CANADIAN COTTAGE AND RECREATIONAL PROPERTIES OWNED BY UNITED STATES RESIDENTS: S. 116 INCOME TAX ACT CONSIDERATIONS AND THE CANADA – UNITED STATES TAX CONVENTION (1980) (Fifth Protocol)

If you practice in cottage country, or anywhere where there is significant amount of recreational property, you are going to need to know how to deal with the special requirements of tax withholding and income tax reporting associated with American resident vendors. In my area of Northwestern Ontario I would venture to guess at no less than 50% of all cottages, or cabins or camps as they are variously referred to depending upon where you are located around the Province, are owned by U.S. non-residents. These cottages get into the family DNA for them just as they do for us, and many of these properties have been owned and passed down from generation to generation. Updating those titles as the generations change, or making conveyances to third party purchasers, require the application of special rules pursuant to the **Canada – United States Tax Convention (1980)** and the **Income Tax Act R.S.C. 1985 c.1 (5th Supp.)** (**the Tax Convention**)

Residency:

The determination of residency of the vendor is critical to how a transaction is to be handled and it is always the first fact that you need to determine. As you all know, the people at Canada Revenue Agency will never say something in simple plain English or French if they can think of something more complicated. Somehow it seems that residents of Canada can't just be residents; thereby automatically leaving all non-residents to be non-residents. No, that would be too simple. Instead CRA outdid themselves when they came up with the twisted double negative concept of the s.116 ITA definition of a Canadian resident instead being "not a non-

resident". I will not dwell on the test for residency except to say that it is not always patently obvious from the circumstances of your client and you should always dig further if you get the sense that something is not right. If you encounter a situation where there is any question, I would direct you to Canada Revenue Agency's website at: **www.cra-arc.gc.ca/tax/nonresidents/common/residency-e.html**,and to the **CRA circular IT-221R3**. I have also included some additional comments on the links section at the end of this paper which you may find to be helpful.

Remember always that it is residency, not citizenship, which is the determining factor for tax treatment. Do not allow yourself to be confused by those who are ex-pats, or Canadian citizens but who actually reside in the USA or some other foreign jurisdiction, or even those who claim Canadian residency but where the available evidence, such as address for communication or service, indicates they may not be. I draw your attention to the recent 2017 decision: ANNIBAL KAU v. HER MAJESTY THE QUEEN, 2018 TCC 156 (CanLII) where the Court ruled that the purchaser's solicitor failed to make reasonable inquiry as to the status of the vendor's residency even though the vendor provided an unsworn affidavit stating that he was not a non-resident of Canada. Remember also that the provisions of the Canada – United States Tax Convention only deal with residents of those two countries. Separate rules apply when you are dealing with vendor residents of other countries which I will not deal with in this paper.

Section 116 ITA:

When Canadian residents dispose of real property they report that disposition when they file their annual tax return. Under s.116 however, non-resident vendors must notify CRA about the disposition of taxable Canadian property either before the closing, or within 10 days thereafter

by way of filing a Form T2062. S. 248(1) ITA defines taxable Canadian property to include any “real property in Canada".

There are severe implications for both the vendor and the purchaser who fail to follow the rules. A vendor who fails to report is liable to be assessed a penalty plus interest: s.162(7) ITA provides that every person that fails to comply with a duty or obligation imposed by the Act is liable to a penalty equal to the greater of $100 and $25 per day, up to a maximum of $2500. I have on one occasion seen the penalty actually imposed where the vendor's solicitor failed to report the transaction within the required 10 days and so I urge you not to take that requirement lightly. A $2500 penalty having to be paid personally by the lawyer who was slow to report has a way of taking a lot of the fun and profit out doing the deal.

Similarly, the purchaser's solicitor must ensure that the potential liability is accounted for. This is precisely why we require the vendor to provide a s.116 sworn affidavit on closing. If the vendor fails to comply with the provisions of s.116(3), then the purchaser is obligated to hold back the tax, deduct it from the purchase price, and remit it directly to CRA. Should the purchaser fail to maintain the holdback, 25% of the sale price for recreational property, and CRA has not issued a Certificate of Compliance, then the purchaser becomes liable under s.116 (5) ITA to pay the tax. Always make sure that you either have the standard s.116 declaration stating that the vendors are “not non-residents”, or if they are non-residents, that the vendors solicitor has undertaken to hold back and remit the withholding tax and to provide you with a copy of the Certificate of Compliance before the balance of the holdback funds are released to the vendors. In my practice area the vendor’s lawyer typically receives the full amount of the sale proceeds and undertakes to remit and obtain the Certificate of Compliance and provide the purchaser’s solicitor with the purchasers copy. In the alternative the purchaser’s solicitor can maintain the 25% holdback until the Certificate has been provided from the vendors solicitor, or the

purchasers solicitor can make the remittance directly to CRA and obtain the Clearance Certificate if that is your preferred practice. It is after all the purchaser who is responsible to see that the tax is remitted, if not by the vendor then by the purchaser personally. Of course you will always want your vendor clients to be well aware of this process and the holdback requirements ahead of time, in case they are counting on getting the full amount of the closing proceeds immediately after closing.

Form T1261

As a part of the filing process each owner is required to obtain an **Individual Tax Number (ITN) for Non-Residents** from CRA. There is a fillable form online and you will not be able to file the Form T2062 to obtain a Certificate of Compliance unless you also supply the required application and original or certified copies of identification in support to get the ITN.

Form T2062

Unless you are going to just remit 25% of the net sale proceeds to CRA on closing, there is a considerable amount of paperwork required to be filed when the disposition is reported. It is important that you notify your client immediately as to what will be needed, so that you are not delayed in closing, or placed at risk of missing the 10 day T2062 filing deadline after closing.

When you send in the T2062 you must include supporting documentation to enable CRA to properly assess the withholding tax. Make sure to include:

- the offer to purchase (for an arms-length transaction);
- the original deed from the time of acquisition;

- a copy of the registered transfer from the sale;
- copy of original receipts that your clients may have for capital improvements made by them during the period of their ownership if you are going to limit the amount of the withholding tax due on closing by determining their final ACB; and
- a letter of opinion or an original appraisal from a realtor (a certified appraiser is usually not required) if you are doing a non-arm's length transfer such as from parents to adult children. Depending upon when and how the vendors originally acquired title, you may need this appraisal to establish not only the current Fair Market Value (FMV) but also the FMV at the time of their original acquisition or at December 31, 1971 and/or December 31, 1984
- the ITN for each vendor

The amount of withholding tax due and payable upon the transfer is a function of the difference between the adjusted cost base of the property (ACB) and the FMV proceeds of disposition, factored in some cases by the period of ownership. More on this later.

Firstly though, I want to say that in recent years I have found the CRA to have become increasingly picky about the receipts that are tendered to support the calculation of the adjusted cost base. Where once they were content with a mere written summary from the vendor, with receipts or even copies of receipts to be available for inspection if requested, they now frequently require original receipts (mere cashed cheques will not do!). These original receipts must clearly identify the expenditures as having been incurred for capital improvements and not just for repairs or maintenance items.

Production of the proper receipts can have a significant impact on the amount of tax that is due. If your clients have constructed buildings, docks and boathouses, replaced roofs, installed

septic fields and solar systems or anything that counts as a capital improvement these can be added to increase the ACB and thus limit the amount of the 25% withholding tax.

Your vendor clients will have a considerable amount of homework to do so the sooner that you get them started on digging out those many years of receipts, the sooner you can close and file in an orderly fashion.

A "disposition" is defined in subsection 248(1) ITA as including "any transaction or event entitling a taxpayer to proceeds of disposition of the property". The definition in s. 54 of "proceeds of disposition" is used for calculating the proceeds amount for s.116 reporting. If the transfer is non- arm's length in nature for less than FMV, such as a gift from parents to adult children, then the proceeds will be deemed by the operation of s.116 (5.1) to be equal to FMV.

Occasionally, if your client is well organized and you have enough time before closing, you may be able to apply for the Certificate of Compliance ahead of closing. If you don't have the money to remit however, or if you calculate that there will be a loss or no gain, you can request a comfort letter from CRA ahead of closing. The letter will authorize the purchaser not to remit any amount and confirms that no penalties or interest will be charged as long as the purchaser remits any required tax when required to do so by CRA.

Calculation of the Withholding Tax:

If your client originally acquired the property after December 31, 1984 then the calculation of the withholding tax is a very straight forward process. As indicated on the Form T2062, the amount of the ACB is deducted from the proceeds of disposition to provide a gain or loss. Twenty-five percent (25%) of that gain is then required to be remitted to CRA with the Form T2062.

Remember, we are dealing here only with typical residential type cottage transactions. Entirely different rules apply to commercial type properties, depreciable taxable Canadian properties, resource properties etc. These types of properties as referred to in s.116 (5.2) ITA are subject to a 50% holdback and remittance to CRA. In those cases payment is remitted directly to CRA and that payment is confirmed by a letter of acknowledgement issued by CRA. No Certificate of Compliance is issued but rather the vendor must then file a tax return to report the disposition. The purchaser has no further obligations once the letter of acknowledgement has been produced.

Also, keep in mind that many non-resident transactions are structured entirely or in part in U.S. dollars. In such cases the adjusted cost base is converted into Canadian dollars at its historical rate while the proceeds of disposition are converted at the exchange rate in effect at the date of disposition.

Timing Is Everything: The Pro-Rata Method

When you are acting for U.S. non-resident vendors, the **Canada - United States Tax Convention (1980)** (the **Tax Convention**) will come into play. As of the date of this paper the most recent amendments to the Convention occurred in September 2007 as the **Fifth Protocol**.

Pursuant to Article XIII, paragraph 9, your client may qualify for a reduction in the amount of tax payable by utilizing the **Pro-Rata Method**. Capital gains in Canada only became taxable after 1971 and under the **Tax Convention** any gains derived in Canada were exempt in Canada until December 31, 1984, provided that the property was owned on September 26, 1980. CRA deems that it is reasonable to assume that the gains accrued evenly over the total period of

ownership and so a formula has been devised to factor out the amount of the gains that accrued prior to December 31, 1984.

The reduction of the capital gain is normally calculated according to the following ratio:

The number of months between the date of acquisition or January 1, 1972 (whichever is later) and December 31, 1984

Divided by

The number of months between the date of acquisition or January 1, 1972 (whichever is later), and the date of disposition

This ratio can result in a significant reduction in the amount of withholding tax and capital gains tax payable and should be utilized where circumstances permit. Enclosed with your materials you will find a link to publication **IT-173R2SR** entitled **Capital Gains Derived in Canada by Residents of the United States**. This bulletin includes two excellent examples of real dollar calculations and I would commend them to you. I find that as time passes this option becomes less frequently available to employ but if it does you may save your clients a lot of money and in the process justify a value added service to the transaction. As with any area of practice, if you get to be known as someone who knows what to do, clients will both refer to friends and come back, oftentimes on a generational basis.

There may be other occasions where your client may feel that the gains should be allocated unevenly. Perhaps there was significant appreciation in property values prior to December 31, 1984 and less thereafter owing to market forces or the declining condition of the property. In

these unusual cases you can seek to employ the “Transitional Tax Treaty Rule Method” or as it is often referred to, the “Fresh Start Rule”. You cannot use this method without the prior approval of CRA but if approval is given then a December 31,1984 FMV appraisal value must also be submitted with the Form T2062 and income tax filing.

Transfers Not at Arms-length: Spouses, Adult Children and Related Parties:

As I mentioned in the beginning, the cottage soon becomes a part of the fabric of life for many and the time often comes to add parties to the title or transfer the property to adult children or to related parties who are deemed not to be at arms- length. This is usually done in the form of a gift to adult children but may occasionally take the form of a sale to a related party. Perhaps a niece or a nephew. In these cases, even where consideration is being paid, CRA will disregard the amount of the consideration but rather will deem the transfer to take place at current Fair Market Value (FMV).

You will therefore need to obtain a current FMV appraisal from a qualified realtor or appraiser to establish this value for the purposes of determining whether there is any gain. This FMV will in turn become the cost base for the new owners.

Unfortunately, this rule also applies to transfers where a non-resident owner seeks to add a spouse to title, either resulting from re-marriage or to update title. In my part of the country many of these cabins and remote locations were originally bought together by groups of fishing friends and were registered in their names only. Years later when they seek to add their spouses to title they are surprised to find that a full reporting and potential payment of tax is required. This includes the requirement to obtain a FMV appraisal and to pay the withholding tax, if any.

The only exception to the reporting requirements regarding spouses relates to property that is transferred to a spouse which occurs as a result of the death of a spouse. The property can then be transferred from one non-resident spouse to the surviving spouse at the original cost base of the deceased spouse without having to file under section 116. This of course must be supported by the proper testamentary documents. No T2062 filing is required for the estate of a deceased owner, but rather the estate reports by filing a tax return in Canada.

Tax Returns:

Many non-resident vendors fail to understand that their reporting requirements are not over just because they have filed the Form T2062 and received their Certificate of Compliance.

Even if they are not obligated by law to file a tax return in Canada, they are still entitled to do so. The initial payment triggered by filing of the Form T2062 is merely a withholding tax which is held by CRA as security against non-resident vendors who may have been tempted to leave the country after closing and never pay their tax. The income tax return that they file by April 30th the next year is what actually counts to calculate the amount of the capital gains tax payable, if any.

Please note that it will very often be in your client's best interests to file this tax return in Canada since certain expenses that were not applicable in calculating the withholding tax, such as legal fees, real estate commissions, appraisal costs etc. will be deductible as against the capital gains tax. They will most likely get a refund and very often it is substantial.

Copies of the income tax returns and guides can be obtained from the **CRA website: www.cra.gc.ca**. Reference should also be made to the **Guide 5013- G, General Income Tax and Benefit Guide for Non-Residents and Deemed Residents of Canada.**

You can always refer them to a friendly local accountant or, if you do any amount of this type of work and believe in the concept of providing “value added” services to your clients, your office can prepare the return for filing by them.

This is a surprisingly simple return to file if you have already made a comprehensive filing to obtain the Certificate of Compliance when you filed the original T2062.

Documents required to file the tax return are:

- TI General Income Tax and Benefit Return for Non-residents and Deemed Residents of Canada;
- Schedule 1 Federal Tax;
- Schedule 3 Capital Gains; and
- Certificate of Compliance; and
- A copy of the account for legal fees and disbursements and the realtors commission statement.

I find that my clients would sometimes prefer that we assist them with this filing rather than have to engage an accountant however I would urge caution in this respect. When it comes to capital expenditures there are a lot of different situations and types of expenditures that may or may not qualify. If you have any doubts or are not comfortable with doing the return, then you are best to refer to an accountant.

U.S. Tax Filing:

On a final note, you must make your clients aware that just because they have reported and obtained a Certificate of Compliance, and filed a tax return in Canada, they are not finished yet. United States citizens are required by law to report to the Internal Revenue Service annually on their worldwide income when they file their U.S. tax returns. Capital gains in Canada and the U.S. are calculated differently so they will be required to fully re-report and be re-assessed in the U.S. but, as a result of the **Tax Convention (1980)** they will get credit in the U.S. for the tax they paid in Canada. They will do that by filing the Certificate of Compliance which you obtained for them from Canada Revenue Agency.

Closing Remarks:

I hope that you will find this presentation to be of some assistance in guiding you through the general principals of non-resident conveyancing for your U.S. non-resident clients. For further assistance please take note of the links and supporting documents referred to below, and some further commentary on the factors to be considered in determining residency for the purposes of s. 116 ITA.

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February 4, 2016

updated July 2019

List of Links and Supporting Documents:

S5-F1-C1, Determining an Individual's Residence Status found at: http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s5/f1/s5-f1-c1-eng.html

Request by a Non-Resident for a Certificate of Compliance Related to the Disposition of Taxable Canadian Property found at: http://www.craarc.gc.ca/E/pbg/tf/t2062/README.html

Disposing of or Acquiring Certain Canadian Property found at: http://www.cra-arc.gc.ca/tx/nnrsdnts/cmmn/dsp/menu-eng.html#nrcp

IC72-17R6 Procedures Concerning the Disposition of Taxable Canadian Property by Non-Residents of Canada - Section 116 found at: http://www.cra-arc.gc.ca/E/pub/tp/ic72-17r6/README.html

IC77-16R4 Non-Resident Income Tax found at http://www.cra-arc.gc.ca/E/pub/tp/ic77-16r4/README.html

2015 Income Tax and Benefit Package (for non-residents and deemed residents of Canada) found at: http://www.cra-arc.gc.ca/formspubs/t1gnrl/nnrsdnts-eng.html

Supplemental to this paper: Residency – Individuals:

Under Canada's tax system your liability for income tax in Canada is based on your status as a resident or non-resident of Canada. Residency must be established before your tax status in Canada can be determined.

A determination of residency can only be made after all factors have been considered and your clients' circumstances have to be reviewed in their entirety to get an accurate picture of their residency. Residential ties to Canada include such things as having:

- a home in Canada
- a spouse or common-law partner and dependants who stay in Canada, while you are living abroad
- personal property in Canada, such as a car or furniture
- social ties in Canada
- economic ties in Canada

Other ties that may be relevant include:

- a Canadian driver's license
- health insurance with a Canadian province or territory

Residential ties that you maintain or establish in another country may also be relevant to residency.

Special rules may apply in the following circumstances:

- If you do not have residential ties in Canada, you may be a deemed resident if you stayed in Canada for 183 days or more over an averaged period of time.

- You are a government employee outside Canada, or you are a member of the Canadian Forces serving outside of Canada.

The above information is of a general nature only. For more information on residency, please see, **Determination of an Individuals Residency Status Interpretation Bulletin IT 22R3** and take note of the decision in Kau v. The Queen.

Canada Revenue Agency can also give you an opinion on your status. To get this, complete **Form NR74, Determination of Residency Status (Entering Canada) or Form NR73 Determination of Residency Status (Leaving Canada).** Send your completed form to the International Tax Services Office. After your residency has been determined, you can get information on your Canadian tax liability and filing requirements on the International and non-resident web pages.

This paper by Clare Brunetta was originally included in an OBA presentation on February 4, 2016 and updated in July 2019