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THE TAXATION OF NON-RESIDENTS' CANADIAN SOURCED PROPERTY INCOME

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Overview

The *Income Tax Act* (Canada) (the "Act") provides for three different types of withholdings on payments to non-residents. These are:

(i) withholding taxes imposed under Part XIII on most types of income from property received by a non-resident from a Canadian resident payor;

(ii) withholding under subsection 153(1) and Regulation 105 on amounts paid to non-residents for services rendered in Canada; and

(iii) the certificate of compliance and withholding provisions of section 116 relating to possible tax liabilities for gains on taxable Canadian property disposed of by non-residents.

Part XIII non-resident withholding tax is a true tax imposed on the non-resident payee. The withholdings under section 153 and section 116 are collection mechanisms requiring withholding on account of any ultimate tax liability of the payee from working in Canada or on Canadian gains. In this respect these latter two are similar to traditional employee withholding requirements.

Part XIII Non-Resident Withholding Taxes

Part XIII of the Act levies a tax on most types of income from property received from a Canadian by a non-resident. The tax is imposed on the non-resident, however, the Canadian payor has withholding, remitting and reporting obligations.

The statutory rate of tax is 25%. However, this rate is frequently reduced by treaties with specific countries. If a treaty reduction is applicable, subsection 10(6) of the *Income Tax Application Rules* ("ITARs"), overrides the 25% rate for purposes of the payor's withholding obligation as well as the payee's tax liability. As a general rule, a payor can rely upon an address in the treaty country as entitling it to reduce the amount of withholding at source. See Canada Revenue Agency ("CRA") Information Circular IC 76-12, which was revised in late 2007.

While a large number of outbound payments are subject to Part XIII tax, the principal commercial payments are:

- interest (paragraph 212(1)(b));
- dividends (subsection 212(2));
- rents and royalties (paragraph 212(1)(d)); and
- management fees (paragraph 212(1)(a))

Interest

Until January 1st, 2008, the general rule was that outbound payments of interest to non-residents were subject to withholding at the 25% or lesser treaty reduced rate. There were a large number of statutory and treaty exemptions applicable to interest. Entitlement to these exemptions turned upon the nature of the payor, of the recipient, or of the debt itself.

However, in the 2007 Federal Budget (the "2007 Budget") the Federal Government announced its plans to eliminate withholding taxes on interest paid or credited by Canadian resident borrowers to arm's length non-residents. The 2007 Budget further indicated that Canadian withholding tax on interest was to be eliminated on non-arm's length cross border debt between Canada and the United States as part of the protocol to the Canada- U.S. Income Tax Convention (the "Treaty").

The 2007 Budget legislation implementing elimination of arm's length interest withholding tax received Royal Assent on December 14, 2007. Under those provisions, interest paid or credited after 2007, is only subject to withholding tax under paragraph 212(1)(b) if:

(i) it is not fully exempt interest, and is paid or payable to a person with whom the payer is not dealing at arm's length, or

(ii) it is participating debt interest.

Non-arm's length interest:

Given the foregoing, interest paid or credited to a non-arm's length non-resident of Canada is subject to withholding taxes at the 25% or lesser treaty reduced rate unless such interest is "fully exempt interest".

The meaning of “arm's length” is not defined in the Act. However, section 251, provides certain statutory rules for determining arm's length relationships. Subsection 251(1) provides that related persons are deemed not to deal with each other at arm’s length. The definition of “related persons” is provided for under subsection 251(2). Personal trusts and their beneficiaries may also be deemed not to deal with each other at arm’s length by virtue of paragraph 251(1)(b). In every other case, paragraph 251(1)(c) provides that it is a question of fact whether person not related to each other are dealing with each other at arm’s length. A discussion of the meaning of “arm’s length” is beyond the scope of this paper. For further information, refer to *Interpretation Bulletin* IT-419R2, *Meaning of Arm's* Length, dated June 8, 2004.

“Fully exempt interest” is defined in subsection 212(3) and incorporates many of the exemptions that were part of paragraph 212(1)(b) before the changes in the 2007 Budget were implemented.

Exempt Payors:

The principal exemption in this category is the exemption for government debt set out in paragraph (a) of the definition of “fully exempt interest”. This extends to Canadian federal, provincial, municipal, and certain quasi-governmental entities such as Crown corporations. As always, it is important to read the exemption carefully. Note that government guaranteed debt is also exempt if the guarantee is from the federal government (otherwise than by being insured by the Canada Deposit Insurance Corporation ("CDIC"), however, provincial or municipally guaranteed debt is not exempt. Schools and hospitals are similarly exempted if repayment of principal and interest under the obligation is made, guaranteed or secured by a provincial government.

Exempt Debt:

Interest paid by Canadian residents on their foreign personal mortgage obligations is also considered fully exempt interest. This facilitates Canadians acquiring foreign vacation properties with mortgage financing by a local non-resident lender: See paragraph (b) of the definition of “fully exempt interest”. The debt must be personal debt, i.e. interest on the debt is not deductible from Canadian income.

Exempt Recipients:

Paragraph (c) of the definition of "fully exempt interest" exempts interest that is paid or payable to a prescribed international organization or agency. See Regulation 806 for the list of organizations including the International Monetary Fund and the World Bank.

Exempt Deemed Interest under Securities Lending Arrangements

Finally, paragraph (d) of the definition of "fully exempt interest" exempts certain amounts that are deemed to be interest pursuant to subsection 260(8) in respect of a securities lending arrangement where such arrangement involves certain qualified securities that are transferred or loaned to a borrower and where the borrower entered into the securities lending arrangement in the course of carrying on a business outside of Canada.

Participating Debt Interest

"Participating Debt Interest" is defined in subsection 212(3) to mean interest (other than certain amounts that are "fully exempt interest", as described above) that is paid or payable on an obligation where all or any portion of the interest is contingent or dependent on the use of or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class of shares of a corporation.

The language of this new provision was adopted from the former postamble of paragraph 212(1)(b). It is intended to be an anti-avoidance provision which precludes withholding tax exempt deductible interest from being paid to a non-resident investor who might otherwise be taxed as a non-resident carrying on business in Canada and thereby be subject to income and branch tax on its share of the profits. See for example, CRA Technical Interpretation 2000-0046375. However, the broad language of the provision means it can apply in some unexpected situations.[1]

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[1] See Canada Revenue Agency, *Income Tax Technical News* No. 41 dated December 23, 2009 where the CRA discusses how the the definition of "participating debt interest" may apply to convertible debt and invites the "practitioner community" to make submissions regarding the CRA's administrative interpretation.

Interest Accruals and Discounts

If a non-resident sells a debt with accrued interest, the amount paid by a Canadian purchaser for the accrued interest may be subject to withholding tax under subsections 214(6), (7) and (8) if the exemptions discussed above are not applicable. Subsection 214(14) captures potential withholding tax on original issue discounts when paid by the issuer by deeming the redemption or repayment to be an acquisition for purposes of subsection 214(6).

Guarantee Fees and Stand-by Charges

Subsection 214(15) provides that guarantee fees and stand-by charges in respect of lending commitments and loan obligations are deemed to be interest on the debt obligation in question. Because the interest is deemed to be paid on the underlying obligation, if the obligation is withholding tax exempt the stand-by charges or guarantee fees will also be exempt from withholding tax. This deeming provision gave rise to the *Income Tax Conventions Interpretation Act* (sometimes called the Anti-Melford Act) which is discussed in Maralynne Monteith's paper at this Conference.

Fifth Protocol

The negotiations between Canada and the United States in respect of an agreement to amend the Treaty lasted for many months and culminated in the announcement of a new protocol to the Treaty on September 21, 2007 (the "Protocol"). The Protocol came into force on December 15, 2008. Under the terms of the Protocol, interest (pursuant Article XI of the Treaty) is only be taxable in the State where the beneficial owner of such interest is resident (subject to certain exceptions).

Article 27 of the Protocol contains the rules governing the entry into force of the various provisions of the Protocol. This Article states that in applying the Protocol to interest paid or credited during the first two calendar years that end after entry into force, interest that arises in a State (the source State) that is not otherwise exempt under paragraph 3 of Article XI (Interest) as it read on January 1, 2007, and the payer of the interest and the beneficial owner of the interest are related, or would be deemed to be related if the provisions of paragraph 2 of Article IX (Related Persons) applied for this purpose, then such interest may be taxed in such source State. Where the interest is paid or credited during the first calendar year after the entry into force the maximum withholding tax would be 7% of the gross amount of the interest. This means that for interest paid or credited to a related U.S. resident in 2008 is subject to a 7% withholding tax rate. The rate is reduced to 4% for interest paid to a related U.S. resident in 2009 and eliminated altogether in 2010.

Notwithstanding these new relieving provisions, one of the applicable exceptions in the amended version of Article XI (Interest) of the Treaty will apply where:

> interest arising in Canada that is determined with reference to receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor to a related person...

In that case, the interest may be subject to Canadian withholding tax but if the beneficial owner of the interest is a resident of the United States, the maximum withholding tax rate cannot exceed the withholding tax on dividends rate as prescribed in subparagraph (b) of paragraph 2 of Article X (Dividends) of the Treaty (15%).

It is important to note that this exception to the exemption from withholding tax on interest is of narrower application than the exception provided for in the Act – "participating debt interest". In order for this exception in the Protocol to apply, the profits or cash flow which are referred to in computing the interest on an obligation must be profits or cash flow of the debtor or a related person. Dividends, partnership distributions or similar payments referred to in the computation of interest must be payments by the debtor to a related person. The participating debt interest exception in the Act has no such limitations.

Dividends

Subsection 212(2) imposes a 25% withholding tax on dividends. In addition to being imposed on actual dividends, it applies to

- deemed dividends: upstream, outbound benefits, eg. guarantees, inappropriate transfer pricing, etc.: see paragraph 214(3)(a); and

- non-arm's length capital gains stripping: section 212.1 is similar to section 84.1. And see related IT-489.

It should be remembered that Part XIV branch tax is the equivalent of withholding tax on dividends for non-residents that operate Canadian branches in lieu of establishing Canadian subsidiaries. In order to identify the portion of the Canadian branch's earnings that are the equivalent of dividends that would have been paid by a separate Canadian subsidiary, branch tax is imposed on branch profits that are not reinvested in Canada.

Withholding tax rates on dividends, and on branch tax, may be reduced by applicable tax treaties. In the case of branch tax, section 219.2 specifically applies reduced treaty dividend rates to branch tax: See IT-137.

Fifth Protocol

The Protocol also created rules to determine whether dividends (or other income, profit or gain) paid or received by certain "hybrid" entities are eligible to benefit from reduced rates of tax under the Treaty. These rules were introduced to deal principally with U.S. limited liability corporations (LLCs) and Canadian unlimited liability corporations (ULCs).

For taxation years prior to the implementation of the Protocol, the CRA's long-held administrative position is that an LLC is not eligible to claim benefits under the Treaty because it is not liable to taxes as required to be resident under Article IV of the Treaty.[2] Typically, LLCs are treated as flow through or disregarded entities for purposes of U.S. tax law so that income earned by the LLC is only included in computing the income of its shareholders. On this basis, the CRA took the position that the LLC was not liable to tax in the U.S. and therefore, was not eligible to claim benefits under the Treaty. Therefore, to the extent that a U.S. LLC is the beneficial owner of dividends paid by a Canadian corporation, the CRA's position is that the dividend withholding tax rate of 25% is applicable.

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[2] See Canada Revenue Agency, Income Tax – Technical News No. 25, dated February 26, 2007. However, see *TD Securities (USA) LLC v. The Queen*, 2010 TCC 186. In this case, the Tax Court concluded that the taxpayer, a Delaware LLC, was entitled to the reduced rate of branch tax under the Treaty.

For dividends paid to LLCs after January 31, 2009, the changes to Article IV effectively extended the lower rates of dividend withholding tax under the Treaty. Paragraph 6 of Article IV was added by the Protocol and provides as follows:

> 6. An amount of income, profit or gain shall be considered to be derived by a person who is resident of a Contracting State where:
>
> (a) The person is considered under the taxation law of that State to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and
>
> (b) By reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person.

Interestingly, this paragraph does not deem an LLC to be resident of the U.S. for purposes of the Treaty but rather deems amounts (including dividends) to be derived by a treaty resident where the provisions of paragraph 6 are met. Notwithstanding the relieving nature of this provision, it may not apply to all payments to LLCs; see, for example CRA *Technical Interpretation*, "Canada-United States Tax Convention (1980)", doc. no. 2009-0345351C6 – dated February 11, 2010 where the CRA concludes that dividends paid by a ULC to an LLC after 2009 that are disregarded for U.S. tax purposes are not eligible for reduced rates of Canadian withholding tax.

The Protocol also added new restrictions in respect of certain payments by hybrid entities. Paragraph 7 of Article IV provides as follows:

> 7. An amount of income, profit or gain shall be considered not to be paid to or derived by a person who is a resident of a Contracting State where:
>
> (a) The person is considered under the taxation law of the other Contracting State to have derived the amount through an entity

that is not a resident of the first-mentioned State, but by reason of the entity not being treated as fiscally transparent under the laws of that State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that amount had been derived directly by that person; or

(b) The person is considered under the taxation law of the other Contracting State to have received the amount from an entity that is a resident of that other State, but by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that State.

This paragraph was intended to deny the tax benefits associated with cross-border corporate hybrid structures designed to be realize treaty benefits in circumstances where the shareholders of such hybrid entities are not subject to tax on the income earned by the hybrid in their jurisdiction of residence. These provisions give rise to a variety of complex technical issues. For purposes of this paper, however, discussion is limited to a common situation involving payments of dividends or deemed dividends by a Canadian ULC in order to illustrate examples of these technical issues. In that situation, paragraph 7(b) would deny a U.S. resident shareholder of a ULC the reduced rates of Canadian withholding tax on a dividend or deemed dividend where the ULC is treated as fiscally transparent under U.S. tax law and the treatment of the dividend under U.S. tax law is not the same as its treatment would be if the ULC were not treated as fiscally transparent under U.S. tax law. In most cases, any dividend or deemed dividend received by a U.S. resident shareholder from a ULC is ignored since the ULC itself is disregarded for U.S. tax purposes. In other words, the income earned by the ULC is treated for U.S. tax purposes as though it was earned by the shareholder and therefore, recognition of the dividend receipt would result in double counting. As a result of the application of this rule, the dividend or deemed dividend received by a U.S. resident shareholder of a Canadian ULC that was fiscally transparent for U.S. tax purposes may be subject to 25% Canadian withholding tax.

The breadth of the application of this rule seems to be unintended and both Canada and the U.S. authorities acknowledged that the rule applies in many situations that are not abusive.[3] To provide relief to U.S. shareholders in these circumstances, the CRA announced that it was willing to issue favourable rulings where distributions from ULCs were made as part of two-step process.[4]

Rents and Royalties

Paragraph 212(1)(d) imposes a withholding tax on rents, royalties and similar payments. You will see that the charging language is very broad and imposes broad definitions. There are exclusions for copyright royalties in the Act and in most treaties. For years there had been ongoing debate as to whether software payments were in the nature of copyright royalties given that software is copyrightable. Canada's practice was to extend an exemption on computer software payments in its treaty negotiations and there is no express reference to computer software payments in the statutory copyright royalty exclusion: See IT-303. However, in Angoss International Limited (99 DTC 567) the Tax Court confirmed that computer software royalties are exempt from withholding tax pursuant to the statutory exemption for copyright royalties. See also Syspro Software Ltd. (03 DTC 931).

Again, the rate of withholding tax on rents and royalties is frequently reduced by treaty, however, it is rarely reduced in respect of rents on real property.

There is a net rent election available for real property rents (and timber royalties) under section 216: See also IT-393 and IC 77-16R4 (paras 42 to 44). Section 216 permits an election to pay Part I tax on net income in lieu of Part XIII withholding tax on gross revenues and is particularly needed where a property is mortgaged or has significant operating expenses associated with it. It is possible to use a Canadian paying agent to avoid lessees' withholding obligations.

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[3] See Joint Committee on Taxation for the U.S. Senate Committee on Foreign Relations, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada* (JCX-57-08), July 8, 2008. www. jct.gov

[4] See, for example, Canada Revenue Agency, *Distribution of Retained Earnings by ULC*, doc. number: 2009-0350471R3 dated March 17, 2010. Other permitted “work arounds” have been developed for deductible interest or royalty payments by ULCs. See, for example, Canada Revenue Agency, *Article IV(7)(b)*, doc. no: 2009-0348041R3 dated April 21, 2010.

Section 216 elections must be filed within two years after the year in which the income was earned and there are no express fairness rules or other provisions in the Act that allow late filed section 216 returns. CRA was previously unwilling to exercise its discretion under subsection 220(3) to extend the time, however, the Federal Court Trial Division in Kutlu, 97 DTC 5180 imposed an obligation on CRA to remedy the resulting injustice. (Revenue withdrew its appeal to the Federal Court of Appeal.) In Wright, 2001 DTC 437, CRA did extend the time but tried unsuccessfully to collect arrears interest on the unpaid Part XIII tax for the interim period.

Management Fees

Paragraph 212(1)(a) imposes withholding tax on management or administration fees and charges. Under subsection 212(4), arm's length fee for service and cost reimbursement arrangements are specifically excluded: See also IT-468. In circumstances where a management fee may otherwise be subject to withholding tax, the ˝business profits˝ and ˝other income˝ provisions of Canada's treaties should be considered for purposes of claiming an exemption.

Deeming Provisions for Part XIII Purposes

There are a number of special deeming provisions in Part XIII. There are provisions for:

- deemed persons;
- deemed residents; and
- deemed payments.

Partnerships as Deemed Persons:

Paragraph 212(13.1)(a) deems a payor partnership to be a Canadian resident person. In this way, the withholding and liability obligations on Canadian payors is equally visited upon partnerships. This is necessary because section 96 in Part I only says that partnerships compute income "as if" they were a person. It does not deem them to be persons.

Paragraph (b) of that subsection deems payee partnerships, other than Canadian partnerships, to be non-resident persons. A Canadian partnership is defined in section 102 as a partnership, all of the partners of which are Canadian.

When there is withholding against a partnership because it is not a Canadian partnership, any Canadian partners can claim a Part I credit for their share of the withholdings: See IT-81. CRA does not want Canadian residents claiming refunds of non-resident withholding tax.

This provision gives cause for concern as to whether non-resident partners in non-resident partnerships can obtain treaty benefits at either the partnership or the partner level. While the Act generally treats partnerships as flow-throughs, they are not necessarily regarded as flow-throughs for treaty purposes because they are deemed to be persons by this provision for withholding tax purposes. However, CRA's administrative practice is generally to look through non-resident partnerships and extend treaty benefits to partners on a flow-through basis. See, for example, Advance Tax Ruling 2001-0085693 and more recently, see Technical Interpretation 2004-0074241E5.

Non-residents as Deemed Residents:

Subsections 212(13) and (13.2) provide that non-residents who pay, among other things:

- rent for the use of property in Canada;
- any deductible expense (not just interest or rent) on debt secured by Canadian real property; or
- any other amount to a non-resident that is deductible by the payor in computing its Canadian taxable income (unless it is in respect of a treaty-protected business or property)

are deemed to be Canadian residents. This effectively deems Canadian branches of non-residents to be Canadian residents with respect to payments they may make to non-residents.

Additionally, subsection 212(13.3) provides that a foreign bank branch is deemed to be a Canadian resident for Part XIII withholding tax purposes in respect of its payments and its receipts.

Interest Accruals and Discounts as Deemed Payments:

Reference has already been made to subsections 214(6), (7), (8) and (14) which can deem a portion of a purchase price for a note or a portion of a note repayment to be interest. For example, if an issuer issues a $100 note at a 4% discount, the issuer receives $96 from the lender. When the issuer repays the $100 note on maturity, the $4 discount is deemed to be interest paid at that time.

Preamble of Subsection 212(1)

The preamble of subsection 212(1) provides that every non-resident person is liable to pay withholding tax on every amount that a resident of Canada pays or credits to the non-resident person "as, on account or in lieu of payment of, or in satisfaction of…" an applicable type of income from property (for example, rent).

For many years, the CRA appeared to apply a reasonably narrow interpretation of this preamble in determining how Part XIII taxes would be imposed. However, the Federal Court of Appeal decision in <u>Transocean Offshore Limited</u> (2005 DTC 5201), has shown that payments to a non-resident "in lieu" of rent are subject to Canadian withholding tax. In light of this decision, care should be taken to ensure proper consideration is given to whether certain payments made to a non-resident could be considered to be made in lieu of property income enumerated in subsection 212(1) and thereby may be subject to Part XIII withholding taxes.

Part I versus Part XIII for Canadian Branches

A non-resident may carry on a business in Canada and be subject to Part I and Part XIV tax. As part of that Canadian branch operation it may be in receipt of Canadian sourced property income that would be subject to withholding because it is paid to a non-resident. Paragraph 214(13)(c) and accompanying Regulation 800 provides that Part XIII tax is not payable by a non-resident on its receipts in these circumstances. However, Canadian payors will generally want a waiver from the Minister, and perhaps an indemnity, to avoid withholding at source under subsection 215(1). For non-resident insurance companies, subsection 215(4) and Regulations 800 and 801 provide that no withholding is required on any payments received and Part XIII tax is self-assessed in an annual return on all amounts not included in their Canadian Part I income. For foreign bank branches, subsection 212(13.3) deems them to be a Canadian resident in respect of their receipts. For other non-residents, there is no withholding on amounts reasonably attributable to business carried on through a Canadian permanent establishment. However, payors will ultimately want a CRA waiver or an indemnity to rely on.

Derivatives

Swaps:

The net payment on interest rate swaps and currency swaps are not ordinarily subject to Canadian non-resident withholding tax even when the net payment is outbound. This is because the payment is regarded as a contractual obligation otherwise than as interest as there is no debtor/creditor relationship in existence: See question 60 of 1984 Roundtable. If, however, the timing of the contra payments is not the same so that inbound payments are made more frequently than outbound payments, the Canadian can be regarded as a net borrower in respect of the deferred payments and a portion of an outbound swap payment may be subject to Canadian non-resident withholding tax. However, to the extent the counterparties to the transaction deal with each other at arm's length and the payments are not "participating debt interest" no withholding tax should apply.

Securities Loans and Repurchase Agreements (REPO's):

Special withholding tax provisions detailing the treatment of securities loan payments are provided for in subsection 260(8). Securities lending arrangements are defined in section 260 to be arm's length transactions in respect of qualifying securities where the lender expects to be returned an identical security by the borrower and the borrower is obligated to pay dividend compensation payments in respect of dividends that would have been received by the lender on the loaned security. In addition, a borrower will generally be required to pay a borrow fee to the lender. If the lender is provided cash collateral in lieu of securities collateral from the borrower, no borrow fee is paid and instead the lender is entitled to keep the earnings on the cash collateral net of any rebate payable by it to the borrower.

Dividend compensation payments (also called manufactured dividends or substitute payments) are deemed to be interest when paid by a Canadian borrower to a non-resident lender. It is not deemed to be interest *on the loaned security* unless the collateral is money or government debt. Government debt collateralization permits the substitute payments to be regarded as interest or dividend on the underlying security and allows for the government debt exemption to be maintained. (In the case of equities, government debt collateralization can have the effect of increasing the treaty rate from 10% on interest to 15% on portfolio dividends.) There is also an extended exemption in respect of substitute payments on any borrowed government debt whether or not Canadian. Given the broad definition of participating debt interest discussed above, there is some concern that dividend compensation payments under a securities lending arrangement that is not collateralized with money or government debt could be subject to Canadian withholding tax even where the lender and borrower deal with each other at arm's length.

The borrow fees (also called a loan premium), which are the lender's return, are deemed to be interest when paid by a Canadian borrower to a non-resident lender. It is not deemed to be interest on the borrowed security, even if it is a collateralized government debt loan. If no borrow fee is payable because the Canadian borrower has provided the lender with cash collateral, an imbedded fee is picked up in an amount equal to the prescribed interest rate times the cash collateral provided less any rebate paid and it is this amount which could be subject to withholding tax as outbound interest but generally only where the borrower and lender do not deal with each other at arm's length.

In U.S./Canada cross-border securities loans, U.S. lenders that are pension funds are entitled to an interest exemption under Article XXI of the Canada-U.S. Treaty in respect of all interest received by it, including the deemed interest on the borrow fee.

A rebate paid by a Canadian lender to a non-resident borrower on cash collateral is also regarded as interest by CRA. That Canadian withholding tax could be payable appears somewhat counter-intuitive as there is a net flow of funds into the Canadian lender from the non-resident borrower. There is an exemption for Canadian dealers and financial institutions in these circumstances. See subsections 212(19) and 20) and the definition of "fully exempt interest". This also applies to the repo spread in a repurchase agreement transaction. There are limits on the extent to which Canadian financial institutions and dealers can rely on this exemption without attracting a penalty tax in subsection 212(19). However, this does not affect the non-resident's exemption from withholding tax.

Administration and Enforcement

While Part XIII withholding tax is payable by the non-resident, subsection 215(6) imposes a liability on payors to withhold and liability for a failure to withhold. There is no due diligence defence provided for in the Act; however see Information Circular IC 76-12 with respect to relying on addresses for reduced treaty rates. See also the MacMillan Bloedel case (79 DTC 297) decided under the old U.S. treaty.

As mentioned above, Part XIII both (i) imposes a tax on the non-resident recipient of 25%, and (ii) requires that the Canadian payor withhold 25% from the payment and remit that amount to CRA. Canada's income tax treaties only reduce (or, in the case of an exemption, remove) the rate of tax payable by the non-resident. Subsection 10(6) of the ITARs reduces the 25% rate of withholding at source by the Canadian payor to the rate under an applicable treaty.

Thus, if a payor wants to extend treaty benefits at source by withholding at a treaty rate, or, in the case of an exemption, not withholding, the Canadian does so somewhat at its own risk as to whether the payee is entitled to the treaty benefit. However, as a practical matter, CRA authorises a payor to accept the name and address of the payee as being that of the payee unless there is reasonable cause to suspect otherwise (see IC 76-12). In cases of doubt, provision is made for relying upon a certificate signed by the payee as to its beneficial ownership and country of residence. Similarly, IC 77-16 authorises Canadian payors to rely upon CRA's published list of treaty exempt investors under Article XXI of the U.S. Treaty and upon copies of CRA's Certificates of Exemption issued under subsection 212(14). CRA has also approved an electronic certification method for extending exemption at source to U.S. pension fund Article XXI investors on Canadian securities owned by them that are public securities registered in the name of a stock exchange depository and held by the investor's custodian: See paragraph 81 of IC 77-16.

No action lies for withholding in compliance or intended compliance by virtue of subsection 227(1). However, one should be concerned about the possibility of a foreign lawsuit as the other party is a non-resident. This would be a particular concern where foreign law applies. As a result of this statutory protection from liability, a Canadian payor should withhold the tax and remit if it is in doubt; however, it may incur its lender's wrath.

Where payments are paid through an intermediary, whether as paying agent or as collection agent, the agents are subject to the withholding obligations: See subsections 215(2) and (3).

Amounts withheld are deemed to be trust monies by subsection 227(4) and are required to be remitted ˝forthwith˝ by subjection 215(1). However, Information Circular IC 77-16 authorises remittances to be made by the 15th of the following month. Subsection 227(4.1) gives CRA an enhanced priority over other creditors to collect these deemed trust monies. Similarly, section 224 gives CRA enhanced garnishment rights to collect unremitted withholdings.

A failure to withhold and remit can also result in interest (subsection 227(8.1) and (9.2)), penalties (subsection 227(8) and (9)) and directors' personal liability (subsection 227.1).

If a payor has paid an amount without withholding and pays the tax pursuant to its liability under section 215 therefor, it is entitled to recoup any tax paid from the payee: subsection 215(6). This can be done by way of offset, reducing subsequent payments or by commencing a claim for the amount. However, this right of indemnity is a Canadian statutory right and may not apply if there is non-Canadian governing law.

Refunds and Assessments

There is no limitation period for CRA to issue assessments for Part XIII tax against the non-resident or against the resident payor: See subsections 227(10) and (10.1) for resident payors and non-resident payees, respectively. The use of the words "at any time" in those subsections probably precludes the application of federal or provincial limitation periods: see Markevich (2003 DTC 5185 (SCC); 2001 DTC 5305 (FCA); reversing the FCTD 99 DTC 5136).

If withholding is made from a non-resident who believes that no tax was payable or that a reduced rate was payable, the non-resident must apply for refund within two calendar years: See subsection 227(6). Form NR7R is used for this purpose. If CRA disagrees with the refund request, CRA will issue an assessment which will have to be objected to.

Objections and Appeals

Once tax is assessed against the resident payor or a non-resident payee, the normal objection and appeals provisions apply *mutatis mutandis*: see subsections 227(10) and (10.1). It is important to note that collection restrictions are <u>not</u> applicable to amounts that have been, or should have been, withheld.

Withholding on Services

There is no Part XIII non-resident withholding tax levied on services provided by non-residents. (The treatment of foreign actors discussed below is the exception.) However, paragraph 153(1)(g) of Part I and Regulation 105 require a 15% withholding on amounts paid to non-residents for services rendered in Canada, whether as employee or otherwise. This is a withholding collection mechanism akin to employee withholdings. That is, it is not a withholding tax *per se*, but a withholding on account of tax and the non-resident is entitled (if not required) to file a Part I return against that income. A non-resident with a treaty exemption (for example, without a permanent establishment or a fixed base in Canada) could claim that in its Part I return. However, the annual return is filed the following year and consideration should be given to obtaining a subsection 153(1.1) waiver from CRA in advance of the payment. A withholding of tax in excess of a treaty rate or exemption is recognised as ˝undue hardship˝ by CRA for these purposes: See Information Circular IC 75-6.

The decision of the Tax Court of Canada in *Weyerhaeuser Company Limited v. The Queen*, 2007 DTC 392, provides some guidance about the interpretation of Regulation 105 and the types of documentation that Canadian payors can accept from non-resident service providers for purposes of computing the appropriate amount of withholdings.

Provinces may also require withholding on payments to non-residents of Canada for services rendered in the province.

Non-resident actors: Part XIII generally imposes tax on property income. However, subsections 212(5.1) to (5.3) impose Part XIII tax at a rate of 23% on a non-resident's income from Canadian acting services in films and videos.

<u>Section 116 Withholding</u>

Section 116 is also not a withholding tax but is a withholding on account of any potential tax liability arising to the non-resident on Canadian gains realised by it. In the absence of a non-resident being able to provide a certificate of compliance under section 116 from CRA, a purchaser (whether resident or not) of ˝taxable Canadian property˝ (TCP) will be required to withhold 25% or 50% of the purchase price. TCP (defined in section 248) includes Canadian real estate and private company shares (subject to comments below). Certain public company shares, among other things, are “excluded property” that are not subject to section 116 withholding.

Effective after March 4, 2010, the definition of “taxable Canadian property” in the was amended so that unlisted shares of a corporation will only be TCP where, at any time in the prior 60 months, more than 50% of the fair market value (“FMV”) of the share was derived, directly or indirectly from one or any combination of real property situated in Canada, Canadian resource properties, timber resource properties and options in respect of such properties (whether or not the property exists). Similar rules also apply for an interest in a partnership or an interest in a trust (but not a mutual fund trust or an income interest in a Canadian trust).

Furthermore, after March 4, 2010, Canadian corporation shares that are listed on certain designated stock exchanges and interests in mutual fund corporations and trusts are only TCP if at any time during the last 60 months 25% or more of the shares (of any class) or units belonged to the vendor and/or any person not dealing at arm’s length with the vendor AND more than 50% of the FMV of the share or unit was derived directly or indirectly from one or any combination of properties described above.

These changes greatly reduce the number of transactions that give rise to the requirement to obtain a certificate of compliance.

Where a certificate of compliance is required but is not obtained in advance, the non-resident is obliged to notify CRA within 10 days. This will pick up non-arm's length transfers where the purchaser may be willing to risk liability for a failure to withhold under section 116. This is discussed in greater detail in Information Circular IC 72-17.

The 2008 Federal Budget announced changes to the provisions of section 116 to broaden the so-called “safe harbour” for purchasers who might otherwise be required to withhold amounts from the purchase price payable to acquire TCP. These provisions are applicable for dispositions of TCP that occur after 2008. These rules provide, among other things, that in order to avoid withholding (25% or 50%) under section 116 (i) the purchaser must conclude after reasonable inquiry that the non-resident disposing of the TCP is resident in a treaty country; (ii) the property would be “treaty-protected property” if the non-resident were a resident of such country; and (iii) the purchaser must provide a notice setting out the date of the acquisition, the name and address of the vendor, a description of the property, the purchase price paid for the property and the name of the particular country referred to in (i) and (ii) above. “Treaty-protected property” of a taxpayer is defined in subsection 248(1) to mean 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 of the Act.

Despite the first requirement being a question of mixed law and fact, in the ordinary course, this requirement should be easily satisfied by having the vendor represent and warrant in the purchase and sale agreement that it is a resident of the relevant treaty country. This representation and warranty, or any other “reasonable inquiry” should meet the reasonable inquiry test even if the vendor’s residency is ultimately incorrect. However, the second requirement is more problematic because there is no “reasonable inquiry” defence.

There are a variety of circumstances that may exist that would make it difficult or impossible for a purchaser of TCP to determine, with certainty, whether the TCP being acquired was treaty protected property. For example, there may be circumstances where a limitation on benefits article of an income tax treaty may apply.

Due to the difficulty of independently and definitively concluding that property is treaty protected property, many purchasers of TCP continue to withhold 25% or 50% of the purchase price pending receipt of a section 116 certificate of compliance.

However, in some circumstances a purchaser may be willing to take the risk that TCP is treaty-protected property of the vendor (i.e. where the vendor and purchaser are related or do not deal at arm’s length).

Notwithstanding these concerns, the CRA has made public comments that, administratively, it will generally not impose liability on purchasers in circumstances where the purchaser has made “every reasonable effort” to confirm the property is treaty-protected property. The CRA indicated that where the purchaser is able to obtain this type of information, for example, through representations and warranties given by an arm’s length vendor in the purchase agreement, the CRA will generally not hold the purchaser liable if the property subsequently is determined not to be treaty-protected property.

Provincial Withholding Tax

Canada's provinces do not also levy withholding taxes on amounts paid to non-residents. There may be constitutional restrictions. Provinces who are party to a Tax Collection Agreement with the federal government have agreed therein not to levy non-resident withholding taxes. However, at least Ontario creatively requires a portion of certain non-arm's length payments to non-residents be added back to the Canadian payor's income (see *Ontario Corporations Tax Act*, subsections 11(5) and (5.1)); this results in an effective 5% provincial withholding on outbound non-arm's length payments of certain rents, royalties, and management and administration fees. Effective for taxation years that end after 2008, Ontario has repealed this tax as part of the harmonization of Ontario corporation tax with the federal tax system.