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# Finance levels playing field for non-resident property investors

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TAX LAW

# Finance levels playing field for non-resident property investors

By James Hutchinson

The federal budget released by the Department of Finance on March 23 ("Budget") introduced changes to the *Income Tax Act* (the "Act") that will ensure that non-residents of Canada pay their fair share of tax on the disposition of taxable Canadian property ("Proposed Amendments").

Taxable Canadian property includes, among other items, such property as real property situated in Canada, certain partnership interests, Canadian resource properties and shares of private Canadian corporations.

When a non-resident person disposes of taxable Canadian property the non-resident must pay a tax of 25% on the gain that the non resident realized on the taxable Canadian property.

For certain types of taxable Canadian property (ie. shares of private Canadian coporations), the 25% tax is eliminated under a tax treaty between Canada and the country in which the non-resident person resides.

For other taxable Canadian property (ie. real property situated in Canada) Canada retains the right to tax the non-resident on the disposition of such property.

**Tax Leakage under the Current System:** The current system allows non-residents to invest on a tax free basis in taxable Canadian property provided that the non-resident holds the taxable Canadian property through a mutual fund trust or mutual fund corporation. Any capital gains realized by the mutual fund trust or mutual fund coporation can be flowed through to the non-resident on a tax free basis.

Also, if the mutual fund trust or mutual fund coporation are listed on a prescribed stock exchange (ie. TSX, NYSE among others), the disposition of such shares or units will not result in any tax being paid by the non-resident.

**Proposed Amendments:** The Proposed Amendments will require that after March 22, each mutual fund in Canada will have to maintain a "taxable Canadian property gains distribution account" ("TCP Gains Distribution Account").

The TCP Gains Distribution Account will include all gains realized by the mutual fund on the disposition of taxable Canadian property held within the mutual fund or any taxable Canadian property gains distributions that are received by the mutual fund from another mutual fund.

When a capital gain distribution is made to the non-resident from a mutual fund trust's TCP Gains Distribution Account it will be deemed to be a distribution of trust income and will be subject to a 25% withholding tax.

This is usually reduced to 15% under an applicable tax treaty. When a capital gains dividend is paid to the non-resident from a mutual fund corporation's TCP Gains distribution account it will be deemed to be a taxable dividend and will be subject to a 25% withholding tax.

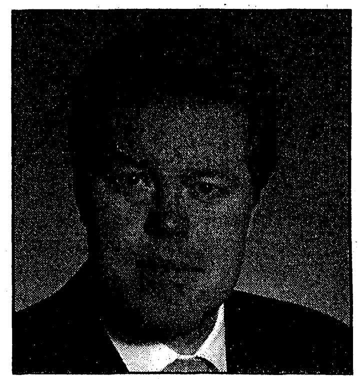
This amount is usually reduced to 15% under an applicable tax treaty. Therefore, to the extent that a mutual fund disposes of taxable Canadian property and pays out the gains on such sale to non-resident investors, the non-resident investors will be taxed as if they had disposed of the underlying taxable Canadian property.

In addition the Proposed Amendments will require, beginning in 2005, that distributions made from exchange listed Canadian mutual funds the value of which is primarily (more than 50%) attributable to Canadian real estate, timber property or resource property will be subject to a 15% withholding tax.

This amendment will apply to most real estate investment trusts and resource based income trusts but should not apply to other mutual funds that hold their portfolios in assets other than Canadian real property and resource properties.

The distribution will be deemed to be a disposition of taxable Canadian property. The mutual fund will have an obligation to withhold and remit the tax to the government.

The non-resident will not have to report the distribution on a Canadian tax return nor will the non-resident have to reduce the cost base of the shares or units of the mutual fund.



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If the non-resident realizes a loss on the shares or units that have been subject to the 15% withholding tax, the non-resident can file a Canadian tax return and claim a refund on the taxes paid under this new provision. Such losses can be carried back three years and carried forward indefinitely.

The Proposed Amendments also clarify that if a mutual fund has been established primarily for non-residents (more than 50% of the shareholders or unit holders are non-residents), the mutual fund is restricted to holding no more than 10% of its assets in taxable Canadian property.

The Proposed Amendments deem Canadian resource property and timber resource property to be taxable Canadian property for the purpose of this restriction. Therefore, any mutual fund that holds a large investment in Canadian resource property and timber resource will have to ensure that a majority of its shareholders are Canadian residents or consequently reduce its holding of taxable Canadian property to below 10%.

Transitional relief has been provided for those mutual funds that are currently not in compliance with the above restrictions.

In theory, the Proposed Amendments should be applauded in that they are tax neutral to the Canadian taxpayer, strive to treat all non-resident investors in the same manner and will provide the government with additional funds. Time will determine whether the increase in tax revenue collected from non-residents investing in taxable Canadian property through mutual funds will outweigh the compliance, withholding and reporting burden that will be imposed on Canadian mutual funds and their managers.

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