

# Tax Planning for Real Estate Investments in Canada by Foreign Investors



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Thanks to the years of prosperity that both the residential and commercial Canadian real estate markets have enjoyed since the beginning of the new millennium, Canadian real property is now, more than ever, a favoured type of asset for Canadian and foreign investors.

This favorable context can be explained, notably, by low mortgage rates, sustained economic growth, especially in Western Canada, the need to fulfill unanswered demand in the residential market that had accumulated in the nineties and the burst of the technological bubble. For some foreign investors, especially those from the European Union, the strength of the local currency compared to the Canadian dollar only adds to the appeal of the Canadian real estate market.

While indicators have ceased, lately, to all point in the same direction and while some Canadian real estate specialists are concerned about a possible slowdown in the coming years, Canadian real estate nevertheless remains a preferred type of investment.

Whether the purchase of real estate is intended for personal use, for speculative purposes, for generating long-term lease revenues or for carrying on business, tax implications abound, each of which may affect the return on such a real estate investment, particularly in the case of a non-resident of Canada.



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Accordingly, careful tax planning, suited to the particular needs and circumstances of the investor, becomes a key component in the adequate management of the risks that are inherent to such an investment.

The purpose of the present article is, of course, not to provide a comprehensive listing of all possible tax implications nor to present in detail the various forms of tax planning that may be available to address them, but rather to give a brief overview of some of the available opportunities to illustrate the crucial importance of adequate tax planning as a preliminary step to a successful real estate investment.

*\* With the collaboration of Daniel Lacelle (national leader of the Tax Group), Naïm Alexandre Antaki (Business Law) and Christos Panagopoulos (articling student).*

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## **1. Principal investment structures**

### **1.1 Ownership of real property by a non-resident individual**

#### *i) Commercial real property*

A non-resident of Canada may directly own commercial real property. However, the gross rental revenue collected from Canadian lessees will be subject to a 25% tax withholding pursuant to federal legislation.<sup>1</sup>

Nevertheless, for federal taxation purposes, a non-resident may elect to be taxed on the net rental revenue he collects.<sup>2</sup> Moreover, in Québec, the non-resident investor would not be subject to any provincial taxation since he is not residing in the province of Québec at the end of the year.

Due to the risks associated with civil liability, it is not recommended that an individual directly own commercial real property.

#### *ii) Residential real property*

In contrast with a Canadian resident who owns residential real property as his principal residence, a non-resident would not benefit from a capital gain exemption when disposing of said real property.

### **2. Ownership of real property by a trust**

#### *i) Trust residing in Canada*

The ownership of real property by a trust created and regulated pursuant to the laws of a Canadian province and having trustees residing in Canada would be subject to the same Canadian fiscal rules that apply to real property owned by a Canadian individual, even if its beneficiaries are non-residents of Canada.

For such a trust, rental revenue will be included in the investment income of the trust. Furthermore, all distribution of said revenue made by the trust to its non-resident beneficiaries would be subject to a 25% tax withholding. This distribution may also be subject to an additional 36% tax, thus bringing the total tax rate of said distribution to more than 50%.

The principal advantage of using a trust is avoiding the Québec tax on capital, which is particularly burdensome.<sup>3</sup> Following recent modifications to Québec tax legislation,

Canadian trusts who designate foreign beneficiaries are less appealing. Therefore, they must be combined with different types of entities in order to be advantageous from a tax point of view.

Finally, the trust, for Canadian taxation twenty-one-year period following its creation. Thus, all the latent plus value must necessarily be cashed in at the expiration of the 21<sup>st</sup> year. Fiscal planning may be used to minimize such an impact.

#### *ii) Non-resident trust*

The ownership of real property by a non-resident trust, such as a trust resident of the Island of Jersey, may be an appropriate structure in order to own real property in Canada. In fact, this structure has the principal advantage of avoiding Québec taxation on its rental revenue and also avoiding the Québec tax on capital, which is one of the most frequent consequences affecting real estate investments.

Similarly to the ownership of real property by a non-resident individual, the non-resident trust must pay a 25% tax on its gross rental revenue unless it elects to be taxed on its net rental income. As opposed to a Canadian resident trust, no tax withholding will be applicable where a payment to a non-resident beneficiary is made by the non-resident trust.

One must keep in mind, the use of non-resident trustees for the administration of the real property may cause certain problems from a practical point of view, which will need to be addressed.

### **3. Ownership of real property by a corporation**

#### *i) Resident corporation resident of Canada*

The rental revenue generated by real property owned by a Canadian corporation controlled by non-residents will be subject to federal and provincial income tax and to the Québec tax on capital.

Regarding the repatriation of benefits by way of dividend distribution to non-resident shareholders, 25% of the declared dividend will be subject to a tax withholding, unless the countries of residence of the non-resident shareholders are parties to a tax treaty with Canada which usually reduces the rate to 5%, 10% or 15%, which is the case in most of the countries in the euro zone.



#### *ii) Non-resident corporation of Canada*

The rental revenue received by a non-resident corporation and paid by a Canadian lessee will be subject to a 25% withholding on the gross rental revenue. Even though the corporation is a non-resident of Québec, said corporation will be deemed to have an establishment for Québec income tax purposes since it is the owner of real property which is principally used to produce a rental revenue. Thus, it will be subject to income tax and to the Québec tax on capital.

#### **4. Ownership of real property by a Canadian partnership**

It is also possible to invest in real property by way of a Canadian partnership, which does not constitute a distinct legal entity but rather a grouping of individuals who hold the common goal of carrying on a business in order to make a profit.

For tax purposes, the partnership will be considered as a distinct individual residing in Canada, and this, only for the purposes of calculating its revenue. Once the partnership's revenue is determined, it will be distributed to the partners of the partnership according to their share in the profits or the losses of the partnership.

As a result, the tax consequences of a Canadian partnership will be determined according to the legal status of each partner, which can be an individual or a corporation. Canadian residents must be partners of the partnership in order for the partnership to maintain its Canadian status. Thus, a more complex structure must be considered in certain situations.

#### **5. Financing real property by a non-resident**

According to the fiscal provisions currently in force, all interest payments made by a Canadian resident to a non-resident are subject to a 25% tax withholding calculated on the gross interest amount paid. This rate is generally reduced to 10% due to tax treaties. You should be aware that the federal budget of March 19, 2007 announced major changes in that respect that are not yet in force.

Furthermore, federal legislations contain thin capitalization rules which apply to Canadian corporations receiving financing from foreign corporations with whom

they deal at arm's length. Generally, these rules limit the capitalization lending ratio versus the shareholders' equity of the Canadian corporation to a 2:1 ratio. Any excess to these rules will limit the amount of interest deductibility from interest that is paid by a Canadian corporation to the non-resident corporation. Thus, these rules force non-resident corporations to finance one third of the Canadian corporation with whom it deals at arms' length by way of shareholders' equity instead of lending.

### **B. Particular fiscal rules**

#### **1. Sales Taxes**

The *Goods and Service Tax* (federal) ("GST") and the *Québec Sales Tax* ("QST") are considered sales taxes. The GST consists of a 6% tax and the QST is a 7.5% tax applicable on the gross amount plus the GST. Renting real property is considered a taxable supply for GST and QST purposes. Therefore, non-residents must register with and collect the GST and the QST on the rent if they have commercial activities in Canada generating \$30,000.00 or more annually.

#### **2. Certificate 116**

When disposing of real property, a non-resident of Canada must obtain a certificate in respect of proposed disposition pursuant to section 116 of the *Income Tax Act* (Canada). This certificate is used to prove that the taxes owed by the non-resident have been paid. Québec also requires this procedure.

In the absence of said certificate, the buyer of the property may be responsible of an amount equal to 25% of the acquisition price (plus, in Québec, 12% of the acquisition price) and will be obliged to withhold this amount until the non-resident supplies him with said certificate.

#### **3. Fees**

The buyer of real property located in Québec, including a non-resident buyer, must pay to the municipality in which the real property is located a sum calculated by multiplying the lowest amount between the disposition price and the value determined by an evaluation of the property by a rate varying from 0.5% to 1.5%.



## Conclusion

The appropriate fiscal structure for any real estate investment by a non-resident depends on circumstances of each case. These circumstances will notably allow to determine if the real property is held as an enterprise or as a simple investment, which will lead to a different tax treatment.

Thus, in order to minimize potential tax consequences and to optimize the return on such real estate investment while taking in account the client's needs and objectives, it may be appropriate to put aside some of the structures above-mentioned. It could also prove useful to combine some of these structures or to rely on other more specific investment tools.

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*This document is a summary of the certain Canadian tax consequences regarding real estate investing in Canada. This document is for discussion purposes only and does not constitute a legal opinion nor a tax opinion.*

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1. The *Income Tax Act* (Canada) requires a 25% tax withholding with respect to the rent paid by Canadian residents to non-residents of Canada. As a result, a non-resident of Canada must pay a 25% tax on his gross rental property received by a non-Canadian. The lessee who pays the rent is responsible for withholding and remitting the 25% tax to Canadian tax authorities.
2. Section 216 of the *Income Tax Act* (Canada). It is possible for a non-resident individual to elect to be taxed on his net rental revenue instead of being taxed on his gross rental revenue. Thus, no 25% withholding must be made by the Canadian lessee.  
(See note 1)
3. A capital tax is also payable by all corporations having a stable establishment within Québec. The tax rate in 2007 is 0.49% on the paid-up capital showing in the corporation's financial statements. The paid-up capital includes the capital stock, the surplus, the retained earnings, provisions, reserves, all debts existing more than six months and the loans and advances made by the corporations. The capital may be reduced by deficit amounts, loans and advances to other corporations, etc. Also, an exemption for the first \$1 000 000 in the capital of the capital stock is also applicable.

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