

- outstanding principal and interest in respect of the mortgage foreclosed, amount of any mortgage to the same mortgagee which ranks subsequent in priority to the mortgage foreclosed and costs (other than realty taxes) paid by the mortgagee
- fair market value of the land, as established to the satisfaction of the Ministry of Finance

Business Transactions

Power of Sale

(a) Income Tax Considerations:

- The exercise of a power of sale results in the disposition of the property. The terms of sale will apply to determine the consequences of the resultant disposition, as is the case with any other sale.

(b) Land Transfer Tax Considerations:

- Initiating power of sale proceedings does not attract land transfer tax
- Taxable transaction to the purchaser under power of sale

Business Transactions

Quit Claim

(a) Income Tax Considerations:

- Provided that the quit claim to the creditor/mortgagee is made as a consequence of the debtor/mortgagor's failure to pay (i.e., the concept of "surrender of property" in subsection 79(2), ITA) the income tax considerations are the same as in the case of foreclosure

(b) Land Transfer Tax Considerations:

- Same as in the case of foreclosure

Business Transactions

Non-resident Situations

Non-resident Vendor of land and building

(a) Income Tax Considerations:

- Non-resident is taxed in Canada on the disposition of "taxable Canadian property" [subsection 248(1), ITA] which includes real property situated in Canada
- learance certificate requirement pursuant to section 116, 1TA
 - Procedure:
 - Form T2062 (land) and T2062A (building) submitted to CRA, either in advance of sale or within ten (10) days thereafter. As a practical matter, the form is typically submitted prior to closing because of timing constraints.
 - supporting materials will include: copy of agreement of purchase and sale; documents to support vendor's calculation of cost; copies of deeds
 - failure to withhold non-resident tax if the property was rented in the past may become an issue as there is an explicit question on the Form T2062

- different district offices seem to have different procedures regarding the number of past years rental income required to be disclosed with “catch-up” non-resident withholding tax remitted as a prerequisite to the issuance of the section 116 clearance certificate
- given potential personal liability pursuant to subsections 116(5) and (5.2), ITA, the Purchaser will typically negotiate the right to withhold funds at closing if the section 116 certificate is not delivered at that time, equal to 25% of the Purchaser’s cost of the land and 50% of the Purchaser’s cost of the building
 - subsection 116(5), ITA applies in respect of the land and subsection 116(5.2), ITA applies in respect of the depreciable property, i.e., building, and
- states that “unless after reasonable inquiry the purchaser had no reason to believe that the non-resident person [i.e., the Vendor] was not resident in Canada”, the Purchaser is liable to pay and must remit to the Receiver-General 25% of its cost of the land and 50% of its cost of the building by the 30th day after the end of the month in which the Purchaser acquired the property
- thus, Purchaser will negotiate the right to withhold the above amounts to be held in escrow until the 30th day of the month following the month of closing at which time, the Purchaser will remit the withheld funds to the Receiver General if a satisfactory section 116 clearance certificate is not delivered
- because of processing time at the CRA, it is possible that the section 116 certificate may not be issued prior to that time. An administrative practice has developed whereby the CRA will issue a “comfort letter” instructing the Purchaser to continue to hold the withheld funds and to not remit same while the Form T2062 is under review
 - above is an administrative practice only for which there is no provision in the ITA
 - non-resident vendor should negotiate to include above concept in the agreement of purchase and sale
- Recently the CRA has required the non-resident vendor to apply for an identification number as part of the section 116 process: Business Number in the case of a non-resident corporation and an Individual Tax Number in the case of a non-resident individual

Non-Resident Mortgagee

(a) Income Tax Considerations:

- Non-resident withholding tax under Part XIII, ITA applies in respect of interest paid to the non-resident mortgagee, unless a specific exemption is available. Rate of withholding tax is 25% unless reduced pursuant to the terms of a bilateral tax treaty with the jurisdiction of residence of the non-resident mortgagee
 - exemption pursuant to subparagraph 212(1)(b)(vii), ITA may apply (sometimes referred to as the “5/25” exemption)
 - in general terms, subparagraph 212(1)(b)(vii), ITA is applicable where:
 - the borrower is a Canadian resident corporation which is arm’s length to the non-resident lender

- under the terms of the debt, no more than 25% of the principal amount of the debt can be required to be paid within 5 years of the date of the debt obligation, other than an event of default. There has been much administrative interpretation by the CRA on events which may constitute events of default
- Withholding tax changes as announced in the March 19, 2007 Federal Budget
 - It was announced that Canada and the United States have agreed in principle to certain amendments to the Canada-US Tax Treaty which, once fully phased-in, shall effectively eliminate withholding tax on Canada-US cross border interest. Thus, recourse to the 5/25 exemption will no longer be necessary. Interest paid between arm's length persons will first be eliminated, as of the beginning of the calendar year following the entry into force of the treaty amendments. The elimination of withholding tax on non-arm's length interest payments will be subject to a three (3) year phase-in, commencing as of that time.
 - It should be noted that although the amendments have apparently been agreed in principle, the protocol has not yet been signed (apparently intended to be signed before the end of 2007). Following signing, the protocol must be ratified by each country.
 - The 2007 Budget also proposed that Canadian withholding tax be eliminated on all interest payments to arm's length non-residents, regardless of country of residence. Although the Budget materials were somewhat ambiguous as to the timing of the foregoing, it appears that this proposal is to be effective as of the date on which withholding tax is eliminated on arm's length Canada-US interest payments, i.e., beginning of the calendar year following the entry into force of the treaty amendments.

Business Transactions

Interest Expense and Financing

(a) Income Tax Considerations:

- What is interest?
 - represents compensation for the use of money belonging to another person
 - accrues day by day
 - referable to a principal sum
- Interest is generally considered to be a capital expenditure and accordingly, specific provisions of the ITA must be met in order for interest to be deductible. In other words, it is not simply deducted in the computation of profit.
- Interest deductibility governed by paragraph 20(1)(c), ITA which requires:
 - the amount (of interest) be paid or payable in respect of the year
 - the amount (of interest) must be paid pursuant to a legal obligation
 - the amount (of interest) must be reasonable
- In general terms:
 - where interest is payable on borrowed money, the use of the money must be established and the purpose of the use must be the earning of income from business or property

- where interest is payable on an amount payable for property acquired, the property must be acquired for the purpose of earning income
- Leveraging owned real estate:
 - interest deductibility governed by the above principles and therefore will depend on the purpose of the use of the borrowed money
 - if the borrowed money is distributed to shareholders (assuming that the real estate is owned by a corporation) as a dividend, interest deductibility is restricted to the interest on a notional borrowing equal to “accumulated profits”
 - “accumulated profits” is not defined in the ITA but is administratively considered to mean unconsolidated retained earnings with investments accounted for on a cost basis [see Interpretation Bulletin IT-533, “Interest Deductibility and Related Issues”, October 31, 2003, paragraph 23].
 - if the borrowed money is used to make interest-free loans to shareholders, the interest payable by the corporation is generally not deductible since it will not have been used to earn income