Non-resident vendors of real estate: tips to make your transaction close smoothly

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Introduction – what will this paper cover

Most real estate lawyers are aware of the need to obtain an affidavit from a vendor of real estate declaring that the vendor is not a non-resident for income tax purposes. It is important for lawyers acting on real estate transactions to understand what the actual requirements are for compliance with the *Income Tax Act*[1] (the "ITA") in order to avoid interest and penalties from applying to purchasers. This paper contains some suggestions on steps that vendors can take to minimize the amount of the holdback, or at least to simplify the process for releasing the holdback. From the perspective of a purchaser's lawyer, this paper then reviews what to look for when receiving a non-resident affidavit to avoid liability for your clients. Attached are a series of questions submitted to the CRA, and CRA responses, with respect to the interaction between the two charging provisions in the ITA with respect to the holdback.

What are 116 affidavits all about?

Section 116 of the ITA exists to ensure the Canadian government has sufficient security to collect tax on capital gain on real estate in Canada. Practically, the government of Canada can only enforce the collection of tax on assets located in Canada.

An assessment by the CRA generally has the force of any court judgment. However, a judgment based on a tax debt is normally not enforceable in a foreign jurisdiction, as most jurisdictions

[1] *Income Tax Act (Canada)*, R.S.C. 1985, c. 1 (5th Supp). Referred hereafter as "ITA".

have a general principle not to use their tax or revenue collection systems as agents to collect foreign taxes owing on behalf of foreign governments. So, the CRA has little ability to enforce against a non-resident with no assets in Canada.[2] This rule against enforcing a foreign government's tax debt is generally followed in most other countries.[3] While this rule is overridden in a couple of tax treaties,[4] [5] [6] [7] a number of other countries still have domestic legislation that prevents collection against its own citizens.[8]

If, after disposing of any particular asset located in Canada, there are insufficient assets remaining in Canada for the government to enforce collection against, the government will have an uncollectible tax amount. Accordingly, the policy goal behind s. 116 is to provide security prior to the removal from Canada of proceeds of sale of an asset.

What does s 116 of the ITA require?

S. 116 of the ITA sets out a process for vendors to obtain a certificate. The process is essentially a "pre-return" with respect to the capital gains.

The holdback requirements under section 116 can be onerous on vendors and their legal counsel. The act requires the purchaser to hold back 25% or 50% of the gross purchase price and remit the holdback to the government. Information about which holdback applies is discussed later in this paper.

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[2] See *United States v. Harden,* [1963] C.T.C. 45- (SCC)
[3] *Attorney General of Canada v. T.J. Reynolds Tobacco* (2001), 268 F3d 103 (US Court of Appeals, 2nd Circuit)
[4] Canada-U.S. Tax Convention, Art. XXVI-A
[5] Canada-Netherlands Tax Convention, Art 26A (Protocol, August 25, 1997)
[6] Canada-Germany Tax Convention, Art. 27 (April 19, 2001)
[7] Canada-Norway Tax Convention, Art. 28 (July 12, 2002)
[8] Canada-U.S. Tax Convention, Art. XXVI-A:8

This requirement is also reflected in the OREA agreements[9]. However, it should be noted that even if the requirement was not listed on the OREA agreement, or if a purchaser and vendor use their own form of agreement which does not include the holdback requirement, the ITA overrides any agreement you have and obligates the purchaser to hold back.

It is important to stress here that the obligations on the purchaser are completely independent of any eventual tax obligations of the vendor. The 25% or 50% holdback requirement is not calculated based on the vendor's capital gain, or on some estimation of tax that the vendor will ultimately pay. The holdback of 25% or 50% is on the entirety of the purchase price.

In the case of a 25% holdback, this means that the buyer's lawyer is only providing 75% of the purchase price on closing. A vendor is not entitled to refuse to close solely due to the holdback. A vendor who refuses to close because of the holdback would itself be in breach of the agreement of purchase and sale, and not the purchaser.

This can create problems for vendors who have mortgages or other debts to be paid out on the sale of the property, and there will certainly be instances where a vendor would have to bring money into a deal in order to convey clear title on closing.

What happens to the holdback after closing?

Pursuant to s. 116 of the *ITA*, the purchaser is obligated to hold it back and remit it to the CRA within 30 days after the end of the month of the transfer.[10] If the purchaser fails to hold back

[9] See: OREA Form 100, paragraph 17; OREA Form 101, paragraph 20; OREA Form 102, paragraph 19; OREA Form 500, paragraph 17; and OREA Form 501, paragraph 20. An extract from OREA Form 100 is attached showing the relevant provision.

[10] ITA subsection116 (5) and paragraph 116 (5.3)(b)

or to remit the holdback, then the purchaser becomes liable to the CRA for the amount of the holdback. The purchaser will be liable for interest that commences on the 30th day after the end of the month in which the closing takes place, as well late payment penalties[11]. It should also be noted that the debt owing to the CRA in this case would form a super-priority. It is possible that the super-priority would have priority over a mortgage given on closing[12].

After the purchaser has remitted funds to the CRA, the vendor would need to file a tax return with the CRA, and the amount remitted as the holdback is treated as an amount paid on account of the tax. In almost every instance, the vendor will receive a refund for the excess amount remitted.

Is there any alternative to avoid or reduce this holdback?

Yes, there are steps that a vendor can take to eliminate or reduce this holdback.

Prior to a sale, a vendor can file a notice[13] with the CRA providing much of the information that would be provided on the eventual return. The CRA will provide a certificate reducing the amount of the holdback to the estimated amount of tax that would apply to the capital gain. The amount of the holdback can be still further reduced by a vendor by either paying the tax calculated, or by providing security for the tax. It should be noted that the CRA is willing to

[11] ITA subsection 227(9). The penalties commence the first day that payment is late, and increase up until the 8th day late, at which time the penalty is 10% of the withholding under section 116. In the case where gross negligence applies to the failure to withhold, the penalty is 20% of the withholding!

[12] ITA subsections 227(4) & (4.1). Pursuant to paragraph 227(4.1)(a), the deemed trust commences at the time of withholding. It is unclear whether the time of withholding is at the time the funds are paid to the vendor, or if it is at the time the remittance is due to the CRA.

[13] See CRA Form T2062 (in respect of non-depreciable property) / T2062A (in respect of depreciable taxable Canadian property)

accept mortgages on other properties as security, which is a strategy that would minimize the amount of cash that needs to be remitted to the CRA.

Your client is a non-resident vendor – tips for making your sale go smoothly

Real estate lawyers should make a point to ask their vendor clients on intake whether they are non-residents. If a vendor client is a non-resident, the client should apply for a s. 116 certificate from the CRA as soon as possible. These certificates will take several months in order to be issued. This is normally a far longer time period than the amount of time between when a client contacts a lawyer and the date of the final closing. Yet, applying for the certificate opens the door to other steps which can, in many cases, reduce the burden to your client of the holdback requirement.

As a vendor's lawyer, you should verify that the purchaser has the holdback funds on closing, and that it is remitted to the CRA. For your client to obtain their refund, the amount must be paid to the CRA. I would recommend that vendor's lawyers obtain an undertaking from a purchaser and the purchaser's lawyer to hold back and remit by the due date. A sample undertaking is attached to this paper.

I previously mentioned that applying for a s. 116 certificate can alleviate the burden of the holdback requirement on vendors, even if the certificate is not issued in time for closing. Although s. 116 certificates can take several months to be issued, the CRA continues to have a practice of issuing a comfort letter, being a letter from the CRA that grants an administrative easing of the rules. Generally the comfort letters will set out that the appropriate holdback amount can be held in the purchaser's lawyer's trust account, and that once a s. 116 certificate

ready to be issued, the lawyer need only to remit the amount on the proposed certificate to the CRA, and the balance can be released to the vendor. A sample comfort letter is attached to this paper.

The timeline for obtaining a comfort letter is 60 to 90 days, which is still much longer than the amount of time between when most clients sign an agreement of purchase and sale and the closing date. It should be stressed, however, that the holdback doesn't need to be remitted to the CRA by the purchaser until 30 days after the end of the month in which the closing of the transaction takes place. In situations where there is a 30-day closing period, with a closing shortly after the start of the month, you can often have almost 90 days before the holdback must be remitted. If the CRA issues their comfort letter prior to the remittance date, then the funds can be held by the lawyer, rather than remitted to the CRA.

After the closing of the sale, a vendor is required to notify the CRA of the sale within 10 days, failing which a penalty applies.[14]

As a purchaser's lawyer, what do you need to look for in a s. 116 affidavit?

In situations where the vendor is not a non-resident, the normal practice in real estate transactions is for the vendor to sign an affidavit (a "s. 116 affidavit") stating that the vendor is not a non-resident. This practice stems from the requirements of subsection 116 (5) of the ITA, but it is worthwhile examining this subsection to understand what is required for a purchaser to avoid liability under this subsection.

[14] ITA subsection 116(3)

The relevant portions of subsection 116(5) are as follows:

> "Where … a purchaser has acquired from a non-resident person any (real property), the purchaser, unless
>
> (a) after reasonable inquiry the purchaser had no reason to believe that the (Vendor) was not resident in Canada,
>
> … or,
>
> (b) a certificate … has been issued to the purchaser by the Minister in respect of the property
>
> is liable to pay… within 30 days after the end of the month in which the purchaser acquired the property, as tax…. 25% of the amount, if any, by which
>
> (c) (*the purchase price of the property*) exceeds
>
> (d) (*the 116 certificate*)
>
> and (the purchaser) is entitled to deduct or withhold…any amount paid by the purchaser as a tax.[15]

(*emphasis added and paraphrases substituted for illustrative purposes and for simplification*)

A similar subsection applies in the case of a 50% holdback.[16]

Note that the legislation requires a purchaser to make a "reasonable inquiry". This is where the practice of providing s. 116 Affidavits comes from. The legislation also requires a purchaser to have "no reason to believe that the (Vendor) was not resident in Canada". This does not mean that a purchaser can simply receive a s. 116 Affidavit and have discharged its obligations. A purchaser (and by extension, their lawyer) must look for red flags throughout the transaction.

[15] ITA subsection 116(5)
[16] ITA subsection 116(5.3)

A recent tax court case[17] had a situation where a s. 116 affidavit was provided, but the purchaser was still liable for the holdback. In that case, the purchaser knew that the condo being purchased was an investment property and that the owner did not live there. At the time of purchase by the vendor, which was 2 years prior, the address for service was located in "Danville, California". This was the same address for service used on the sale of the property. The purchaser made the standard requisition letter inquiry and received the response "to be provided at closing".

On closing, a document labelled "Affidavit" was provided, executed in California. A copy of the document is attached to this paper. The jurat of the document stated it was "declared", and not "solemnly declared", or any other wording that referred to the document as a sworn declaration, or that it had been declared under penalty of perjury. There were also no opening or closing lines to the document.

The court ruled that requisitioning evidence of compliance with s. 116 of the *ITA* and receiving a properly executed affidavit would have been fine if there were no further red flags. The affidavit provided in this case had various technical issues which caused it to fail to meet the requirements of a proper affidavit, and bore the red flag of having been executed outside of Canada. The court also noted that an address for service located outside of Canada, by itself, is not conclusive, but also constitutes a red flag, in particular where it is the same address for service that the vendor used when it acquired the property. The court said that where a purchaser sees a red flag, there is an obligation to ask follow-up questions. Best practices

[17] Kau v the Queen, 2014-1304(IT)G

would dictate that purchasers should obtain those explanations on a sworn declaration or proper affidavit.

25% of 50%

A critical issue with comfort letters issued by the CRA is that they suspend the application of penalties and interest for failing to remit the tax owing, but do not provide any clarity to purchasers and vendors as to whether the 25% withholding rate or the 50% withholding rate applies.

The 50% withholding rate applies, *inter alia*, to all real property that is depreciable property in Canada, and the 25% rate applies to all real property that is not depreciable property in Canada.[18] Depreciable real property generally will be any property used to earn income from property or business, except for land. Non-depreciable real property will generally consist of personal use property or land (whether the land is for personal use or used to generate income from property or business).

The author of this paper submitted a list of questions to the CRA to clarify various issues with respect to the interaction between the two withholding rates. Chiefly, the questions were

1) Whether the 25% holdback can apply to a part of the property, and the 50% holdback can apply to another part;
2) Where the 25% holdback applies to one part of the property and the 50% holdback applies to another part, on what basis the differing holdbacks should be applied; and

[18] ITA subsections 116(5.3) and (5), respectively.

3) What evidence a purchaser should obtain to protect themselves from an assertion by the CRA that a higher holdback amount should have been withheld.

Please refer to the attached for the specific questions and answers provided by the CRA. The CRA's response to question 3 was, in the author's view, deficient in providing guidance. A follow-up question has been submitted to the CRA, but at the time of completing this paper, an answer had not yet been received.

Conclusion

This paper has reviewed the technical requirements of section 116, and in particular the obligations it imposes on purchasers where they are purchasing real property situated in Canada from a non-resident, and how the vendor can obtain a refund of the excess holdback, including a procedure that vendors can follow which will simplify and expedite releasing the excess holdback. Finally, solicitors should be aware that different withholding rates apply if the property is used to generate income from business or property.

R-4

UNDERTAKING

TO: Anibal Kau

AND TO: Eric Nian Zou Barrister & Solicitor
Barrister & Solicitor

RE: Kau purchase from YAKIA
4 Spadina Avenue K, Suite 1816, Toronto

IN CONSIDERATION of and notwithstanding the closing of the above transaction, I hereby undertake as follows:

1. TO deliver up vacant possession of the premises on closing;
2. TO pay all arrears of taxes to the extent that an allowance has not been granted to the purchaser on account thereof and to pay the 2011 taxes in accordance with the Statement of Adjustments;
3. TO readjust, forthwith upon demand any item on the Statement of Adjustments, if necessary;
4. TO pay all utilities accounts, including hydro-electric, water and gas charges, to the date of closing;
5. ~~TO supply and pay for fuel oil in accordance with the Statement of Adjustments, if applicable;~~
6. TO pay arrears of Common Expenses, if applicable, as well as any current payment for which an adjustment has been made;
7. TO pay off and discharge any existing mortgages, liens, executions and other encumbrances affecting the subject property which are not being assumed by the purchaser;
8. TO leave on the premises all chattels and fixtures specified in the Agreement of Purchase and Sale, in good working order, free of encumbrances, liens and claims of any kind whatsoever. NKMM

TAX COURT OF CANADA
COUR CANADIENNE DE L'IMPOT
EXHIBIT PIECE R-4
NAME Anibal Kau
DATE Nov 9/11
COURT REGISTRAR - GREFFIER DE LA COUR
N° 2014-1304(IT)G

DATED at Danville, CA this 24th day of June, 2011.

Mehran Yekta

AFFIDAVIT

I am not a non-resident of Canada within the meaning of Section 116 of the Income Tax Act (Canada) and nor will I be a non-resident of Canada at the time of closing.

DECLARED before me
at the Town of Danville
in the Contra Costa County
of California, USA
this 24th day of June
2011.

Mehran Yekta

A COMMISSIONER, ETC.

Siavash Haddad
See Notary Attachment! SD

SIAVASH HADDAD
Notary Public, CA
June 24, 2011

SIAVASH HADDAD
COMM. # 1824269
NOTARY PUBLIC - CALIFORNIA
ALAMEDA COUNTY
My Comm. Exp. Nov. 24, 2012

15. **PLANNING ACT:** This Agreement shall be effective to create an interest in the property only if Seller complies with the subdivision control provisions of the Planning Act by completion and Seller covenants to proceed diligently at Seller's expense to obtain any necessary consent by completion.

16. **DOCUMENT PREPARATION:** The Transfer/Deed shall, save for the Land Transfer Tax Affidavit, be prepared in registrable form at the expense of Seller, and any Charge/Mortgage to be given back by the Buyer to Seller at the expense of the Buyer. If requested by Buyer, Seller covenants that the Transfer/Deed to be delivered on completion shall contain the statements contemplated by Section 50(22) of the Planning Act, R.S.O.1990.

17. **RESIDENCY:** (a) Subject to (b) below, the Seller represents and warrants that the Seller is not and on completion will not be a non-resident under the non-residency provisions of the Income Tax Act which representation and warranty shall survive and not merge upon the completion of this transaction and the Seller shall deliver to the Buyer a statutory declaration that Seller is not then a non-resident of Canada; (b) provided that if the Seller is a non-resident under the non-residency provisions of the Income Tax Act, the Buyer shall be credited towards the Purchase Price with the amount, if any, necessary for Buyer to pay to the Minister of National Revenue to satisfy Buyer's liability in respect of tax payable by Seller under the non-residency provisions of the Income Tax Act by reason of this sale. Buyer shall not claim such credit if Seller delivers on completion the prescribed certificate.

18. **ADJUSTMENTS:** Any rents, mortgage interest, realty taxes including local improvement rates and unmetered public or private utility charges and unmetered cost of fuel, as applicable, shall be apportioned and allowed to the day of completion, the day of completion itself to be apportioned to Buyer.

19. **PROPERTY ASSESSMENT:** The Buyer and Seller hereby acknowledge that the Province of Ontario has implemented current value assessment and properties may be re-assessed on an annual basis. The Buyer and Seller agree that no claim will be made against the Buyer or Seller, or any Brokerage, Broker or Salesperson, for any changes in property tax as a result of a re-assessment of the property, save and except any property taxes that accrued prior to the completion of this transaction.

20. **TIME LIMITS:** Time shall in all respects be of the essence hereof provided that the time for doing or completing of any matter provided for herein may be extended or abridged by an agreement in writing signed by Seller and Buyer or by their respective lawyers who may be specifically authorized in that regard.

21. **TENDER:** Any tender of documents or money hereunder may be made upon Seller or Buyer or their respective lawyers on the day set for completion. Money shall be tendered with funds drawn on a lawyer's trust account in the form of a bank draft, certified cheque or wire transfer using the Large Value Transfer System.

22. **FAMILY LAW ACT:** Seller warrants that spousal consent is not necessary to this transaction under the provisions of the Family Law Act, R.S.O.1990 unless the spouse of the Seller has executed the consent hereinafter provided.

23. **UFFI:** Seller represents and warrants to Buyer that during the time Seller has owned the property, Seller has not caused any building on the property to be insulated with insulation containing ureaformaldehyde, and that to the best of Seller's knowledge no building on the property contains or has ever contained insulation that contains ureaformaldehyde. This warranty shall survive and not merge on the completion of this transaction, and if the building is part of a multiple unit building, this warranty shall only apply to that part of the building which is the subject of this transaction.

24. **LEGAL, ACCOUNTING AND ENVIRONMENTAL ADVICE:** The parties acknowledge that any information provided by the brokerage is not legal, tax or environmental advice.

25. **CONSUMER REPORTS: The Buyer is hereby notified that a consumer report containing credit and/or personal information may be referred to in connection with this transaction.**

26. **AGREEMENT IN WRITING:** If there is conflict or discrepancy between any provision added to this Agreement (including any Schedule attached hereto) and any provision in the standard pre-set portion hereof, the added provision shall supersede the standard pre-set provision to the extent of such conflict or discrepancy. This Agreement including any Schedule attached hereto, shall constitute the entire Agreement between Buyer and Seller. There is no representation, warranty, collateral agreement or condition, which affects this Agreement other than as expressed herein. For the purposes of this Agreement, Seller means vendor and Buyer means purchaser. This Agreement shall be read with all changes of gender or number required by the context.

27. **TIME AND DATE:** Any reference to a time and date in this Agreement shall mean the time and date where the property is located.

INITIALS OF BUYER(S): _____ **INITIALS OF SELLER(S):** _____

SOLICITOR'S UNDERTAKING

re: s. 116 ITA

TO:

AND TO:

RE:

IN CONSIDERATION of and notwithstanding the closing of the above transaction, we, _____, undertake to holdback ____ of the gross sale proceeds from the above transaction until _____, on which date I will remit such sum to the Receiver General of Canada on account of the Purchaser's obligations pursuant to subsection 116(5) of the *Income Tax Act (Canada)*, except that if prior to _____, I am in receipt of:

1. A s. 116 ITA clearance certificate from the Canada Revenue Agency (CRA) pursuant to s. 116 of the Income Tax Act (Canada), which I will provide you with a copy of forthwith, or

2. A comfort letter is issued by the CRA in respect of the withholding prior to _____, which I will provide you with a copy of forthwith,

then I will continue the holdback until the CRA directs that the holdback be remitted to them or directs that the holdback may be released, as the case may be

DATED at _____, this day of .

Canada Revenue Agency | Agence du revenu du Canada

Ottawa ON K1A 0L9

Reference Number

Dear Sir or Madam:

Re: Your request for a Certificate of compliance

sale to

We received the notice of disposition, Form T2062, for the sale of the property described below.

This letter is not a Certificate of Compliance with regards to the sale of this property.

We are reviewing the application for a Certificate of Compliance. Please hold in trust for the Receiver General the tax withheld for the vendor as required by subsection 116(5) and/or 116(5.3) of the Income Tax Act until we finish our review. We will let you know how much tax is owing.

As long as we receive the payment within the time frame provided we will not charge penalties and interest under subsections 227(9) and (9.3).

You can find most CRA forms and publications, as well as information on taxes, credits, programs and filing information, on our website at **www.canada.ca/taxes**.

Yours truly,

Canada

CRA Responses to Questions

Received from: Renzo Isabella/Isabella Law Professional Corporation concerning purchaser's liability under section 116 of the Income Tax Act[i]: 25% or 50%?

S 116 provides for 2 types of holdbacks

- *For non-depreciable capital property, at a rate of 25%*
- *For depreciable capital property, at a rate of 50%*

*CRA practice is to issue comfort letters, to permit real estate transactions to close with a holdback in place in the lawyer's trust account while a clearance certificate is processed. However, the comfort letters do not indicate the rate of holdback, and simply state that the appropriate amount is to be held back***.**

Where a vendor has submitted a Notification in respect of section 116 and a certificate of compliance has not been issued by the time the purchaser remittance is due, the purchaser or vendor may request that the Canada Revenue Agency (CRA) provide a section 116 Comfort-Hold Remittance letter (comfort letter).

Examples of when a comfort letter will be considered:

- CRA delay in processing a T2062
- additional information has been requested by CRA
- a referral to another section in CRA has been made

The comfort letter advises the purchaser to hold in trust, for the Receiver General, the tax withheld for the vendor as required by subsection 116(5) and 116(5.3) until the CRA completes its review and requests the tax owing.

Comfort letters are usually issued at the beginning of the T2062 notification process, well before a CRA officer has reviewed the file and therefore the CRA has not considered nor confirmed the nature of the property. At this point, however, the purchaser and vendor are considerably more cognisant of the facts in relation to the nature of property involved.

<u>An overview of Section 116:</u>

When buying property from a non-resident of Canada, a purchaser withholds an amount of the purchase price from the vendor because the purchaser can become liable to pay an amount under section 116. Where the CRA has not issued a certificate of compliance, the purchaser is liable to pay an amount to the CRA within 30 days of the end of the month in which the property was acquired.

The amount of payment that could be required depends upon the type of property involved.

- Subsection 116(5) requires a payment of 25% of the purchase price [for property other than property described in subsection 116(5.2)[ii]]
- Subsection 116(5.3) requires a payment equal to 50% of the purchase price for property referred to in subsection 116(5.2), such as a rental building.

Examples:

If the property is a personal-use property (for example a principal residence or a summer cottage), the 25% rate applies pursuant to subsection 116(5).

If the property is an income-producing property (for example, a rental property), the 50% withholding rate applies to the cost of the building pursuant subsection 116(5.3).

As mentioned, the CRA may issue a comfort letter to the purchaser to allow the purchaser to retain, without remitting, the amount until the CRA completes the review. This comfort letter confirms that a notification has been received and is under review. The letter authorizes the purchaser to not remit any amount at that time and advises that penalties and interest will not be charged as long as the purchaser remits any required tax when notified by the CRA to do so.

In order to comply with subsections 116(5) and (5.3), the purchaser, or the purchaser's solicitor, must make the determination of the amount required to be withheld from the purchase price until the such time as the CRA completes its review and requests the tax owing.

Q1. In situations such as real estate where a single agreement covers a transfer of land and building, is the CRA interpreting the legislation as requiring a 25% holdback on land and a 50% holdback on building?

Yes, **<u>if</u>** the property is an income producing property that includes both land and building, then the rates are:

- 25% - land
- 50% - building

Whenever a property disposition includes both land and buildings, and the building is depreciable property (e.g. rental property), the purchase price must be allocated between the land and the building. The 25% rate applies to the portion of the price that applies to the land [subsection 116(5)] and the 50% rate applies to the portion of the price that applies to the building [subsection 116(5.3)].

Example:

A rental property is purchased for $500,000.00

The building is estimated to represent 90% of the value of the entire property

The amount the purchaser could become liable to pay, and therefore, the amount that should be withheld, is calculated as follows:

Building: $500,000 x 90% = $450,000 x 50% =	$225,000
Land: $500,000 x 10% = $50,000 x 25% =	$ 12,500
Total:	$237,500

This amount is determined in consideration of any potential taxes for which the non-resident vendor may ultimately be liable in respect of the recapture of capital cost allowance on the building, and any capital gain on the disposition. Both a T2062 notification and a T2062A notification are required to be filed by the non-resident vendor when the property is land and building **and** the building is depreciable (e.g. a rental property).

Note: An allocation of the cost between land and building is not required when the property is Personal- Use Property (e.g. a personal residence or a summer cottage that is not rented).

Q2. Where the allocation between land and building is required, on what basis should the parties allocate the purchase price between land and building?

The allocation must be "reasonable" based on the fair market values of similar properties in the area and on the circumstance of the specific case (for example, is the building in disrepair; is the property valuable only because of the land?).

Sometimes, the breakdown of the value between land and building is stated in the purchase and sale agreement (which again needs to be based on market conditions). The CRA will generally accept this breakdown when it appears to be reasonable and the parties (the buyer and the seller) are dealing at arm's length. The provincial registry may be helpful. In some provinces, the registry provides a breakdown of the assessed value between land and building.

Generally speaking, CRA will accept a reasonable breakdown for purposes of determining the amount of the holdback. In the rare case where there is a major disagreement in the values used, then a formal appraisal may be required.

Note: If, as the purchaser, it is uncertain whether subsection 116(5) or (5.3) applies, then it is best to withhold 50% of the full purchase price [i.e. apply subsection 116(5.3)] until a certificate of compliance or other confirmation is received from the CRA.

If it is to be conducted based on vendor's filings, what should parties do in situations where:

- *a vendor claims they have not taken any depreciation or claims they have not made any filings, or*

A property is a depreciable property regardless of whether or not the vendor has claimed capital cost allowance [depreciation]. Therefore, when acquiring a building that is depreciable [i.e. an income producing property], the amount the purchaser could become to liable to pay is 50% of the cost of the building plus 25% of the cost of the land, regardless of whether the vendor has claimed capital cost allowance in respect of the building.

- *where, the property is a personal use property and no depreciation has been taken*

An allocation between land and building is not required when the property is a personal use property. The amount the purchaser could become liable to pay is 25% of the cost of the personal use property [land and building].

Q3. What evidence supporting the answers to Q2 should a purchaser obtain to protect themselves from a CRA assertion that a higher amount should have been allocated as depreciable capital property?

As mentioned above, the CRA will normally accept a reasonable breakdown. The breakdown reported on a T2062/T2062A notification provided by a vendor would normally be accepted, provided it is reasonable in the circumstances.

However, if the situation arises where the CRA requests the remittance of the holdback from the purchaser, and the purchaser does not agree with the amount requested, then the purchaser should provide CRA with the calculation of the amount withheld by the purchaser. Purchasers can provide the CRA with information to show how they calculated the allocation, including any documentation they may have used to support their calculation, such as:

- provincial tax assessment values ,
- comparable information relating to other properties in the area,
- details on the condition of the building,
- a copy of any appraisal or letter of opinion obtained from a realtor familiar with properties in the area.

Usually, the allocation of the cost between the building and the land is not an issue. If there is a major disagreement where the CRA and the purchaser are far apart in terms of the allocation, a professional appraisal would be required to resolve the issue.

As noted above, if as the purchaser, the amount required to be withheld is uncertain, then it is best to withhold 50% of the purchase price until a certificate of compliance, or other confirmation, is received from the CRA.

References:

Income Tax Act subsections 116(5.2) and 116(5.3)

IC72-17R6 Procedures Concerning the Disposition of Taxable Canadian Property by Non-Residents of Canada - Section 116

Disposing of or acquiring certain Canadian property

T2062 Request by a Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Taxable Canadian Property

T2062A Request by a Non-resident of Canada for a Certificate of Compliance Related to the Disposition of Canadian Resource or Timber Resource Property, Canadian Real Property (Other Than Capital Property), or Depreciable Taxable Canadian Property

[i] Unless otherwise note, all legislative references are to the Income Tax Act (Revised Statutes of Canada, 1985, c. 1 (5th Supp.))

[ii] For the subject matter of this paper, references to subsection 116(5.2) are in respect of a disposition of depreciable property that is a taxable Canadian property, such as a rental building.

Section 116 Notification Process

Common Issues and Best Practices

General overview of the Section 116 Process

Section 116[i] applies when non-residents of Canada dispose of certain types of property located in Canada.

The property must be taxable Canadian property (TCP) as defined in section 248. TCP includes:

- Real or immovable property situated in Canada
- Life insurance policies in Canada
- Property used or held in a business carried on in Canada
- Resource property situated in Canada
- Certain shares, interests in partnerships and trusts

Vendors Obligations:

Non-resident (NR) vendors disposing of TCP are required to notify the Canada Revenue Agency (CRA) either before they dispose of TCP, or no later than 10 days after the disposition. The CRA will issue a certificate of compliance to the NR vendor when:

- the required information is submitted and verified, and
- the appropriate payment of tax or security is received.

A copy of the certificate of compliance is sent to purchaser. The certificate protects purchaser from further tax liability.

What happens if the vendor does not comply with the Section 116 obligations?

Non-resident vendors who fail to comply with the notification requirements will be assessed a penalty equal to the greater of:

- $100 (minimum penalty), or
- $25 multiplied by the number of days, not exceeding 100 days, during which the failure continues (maximum penalty is $2,500)

Purchaser Obligations:

If a certificate of compliance has not been issued, the purchaser should remit the withholding to the Receiver General within 30 days after the end of the month in which the property was acquired, unless CRA has issued a comfort letter advising the purchaser to hold the payment until our review is complete.

When can a Purchaser's Liability Assessment be raised?

A purchaser may become liable to pay tax, penalty and interest when:

- the vendor does not comply with notification requirements;
- the purchaser fails to remit the tax required within 30 days after the end of the month of acquisition, or as and when required by the CRA in the case where a comfort letter was issued;
- the purchaser fails to make "Reasonable Inquiry" of vendor's residency status.

- Purchaser liability under Subsections 116(5) and (5.3) does not extend to a case where, "after reasonable inquiry", the purchaser had no reason to believe that the vendor was not resident in Canada.
- "Reasonable inquiry" is not defined under the ITA. The purchaser must take prudent measures to confirm the vendor's residence status. Each case will be reviewed on an individual basis. See paragraph 58 in Information Circular IC72-17, Procedures Concerning the Disposition of Taxable Canadian Property by Non-Residents of Canada - Section 116.

Key elements that impact the issuance of a Certificate of Compliance

Identification Number

Vendor identification is crucial to:

- ensure the proper recording of the notification filed by the NR
- ensure the payment and/or security received is allocated to the NR
- facilitate the processing of income tax returns reporting the disposition
- ensure the correct information is entered on the Certificate of Compliance

A Certificate of Compliance requires an account number before the certificate can be issued. Account numbers include:

- Business Number (BN)
- Social Insurance Number (SIN)
- Individual Tax Number (ITN)

If the NR is a corporation, a business number is required – Form RC-1 and supporting documents (RC1 Request for a business number and certain program accounts)

If NR individual vendor does not have an account number, an ITN must be obtained - *T1261 Application for a Canada Revenue Agency Individual Tax Number (ITN) for Non-Residents*. The T1261 should not be submitted if vendor already has a SIN, ITN or TTN.

Common issues found in T1261 applications:

- the T1261 is not always signed - it must be signed by the applicant (the NR vendor)
- supporting documents are not complete or valid. Remember, the supporting documents must:
  - be current;
  - verify identity of the NR, including name and date of birth;
  - be original or certified or notarized copy;
  - include a photograph.

NOTE: At this time, the CRA cannot process applications for an ITN alongside a request for certificate of compliance. To speed up processing, please apply for an ITN separately, in advance if possible, by completing Form T1261, Application for a Canada Revenue Agency Individual Tax Number (ITN) for Non-Residents and follow the mailing instructions on the form. To ensure timely processing, tick the box indicating the reason you are asking for an ITN.

Rental Properties:

- Two notifications are required:
  - T2062 for capital gain or loss on the disposition of the land and on the depreciable property;
  - T2062A to report any recapture of CCA or terminal loss on the disposition of the depreciable property.
- A breakdown between land and building is required.

Personal-use property (PUP):

- One notification generally required for PUP (T2062).
- A breakdown between land and building is not required.
- If the PUP is a principal residence, include a Form T2091: T2091(IND), Designation of a Property as a Principal Residence by an Individual (Other Than a Personal Trust), signed by the NR vendor.

Submitting documents electronically

- Documents relating to T2062 notifications of non-resident dispositions can be submitted electronically through the CRA's secure portals, including My Account, My Business Account, and Represent a Client as well as by fax to 1-833-329-1161.
- For more information see "Where do I send my completed notification form?" available at **canada.ca/cra-non-residents-dispositions**.

Note: Due to potential restrictions on mail operations resulting from the COVID-19 pandemic, and until operations resume in full, the CRA may experience delays accessing any documents sent by mail. It is recommended, if possible, that you send your documents by fax or online through My Account, My Business Account or Represent a Client.

For all types of dispositions:

- When there is more than one vendor, a separate notification must be filed for each individual, based on their percentage of ownership in the property.
- If the vendor was formerly a resident of Canada the "date of departure" must be provided on the notification.
- Provide the complete address of the property including the postal code.
- Provide the vendor's non-Canadian address not just a Canadian "care of" address.
- Answer all questions on the form whether or not they apply (we cannot assume that the answer to an "unanswered" question is "NO" or "N/A").
- If the property was not rented, please indicate the use of the property - as requested in question #2 on the T2062 and the T2062A forms.
- Provide the actual sale price - not the "net" after deducting outlays and expenses (outlays and expenses cannot be claimed on the T2062/T2062A to reduce the gain subject to Section 116. These expenses can be claimed on the non-resident's tax return filed subsequently.
- Ensure the notification form(s) is/are signed.
- If you are using a cover letter, use the term "**Certificate of Compliance**"; using the term "*clearance certificate*" may cause the application to be distributed to another area, causing a delay.
- Include all requested supporting documents from the supporting documents List (found on the T2062 and related forms), such as:
  - the offer to purchase (proposed disposition);
  - the sales agreement (actual disposition);

- the purchase agreement (at the time the current NR vendor acquired the property);
- a list of any additions to the property and receipts/invoices to support the additions;
- if the property is a rental property, provide documents/explanation to support the allocation of the proceeds between land and building;
- details regarding any change of use (from income-producing to personal use or vice versa) in the property since the property was purchased;
- for transactions between non-arm's length parties, provide an appraisal report or letter of opinion from an appraiser or agent to support the fair market value at the time of the transaction.

Making a payment:

Payments can be sent by wire transfer or cheque. Please include "Section 116" and your account number (SIN, TTN, ITN, business number or trust account number) on any payment you send to the CRA. A misallocated payment may cause a delay in issuing the Certificate of Compliance. If mailing your payment, please send it to the following address:

Canada Revenue Agency
PO Box 3800 STN A
Sudbury ON P3A 0C3

Summary:

We have tried to provide you with some of the key issues that arise that can cause delays in processing the notifications received by the CRA. We have found over the last several years, that approximately 40% of T2062/T2062A notifications we receive are incomplete. An incomplete notification results in delays since the vendor or representative has to be contacted to request the missing information.

Variances in levels of inventory, available resources, and issues that are beyond control, impact the time it takes to process the notifications and issue certificates.

The T2062 notifications are processed on a first-in-first out basis in each of CRA's five Section 116 Centres of Expertise. The CRA strives to process these notifications as efficiently as possible as we do understand the hardship that can be caused by undue delays.

We hope the information provided here is helpful.

Should you require assistance completing the forms, or have other questions, you may call:

1-800-959-8281 (individuals)

1-800-959-5525 (businesses)

[i] Unless otherwise note, all legislative references are to the Income Tax Act (Revised Statutes of Canada, 1985, c. 1 (5th Supp.))