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U.S. Canada Cross-Border Tax: Getting out of Canada

With the U.S. economy not as robust as it once was, it seems that Americans are currently more interested in selling their Canadian assets, particularly recreational property, than buying Canadian assets. It is therefore useful to consider the issues that arise when a U.S. person sells Canadian real estate.[1]

As described in greater detail below, the following points are relevant:

- The U.S. person will be required to prepay tax on any gain arising from the Canadian real estate; and
- If the real estate has been rented, the Canada Revenue Agency (**CRA**) will require the U.S. person to catch up on any unpaid tax on the rental revenue.

The first issue that arises is that Canada has a withholding tax system that strongly parallels the U.S. FIRPTA system. That system applies whenever a non-U.S. person sells a U.S. real property interest. The Canadian system is generally referred to by the section of the Income Tax Act that imposes the system, section 116. The essential features of the system are as follows:

- The U.S. person must notify the CRA of the sale of Canadian real estate either before the sale closes or within 10 days of the closing;
- The notification must identify the U.S. person, the real estate being sold, the sale price and the U.S. person's tax cost of the real estate;
- The CRA will verify the information and then compute the withholding tax; and
- The U.S. person will pay the withholding tax and in exchange the CRA will release to the U.S. person a document generally called "a section 116 clearance certificate".

A typical real estate purchase and sale agreement will contain a representation that the vendor is "not a non-resident for purposes of the Income Tax Act". Obviously, a U.S. person will not be able to give such a representation. When the purchaser is informed

[1] The rules discussed in this note apply equally to all non-residents of Canada not just Americans.

that the representation is not being given, the purchaser will then know that the section 116 system is in play. That section makes the purchaser liable for the vendors withholding tax unless the vendor delivers on or before closing a section 116 clearance certificate.

Under section 116, the purchaser is entitled to withhold 25% of the purchase price if the vendor does not provide a section 116 clearance certificate. If no certificate is delivered by the end of the month following the month of closing,[2] then under section 116, the purchaser must remit the amount withheld to the CRA. In practice, section 116 remittances never occur in this manner. Typically, the non-resident vendor will write to the CRA shortly before the remittance would otherwise occur and the CRA will send a "comfort letter" to the purchaser advising the purchaser not to remit until the section 116 process has been completed. Obviously, a comfort letter will not be available if the vendor has not notified the CRA of the sale, as described above. The need for comfort letters is driven by the fact that it takes the CRA at least 2 months to process the section 116 filing and release the section 116 certificate.

The non-resident vendor typically pays for the section 116 clearance certificate by directing the purchaser to satisfy the withholding tax obligation with a portion of the purchase price that has been withheld. As a result, the U.S. person does not need to separately come up with cash to pay the section 116 withholding tax. The selling of Canadian real estate triggers an obligation to file a Canada tax return for the year in which the sale occurs. Since the tax liability arising from the sale is prepaid, the U.S. person does not necessarily have much incentive to file the return. Note though, that the prepayment of tax under section116 typically results in an overpayment in comparison to the actual tax paid. The only way to get a refund of the overpayment is to file the return. As well, often tax cost disputes arise during the course of obtaining a section 116 clearance certificates. The tax return process gives the U.S. person a forum to dispute the CRA's tax cost computation used for purposes of the section 116 process.

Finally, with respect to section 116, it should be noted that the CRA conducts a "mini-audit" of the application for a section 116 clearance certificate. Of primary concern to the CRA is that the applicant has paid the tax payable in respect of any rent received. Under the Income Tax Act, non-residents of Canada are liable to pay a tax of 25% of the gross amount of any rent received. The non-resident can be taxed on a net basis but in order to benefit from this provision, the non-resident must commit to filing Canadian income tax returns on an annual basis. The CRA will not issue a section 116 clearance certificate unless all back taxes are cleared up. There have been cases where a vendor

[2] For example, if the purchase and sale closes in March, the purchaser has until the end of April to remit the amount withheld.

decides to let the purchaser remit the 25% of the purchase price withheld and not initiate the section 116 process.

Section 116 applies generally to the sale of by a non-resident of "taxable Canadian property". The Income Tax Act contains a list of the types of properties that are considered to be taxable Canadian property. Canadian real estate is included in the list. Also included in the list is any other property (such as shares, partnership or trust interests) whose value is attributable to Canadian real estate. So, U.S. persons selling these types of assets should be aware that the purchaser may withholding 25% of the purchase price if a section 116 clearance certificate is not produced on closing.

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