

Contrary to what many feared or predicted, Canadian real estate has not suffered a monumental set-back in values during 2009. Despite the recession and challenging financing conditions, there were much fewer distressed sale opportunities than was anticipated by those investors with capital earmarked for “value investing”. In many cases lenders, landlords and tenants appeared to be working together to keep difficult situations from getting worse.

Many brokerages have reported that 2009 transaction volumes, in general, are comparatively low. Even though Canada has not suffered a disorderly shakeout in financial and real estate markets to the same extent that other developed countries have, the lack of market confirming-transactions has led to valuation uncertainty which has had the effect of keeping buyers and sellers on the sidelines for now.

The recession and the uncertainty surrounding the timing and strength of recovery has caused investors to focus more intently on the basics – re-assessing business processes to better understand and improve operational efficiency, identifying and responding to business risks in a systematic manner, cutting costs, improving cash management and enhancing tenant and lender relationships. The renewed focus on the basics should result in stronger organizations which will be better capitalized and able to take advantage of opportunities arising as economic conditions improve.

In this newsletter we are pleased to provide you with recent income tax developments affecting foreign investment in Canadian real estate.

We hope you will find this to be a useful update and encourage you to reach out to us directly with any questions you may have.

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## Rental Income

### Good News for non-resident corporations investing in Ontario

Under Canadian tax rules, a taxpayer is subject to corporate tax at the federal level. Additionally, Ontario imposes a further level of provincial income tax. The provincial level of corporate tax in Ontario is 14% and it has been set at that level for several years. For taxation years commencing in 2009, non-resident corporations earning rental income in Ontario will enjoy a lower tax rate.

Prior to 2009, non-resident investors in Ontario real estate were subject to the 14% provincial income tax on top of the federal tax. However, with the introduction of the Ontario Taxation Act, non-residents will be spared the provincial tax on rental income earned in the province of Ontario under certain circumstances.

The tax treatment of rental income earned by a non-resident depends upon whether or not the rental operation is considered to be a business carried on in Canada. Under the old rules, no distinction was made regarding the nature of the rental income. Regardless of whether the income was “business income” or “income from property”, the rental income was subject to the 14% provincial tax. Currently, this distinction is relevant because if the rental income is “business income” it will still be subject to Ontario provincial tax, but if it is considered to be “income from property” then Ontario tax will no longer be imposed. These new rules will apply regardless of whether the income is directly earned by the investor or indirectly through a partnership.

Corporate taxpayers fortunate enough to find themselves in this situation may wish to verify their instalment accounts to determine if they can reduce their periodic payments.

### Corporate tax rates for non-resident corporations reporting rental income

	2008	2009	2010	2011	2012 & After
Federal	29.5%	29.0%	28.0%	26.5%	25.0%
Ontario	14.0%	0.0%	0.0%	0.0%	0.0%
	<b>43.5%</b>	<b>29.0%</b>	<b>28.0%</b>	<b>26.5%</b>	<b>25.0%</b>

## Land Development Projects & The Inventory Write-Downs

### Diminution in values

Due primarily to factors affecting the credit markets, industry professionals believe that land values have decreased substantially during 2009. Financial statements will record “Write-downs” in land inventory investments with more frequency in 2009 than in previous years.

Land inventory write-downs are generally deductible for income tax purposes provided that they relate to the loss in value of the inventory of a business. The Canada Revenue Agency “CRA” changed the rules regarding the deductibility of land inventory write-downs in 2005 so as to deny the deduction related to property described as inventory held in an adventure or concern in the nature of trade. The effect was to prohibit inventory “write-downs” if the property was held for speculative purposes however, the deduction is still permitted were the loss in value relates to the inventory of a business.

The distinction between a “business” and an “adventure or concern in the nature of trade” is a question of fact.

For example, a taxpayer who subdivides a parcel of land into multiple lots, services the lots, and devotes significant time, attention and resources to market and sell the lots may be able to claim an inventory write-down if the unsold lots decline in value on the basis that his business is more than a mere adventure in the nature of trade. Further, if a corporation held (say) 10 parcels of land that it intended to “flip” and did that regularly, that may also be considered a “business”. On the other hand, a taxpayer whose only real estate activity constitutes buying a parcel of vacant land for resale may only be engaged in an adventure in the nature of trade.

## **Land Development Projects & The Inventory Write-Downs (continued)**

An adventure in the nature of trade is generally an isolated speculative transaction. Factors that may be relevant could include the time, attention and resources accorded to the transaction, the frequency or regularity of similar transactions, the taxpayer's intention and course of conduct with respect to the property, and the nature of the property. It should be noted that any subsequent reversal of the decline in value (write-up) would be treated as taxable income.

Any write-downs claimed should be supportable based on market transactions and third party appraisal opinions.

## **Canada/U.S. Tax Treaty**

### **Fifth protocol to Canada/U.S. tax treaty**

Although the Fifth Protocol came into force late in 2008, many of the new changes will take effect in 2009 or later. However, certain measures will be given retrospective effect. For some taxpayers, the new Protocol will result in significant tax savings, and for others the adverse new changes are significant enough to warrant revising their corporate structure.

### **Withholding tax on non-participating interest**

Effective January 1, 2008 Canada's domestic law changed such that the withholding tax on non-participating interest paid to arm's length non-resident lenders has been eliminated. The changes made in the treaty Protocol go one step further since they apply to non-arm's length lenders. Prior to the Fifth Protocol, the treaty rate applicable to interest was 10%. For interest paid in 2008, the rate is reduced to 7%; for interest paid in 2009, the rate is reduced to 4%; and for 2010 and subsequent years, there will be no withholding tax on interest. Since withholding tax is determined on a cash basis, you may wish to accrue the expense, but defer payment until 2010 to avoid withholding tax.

### **Withholding tax on non-participating interest (continued)**

For participating interest payments made to a U.S. lender, the withholding tax rate will be 15% effective February 1, 2009. Participating interest payments include payments where the interest is based on sales, profits, income, or cash flow of the borrower; any change in the value of the property; or any dividends or partnership distributions made by the borrower.

### **Extension of benefits to LLC's & loss of benefits for ULC's**

Before the Fifth Protocol to the treaty, U.S. Limited Liability Companies ("LLC's") were not given treaty protection. Starting in 2009, U.S. resident members of LLC's will benefit from the treaty.

On the other hand, Canadian unlimited liability companies ("ULC's") will no longer benefit from treaty protection after January 1, 2010. Therefore, U.S. residents owning Canadian real estate through Nova Scotia Unlimited Liability structures should consider reorganizing in order to optimize their after tax returns.

### **Guarantee fees exemption and 5% dividend rate on dividends through partnership**

Certain other changes included in the treaty Protocol will broaden the benefits applicable to guarantee fees and dividends received through a partnership. Under the coming into force rules, there will be no withholding taxes on guarantee fees and the withholding tax rate applicable to dividends will be determined as if the partnership was disregarded such that the 5% reduced rate may apply.

## **Canada/U.S. Tax Treaty (continued)**

### **LOB provisions**

Prior to the Fifth Protocol, the limitation on benefits (“LOB”) provisions of the treaty only applied to the U.S. Under the treaty Protocol, Canada can now apply them as well. The effect of these provisions is to limit the Canadian tax benefits otherwise afforded by a Canadian tax treaty. This change is effective for amounts subject to taxes withheld at source on or after February 1, 2009. For other treaty-related issues, the change will be effective for taxation years that begin after 2008.

### **Binding arbitration**

The treaty now contains provisions to settle tax disputes between jurisdictions. Unresolved disputes can now be settled by binding arbitration.

### **Expanded inclusion of services**

The definition of permanent establishment has been expanded for service providers. Under certain circumstances, cross border service providers' activities will be caught by the new definition even if there is no fixed base in the other country. This change takes effect for the third taxation year ending after December 15, 2008. As a result, if you provide services in the other country for a period or periods aggregating 183 days or more, you may find yourself liable to tax in the other country, even if you do not have a fixed base in the other country.

### **Stock option benefits and pension benefits**

In order to ensure that there is no double tax on stock option benefits, the treaty now includes an apportionment mechanism. This change addresses the issue of when a stock option is granted by an employer in one country but is exercised by the employee while employed in the other country. This rule takes effect for taxation years that begin after 2008. For pensions, the Protocol provides for the mutual tax recognition of pension plan contributions. The pension plan provisions take effect January 1, 2009.

### **Departure tax**

A new rule applicable to any emigration after September 17, 2000 is included in the Protocol. This rule enables departing taxpayers to have a deemed disposal and re-acquisition of their assets immediately before emigration.

This rule will step up the cost base in the underlying assets so as to eliminate double tax on a future disposition. If an emigrating U.S. citizen elects to dispose of the assets, the election will accelerate tax under U.S. law to allow a tax credit for Canadian tax.

### **Dual resident corporations**

The treaty Protocol will specifically deny benefits to corporation that are dual residents. Specifically, this rule will apply where a corporation has continued from one country to another without discontinuing from the original country of incorporation.

## Late Filing Penalties

### Don't be Late!

The Canadian tax system imposes severe penalties for late-filed tax returns. CRA imposes a penalty for failure to file a tax return equal to 5% of the unpaid taxes plus 1% of such unpaid tax per month of default, not exceeding 12 months. Furthermore, on a second or further occurrence, the penalty will be the sum of 10% of the unpaid tax plus 2% of the unpaid tax per month of default, not exceeding twenty months.

But what if there is no underlying tax payable? Does this mean that there is no late-filing penalty? The answer depends on whether the taxpayer is a Canadian resident or a non-resident. For Canadian resident taxpayers, the answer is no penalty applies.

If the taxpayer is a non-resident, they may be liable to a penalty which is computed as the greater of the following two amounts: i) 5% of the unpaid taxes plus 1% of such unpaid tax per month of default, not exceeding 12 months; or ii) the greater of \$100 and \$25 per day, up to 100 days, that the failure to file continues.

But is the non-resident liable to a penalty in the first instance? On the surface, no tax was payable therefore there should be no penalty payable.

This question was recently considered in the Tax Court of Canada in a case called *Exida.com*. The taxpayer was a non-resident corporation carrying on business in Canada. It had no income tax payable, but it had late-filed its corporate tax return. The minister imposed the maximum penalty of \$2,500, as calculated by the formula above. The taxpayer argued that since there was no tax payable, there should be no penalty. The Court held that a distinction should be made between "liable versus payable". In this case, the taxpayer merely had to be liable for a penalty thus the minister correctly assessed the taxpayer for failure to file an income tax return.

The court's findings contradict an earlier case which held that a late-filing penalty should not be imposed if there was no tax payable at the filing deadline.

In light of the newer case, non-resident taxpayers should take precautions to ensure that their tax returns are not filed late.

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Segal LLP has the knowledge and experience to help you identify issues and to assess the tax implications related to your business. We can keep you abreast of changes in tax law, and can assist in formulating strategies to take advantage of all recent developments.

## About Segal LLP

Segal LLP was established in 1976, since then we've grown to be one of Canada's 30 largest accounting firms – offering integrated solutions in Business Advisory, Assurance, Taxation and Financial Recovery.

### Transaction Advisory

Our practice includes advisory services to high-net-worth non-residents. Areas of expertise include, but are not limited to:

- Transaction advisory
- Advisory services to non-resident investors and real estate syndicates
- Treaty returns
- Cross border tax issues
- Delaware trusts
- Tax clearance certificates

### Taxation Advisory

Our commitment to understanding our clients' tax requirements is essential. It allows us to better leverage the collective knowledge and experience of our team in finding innovative and creative solutions. Areas of expertise include, but are not limited to:

- Tax planning
- Tax minimization strategies
- Shareholder remuneration
- Income splitting
- Assisting clients with tax audits or other dealings with the tax authorities

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He also has extensive experience working with real estate, professional corporations, and clients in the manufacturing, communications, and technology sectors.