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Taxation of Non-resident Investors in Canadian Investment Funds

by Melody Chiu

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This article deals with the Canadian tax implications for non-resident investors that do not otherwise carry on business in Canada of investing in different types of Canadian investment fund vehicles. It also highlights the relevant articles in the fifth protocol to the Canada-U.S. tax treaty and proposed changes in the 2010 federal budget that may affect the taxation of non-resident investors in Canadian investment funds, and outlines recent withholding tax developments.

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TAXATION OF NON-RESIDENT INVESTORS IN CANADIAN INVESTMENT FUNDS

*Melody Chiu****

The author discusses the Canadian tax implications for a non-resident investor that does not otherwise carry on business in Canada of investing in different types of Canadian investment fund vehicles. She also highlights the proposed changes in the 2010 federal budget affecting non-resident investors and the articles in the fifth protocol to the Canada-US tax treaty that may affect the taxation of a US investor in Canadian investment funds, addresses Canadian withholding tax procedures with respect to the claiming of treaty eligibility, and outlines recent withholding tax developments.

KEYWORDS: NON-RESIDENT ■ INVESTMENT FUNDS ■ WITHHOLDING TAXES ■ TAXABLE CANADIAN PROPERTY

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INTRODUCTION

According to Statistics Canada, net foreign investments in Canadian securities increased from $35 billion in the period January to October 2008 to $86.4 billion in the same 10-month period in 2009.[1] Of those amounts, net bond investments increased from $28.3 billion to $59.2 billion, and net Canadian stock investments increased from $4.9 billion to $25.1 billion. Although the statistics do not specifically reflect non-resident investments in Canadian investment funds, they illustrate non-resident investors' keen interest in the Canadian market. The likely explanation for the increase in non-resident investment is that Canada's economy is less volatile than the economies of other countries. As tax advisers, however, we would like to think that the increase is due in part to the relaxation of Canadian withholding taxes on certain interest received by non-residents and the elimination of filing requirements when a non-resident disposes of certain Canadian property.

A non-resident investor in a Canadian investment fund may be subject to Canadian taxes on

1. income earned by the investment fund and paid or credited to the non-resident, or
2. gains realized from the disposition of taxable Canadian property.

Canadian taxes paid may be creditable in computing the non-resident's income in its country of residence; however, a discussion of that topic is beyond the scope of this article.

1 Statistics Canada, "Canada's International Transactions in Securities," *The Daily*, December 17, 2009 (http://www.statcan.gc.ca/daily-quotidien/091217/dq091217b-eng.htm). These figures represent net investments—that is, cash investments into Canada less cash withdrawals out of Canada.

The commonly used investment fund vehicles that are considered in this article are trusts, corporations, and partnerships. Each vehicle is taxed differently in Canada; the appendix presents a numerical example comparing the tax consequences of investments in the three different types of funds.

GENERAL PRINCIPLES

Income Paid or Credited to Non-Resident Investors

Withholding Taxes Under Domestic Rules

Subsection 212(1) of part XIII of the Income Tax Act[2] requires non-residents to pay a 25 percent withholding tax on various types of income paid or credited, or deemed to be paid or credited, by a resident of Canada. An amount is paid or credited, or deemed to be paid or credited, if it was legally set aside for use by the non-resident.[3] If a non-resident reinvests its income distributions from a Canadian investment fund, the reinvestment is considered income paid or credited because the distribution payable was settled by the issuance of additional Canadian fund securities, which constitutes a payment for part XIII purposes.

Canadian investment funds—specifically, those that are trusts and corporations—generally reinvest an investor's distributions into additional securities of the fund at the net asset value (NAV) after the distribution on the distribution date, unless the investor specifically requests that its distributions be paid in cash or by cheque. This process is similar to dividend reinvestment programs (although reinvestment is typically at NAV and not at a discount to NAV) and is the preferred method of paying distributions by investment funds, resulting in a far smaller administrative workload than payment by cheque to hundreds of investors. In some situations, Canadian investment funds may not reinvest a non-resident's distributions if the percentage of a fund's securities held by non-residents is restricted and certain thresholds are exceeded—for example, for mutual fund trusts and mutual fund corporations. When reinvestment is allowed, the amount of a non-resident's reinvested distribution is usually net of the applicable withholding tax that is remitted to the Canada Revenue Agency (CRA) on account of the non-resident.

Although subsection 212(1) requires the non-resident to pay the withholding tax, subsection 215(1) requires the person that pays or credits an amount on which part XIII tax is payable, "notwithstanding any agreement or law to the contrary," to deduct or withhold from the amount the applicable part XIII tax and to remit the withheld tax with a statement in prescribed form by the 15th day of the month following the payment to the non-resident.[4] This means that the Canadian investment

2 Unless otherwise stated, statutory references in this feature are to the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

3 This is the general interpretation of the courts and the Canada Revenue Agency: see, for example, *Information Circular* 77-16R4, "Non-Resident Income Tax," May 11, 1992, at paragraph 5.

4 The prescribed form is form PD7AR-NR, "Remittance Form," to be included with the withholding tax payment in accordance with paragraph 54 of IC 77-16R4, supra note 3.

fund is responsible for withholding taxes from any income paid or credited to its non-resident investors, and that the fund is unable to contract out of this responsibility.[5] Furthermore, the liability for withholding tax resides with the Canadian investment fund: under subsection 215(6), a payer that fails to deduct or withhold part XIII tax can be obliged to pay on behalf of the non-resident the whole amount of the part XIII tax that should have been deducted or withheld.

The same provision, however, entitles the payer to deduct or withhold from any subsequent amount paid or credited to the non-resident or to otherwise recover from the non-resident any amount paid as tax under part XIII on behalf of the non-resident. If a Canadian investment fund did not withhold enough tax from a non-resident's distributions, it can reduce subsequent distributions to the non-resident to recover the tax under subsection 215(6). The fund will have to consider other means of recovery if the non-resident investor has already sold its investment in the fund.

In addition to the liability for the non-resident's tax, the Canadian investment fund may be subject to a penalty equal to 10 percent of the amount that should have been withheld or deducted (20 percent if the failure was made knowingly or in circumstances amounting to gross negligence). Further, the non-resident investor is jointly and severally liable with the Canadian investment fund to pay interest on the amount that should have been remitted to the CRA pursuant to subsection 227(8.3). The interest is calculated at a prescribed rate,[6] compounded daily from the day on which the amount was required to be deducted or withheld to the day of payment.

The Canadian payer is required to remit to each non-resident, on an annual basis, a form detailing the non-resident investor's income and withholding tax paid for the calendar year.[7]

Withholding Taxes Under the Canada-US Tax Treaty

If a treaty is in force between Canada and the investor's country of residence, income tax application rule 10(6) will automatically apply to reduce the 25 percent rate of withholding specified in the Act to the relevant treaty-reduced rate.

Recent changes under the fifth protocol to the Canada-US tax treaty[8] provide US investors with broader access to treaty relief from withholding tax on amounts paid or credited from Canadian investments. Article IV(6) extends treaty benefits to

5 The responsibility could be that of the trustee if the fund is a trust, or of the partners or general partner if the fund is a partnership. For the purposes of this article, I refer to the withholding tax liability being that of the investment fund.

6 Prescribed rates are found in regulation 4301(a) and are reset quarterly. In 2009, the prescribed rates were 6 percent in the first quarter and 5 percent in the last three quarters.

7 Regulation 202. The prescribed form is form NR4, "Statement of Amounts Paid or Credited to Non-Residents of Canada."

8 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC, on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the Canada-US tax treaty").

members of fiscally transparent[9] entities such as partnerships and limited liability corporations (LLCs) on payments made after January 31, 2009. The article provides as follows:

> An amount of income, profit or gain shall be considered to be derived by a person who is a resident of a Contracting State where:
>
> (a) The person is considered under the taxation law of that State to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and
>
> (b) By reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person.

For example, if a US resident is a member of an entity that receives Canadian dividends that were subject to withholding taxes and the entity is not resident in Canada, provided that the US tax laws treat the income as being received directly by the member, withholding taxes will be calculated at the member level rather than at the entity level. There are no similar articles in Canada's other tax treaties. Accordingly, the following discussion applies only to US investors.[10]

Under article IV(6), treaty-eligible US partners are considered to derive the Canadian income directly and can obtain treaty benefits on their portion of payments to the partnership, provided that the partnership is fiscally transparent in the United States. Therefore, a US investor that invests directly into a Canadian investment fund that is a partnership will be eligible for treaty benefits on its portion of the income earned by the fund. A US investor that is a partner of a partnership which in turn invests in a Canadian investment fund that is a trust or corporation will be eligible for treaty benefits on the partner's portion of the income paid or credited by the Canadian investment fund, provided that the partnership is fiscally transparent in the United States.

LLCs are considered corporations for the purposes of the Act, even though they may be treated as partnerships or disregarded entities for US tax purposes.[11] Because LLCs are not subject to US income taxes, they formerly were not eligible for treaty benefits: they were not considered "residents" of or "liable to tax" in the United

9 The CRA has provided its definition of "fiscally transparent" in CRA document no. 2007-0261901C6, July 17, 2008. The definition includes entities for which the income earned is taxed at the beneficiary, member, or participant level, and entities that are fiscally transparent for US tax law purposes, including LLCs that do not elect to be taxed as corporations.

10 The discussion of US persons' eligibility for treaty benefits throughout this article assumes that the US person meets the conditions set out in article XXIX A (limitation on benefits) of the Canada-US tax treaty, as amended by the fifth protocol.

11 The CRA has said that LLCs created under the legislation of a state of the United States are corporations for the purposes of the Act: see, for example, CRA document nos. 9729780, November 14, 1997, and 9713120, May 20, 1997.

States for the purposes of the Canada-US tax treaty.[12] Accordingly, income paid or credited to an LLC was subject to the full 25 percent withholding tax rate. Now, under article IV(6), treaty-eligible members of LLCs are considered to derive the Canadian income directly and can benefit from the treaty on their portion of payments to the LLC, provided that the LLC is fiscally transparent in the United States.[13]

On a literal reading of article IV(6), it may be possible for a US person to obtain treaty benefits when its investment is held through a non-US and non-Canadian entity, provided that the entity is fiscally transparent in the United States. For example, when a US resident invests in a Cayman Islands partnership that is fiscally transparent in the United States, the Canada-US tax treaty will apply to the US resident's Canadian income received through the partnership. The technical explanation to the fifth protocol[14] gives the example of a US resident owning a French entity that earned Canadian-source dividends. If the French entity is fiscally transparent in the United States, then, regardless of its treatment under Canadian or French law, the US resident will be considered to derive the Canadian dividends directly for the purposes of the Canada-US tax treaty, thereby ignoring the Canada-France tax treaty.[15] Department of Finance officials have confirmed that the lower of two treaty rates could apply.[16]

Recent court cases relating to treaty eligibility, such as *The Queen v. Prévost Car Inc.*[17] and *The Queen v. MIL (Investments) SA*,[18] are relevant. These cases have been extensively discussed elsewhere and are beyond the scope of this article, which deals mainly with widely held Canadian investment funds. However, when a non-resident

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12 According to CRA document no. 2004-0064761R3, January 1, 2004, an LLC could be treaty-eligible if it elected under the Internal Revenue Code of 1986, as amended, to be a corporation that would be subject to US income taxes.

13 The 15 percent dividend withholding tax rate in article X(2) can be reduced to 5 percent if the US resident is the beneficial owner of at least 10 percent of the voting stock of the paying Canadian company. As a result of the fifth protocol's changes to article X(2), the beneficial ownership test now allows a US resident to include its proportionate share of the Canadian stock held through fiscally transparent entities such as LLCs. This situation is unlikely to arise in the case of widely held Canadian investment funds because it is unlikely that a non-resident would hold more than 10 percent of a corporate fund's voting stock.

14 United States, Treasury Department, Technical Explanation of the Protocol Done at Chelsea on September 21, 2007 Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as Amended by the Protocols Done on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997.

15 Convention Between Canada and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Paris on May 2, 1975, as amended by protocols signed on January 16, 1987 and November 30, 1995.

16 See Douglas A. Cannon, Marc Darmo, and Jeff Oldewening, "The Fifth Protocol to the Canada-US Income Tax Convention: A Review of Selected Provisions," in *Report of Proceedings of the Fifty-Ninth Tax Conference*, 2007 Conference Report (Toronto: Canadian Tax Foundation, 2008), 24:1-92, at 24:10.

17 2009 DTC 5053 (FCA).

18 2007 DTC 5437 (FCA).

investor uses blocker entities to invest in Canada to obtain treaty benefits, it is important (1) to ensure that there is sufficient support for the determination of the residence of the blocker in the treaty country and (2) to consider the possible application of the general anti-avoidance rule (GAAR) in section 245.

Withholding Tax Administration

As indicated above, the treaty-reduced rates automatically apply as a matter of law. The Canadian investment fund has the withholding tax liability and, jointly with the non-resident, is liable for any interest on outstanding payments. Also liable are agents or other persons who receive amounts on behalf of non-residents.[19] Although no legislative provisions specify the level of due diligence that a payer must perform to determine whether a non-resident investor is treaty-eligible, the CRA has provided some guidance on its administrative and assessing policy, which does not have the force of law.

The CRA has stated that the payer can accept the name and address of the non-resident as being that of the beneficial owner unless there is reasonable cause to suspect otherwise.[20] In any doubtful situations, the payer may request that the non-resident investor provide a certificate of its residence so that a lower rate of withholding tax, in accordance with a tax treaty, can be applied.[21] If such a certificate is not provided, the payer will likely withhold at the full 25 percent rate to absolve itself of any liability.

If a non-resident investor is eligible for treaty benefits but the payer has withheld an amount in excess of the amount that the non-resident was liable to pay, pursuant to subsection 227(6) the non-resident can request a refund of the excess from the CRA, provided that the request is made within two years after the calendar year-end in which the amount was paid.[22] However, non-resident investors would rather not

19 Subsection 215(3) contains withholding tax requirements for agents or other persons who receive an amount on behalf of a non-resident for which part XIII tax is applicable but has not been withheld. On a literal reading of the application of subsections 215(1) and (3), one could infer that every person involved in a payment from a Canadian investment fund—from various agents such as custodians and sub-custodians to the agent or broker that made the payment directly to the non-resident investor—could be liable and subject to penalties for the withholding taxes not remitted. Further, subsections 215(1) and (3) do not specify that the payer is Canadian, which might also imply that the liability and penalties could apply to non-resident intermediaries or agents, although they might be difficult for the CRA to enforce.

20 Paragraph 4 of *Information Circular* 76-12R6, "Applicable Rate of Part XIII Tax on Amounts Paid or Credited to Persons in Countries with Which Canada Has a Tax Convention," November 2, 2007.

21 The CRA administrative concession for full treaty exemption in the case of pension funds or charitable organizations, for example, under the Canada-US tax treaty is described in paragraph 78 of IC 77-16R4, supra note 3, which requires an application process. Presumably, the same procedures would be required under other treaties with similar articles.

22 The prescribed form is form NR7-R, "Application for Refund of Non-Resident Part XIII Tax Withheld."

file refund requests because they prefer to have access to money when it is owed to them and to avoid possible delays in the CRA's processing of their requests. Therefore, to avoid any excess withholdings, non-resident investors should provide the Canadian investment fund with proper documentation supporting their treaty eligibility when requested.

In light of the recent changes to the Canada-US tax treaty and the joint liability of payers and non-residents for withholding taxes, payers are required to use due diligence to determine the correct withholding tax rates. However, it is often difficult for the Canadian payer to do so for fiscally transparent entities in addition to determining whether any non-resident investor is treaty-eligible. The new limitation-on-benefits (LOB) provision in article XXIX A of the Canada-US tax treaty has exacerbated the difficulty; it would be administratively challenging, or perhaps impossible, for a Canadian investment fund to determine whether a US resident was a qualifying person. In June 2009 the CRA released for commentary by the tax community draft forms that would help payers determine which treaty rate to apply by having the non-resident investors, including fiscally transparent entities and partnerships, certify their treaty eligibility.[23] These forms are not mandatory and need not be remitted to the CRA. However, a diligent Canadian payer may request that a non-resident investor complete its applicable form. As at January 2010, the CRA had stated that it is considering comments from the tax community and will release the forms in their final versions when its review is complete. The CRA has indicated that the current guidance in *Information Circular* 76-12R6 will continue to apply until the forms are finalized.[24] Further, when the payer believes that the LOB provisions in the Canada-US tax treaty may apply to deny a US investor treaty benefits, the payer can request from the US investor certification that it is treaty-eligible.

Gains Realized from the Disposition of Taxable Canadian Property

Domestic Income Taxes

Pursuant to paragraph 115(1)(b), a non-resident is subject to Canadian income tax (part I tax) on the non-resident's gains realized from the disposition of "taxable Canadian property" (TCP) unless the property was "treaty-protected property" as defined in subsection 248(1). TCP currently includes, among other things, real property situated in Canada, shares of unlisted Canadian corporations, units of a unit trust that is not a mutual fund trust,[25] and an interest in a partnership if it holds certain property.

23 Form NR303, "Declaration of Benefits Under a Tax Treaty for a Hybrid Entity"; form NR302, "Declaration of Benefits Under a Tax Treaty for a Partnership with Non-Resident Partners"; and form NR301, "Declaration of Benefits Under a Tax Treaty for a Non-Resident Taxpayer" for all other non-residents.

24 Supra note 20; see Canada Revenue Agency, "Proposed Declaration Process for Applying Treaty Benefits to Income Paid to Non-Residents," last updated October 28, 2009 (http://www.cra-arc.gc.ca/formspubs/frms/nr301-2-3-eng.html).

25 As defined in subsection 132(6).

Whether an entity is TCP is a question of fact. The 2010 federal budget proposed a change to the definition of "taxable Canadian property."[26] Under this proposal, property will be TCP if, at any particular time during the 60-month period that ends at the time of the disposition, more than 50 percent of the fair market value of the shares, an interest in a partnership, or an interest in a trust, as the case may be, was derived directly or indirectly from one or any combination of

1. real or immovable property situated in Canada;
2. Canadian resource properties;
3. timber resource properties; and
4. options in respect of, or interests in, or for civil-law rights in, property described in any of points 1 to 3, whether or not the property exists.

Currently, shares listed on a designated stock exchange or of a mutual fund corporation and units of a mutual fund trust are not TCP unless the non-resident, together with non-arm's-length parties, owns more than 25 percent of the securities. The proposals also narrow this definition.[27] In addition to the 25 percent holding test, the 50 percent fair market value test described above must also be met in order for this type of property to be TCP to the non-resident.

The proposed change is beneficial for non-residents investing in Canada because it eliminates onerous filing requirements (described below) and reduces taxes paid in Canada. Further, while gains from the disposition of most Canadian investments are treaty-eligible, the narrowed definition allows non-residents to rely on domestic law rather than on a treaty for an exemption from gains. This will be most beneficial to non-residents in non-treaty countries. The proposed change will apply to dispositions occurring after March 4, 2010.

"Treaty-protected property" means property any income or gains from a disposition of which would, because of a tax treaty with another country, be exempt from tax under part I. For example, shares of an unlisted Canadian corporation and units of a unit trust that is not a mutual fund trust are TCP, and certain units of a partnership can be TCP. If a US resident disposes of such shares or units, articles XIII(3) and (4) of the Canada-US tax treaty provide that the gain will be exempt from Canadian taxation if the value of the shares or units is not derived principally from real property situated in Canada. This exemption is found in most of Canada's tax treaties, although in each case the relevant treaty provisions should be reviewed.[28] If a non-resident investor does not meet the treaty eligibility requirements, restructuring

26 Canada, Department of Finance, 2010 Budget, Notice of Ways and Means Motion To Amend the Income Tax Act and Income Tax Regulations, March 4, 2010, resolution no. 38.

27 Ibid.

28 For example, article 13(5) of the Canada-China tax treaty (Agreement Between Canada and the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Beijing on May 12, 1986) provides that gains derived by a resident of a contracting state from the alienation of any property other than

may be available to include a blocker that is resident of a treaty country. However, as noted above, care should be taken to ensure that GAAR does not apply to the structure.

A non-resident's gain from its disposition of TCP is calculated under Canadian tax rules. The gain is generally calculated as the amount by which the investor's proceeds of disposition, less any reasonable costs of disposition, exceed its adjusted cost base of the property.[29] (The calculation of an investor's adjusted cost base is discussed separately in the sections that follow for each type of investment fund vehicle.) Once the gain is computed, the applicable rate of Canadian income tax will depend on the legal characterization of the non-resident investor. A non-resident corporation is subject to a 28 percent federal corporate rate in 2010.[30] The rate for an individual non-resident is graduated; the highest rate is 42.92 percent for income for tax purposes that exceeds $127,021 in 2010.[31] Provided that the TCP is capital property to the non-resident investor, only 50 percent of the capital gain is included in its income for tax purposes.[32]

Filing Requirements

Regardless of whether a non-resident is exempt from Canadian income taxes on its gains realized from the disposition of TCP, Canadian tax filings may be required from the non-resident investor. Subsection 116(3) requires a non-resident that disposes of TCP other than "excluded property" (discussed below) to send to the minister, within 10 days after the disposition, certain information relating to the disposition, including a description of the property, the proceeds of disposition, and the non-resident's adjusted cost base. This notice is not required if the non-resident requested a clearance certificate prior to the disposition pursuant to subsection 116(1). The minister issues the clearance certificate when satisfied with the information provided by the non-resident. Without a clearance certificate, the purchaser is liable to pay and must remit to the minister on behalf of the non-resident as a prepayment of the non-resident's ultimate tax liability 25 percent of the non-resident's proceeds of disposition, and may withhold that amount from the proceeds or otherwise recover that amount from the non-resident vendor. The non-resident will not be able to recover any portion of the payment unless it files a Canadian income tax return.

This process is cumbersome for a partnership that disposes of TCP. The partnership is not taxed on the gain; rather, its partners are subject to tax on their portions of the gain. Accordingly, each of the partners is required to file a notice with the minister. Through a CRA administrative concession, however, the partnership can

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those referred to in articles 13(1) through (4) (immovable property, business property, and ships and aircraft) may be taxed in the contracting state in which they arise.

29 Subsection 40(1).

30 Pursuant to subsections 123(1) and 123.4(2).

31 Pursuant to subsections 117(2) and 120(1).

32 Paragraph 38(a).

file one notice on behalf of all of its partners, provided that certain information is submitted with the notice or request.[33]

"Excluded property" is defined in subsection 116(6) and includes shares of a class of the capital stock of a corporation listed on a recognized stock exchange,[34] units of a mutual fund trust, and property that is a treaty-exempt property of the non-resident. Under subsection 116(6.1), a property is a "treaty-exempt property" if it is a treaty-protected property of the non-resident person and, if the purchaser and the non-resident person are related at the time of disposition, the purchaser provides notice under subsection 116(5.02) to the minister outlining certain information in respect of the disposition.[35] In short, no section 116 notice is required if the property was treaty-protected property, provided that the disposition was not between related parties.

Even with the proposed 2010 federal budget changes, purchasers, in order to protect themselves from any liability pursuant to subsection 116(5), may still require that non-residents provide a clearance certificate. As is the case for a payer under part XIII, there are no legislative provisions or proposals specifying the level of due diligence that a payer is to perform to determine whether the non-resident vendor's property is treaty-exempt property or whether the property meets the 25 percent holding test to be excluded from the proposed TCP definition. Non-resident vendors may find that even with these changes, purchasers may still require them to obtain clearance certificates.

If the section 116 notification is required, the non-resident investor may also be required to file Canadian income tax returns reporting the disposition of TCP, unless three criteria are met:[36]

1. no tax was payable under part I for the year;
2. the non-resident had no tax liability under the Act in respect of previous years; and
3. each TCP disposed of was excluded property as defined in subsection 116(6), or the minister has issued to the non-resident a section 116 clearance certificate.

33 *Information Circular* 72-17R5, "Procedures Concerning the Disposition of Taxable Canadian Property by Non-Residents of Canada—Section 116," March 15, 2005, paragraph 10.

34 Defined in subsection 248(1) as a designated stock exchange, any other stock exchange if that stock exchange is located in Canada, or any other stock exchange in a country that is a member of the Organisation for Economic Co-operation and Development (OECD) and has a tax treaty with Canada. "Designated stock exchange" is defined in subsections 248(1) and 262(1) to include the Montreal Exchange, the TSX Venture Exchange (tiers 1 and 2), the Toronto Stock Exchange, and various foreign stock exchanges.

35 The definition of "treaty-exempt property" was added by the 2008 federal budget (Canada, Department of Finance, 2008 Budget, Notice of Ways and Means Motion To Amend the Income Tax Act, February 26, 2008, resolution 19) and is applicable for dispositions that occur after 2008.

36 See the definition of "excluded disposition" in subsection 150(5).

Accordingly, non-residents eligible for treaty relief from the taxation of capital gains on the disposition of TCP may not be required to file Canadian income tax returns. Further, a non-resident that has received a certificate under section 116 with respect to property disposed of that was not treaty-protected property is not obliged to file a Canadian income tax return. However, the non-resident may wish to do so if a tax refund is available.

The 2010 federal budget also proposes to amend section 164 to permit the CRA to issue a refund of a non-resident's taxes up to two years after the date on which the purchaser of the property is assessed by the CRA for taxes that the purchaser failed to withhold from the non-resident's proceeds.[37] This change will avoid situations in which the purchaser is assessed for taxes that are remitted on the non-resident's behalf after the non-resident's time to request a refund through filing an income tax return has passed. The proposed change will apply for refunds claimed in tax returns filed after March 4, 2010.

For dispositions that occurred before 2009, section 116 required that a non-resident notify the minister of a disposition of TCP and file Canadian income tax returns, whether or not the gain from the disposition was treaty-eligible. Many non-resident investors—in particular, partnerships with non-resident partners—viewed these reporting and filing requirements as onerous. A practice developed of using blockers, such as corporations that were fiscally transparent in their foreign jurisdiction, to invest in TCP so that each partner would not have to file the required documents. Legislation resulting from the 2008 federal budget alleviated this situation by introducing the exemption for treaty-protected property. Non-residents can now consider restructuring their investments in Canadian investment funds; however, the tax implications both in Canada and in the foreign country should be taken into account to ensure that capital gains are not triggered prematurely with the transfer of Canadian property.

TRUSTS

Basic Principles

Trusts are treated as taxable entities for tax purposes in Canada. However, trusts are generally not subject to income taxes, provided that the income earned by a trust is paid or made payable through distributions to beneficiaries (including non-resident beneficiaries), because those amounts are deductible by the trust in computing its income.[38] A trust that is not a mutual fund trust may be subject to part XII.2 tax levied at a rate of 36 percent if it has "designated income," which includes gains from the disposition of TCP and business income, that is distributed to a "designated beneficiary," which includes non-resident beneficiaries. These types of trusts do not normally have non-resident investors because of the cost of part XII.2 tax. The most commonly used investment trust is a mutual fund trust.

37 Supra note 26, resolution no. 41.

38 Pursuant to subsection 104(6).

By definition, a mutual fund trust is a widely held investment[39] whose only undertaking is the investing of its funds in property (other than real property or an interest in real property), and/or the acquiring, holding, maintaining, improving, leasing, or managing of any real property (or interest in real property) that is capital property of the trust. One of the benefits of investing in a mutual fund trust is that some if not all of its capital gains earned in a year can be retained (that is, not distributed to investors) when there are redemptions of units in the trust and the trust has an unrealized gain at the end of a taxation year in respect of its investments ("capital gains refund").[40]

The purpose of the capital gains refund is to enable the mutual fund trust to avoid the double taxation that could result when an investor redeems out of the trust. For example, assume that a mutual fund trust has an unrealized gain of $1,000. One of its investors wants to redeem its 10 percent share of the trust. If the trust sells its securities to pay for the investor's redemption, it will realize a $100 capital gain that will be distributed to its remaining investors. The redeeming investor will also realize a $100 capital gain on its redemption of trust units. Thus, the same $100 capital gain is taxed in the hands of the remaining investors and the redeeming investor. By virtue of the capital gains refund mechanism, the redeeming investor will continue to be subject to tax on its $100 capital gain; however, the trust will not have to distribute the $100 capital gain that it realized to its remaining investors. Rather, the $100 capital gain can be retained by the trust and subjected to tax at the fund level; that tax is then refundable to the trust. Because the payment of distributions reduces a trust's NAV, the capital gains refund mechanism allows the remaining investors to defer the recognition of a capital gain earned by the trust, which would otherwise have been distributed, until the investor redeems or sells its units of the trust.[41]

Income Paid or Credited to Non-Residents

Paragraph 212(1)(c) specifies that income of a trust that is included in the income of a non-resident under subsection 104(13) is subject to the 25 percent withholding tax rate. Since a trust is subject to tax on 50 percent of its capital gains, only 50 percent of its capital gains distribution designated to non-residents will be subject to withholding taxes.[42] Paragraph 212(1)(c) exempts non-residents from the 25 percent tax on income paid in respect of a mutual fund trust's taxable capital gains that is

39 Conditions in regulation 4801 include the requirement that at any time there be no fewer than 150 beneficiaries, each of whom holds a block of units with an aggregate fair market value of at least $500.

40 The capital gains refund is defined in subsection 132(1).

41 This is the optimal result. Because this calculation is based on a formula that has limitations, the actual capital gains refund does not always reflect the optimal result.

42 Paragraph 38(a) provides that Canadians, including trusts, are required to include 50 percent of capital gains in their taxable income. Therefore, a trust will deduct only 50 percent of the capital gains distributed to its beneficiaries when calculating its taxable income, even though it will distribute 100 percent of its capital gains.

allocated to the non-resident beneficiary pursuant to subsection 104(21). In effect, paragraph 212(1)(c) causes amounts deducted by a Canadian trust and paid or payable to non-resident beneficiaries to be subject to 25 percent withholding tax under part XIII.[43] There is no withholding tax on so-called return-of-capital distributions.[44]

A trust can deduct from its income amounts that are payable to a beneficiary whether or not they are actually paid. Part XIII tax, however, applies at the time the amounts are paid. To ensure that tax is not improperly deferred, paragraph 214(3)(f) deems amounts payable by a trust to be paid or credited to the non-resident and therefore subject to withholding tax under paragraph 212(1)(c). Paragraph 214(3)(f) applies to amounts on which a non-resident would be taxed if the non-resident were subject to part I tax (that is, regular Canadian income tax). The provision deems such amounts to be paid on the earlier of the day on which the trust income is paid and 90 days after the trust's year-end.

The 25 percent withholding tax rate can be reduced if the non-resident is eligible for treaty benefits. For example, the rate is reduced to 15 percent for trust income paid or credited to US investors, subject to article IV and the LOB provisions in the Canada-US tax treaty.[45]

Subsection 212(11) provides that income loses its character and becomes income from a trust when it is distributed to a non-resident investor. Accordingly, if a trust earns interest, the interest loses its character when it is distributed to non-resident investors and becomes trust income. The trust income is subject to the 25 percent part XIII withholding tax rate unless a treaty-reduced rate applies. Effective in 2008, there are domestic exemptions from withholding taxes on interest, other than interest on non-arm's-length debt or participating debt.[46] Therefore, it would be disadvantageous for a non-resident investor to invest in a trust that earns mostly interest income, because the non-resident would be exempt from withholding taxes if it received interest and held the Canadian debt as a direct investment.[47]

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43 The remaining 50 percent or the non-taxable capital gains distribution should not be subject to withholding taxes because that amount was not deducted by the trust in computing its income.

44 Return-of-capital distributions are not included in a beneficiary's income under subsection 104(13) and therefore are not subject to withholding taxes under subparagraph 212(1)(c)(i).

45 Article XXII(2) of the Canada-US tax treaty.

46 See paragraph 212(1)(b). "Participating debt interest" is defined in subsection 212(3).

47 Paragraph 212(9)(c) provides that if a mutual fund trust was maintained primarily for the benefit of non-resident persons, interest that would be exempt from part XIII tax if earned directly by the non-resident investor will be similarly exempt if earned through a trust. This implies that arm's-length interest and fully exempt interest, such as government bond interest, will not be subject to part XIII tax when a non-resident earns the interest through a trust. However, a mutual fund trust typically is not maintained primarily for the benefit of non-resident persons, because the trust will lose its status as a mutual fund trust under subsection 132(7) unless all or substantially all of the trust's property does not consist of TCP or the trust did not issue its units to a person that it had reason to believe, after reasonable inquiry, was non-resident. This does not mean that a mutual fund trust cannot issue its units to non-residents; rather, its units must be maintained primarily for Canadian investors.

The character of Canadian dividends received by a trust can be maintained when the dividends are made payable to Canadian investors pursuant to subsection 104(19), which permits a trust to designate Canadian dividends as being received directly by the beneficiary and not by the trust. This designation does not apply to amounts paid to non-residents. Accordingly, non-resident investors do not get the benefit of treaty-reduced withholding rates on dividends when the dividends are earned and made payable by a trust.

A notable exception to this rule is a payment from a specified investment flow-through (SIFT) trust. A SIFT trust is generally a Canadian trust with units listed or traded on a stock exchange or other public market that holds non-portfolio properties such as business properties.[48] Subsection 104(16) provides that certain distributions paid from SIFT trusts that are taxed as dividends under Canadian tax law will be considered Canadian dividends paid from a Canadian corporation for the purposes of part XIII withholding. This allows certain organizations that are not exempt from withholding taxes on trust income to be exempt from withholding taxes on certain distributions from SIFT trusts. For example, article XXI(2) of the Canada-US tax treaty provides for an exemption from withholding taxes on interest and dividends earned directly by US pension funds, but not trust income. Therefore, if a SIFT trust distributes Canadian dividend income to a US pension fund, the amount will be considered a dividend and will be subject to the nil treaty rate for the pension fund under articles XXI(2) and (3).

Article X(3) of the Canada-US tax treaty has been revised to read as follows:

> For the purposes of this Article, the term "dividends" means income from shares or other rights, not being debt-claims, participating in profits, as well as income that is subjected to the same taxation treatment as income from shares under the laws of the State of which the payer is a resident.

The revision substituted the word "payer" for "company." Consequently, distributions from Canadian SIFT trusts that are treated as Canadian dividends under Canadian tax laws will be considered dividends for the purposes of article X. However, it is uncertain whether an amount designated by a trust that is not a SIFT trust to be paid as a dividend will be affected by the change to the definition of "dividend" in the treaty. Such dividends may continue to be classified as other income and thus taxed at a rate of 15 percent when paid to a US pension fund.

In addition, article XXII(2) of the Canada-US tax treaty provides an exemption from withholding taxes to the extent that any amount distributed out of the Canadian trust's income arose outside Canada. Thus, if the Canadian trust distributes to a

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48 "SIFT trust" is defined in subsection 122.1(1). Unlike the trusts described in this article, the SIFT trust is subject to income taxes on earnings from its non-portfolio properties if it began trading after October 31, 2006. If the SIFT trust began trading on or before October 31, 2006, these rules will be effective in 2011, unless the SIFT trust exceeded certain growth pursuant to subsection 122.1(2).

US resident income that it earned outside Canada, no withholding taxes will apply. No similar paragraph is found in Canada's other major tax treaties.

While there are domestic exemptions from withholding taxes on the taxable portion of capital gains distributions paid or payable by mutual fund trusts, two other taxes may apply to non-resident investors in a mutual fund trust.

Part XIII.2 withholding tax applies to "assessable distributions" (the non-taxable portions of capital gains distributions and return-of-capital distributions) not otherwise subject to part XIII that are paid or payable from a mutual fund trust that is a "Canadian property mutual fund investment" of which

1. units are listed on a designated stock exchange, and
2. more than 50 percent of the fair market value of the units is attributable to real property in Canada, a Canadian resource property, or a timber resource property.[49]

The tax is levied at 15 percent; the non-resident can recover the tax by carrying back its loss, known as a "Canadian property mutual fund loss," calculated as the lesser of the total assessable distributions received and the loss realized from the disposition of its mutual fund trust units. This loss can be carried back three years or carried forward indefinitely.[50] It is expected that the mutual fund trust will notify the non-resident investor if its distributions are assessable distributions, and it may advise the non-resident to file the required part XIII.2 return to report the tax so that the tax can be recovered in subsequent years.[51]

In addition to part XIII.2 tax, subsection 132(5.1) may operate to apply part XIII taxes to the non-taxable portion of a capital gains distribution if more than 5 percent of the distribution was received by non-residents and the trust had a "TCP gains balance"—generally, gains arising from the trust's disposition of TCP. If the non-resident had invested directly in TCP, it would be subject to Canadian income tax on gains arising on a disposition of the TCP. The purpose of this additional part XIII tax is to ensure that non-residents are taxed on TCP gains even when the TCP is held by a mutual fund trust in which the non-resident invests. Unlike part XIII.2 tax, this tax is not refundable.

Gains Realized from the Disposition of Taxable Canadian Property

As outlined above, non-residents may be subject to Canadian income taxes if the non-resident disposes of TCP. Units of a trust may be TCP if

49 A "Canadian property mutual fund investment," as defined in subsection 218.3(1).

50 Subsection 218.3(6).

51 The prescribed form for this return is form T1262, "Part XIII.2 Tax Return for Non-Resident's Investments in Canadian Mutual Funds."

1. they are units of a trust that is not a mutual fund trust;[52] or
2. they are units of a mutual fund trust of which, at any time during the 60-month period that ends at the time of disposition, the non-resident, together with persons with whom the non-resident did not deal at arm's length, held 25 percent or more of the issued units.[53]

As noted above, under the 2010 federal budget proposals, after March 4, 2010 such units will be TCP only if, in addition to meeting one of these criteria, the units also meet the 50 percent fair market value test.

The non-resident investor will likely be subject to fewer Canadian income tax filings and withholding taxes if the Canadian trust investment is a mutual fund trust. If it is TCP, the non-resident investor must maintain records sufficient to support its adjusted cost base for Canadian tax purposes, which will be used to calculate the gain from its disposition of the trust units. In general terms, the adjusted cost base for a trust investment is calculated as

1. the investor's initial investment, plus
2. reinvested distributions, which should exclude any part XIII tax paid on the distributions, less
3. return-of-capital distributions.

If an investor purchases identical units of the trust on different occasions, the cost bases of the identical units are to be averaged to determine the adjusted cost base per unit.[54]

CORPORATIONS

Basic Principles

A corporation, regardless of whether it is an unlimited liability company that is fiscally transparent in foreign jurisdictions, is taxed as a single entity in Canada. Unlike a trust, a corporation cannot deduct distributions paid to shareholders in computing its income; however, it generally can deduct intercorporate dividends received from other Canadian corporations.[55] Canadian dividends earned by a "private" or "subject" corporation are also deductible, but they are subject to part IV tax, which is refundable by the corporation when it pays taxable dividends to its shareholders.[56] This results in the corporation being subject to income taxes on

52 Paragraph (i) of the definition of "taxable Canadian property," subsection 248(1).

53 Paragraph (j) of the definition of "taxable Canadian property," ibid.

54 Subsection 47(1).

55 Subsection 112(1).

56 "Private corporation" is defined in subsection 89(1) to include a corporation that is not a public corporation or controlled by a public corporation. "Subject corporation" is defined in subsection 186(3) to include a corporation that is controlled by an individual or a group of individuals.

other forms of income, such as interest, foreign income, and taxable capital gains. Because of the tax liability imposed at the corporate level, a Canadian investment fund that is structured as a corporation and earns this kind of income may be less attractive to a non-resident than a trust. A mutual fund corporation may be used to reduce the tax liability of a corporation, as explained below.

By definition,[57] a mutual fund corporation is a public corporation[58] whose only undertaking is the investing of its funds in property (other than real property or an interest in real property) and/or the acquiring, holding, maintaining, improving, leasing, or managing of any real property (or interest in real property) that is capital property of the corporation. Notwithstanding that a mutual fund corporation is a public corporation, it is subject to part IV taxes on Canadian dividends received, but it will obtain a refund of those taxes when taxable dividends are paid to shareholders.[59] A mutual fund corporation can also obtain a refund of taxes on realized capital gains through a capital gains refund or through the payment of capital gains dividends.

The capital gains refund allows the mutual fund corporation to retain some or all of its capital gains when there are redemptions of shares of the corporation.[60] A mutual fund corporation is subject to non-refundable income taxes on other forms of income such as interest and foreign income.[61] If those types of income are significant, the value of shares of the mutual fund corporation to a non-resident investor will be less than the aggregate value of the same underlying investments held in a mutual fund trust because of the tax liability at the corporate level. Depending on the investments of the corporation, this tax may not be significant.

Income Paid or Payable to Non-Residents

Pursuant to subsection 212(2), a non-resident investor will be subject to part XIII withholding taxes on taxable dividends paid or credited by Canadian corporations.

57 See subsection 131(8).

58 "Public corporation" is defined in subsection 89(1) as a corporation (1) whose shares are publicly traded and listed on a designated stock exchange in Canada, or (2) that elects to be a public corporation, provided that at the time of the election the conditions in regulation 4800 are met, which includes the requirement that there be no fewer than 150 or 300 shareholders (depending on the type of shares), each of whom holds a block of units with an aggregate fair market value of at least $500.

59 Subsection 131(5) deems a mutual fund corporation to be a private corporation for the purposes of part IV if the mutual fund corporation is not an "investment corporation" throughout the year. "Investment corporation" is defined in subsection 130(3) as a corporation that meets particular investment and holder tests. Relatively few mutual fund corporations qualify as investment corporations, with the result that most are subject to part IV tax in respect of Canadian dividends received.

60 The method of calculating the capital gains refund for a mutual fund corporation is set out in subsection 131(2).

61 Mutual fund corporations are not eligible for the general rate reductions in section 123.4, because they can benefit from the capital gains refund. The federal corporate tax rate for a mutual fund corporation is 28 percent.

Capital gains dividends paid by a mutual fund corporation are exempt from withholding taxes under this provision. As is the case with mutual fund trusts, however, part XIII.2 withholding tax will apply on assessable distributions, and the additional part XIII tax will apply if more than 5 percent of the dividend was received by non-resident shareholders and the mutual fund corporation had a TCP gains balance.[62] Both taxes are calculated in a manner similar to the taxes applicable to mutual fund trusts.

Gains Realized from the Disposition of Taxable Canadian Property

As outlined above, a non-resident that disposes of TCP may be subject to Canadian income taxes. Shares of a Canadian corporation may be TCP if

1. the shares are not listed on a designated stock exchange, other than shares of a mutual fund corporation,[63] or
2. the shares are listed on a designated stock exchange or are shares of a mutual fund corporation, if at any time during the 60-month period that ends at the time of the disposition, the non-resident, together with persons with whom it does not deal at arm's length, owned 25 percent or more of the issued shares of any class of the capital stock of the corporation that issued the share.[64]

As noted above, under the 2010 federal budget proposals, after March 4, 2010 such shares will be TCP only if, in addition to meeting one of these criteria, the shares also meet the 50 percent fair market value test.

The non-resident investor will likely be subject to fewer Canadian income tax filings and withholding taxes if the Canadian corporate fund is a mutual fund corporation or if its shares are listed on a designated stock exchange. If it is TCP, the non-resident investor will have to maintain records sufficient to support the adjusted cost base for Canadian tax purposes that will be used to calculate its gains from the disposition of the shares. In general terms, the calculation of the adjusted cost base for a corporate investment is similar to the calculation of a trust's adjusted cost base, as described above.

PARTNERSHIPS

Basic Principles

Partnerships are not taxable entities; rather, the partners are subject to tax on their proportionate share of the partnership's income and gains, regardless of whether the amounts were distributed. Nevertheless, a partnership calculates its taxable income

62 The additional part XIII tax is calculated under subsection 131(5.1) for mutual fund corporations.

63 Paragraph (d) of the definition of "taxable Canadian property," subsection 248(1).

64 Paragraph (f) of the definition of "taxable Canadian property," ibid.

for Canadian tax purposes as if it were a taxpayer and notifies its partners of their share of the partnership's income and gains.[65]

A non-resident is required to report the income on a Canadian income tax return if the income and gains earned by the partnership relate to the partnership's carrying on business in Canada or the partnership's disposition of TCP.

Income Earned by Non-Residents

Distributions from partnerships are not subject to part XIII withholding taxes. However, withholding taxes will apply to income paid or credited to the partnership, as discussed below.

Passive Income

Paragraph 212(13.1)(b) provides that part XIII tax applies on amounts paid or credited to any partnership that is not a Canadian partnership.[66] This category includes any partnership (including a partnership created in Canada) with at least one non-resident partner. Partnerships are generally not eligible for treaty benefits because they are not considered "resident" for the purposes of any treaty by virtue of their not being liable for income taxes in any jurisdiction. As a result, a partnership is subject to the full 25 percent withholding tax rate on amounts paid or credited to it. Administratively, the CRA has allowed partners of a partnership to obtain treaty benefits on their portion of the income paid or credited to the partnership.[67] As discussed earlier, treaty-eligible US partners of partnerships need not rely on this administrative concession, owing to the "fiscally transparent" provisions in article IV(6) of the Canada-US tax treaty.

Generally, income received by the partnership retains its character in the hands of a partner. For example, a partner is considered to have directly received the dividends and interest earned by the partnership. Accordingly, part XIII tax applies to dividends received. Interest received by the partnership, other than interest on non-arm's-length debt or participating debt, is exempt from withholding taxes under domestic rules.[68]

Business Income

If the partnership carries on business in Canada, the partners of the partnership are considered to carry on the business of the partnership by virtue of paragraph 96(1)(c). In this situation, the partners are subject to tax on their proportionate

65 The prescribed form for reporting partners' income is form T5013, "Statement of Partnership Income."

66 As defined in subsections 248(1) and 102(1).

67 In various CRA documents, including document nos. 9231095, February 18, 1993, and 2004-0074241E5, July 19, 2005.

68 Paragraph 212(1)(b).

shares of the partnership's business income under part I of the Act and are required to file Canadian tax returns. Whether an investment fund carries on a business is a question of fact. In most situations, an investment fund structured as a partnership does not consider itself to be carrying on a business in Canada; however, this point should be confirmed by the partnership.

Even if the partnership carries on a business, most treaties with Canada will provide relief from taxation in Canada.[69] As a practical matter, a tax return should be filed to avoid failure-to-file penalties under subsection 162(2.1) or (7). The treaty-protected tax return is an abbreviated version of the return that Canadian residents must file, so the administrative burden is somewhat lightened.

Gains Realized from the Disposition of Taxable Canadian Property

A non-resident investor may be subject to Canadian income taxes if it realizes gains either from a disposition of a partnership interest that is TCP or from a disposition of TCP by the partnership. A partnership interest is TCP if, at any particular time during the 60-month period that ends at that time, the fair market value of all of the properties of the partnership, each of which was

1. TCP,
2. Canadian resource property,
3. a timber resource property,
4. an income interest in a trust resident in Canada, or
5. an interest in or an option in respect of a property described in point 2, 3, or 4, whether or not that property exists,

was greater than 50 percent of the fair market value of all its property. As discussed above, the 2010 federal budget proposals narrow the definition of TCP, and thus fewer partnership interests will be TCP.

It can be difficult for a non-resident to determine whether its partnership investment is TCP. The partnership should be able to advise non-residents on its status and on whether additional filings to report TCP gains are required. If the partnership units are TCP, the non-resident partner is responsible for maintaining records sufficient to support its adjusted cost base for Canadian tax purposes, which will be used to calculate its gains from the disposition of the partnership units. In general terms, the adjusted cost base for a partnership investment is calculated as

1. the investor's initial investment, plus
2. additional contributions, plus

69 For example, articles V and VII of the Canada-US tax treaty provide relief from business profits taxation in the other country if the resident of one country does not have a permanent establishment in the other country.

3. the investor's share of the income of the partnership, less
4. the investor's share of the loss of the partnership, less
5. distributions of capital.[70]

If the partnership disposes of TCP, each partner is considered to dispose of its proportionate share of the TCP. In addition to the section 116 notification process discussed above, each partner is required to file a Canadian income tax return to report its share of the partnership's TCP gain, unless the TCP was excluded property. The information necessary to report any TCP gain should be obtained from the partnership. The filing of income tax returns to report TCP gains of a partnership becomes onerous in situations where each partner's proportionate share is nominal.

COMPARING INVESTMENT FUND VEHICLES

The appendix to this article illustrates how income earned in a trust, a corporation, or a partnership is taxed at both the fund level and the non-resident investor level, and shows the implications for the NAV of the investment fund vehicle. For simplicity, the examples in the appendix assume that the capital gains refund does not apply to the mutual fund trust or the mutual fund corporation. If the mechanism were to apply, the capital gains distributions or dividends would be reduced and the NAV would increase accordingly.

The appendix shows that the tax implications for the non-resident investor depend on the type of income that is earned by the investment fund vehicle. In the example, both interest and other such income are flowed tax-free from a partnership. The same types of income are subject to withholding taxes when earned through a mutual fund trust or a mutual fund corporation. Moreover, a mutual fund corporation is not the ideal vehicle through which to earn interest or other such income, since such income is subject to income tax at the corporate fund level.

One should also consider the tax consequences of a non-resident investor's disposition of Canadian investment fund units or shares. If the units or shares are not TCP (as that term is described in the case of each type of fund vehicle), the disposition will have no Canadian tax implications.

RECENT INTERNATIONAL DEVELOPMENTS

The OECD Committee on Fiscal Affairs is currently reviewing withholding tax requirements and liability. In 2006, the OECD asked a consultative group made up of representatives from countries in Europe, Asia, and North America, including the CRA, to review and comment on the withholding tax procedures of each country.[71]

70 Paragraphs 53(1)(e) and 53(2)(c). The partner's share of the partnership income and loss can generally be ascertained from form T5013, provided by the partnership to its partners.

71 The full name of the group is the Informal Consultative Group on Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors.

The group's main concern was whether there was double taxation or double non-taxation in the income source country and the investor's country. Specifically considered were investments held through collective investment vehicles (CIVs) and investments held through custodians and nominees. For economies of scale, most investors pool their funds by using CIVs, which are widely held, hold diversified portfolios of securities, and are subject to investor protection regulation in the countries in which they are established. Depending on the country in which a CIV is established, it can take the form of a corporation, a partnership, a trust, or a contractual arrangement. Each structure may be treated differently for treaty purposes, depending on the income source country.

With respect to CIVs, the CRA, for example, considers an investment fund structured as a Luxembourg société d'investissement à capital variable (SICAV) an entity for Canadian tax purposes, but not liable for tax and therefore not treaty-eligible for the purposes of the Canada-Luxembourg tax treaty.[72] The CRA has taken the view that an Irish common contractual fund (CCF) is a non-entity for Canadian tax purposes for which the non-resident investors could potentially obtain treaty benefits on their portion of Canadian income.[73] However, it is difficult for the CCF to certify and track its treaty-eligible investors, as is required by Canadian payers in order to apply treaty-reduced withholding tax rates. Accordingly, non-resident investors investing in Canada through entities such as SICAVs and CCFs may be subject to more tax than they would have been had they invested in Canada directly.

In January 2009, the consultative group released two reports for the OECD's consideration.[74] One report addressed the legal and policy issues relating to CIVs; the other addressed general approaches to procedures for the making and granting of treaty claims for intermediary structures. The reports included suggestions for

1. improving the process by which treaty benefits can be claimed,
2. updating the model convention to deal with CIVs, and
3. adopting new administrative procedures in current and future treaty revisions.

In December 2009, in response to the consultative group's recommendations with respect to CIVs, the OECD released for public discussion and commentary a report setting out proposed changes to the OECD model tax convention commentary

72 Convention Between Canada and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Luxembourg on September 10, 1999. See CRA document no. 2004-0054831E5, March 29, 2004.

73 CRA document no. 2004-0106731R3, January 1, 2005.

74 OECD, Informal Consultative Group on Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles* (Paris: OECD, January 12, 2009), and *Possible Improvements to Procedures for Tax Relief for Cross-Border Investors* (Paris: OECD, January 12, 2009).

dealing generally with whether CIVs or their investors are entitled to treaty benefits on income received by CIVs.[75] The report considered procedural changes to existing treaties and proposed amendments to future treaties. One of the discussion points was whether a CIV qualified as a "person," a "resident of a Contracting State," and the "beneficial owner" of income for the purposes of treaty eligibility. If the CIV does not meet these treaty definitions, then, in principle, the investors should be able to claim treaty benefits, or countries should adopt procedures to allow a CIV to make claims on behalf of its investors. Currently, the CRA considers some entities, such as the Luxembourg SICAV, to be corporations not eligible for treaty benefits. If the CRA accepts the OECD proposals, an investor in a SICAV will be able to claim treaty benefits on its portion of the Canadian income received by the SICAV, through rules similar to the new rules applicable to LLCs in article IV of the Canada-US tax treaty.

CONCLUSION

The Canadian tax implications for a non-resident investor in Canadian investment funds will depend on the type of entity in which the non-resident invests; the choice will affect the amount and type of distributions, the applicable withholding taxes, and whether gains from the disposition of the interest will be subject to tax in Canada. Consideration should be given to the types of investments that will be held in the investment fund to determine which vehicle best achieves tax efficiency for its non-resident investors.

With the growth in cross-border investments, access to non-resident treaty benefits is becoming increasingly important. The recent withholding tax developments are promising for non-resident investors who are treaty-eligible, and help to ensure that the investors will be able to access treaty benefits. They may also ensure that appropriate withholding tax procedures are in place to permit non-resident investors to continue to benefit from treaty rates even when investments into Canada are made through custodians or nominees or indirectly through other investment vehicles. When treaty benefits are difficult to obtain for non-resident investors, such as those that invest through SICAVs and CCFs, either the CRA's administrative views should be reconsidered or treaties should be renegotiated. Regardless of the approach, the attainment of a successful result is likely to require extensive consultation.

The proposed changes in the 2010 federal budget narrow the circumstances in which treaty-eligible and non-treaty-eligible investors are taxable on the sale of their investments and have Canadian filing obligations.[76] These changes are a further significant step in the right direction for non-resident investors in Canada.

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75 OECD, Informal Consultative Group on Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*, Public Discussion Draft (Paris: OECD, December 9, 2009).

76 Supra note 26.

APPENDIX Taxation of Income Earned in a Trust, Corporation, or Partnership

Assumptions

- Net asset value before distributions/dividends 500,000,000
- Income earned by investment fund
  - Other income (futures contracts)....... 1,000,000
  - Canadian dividends 1,000,000
  - Interest................. 1,000,000
  - Capital gains............ 2,000,000
- 10% of fund held by non-resident.
- Treaty-eligible non-resident is a US resident and qualifying person.
- Capital gains are not from the disposition of taxable Canadian property.
- No capital gains refund is available to the mutual fund trust and mutual fund corporation.
- Distributions or dividends are paid in cash and not reinvested in additional securities of the fund. Therefore, the net asset value decreases by the amount of the distributions or dividends.

Mutual fund trust		Mutual fund corporation		Partnership	
Fund-level income taxes		*Fund-level income taxes*		*Fund-level income taxes*	
Total non-refundable income taxes[a]	na	Other income (futures contracts)	1,000,000	Total non-refundable income taxes[j]	na
		Interest	1,000,000		
		Total income[e]	2,000,000		
		Total non-refundable income taxes[f]	840,000		

(The appendix is continued on the next page.)

APPENDIX Continued

Mutual fund trust		Mutual fund corporation		Partnership	
Distributions to investors		*Distributions to investors*		*Distributions/dividends to investors*	
Other income (futures contracts)	1,000,000	Taxable dividends	1,000,000	Total distributions/dividends[j]	na
Canadian dividends	1,000,000	Capital gains dividends	2,000,000		
Interest	1,000,000	Total dividends[f]	3,000,000		
Capital gains	2,000,000				
Total distributions[a]	5,000,000				
Net asset value after distributions	495,000,000	Net asset value after dividends and tax	496,160,000	Net asset value after dividends and tax[k]	499,999,750
Distribution to non-resident (10% of total)	5,000	Dividends to non-resident (10% of total)	3,000	Distribution to non-resident[j]	na
If non-resident is not treaty-eligible		*If non-resident is not treaty-eligible*		*If non-resident is not treaty-eligible*	
Withholding taxes on income[b]	750	Withholding taxes on taxable dividends[g]	250	Withholding taxes on income[l]	250
Withholding taxes on capital gains[c]	0	Withholding taxes on capital gains dividends[h]	0	Withholding taxes on capital gains[m]	0
Total withholding taxes	750	Total withholding taxes	250	Total withholding taxes	250
After-tax distributions	4,250	After-tax dividends	2,750	After-tax distributions	na

(The appendix is concluded on the next page.)

APPENDIX Concluded

Mutual fund trust		Mutual fund corporation		Partnership	
If non-resident is treaty-eligible		*If non-resident is treaty-eligible*		*If non-resident is treaty-eligible*	
Withholding taxes on income[d]	450	Withholding taxes on taxable dividends[i]	150	Withholding taxes on income[n]	150
Withholding taxes on capital gains[c]	0	Withholding taxes on capital gains dividends[h]	0	Withholding taxes on capital gains[m]	0
Total withholding taxes	450	Total withholding taxes	150	Total withholding taxes	150
After-tax distributions	4,550	After-tax dividends	2,850	After-tax distributions	na

na Not applicable.

[a] A trust will not be subject to income taxes, because it deducts distributions paid or payable to investors from its income.

[b] Total income distributions of $3,000 × 25% withholding tax.

[c] Capital gains distributions are not subject to withholding taxes when paid by a mutual fund trust pursuant to paragraph 212(1)(c) and subsection 104(21).

[d] Total income distributions of $3,000 × 15% withholding tax.

[e] Taxed at 42%, the 2009 effective corporate rate applicable to a mutual fund corporation that is an Ontario corporation (28% federal + 14% Ontario).

[f] A mutual fund corporation will not be subject to tax on capital gains and Canadian dividends when paid to investors. However, it will be subject to tax on other types of income.

[g] Taxable dividends of $1,000 × 25% withholding tax.

[h] Capital gains dividends are not subject to withholding taxes pursuant to subsection 212(2).

[i] Taxable dividends of $1,000 × 15% withholding tax.

[j] Partnerships are not taxable entities and do not have to pay distributions to reduce their income taxes.

[k] The net asset value of the partnership will be reduced by the 25% rate of withholding taxes withheld on the non-resident partner's allocation of the income.

[l] Canadian dividends of $2,000 × 25% withholding tax. The interest portion will be exempt from withholding taxes pursuant to paragraph 212(1)(b) and the other income from futures contracts generally will be exempt from withholding taxes unless the contracts are considered to be an interest in or option in respect of TCP.

[m] Capital gains are not subject to withholding taxes if not from the disposition of TCP.

[n] Canadian dividends of $2,000 × 15% withholding tax. The interest portion will be exempt from withholding taxes pursuant to paragraph 212(1)(b) and the other income from futures contracts generally will be exempt from withholding taxes unless the contracts are considered to be an interest in or option in respect of TCP.