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Change in Canadian tax rules makes it easier to invest in Canada

In an effort to stimulate foreign investment and better align Canada's domestic tax rules with those of its major trading partners, the Canadian government recently proposed changes to the *Income Tax Act* (Canada) (the "**Tax Act**") aimed at easing the tax and administrative burdens that have historically been placed on non-residents that invest in Canadian corporations (the "**Amendments**").

On July 12, 2010, the Amendments received Royal Assent and were brought into force.[1] The Amendments will eliminate many of the tax and administrative barriers that have historically discouraged investment in Canada and may provide opportunities for non-resident investors to simplify existing investment structures.

the amendments

In the past, non-residents of Canada have generally been subject to Canadian taxation on gains arising from the disposition of "taxable Canadian property" (subject to relief provided by an applicable tax treaty). "Taxable Canadian property" previously included a broad range of property with a direct connection to Canada, such as shares of private Canadian corporations and certain interests in Canadian partnerships and trusts.

To ensure non-residents comply with their Canadian tax filing and payment obligations, the Canadian government maintains a detailed reporting and compliance regime under section 116 of the Tax Act. Unfortunately, the wide scope of the Canadian tax rules, coupled with the costs and administrative burdens associated with the section 116 regime, often discouraged foreign investment in Canada.

The Amendments have significantly narrowed the definition of "taxable Canadian property" in the Tax Act. In effect, the Amendments will generally exempt non-resident investors (regardless of their entitlement to claim the benefits afforded by a tax treaty) from Canadian federal income taxes in respect of capital gains realized on the disposition of shares of many

[1] *Jobs and Economic Growth Act*, S.C. 2010, c. 12.

types of private Canadian corporations (as well as interests in certain Canadian partnerships and trusts). Generally, subject to certain deeming rules, Canadian capital gains taxation should not apply in respect of such dispositions, provided the relevant shares (or interests) have not, at any time during the 60 months preceding the relevant disposition, derived more than 50% of their fair market value, directly or indirectly, from real property situated in Canada[2] (such shares being "**Qualifying Shares**" for the purposes of this advisory).

benefits of the amendments to non-resident investors

As many of Canada's tax treaties already exempt dispositions of Qualifying Shares from Canadian capital gains taxation, the chief benefit of the Amendments for many non-resident investors will be a reduction in transaction costs. For instance, prior to the enactment of the Amendments, the administrative hurdles associated with claiming Canadian treaty benefits were frequently viewed as so burdensome by non-resident private equity investors constituted as limited partnerships that it was difficult or impractical for many non-resident funds to invest in Canadian entities without utilizing relatively complicated and expensive structuring measures. One such measure that was frequently adopted required non-resident investors to hold their Canadian equity investments through intermediary "blocking entities" in treaty jurisdictions such as Luxembourg and the Netherlands. The Amendments may render such structuring measures unnecessary in the future.

The Amendments will also result in a consequential easing of non-resident compliance-related obligations. Most importantly, Qualifying Share dispositions should no longer generally be subject to the compliance certificate and notification requirements imposed by section 116 of the Tax Act. In the past, section 116 of the Tax Act required non-resident vendors (which, in the case of private equity funds, meant all of their limited partners) to obtain a compliance certificate from the Canada Revenue Agency in order to alleviate the obligation otherwise borne by a purchaser to withhold and remit a portion of the purchase price of Qualifying Shares on account of the potential Canadian tax liabilities of the non-resident vendor.

The removal of Qualifying Shares from the definition of "taxable Canadian property" should also generally eliminate the need for a non-resident vendor of Qualifying Shares to file a Canadian income tax return solely as a consequence of the share disposition.

Other beneficiaries of the Amendments include those non-resident investors that are not eligible to claim the benefits afforded by a tax treaty and those investors that are resident in a country whose tax treaty with Canada does not provide an exemption from Canadian capital gains tax on the sale of Qualifying Shares. Whereas such investors were historically subject to Canadian taxation in respect of the sale of

[2] For the purposes of this advisory, real property situated in Canada includes (i) real or immovable property situated in Canada, (ii) Canadian resource properties, (iii) timber resource properties, and (iv) options in respect of such property.

Qualifying Shares, the Amendments may result in such dispositions no longer being subject to Canadian taxation.

evaluate current structures

In light of the Amendments, non-resident investors and, in particular, non-resident private equity funds should evaluate whether there are opportunities to simplify existing investment structures, as many of the structures implemented in recent years impose ongoing administrative costs and burdens that may no longer be necessary or warranted.

It should be noted, however, that while the Amendments will relieve the Canadian capital gains tax burden associated with certain Qualifying Share dispositions, the Amendments will not affect the existing withholding tax treatment of dividends paid to non-residents. Accordingly, it may continue to be advantageous to hold shares of an entity, which is expected to periodically declare dividends, through a specialized holding structure.

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The Amendments will have a profound effect on the structuring of future inbound investment in Canada. Complicated structuring measures that were historically required may no longer be necessary. Moreover, while the creation or maintenance of certain intermediary holding structures may continue to be warranted, the enactment of the Amendments should serve as a strong motivation to review all existing arrangements and traditional planning approaches.

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a cautionary note