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# TAXABLE CANADIAN PROPERTY CHANGES FACILITATE INBOUND INVESTMENT

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Foreign investors, particularly private equity funds, have long had to deal with the complexity of the reporting requirements under section 116 of the *Income Tax Act* (Canada) (the "Tax Act") when disposing of investments that are taxable Canadian property ("TCP"), such as shares of private Canadian companies. Gains on shares of private companies would normally be exempt from Canadian taxation under most of Canada's income tax treaties, as long as the value of the shares was not derived principally from real or immovable property situated in Canada. Despite such treaty protection, foreign investors have been required to undertake extensive reporting obligations, and to file Canadian tax returns.

On March 29, 2010 Canada's Minister of Finance introduced Bill C-9, the *Jobs and Economic Growth Act*, into the House of Commons. Bill C-9 will implement the changes to the TCP regime that were announced in the March 4, 2010 Federal Budget. These changes significantly reduce tax and compliance burdens in respect of inbound investment. This bulletin highlights the implications of these changes for investments and transactions in Canadian securities by non-residents of Canada.

## Background of the TCP Regime

The TCP regime imposes Canadian tax on non-residents' gains from disposing of TCP where those gains are not exempted under an applicable tax treaty between Canada and the owner's country of residence. The TCP regime also imposes often onerous tax compliance requirements when TCP is disposed of, even in circumstances where no Canadian tax is payable.

TCP consists of the properties listed in the definition of "taxable Canadian property" in subsection 248(1) of the Tax Act, as well as properties that are

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deemed by certain provisions of the Tax Act to be TCP. The purpose of the deemed TCP rules is to ensure that a non-resident cannot avoid Canadian tax through a tax-deferred transaction. The deemed TCP rules apply where shares or other property constituting TCP are disposed of for new shares on a tax-deferred basis, including on share-for-share exchanges, security conversions and amalgamations, and deem the new shares also to be TCP.

Non-residents disposing of TCP that does not qualify as "excluded property" are required to obtain a section 116 compliance certificate from the Canada Revenue Agency ("CRA") in respect of the disposition, whether or not any gain is realized, and are subject to Canadian tax return filing obligations. Purchasers of such TCP in respect of which an adequate section 116 certificate is not obtained are required to remit to the CRA, and are personally liable for, a payment of up to 25% of the sale proceeds on account of the non-resident's tax liability. Although 2008 amendments to the Tax Act attempted to ease section 116 compliance burdens for treaty-exempt TCP by adding it to the list of excluded property, these changes generally have not been effective for arm's length transactions because no statutory due diligence defence is available to a purchaser where the TCP is not in fact treaty-exempt.

The TCP regime has been widely and extensively criticized for impeding inbound investment. As a result of the potential purchaser liability and the CRA's frequent inability to issue a section 116 certificate in time for the closing of a transaction, non-resident sellers of TCP often have had to incur the costs and cash flow burdens associated with escrow arrangements whereby 25% of the amount of their sale proceeds is held back pending issuance of the section 116 certificate. The compliance burden can be especially onerous for private equity funds structured as partnerships, where it may be impossible to obtain all of the information required in order to apply for a section 116 certificate. In many instances the section 116 procedures have been unworkable, with the result that these funds must either forego Canadian investments or invest in Canada through third-country "blocker" structures.

In response to these criticisms, the 2010 Federal Budget announced changes to the TCP regime to facilitate inbound investment and to build Canada's reputation as an investor-friendly country.

## Changes to the TCP Regime

Bill C-9 will amend the Tax Act to significantly narrow the circumstances in which Canadian securities will be TCP or deemed TCP. In its 2010 Budget, Quebec announced that these amendments will be adopted for Quebec tax purposes. These amendments will also be applied automatically in the other provinces.

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## *Definition of TCP*

Under the amended definition of TCP, after March 4, 2010:

1. Shares in a Canadian company (other than a mutual fund corporation) that are not listed on a designated stock exchange are TCP only if at any time in the 60 month period ending on their disposition more than 50% of their fair market value was derived directly or indirectly from real or immovable property situated in Canada, Canadian resource properties, timber resource properties, options or interests in any of the foregoing property, or any combination of the foregoing property (“derived value test”).
2. Shares in a Canadian company that are listed on a designated stock exchange are TCP only if at any time in the 60 month period ending on their disposition the non-resident alone or together with non-arm's length persons owned 25% or more of the issued shares of any class of the company (“ownership test”) and the shares meet the derived value test.
3. Mutual fund corporation shares and mutual fund trust units are TCP only if they meet both the ownership test and the derived value test.
4. Partnership interests and trust interests (other than mutual fund trust units or income interests in a Canadian trust) are TCP only if they meet the derived value test.
5. Interests and options in Canadian securities described in any of paragraphs 1-4 above also constitute TCP.

The amended definition of TCP applies to both securities acquired before, and owned on or after, March 5, 2010, as well as to securities newly acquired on or after that date.

## *Deemed TCP*

Bill C-9 will also amend the “deemed TCP” rules, effective after March 4, 2010, to impose a time limit: where shares that are TCP under the amended definition are exchanged for new shares on a tax deferred basis, the new shares continue to be deemed TCP, but only for 60 months after the exchange, and not, as under the prior rules, for as long as the exchanging shareholder owns the new shares. As a result, if the new

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shares are disposed of after the 60-month period and are not otherwise TCP under the amended definition, the investor will no longer be required to comply with the tax and compliance burdens associated with disposing of deemed TCP.

It should be emphasized that the deemed TCP rules appear to trump the amended definition of TCP in circumstances where shares acquired by a non-resident on a tax-deferred exchange occurring before March 5, 2010 were deemed TCP under the prior definition. In those circumstances, the shares will be subject to the 60-month deemed TCP period applicable under the new rules even if the shares are not caught by the amended definition of TCP. In addition, Finance has confirmed that the implementation of a subsequent tax-deferred transaction involving the shares within the original 60-month period will trigger a new 60-month period from the date of that subsequent transaction.

## Implications of the Changes

### *Enhanced International Competitiveness*

The amendments significantly narrow the scope of TCP, particularly in respect of securities of private Canadian companies. No longer will all unlisted shares in Canadian corporations, along with warrants, options, and subscription receipts for such shares, be TCP. In particular, shares and other securities of private Canadian companies that operate outside the Canadian resource sector and do not own significant Canadian real property, either directly or in subsidiary entities, will not be TCP. The circumstances in which listed shares are TCP have also been narrowed. Previously, such shares were TCP if the ownership test was met, while after March 4, 2010 both the ownership test and the derived value test must be satisfied or the shares are not TCP. The amendments eliminate both section 116 compliance requirements and tax return filing obligations for securities that are no longer TCP under the amended rules.

Private equity funds may now invest directly in Canadian securities outside the Canadian real estate and resource industries rather than having to use holding companies and "blockers" located in tax treaty jurisdictions. Accordingly, the amendments should facilitate foreign private equity and venture capital investment in various Canadian business sectors such as technology and life sciences.

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## *Investors Without Treaty Benefits*

For non-resident investors who would not be treaty exempt from Canadian tax on capital gains arising from the disposition of Canadian securities, the new rules provide a domestic exemption where the securities disposed of are not TCP or deemed TCP under the amended rules. In addition to private equity funds which may now invest directly in such securities, the changes will benefit other investors from countries with which Canada does not have a tax treaty, as well as investors from countries such as Australia, China, India, Japan and several in South America whose tax treaties with Canada do not exempt capital gains.

## *Where Treaty Benefits Are Still Relevant*

Where shares are TCP or deemed TCP under the amended rules, the availability of treaty relief generally remains relevant. Although most of Canada's tax treaties maintain Canada's right to tax shares deriving their value principally from Canadian real and resource properties, under many of the treaties the circumstances in which Canada can do so are more limited than under the amended definition of TCP. For example, many of Canada's treaties provide that the relevant time for applying the derived value test is at the time of disposition, without a 60-month look-back period. Similarly, an applicable tax treaty may exempt gains on securities even though they are deemed TCP for the 60-month period following a tax-deferred exchange. As well, many of Canada's tax treaties (but notably not the Canada-US treaty) provide that real property, other than a rental property, in which the business of the Canadian company (or subsidiary entities) is carried on is not included in determining whether the shares derive their value principally from real or resource property. Under such a treaty, gains on shares deriving more than 50% of their value from exploitation of Canadian resource property or from manufacturing plants, hotels and resort properties may still be exempt from Canadian income tax. Finally, where an applicable tax treaty maintains Canada's right to tax TCP, the treaty may also contain a provision providing for the deferral by Canada of the Canadian tax otherwise payable on the disposition of property where the property is disposed of on a tax-deferred basis in the owner's residence country.

## *Going Public Structures*

The amended TCP regime will broaden the structures that a private Canadian company with non-resident shareholders can use to go public. For example, before March 5, 2010, if a going public transaction were achieved by the private company amalgamating with a Canadian public company, listed shares of the

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amalgamated company received by non-residents in exchange for their private company shares would be deemed TCP to those shareholders even if the ownership test were not met. However, for a going public transaction which occurs after March 4, 2010, as long as the non-residents' private company shares do not satisfy the derived value test and are not deemed TCP under the prior rules, the listed shares of the amalgamated company received on the exchange will not be deemed TCP.

## *M&A Transactions*

Non-residents disposing of Canadian shares that are not TCP under the amended rules will not be subject to the requirements of section 116, thereby eliminating the costs, complexities and cash flow burdens associated with section 116 compliance and related tax hold-backs and escrow arrangements. For shares that continue to be TCP and are therefore subject to section 116 compliance, the CRA's ability to promptly process section 116 applications should be enhanced.

However, the tax changes do not provide any enhanced purchaser relief for situations in which shares remain TCP for which a section 116 certificate is required. A purchaser who incorrectly assumes or determines that the shares are not TCP and fails to withhold remains personally liable for a 25% tax. Accordingly, purchasers can be expected to undertake due diligence as to the composition of the assets of a target company and its subsidiaries over the 60-month period prior to the acquisition, and depending on the outcome of that due diligence, to require the seller(s) to provide representations and indemnities, or to deliver a section 116 certificate.

Due diligence will also be important for private equity funds and other non-residents contemplating an inbound investment in circumstances where tax treaty relief may not be available on a subsequent disposition. The composition of the investee's assets over the prior 60-month period and its contemplated capital expenditures should be reviewed to determine if the derived value test may result in ownership of TCP.

## *Tax-Deferred Transactions*

If non-residents own shares that are TCP under the amended rules and are presented with an opportunity to participate in a tax-deferred share exchange, they should evaluate the benefits of doing so, given that the

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new shares will automatically be “tainted” as TCP for 60 months following the exchange. If the old shares do not have a significant gain or if any such gain would otherwise be exempt from Canadian tax under an applicable tax treaty, it may be better not to use the tax deferral so that the new shares do not become deemed TCP.

## *Alternative Exit Strategies*

While the 2010 federal budget changes exempt non-residents of Canada from capital gains tax on dispositions of Canadian securities that are not TCP or deemed TCP after March 4, 2010, they do not modify the circumstances in which Canada imposes non-resident withholding tax. Dividends, and amounts treated as dividends under the Tax Act, are still subject to withholding tax at a 25% statutory rate (subject to reduction under an applicable tax treaty, generally to 5% for significant corporate shareholders and to 15% otherwise). Accordingly, if a Canadian company were to redeem a non-resident’s shares for proceeds greater than their paid-up capital, the excess would be deemed to be a dividend on which withholding tax would be imposed. Similarly, sale proceeds may be treated as deemed dividends and subject to withholding tax where shares of a Canadian company are sold by a non-resident to another Canadian company with which the seller does not deal at arm’s length. Accordingly, the possibility of deemed dividend treatment must still be considered in planning a non-resident’s exit strategy.

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