

## ***Relieving TCP Changes – Not for everyone, yet***

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The substantial reduction of tax compliance obligations for non-residents disposing of Canadian investments announced in the 2010 Federal Budget<sup>1</sup> has been applauded.<sup>2</sup> Indeed, the notices required under section 116 of the *Income Tax Act* (“Act”) for certain dispositions of “taxable Canadian property” (“TCP”) and the related compliance and filing obligations had been strongly denounced as creating significant barriers to foreign investment in Canada. The burden of these measures was perhaps most acutely felt by widely held private equity funds whose already complex ownership structures in many instances had to be adapted so as to allow for compliance with section 116 in completing their exit strategy. As noted in the Budget documents: “*Narrowing the definition of taxable Canadian property will eliminate the need for tax reporting under section 116 of the Income Tax Act for many investments, enhancing the ability of Canadian businesses, including innovative high-growth companies that contribute to job creation and economic growth, to attract foreign venture capital.*” While the new narrower definition of TCP may facilitate structuring a cross-border venture capital investment into Canada, the effects of the former TCP regime may linger on for years in respect of existing investments made by foreign investors who are not entitled to the benefits of a Canadian tax treaty.

Under the Act, and subject to the terms of an applicable tax treaty between Canada and the investor’s jurisdiction of residence, Canada taxes non-resident investors on gains derived from dispositions of TCP. A statutory obligation on the non-resident investor to provide notice to the CRA in respect of the disposition,<sup>3</sup> and an obligation to file a tax return in Canada for the year in which the disposition of TCP takes place,<sup>4</sup> force the non-resident investor to disclose the potentially taxable transaction to the Canada Revenue Agency. Because a purchaser may be subject to potential liability when acquiring TCP from a non-resident vendor where notification requirements have not been met contemporaneously with the disposition, the TCP regime is further supported by potential withholding by the purchaser on the purchase price of the TCP.

The new, more focussed scope of the definition of TCP (i) eliminates section 116 reporting in respect of shares of Canadian corporations, other than shares which derive their value principally from real property situated in Canada, and (ii) correspondingly limits the dispositions of shares of Canadian corporations for which a non-resident of Canada is potentially liable to tax under Canada’s domestic law.

Under the former definition of TCP, any share of the capital stock of a Canadian resident corporation not listed on a designated stock exchange constituted TCP. Under the new definition, shares of a Canadian resident corporation that are not listed on a designated stock exchange will be TCP *only* if, at any time during the preceding 60 months, more than 50% of the fair market value of such shares was derived, directly or indirectly, from (i) real property situated in Canada (ii) Canadian resource properties, (iii) timber resource properties, (iv) options or interests in respect of the properties described in (i) to (iii), or any combination of the foregoing (referred to here, collectively, as the “real property assets”).

The new TCP regime also brings changes to the status of shares that are received in certain tax deferred transfers. Under the former rules, shares of a Canadian resident corporation that were received in a tax deferred transaction<sup>5</sup> as consideration for the disposition of property that was TCP, were deemed to be TCP indefinitely. Under the new rules, the deemed TCP status of shares acquired in such circumstances falls away (assuming the shares are not otherwise TCP) on the expiry of a 60 month period following the tax deferred transaction. These new deeming rules are a welcome change. A disposition of “deemed TCP” does not give rise to contemporaneous notification requirements under section 116 on the basis that “deemed TCP” is an “excluded property” for purposes of section 116;<sup>6</sup> however, subject to certain

exceptions, the foreign investor disposing of deemed TCP will be required to file a Canadian tax return for the year and pay Canadian income tax on any taxable capital gain resulting from the disposition.<sup>7</sup>

In the private equity context, for example, investors may acquire convertible preferred stock of an investee corporation, which later is converted into common shares prior to an initial public offering by the investee corporation. The common shares acquired pursuant to the conversion were deemed to be TCP indefinitely under the former TCP regime. Under the new regime, the common shares are only deemed to be TCP for 60 months following the date of conversion.

All these new rules apply in determining, after March 4, 2010, whether a property is a taxable Canadian property of a taxpayer.

But here is how the former broader scope of the TCP definition lingers on. Shares that were acquired in a tax deferred transaction prior to March 5, 2010 and that were at that time deemed to be TCP are not immediately tested under the new TCP definition in determining, after March 4, 2010, whether the shares are TCP. Rather, the deemed TCP status of such shares acquired under the former TCP regime continues for 60 months following the date of the tax deferred transaction. In other words, even if the shares acquired in such a transaction do not derive (and possibly never have derived) more than 50% of their value from real property assets, such shares will be deemed to be TCP for 60 months. Furthermore, if, after March 4, 2010 (but within 60 months of the original tax deferred transfer), the same deemed TCP share is exchanged for a new share in another tax deferred transaction (e.g. pursuant to an amalgamation or share-for-share exchange), the new share preserves deemed TCP status for another 60 months. Accordingly, non-resident investors who acquired shares of a Canadian corporation in a tax deferred transaction after March 4, 2005 should determine whether they continue to hold deemed TCP notwithstanding the new narrower definition of TCP.

The Budget documents indicate that eliminating the need for section 116 reporting and reducing the administrative burden on taxpayers was the primary impetus for changing the TCP definition. Property deemed to be TCP was (and continues to be) an “excluded property” for purposes of section 116 reporting. Thus, the “transitional” impact of the change to the deeming rules was perhaps not a primary concern.

However, to address these irritants, the Minister opted to narrow the definition of TCP rather than extend the list of “excluded properties” for which section 116 reporting is not required. This approach shows a willingness to restrict the scope of Canada’s taxation of gains arising on dispositions of property by non-residents and, as stated in the Budget documents, to “*bring Canada’s domestic tax rules more in line with our tax treaties and the tax laws of our major trading partners*”. In this respect, it is unfortunate that deemed TCP status under the former TCP regime trumps a current determination as to TCP status under the new definition, even if only for 60 months following a pre-Budget rollover transaction. Such an approach defers and may potentially deny the benefits of the narrower TCP definition for an important segment of current foreign venture capital investment in Canada.<sup>8</sup>

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<sup>1</sup> Federal Budget, March 4, 2010. The proposals which amend the definition of TCP are included in the *Jobs and Economic Growth Act*, S.C. 2010, c.12, which received Royal Assent on July 12, 2010.

<sup>2</sup> E.g. CVCA press release “CVCA Applauds Budget Decision to Remove Foreign Investment Barrier”, March 4, 2010.

<sup>3</sup> Where the shares disposed of are “treaty-protected property”, the purchaser may provide notice to the CRA; in such circumstances, no certificate of compliance is issued by CRA and withholding by the purchaser is not required.

<sup>4</sup> Non-residents may be exempted from the obligation to file a return in specific circumstances. However, if tax is payable in the year in respect of the disposition, a return must be filed.

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<sup>5</sup> Specific deeming rules continue the TCP status of property received as consideration for TCP in the case of a small business share rollover (subsection 44.1(2)), a share conversion (section 51), a transfer of property to a Canadian corporation on a rollover basis (subsection 85(1), a share for share exchange (section 85.1), and an amalgamation (subsection 87(4)). Similar rules also apply in the context of a transfer of property to a Canadian partnership (subsection 97(2)) and certain transfers of property from and to a trust (subsections 197(2) 107(3.1), 248(25.1) and section 107.4). No similar deeming rule applies in the context of an exchange of shares in the course of a reorganization of the capital of a corporation pursuant to section 86 of the Act.

<sup>6</sup> Paragraph 116(6)(a) of the Act.

<sup>7</sup> See note 4. An exemption from tax in Canada may be available under an applicable tax treaty.

<sup>8</sup> See note 5. It may be possible to shed “deemed TCP” status of shares through an exchange of the deemed TCP shares for new shares of the corporation as part of a reorganisation of capital pursuant to section 86. The shares received on the exchange would not be TCP (assuming they are not otherwise TCP under the new TCP definition). This disposition of the old “deemed TCP” will not give rise to section 116 reporting and would not, in and of itself, cause the non-resident investor to be subject to the obligation to file a tax return in Canada. However, this approach may not be available for commercial or other reasons.

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