
RYE AND PARTNERS

BARRISTERS & SOLICITORS

KEEPING IN TOUCH

HIGHLIGHTS

In this edition of *Keeping in Touch* we wish to alert non-residents of Canada who indirectly own property or investments in Canada to the potential for adverse Canadian legal or tax consequences arising out of transactions which are carried out wholly outside Canada. Property or investments situated in Canada may be indirectly affected by a transaction in which only non-residents of Canada and property or legal entities situated outside Canada are directly involved.

You will find below some of the many issues involved in non-resident ownership and investment in Canada. Care needs to be taken to identify possible Canadian consequences so that all steps available to avoid undesirable results in Canada can be planned for in advance.

TAX CONSIDERATIONS

Taxable Canadian Property

Recent amendments to the *Income Tax Act* (Canada) (the "ITA") will have extended the definition of "taxable Canadian property" to the capital stock of non-Canadian corporations and interests in non-Canadian trusts in a number of circumstances so that, on the sale or other disposition of such shares or interests, a taxable capital gain may be realized for Canadian tax purposes even though the transaction takes place outside Canada and involves only non-residents of Canada.

Formerly, the definition of taxable Canadian property contained in the ITA included an interest in a partnership where, at any time during the twelve months immediately preceding the disposition of the interest, 50% or more of the fair market value of the partnership property consisted of real property situated in Canada and/or other taxable Canadian property.

This definition has now been extended to include the shares of corporations of a class not listed on a prescribed stock exchange and to interests in trusts, whether or not the corporation or trust is resident in Canada, where the underlying taxable Canadian property consists of real property situated in Canada and/or Canadian resource or timber properties at any time during the immediately preceding 60 month period.

Canadian taxation authorities are entitled to look through any number of levels of corporations, trusts and partnerships, both Canadian and non-Canadian, to ascertain the underlying source of value of any shares or interests disposed of by non-residents of Canada.

In addition, such rules are applicable not only to actual dispositions, such as a sale, but also to dispositions which are deemed to occur for the purposes of the ITA, such as on the death of a shareholder when proceeds of disposition equal to current fair market value are deemed to be received.

Any disposition or deemed disposition by a non-resident of Canada of shares or interests deemed

IN BRIEF

Non-residents of Canada who own Canadian property, either directly or indirectly, are advised to investigate the potential for adverse Canadian legal or tax consequences arising out of transactions to be concluded outside Canada so that available action to avoid any detrimental results can be planned for prior to implementation.

to be taxable Canadian property by these provisions are subject to the onerous reporting provisions under the ITA and to the imposition of Canadian capital gains tax on any capital gain realized, whether or not

the gain is attributable to the underlying Canadian real or resource property.

Failure to comply with the reporting requirements or pay any exigible tax in a timely fashion can result in substantial interest accruing on any capital gains tax owing, as well as in the imposition of significant penalties following a failure to report the subject transactions whether or not any capital gains tax is payable.

The precise effect of the amendments will depend on whether a tax treaty is in effect between Canada and the foreign jurisdiction and the terms of the treaty. Some treaties will limit the applicability of the provisions while others will have no effect.

Corporate Reorganizations

Reorganizations of non-Canadian corporations can result in unanticipated tax consequences in Canada even though the tax rules of the jurisdiction in which the reorganization takes place do not recognize the reorganization as a taxable event. Tax effects in Canada can arise in a variety of circumstances, some of which may result in the immediate imposition of tax, and others of which may adversely affect tax values or have other long term tax consequences. Several examples may be cited.

If, in the course of a corporate reorganization, shares of a non-Canadian corporation which would constitute taxable Canadian property under the above-described rules are transferred to a new shareholder within a corporate group, a disposition of the shares at current fair market value may take place for Canadian tax purposes, whether or not there is a change in ultimate control, resulting in the imposition of the reporting requirements and capital gains tax on any gain deemed thereby to have been realized.

A corporate reorganization involving only non-Canadian corporations may or may not constitute a taxable event for Canadian tax purposes depending on the formalities required to effect the reorganization under the law of the jurisdiction in which it takes place. For example, where a non-Canadian corporation which owns taxable Canadian property, such as Canadian real estate, is involved in a corporate merger or amalgamation, the underlying legal theory will determine whether or not a disposition of the taxable Canadian property is deemed to occur for Canadian tax purposes by reason of the merger.

Although the corporate law in all Canadian jurisdictions, as well as in many non-Canadian jurisdictions, treats an amalgamated corporation as a continuation of the predecessor corporations so that an amalgamation or merger taking place in those jurisdictions would for most purposes be a non-event for Canadian tax purposes, the law applicable to the

merger or amalgamation of corporations under other non-Canadian jurisdictions may involve the transfer of corporate assets between the pre- and post-amalgamation corporations so that a disposition would take place for Canadian tax purposes.

The ITA contains rollover provisions which deem properties owned by the predecessor corporations to be disposed of by them and to be reacquired by the amalgamated corporation; and then allows a number of tax deferrals and the flow through of various tax values, thereby eliminating most immediate tax consequences. Such provisions apply, however, only to taxable Canadian corporations.

Where a transfer of properties occurs by reason of the merger or amalgamation of non-Canadian corporations which own taxable Canadian properties, the rollover provisions of the ITA would not be applicable and a disposition of those properties would be deemed to occur at current fair market value resulting in capital gains tax being imposed in Canada on any gains thereby deemed to be realized.

Accordingly, although the merger or amalgamation may not be recognized as a taxable event in the jurisdiction in which it takes place, that will not necessarily be the case in Canada and significant tax liability can result. Once again, if a tax treaty is in effect between Canada and the jurisdiction of the amalgamation, it may contain relieving provisions but in many cases it will not.

A corporate reorganization which takes place outside Canada may also have adverse tax consequences for a Canadian subsidiary where the reorganization results in a change of control. A fiscal year end occurs for Canadian tax purposes immediately on the occurrence of a change of control and the entitlement to carry forward losses for deduction from income earned or capital gains realized in subsequent fiscal periods is severely restricted or eliminated completely.

For instance, all capital losses, whether realized or accrued prior to the change of control, are eliminated subject to a mechanism permitting accrued capital gains to be deemed to be realized and offset against any accrued capital losses which would otherwise be eliminated on the change of control. Non-capital losses arising out of property investments are also eliminated. Only business losses may be carried forward beyond the change of control but they are permitted to be deducted only from income generated by the same or a similar business.

INVESTMENT CANADA ACT

Indirect acquisitions of Canadian businesses by non-Canadians may be subject to the requirements of the *Investment Canada Act* (the "ICA") which is applicable to transactions in which control of an entity in Canada carrying on a Canadian business is

acquired indirectly by a non-Canadian through the acquisition of control of a non-Canadian corporation. Such indirect acquisitions of control of Canadian businesses by non-Canadians are subject to the review and notification requirements of the ICA.

Although all transactions which result in the acquisition of control of a Canadian business by non-Canadians are notifiable under the ICA, only those which exceed the thresholds provided for under the ICA are reviewable as well.

An indirect investment originating in a *North American Free Trade Agreement* ("NAFTA") member country is only notifiable; it is not reviewable. Where either the investor or the vendor is from a *World Trade Organization* ("WTO") member country, the acquisition or investment is reviewable only where:

- (1) the value of the assets of the Canadian business is \$250 million or more, subject to a yearly adjustment for inflation; and
- (2) the Canadian business being indirectly acquired represents 50% or more of the total value of the international transaction.

The addition of the 50% requirement eliminated the review requirement for most indirect acquisitions of Canadian businesses originating in WTO member states. Such investments are nonetheless notifiable. Where the foreign investor and vendor are not from a WTO or NAFTA member country, indirect acquisitions of control of Canadian businesses entities with assets greater than \$50 million are reviewable.

Indirect acquisitions of Canadian businesses which are in the financial services sector, transportation services sector, uranium production sector or telecommunications sector are subject to the \$50 million review threshold regardless of the nationality of the investor or vendor. Finally, acquisitions in cultural industries may be reviewable if the Canadian government so decides even if they fall below the thresholds.

Where an acquisition is subject to review, it is not to be completed until government approval is obtained. This involves filing an application with the Director of Investments appointed pursuant to the ICA setting out the investor's plans for the Canadian business. For transactions which fall outside of the review thresholds, the only requirement is that the purchaser file a summary notification of the transaction.

COMPETITION ACT

The definition of merger in the *Competition Act* (Canada) (the "CA") is broad enough to encompass virtually any joining together of assets or businesses in whole or in part, apart from a number

of exceptions enumerated in the CA. In general terms, the CA deems a merger to occur when direct or indirect control over, or a significant interest in, the whole or a part of a business of another person is acquired or established. A direct or indirect holding of less than a 10% voting interest in another entity will generally not be considered a significant interest.

If a proposed transaction meets certain quantitative criteria, the pre-merger notification provisions of the CA may require that the parties delay completion of the transaction until certain information has been filed and a prescribed waiting period (either 7 or 21 days) has expired.

For the purpose of deciding whether pre-notification is required, two criteria must be satisfied. Firstly, the value of the parties' (including their affiliates') assets in Canada or the revenues generated in Canada therefrom must exceed \$400 million. Secondly, the value of, or revenues generated from, the assets subject to the proposed transaction should exceed \$70 million in the case of an amalgamation and \$35 million in the case of combinations or acquisitions of assets or shares.

The Director of Investigation and Research of the Bureau of Competition Policy (the "D.I.R.") will review a proposed transaction or a transaction already completed upon pre-notification or application by an interested third party. Various evaluative criteria, such as market share and concentration barriers to entry into the market, are then used to determine the likely effects of the merger on competition in a relevant market. If the D.I.R. finds that a proposed merger is likely to prevent or lessen competition substantially, it may order the parties not to proceed with the merger.

If the notification requirements do not apply with respect to a particular transaction and the transaction is not under review, the parties should nevertheless ensure that the transaction does not result in a violation of other provisions of the CA, such as those dealing with monopolies or price determination, against which both criminal and civil sanctions are available.

CONCLUSION

It will be apparent from the few examples discussed above that possible Canadian tax and legal consequences should be investigated before any transactions are undertaken outside Canada by non-residents of Canada where the parties own property or other investments in Canada even if the Canadian assets will not be directly affected.

It is vital for non-residents of Canada who hold indirect interests in Canadian real and resource properties to remain continuously informed of the significance of those properties to the value of their overall portfolios and to take steps, where possible,

to avoid the 50% valuation threshold being met.

Where interests in Canadian property or other investments in Canada are held within a corporate group, the potential Canadian legal and tax effects should be investigated prior to the implementation of any corporate reorganization involving members of the group, even though only non-Canadian members will be directly involved. Timely investigation is important so that potential Canadian legal or tax consequences can be discovered before implementation and action can be taken to reduce or eliminate any adverse results.

A failure to identify potential problems and take available action to minimize adverse results prior to implementation can result in the imposition of substantial taxes and penalties, as well as other

detrimental consequences such as an order of divestiture, which may be entirely avoidable. With proper planning most transactions can be structured to achieve the desired results without unexpected adverse consequences.

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