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Nonresidents of Canada Investing in Canadian Real Estate

The Vancouver real estate market is particularly attractive to nonresident investors.

There are various Canadian tax issues when a nonresident of Canada invests in Canadian real property—and often they are ignored.

Professional advisors should inform their nonresident clients prior to investing, since noncompliance with the Canadian income tax rules, particularly the withholding tax rules, can result in significant penalties.

Nonresidents of Canada may be subject to Canadian income taxes if they

a) receive rent from Canadian real estate, or

b) dispose of Canadian real estate.

They also may be subject to Canadian income taxes as a result of receiving other income, such as employment income.

Compliance Rules for Rental Property

To ensure nonresidents of Canada comply with the Canadian income tax laws, there is a complicated system of rules involving both the nonresident and the nonresident's agent, if any exists. For Canadian rental property, this compliance system includes rules with respect to withholding taxes, NR6 forms, NR4 forms, and Section 216 returns.

Any rents paid to nonresidents are subject to a 25 percent withholding tax on the "gross rents"; that is required to be withheld and remitted to Canada Revenue Agency (CRA) by the payer, each time rental receipts are paid or credited to the account of the nonresident by the payer. The payer is considered the Canadian agent of the nonresident or, if there is no agent, the tenant.

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If the withholding taxes are not remitted by the 15th day following the month of payment to the nonresident, the payer will be subject to penalties and interest on the unpaid amounts.

The requirement to withhold tax on the gross rents can be reduced if the nonresident selects a Canadian agent to act on his or her behalf and an NR6 Form is filed and approved by CRA annually and signed by both the nonresident and the agent.

The NR6 Form is used to estimate the net rental income that is expected to be received during the current taxation year. If the net rental income is in a loss position and CRA approves the NR6 Form, then there may be no withholding requirement for the current year.

If the net rental is not in a loss position, then the 25 percent withholding tax is calculated on the net rental income amount and remitted as rent is received.

An NR6 Form must be filed and approved for each taxation year before the first rent payment is received. In most cases, the NR6 must be filed by December 31 of the previous year.

Any tax that is withheld can be claimed as a credit against taxes payable when filing a Section 216 personal tax return for the year. If the amount paid exceeds the income taxes payable, CRA will issue a refund.

Filing the NR6 Form can have a significant positive impact on the cash flow of the investor because

1. the remittance of withholding taxes is based on the net rental income, and
2. it avoids penalties on unremitted amounts.

For example, if an investor is not aware of the withholding tax rule, does not file the NR6 Form, and does not pay the 25 percent withholding tax on the gross amount received, he will be subject to penalty and interest on the unremitted amount, even if the rental income was in a loss position.

At the end of each calendar year, an NR4 Information Return must be prepared and filed by March 31 summarizing the amount of rents paid or credited to the nonresident by the Canadian agent, as well as the amount of withholding taxes, if any, paid to CRA. The Canadian accountant of the nonresident often prepares the NR4 Information Return.

A Canadian income tax return must be filed by June 30 in respect to the preceding calendar year. This income tax return is pursuant to Section 216 of the Canadian *Income Tax Act* and will include only the income and expenses relating to the rental property.

In determining the net rental income from rental, the expenses relating to the rental property may include the following.

- Advertising
- Insurance
- Interest on mortgages obtained to finance the purchase of the rental property
- Repairs and maintenance
- Management and administrative fees
- Condominium fees
- Accounting fees
- Property taxes
- Utilities

If the net result is income, depreciation on the rental building as well as furniture and equipment included in the rental property can be claimed. Very often, depreciation is not claimed because that would be recaptured when the building is sold, resulting in a larger gain and subject to a higher marginal tax rate.

If the investor also uses the rental property for personal vacation purposes, a reasonable estimate of the personal-use portion of the expenses related to the property should be determined. That estimate should be deducted from the total expenses, with only the net amount being deducted from rental income in determining net rental income.

As indicated on the list above, the interest payable on a bank loan obtained to finance the purchase of the rental property is deductible in determining the net rental income.

If the loan is provided by a foreign bank, Canadian withholding taxes likely will be payable with respect to the interest payable to the foreign bank.

Disposition of Real Property

A nonresident of Canada is subject to Canadian income tax on dispositions of Canadian real property.

To ensure the nonresident complies with the Canadian tax rules on the sale of property, the purchaser of the property is required to withhold a portion of the vendor's proceeds and remit it to CRA on behalf of the nonresident vendor.

The requirement to withhold a portion of the proceeds can be avoided if certain clearance certificates are provided by CRA, either reducing or eliminating the withholding taxes to be remitted by the purchaser. That is where a BC Notary can help the nonresident vendor obtain the clearance certificates within a reasonable time to avoid lengthy waiting periods before the sale proceeds can be disbursed to the vendor.

In general, the purchaser is required to withhold

- 25 percent of the gross proceeds related to the disposition of land, and
- 50 percent of the gross proceeds related to the disposition of buildings.

To reduce, or eliminate, the required withholding taxes, the nonresident can file certain forms with CRA to request clearance certificates from CRA that provide for a lower withholding tax amount. To avoid penalties, Form T2062 must be filed with CRA not later than 10 days after the date of disposition.

If approved, the withholding taxes related to the land disposition can be reduced to 25 percent of the difference between the gross proceeds and the cost of the land.

In addition, the withholding taxes related to the building disposition can be reduced to a percentage of the difference between the gross proceeds and the undepreciated capital cost of the building. The percentage related

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Swiss German
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Urdu
Vietnamese

to the building may differ, depending on the amount of the difference.

Once CRA issues the requested clearance certificates, the purchaser will be required to remit only the amount stated by CRA.

If the nonresident investor had never filed income tax returns under Section 216 to declare the rental income, nor had he withheld income taxes on the rents received, this is the time the investor will have to file all the prior years' returns, which will be subject to interest and penalties on the unremitted monthly withholding taxes.

The process also will result in delays in receiving the clearance certificate from CRA, with the consequence that the BC Notary representing the nonresident vendor will have to hold back 25 percent of the of the gross proceeds related to the disposition of land, and 50 percent of the gross proceeds related to the disposition of buildings, until the clearance certificate or a letter of intent is received from CRA.

It is important to keep good records of all transactions related to the investment property.

The nonresident also will be required to file a special Canadian personal income tax return by June 30 of the year following the disposition of the real property. In that return, the nonresident would report the actual gains or losses on the sale.

In calculating the gain or loss on the property, the nonresident will be able to claim the real estate commissions and legal fees as a deduction in determining the net proceeds of the sale.

Generally, the actual income taxes payable with respect to the sale of the property will be less than the withholding taxes remitted on the sale of the property. As a result, the nonresident generally will receive a refund of a portion of the withholding taxes that were originally remitted to CRA

It is important to keep good records of all transactions related to the investment property. The nonresident should keep all receipts of the cost of improvements and additions to the building. All those costs will reduce the capital gain at the time of sale. Without those receipts, CRA will deny the claim for the additional expenses to the original cost of the property.

This is just a brief summary of the rules of which a foreign investor should be aware when investing in real property in Canada. Very often, the nonresidents are not aware of all the rules and they rely on the help of professionals like BC Notaries, lawyers, accountants, and real estate agents to guide them through these various rules from the day they decide to acquire the investment. ▲

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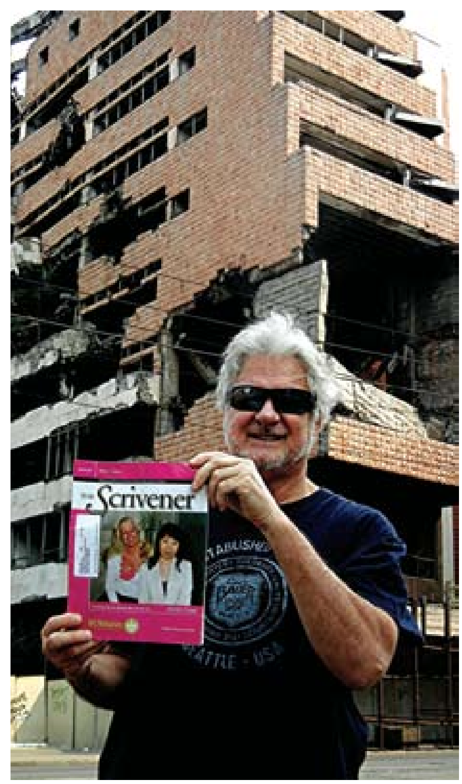
Where in the World has *The Scrivener* Been?

Marco Castro *enjoying the beautiful beach in Maceió, Brazil*

During her tour of New Orleans—the Birthplace of Jazz music, ***Esther Chiu*** *sailed on the* Natchez, *the only authentic sternwheel steamboat still operating on the muddy Mississippi River. She then went on to enjoy a 7-day cruise to Jamaica, Grand Cayman, and Cozumel.*

Hope Air's ***Dennis Kiffiak*** *at the memorial for Marxist Che Guevara in Santa Clara, Cuba*



Trevor Todd *in front of the bombed-out Serbia High Command Defence Ministry in Belgrade that NATO bombed for 77 days in 1999*