

TAX GUIDE FOR INDIVIDUAL NON-RESIDENT OWNERS OF CANADIAN REAL PROPERTY

Non-resident owners of Canadian real estate often encounter an unpleasant surprise in the form of a significant Canadian income tax liability when they ultimately sell that real estate.

The purpose of this guide is to provide the non-resident property owner with some general information concerning Canadian income tax filing requirements, both ongoing and at the time of disposition.

INCOME TAX IMPLICATIONS OF THE DISPOSAL OF CANADIAN REAL ESTATE BY A NON-RESIDENT OF CANADA

WITHHOLDING TAX - DISPOSAL

Any person purchasing Canadian real estate from a non-resident has an obligation to withhold and remit to Canada Revenue Agency ("CRA") 25% of the gross sale proceeds with respect to the purchase. This liability increases to 50% where the real estate was depreciable property (a building used for rental or business purposes) or where the real estate was not held by the non-resident as capital property (for example, held for speculative purposes). A purchaser who fails to withhold this tax is liable for it (unless they had no reason to believe that the vendor was not a Canadian resident) and CRA has the ability to enforce this liability. Because of this substantial purchaser's liability, it is standard practice for a purchaser's legal advisor to either require the vendor to certify in writing as to the vendor's Canadian residency status or require withholding of this tax.

The withholding tax requirements can be reduced or eliminated if the vendor obtains a "Certificate of Compliance" from CRA on a timely basis. This process requires the filing of a form with CRA in advance of the disposition or within 10 days thereafter, together with evidence as to what the sale proceeds are and what the vendor's adjusted cost base of the property is. (Penalties may apply in the event of late filing). One result of this filing is to allow the withholding tax to be calculated at 25% (or 50% as applicable) of the gross sale proceeds net of the purchase cost of the property.

CRA will review and approve the information and upon receipt of the appropriate withholding tax, issue a Certificate of Compliance. Note that where the vendor's proceeds are less than or equal to cost, the withholding tax will be entirely eliminated by this process.

A Certificate of Compliance is required any time that a disposition by a non-resident occurs and thus must also be obtained if the property is gifted by a non-resident regardless of whether or not a gain is realized on the property. Where a gift occurs, the "proceeds" for these purposes are considered to be the value of the property at the time that the gift is made. No Compliance Certificate is required where there is a "deemed" disposal on the death of a non-resident, but the executor acting on behalf of the decedent will still be required to file a tax return for the non-resident for the year of death to report any "deemed" gain or loss realized on the death of the individual.

CRA will typically recognize the effect of a principal residence designation in processing a Certificate of Compliance. Thus, a non-resident who was formerly a resident of Canada and who is selling a former principal residence may have the withholding tax liability reduced by virtue of a principal residence designation. Furthermore, if a tax treaty between Canada and the vendor's home country will apply to reduce the non-resident's tax liability with respect to the disposal, CRA will generally allow the withholding tax to be reduced on proof being provided that the tax treaty exemption will apply to the disposal.

CRA's Burnaby-Fraser Tax Services Office may take 8 weeks or more to process a Certificate of Compliance request (although they will provide expedited service in cases of hardship, generally where the sale cannot complete unless the certification is provided prior to closing). Where a certificate cannot be obtained from CRA prior to closing, the vendor's lawyer will often agree to hold the required percentage of the gross proceeds in trust pending receipt of the certificate.

Although the purchaser has a statutory requirement to remit the tax within 30 days after the end of the month following closing, this requirement is not generally enforced by CRA where the Certificate of Compliance request has been filed on a timely basis.

Also note that before the Certificate of Compliance is released, the non-resident will have to pay any outstanding income tax or any unpaid withholding tax on rental income. (A more detailed discussion of withholding tax requirements on rental income is discussed later in this memo).

CANADIAN TAX RETURN FOR YEAR OF DISPOSITION

The process described in the previous section constitutes a withholding tax only. The actual Canadian income tax liability is determined by filing a Canadian tax return by April 30 of the following year. That return will usually only include the property disposition and often results in a refund of tax to the non-resident as the withholding tax rate typically is higher than the actual tax liability. (Note that costs of disposal, including real estate commissions, legal fees, etc., reduce taxes payable on the return whereas they do not reduce the withholding tax payable for Certificate of Compliance purposes). Late-filed returns are permitted within certain limits.

INCOME TAX IMPLICATIONS OF THE RENTAL OF CANADIAN REAL ESTATE BY A NON-RESIDENT OF CANADA

The non-resident real estate owner is often under the impression that rental income earned from Canadian real estate bears no ongoing Canadian income tax liability, particularly if costs associated with the rental (interest, property taxes, etc.) exceed the gross rents received. This is not the case and failure to adhere to the proper filing procedures as described below can result in large Canadian income tax liabilities that could have been avoided had those filings been made.

WITHHOLDING TAX – GROSS RENTS

The non-resident landlord is obligated to pay a specified percentage (usually 25%) of the gross rents received on account of withholding tax. The non-resident will normally engage a Canadian agent to collect the rents and remit them to CRA on their behalf.

In cases where there are significant rental expenses, the 25% withholding tax obligation may constitute a hardship to the non-resident. CRA Form NR6 can be filed to provide relief from the "25% of gross" withholding tax. This form requires the filing of a statement showing estimated income and expenses for the upcoming year and an undertaking (jointly between the non-resident and their agent) to file a Canadian tax ("T1") return to report the income and expenses within 6 months after the end of

the calendar year. Where an NR6 is filed and accepted by CRA (generally the NR6 must be filed before the start of the relevant calendar year), the withholding tax requirement can be reduced to 25% of the estimated net income (before capital cost allowance) from the property. This can eliminate the remittance of withholding tax where the rental income is offset by sufficient rental expenses. Note however that where the non-resident does not file a T1 return within 6 months of the end of the calendar year, he/she and their agent become liable for the 25% tax on gross rents. Also note that in the event that the reduced withholding tax is insufficient to fully offset Canadian income tax calculated at the regular rates, any deficiency must be paid with the T1 return filed for the year.

FILING OF T1 RETURN

As noted above, the filing of a T1 return is mandatory where an NR6 is filed to reduce withholding tax. Where an NR6 is not filed, an “elective” T1 return may still be filed within two years from the end of the relevant calendar year in order to recover tax withheld in excess of the actual tax liability that would arise on the net rental income computed at regular Canadian rates. This return can also be filed by a non-resident landlord who may have been renting out his/her property for a number of years, unaware that they had any Canadian filing requirements. In such a case, filing elective returns now may alleviate a tax liability in respect of previously un-remitted withholding tax at least to the extent that the late filing of returns is allowed under the two-year deadline referred to above. CRA's current practice is to accept late filed returns outside the two-year period if this is the only time the taxpayer has late filed such returns and if the CRA has not made a demand for them to file the returns.

It was formerly common for non-residents to ignore both the “25% of gross” withholding tax and the NR6 requirements and simply file Canadian T1 returns reporting the rental income on a net basis after the end of the calendar year. CRA no longer permits this practice and they will now assess the 25% gross withholding tax plus interest where an NR6 is not filed on a timely basis.

INFORMATION RETURN

Regardless of whether or not an NR6 has been filed, an information return form (NR4) must be filed for the calendar year by the non-resident's agent by March 31 of the following year. This information return reports the gross rental income received by the non-resident and the amount of the withholding tax paid to CRA. Failure to file (or late filing of) this information return can result in the assessment of penalties.

CONCLUSION

A non-resident real property owner cannot escape the Canadian tax net due to the purchaser liability provisions of the Income Tax Act. Vendors who ignore the rules (particularly landlords) can be subject to significant income tax liabilities where proper procedures are not followed.

The foregoing provides a practical overview of the income tax requirements for non-resident property owners. Further information can be obtained from KNV Chartered Accountants LLP.

The information provided in this publication is intended for general purposes only. Care has been taken to ensure that the information herein is accurate, however no representation is made as to the accuracy thereof. The information should not be relied upon to replace specific professional advice.