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U.S. Investment in Canadian Real Estate

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I. Introduction

THE ACQUISITION of Canadian real estate by nonresidents is governed by a variety of federal and provincial regulations. The federal government regulates the acquisiton or establishment of businesses in Canada by nonresidents through the Foreign Investment Review Act. Under this Act the nonresident's acquisition of Canadian real estate may be subject to review by the Foreign Investment Review Agency (FIRA). In addition, several provinces have statutory provisions dealing with the acquisition of Canadian real estate by nonresidents. Ontario and Quebec impose substantial land transfer taxes upon the acquisition of Canadian real estate by nonresidents while certain other provinces limit the quantity and type of land which may be acquired by nonresidents of Canada.

A. *Foreign Investment Review Act*

Under the Foreign Investment Review Act, both the acquisition of control of an existing Canadian business and the establishment of a new Canadian business are subject to the review and approval of the FIRA. Conversely, if the acquisition of Canadian real estate by a nonresident does not constitute the acquisition of control of a Canadian business enterprise or the establishment of a new Canadian business the acquisition does not require the approval of FIRA. For this purpose a "business" is defined to include "any undertaking or enterprise carried on in anticipation of profit." Basically the distinction is one between the acquisition of real estate as an investment and the acquisition of real estate as part of carrying on a business.

FIRA has issued guidelines as to the circumstances to be considered in deciding whether a particular acquisition of Canadian real estate requires its approval. These guidelines set forth the following factors as being relevant in determining whether a nonresident who acquires Canadian real estate is acquiring control of a Canadian business enterprise.

1. The Nature Of The Property

The nature of the property can determine whether the FIRA approval is required for the acquisition of a particular piece of land. FIRA basically considers certain "types" of property relevant to determining

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their jurisdiction: (a) rental property, (b) real estate acquired in connection with other assets associated with carrying on a business, and (c) real estate that is a "circulating asset."

In the case of rental property the guidelines indicate that if the value of the property or its purchase price exceeds $10 million, ownership of the rental property will be considered to be the carrying on of a business. It would appear that even where the value of the rental property is less than $10 million, owning it may constitute carrying on a business by reference to other factors. If real estate is acquired in connection with the acquisition of other assets normally associated with the carrying on of a business, the acquisition of the real estate may be subject to a review by FIRA. Where the Canadian real estate constitutes a "circulating asset" (generally property frequently acquired and disposed of by the transferor) the acquisition of the real estate by a nonresident person will not be considered to be the acquisition of a business unless other factors, such as the value of the property and whether the property constitutes all or substantially all of the property used in the business, are significant enough to require review by the Agency.

2. Circumstances Relating To The Transferor

If the transferor is engaged in speculating, trading, dealing, developing, exploiting, leasing, or renting real estate the acquisition of the real estate is more likely to be considered to be the acquisition of a business. If the transferor of the real property holds the real property as a passive investment, however, ownership of the real estate is less likely to be regarded as a business.

3. Circumstances Relating To The Transferee

If the nonresident purchaser is engaged in speculating, trading, developing, exploiting, leasing, or renting real estate the acquisition of real estate in Canada is more likely to be subject to review and approval by FIRA.

Note that under the definition of business in the Act, the acquisition of real property by a nonresident with the intention of reselling it at a profit in the future would likely constitute a business. However, subsection 3(9) of the Act provides that the holding of land and the maintenance and improvement of the land for the personal use and enjoyment of the owners does not in itself constitute the carrying on of a business.

In summary, FIRA does not generally exercise its powers of review and approval unless the real estate is acquired in connection with a business carried on by a nonresident, or the value of rental property exceeds $10 million, or the nature of the property or business of the transferor arouses the Agency's interest.

B. Provincial Restrictions

1. Ontario

Under the Land Transfer Tax Act which was introduced in April, 1974, the registration of a conveyance of land, other than unrestricted land, by a nonresident person is subject to a tax of 20 percent of the value of the consideration for the conveyance. This is substantial when compared with the ordinary rate of land transfer tax in Ontario of 2/5 of one percent on the first $45,000 and 4/5 of one percent upon any excess. "Land" is defined to include land and buildings, a leasehold interest, an option in respect of real property rights created under an agreement of purchase and sale with respect to real property and goodwill attributable to the location of land or buildings. The 20 percent rate of tax is not eligible in respect of acquisitions of "unrestricted land" by nonresidents. "Unrestricted land" is defined to include land zoned for commercial or industrial uses, land assessed as residential under the Assessment Act or land that is actually used for commercial, industrial or residential purposes. Agricultural land, woodlands, recreational land and orchards are specifically excluded from the definition of unrestricted land. Therefore, the 20 percent land transfer tax will only apply to acquisitions of undeveloped land by nonresidents. The acquisition of rental property by nonresidents will be subject to the basic rate of tax. In certain situations, relief from the 20 percent rate of tax may be obtained by nonresidents.

The Ontario Land Speculation Tax Act which was also introduced in April, 1974 imposed a 20 percent tax on gains with respect to the disposition of land located in Ontario. This tax applied to both resident and nonresident speculators but was repealed with respect to dispositions of lands and closings occurring after October 24, 1978.

2. Quebec

The Quebec Land Transfer Duties Act, which was introduced in May, 1976, imposes a tax of 33 percent of the value of the consideration paid by a nonresident for the acquisition of land situated in Quebec. "Land" is defined to include undeveloped land, land on which a building is situated if the value of the building is less than the value of the land, and land on which a building is situated where the amount of land is in excess of that necessary for the use or enjoyment of the building or the carrying on of a business. In the latter two situations, the amount of the tax is imposed upon the value of the land and the building. The Quebec statute provides for exemption from, or deferral of, the tax in many situations. The legislation also contains rules designed to prevent the avoidance of the tax through the use of corporations, trusts, or partnerships.

3. Alberta

Under the Ownership of Agricultural and Recreational Land Act and the Regulations thereunder, persons who are nonresidents of Canada and who are not Canadian citizens, and certain foreign controlled corporations are prohibited from acquiring certain land in excess of 20 acres. "Land" for purposes of the Alberta Act and Regulations does not include Crown land, land in a city, town or village, or mining land.

4. Manitoba

The Manitoba Agricultural Lands Protection Act provides that persons who are not Canadian citizens or landed immigrants, and certain corporations whose principal business is not farming are prohibited from acquiring agricultural land in Manitoba in excess of 20 acres after April 1, 1977. "Agricultural" land is defined as land used for farming or which could reasonably be used for farming and which is situated outside a city, town or village.

5. Saskatchewan

The Saskatchewan Farm Ownership Act of 1974 prohibits nonresidents of Saskatchewan, and corporations controlled by nonresidents, from acquiring farm land in Saskatchewan in excess of a value of $15,000 as assessed for municipal tax purposes, excluding any buildings on the land. Persons holding farm land with an assessed value in excess of $15,000 are required to reduce their holdings within certain time limits. "Land" is defined to mean land situated outside a city, town or village which is capable of being used for farming. Specifically excluded from the definition of land are minerals, and land used for the purpose of extracting, processing, storing or transporting minerals.

6. Prince Edward Island

The Prince Edward Island Real Property Act prohibits nonresidents of Prince Edward Island who are not Canadian citizens from acquiring real property in excess of 10 acres, property with a shore frontage in excess of 10 acres, and property with a shore frontage in excess of 330 feet without the consent of the Lieutenant-Governor-in-Council. A constitutional challenge to the Prince Edward Island legislation was rejected by the Supreme Court of Canada in the case of *Morgan v. Attorney General for Prince Edward Island,* [1976] 2 Can. S. Ct. 349.

II. Outline of Canadian Tax Consequences of U.S. Investment in Canadian Real Estate

A. General Considerations

Before discussing the various types of investment in Canadian real estate and the various structures for such investments, it will be worthwhile to consider some of the Canadian income tax rules which apply generally to real estate investments.

1. Capital Gains

Profit from the sale of real estate may be characterized as either capital gain, only one-half of which is included in the taxpayer's income, or ordinary business income, the full amount of which is included. Whether such profit is characterized as a capital gain or as ordinary income depends upon an analysis of all of the facts respecting the particular investment.

The basic test is the intention of the taxpayer at the time that he acquired the property. Where the taxpayer acquired the property with the intention of reselling it at a profit, he will generally be considered to have realized ordinary income rather than capital gain. Even where the taxpayer's primary intention is to develop the property or hold it to earn rental income the gain will be considered to be ordinary income if he had a secondary intention to dispose of the property at a profit should his primary intention be frustrated. The taxpayer's sworn testimony as to his intention at the time of acquisition of the property is obviously quite important. Nevertheless, the jurisprudence has established that the following factors which provide objective evidence of the taxpayer's intention are also important:

(a) the length of ownership of the property,
(b) the frequency of similar real estate transactions,
(c) the improvement or development of the property,
(d) the circumstances of the disposition, and
(e) the relationship of the transaction to the taxpayer's ordinary business activities.

None of these factors is determinative by itself; each must be weighed and considered in every case.

The sale of shares of a corporation which owns real estate may be considered to give rise to ordinary income and not capital gain if the sale of the real estate itself would give rise to business income. The same result would apply where an interest in a partnership owning real estate, rather than the real estate itself, is sold.

2. Interest and Property Taxes: Vacant Land

Generally, interest and property taxes which are incurred for the purpose of earning income from real property (whether in the form of rent, business income, or profit on resale) are deductible in computing income. Prior to November 17, 1978, however, interest and property taxes incurred in respect of vacant land were deductible only to the extent that the taxpayer had income from the land for the year. This restriction only applied to vacant land held for the purpose of resale or development or some non-income producing purpose. Therefore, a taxpayer was not entitled to set off the interest or the property taxes incurred with respect to a piece of vacant land against income derived from other sources including other pieces of vacant land. By virtue of an amendment to the Act, interest and property taxes incurred after November 16, 1978 are deductible without limitation where the property is held for resale or development. Land which is the subject of an adventure in the nature of trade is specifically excluded from qualifying as land held in the course of carrying on a business. Therefore, interest and property taxes with respect to such land will only be deductible to the extent of the income from the land for the year. Once construction commences upon the vacant land, interest and property taxes are deductible without limitation.

3. Capital Cost Allowance

Tax depreciation, or capital cost allowance as it is known in Canada, is taken in respect of classes of assets at specified rates on a declining balance basis. Most buildings and other structures are depreciable at the rate of five percent, or ten percent in the case of farm buildings. Land does not qualify for capital cost allowance. For taxpayers other than "principal business corporations" capital cost allowance with respect to rental properties is limited to the income from the property before the deduction of capital cost allowance. In other words, capital cost allowance, which is usually more generous than accounting depreciation, cannot be used to create a loss from the property to off set other income.

This capital cost allowance limitation does not apply to principal business corporations, that is corporations whose principal business is leasing, renting, developing or selling real property. Whether a corporation is a principal business corporation depends upon analysis of its business activities including its profits, assets, capital, gross sales, and the number of employees or agents involved in each business.

Upon the disposition of a building or class of buildings for an amount in excess of the depreciated book value (undepreciated captial cost) the capital cost allowance previously claimed is recaptured and included in income as ordinary income. Because of the class system of capital cost allowance, recapture of capital cost allowance may not arise upon the sale of an individual property if there are other properties in the class.

4. Certificate Procedures

In order to enforce compliance with the capital gains tax levied on dispositions of real estate by nonresidents, the Act imposes liability upon the purchaser unless the purchaser has received a certificate from the Canadian tax authorities. In the absence of a certificate the vendor of Canadian real property is liable for a 15 percent tax on the amount of the consideration paid for the property and the purchaser is entitled to withhold the 15 percent tax from the amount paid to the nonresident vendor. This liability does not arise if the purchaser has no reason to believe, after reasonable inquiry, that the vendor is a nonresident. It is not clear what constitutes reasonable inquiry. It has become customary in most transfers of property for the purchaser to require an affidavit from the vendor that he is a resident of Canada.

If the vendor is a nonresident the purchaser can avoid liability in one of two ways:

(a) by withholding 15 percent of the purchase price, or
(b) by having the vendor obtain one of the certificates provided for in section 116 of the Act.

If the nonresident vendor refuses to obtain a section 116 certificate, the purchaser will have no alternative but to withhold 15 percent of the purchase price. The withholding by the purchaser does not relieve the nonresident vendor of liability for the actual amount of tax with respect to the gain on the disposition of the real property.

A nonresident vendor may obtain a certificate prior to the sale of the real property by notifying the Canadian tax authorities and paying a tax of 25 percent of the amount of the estimated capital gain, or by posting satisfactory security with the tax authorities for the tax ultimately payable. If such a certificate is issued to the vendor, the purchaser will only be liable if the actual sale of the property exceeds the estimated sale price as given in the notice to the tax authorities.

Alternatively, within 10 days of the sale of the property, the vendor may notify the tax authorities and pay a tax of 25 percent of the amount of the actual gain on the sale or furnish security acceptable to the tax authorities. Once the tax has been paid or the security has been furnished the tax authorities are obliged to issue a certificate to both the vendor and the purchaser. This certificate absolves the purchaser from any liability.

The vendor is required to comply with the section 116 procedures even if the amount of the gain on the disposition of the property is exempt from Canadian tax as a result of a tax treaty with another country. However, in this case my understanding is that the Minister of National Revenue will usually issue a certificate without the payment of any estimated tax or the furnishing of security by the nonresident vendor.

B. Types of Investment Structures

For Canadian tax purposes a U.S. investor may basically earn two types of income from an investment in Canadian real estate:

1) rental income, and
2) profit from the sale or disposition of the property.

That investment can be structured in the following ways:

1) direct ownership;
2) co-ownership of the Canadian real estate with another nonresident or a Canadian resident;
3) a partnership with one or more nonresidents or Canadian residents;
4) a trust resident in Canada of which the U.S. investor is the beneficiary; or
5) a Canadian corporation the shares of which are owned by the U.S. investor.

1. Direct Ownership by U.S. Resident

(a) Taxation of Rental Income

The Canadian taxation of rental income derived by nonresidents depends upon whether it is characterized as income from the carrying on of a business, or income from property. Net business income will be subject to tax at the same rates and on the same basis as such income earned by a Canadian resident. For individual nonresidents and testamentary trusts the rates are progressive and the maximum rate varies from approximately 60 to 68 percent depending upon the province in which the real estate is located. For *inter vivos* trusts there is a minimum rate varying from approximately 48 to 56 percent depending upon the province in which the property is located. A nonresident corporation will be subject to a combined federal and provincial rate of approximately 50 percent (plus a 5 percent surtax for 1980 and 1981) and will also be obliged to pay a special 25 percent (reduced to 15 percent in the case of a corporation resident in the United States) branch tax which is intended to compensate for the dividend withholding tax.

On the other hand, if the rental income is characterized as passive investment income it will be subject to withholding tax at the rate of 25 percent (15 percent for residents of the United States) of the gross income. In this case the nonresident can elect to be taxed as if he were a resident of Canada (i.e. on the net rental income at the applicable rate indicated above). Individual nonresidents and testamentary trusts are subject to an additional tax of 43 percent of the basic tax to substitute for the provincial tax.

Whether the ownership of a rental property constitutes the carrying on of a business or a passive investment depends upon the facts of each particular situation. There are very few statutory rules applicable to this question though a large body of jurisprudence has built up over the years. In general, the more services which are provided by a landlord in connection with the rental of the property the more likely it is that the activity will be considered to be a business. Conversely a lease of property on a net basis will almost invariably be considered to be a passive investment.

Where a corporation is used to hold the Canadian real estate it is more likely that the corporation will be considered to be carrying on business than if the property is owned by an individual. A recent case holds that any quantum of activity is sufficient to characterize a corporation's income-producing operations as an active business with revenue. Canada has recently conceded that rental operations will usually constitute a business unless the landlord provides less than the normal services to the tenants (Interpretation Bulletin IT-73R3, dated April 15, 1980).

Under the existing provisions of the Canada-U.S. Tax Convention, rental income is excluded from industrial and commercial profits and Article II of the Treaty goes on to provide that rental income is to be taxed "separately or together with industrial and commercial profits in accordance with the laws of the contracting states." If rental income is "unearned income" within the meaning of Article XI, a maximum 15 percent withholding tax may be imposed by Canada upon such income. However, by virtue of Article XII, a U.S. resident is entitled to pay tax on such rental income on a net basis rather than on a 15 percent withholding tax basis. As a practical matter most nonresidents elect to pay tax on rental income on a net basis. In most of Canada's new tax treaties the taxation of rental income is reserved to the country in which the real property is situated and no maximum rate of tax is prescribed. This treatment is based upon Article 6 of the OECD model treaty.

It should be noted that where property is leased on a net basis, property taxes and other charges paid by the tenant are treated as rent and are subject to withholding tax. (*M.N.R. v. Burland Properties Limited*, 68 D.T.C. 5220).

(b) Dispositions of Canadian Real Estate

The Canadian taxation of profits arising from the disposition of Canadian real estate depends upon whether the profit is characterized as a capital gain or as ordinary business income. If the profit is characterized as a captial gain the nonresident is subject to tax at progressive rates on one-half of the net capital gain at the applicable rate noted above. This result is, of course, altered by Article VIII of the Canada-U.S. Tax Convention which provides that gains derived by a resident of the United States from the sale or exchange of capital assets in Canada are exempt from Canadian tax unless the U.S. resident has a permanent establishment in Canada.

In this regard it should be noted that Revenue Canada takes the position that if a U.S. resident has a permanent establishment in Canada any capital gain realized by him will be subject to Canadian tax even though the capital gain may not be attributable to the permanent establishment in Canada if it is a "fixed place of business" and therefore, the capital gain realized upon the sale of the rental property might be subject to Canadian tax. This result can perhaps be avoided if the rental property is leased on a net basis since in this event there would be no fixed place of business.

There are several situations in which the Canadian tax rules deem a taxpayer to have disposed of property. The most important of these rules are those concerning the deemed disposition upon death and upon a gift of the property. Capital gains realized by a U.S. resident upon such a deemed disposition of Canadian real estate are not considered by Revenue Canada to be exempt by virtue of Article VIII of the Convention since a deemed disposition is not a "sale or exchange."

The renegotiation of the Treaty is likely to remove the Article VIII exemption for capital gains insofar as it relates to real estate. In fact, it seems likely that the disposition by a U.S. resident of shares of a Canadian company whose property consists principally of Canadian real estate will also become subject to Canadian taxation.

If the sale of Canadian real estate by a U.S. resident is considered to be part of the carrying on of a business in Canada by the U.S. resident, Canadian tax will be levied upon the full amount of the net gain realized from the transaction less deductions reasonably applicable. In general, it would appear that a nonresident engaging in an isolated speculative transaction in Canadian real estate will not be considered to be carrying on business in Canada even though the property is offered for sale in Canada by the nonresident or an agent. However, if the sale of the real estate is part of the nonresident's ordinary business of trading in real estate and the property is offered for sale in Canada either by the nonresident directly or by his agent the nonresident will be considered to be carrying on business in Canada.

Even if a U.S. resident is considered to be carrying on business in Canada under Canadian law he may be exempt from Canadian tax as a result of the Canada-U.S. Tax Convention. Under Article I, a U.S. resident will not be subject to Canadian tax with respect to profits from the disposition of Canadian real estate unless he maintains a permanent establishment in Canada. Therefore, under the existing Treaty, as long as the U.S. resident does not maintain an office or other fixed place of business in Canada and does not maintain an agent with general authority to contract on his behalf, he will not be subject to Canadian taxation with respect to real estate profits.

2. Co-Ownership Of Canadian Real Estate By Nonresidents

Under Canadian tax law it is possible for one or more persons to own property jointly without being considered to be in partnership. The distinction between partnership and co-ownership is not, however, a clear one and taxpayers must exercise great care in structuring their relationship in order to achieve the desired results. If a U.S. resident owns property jointly with another nonresident or with a Canadian resident, the tax consequences will be the same as those described above with respect to direct ownership of Canadian property.

3. Partnerships

Under Canadian tax law, a partnership is not a taxpayer. While income is calculated at the partnership level, each partner pays tax upon his proportionate share of the partnership income. The different treatment of a partner as compared to a co-owner of property can have significant tax implications in certain circumstances. For example, where real property is owned by a partnership depreciation or capital cost allowance must be claimed at the partnership level and cannot be tailored to the needs of each individual partner.

The tax treatment of rental income earned by a partnership is basically the same whether the partnership is composed solely of nonresidents, partly of nonresidents or solely of Canadian residents; however, in the latter case the Act provides certain rollovers upon transfers to and from the partnership. Difficult questions arise as to whether a nonresident partner of a partnership carrying on business in Canada is himself carrying on business in Canada. While the character or source of income earned by a partnership flows through to a partner, it is not clear whether an inactive partner will be considered to be carrying on business in Canada as a result of the partnership's business activities in Canada.

Amounts paid by a partnership to a nonresident are subject to Canadian withholding tax if the amount paid is deductible in computing the partnership's income earned in Canada. This result applies even if the partnership is composed exclusively of nonresidents. This may lead to the strange result that a partnership of nonresidents which borrows money in the United States to acquire Canadian real estate will be subject to Canadian withholding tax with respect to the interest payments. In addition, Canadian withholding tax will apply to amounts paid to a partnership which has at least one nonresident partner. The amounts withheld are considered by the Canadian tax authorities to be payments of basic tax with respect to the Canadian resident partners.

In most circumstances an interest in a partnership will be considered a capital asset, the dispostion of which will give rise to a capital gain. Under the Act, a nonresident disposing of an interest in a partnership will be subject to Canadian tax if at least 50 percent of the partnership's property consists of "taxable Canadian property" which includes real property situated in Canada. Article VIII of the Canada-U.S. Tax Convention may exempt a U.S. resident from Canadian tax upon the gain realized on the disposition of the partnership interest as long as the U.S. partner is not considered to be carrying on business in Canada through a permanent establishment in Canada. Canadian cases have established that a partner will be considered to have a permanent establishment if the partnership has a permanent establishment in Canada.

4. Trusts

Where a trust resident in Canada is used to own an investment in Canadian real estate (perhaps to avoid Land Transfer Tax or review by FIRA) several special Canadian tax rules are applicable. In general, a trust resident in Canada is treated as a conduit for tax purposes. But in the case of a trust with nonresident beneficiaries no deduction is allowed to the trust with respect to amounts payable to those beneficiaries with the result that the income will be subject to tax in the trust at the applicable rates (50.4 percent for a trust resident in Ontario).

In the case of an *inter vivos* trust this rate may be less than the amount of tax payable by the U.S. corporation with respect to a real estate investment in Canada. Amounts actually paid to the nonresident beneficiary in the year will be exempt from Canadian withholding tax. If the income is accumulated in the trust and distributed in a subsequent year the ordinary Canadian withholding tax will apply.

Some flexibility may be achieved through the use of a trust since a tax-free rollover is available upon the distribution by the trust of the Canadian real estate to the nonresident beneficiares in satisfaction of their capital interest in the trust. A capital interest in a trust resident in Canada is considered to be taxable Canadian property, the disposition of which at a gain will be subject to Canadian tax. In the case of a U.S. resident, Article VIII of the Treaty may provide an exemption from this tax.

5. Canadian Corporations

The use of a Canadian corporation to own Canadian real estate may or may not be advantageous depending upon the province in which the property is located, the nature of the income derived from the property, the length of time the property will be held and the amount of profit on the disposition of the property.

Income derived by the Canadian corporation from the real property will be subject to combined federal and provincial tax at a rate of approximately 50 percent. In the case of a private corporation earning such income in taxation years commencing before 1980, a special tax scheme integrated the corporate tax and the tax on distributions to shareholders.

Under the pre-1980 scheme of integration the corporation received a refund of one-third of tax paid at a rate of $1 for every $4 of dividends paid to its shareholders. The nonresident shareholders were then subject to the 15 percent withholding tax on the dividends received. Consequently, a U.S. resident shareholder realized an after-tax income of approximately 57 percent of the income earned by the Canadian corporation from the Canadian real estate (i.e. an effective rate of tax of only 43 percent).

For taxation years commencing after 1979 (and for taxation years commencing after October 23, 1979 with respect to corporations created after that date) this scheme of integration will no longer be available for income derived from real property by non-Canadian controlled private corporations. Therefore, such income will be subject to a rate of tax of 57.5 percent when distributed to the U.S. shareholders. The same rate of tax would be paid if a U.S. corporation earned the income from the Canadian real estate.

The use of a Canadian corporation to hold the Canadian real estate, where the activities amount to the carrying on of a business in Canada, will serve to avoid the 25 percent (15 percent in the case of the United States) branch tax.

Interest paid by the Canadian corporation to a nonresident with whom it is dealing at arm's-length will be exempt from Canadian withholding tax if:

1) the indebtedness is incurred after June 23, 1975 and before 1983; and
2) not more than 25 percent of the principal of the loan must be repaid in the first five years.

This exemption from Canadian withholding tax is especially important in light of the recent amendment to the Canadian Act imposing Canadian withholding tax on interest payments made by a nonresident to another nonresident where the interest payments are deductible in computing the nonresident investor's Canadian income.

A significant disadvantage in using a Canadian corporation to hold Canadian real estate is that the disposition of the real estate by the Canadian corporation will result in a capital gain which is subject to Canadian tax. If the property is held directly by a U.S. resident, Article VIII of the Treaty would exempt the gain from tax in many situations. In many situations it would be preferable to have the nonresident shareholder of the Canadian corporation dispose of the shares of the corporation rather than dispose of the real property directly. Potential purchasers may be unwilling, however, to purchase on this basis since the cost of the real property will not be stepped up to fair market value if the shares of the corporation are purchased. Also, in structuring any such arrangement careful attention should be given to the fact that the renegotiation of the Treaty will likely remove the existing exemption in Article VIII with respect to real property.

(a) Thin Capitalization Rules

Under the Canadian thin capital rules the deduction of interest payable on debts to certain nonresidents by a corporation is prohibited to the extent that the corporation's debt-equity ratio is greater than three to one. For example, if a corporation has a debt-equity ratio of five to one, only one-fifth of the interest will be deductible. The amount of the debt is not treated as equity as it is in the United States. The thin capital rules cannot be avoided by back-to-back financing arrangements. However, they can be avoided by third-party loans which are guaranteed by the nonresident investor or which are secured by a pledge of securities or other assets.

(b) Consolidated Returns

Canadian income tax law does not provide for the filing of consolidated returns by the members of a corporate group. Consequently, a loss incurred by one corporation cannot be off set against profits earned in another corporation. Losses of a wholly owned subsidiary corporation can be made available to the parent corporation if the subsidiary is wound up into the parent corporation. Similarly, the losses of a corporation will flow through the amalgamation of that corporation with another corporation.

C. Succession Duties

Since 1972 there has not been any Federal Estate or Gift Tax. The only province which currently levies succession duties is the province of Quebec. Under the Quebec Succession Duty Act, duty will be levied in respect of any property situated in Quebec whether or not the deceased owner is a resident in Quebec and whether or not the transfer of the property upon death occurs in Quebec or elsewhere. The rates of duty range from 20 percent on the first $100,000 of property transmitted to 35 percent of the value transmitted in excess of two million dollars.