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Notice to Readers

The information contained in this handbook is current to April 1, 2012.

All information provided herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

The information takes into account the applicable provisions and judicial and administrative interpretations of the relevant taxing statutes, the regulations there under and applicable tax treaties. The information also takes into account all specific proposals to amend these authorities or other relevant statutes and tax treaties publicly announced prior to the date of this handbook, based on the assumption that these amendments will be enacted substantially as proposed. The information does not otherwise take into account or anticipate any changes in law or practice, by way of judicial, governmental or legislative action or interpretation. These authorities are subject to change, retroactively and/or prospectively, and any such changes could have an effect on the validity of the information.

All statutory references herein, unless otherwise noted, are to the Income Tax Act (Canada) (the Act).

References to the Canada Revenue Agency (CRA) herein also include its predecessors (i.e., the Canada Customs and Revenue Agency, Revenue Canada and the Department of National Revenue).
Common Forms of Real Estate Ownership

Common forms of real estate ownership include:

- Co-ownerships
- Joint ventures
- Partnerships
- Corporations
- Trusts
- REITs

The particular form of ownership is selected specifically for each property. Particular circumstances and considerations influence the preferred form of ownership. For example:

- The tax status of the investor may have structural implications and potential limitations on the nature of property held, revenue earned and activity conducted.
- Financing considerations may require a property to be held in a single, sole-purpose entity to ensure the lender's interest in the property is protected in case of bankruptcy or other similar legal proceedings which may give rise to “super-priority” claims.
- If start-up losses are anticipated, an entity that can flow through losses for tax purposes (for example, a partnership) may be preferred.
- Where flexibility for independent tax planning is desirable, including separate discretion to claim capital cost allowance (CCA), a co-ownership may be preferred.

Co-ownerships

Co-ownerships are commonly used when tax and legal exposures associated with the particular undertaking or business are not expected to be significant. With a co-ownership, the parties each own an undivided interest in the property.

When a party “contributes” a property to a co-ownership, it may have a disposition for tax purposes of an undivided interest in that property. Thus the party that contributes a property with an accrued gain could face a tax liability on creation of a co-ownership.

Where this is the case, the acquiring party to the co-ownership will have an acquisition for tax purposes of an undivided interest in the property contributed by the other party.

A co-ownership of real estate may be in the form of a “joint tenancy” or a “tenancy in common”. A joint tenancy differs from a tenancy in common because each joint tenant has the “right of survivorship” to the other’s share. A right of survivorship means that the surviving individual joint tenant immediately becomes owner of the whole property on the death of the other joint tenant.

In contrast, on the death of an individual tenant in common, his or her interest will pass according to his or her will. Tenants in common may have different shares in a particular parcel of real estate. For example, A and B are tenants in common with respect to Parcel X. A can have a 60% ownership interest in Parcel X while B can have a 40% ownership interest in the same parcel.
A co-ownership must be distinguished from a partnership (discussed below).

**Tax Considerations of Co-ownerships**

Income is not determined at the co-ownership level. Participants determine their income based on their undivided interest in the underlying assets. In this respect, co-owners will generally share proportionately in the revenues and expenses associated with their undivided interest in the property. Co-owners can optimize their CCA claims in respect of depreciable property (such as buildings) and other discretionary deductions (for example, cumulative eligible capital) to suit their own tax situation.

A co-ownership does not have its own fiscal period under the Act and is not regarded as a separate taxpayer. As such, each co-owner should compute its income from the property earned during its taxation year.

Until 2011, the CRA had administratively allowed a co-ownership to adopt a fiscal period separate from those of its co-owners and to allocate income to the co-owners for that period in a manner similar to a partnership provided that there was a valid business reason that justified a separate fiscal period for the co-ownership.\(^1\) This administrative policy was withdrawn with the introduction of the partnership anti-deferral rules discussed below.

The tax positions of the parties to a co-ownership are independent of each other, but the CRA may look for consistent treatment of specific items in similar circumstances.

Income from a co-ownership is not subject to the specified partnership limitations that restrict access to the small business deduction.

A co-ownership is generally preferred when the income from the jointly owned property has to be considered property income (as opposed to business income) to suit the tax situation of a participant such as a tax-exempt entity. In this circumstance, each co-owner is able to determine the character of its share of income from the co-owned property, depending on its own conduct and degree of activity.

**Joint Ventures**

A joint venture is a term used to describe a business undertaking by two or more persons engaged in a single defined project, such as the development of a parcel of real estate. A joint venture is not defined in the Act.

The term “joint venture” may be generally used to describe many forms of real estate ownership (i.e., a co-ownership, partnership or corporation). In some cases, it may be used to describe a contractual relationship among the joint venturers which may be similar to, but distinguishable from, a partnership with respect to a particular business undertaking.

Other contractual relationships that create a joint interest in a business activity include participating debt, convertible debt, head leases and ground leases.

**Tax Considerations of a Joint Venture Fiscal Year End**

The CRA formerly allowed, on an administrative basis, a joint venture to establish a fiscal period, which could differ from the fiscal period of one or more of its participants. In this manner, for tax purposes, financial reporting for the joint venture needed to be prepared only once per year regardless of the fiscal period of its members.

Under the CRA’s former policy, a participant could defer its share of joint venture income if the joint venture established a fiscal period ending after the fiscal period of the

---

\(^1\) See the response to question 40 at the Revenue Canada Round Table at the 1989 Canadian Tax Foundation Annual Conference and Technical Interpretation 2002-0146715, “Fiscal year-end joint venture”, dated July 29, 2002.
participant. The deferral of joint venture income by a participant complied with tax policy because the same opportunity would have been available if the joint venture were structured as a partnership.

In 2011, however, new measures were enacted to limit the deferral opportunity for a corporation that owns a significant interest in a partnership. These provisions are discussed below. Consequently, the CRA withdrew its former policy on joint ventures and issued a revised joint venture administrative policy (the Revised Policy).² For taxation years ending after March 22, 2011, a participant in a joint venture will no longer be able to compute income as if the joint venture had a separate fiscal period. Each participant must include in income for its taxation year its share of the joint venture’s income earned in the participant’s taxation year. For the participant’s first taxation year ending after March 22, 2011, the participant must include in income each of the following amounts:

- its share of joint venture income for the joint venture’s fiscal period that ends within the participant’s taxation year; and
- its share of joint venture income for the period commencing in the participant’s taxation year and ending on the participant’s taxation year end (the period defined herein as JV Stub Period).

As a result, the participant whose fiscal period is not coterminous with that of a joint venture must include in income for its first taxation year ending after March 22, 2011 its share of joint venture income for a period exceeding 12 months.

For a participant in a joint venture who relied on the CRA’s former policy, the CRA will offer transitional relief if the participant elects in writing on or before its filing due date for its first taxation year ending after March 22, 2011. The election is made by attaching a letter to the participant’s return of income for that taxation year indicating that the participant is including income from the joint venture for which it is seeking transitional relief. Recognizing that the Revised Policy was publicly announced after the filing due date of many taxpayers, the CRA allowed a late filing of this election by sending a letter to the Taxation Centre of the participant claiming this transitional relief. The CRA subsequently extended the filing due date for the election to be made on or before September 22, 2012.

Transitional relief will be based on the participant’s share of joint venture income for the JV Stub Period (Eligible Income). The participant must bring the Eligible Income into income gradually over its five taxation years that follow its first taxation year that ends after March 22, 2011 in a manner similar to, and subject to the conditions as, the reserve for qualifying transitional income available to corporate partners of partnerships under section 34.2. The participant may deduct as a reserve the Eligible Income to the extent of 100% for the participant’s taxation year(s) that end in 2011, 85% for year(s) that end in 2012, 65% for year(s) that end in 2013, 45% for year(s) that end in 2014, and 25% for year(s) that end in 2015.

Partnerships

In addition to the ability to flow income or loss to its partners for income tax purposes, partnerships are commonly used when it is desirable for one or more members of the partnership to contribute property with an accrued gain for tax purposes into an investment vehicle that will accommodate the business transaction without immediate tax consequences.

What is a partnership?

The term “partnership” is not defined in the Act.

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According to the Supreme Court of Canada (SCC) in *Backman v. R.* (2001 SCC 10) and *Spire Freezers Ltd. v. R.* (2001 SCC 11), for income tax purposes, the term “partnership” is to be given its legal meaning.

**Legal meaning of “partnership”**

Each of the common law provinces in Canada (i.e., all the provinces except for Quebec) has enacted its own partnership legislation. In general, a partnership is a relationship that exists between two or more persons carrying on business in common with a view to profit.

Note that the existence of a co-ownership of property does not, in itself, create a partnership.

In *Thomas Whealy et al. v. The Queen* (2004 TCC 377), the Tax Court of Canada (TCC) found that, because the partnership disposed of all significant assets and was left with only two newly acquired minimal interests in two gas wells, it did not carry on any business. The taxpayers did not have a view to profit from their interest in the partnership; the taxpayers were co-owners of interests in the partnership’s underlying assets but were not partners of the partnership. In its analysis of the case, the TCC relied on the SCC’s decision in *Backman v. R.* and *Spire Freezers Ltd. v. R.*

In *Interpretation Bulletin* IT-90, “What is a Partnership?” the CRA provides guidance on whether a particular arrangement constitutes a partnership under the Act. Consistent with the case law, the CRA says that the term “partnership” for income tax purposes is to be given its legal meaning.

In contrast to a corporation (discussed below), a partnership is not a separate legal entity. A general partnership is a partnership consisting of members who are jointly and severally liable for the debts of the partnership and who have unlimited liability. A limited partnership consists of limited partners and at least one general partner. A limited partner’s liability is limited to his or her investment in the partnership.

**Tax Considerations of Partnerships**

A partnership is not a taxpayer under the Act, but certain partnerships (i.e., specified investment flow through (SIFT) partnerships) may be liable to pay income tax (discussed below). A partnership must first compute its income for the year as if it were a person resident in Canada then it must allocate its income for the year to its members (see subsection 96 (1)). If the partnership has a loss for the year, the loss may be allocated to its members. Discretionary tax deductions, such as CCA and tax reserves, are determined at the partnership level.

Unless all partners are principal business corporations, rental property rules restricting CCA claims will apply (see Regulations 1100(11), (12), (13), (14), discussed below).

Income from a partnership retains its character when allocated to each partner, for example, as business income, capital gains, income from foreign sources or dividends.

A partnership can have income (or losses) from more than one source, such as business, professional, commission, farming, fishing, rentals and investments. If so, the income from each source is calculated separately.

Subsection 102(1) defines a “Canadian partnership” as one of which all partners are Canadian residents. A partnership that does not meet this requirement is referred to as a non-Canadian partnership (discussed below).

**Fiscal period**

Generally speaking, a partnership may select a non-calendar year-end provided that it does not have an individual (including a trust) as a member of the partnership, in which case it must adopt a December 31 year-end (see subsection 249.1(1)).
A partner must include in computing its taxable income for the year the allocated share of the income of the partnership for the partnership’s fiscal year coinciding with or ending in the partner’s taxation year. This may have allowed corporate partners to defer the recognition of income where the partnership’s fiscal year ends after a corporate partner’s taxation year.

Corporate Partnership Deferral Example – Old Rules

Assume
- A corporate partner’s share of partnership income is $100K per month and remains constant

Result
- Before 2011 legislative changes, the corporate partner realized an 11 month tax deferral

However, as announced in the 2011 Federal Budget and enacted on December 15, 2011, sections 34.2, 34.3 and 249.1 were introduced to limit the deferral opportunity for a corporation that owns a significant interest in a partnership.3

A partnership may retain a fiscal period that differs from the fiscal period of its corporate partners. However, a corporation (other than a professional corporation) that owns a significant interest in the partnership must include in income each of the following amounts:

- its allocated share of the income of the partnership for the partnership’s fiscal year that ends within the corporation’s taxation year; and
- an accrued amount for the partnership’s fiscal period commencing in the corporation’s taxation year and ending on the corporation’s taxation year end (the “Stub Period”).4

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3 This excludes a partnership held by a foreign affiliate of the taxpayer pursuant to subsection 34.2(8).
4 This excludes taxable dividends deductible under subsection 112(1) and 113(1)
A “significant interest” is a partnership interest of a corporation entitled, together with partnership interests held by related and affiliated persons or partnerships, to more than 10 percent of the income or loss of the partnership or the assets (net of liabilities) of the partnership on dissolution.\(^5\)

A partnership’s “Stub Period Accrual” can be calculated using a formula (Formulaic Approach) and will include income from all sources. Alternatively, the corporation will be able to designate a lesser amount as the Stub Period Accrual (Designation Approach). The designation cannot be amended or revoked. This discretionary designation is intended to allow a corporate partner to reduce its Stub Period Accrual to reflect its knowledge of the actual partnership income for the Stub Period.

Losses of a partnership cannot be accrued for the Stub Period.

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5 Definition of “significant interest” in subsection 34.2(1).
Each year, and separately for each partnership, the corporate partner may adopt either the Formulaic Approach or the Designation Approach. The method is only binding for the particular taxation year for the particular partnership. Therefore, the corporate partner has discretion to change the accrual method used in a subsequent year.

To mitigate the cash tax impact of the initial recognition of incremental income, a corporate partner may claim a transitional reserve on certain “qualifying transitional income” (QTI) over a five-year period as follows:

- 100% for the corporate partner’s taxation year(s) ending in 2011;
- 85% for the corporate partner’s taxation year(s) ending in 2012;
- 65% for the corporate partner’s taxation year(s) ending in 2013;
- 45% for the corporate partner’s taxation year(s) ending in 2014, and;
- 25% for the corporate partner’s taxation year(s) ending in 2015.

QTI is thereby included in income over the five year period from 2012 to 2016.

There are circumstances where such transitional relief may not be available, for example, if the corporation was not a member of the partnership at March 22, 2011.

The reserve is also denied in the event that the corporate partner becomes tax exempt, no longer principally carries on the activities to which the reserve relates, becomes bankrupt, dissolves or winds-up (other than a dissolution to which subsection 88(1) applies).

QTI includes the total of the corporation’s initial accrual of partnership income for the corporation’s first taxation year ending after March 22, 2011 (i.e. its initial Stub Period Accrual), and partnership income allocated to the corporation under a “single-tier alignment election” or a “multi-tier alignment election” (deemed or actual), discussed below. QTI is computed as if the partnership deducted the maximum amount of any expense, reserve, allowance or other discretionary amount.

The initial calculation of QTI is adjusted upwards or downwards to “true-up” the QTI with the corporate partner’s pro rata share of the actual income of the partnership for the Stub Period. This true-up to the reserve is generally made in the second taxation year ending after March 22, 2011 (if there has been no intervening short taxation year of the corporation).

Although the Stub Period Accrual may include accrued capital gains, the non-taxable portion of such amount is not included in the computation of a corporate partner’s capital dividend account.

A penalty mechanism deters an excessive discretionary designation for a taxation year (the “Deterrent Penalty”). The Deterrent Penalty requires a corporate partner to include in income for the following taxation year an additional amount determined by a formula that consists of two amounts:

- an “income shortfall adjustment” that is computed by reference to prescribed rates; and
- a “penalty” applicable where the income shortfall adjustment inclusion exceeds an amount equal to 25% of a “base amount” multiplied by the prescribed rate of interest for the relevant period. The penalty is equal to 50% of this excess. The base amount is the lesser of the pro-rated portion of the actual income of the partnership for the fiscal period that includes the Stub Period and the adjusted stub period accrual computed as if the Designation Approach had not been used.
In certain circumstances, a corporate partner with a significant interest in a partnership may elect to change the fiscal period of the partnership to align to the taxation year of one or more of the corporations (a “single tier alignment election”).

Each partnership in a tiered partnership structure is generally required to adopt a calendar fiscal period. Alternatively, in certain circumstances, a corporate partner with a significant interest in a tiered partnership structure may elect to align the fiscal periods of each partnership in a tiered structure to end on the same day (a “multi-tier alignment election”).

The single tier and multi-tier alignment elections are due by the earliest filing due date of a corporate partner for its first taxation year ending after March 22, 2011 and are binding on all corporate partners (regardless if they hold a significant interest in the partnership(s)). On December 16, 2011, the Department of Finance (Finance) announced its intention to provide a short extension of this deadline to January 31, 2012.

**KPMG Observations**

A corporate partner with significant interests in multiple partnerships may expect to realize during the Stub Period taxable income in one partnership offset by losses in another partnership. However, a Stub Period Accrual cannot be negative. Therefore, the Designation Approach may be used to achieve the offset.

The formula for computing the Deterrent Penalty allows a corporate partner to offset an over-reported Stub Period Accrual for one partnership against an under-reported stub period accrual of another partnership. Therefore, a discretionary designation can be made for the profitable partnership equal to the expected loss of the unprofitable partnership.

A deferral opportunity is available for a corporation that conducts condominium development activity in a partnership which adopts a fiscal period that differs from the fiscal period of its corporate partners. As discussed below under the “Sale of Condominium Units,” revenue on the sale of a condominium unit is generally recognized on the second closing date, when the condominium is registered and legal title to the property is transferred to the purchaser. This commonly results in the realization of a significant portion of the profit related to that project. Therefore, substantial income may be recognized for tax purposes on this single date. Depending on the timing of the second closing date and the year ends of the partnership and its corporate partners, a deferral of close to two years may result.

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**Income Shortfall Adjustment**

\[
\text{Income Shortfall Adjustment} = \text{Lesser of:} \quad \begin{align*}
\text{The Actual Stub Period Accrual for the prior year} & \quad \text{Adjusted Stub Period Accrual for the prior year excluding the designated amount (F)} \\
\text{Adjusted Stub Period Accrual for the prior year} & \times \text{Prescribed Interest Rate for the current year}
\end{align*}
\]

- Income shortfall adjustment recognizes the time value of money for the income deferred by reason of the designation

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6 Preamble to the definition “income shortfall adjustment” in subsections 34.3(1) and 34.3(3).
**Specified Investment Flow-Through (SIFT) Tax**

A SIFT partnership is liable to tax under the Act. A SIFT partnership is a partnership that, at any time during the taxation year, is:

- a Canadian resident partnership\(^7\) (e.g., a Canadian partnership and a partnership formed in Canada);
- investments in the partnership are listed or traded on a stock exchange or other public market; and
- the partnership holds one or more non-portfolio properties (e.g., shares of a Canadian corporation if the shares have a total fair market value (FMV) that is greater than 10% of the equity value of the corporation and real estate in Canada if the FMV of all the real estate in Canada held by the partnership is greater than 50% of the equity value of the partnership; (see section 197 and subsections 122.1(1) and 248(1) for various definitions).

Generally, the SIFT rules apply to partnerships whose equity is publicly traded. To determine if a private partnership’s equity is considered “listed or traded on a stock exchange or other public market”, a review of the equity of the partnership and its partners must be made, accounting for the broad definitions of “security” and “investment” in section 122.1 of the Act.

An "investment" in a partnership is defined in subsection 122.1(1) to mean a property that is a “security” of a partnership (the “Security Test”); or a right which may reasonably be considered to replicate a return on, or the value of, a security of the partnership (the “Replicate Test”).

If a public corporation is affiliated with a partnership (for example, if the corporation is the majority interest partner by being entitled to more than 50% of the income or loss of the partnership or the net assets of the partnership on dissolution), under the Security Test, the partnership would be a SIFT if the corporation’s publicly-traded securities constitute a right to the capital, revenue or income of that partnership. Similarly, under the Replicate Test, a public corporation that owns an interest in a partnership would cause the partnership to be a SIFT if the corporation’s publicly-traded securities constitute a right that replicates a return on, or the value of, a security of the underlying partnership.

The CRA has issued guidance which states that it depends on the reasonable expectations of a hypothetical investor to determine if the Security Test or Replicate Test is met.\(^8\)

The CRA stated that the following factors would likely result in the shares of a company being regarded as a security of the partnership:

- the terms of the shares provide shareholders with a legal entitlement to, or in respect of, amounts of capital, revenue or income from the partnership, or interest payable by the partnership, and can include exchange features;
- the value of, or return on, a class of shares is specifically based on amounts that may reasonably be tracked to revenue, income or capital of the partnership, or to interest payable by the partnership; or
- in the event of a dissolution, or where the partnership returns capital to the corporation for whatever reason, shareholders are entitled to receive from the corporation a return of capital or dividend payment equal to a preset amount or a proportionate amount as determined by an existing formula.

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\(^7\) Subsection 248(1).

\(^8\) Technical Interpretation 2009-0309281E5, “Specified investment flow-through partnership issues”, dated May 3, 2010 and the CRA response to the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants dated May 3, 2010 regarding the application of the SIFT Rules to Private Partnerships and Private Trusts.
The CRA also stated that the following factors would increase the likelihood that the Replicate Test was met:

- the corporation has no other material business undertakings; and
- the corporation has a practice of paying dividends based on its earnings from the partnership (by reason of the share terms or otherwise).

An exemption from the SIFT rules is available for a partnership that is considered an excluded subsidiary entity. To qualify as an excluded subsidiary entity for a taxation year, an entity’s equity must not be listed or traded on a stock exchange or other public market and the partnership must be wholly owned by a SIFT, real estate investment trust (REIT) or taxable Canadian corporation, or other excluded subsidiary entities at any time during the taxation year. Therefore, a partnership that owns non-portfolio property (substantial real estate or resource properties) and has a partner that is an individual, a tax-exempt entity or a non-resident, would not be an excluded subsidiary entity and may be a SIFT partnership if the Security Test or the Replicate Test determine that “investments” in the partnership are listed or traded on a stock exchange or other public market.

SIFT tax is computed on the non-portfolio earnings of the SIFT partnership for the year. Non-portfolio earnings include income from a business carried on by the SIFT partnership in Canada and income from non-portfolio properties of the partnership. Non-portfolio earnings do not include returns of capital and taxable dividends received by the partnership.

The net after-SIFT-tax non-portfolio earnings amount is deemed to be a dividend received by the SIFT partnership from a taxable Canadian corporation, and the portion of the deemed dividend allocated to a partner resident in Canada is deemed to be a dividend eligible for a lower rate of tax (see the definition of “eligible dividend” in subsection 89(1)).

**Transferring property to a Canadian partnership**

In general, the transfer of property with an accrued gain to a partnership by a taxpayer who, immediately after the transfer, is a member of the partnership gives rise to a realization of the accrued gain by the taxpayer. However, a deferral (or “rollover”) of the entire or part of the gain is available for transfers of certain property to a “Canadian partnership” when the partner and the partnership elect pursuant to subsection 97(2).

Where subsection 97(2) has been used to transfer depreciable property to a partnership, subsection 97(4) deems the capital cost of the property to the taxpayer (the transferor) to be the capital cost of that property to the partnership. The excess of the capital cost to the transferor and the transferor’s proceeds of disposition will be deemed to be CCA previously deducted by the partnership. As a result, on a subsequent disposition of the property, the partnership will be potentially subject to recaptured CCA up to the transferor’s original capital cost.

If any member of a partnership is a non-resident, the partnership will not be a Canadian partnership as defined in subsection 102(1) and no partner will be able to access certain rollover provisions.  

**Real property inventory rollover**

Real property that is inventory can be transferred to a Canadian partnership on a rollover basis. In contrast, a rollover is not available on the transfer of real property inventory to a corporation.

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9 Among the tax consequences of not being a “Canadian” partnership, assets may not be transferred to the partnership on a tax deferred basis under subsection 97(2) and the partnership may not be dissolved on a tax deferred basis under subsections 98(3) and 98(5). In some circumstances, the partnership may still be converted to a corporation pursuant to subsections 85(2) and 85(3).
The CRA has indicated that it may challenge transactions that effectively accomplish a rollover of land inventory to a corporation using intermediate transfers to partnerships. However, in certain circumstances, the courts have determined that the general anti-avoidance rule (GAAR) did not apply.

In *Loyens et al. v. The Queen* (2003 TCC 214), as part of a series of transactions, two brothers (A and B) effectively achieved a rollover of land inventory to Lossco, a corporation with available loss carryovers that was owned by A and B. The rollover was accomplished by using a partnership as an intermediary because the brothers could not have achieved the same result directly. A and B were then able to utilize the losses in Lossco to offset the gain on the sale of the land inventory.

The TCC said that GAAR did not apply to these transactions because they did not result in a misuse or abuse of the provisions of the Act as a whole. The TCC found that the purpose of the real property inventory restriction in subsection 85(1) is to prevent the conversion of income into capital gains by a real property trader. The TCC concluded that there was no misuse of these provisions because the transactions did not violate the policy of converting income to capital gains.

**Transferring partnership property to members of the partnership**

In general, the transfer of property with an accrued gain by a partnership to a member of the partnership will give rise to a gain realized by the partnership. However, in certain circumstances, a Canadian partnership that has ceased to exist may defer the realization of the accrued gain (see subsection 98(3) and 98(5)). In addition, where a partnership that has transferred property to a taxable Canadian corporation on a rollover basis under subsection 85(2) is wound up within 60 days after the transfer to the corporation; and where, immediately before the winding-up of the partnership, the only property of the partnership is money or property received from the corporation as consideration for the transfer (i.e., shares of the corporation), the partnership member may also defer the realization of the accrued gain on the shares of the corporation.

**Partnership not a separate entity in certain circumstances**

A partnership is treated as a separate person under the Act only for purposes of computing the income or loss of the partnership to be allocated to its members. For purposes of filing elections or paying tax, a partnership is generally viewed as a contractual arrangement among the partners and not as a separate entity.

**Conversion from General Partnership to Limited Partnership or vice versa**

The CRA has stated that generally the conversion of a general partnership to a limited one does not result in a disposition of the partnership interests of the general partners who become limited partners. This view is predicated, however, on there being no significant change in the rights and obligations of the partners other than potential liability.11 This position is also applicable to limited partners who become general partners.12 If a limited partner has limited partnership losses available for carryforward at the time the partnership converts from limited to general, those losses will not be available in the future.

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10  “Inventory” includes real estate inventory held by a business and held as an adventure or concern in the nature of trade. For income tax purposes, this distinction appears to be relevant only when inventory is valued (since subsection 10(1.1) does not permit a taxpayer to value land that is held as an adventure or concern in the nature of trade at an amount lower than cost). However, the distinction is relevant for GST purposes.

11  “Revenue Canada Round Table”, 1990 Conference Report, Question 30.

12  1992 Corporate Management Tax Conference, Question 11.
Issues with Partnerships

Presumption of carrying on business

Jurisprudence supports the view that each member of a partnership is considered for tax purposes to be carrying on any business that is carried on by that partnership.

However, for certain purposes of the Act, limited partners are deemed not to carry on the business of the partnership solely because of the acquisition and holding of the partnership interest (see subsection 253.1). Mutual fund trusts or certain tax-exempt entities, such as pension funds, cannot "carry on business", and thus avoid being members of partnerships. Such entities may acquire and hold a limited partnership interest in a limited partnership and must rely on the protection of section 253.1.

The existence of a partnership may give rise to a presumption that a business is being carried on by the partnership; however, one must consider the activity carried on by the partnership to make a determination whether the partnership is carrying on an actual business for tax purposes.

Income and loss allocation

Where partners have agreed to share income or loss in a certain manner and the principal reason of such allocation can reasonably be considered to be the reduction or postponement of tax, subsection 103(1) deems the partners’ share of income or loss to be that amount that is reasonable having regard to all the circumstances.

Similarly, where non-arm’s length partners agree to share income or loss in a manner that is not reasonable in the circumstances having regard to the capital invested or work performed for the partnership, subsection 103(1.1) deems the income or loss of a partner to be the amount that is reasonable in the circumstances.

For partnership fiscal periods ended on or after December 31, 2000, the CRA has expressed the view that salaries or wages paid by a partnership to its partners are not deductible in computing the partnership’s income for tax purposes.13

For partnership fiscal periods ended before December 31, 2000, based on written comments made by the CRA at paragraph 11 of IT-138R, some taxpayers took the position that it was possible for a partner to be allocated an amount of income (or loss) greater than the income (or loss) realized by the partnership. This circumstance commonly arose when a partner was allocated a larger loss than incurred by a partnership, when the partnership loss was augmented by “salary” paid to a partner. With the cancellation of IT-138R on December 31, 2000, this interpretation is no longer available.

Adjusted cost base

Generally, a partner’s adjusted cost base (ACB) at any time is that partner’s original cost of the partnership interest, plus certain upward adjustments under paragraph 53(1)(e), including:

- The partner’s share of income from all fiscal periods ending before that time;
- The partner’s share of any capital dividends and life insurance capital dividends received by the partnership before that time;
- The partner’s additional capital contributed since the partner acquired the partnership interest, and

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The partner’s negative ACB amount since the partner acquired the partnership interest, and which was considered to be a gain from a disposition before that time under subsection 40(3.1) or paragraph 98(1)(c) or 98.1(1)(c).

Minus certain downward adjustments under paragraph 53(2)(c), including:

- The partner’s share of losses, investment tax credits (see subsection 127(5)), and resource deductions (see section 66) from all fiscal periods ending before that time;
- The partner’s drawings from the partnership since the partner acquired the partnership interest;
- The partner’s limited partnership loss to the extent that the limited partner deducted the loss, and
- For certain limited partners or specified members, the amount of any non-recourse debt that can reasonably be considered to have been used to acquire the partnership interest that is not a tax shelter investment.

In Income Tax Technical News ITTN-25 dated October 30, 2002, the CRA expressed the view that a taxpayer’s interest in a limited partnership is considered one capital property, regardless if such interest was represented by units of multiple classes. Therefore, the ACB of the partnership interest is the aggregate of all units of the partnership held by the taxpayer. In a partial disposition (for example, the disposition of only one class of units held by the taxpayer), the ACB of the partial interest would be determined pursuant to subsection 43(1) (being the portion of the entire ACB that can reasonably be regarded as attributable to that portion disposed of).

**Negative ACB**

A taxpayer will generally, realize a capital gain at any time where the total of the original cost of a particular capital property and upward adjustments is less than downward adjustments. However, the interest in a partnership held by a partner active in the business of the partnership (typically a general partner) is not subject to this rule. That is, the ACB of an active partner’s interest in the partnership is allowed to remain negative, but when the partnership has ceased to exist, for example, there is a deemed capital gain in the amount of the negative ACB (see subsection 40(3) and paragraphs 53(2)(c), 98(1)(c) and 98.1(1)(c)).

A limited partner or specified member (i.e., non-active member) of a partnership is deemed to realize a capital gain at the end of the fiscal period of the partnership if the ACB of its partnership interest is negative (see paragraph 40(3.1)(a) and subsection 40(3.11)). Note that certain partnership interests are excluded from this rule (see subsection 40(3.15) for partnerships which actively carried on a business on February 22, 1994).

Where subsection 40(3.1) has applied, subsection 40(3.12) provides that a corporation, an individual (other than a trust), or a testamentary trust which is a member of a partnership at the end of a fiscal period of the partnership may elect, in certain circumstances, to treat a positive ACB as a capital loss from the disposition of the partnership interest at that time. However, such amount may not exceed the amount by which previous gains required to be reported under subsection 40(3.1) exceed previous losses claimed under subsection 40(3.12). There is no prescribed form for this election; a statement should be attached to the partner’s tax return for the relevant year.

Based on draft technical amendments released on October 31, 2011, for dispositions after October 31, 2011, a corporation’s capital dividend account is computed without reference to the deemed capital gain on the negative ACB of a limited partner in a partnership and the deemed capital loss if the ACB of the partner’s interest subsequently becomes positive.
**Limited Partnership Losses**

Partnership losses available to be claimed by a limited partner are limited to the “at-risk” amount of that partner’s interest in the partnership by subsections 96(2.1) to (2.7). Partnership losses exceeding the at-risk amount may be carried forward indefinitely. Such “limited partnership losses” under paragraph 111(1)(e) may be claimed by the partner against any income to the extent that the partner’s at-risk amount becomes positive.

However, these rules do not appear to accommodate the carryforward of restricted limited partnership losses if the limited partner is itself a limited partnership. In such a case, the CRA has stated that the restricted losses are unavailable to the members of the top partnership.\(^{14}\)

Unutilized limited partnership losses cannot be claimed after the limited partnership has been dissolved, as the partner no longer has an at-risk amount in respect of the particular limited partnership.\(^{15}\)

Unutilized limited partnership losses are also not available to a general partner who was formerly a limited partner of the particular partnership.\(^{16}\)

In simplified terms, a limited partner’s at-risk amount is the ACB of the limited partner’s interest in the partnership at that time

**plus:**

- Any partnership income allocated to the limited partner for the fiscal period

**minus:**

- Any amount that the limited partner owes to the partnership (other than any such amount deducted under subparagraph 53(2)(c)(i.3) in calculating the ACB of the limited partner’s interest in the partnership or under section 143.2 in calculating the cost of that partnership interest), and

- Any amount or benefit the limited partner, or a person not dealing at arm’s length with the limited partner, is entitled to receive in any form or manner, immediately or in the future; and absolutely or contingently, to reduce the impact of any loss to the partnership interest.

For purposes of the at-risk calculation, if the limited partner acquires the limited partnership interest from an existing partner, the ACB of that partnership interest is calculated under subsection 96(2.3) as if the cost of the interest to the limited partner is the **lesser of:**

- The cost otherwise determined; and

- The ACB (not less than nil) of the selling limited partner.

**Elimination of Section 88 Bump on Certain Partnership Interests**

Section 88 generally permits a taxable Canadian corporation (the parent) that has acquired control of another taxable Canadian corporation (the target) to increase the cost base of certain capital assets acquired by the parent company on a wind-up or vertical amalgamation with the parent. The parent is permitted to add the amount paid for the shares to (bump) the cost of certain assets acquired on the amalgamation or wind-up, within certain limits.

The bump applies to non-depreciable capital assets, such as land, shares of a corporation or an interest in a partnership but does not apply to income producing assets

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such as eligible capital property, depreciable property, inventory and resource property (assets that if sold produce income rather than capital gains).

A common technique to allow for the transfer of income assets held by a target corporation to tax-exempt persons or flow-through entities following an acquisition of control was to have the target corporation transfer the income assets to a partnership on a rollover basis prior to the acquisition of the target corporation. Since the partnership interest held by the target corporation would generally constitute non-depreciable capital property, the acquirer could bump the tax cost of the partnership interest on the wind-up or amalgamation of the target corporation. The partnership interest could then be sold by the acquirer without any capital gain being realized and, if the purchaser were a tax-exempt person or flow-through entity, it could generally continue to operate or wind up the partnership without being subject to any Canadian tax. Any income realized by the partnership in respect of the income assets generally would not be subject to Canadian tax in the hands of its partners due to their tax-exempt or flow-through status.

The 2012 Federal Budget proposes to deny a bump to the tax cost of a partnership interest to the extent that the accrued gain in respect of the partnership interest is reasonably attributable to the amount by which the fair market value of income assets exceed their cost amount.

These rules apply to income assets that are held directly by the partnership or indirectly through another partnership. However, assets directly owned by a taxable Canadian corporation, shares of which are owned by the partnership, will not be considered to be indirectly held by the partnership.

This measure will apply to amalgamations that occur and wind-ups that begin, on or after March 29, 2012. However, the new measure will not apply where a taxable Canadian corporation amalgamates with its subsidiary before 2013, or begins to wind up its subsidiary before 2012, provided that before March 29, 2012 the corporation had acquired control or was obligated, as evidenced in writing, to acquire control of the subsidiary and the corporation had the intention, as evidenced in writing, to amalgamate with or wind up with the subsidiary.

**Non-Resident Partner**

A non-resident member of a partnership that carries on business in Canada is subject to Canadian income tax (see subsection 2(3)), subject to the relevant tax treaty providing relief to the non-resident.

**Partnership Information Return Filing Requirements**

For partnerships (and nominees/agents for partnerships) with fiscal period ending on or after January 1, 2011, new filing criteria for the Partnership Information Return came into effect.

If a Partnership Information Return must be filed, the partnership must do so using its business number (BN) with an RZ Program Identifier.

The CRA replaced the requirement about the number of partners in a partnership with a requirement related to financial thresholds, and clarified the requirements for the types of partners.

Effective January 1, 2011, a partnership that carries on a business in Canada, or a Canadian partnership with Canadian or foreign operations or investments, has to file Form T5013 for each fiscal period of the partnership:
■ If, at the end of the fiscal period, the partnership has an absolute value of revenues plus an absolute value\(^7\) of expenses of more than $2 million, or has more than $5 million in assets\(^8\); or

■ If, at anytime during the fiscal period,
  – the partnership is a tiered partnership (has another partnership as a partner or is itself a partner in another partnership);
  – the partnership has a corporation or a trust as a partner;
  – the partnership invested in flow-through shares of a principal-business corporation that incurred Canadian resource expenses and renounced those expenses to the partnership; or
  – the Minister of National Revenue requests one in writing.

**Partnership Waivers**

The CRA may not, for a fiscal period of a partnership, make a determination or redetermination of any income, loss, deduction or other amount in respect of the partnership if more than three years have elapsed since the latter of the deadline for filing the relevant information return and the day that it is actually filed. However, where a waiver is obtained by the CRA, the period of time for making the determination or redetermination is extended. In the case of a partnership, the CRA must currently obtain such a waiver from each partner. If one or more partners do not provide a waiver, the three-year period for the CRA to make a (re)determination cannot be extended.

The 2012 Federal Budget proposes that a waiver may be made by one member of the partnership if the member is designated on behalf of all of the partners. This measure will take effect when this 2012 budget measure is passed into law.

**Corporations**

*The Act defines a “corporation” (see subsection 248(1)) as an incorporated entity. A corporation may be incorporated in Canada under either provincial or federal statute.*

*A corporation is a legal person separate and apart from its shareholders. Shareholders of a corporation have limited liability.*

**Tax Considerations of Corporations**

A corporation is a taxpayer under the Act. Thus, it pays tax on its taxable income for the year. A corporation paying dividends (other than patronage dividends) to its shareholders in the year is not entitled to claim a deduction for the amount of the dividend in computing its income for the year. Shareholders must include in income dividends received from the corporation.

Losses of a corporation for the year cannot be allocated to shareholders of the corporation. To the extent the corporation has a non-capital loss for income tax purposes for a taxation year ending after December 31, 2005, this loss may be carried forward 20 years to a subsequent taxation year or back three years to a previous taxation year of the corporation (non-capital losses incurred prior to 2006 may be carried forward either seven or ten years, depending on the year in which the loss was incurred).\(^9\)

Eligible property (which specifically excludes real property inventory) may be transferred to a taxable Canadian corporation on a tax-deferred basis under subsection 85(1).

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\(^{7}\) The absolute value refers to the numerical value of a number without regard to its positive or negative sign.

\(^{8}\) Assets should be determined based on the cost of all assets, tangible and intangible, without taking into account accumulated depreciation or amortization.

\(^{9}\) A short taxation year counts as one year for these purposes.
For a Canadian resident, eligible property includes capital property, inventory (other than real property inventory); and certain other types of property. For a non-resident, the type of property eligible to be transferred under section 85 to a Canadian corporation is restricted to real property that is capital property used in a business carried on by the non-resident in Canada. Subsection 85(1.2) provides further conditions that must be met for the transfer by the non-resident to be eligible for section 85 rollover treatment.

Active business income of a Canadian-controlled private corporation (CCPC) may be entitled to a lower tax rate on the first $500,000 of taxable income.

Passive income may be taxed differently depending on the corporate status.

For general corporations (other than financial institutions and insurance companies), federal Large Corporations tax and provincial capital taxes are fully eliminated on the following dates:

<table>
<thead>
<tr>
<th>Province</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal</td>
<td>January 1, 2006</td>
</tr>
<tr>
<td>British Columbia</td>
<td>September 1, 2001</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>July 1, 2008</td>
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<tr>
<td>Manitoba</td>
<td>January 1, 2011</td>
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<tr>
<td>Ontario</td>
<td>July 1, 2010</td>
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<tr>
<td>Quebec</td>
<td>January 1, 2011</td>
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<td>Nova Scotia</td>
<td>July 1, 2012</td>
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<td>New Brunswick</td>
<td>January 1, 2009</td>
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**Planning Idea — Converting active income into passive income**

This idea may be beneficial if a corporation’s rental income is “active business income”; but the corporation is not entitled to the small business deduction and bonuses are not feasible. The refundable taxes paid on passive income can also facilitate estate planning.

**Approach**

Consider transferring employees to an unassociated entity (corporation, partnership or trust) which will thereafter provide the property management services. The property-owning corporation must retain no more than five full-time employees.

**Result**

The corporation’s rental business will then be a “specified investment business”; and 26.67% of its federal income tax will be added to its “refundable dividend tax on hand” balance. Refundable taxes can then be recovered on the payment of dividends to the shareholder(s). The effective tax rates on passive income earned by a CCPC and distributed to a Canadian resident shareholder are substantially the same as if such income was earned personally.

Falling federal and provincial corporate tax rates influence this planning idea.

If the shareholder does not personally require the income, active business income earned by – and taxed in – a corporation may yield cash tax savings that can be reinvested by the corporation until ultimately paid to the shareholder as a dividend. Further with the introduction of enhanced gross-up and dividend tax credit for eligible dividends after 2005, the ultimate tax cost of using a corporation to earn active business income (subject to high general tax rates) is substantially mitigated. Tax results will differ from province to province due to different provincial corporate and personal tax rates.

**Note:** This or any other planning idea should only be acted on with appropriate professional advice after a thorough examination of the particular situation.
Trusts

“A trust is an equitable obligation, binding person(s) [the trustee(s)] to deal with property over which they have control (which is called the trust property), for the benefit of persons (who are called the beneficiaries or cestuis que trust), of whom he may himself be one, and any one of whom may enforce the obligation.”

The Act defines a trust to include an “inter vivos trust” and a “testamentary trust” (see subsection 108(1)).

A testamentary trust is a trust that arose on and as a consequence of the death of the individual who created the trust (see subsection 108(1)). An inter vivos trust is a trust other than a testamentary trust (see subsection 108(1)).

Tax Considerations of a Trust

A trust is treated as a separate taxpayer under the Act and is generally taxed as an individual, other than as discussed below.

The residence of a trust is a question of fact. According to the CRA and consistent with case law at that time, a trust is generally considered to reside where the trustee who manages the trust or controls the trust assets resides.

However, recent jurisprudence has found that a “central management and control” approach should be used to determine the residency of a trust consistent with the test used to determine the residency of a corporation. This issue will ultimately be decided by the SCC which has granted leave to further appeal the Federal Court of Appeal decision in Garron Family Trust.

Except for testamentary trusts and SIFT trusts (in respect of distributed non-portfolio earnings), trusts pay tax at a flat rate equal to the highest marginal rate applicable to individuals.

A trust is generally allowed a deduction in computing its income for the year to the extent that any part of the income is paid or becomes payable to beneficiaries (see subsection 104(6)) in the year. To the extent income is paid or becomes payable (e.g., the beneficiary is entitled in the year to enforce payment of the amount per subsection 104(24)) in the year, the trust acts as a conduit and the beneficiaries pay tax directly on the income of the trust (see subsection 104(6) and (13)) for the year.

To prevent trusts from holding property indefinitely without recognizing accrued gains, trusts are generally deemed to dispose of all their properties at their FMV every 21 years. Certain trusts (including mutual fund trusts and trusts the interests in which have vested indefeasibly) are not subject to this 21-year deemed disposition rule.

In general, if a taxpayer transfers property to a trust, the taxpayer will be considered to have disposed of the property at its FMV.

Trusts can only distribute income, not losses, to their beneficiaries. Therefore, the taxable income of the trust should be monitored so that losses are not “stuck” in the trust. Non-capital losses of trusts incurred after 2005 can be carried back 3 years and forward 20 years.

Distributions of capital from a trust to a corporate beneficiary would not form part of the corporation’s capital dividend account and therefore, to the extent that the capital distribution represents retained earnings of the trust, tax inefficiencies may arise due to the lack of integration.

Trusts are used to own real estate because they allow for the flow-through of income, allowing the beneficiaries to manage their own tax positions, while providing income splitting and certain income characterization opportunities. Trusts are always subject to the rental property CCA restrictions. Operations should be structured to ensure adequate liability protection is in place.

**Alternative Minimum Tax**

Trusts are generally subject to Alternative Minimum Tax (AMT), which is a federal and provincial tax applicable to individuals (including trusts other than mutual fund trusts) that arises when their regular income tax liability is less than a minimum amount. In the context of a typical real estate investment, AMT may arise when a trust deducts interest and certain tax preference items to shelter rental income, or utilizes non-capital loss carryforwards that arose from such deductions.

AMT may arise where the Trust is a member of a limited partnership which allocates losses to the Trust regardless of the nature of the activity of the limited partnership. The risk of an AMT liability may be minimized if such activity is conducted directly by the trust (i.e. as a co-owner) or indirectly as a general partner of a partnership.

AMT is intended to be a prepayment of tax; any AMT paid can be applied to reduce the taxpayer's regular income tax liability in any of the next seven taxation years, to the extent that such liability exceeds a minimum amount. Depending on the lifespan of the real estate project, AMT may not be fully recovered. For example, AMT can easily arise when a trust incurs losses due to deductions for interest and other soft costs before the property is fully leased and then applies those losses against net rental income or taxable capital gains in a subsequent year. If a taxable capital gain arises on the disposition of the property and the trust has no further activity or income tax liability, the AMT may not be recovered.

**Part XII.2 Tax**

It is typically not advantageous for non-residents investing in Canadian real estate through a Canadian trust to designate the related income to be distributed to the non-resident beneficiaries.

Part XII.2 imposes a tax at a rate of 36 percent on designated income of the trust that is payable by a Canadian-resident trust to a non-resident beneficiary. The designated income of the trust is its income from carrying on a business in Canada and its income from real property in Canada, including taxable capital gains from dispositions of Canadian real property.

Part XII.2 tax is deductible in computing income under Part I.

**KPMG Observations**

In addition to the tax payable under part XII.2, withholding tax is imposed at the domestic rate of 25 percent on amounts distributed to a non-resident beneficiary of the trust. Thus, the rate is effectively increased to 52 percent to the extent that the trust makes all of its designated income payable in the year to its non-resident beneficiary, or, for example, to 45.6 percent where the withholding tax rate is reduced by a treaty to 15 percent.
SIFT Trusts

A SIFT trust is liable to tax under the Act (except if the trust is a real estate investment trust, as defined at subsection 122.1(1), as discussed below). A SIFT trust is a trust that at any time during the taxation year is resident in Canada; investments\(^2\) in the trust are listed or traded on a stock exchange or other public market; and the trust holds one or more non-portfolio properties (see section 122 and subsections 122.1(1) and 248(1) for various definitions). Consistent with commentary for a SIFT partnership, if a private trust is "affiliated" with a publicly traded enterprise\(^2\) the broad definitions contained in the Act and CRA guidance on the meanings of "security" and "investment" must be reviewed to determine if the private trust is a SIFT trust.

Distributed non-portfolio earnings of a SIFT trust for the year are not deductible by the trust (see subsection 104(6)). The SIFT tax is computed on the distributed non-portfolio earnings of the SIFT trust for the taxation year.

Distributed non-portfolio earnings of a SIFT trust are deemed to be taxable dividends paid by a taxable Canadian corporation to the unitholders of the trust. In addition, these dividends received by unitholders resident in Canada are eligible for the enhanced dividend gross-up and the enhanced federal and provincial dividend tax credits available to an "eligible dividend" as defined in subsection 89(1).

Bare trust

It is common to use a "bare trust" to hold legal title to real estate. Generally, in a bare trust, the trustee is the registered owner of the property without any duty to perform except to convey the property to the beneficiary on demand.

A bare trust may include a fiduciary, including an agent that holds legal title to property for the principal.

For real estate, the bare trustee is typically a corporation formed solely for that purpose.

For income tax purposes, a bare trust is ignored and the property of the trust, including any profit or loss realized on the property, is considered that of the beneficiary. In addition, any transfer of title to the property from the bare trust to the beneficiary does not result in a disposition for income tax purposes.

Real Estate Investment Trusts

A real estate investment trust is generally structured to flow through income to unitholders without entity-level income or capital taxes.

Before the enactment of the SIFT rules in 2007, the Act did not contain a definition of a "real estate investment trust" (REIT).

A "real estate investment trust" is not subject to the SIFT tax.

A REIT is established as an inter vivos trust that is a "unit trust" and a mutual fund trust. All of the prescribed conditions must be met at all times for the trust to qualify.

Unit Trust Requirements

The unit trust requirements are found in subsection 108(2). To qualify as Unit Trust, the trust must be an inter vivos trust, the interest of each beneficiary under which is referenced to units.

\(^2\) Subsection 122.1 defines "investment" as a property that is a security of the trust or partnership, or a right which may reasonably be considered to replicate the return on or the value of such security. Proposed legislation will exclude an "unaffiliated publicly-traded liability" of the trust or partnership and "regulated innovative capital".

\(^2\) Often if the "majority-interest beneficiary" of the trust is a publicly listed corporation or real estate investment trust.
Unit trusts may be either “open-end” or “closed-end”.

Paragraph 108(2)(a) sets out the requirement of an open-end unit trust with redeemable interests:

- 95% or more of the FMV of all units of the trust must have a right of redemption by the holder.
- The right of redemption is typically structured as a “soft” in specie redemption feature that balances the requirement for a redemption feature and terms that limit the cash portion of such redemption (recognizing that real estate is an illiquid investment).

Paragraph 108(2)(b) sets out the requirements of a closed-end unit trust with non-redeemable interests:

- The trust must meet tests relating to the nature of its income and property:
  - At least 80% of property must consist of “good basket” assets, i.e., a combination of shares, cash, bonds, debentures, mortgages, notes or similar obligations, marketable securities, real property situated in Canada and certain Canadian natural resource properties;
  - Not less than 95% of the trust’s income must generally be derived from, or from the disposition of, good basket assets; and
  - Not more than 10% of the property of the trust may consist of bonds, securities or shares in the capital stock of any single corporation or debtor (other than the Government of Canada, a province or a Canadian municipality).26
- 1995 amendments permitted “real property” holdings. If a trust’s real property holdings enable the trust to be a closed-end unit trust under paragraph 108(2)(b), the units must also be listed on a designated Canadian exchange in the year or the following year.
- If a closed-end unit trust holds an interest in a limited partnership, the CRA expressed its views27 that:
  - The unit trust can generally invest in a limited partnership and, if necessary, can rely upon section 253.1 which provides that a trust would not be considered to be carrying on the business of the partnership solely by virtue of its ownership of a limited partnership interest;
  - When testing if the closed-end trust has complied with the 80% good basket property and 95% good basket income requirements, the trust may look-through to its proportionate share of the property held and income earned by the limited partnership;
  - Where a limited partner’s interest in a limited partnership is also a “marketable security,” the CRA would accept that the interest of the limited partner is itself a property described in subparagraph 108(2)(b)(iii) for purposes of determining whether the 80% test has been met; and,
  - More than 10% of the property of a closed-end unit trust can be invested in a single limited partnership, as the interest of a limited partner in a limited partnership would not be in respect of “any one corporation or debtor.” However, the limited partnership must be looked-through in determining if the trust’s proportionate share of the property held by the limited partnership meets this condition.
- In complying with the 80% and the 10% property tests28 of a closed-end unit trust, the CRA has stated that “cost” should normally be used as the unit of

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26 Canada, Department of Finance, Legislative Proposals, Draft Regulations and Explanatory Notes Relating to Income Tax (Ottawa: Department of Finance, September 2004).
measurement. FMV could be used as the unit of measurement if sufficient evidence is available to demonstrate that the trust qualified on this basis throughout the year.29

**Mutual Fund Trust**

Benefits of mutual fund trust status:

- Units are eligible investments for deferred income plans (Registered Retirement Savings Plans, Tax-Free Savings Accounts, Registered Education and Disability Savings Plans and Deferred Profit-Sharing Plans)
- No AMT
- No Part XII.2 tax for non-resident or tax-exempt investors (however, Part XIII.2 imposes a 15% tax on otherwise non-taxable distributions to non-resident unitholders of “Canadian property mutual fund investments”)
- No deemed disposition after 21 years30
- No provincial capital taxes
- A flow-through vehicle if income of the trust is paid or made payable to unitholders, unless it is a SIFT trust
- Eligible for the “REIT Exception” (discussed below) if the four REIT conditions are met.

To qualify as mutual fund trust, a trust must be a unit trust resident in Canada, comply with investment restrictions, and meet requirements for public distribution.31

A mutual fund trust must:

- Be a unit trust resident in Canada
- Not be maintained primarily for non-residents (i.e., be owned less than 50% by non-residents)
- Comply with restricted undertakings to:
  - Investing of funds in property, or
  - Acquiring, holding, maintaining, improving, leasing or managing of real property and/or immovable property that is capital property of the trust.
- Comply with minimum distribution requirements:
  - Units must be qualified for distribution to the public
  - At least 150 beneficiaries
  - Each beneficiary must hold at least one block of units:
    - 100 units if FMV is less than $25 per unit
    - 10 units if FMV is greater than or equal to $100
    - 25 units in other cases
  - Each beneficiary must hold units with an aggregate FMV of not less than $500.

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28 Numerous statements on the application of subparagraphs 108(2)(b)(iii) and (v) permitted percentage determinations to be made on the basis of cost (see CRA documents 5-8243 dated July 6, 1989 and 9726153 dated 1997).
30 By virtue of the exemption to the application of subsection 104(4) in paragraph (f) of the definition of “trust” in subsection 108(1).
31 Public distribution is referred to as “qualified for distribution to the public” and is used in regulation 4801(a)(i) and defined in regulation 4803(2)(a).
Where a trust meets all the conditions to be a mutual fund trust before the 91st day after the end of its first taxation year, the trust may elect under subsection 132(6.1) to be a mutual fund trust from the beginning of that first year. The trust then retroactively obtains “qualified investment” status for an investment in the trust by a deferred income plan (Regulation 4900(1)(d), as confirmed in Technical Interpretation 2002-0159245 dated December 31, 2002.)

Taxation of a Mutual Fund Trust (that is not a SIFT Trust)

**Basic rules**

A mutual fund trust that is not a SIFT trust for a particular year is taxed as follows:

- A mutual fund trust is taxed as an individual subject to tax at the highest personal marginal tax rate.
- Trust income is reduced by amounts paid or payable as distributions to unitholders.
- Distribution of all income eliminates the tax liability of the trust.
- To the extent tax credits and refundable income taxes are available, the REIT can retain some taxable income without creating a cash tax liability because the credits can eliminate tax otherwise payable.

**First Generation REITs**

The first Canadian REITs were closed-end mutual fund trusts (made possible by 1995 technical amendments) that complied with restricted undertakings.

- Allocated taxable income (see subsection 104 (13))
- ACB reduction for return of capital
- Deduction for income paid or payable to unitholders (see subsection 104 (6))
Second Generation REITs

The next generation REITs were structured as open-end unit trusts that are not restricted in the nature of the assets or property they can own and the income that can be earned from those assets, other than the normal restrictions imposed on all mutual fund trusts.

Open-end trust status creates a more flexible structure for large single investments and revenue sources.

- ACB reduction for returns of capital
- Deduction for income paid to unitholders
- Deductions for amounts paid to the Mutual Fund Trust:
  - Interest on Notes
  - Sub Trust income
- Income allocated to partners

Public Investors

Mutual Fund Trust (Open-end)

Sub Trust

LP

Real Property in Canada
Third Generation REITs

With the elimination of the foreign property limits for deferred income plans for the 2005 and subsequent taxation years, the REIT structure has been further simplified.

SIFT Rules

The structure of REITs changed substantially after the announcement of the SIFT rules on October 31, 2006. At that time, the Government introduced its Tax Fairness Plan in an effort to restore balance and fairness to the federal tax system by creating a level playing field between trusts and corporations.

Generally, the rules subject distributions of certain SIFT income to tax at corporate income tax rates in the SIFT entity. A SIFT trust cannot deduct distributions of such income for tax purposes. Investors are taxed as though the distributions were eligible dividends from a taxable Canadian corporation.

SIFT legislation was implemented in Bill C-52 which received Royal Assent on June 22, 2007 and further amendments were contained in the Budget Implementation Act, 2009.

On December 16, 2010, Finance proposed new draft income tax legislation (the 2010 Proposals) which modified some of the rules relevant to the determination of whether an entity qualifies as a REIT in section 122.1. Additional draft amendments to discourage structures designed to circumvent the SIFT regime were introduced on July 20, 2011 (the 2011 Proposals).
The 2011 Proposals:

- Restrict the deductibility of certain amounts payable on publicly traded stapled securities\(^{32}\) issued by a taxpayer (trust, corporation, or partnership), or issued in combination with its subsidiary\(^{33}\), REIT, or a subsidiary of a REIT (for example, the deduction of rent on Canadian real property would be denied to a Canadian taxable entity (the “Operator”) if paid to a REIT (the “Landlord”) where the securities of the Operator and the Landlord are stapled together and trade as a single security on a stock exchange);

- Clarify that “non-portfolio property” has the same meaning for a corporation as it does for a SIFT partnership or trust;

- Subject SIFTs to the monthly income tax instalment payment requirement; and

- Expand the definition of “qualifying investor” of an “excluded subsidiary entity” to generally include a person or partnership that does not own, or have a right to own a share that is listed or traded on a stock exchange or other public market, or property whose FMV is primarily determined by reference to a publicly listed or traded share.

The 2011 Proposals to amend the definition of “qualifying investor” will be deemed to have come into force on October 31, 2006. However, an entity that would be considered an “excluded subsidiary entity” as a result of this proposed amendment can elect to have this change apply to taxation years beginning after July 20, 2011.

The remainder of the 2011 Proposals will take effect, in general, for taxation years beginning after July 20, 2011, although a transitional period is available for entities that have issued stapled securities prior to July 20, 2011 (or subsidiaries of those entities). The transitional period will generally end on July 20, 2012, but is extended to January 1, 2016 for entities that had outstanding stapled securities on October 31, 2006.

Certain REITs (now codified in section 122.1) are exempt from the SIFT tax.

The final legislation and proposed amendments address certain (but not all) technical deficiencies for REITs.

### Legislative Chronology

<table>
<thead>
<tr>
<th>Date</th>
<th>Legislative Event</th>
<th>Changes Favourable to REITs</th>
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</thead>
<tbody>
<tr>
<td>October 31, 2006</td>
<td>Tax Fairness Plan announced</td>
<td>Qualifying REITs were exempted from SIFT tax</td>
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<tr>
<td>December 22, 2006</td>
<td>Tax Fairness Plan draft legislation released</td>
<td>Wider CCA classes</td>
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<tr>
<td>March 29, 2007</td>
<td>2007 Bill C-52 Budget Implementation Bill and revised REIT rules introduced</td>
<td>Rent includes ancillary income</td>
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<td></td>
<td>Revenue test clarified</td>
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<td></td>
<td></td>
<td>Qualifying REIT subsidiaries can perform management or hold legal title</td>
</tr>
<tr>
<td>June 22, 2007</td>
<td>Bill C-52 Budget Implementation Bill received Royal Assent</td>
<td>Foreign property restriction removed</td>
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<tr>
<td>December 20, 2007</td>
<td>Technical amendments to the</td>
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</table>

\(^{32}\) A stapled security involves two separate securities that are “stapled” together such that the securities are not freely transferable independently of each other.

\(^{33}\) Under the 2011 proposals, a subsidiary is defined as an investment in another entity whose fair market value is more than 10 percent of the equity value of the parent entity, and an entity that is a subsidiary of a subsidiary of the parent entity.
<table>
<thead>
<tr>
<th>Date</th>
<th>Legislative Event</th>
<th>Changes Favourable to REITs</th>
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</thead>
<tbody>
<tr>
<td>July 14, 2008</td>
<td>Draft REIT technical amendments released</td>
<td>Qualifying assets expanded</td>
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<td>Trust-on-trust structure facilitated</td>
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<td></td>
<td></td>
<td>Nominee subsidiaries permitted to hold legal title to properties of the REIT or another subsidiary</td>
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<td></td>
<td>Excluded subsidiary entities not subject to SIFT tax</td>
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<tr>
<td>November 28, 2008</td>
<td>REIT technical amendments included in Notice of Ways and Means Motion</td>
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<tr>
<td>March 12, 2009</td>
<td>REIT technical amendment included in Bill C-10. The Budget Implementation Act, 2009 received Third Reading in the House of Commons on March 4, 2009 and is considered substantively enacted for GAAP purposes. This Act received Royal Assent on March 12, 2009</td>
<td>REITs can hold up to 10 percent of its non-portfolio property that is not qualified REIT properties</td>
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<tr>
<td></td>
<td></td>
<td>Passive revenue restriction decreased to 90 percent</td>
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<tr>
<td></td>
<td></td>
<td>Qualifying revenues clarified and expanded</td>
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<tr>
<td></td>
<td></td>
<td>Certain foreign currency gains treated as qualifying revenues</td>
</tr>
<tr>
<td>December 16, 2010</td>
<td>Draft REIT legislation released</td>
<td>Deny the deductibility of certain amounts payable within a publicly traded stapled structure</td>
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<td>Expands the definition of “qualifying investor”</td>
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<td>Clarifies the definition of “non-portfolio property”</td>
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<td>Subjects SIFTs to monthly tax instalments</td>
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<tr>
<td>July 20, 2011</td>
<td>Proposed draft legislation announced</td>
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**REIT Exception**

A "real estate investment trust" is not a SIFT and is therefore not subject to the new SIFT rules if it can meet four tests throughout the year:

1. **Property Test**, requiring that the trust must not hold any non-portfolio property (NPP) other than "qualified REIT properties" at any time in the taxation year.

   The 2010 Proposals modify the Property Test to allow the REIT to hold up to 10 percent of its NPP in assets that are not "qualified REIT property" as long as it does not exceed 10 percent of the FMV of all NPP at any time in the taxation year.

2. **95% Passive Revenue Test**, requiring that at least 95% of the trust's revenues for the taxation year must be derived from:
   - rent from real or immovable properties
   - interest
- capital gains from dispositions of real or immovable properties
- dividends, and
- royalties.

The 2010 Proposals require that at least 90 percent of the REIT’s “gross REIT revenue” is from the sources noted above. The 2010 Proposals also clarify that the test is based on gross receipts.

In addition, for purposes of this test, qualifying revenues include gains from dispositions of “eligible resale properties”; however, such gains are not qualifying revenues under the Real Property Revenue Test (see below).

3. **75% Real Property Revenue Test**, requiring that at least 75% of the trust’s revenues for the taxation year must be derived from:
   - rent from, or mortgage interest on, real or immovable properties, and
   - capital gains from dispositions of such properties.

   Similar to the Passive Revenue Test, the 2010 Proposals clarify that the 75 percent Real Property Revenue Test is based on “gross REIT revenue”.

4. **Qualifying Property Value Test**, requiring that the total FMV of all trust properties, each of which is real or immovable property, bankers’ acceptances, money, certain deposits with financial institutions, or certain government debt, must be at least 75% of the trust’s equity value throughout the taxation year.

   A trust must satisfy these four conditions at all times throughout its taxation year.

5. The 2010 Proposals add a fifth condition that requires investments in the trust to be listed or traded on a stock exchange or other public market at any time in a taxation year in order to qualify as a REIT.

**KPMG Observations**

*Under the current rules, there are no curative provisions. In the event that a trust acquires a de minimis amount of NPP, the penalty (loss of REIT status) is rather harsh and seems disproportionate to the problem.*

*Under the 2010 Proposals, there is a relieving provision that allows a REIT to hold up to 10 percent of its NPP that is not qualified REIT property. Once enacted, a trust will have a safe harbour to continue to qualify as a REIT if it inadvertently acquired non-qualifying property.*

*Although the 2010 Proposals introduced a fifth condition to the REIT proposal, the definition of “real or immovable property” remains the same. As such, for securities of a subsidiary entity to be “real or immovable property”, the subsidiary need only comply with the first four REIT conditions. Investments in the subsidiary entity do not need to be publicly listed or traded.*

*A publicly listed partnership cannot qualify for the REIT exception.*

REITs with operating components or separate business activities other than the earning of rent on real or immovable properties, such as hotels and seniors’ housing, cannot meet the REIT Exception.
Key Definitions

1. For these purposes, “rent from real or immovable properties” includes:
   - Rent or similar payments for the use or right to use real or immovable properties;
   - Payment for services ancillary to and customarily supplied or rendered in connection with the rental of such properties; and
   - Payment included in the income of a beneficiary of a trust under 104(13)(a) that was derived from rent from real or immovable properties.

   Under the 2010 Proposals, “rent from real or immovable properties” no longer includes a payment included in the income of a beneficiary of a trust under 104(13)(a) that was derived from rent from real or immovable properties. Rather, the 2010 Proposals replace this part of the definition with a more liberal flow-through rule in proposed subsection 122.1(1.2).

   When an entity holds an interest, which is NPP, of another entity (the “subsidiary entity”), and an amount has become payable by the subsidiary entity to the parent entity and is included in the parent entity’s gross REIT revenues, under subsection 122.1(1.2) of the 2010 Proposals, when that amount is reasonably considered to be paid out of a particular source, and has become payable out of the subsidiary entity’s gross REIT revenues, then that amount is deemed to be gross REIT revenues of the parent entity from the same particular source.

   Furthermore, the CRA has recently issued a technical interpretation which clarifies that income distributed by a subsidiary trust to another subsidiary trust and then by that subsidiary trust to the parent trust will maintain its source characterization.34

   The 2010 Proposals clarify that all qualifying revenue items (including capital gains and mortgage interest) of a subsidiary trust retain their source when applying the REIT revenue tests to the parent trust.

KPMG Observations

Under the current rules, the taxable net rental income of a subsidiary trust that is paid or made payable to a beneficiary is qualifying revenue for both the 95% Passive Revenue Test and 75% Revenue Test of the beneficiary.

However, under proposed subsection 122.1(1.2), only revenues from securities that are NPP are considered qualifying revenues. Securities of a foreign entity generally are not NPP because the entity is not a subject entity. Accordingly, revenues sourced from these entities are not qualifying revenues for purposes of the REIT Revenue Tests.

Rent from real or immovable properties does not include:
   - Payment for any other services supplied or rendered to tenants of such properties;
   - Fees for managing or operating such properties;
   - Payments for use of hotel rooms or other lodging facilities; or
   - Rent based on profits.

2. Non-portfolio property includes:
   - Canadian “real or immovable property” if at any time in the year the FMV of such property is greater than 50% of the “equity value” of the trust or partnership;

   - “Securities” 35 of “subject entity” (other than a “portfolio investment entity”) when:

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35 A “security” of a particular entity is defined at subsection 122.1(1) to mean “any right, whether absolute or contingent, conferred by the particular entity or by an entity that is affiliated with the particular entity, to receive, either immediately or in
− Such securities have a FMV greater than 10% of the “equity value” of the subject entity; or
− Such securities (together with securities of affiliates of the subject entity) have a value greater than 50% of the equity value of the trust or partnership itself;

■ Property used by the trust or non-arm’s-length person in carrying on a business in Canada.

**KPMG Observations**

*Mortgages and mezzanine loans may represent “securities” of a “subject entity”, especially where the debt is owed by a single-purpose entity.*

*A REIT is permitted to derive 5% of its total revenue from active sources, other than rent from real or immovable properties. However, as a mutual fund trust, a REIT cannot hold any property (e.g., computers, furniture and equipment) used in carrying on a business in Canada. Therefore, third-party management activity, if any, should be conducted by a qualifying management subsidiary, the shares of which are qualified REIT property.*

3. **“Subject entity”** means:
   ■ A Canadian resident corporation or trust;
   ■ A “Canadian resident partnership”; or
   ■ A non-resident person or partnership with principally Canadian income sources;
   ■ But does not include an individual.

4. **“Excluded subsidiary entity”** means an entity, the equity of which is not at any time in the taxation year:
   ■ Listed or traded on a stock exchange or other public market; or
   ■ Held by any person or partnership other than:
      − A “real estate investment trust”;
      − A taxable Canadian corporation;
      − A SIFT trust;
      − A SIFT partnership; or
      − An excluded subsidiary entity.

SIFT tax, however, may apply to a private partnership where (1) the majority interest partner is directly or indirectly a publicly traded trust; and (2) any partner is other than a SIFT trust, REIT, taxable Canadian corporation or another excluded subsidiary entity. This issue is discussed above in the tax considerations of partnerships.

The 2011 Proposals expand the list of qualifying interest holders to include a person or partnership that does not own, or have a right to own:

■ a share that is listed or traded on a stock exchange or public market, or
■ property whose FMV is determined by reference to a publicly listed or traded share.

This relieving provision would therefore include an individual, a tax-exempt entity or a non-resident person provided that the securities or rights held by that person in the entity are not the kind described above.

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the future, an amount that can reasonably be regarded as all or any part of the capital, of the revenue or of the income of the particular entity, or as interest paid or payable by the particular entity.” For greater certainty, a “security” includes a liability of the particular entity and, in the case of a particular entity that is a corporation, shares of the corporation, among other things.
However, an individual that holds exchangeable securities (units of a private partnership that are exchangeable for publicly traded units of a REIT) would not be a qualifying interest holder and the entity may not be an excluded subsidiary entity.

5. **“Portfolio investment entity”** means an entity that does not hold any NPP.

6. **“Equity”** of an entity means:
   - A share of the capital stock of a corporation;
   - An income or capital interest in a trust;
   - An interest as a member of a partnership;
   - A liability, any amount paid or payable in respect of which is contingent or dependent on the use or production from property, or is completed by reference to revenue, profit, cash flow, etc. (i.e., participating debt); and
   - A right to, or to acquire, anything described above.

7. **“Equity value”** means the FMV of all shares, trust interests, or partnership interests, and is relevant for valuation testing in the REIT Canadian Property Test and the determination of NPP (securities of a subject entity).

8. **“Real or immovable property”** means:
   - Real or immovable property under property law;
   - Securities of an entity that meets all four REIT tests; or
   - Certain depreciable property, including:
     - Buildings in CCA Class 1, 3 or 31;
     - Property **ancillary** to the ownership or use of such buildings; or,
     - Lease, or leasehold interest, in land or Class 1, 3 or 31 buildings.

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**KPMG Observations**

*Certain depreciable real property (e.g., parking lots and surface construction on surplus land) that are not ancillary to a building are not “real or immovable property”.*

9. **“Qualified REIT property”** means:
   - **“Real or immovable property”**;
   - **Securities** of a **subject entity**, if the entity derives all or substantially all (generally, 90% or more) of its revenues directly from maintaining, improving, leasing or managing real or immovable properties that are wholly or partially owned capital properties of the trust or of an entity of which the trust holds a share or an interest;
   - **Securities** of a **subject entity**, if the entity holds no property other than legal title to wholly or partially owned real or immovable property or ancillary property of the trust or of a wholly-owned subsidiary of the trust; and
   - **Property ancillary** to the earning of rental revenue from, or capital gains from the disposition of, real or immovable properties.

The definition of “qualified REIT property” includes a security of a subject entity which earns substantially all of its revenues from maintaining, improving, leasing or managing real or immovable capital properties (including co-owned properties) of a trust or an entity of which the trust holds a share or interest. The 2010 Proposals extend qualifying revenues for this purpose to include revenue from maintaining, improving, leasing, or managing “eligible resale properties” of an entity in which the REIT holds an interest.

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However the 2010 Proposals also narrow the definition of “qualified REIT property” to include only real or immovable property that is capital property.

Finance also clarified the existing ancillary provision to narrow the types of properties that can be considered ancillary. In particular, only tangible personal property, or for civil law purposes, corporeal movable property (and, therefore, excluding securities such as equity and debt) can qualify as ancillary for this purpose. On January 28, 2011, the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (the Joint Committee) submitted to Finance that this revised view of ancillary property was unnecessarily restrictive.

**KPMG Observations**

"Ancillary Property" – The term “ancillary” is not defined in the Act. Given its ordinary meaning and comments from the CRA, ancillary property (or ancillary revenue) must be related or auxiliary to the rental of such property, but it must also be less significant and subordinate to the rental activity and it must not constitute a separate undertaking.

Under the 2010 Proposals any security of another entity (including a vendor take-back mortgage, a receivable, or a right arising under an indemnity or a guarantee) cannot be qualified REIT property unless that entity meets all the REIT conditions (other than the public listing requirement). In addition, goodwill and certain other intangible property cannot be qualified REIT property. Accordingly, a REIT must ensure that:

(i) A security held by a REIT is not NPP; or
(ii) The FMV of such a security and all other NPP that is not qualified REIT property is less than 10 percent of all NPP held by the REIT.

**KPMG Observations**

Management Subsidiary

The qualifying management subsidiary must only satisfy a revenue test; there are no property restrictions.

Property management activity is “good” revenue of the management subsidiary if the trust or a trust subsidiary owns an interest in the property.

True third-party management revenue (from property in which the trust or a trust subsidiary does not hold an interest) must represent less than 10% of the total revenue of the management subsidiary.

The real property under management must be owned by the shareholder or sister entity of the property management subsidiary. The sister entity does not need to be wholly owned.
In the 2010 Proposals, Finance introduced the following additional definitions:

1. **“Gross REIT revenues”** mean the total of all amounts received or receivable in the taxation year by the entity otherwise than as or on account of capital or capital gains. These amounts do not include recaptured depreciation.

   **KPMG Observations**
   
   For purposes of the Real Property Revenue Test and the Passive Revenue Test, the 2010 Proposals clarify that the tests should be based on gross revenues, which includes capital gains but does not include recaptured depreciation.

2. **“Eligible resale property”** is real or immovable property that is:
   - not capital property;
   - held by an entity in which the REIT holds a security;
   - contiguous to a particular real or immovable property that is capital property of the entity or of another entity in which the REIT holds a security; and is
   - necessary, and incidental, to the holding of that particular real or immovable property.

   **KPMG Observations**
   
   This new definition of eligible resale property allows REITs or its subsidiaries to occasionally hold non-capital property which is contiguous to real or immovable property that is capital property, as well as necessary and incidental to the holding of that property. As a result, this new definition provides relief where, for example, a REIT acquires property, arranges for its development to hold as commercial rental property and resells a portion of the property to another person, such as a desired anchor tenant. In addition, relief is also provided where a REIT has acquired property for resale in the condominium and foreclosure contexts.

   To meet the eligible resale property definition, such property must be held by a subsidiary of the REIT. Since the top entity, the REIT itself, is a mutual fund trust, it cannot hold land inventory. Accordingly, such activity is typically conducted by a subsidiary (often a limited partnership) in order to protect the parent’s status as a mutual fund trust.

   There is an inconsistency in the Passive Revenue Test’s application with respect to eligible resale property. Gross REIT revenue includes any proceeds of disposition of eligible resale properties. However, only the gain from dispositions of eligible resale property is listed as qualifying revenue under the Passive Revenue Test.

   Eligible resale property is not capital property and as such, does not meet the revised definition of “qualified REIT property”. Therefore, since eligible resale property is NPP, it must represent (along with all other NPP of the REIT subsidiary that is not qualified REIT property) 10 percent or less of the FMV of all NPP of the subsidiary entity.

   In addition, real or immovable property that is not capital property can also be held by entities that are not directly held by the REIT. Since, such property would not be held by an entity that is directly held by the REIT, it would not be “eligible resale property”. Consequently, the gain from the sale of such property held in lower tiers would not be qualifying revenue for purposes of the Passive Revenue Test.

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36 Section 253.1.
Foreign Currency Gains

REITs holding foreign real or immovable property may finance the acquisition of such property using debt denominated in a foreign currency. Given the potential foreign currency risk inherent in holding foreign assets, REIT may choose to enter into arrangements that hedge that risk.

The 2010 Proposals permit REITs to earn, as qualifying revenue, gains realized by virtue of foreign currency fluctuations in respect of revenues derived from such foreign real or immovable property including gains realized under certain financing and hedging arrangements in respect of such foreign property. However, foreign currency gains realized by an entity in a REIT structure that does not hold the underlying foreign real or immovable property is not considered qualifying revenue. The Joint Committee has made further submissions to Finance on this issue.

Retroactive Application

Under the 2010 Proposals, a REIT may elect, in writing on or before its filing due-date for its taxation year that includes the date on which the 2010 Proposals are enacted, for the 2010 Proposals to apply to its 2011 and subsequent taxation years.

The ability to elect to have these rules apply retroactively may benefit a REIT that was not eligible for the grandfathered exemption from the SIFT tax (for example, a REIT that became publicly traded after October 31, 2006, a REIT that exceeded its safe harbour limit or a REIT that held “non-portfolio property”).

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37 Proposed subsection 122.1(1.3)
REIT Technical Examples

Example 1 – Subsidiary Trust Structure

- One Canadian REIT obtained a favourable ruling to eliminate its subsidiary trust on a tax-deferred basis (Ruling 2007-0244691R3).
- Subsequently, the definition of "rent from real or immovable properties" was expanded to include a payment that is included in computing income of a beneficiary that was derived from the rental activity of the trust.
- The 2010 Proposals further expand the look through rule to retain the source of all qualifying revenue in order for the beneficiary to meet the REIT conditions.

Example 2 – Canadian and foreign real property ownership

- Non-portfolio property if Canadian real property represents greater than 50% of the equity value of the trust.
- If the Canadian Holdco does not hold any non-portfolio property, it should qualify as a "portfolio investment entity" and accordingly, the shares of the Canadian are not considered non-portfolio property.
REIT Activity Issues

Under the current rules, development activity is potentially problematic.

■ The character of income realized by a REIT and its subsidiaries is relevant for both mutual fund trust status and compliance with the REIT tests.

■ Real property developed for sale is generally classified as business inventory and not capital property. REITs will often sell a small parcel of land as part of a large capital property development project. The character of such land and the nature of the gain (loss) on its disposition are questions of fact.

■ Development activity must be carefully structured as: (1) the trust could lose its mutual fund trust status if it holds real property inventory; and (2) the development of real property for sale by a REIT subsidiary could result in the trust holding NPP, which could cause the trust to be subject to SIFT tax on its “non-portfolio earnings”, including its Canadian rental property earnings.

■ Under the 2010 Proposals, relief is provided to enable REITs or its subsidiaries to occasionally hold non-capital property which is contiguous to capital property and necessary and incidental to the holding of that property. This may include the development of real property for sale.

Mortgage lending and mezzanine loan programs may be problematic.

■ Interest on mortgages is qualifying revenue for both REIT revenue tests, but mortgages are not “real or immovable property”.

■ A mortgage may be “qualified REIT property” only if the debtor meets the REIT tests, which may be problematic if the debtor carries on a development business.

Example 3 – 100% foreign real property

- Taxable dividends received are not subject to SIFT Tax
- If the Canadian Holdco does not hold any non-portfolio property, it should qualify as a “portfolio investment entity” and accordingly, the shares of the Canadian are not considered non-portfolio property.
Mortgage loans may be NPP if they are viewed as assets used in carrying on a business separate from the real estate rental activity.

However, a passive investment in mortgage loans to individuals may be accommodated under the REIT tests.

Furthermore, under the 2010 Proposals, a limited degree of mortgage lending activity may be possible, for example, where the loans are secured by mortgage on real property and the loans (together with all other NPP that is not qualified REIT property) represent less than 10% of the FMV of all NPP held by the REIT.

The U.S Taxable REIT Subsidiary model is not permitted.

The Canadian REIT rules do not accommodate “bad” activity conducted in a subsidiary entity, other than insignificant activity conducted in a qualifying management subsidiary.

Nature of Income Distributed

Income distributed by a trust to unitholders is, in general, considered income from property under paragraph 108(5)(a). Active business income allocated to a corporate beneficiary of a trust is not “aggregate investment income” under subsection 129(4) and therefore is not subject to refundable tax treatment.

However, net taxable capital gains and taxable dividends distributed by the trust to unitholders may retain their character for tax purposes to the extent the trustees make the proper designations (i.e., under subsections 104(19) and 104(21)). A taxable capital gain of a mutual fund trust distributed and designated by the trustees in the year to non-resident unitholders may be considered income from property if the mutual fund trust has a “taxable Canadian property” (TCP) gains balance for that year (i.e., a net capital gains balance from the disposition of taxable Canadian properties; subsections 132(4) to (5.2)).

ACB of a Mutual Fund Trust

The ACB of a unitholder’s mutual fund trust unit is reduced by the amount of any capital distributions paid to the unitholder, except to the extent the distributions relate to income (including taxable capital gains) and/or the non-taxable portion of capital gains allocated to the unitholder (see paragraph 53(2)(h)).

The regular income and taxable capital gains distributed to a unitholder avoid an ACB grind by virtue of clause 53(2)(h)(i.1)(A). Similarly, clause 53(2)(h)(i.1)(B) allows the non-taxable portion of the capital gain to be distributed without reducing the ACB of the unitholder’s mutual fund trust units.

The CRA issued a technical interpretation which clarifies that a mutual fund trust may distribute to a beneficiary (i.e., a unitholder) the non-taxable portion of capital gains realized in a previous year, to the extent such amount was not already distributed and the taxable portion of the gain was designated under subsection 104(21) in respect of that beneficiary. 38

KPMG Observations

This interpretation provides flexibility where the distributions by a mutual fund trust in a year are not sufficient to flow out the full amount of non-taxable capital gains because this treatment allows portions of subsequent-year distributions that would otherwise reduce ACB (e.g., return of capital) to be classified as distributions of the non-taxable portion of capital gains realized in a prior year. To the extent both distributions were made to the same unitholders, there will be no grind to the ACBs of those unitholders in respect of such portion of the distributions.

If the ACB of a unitholder’s mutual fund trust units become negative, the unitholder must recognize a capital gain.

**Pension Plans**

In Canada, the investments that a pension plan is permitted to make are governed by the rules found in the Act as well as in applicable provincial pension benefits standards legislation (for provincially regulated plans) or federal pension benefits standards legislation (for federally regulated pension plans). That said, pension plans that are regulated under the *Pension Benefits Act (Ontario)* (the PBA) or the equivalent legislation in most of the other provinces are required to invest their assets in accordance with the investment rules set out in the Pension Benefits Standards Regulations (the federal investment rules) made under the federal *Pension Benefits Standards Act*, 1985 (the PBSA).

**Permitted investments for pension plans**

The federal investment rules apply in addition to those established by the pension plan itself, and impose both qualitative and quantitative limitations on the investment of pension fund assets. These limitations generally fall into three categories: those established by the prudent-person standard, those set out in the plan’s statement of investment policies and procedures, and those provided for by statute, such as the PBA or the PBSA.

The federal investment rules are important for purposes of the Act because, as summarized below, the Act and its regulations recognise and allow for investments that a pension plan is permitted to make under the PBSA or a similar law of a province.

**Income Tax Rules for Pension Plans**

**Registered pension plans**

Generally, pension plans and their wholly owned subsidiaries are exempt from tax under the Act, provided that they satisfy certain conditions. The exemption for pension plans themselves is set out in paragraph 149(1)(o), which exempts from tax a trust governed by a registered pension plan. Subparagraphs 149(o.1) and (o.2) (the First Exemption and the Second Exemption, respectively) then provide exemptions for corporations that administer a pension plan.

Under the First Exemption, a corporation is exempt from tax if it is incorporated and operated throughout the relevant period:

- solely for the administration of a registered pension plan; or
- for the administration of a registered pension plan, and, with one minor exception relating to retirement compensation arrangements, for no other purpose.

In both cases, the corporation must also be accepted by the Minister of National Revenue as a funding medium for the purpose of the registration of the pension plan.

The Second Exemption only applies if the corporation was incorporated before November 17, 1978, and then only if it was incorporated solely in connection with, or for the administration of, a registered pension plan. In addition, at all times since the later of November 16, 1978, and the date of the corporation’s incorporation, all of the shares and rights to acquire shares of the corporation must be owned by:

- one or more registered pension plans;
- one or more trusts, all the beneficiaries of which are registered pension plans;
- one or more segregated funds, all the beneficiaries of which are registered pension plans; or
- one or more persons prescribed under Regulation 4802. (the shareholder test)
In addition to the foregoing rules in section 149, Regulations 8501 and 8502 impose certain restrictions on the permitted investments and activities of a plan that is a registered pension plan under the Act. For those purposes, a registered pension plan is defined in subsection 248(1) of the Act to mean a pension plan that has been registered by the Minister of National Revenue for the purposes of the Act (where such registration has not been revoked).

The rules in the Regulations complement the federal investment rules discussed above. For example, Regulation 8502(h) requires that a pension plan’s investments cannot include a “prohibited investment” (as defined in Regulation 8514(1)) or any investment not permitted under the pension legislation governing the plan. The “prohibited investment” definition in regulation 8514 parallels the related party investment restrictions found in the federal investment rules. The restrictions are essentially designed to prevent a registered pension plan from investing in securities of an employer or certain other persons connected with the employer, subject to certain exceptions including, among other things, publicly traded shares and debt of publicly traded companies.

In addition, subsection 8502(i) prohibits a trustee or other person that holds property in connection with a registered pension plan from borrowing money for the purposes of the plan, except in limited circumstances, primarily where the borrowing is short-term (90 days or less) or relates to the acquisition of real property that may reasonably be considered to be acquired for the purpose of producing income from property.

Pension Realty Corporation and Pension Investment Corporation

Certain direct or indirect subsidiaries of pension plans also qualify for exemption under subparagraph 149(1)(o.2)(ii), which applies to “pension realty corporations” (PRCs), or subparagraph 149(1)(o.2)(iii), which applies to “pension investment corporations” (PICs). The foregoing subparagraphs closely follow the federal investment rules that apply to PRCs and PICs.

Specifically, for a corporation to qualify as a PRC under the Act, it must satisfy the shareholder test as well as the following tests relating to its activities, its investments and its borrowings:

1. **Activities Test:** The corporation’s activities, whether carried on by the corporation directly or indirectly through a partnership, must be limited to acquiring, holding, maintaining, improving, leasing or managing capital property that is real property or an interest in real property owned by the corporation or by another PRC or a registered pension plan.

2. **Investments Test:** The corporation can make no investments other than real property or an interest therein or in investments that a pension plan is permitted to make under the PBSA or a similar law of a province (such as the PBA).

3. **Borrowing Test:** The corporation can only borrow money for the purpose of earning income from real property or an interest therein.

All of the foregoing tests must be satisfied at all times since the later of November 16, 1978 and the date on which the corporation was incorporated.

A corporation will qualify as a PIC if it satisfies the shareholder test as well as the following tests relating to its investments, its assets, its income and the issuance of debt obligations:

1. **Investments Test:** The corporation can make no investments other than investments that a pension fund or plan is permitted to make under the PBSA or a similar law of a province (such as the PBA).
2. **Asset Test:** The assets of the corporation must be at least 98% cash and investments.

3. **Income Test:** The corporation must derive at least 98% of its income in its taxation year from, or from the disposition of, investments.

4. **Debt Obligation Test:** The corporation cannot issue debt obligations or accept deposits.

**KPMG Observations**

Pension plans continue to be significant players in real estate. Because of their tax-exempt status, they aim to avoid holding property in taxable entities. Because they generally prefer not to be partners, joint ownership of property can be difficult to arrange if the other participant is to contribute appreciated assets to a joint venture.

Alternatives that may address this issue include participating lease arrangements in which rents approximate ownership of what amounts to an undivided interest in a property, with a large prepayment of rent in front that can be amortized into income by the other participant over the term of the lease. This arrangement allows the “vendor” to have cash and at the same time defer recognition of the income using reserves allowed for tax purposes (see paragraph 20(1)(m)).

Other ideas include a pooling of interests of various parties so that the operating income from a group of properties can be shared with no disposition of the property, though a partnership could potentially be considered to exist in connection with the operations.

Where the pension plan wishes to participate in the development of real estate (an activity that cannot be undertaken by a PRC), it may be possible for it to do so through a PIC. A typical structure in these circumstances would involve the PIC investing directly or indirectly in a limited partnership that carries on the real estate development business.

**Note:** This or any other planning idea should only be acted on with appropriate professional advice after a thorough examination of the particular situation.
Ownership and Operating Issues

Property Additions

Acquisitions

*Land/building allocation*

The land/building allocation may be specified in purchase/sale documents.\(^{39}\) If an allocation is not specified in the agreement, consider the following alternatives:

- Allocate to land based on comparable vacant land with the balance to building
- Allocate to land/building based on recent appraisals
- Allocate based on property tax assessments
- Adopt the allocation used for accounting purposes (if the method is reasonable)
- Allocate 10% – 35% to land, depending on location, with better located properties having the larger portion allocated to land (certain facts may require an allocation outside this range).

In addition to buildings, look for potential allocation to paving, furniture and fixtures, automotive equipment, signage and other classes with CCA rates greater than 4%.

Retail sales tax implications must be considered in certain provinces if an allocation is made to tangible personal property (not affixed to real property).

The GST/HST implications of the acquisition of real property are discussed in detail below.

*Intangible assets and below-market leases*

Under Accounting Standards for Private Enterprises (ASPE), operating leases acquired in either an asset acquisition or a business combination, an entity is required to allocate a portion of the purchase price of the property to intangible and tangible assets. Intangible assets include the value of “in-place” operating leases, the differential between original contractual rents and market rents for in-place leases, and tenant relationships. For accounting purposes, these intangibles are deferred and amortized generally over the term of the lease.

Under IFRS, the intangible assets and liabilities are also recognized, however, the presentation of such amounts differs from ASPE. The value of “in-place” leases and favourable (“above market” or unfavourable (“below-market”) contractual terms are incorporated into the carrying cost of the investment property. An intangible asset for customer relationship is recognized separately. The depreciation or amortization of each intangible asset or liability is computed separately.

IFRS and ASPE depreciate/amortize these costs generally over the term of the lease.

For tax purposes, no value is generally allocated to the intangible assets (e.g., leases and tenant relationships). In *Income Tax Technical News* No. 38, dated September 22, 2008, CRA confirmed that the full amount of the purchase price is allocated to the tangible assets (i.e., land and building).

\(^{39}\) Where raw land is acquired for development or where an income-producing property is acquired as inventory, the purchase price allocation among the various components acquired (if any) will be of little significance for income tax purposes.
**Purchase price discount due to non-market rate debt**

Under generally accepted accounting principles (GAAP), a purchase price discount received due to the assumption of a high-interest rate debt obligation in conjunction with the purchase of real property is deferred and amortized as a reduction to interest expense over the remaining life of the obligation.

For tax purposes, the discount is included in the income of the purchaser in the year of purchase either under section 9 or as an inducement payment under paragraph 12(1)(x). No amortization of income is allowed.

Alternatively, an election can be made under subsection 13(7.4) to reduce the capital cost of the depreciable property acquired by the discount. A similar election under subsections 53(2) and 53(2.1) is available for non-depreciable property.

Conversely, if the assumed debt has a stated interest rate that is less than the current rate, a portion of the purchase price may represent a cost of incurring indebtedness. The purchaser therefore should be able to deduct the amount as a paragraph 20(1)(e) financing cost.

**Capital Cost Allowance — Paragraph 20(1)(a)**

Tax depreciation deductions permitted in computing business or property income (see paragraph 20(1)(a)) include:

- **Class 1 (4%)**
  - For residential buildings (such as apartment buildings and retirement homes), used non-residential buildings acquired after March 18, 2007, and buildings acquired after 1987 and before March 19, 2007.

- **New Class 1 (6% and 10%)**
  - For newly constructed buildings and newly acquired buildings that were neither used by anyone nor acquired for use before March 19, 2007, a taxpayer may claim a declining-balance deduction as follows:
    - 6% for property acquired after March 18, 2007 that is an "eligible non-residential building", 90% of the floor space of which is used for a non-residential use
    - 10% for property acquired after March 18, 2007 that is an "eligible non-residential building", 90% of the floor space of which is used by the taxpayer or a lessee of the taxpayer for the manufacturing or processing (m&p) of goods in Canada for sale or lease.

To qualify for these rates, the taxpayer must elect to place the building in a separate class under subsection 1101(5b.1) of the Regulations.

The CRA has stated that this election cannot be late filed and cannot be made by simply identifying a building in the CCA schedule. The election must be made by attaching a letter to the return of income for the year in which the building is acquired.

- An "eligible non-residential building" of a taxpayer is defined in subsection 1104(2) of the Regulations as a building:

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41 A payment (or purchase price allocation) to assume debt with a stated interest rate that is below the market interest rate may not be deductible by the purchaser since the amount is a capital outlay. The amount may be deductible under subparagraph 20(1)(e)(i.1) since it arose in the course of incurring indebtedness.
42 For CCA purposes, the cost of real estate, other than the portion allocated to land, is generally allocated to Class 1. However, a portion of the purchase price may qualify as an addition to a class other than Class 1 for CCA purposes.
43 See draft Regulations 1100(1)(a.1) and (a.2).
o located in Canada;
o included in Class 1 in Schedule II of the Regulations;
o not previously used, or acquired for use, by any person (including a partnership) before March 19, 2007; and
o acquired by the taxpayer on or after March 19, 2007 to be used by the taxpayer, or a lessee of the taxpayer, for a non-residential use.
o Buildings used for M&P that do not meet the 90% usage threshold at the end of the taxation year are still eligible for the 6% CCA rate for other non-residential buildings (provided the building meets the conditions of “an eligible non-residential building” and 90% of the building is used for non-residential purposes).

– The cost of an addition to or an alteration of an existing building is deemed to be the capital cost of a separate building if the existing building was not included in a separate class under Regulation 1101(5b.1).\textsuperscript{45} Therefore, as long as 90% of the floor space of the entire building and its addition\textsuperscript{46} are used for eligible use and an election is made, the cost of the addition or alteration is eligible for the enhanced CCA rates.

■ Class 3 (5%)
  – Buildings acquired before 1988
  – Post-1987 additions, the lesser of
    o $500,000 for each building; and
    o 25% of the capital cost of the building in a Class 3 balance at the end of 1987.

■ Class 6 (10%)
  – Fencing
  – Irrigation ponds (golf course).

■ Class 8 (20%)
  – Furniture and fixtures
  – Irrigation equipment (golf course)
  – Outdoor advertising poster panel or bulletin board.

■ Class 10 (30%)
  – Computer equipment acquired before March 22, 2004
  – Automotive equipment that is not a passenger vehicle in Class 10.1
  – Contractor’s movable equipment acquired for use in a construction business
  – Separate CCA class for computers.

■ Class 10.1 (30%)
  – Passenger vehicles costing more than $30,000 (after 2000).

■ Class 12 (100%)
  – Software other than system software.

■ Class 13 (straight-line)
  – Leasehold interest

\textsuperscript{45} Regulation 1102(23)
\textsuperscript{46} Regulation 1102(24)
Straight-line over the minimum of:

- five years, and
- the term of the lease plus the first renewal term.

**Class 17 (8%)**
- Paving, sidewalks
- Golf course greens, tees and fairways.

**Class 42 (12%)**
- Fibre-optic cable
- New telephone or data communications wiring or cabling acquired after February 22, 2005.

**Class 43.2 (50%)**
- Equipment acquired after February 22, 2005 and before 2020 that generates or conserves energy by:
  - using a renewable energy source;
  - using fuels from waste; or
  - making efficient use of fossil fuels.

**Class 46 (30%)**

**Class 50 (55%)**

**Class 52 (100%)**
- Eligible computers and system software acquired after January 27, 2009 and before February 2011.
- Additions to this class are not subject to the half year rule.

### Non-arm’s Length Transfers

When a depreciable asset is disposed of by a person (i.e., corporation, trust and individual) or partnership to a person or partnership affiliated with the transferor and there would otherwise be a terminal loss on the transfer, the terminal loss is suspended.

The transferee is deemed to acquire the property at the transferor’s capital cost and is deemed to have claimed CCA in previous taxation years for an amount by which the transferor’s capital cost exceeded the FMV of the property at the time of transfer.

The transferor may claim the terminal loss when there is a change in ownership of the transferor, the transferee, or a subsequent change in ownership of the asset to a person or partnership that is not affiliated.

These rules are contained in subsection 13(21.2) and should be reviewed based on the specific facts prior to the transaction to ensure there are no anomalous results.

Similar rules apply to a loss on a non-arm’s length disposition of non-depreciable capital property.\(^{47}\)

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\(^{47}\) See subsections 40(3.3) and (3.4) (stop-loss rules) and section 54 (superficial loss rules).
When a depreciable asset is acquired by a person or partnership (the “Acquirer”) from another person or partnership (the “Transferor”) with whom the Acquirer did not deal at arm’s length, the amount that would otherwise form the undepreciated capital cost (UCC) to the Acquirer may be reduced. Paragraph 13(7)(e) limits the Acquirer's UCC to an amount equal the capital cost of the asset to the Transferor plus 50% of the amount, if any, by which the proceeds of disposition to the Transferor exceed the cost to the Transferor. Effectively, this rule prevents the Acquirer from claiming CCA on the amount of the gain that was not subject to tax on the sale.

The adjustment to the capital cost of the Acquirer is only for purposes of computing the Acquirer's future CCA claims and recapture; the capital cost is not adjusted for the purpose of computing the Acquirer's adjusted cost base. Therefore, when the Acquirer ultimately disposes of the property, the capital gain will be computed with reference to the Acquirer's actual capital cost and not the capital cost adjusted by paragraph 13(7)(e).

A similar provision in paragraph 13(7)(f) adjusts the capital cost when there has been a gain elected on an acquisition of control.

**Affiliated persons**

Affiliated persons are defined in subsection 251.1(1) to include certain relationships between individuals, corporations and other persons, two corporations, corporations and partnerships, partners and partnerships, and two partnerships.

The rules for affiliated persons differ from the rules for associated companies but are just as complex. (The concept of associated corporations is not discussed in this Handbook.)

Affiliated persons are defined as:

- An individual and his or her spouse or common-law partner.
- A corporation and:
  - A person by whom the corporation is controlled
  - Each member of an affiliated group of persons by which the corporation is controlled, or
  - A spouse or common-law partner of a person in (i) or (ii) above.
- Two corporations if:
  - Each corporation is controlled by a person and those controlling persons are affiliated
  - One corporation is controlled by one person and the other corporation is controlled by a group of persons, each of whom is affiliated with that person, or
  - Each corporation is controlled by a group of persons and each member of each group is affiliated with at least one member of the other group.
- A corporation and a partnership if the corporation is controlled by a particular group of persons and each member of that group of persons is affiliated with at least one member of a majority-interest group of partners in the partnership and each member of that majority-interest group is affiliated with at least one member of the particular group.
- A partnership and a majority-interest partner in the partnership.
- Two partnerships if:
  - The same person is a majority-interest partner in both partnerships

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48 While the calculation in paragraph 13(7)(e) is involved, generally the Acquirer's cost for UCC purposes is reduced by any portion of the Transferor's gain that is not taxable.

49 The preamble to subsection 13(7) limits the scope of the subsection to certain sections, including the calculation of CCA and recapture.
A majority-interest partner in one partnership is affiliated with each member of a majority-interest group of partners in the other partnership, or

Each member of a majority-interest group of partners of each partnership is affiliated with at least one member of a majority-interest group of partners in the other partnership.

Note that siblings and children and their parents are not considered affiliated persons.

**Affiliation between a person and a trust**

Paragraph 251.1(1)(g) sets out certain circumstances in which a person and a trust are affiliated. A trust is affiliated with any beneficiary who is entitled to a majority of the trust income or capital (a “majority-interest beneficiary”, defined in subsection 251.1(3)) and generally with any person affiliated with such a beneficiary. This rule applies after March 22, 2004.

Paragraph 251.1(4)(c) provides that a reference to a trust does not include a reference to the trustee or other persons who own or control the trust property. This provision is useful in situations in which an estate or a corporation controlled by the estate could otherwise have been affiliated with the trustee or a corporation controlled personally by the trustee.

**Available for Use**

**Building available for use — Subsection 13(28)**

Depreciation for tax purposes will only be available when the property is considered to be available for use at the earliest of:

- The time at which all or substantially all (i.e., 90% or more) of the building is used for its intended purpose;
- The time at which construction is complete;
- Two years after acquisition (and in some cases earlier), although:
  - a two-year rolling start rule applies for long-term construction projects, and
  - the half-year rule does not apply for construction expenditures incurred before the current year; and
- Immediately before disposition.

For “replacement property”, when the replacement property is acquired, although:
- the property has to be used by the end of the first taxation year following year of disposition; and
- this provision only applies for involuntary dispositions, e.g., expropriations, fires and floods.

For the purposes of this provision, a renovation, alteration or addition to an existing building is considered to be a building separate from the existing building.

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50 Subsection 13(27) contains the general rules for determining when property other than buildings becomes available for use.

51 Technical Interpretation 2003-0035347, “Available for use rules”: The CRA’s view is the time referred to in paragraph 13(28)(a) is not the time that the construction phase of a building is “all or substantially all” complete. The CRA’s view is that the “all or substantially all” requirement will be met when 90% or more of the building’s square footage is used for its intended purpose.
Long-term project election — Subsection 13(29)  

The election is available for properties used in long-term projects. This election allows for:

- a two-year rolling start  
- expenditures in year 1 and year 2 to be fully applied in year 3 and year 4  
- expenditures in year 3 to be applied in year 5 but limited to expenditures in year 1  
- expenditures in year 4 to be applied in year 6 but limited to expenditures in year 2 plus unused expenditures in year 1.

This provision does not apply to rental properties. However, in the development of multiphase properties, it is important to note that each phase is usually considered a separate property. Therefore, subsection 13(28) should apply to bring the earlier phases into the UCC pool prior to the completion of the overall project.

Non-arm’s-length transfers — Subsections 13(30) and 13(31)  

Property transferred in a non-arm’s-length transaction (e.g., through non-arm’s-length purchases and corporate reorganizations) is treated as if it had been acquired by the transferee at the time it was in fact acquired by the transferor (i.e., the available-for-use rules flow through).

Regulation 1100(2.2)(j)(iv) deems “available for use” to be at the earlier of the time the property is acquired by the transferee and the time it became available for use by the transferor. Therefore, in a non-arm’s-length transfer, the half-year rule does not apply where the transferor owned the property at least 364 days prior to the end of the transferee’s taxation year in which the property was acquired.

Anti-avoidance — Subsection 13(32)  

Subsection 13(32) includes an anti-avoidance rule intended to prevent any benefits a taxpayer may achieve by accelerating write-offs through a lease of property to a non-arm’s-length person before the property is otherwise available for use.

The rent paid by the non-arm’s-length person before the property is otherwise available for use is not deductible as ordinary rent but is depreciable under Class 13 as a cost of acquiring a leasehold interest.

Determination of available for use and/or capable of use depends on the facts of each case.

It is essential that all documentary support relevant to the asset be retained (for example, an architecture or engineer certificate of completion).

This rule is effective for property acquired by a taxpayer after 1989.

Current vs. Capital Expenditure  

When a business incurs expenditures related to a property, it is important to determine whether the expenditures are current or capital in nature. There are no specific provisions in the Act for determining whether an expenditure is on account of income or capital. Rather, the determination of whether an expenditure is on account of income or capital will depend on the specific facts and the particular circumstances surrounding the nature and context of the expenditure. As recently summarized by the CRA, jurisprudence

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52 An election pursuant to subsection 13(29) allows a taxpayer to apply the available-for-use rules to costs incurred during a long-term construction contract in years subsequent to the first two years (and, where the second taxation year is less than 358 days, the first taxation year that commences more than 357 days after the end of the first taxation year) where they exceed the costs incurred in the first two taxation years. The election does not affect the application of the available-for-use rules to costs incurred during the first two taxation years.

53 Paragraphs 13(27)(b) and (28)(c) and subsection 13(29).
suggests that there are four guidelines that are relevant in the determination: enduring benefit, maintenance or betterment, integral part or separate asset, and relative value. Generally, an expenditure for the maintenance or repair of a property is a current expense that is deductible in the period. Some of the elements of a current expense are:

- It is a recurring expense for the replacement or renewal of a specific item
- The useful life of the acquired property is relatively short (generally does not exceed a year) and provides little long-term benefit
- It repairs, maintains or restores an asset to its condition when originally acquired by the taxpayer.

Generally, a capital expenditure is made to acquire or improve depreciable or non-depreciable capital property. Some of the elements of a capital expense are:

- It provides a lasting or enduring benefit
- It improves or enhances the property beyond its original condition
- A separate asset is acquired
- The amount of the expenditure is high in relation to the value of the whole property or in relation to previous average maintenance and repair costs
- The costs are incurred to repair property acquired so that it is in a suitable condition for use
- The repairs were made in anticipation of the sale of the asset.

For additional information, see paragraph 4 of Information Bulletin IT-128R, “Capital Cost Allowance — Depreciable Property”.

When expenditures include both current and capital elements and these can be distinguished, an appropriate allocation of the expenditures is necessary. When only an insignificant part of the expenditure is of a capital nature, the CRA may be prepared to treat the whole amount as a current expense.

**Leaky condominiums — Technical Interpretation 2001-0104217**

The cost of maintaining and repairing the original building envelope (including the method originally used for rain penetration control) of such property may be considered deductible as a current expense.

The cost of repairing damage to internal components of a building (such as mouldy insulation and rotted framing) as a result of water penetration to restore them to their original condition using identical or equivalent quality materials (without improving them beyond their original condition) may generally be considered currently deductible.

Redesigning a building envelope to improve its effectiveness to control water penetration (such as adapting the structure to incorporate a new method for rain penetration control) appears to constitute a material improvement to the property beyond its original condition based on relevant case law, and related costs may be considered capital expenditures.

**Replacement Property Rules**

Subsection 13(4) allows a taxpayer to elect to defer tax on the recapture resulting from the disposition of certain depreciable property to the extent that the taxpayer reinvests the proceeds of disposition in a replacement property within the following timeframe:

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54 CRA Views 2010 – 03824041E5 – Capital or current expenditures
- In the case of certain involuntary dispositions, e.g., theft or expropriation, before the end of the taxpayer's second taxation year that begins after the property was disposed of; or
- In other situations, before the end of the taxpayer's first taxation year that begins after the property was disposed of.

The replacement property rules are available for either:
- Property unlawfully taken, destroyed or taken under statutory authority (i.e., expropriated); or
- Former business property as defined in subsection 248(1).

Former business property is capital property that is real property or an interest in real property that is used by the taxpayer primarily for the purpose of gaining or producing income but generally does not include rental property.

An involuntary disposition of rental property, however, may qualify for the replacement property rules.

For dispositions or transactions after December 20, 2002, the July 16, 2010 draft legislation proposes to extend the definition of former business property to a franchise, concession or license for a limited period to carry on a business in a fixed place. A valid election under proposed subsection 13(4.2) must be jointly made by the purchaser and the vendor.

The July 16, 2010 draft legislation also proposes to amend subsection 13(4) to accommodate taxation years that are shorter than 12 months by providing that the periods for acquiring replacement property end at the later of the times mentioned above and:
- In the case of involuntary dispositions, within 24 months after the end of the taxation year in which the property was disposed of; or
- In other situations, within 12 months after the end of the taxation year in which the property was disposed of.

These amendments apply, in the case of involuntary dispositions, to dispositions that occur in taxation years that end on or after December 20, 2000, and in any other case, to dispositions that occur in taxation years that end on or after December 20, 2001.

A new property is only considered a replacement property if:
- It is reasonable to conclude that the property was acquired by the taxpayer to replace the former property
- It is acquired by the taxpayer and used by the taxpayer or a person related to the taxpayer for a use that is the same as or similar to the use to which the taxpayer or a person related to the taxpayer put the former property
- Where the former property was used by the taxpayer or a person related to the taxpayer for the purpose of gaining or producing income from a business, it is acquired for the purpose of gaining or producing income from that or a similar business or for use by a person related to the taxpayer for such a purpose
- Where the former property was TCP of the taxpayer, the particular depreciable property is TCP of the taxpayer; and

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55 Canada, Department of Finance, Legislative Proposals to Amend the Income Tax Act and Related Regulations to Effect Technical Changes and to provide for Bijural Expression in that Act; the Income Tax Amendments Act, 2010 (Ottawa: Department of Finance, July 2010).
Where the former property was TCP (other than treaty-protected property) of the taxpayer, the particular depreciable property is TCP (other than treaty-protected property) of the taxpayer.

Subsection 44(1) offers similar rules for a deferral of a capital gain on the disposition of certain capital property other than shares of a corporation.

A business expansion does not automatically preclude the use of the replacement property rules. There must be a correlation or causal relationship between the acquisition of the replacement property and the disposition of the former property.

**Tax Treatment of Bargain Purchase Option Leases**

The CRA does not plan to issue any written audit policy that would contradict its current public policy that "a lease is a lease and a sale is a sale". Nevertheless, the CRA has acknowledged that there will still be situations in which field auditors will choose not to reassess taxpayers who treat leases involving bargain purchase options (BPO) (i.e., an option to buy the leased property at a low price) as sales.

The CRA withdrew Interpretation Bulletin IT-233R, "Lease-Option Agreements; Sale-Leaseback Agreements", effective June 14, 2001. This IT stated that the substance of the agreement rather than its form determined whether a transaction was a sale or a lease. Since the CRA cancelled this IT, its position has generally been that the taxpayer's legal relationship created by the lease agreement determines the nature of the transaction rather than the underlying reality. In other words "a lease is a lease and a sale is a sale" (see Income Tax Technical News (ITTN) No. 21).

In Ruling 2003-0028033, "Lease – Bargain purchase option", the CRA ruled that a lease with a BPO will continue to be treated as a lease for tax purposes rather than a purchase and sale agreement. However, each lease payment will have the following result: the lessor will receive rental income and an amount deemed to be proceeds of disposition for granting the BPO, and the lessee will pay rent expense and an amount that is the cost of the BPO.

The CRA has also stated that where a BPO exists, a portion of the lease payments could be considered in respect of the right to purchase the property in the future and will be treated as an "option" under section 49. The option amount may be subject to a valuation. Further, where the facts indicate that all or a proportion of the lease payments are for the option, such amount would not be a deductible expense to the lessee.57

The CRA is likely to require taxpayers to allocate a portion of a lease payment to a BPO only in certain situations, such as real estate leasing or other types of lease agreements involving assets that tend to appreciate in value. Lease agreements involving lower-priced equipment in which the industry practice is to include BPOs may not be reassessed by the CRA. Ultimately, this issue is a question of fact.

When the leased property would have been depreciable property to a taxpayer if acquired, the taxpayer and an arm's-length lessor may elect under subsection 16.1(1) to allow the lessee to be treated for income tax purposes as having acquired the property at its FMV and as having financed the purchase through a loan at a prescribed rate of interest.

**Contingent Liabilities**

On March 16, 2011, Finance released broadly worded draft income tax proposals relating to contingent amounts not otherwise caught under the general limitation in paragraph 18(1)(e). In particular, these proposals were intended to address the Federal Court of

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Appeal decision, Collins v. The Queen, 2010 FCA 12, in which the Court held that the taxpayers could deduct interest expenses as they accrued even though the taxpayers had a right to reduce the amount payable in respect of the interest expenses. The Court indicated that it was not the interest amounts payable that were contingent; instead, it was the issue of whether the taxpayers would exercise their right to reduce the amount they were required to pay that was contingent. In response, under new subsection 143.4(2), the amount of a taxpayer’s expenditure, that is otherwise deductible for the purposes of the Act or that otherwise forms part of a capital property to the taxpayer, is reduced by the amount, if any, by which the total amounts each of which is a “contingent amount” of the taxpayer in respect of the expenditure exceeds the total of all amounts each of which is an amount paid by the taxpayer to obtain a “right to reduce” an amount in respect of the expenditure.

A “contingent amount” is broadly defined to include an amount of a taxpayer at any time (other than a time at which the taxpayer is a bankrupt) to the extent that the taxpayer, or another taxpayer that does not deal at arm’s length with the taxpayer, has a right to reduce the amount at that time. In a letter to Finance dated November 7, 2011, The Joint Committee recommended that the definition be narrowed by changing “includes” to “means”.

“Right to reduce” an amount in respect of an expenditure at any time is also broadly defined to mean a right to reduce or eliminate the amount including, for greater certainty, a right to reduce that is contingent upon the occurrence of an event, or in any other way, if it is reasonable to conclude, having regard to all the circumstances, that the right will become exercisable. Discussions with Finance officials indicated that it is Finance’s view that generally any change to a taxpayer’s obligation should be caught (including automatic contractual adjustments and adjustments from legal proceedings). The Joint Committee expressed concern that the intended broad application of the “right to reduce” definition goes “well beyond the sort of situation at issue” in the Collins case, and could apply to any expenditure adjustment.

In addition, the Joint Committee is concerned with the “reasonable to conclude” aspect of the proposed definition of “right to reduce”. Finance’s intention is understood to require a taxpayer to review all circumstances in which an adjustment may be required and then to determine whether, in the particular taxation year, it is reasonable to conclude that an adjustment will be made at a future time. The Joint Committee considers that the uncertainty and additional work required under the proposal is not necessary to address Finance’s concerns. Further, the draft legislation and explanatory notes do not provide any guidance on what sort of level of probability is associated with a “reasonable to conclude” outcome.

If the taxpayer subsequently pays all or a portion of the contingent amount, the taxpayer is considered to have incurred the previously reduced expenditure to the extent it was paid. The amount paid is considered to be incurred in the year paid for the same purpose and to have the same character as the expenditure that was previously reduced.

If a taxpayer, or a person with whom the taxpayer does not deal at arm’s length, has a right to reduce in respect of an expenditure in a year subsequent to the taxation year in which the expenditure occurred, the taxpayer is deemed to have received a “subsequent contingent amount” included in income under paragraph 12(1)(x). This only applies if the original expenditure was not otherwise subject to a reduction under subsections 143.4(2) or 143.4(4). The “subsequent contingent amount” is equal to the amount by which the amount in respect of an expenditure may be reduced under the right to reduce.

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58 Proposed subsection 143.4(1).
59 Proposed subsection 143.4(1).
60 Proposed subsection 143.4(3).
61 Proposed subsection 143.4(4).
exceeds the amount paid to obtain such right. However, if it is reasonable to conclude that one of the purposes of having the right to reduce an amount in respect of an expenditure after the end of the taxation year in which an expenditure is incurred was to avoid a reduction under subsection 143.4(2) of the Act, there is an anti-avoidance rule that would apply to deem the right to reduce to exist in the taxation year in which the expenditure arose (i.e., 143.4(2) would reduce the amount of the expenditure instead of an income inclusion under paragraph 12(1)(x)).

Further amendments also provide the Minister of National Revenue the authority to make assessments, determinations and redeterminations that are necessary to give effect to new section 143.4 notwithstanding that the taxation year in question is otherwise statute-barred from assessment.

A taxpayer includes a partnership for purposes of this new section.

New section 143.4 applies in respect of taxation years ending on or after March 16, 2011. As of the date hereof, the draft legislation has not yet been included in a bill.

**KPMG Observations**

*The impact of proposed section 143.4 should be considered when the purchaser of real property has deferred consideration payable to the vendor which may be reduced if certain performance targets are not achieved (i.e. net operating income guarantees).*

**Financing**

**Interest Deductibility**

For income tax purposes, there is a presumption that interest is a capital expenditure and therefore only deductible as specifically provided for in the Act (see paragraphs 18(1)(b) and 20(1)(c)).

To be deductible, interest must be:

- Paid in the year or payable in respect of the year
- Pursuant to a legal obligation to pay interest on:
  - money borrowed for the purpose of gaining or producing income from a business or property; or
  - an amount payable for property acquired for the purpose of producing income from the property or income from a business, and
  - reasonable.

**Related Court Cases**

Court cases relating to interest deductibility include rulings from the SCC issued September 28, 2001:

- The decision in *Ludco Enterprises Ltd., et al v. The Queen* (2001 SCC 62) validated interest deductions wherever there is a reasonable expectation of receiving income, considering all the circumstances. (Gross income, not net income, is sufficient to satisfy this criterion.) Absent of sham or window dressing, a taxpayer’s ancillary purpose may be a bona fide objective meeting the income-earning purpose requirement.

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62 Proposed subsection 143.4(5).
63 Proposed subsection 143.4(6).
64 Proposed subsection 143.4(7).
65 Proposed subsection 143.4(1).
The decision in *The Queen v. Singleton* (2001 SCC 61) can support taxpayers’ entitlement to restructure their financial affairs so that they can directly link borrowing to income-earning assets to claim an interest deduction.

The decision in *Lipson, E., et al. v. The Queen* (2009 SCC 1, 2009 CSC 1) was not favourable to the taxpayer, as it was determined that GAAR applied to an abuse of the attribution rules. However, the decision confirmed that the Singleton decision still constitutes good law. Thus, debt-structuring to obtain an interest deduction, which had been in doubt as a result of the Federal Court of Appeal decision, was confirmed as acceptable under the GAAR.

**Reasonable expectation of profit (REOP):**

In *Stewart v. R.* (2002 SCC 46), the SCC ruled that, because the taxpayer’s rental activity was clearly commercial with no personal element involved, such an endeavour necessarily involved the pursuit of profit. Thus, the REOP test did not apply to disallow the deduction of the taxpayer’s rental losses.

These decisions could lead to unexpected tax results when a taxpayer derives a tax loss by deducting interest expenses, even if, under any objective standard, there is no reasonable expectation that the taxpayer would earn any income (as opposed to capital gains) or when the presence or the prospect of revenue (as opposed to income net of expenses) is enough to conclude that an expenditure was incurred “for the purpose of earning income”.

**CRA’s Positions on Interest Deductibility**

The CRA’s positions on interest deductibility are outlined in *Interpretation Bulletin IT-533, “Interest Deductibility and Related Issues”,* dated October 31, 2003, and are consistent with the decisions reached by the SCC.

**Draft Legislation to Codify the “Reasonable Expectation of Profit” Test**

In response to *Ludco* and *Stewart*, on October 31, 2003, Finance proposed draft legislation to add section 3.1 to the Act.

**Status of proposed section 3.1**

An extended period of public consultation on the proposals ended in August 2004. Concerns were expressed with the proposals’ structure, and particularly that the proposals’ codification of an objective REOP test might inadvertently limit the deductibility of a wide variety of ordinary commercial expenses. The proposals had wide implications (including, for example, the structuring of participating loans and the tracing of the movement and use of funds, often between different entities).

In the February 23, 2005 federal budget, Finance said that it would release an alternative proposal for comment as soon as possible. Finance said it has sought to respond to commentators’ concerns by developing a more modest legislative initiative that would still achieve the government’s objectives. There have been no further announcements since 2007.

**Proposed section 3.1**

Section 3.1 would have limited the ability of a taxpayer to realize a loss for a taxation year from a business or property unless it was reasonable to assume that the taxpayer would realize a cumulative profit from that business or property:

- In the case of a business, during the time the taxpayer has carried on, or can reasonably be expected to carry on, the business, or
- In the case of property, during the time that the taxpayer has held, or can be reasonably expected to hold, the property.
Section 3.1 was proposed to apply to taxation years beginning after 2004.
Capital gains or capital losses were not included in making the determination of expectation of profit for the purposes of proposed section 3.1.

Two time periods were important under the proposed REOP test:

- **Annual evaluation** — This test would be done annually, e.g., a taxpayer wishing to claim a loss in a year would determine if it was reasonable in that taxation year to expect to realize a cumulative profit from the business over the entire profitability period.

- **Profitability period** — This period refers to the entire period over which the taxpayer held the property or carried on the business. The beginning of the profitability period would be easy to determine; however, the end would be more contentious.

A major concern with proposed section 3.1 was the deductibility of interest expense on money borrowed to acquire shares. A strict reading of the proposal questioned whether this REOP test was met if a taxpayer borrowed money to acquire certain types of common shares of companies that did not typically pay dividends but rather reinvested their income and increased the share value, giving rise to future capital gains in the shareholders’ hands on the disposition of their shares.

It was understood that Finance and the CRA do not intend to change the rules on the deductibility of interest expense on money borrowed to acquire common shares. In this regard, the Joint Committee, the Conference for Advanced Life Underwriting, the Investment Funds Institute of Canada, the Tax Executives Institute and the Society of Trust and Estate Practitioners, among others, sent submissions to Finance expressing their concerns.

**Limit on loss claims — REOP required**

The draft proposals required that a cumulative REOP test be applied each year in which a loss is realized.

Since the REOP test required that a business or property generate an overall cumulative profit, all losses must be recouped to continue to deduct expenses.

This test applied broadly to all business expenses, including interest expense, and could restrict CCA claims. For example, if borrowed money was used or depreciable property was acquired in year 1 of a business and that business became unsuccessful in year 5 for whatever reason, the deduction of interest, CCA and all other related expenses could have been denied in year 5 (and all later years) if there was no reasonable expectation that accumulated net losses would be recouped in the future.

**Potential for Restricted Interest Deductibility in Other Situations**

Deductibility of interest expense is limited by subsections 18(2) and 18(3.1), as discussed below. Other situations where interest deductibility may be restricted are as follows:

**Refinancing** — Properties may be refinanced and the funds generated distributed to another entity. A problem may arise when the amount of the distribution exceeds the entity’s equity in the form of paid-up capital or retained earnings. In real estate, it is common for funds to finance new projects to be sourced by increasing the amount of debt on existing assets, effectively realizing the appreciation in their value without any immediate income tax consequences. Difficulties can arise when the new property is to be acquired in a different entity and the funds have to flow back to another entity in the organization.

**Participating debt** — Historically, interest has been viewed as a capital expenditure deductible for income taxes only as permitted by paragraph 20(1)(c). The courts have required that, to be interest, amounts have to accrue daily and be calculated by reference to the principal. The charges arising from participation features may not meet these criteria.
The Federal Court of Appeal decision in The Queen v. Sherway Centre Limited challenged the conventional wisdom and went against rulings of higher courts with the purpose of bringing the rules up-to-date with current market realities. The daily accrual requirement can be satisfied by viewing interest as capable of being ascertained on a daily basis, rather than expressed on a daily basis as previously professed by the courts. The reference to principal would be satisfied because the interest would only be payable as long as there was a principal amount outstanding.

In Income Tax Technical News No. 16, the CRA states that, while the Sherway decision has caused it to expand its published position, the decision does not mean that all participating payments are considered interest. When all the published criteria are not satisfied but the evidence shows, as it did in Sherway, that the participating payments are intended to increase the interest rate of the loan to the prevailing market rate, the payments will be considered interest.

To meet the prevailing market rate test in the CRA’s guidelines, evidence of the fixed rate of interest at which the taxpayer could have borrowed and the anticipated effective interest rate resulting from the participating loan terms should be documented.

Compound interest — Interest on interest is deductible only when paid. Interest on compound interest may not be deductible at any time. Presumably, such situations are rare under current market conditions.

**KPMG Observations**

**Capitalizing Interest for Accounting and Tax Purposes**

The Real Property Association of Canada (REALpac) Handbooks under Accounting Standards of Private Enterprises (ASPE) and International Financial Reporting Standards (IFRS) recommend the capitalization of interest to qualifying assets during the development period to the extent that the interest costs incurred could have been avoided if the expenditures for the assets had not been made. The amount of interest to be capitalized is determined by first using the actual interest rate on the actual borrowed funds used specifically for development, then, to the extent of excess expenditures, by applying the entity’s weighted cost of borrowing on other financial liabilities to the average amount of expenditures for the asset accumulated during the period.

IFRS 23 requires the capitalization of interest on the development of qualifying assets. The accounting treatment of interest charges can cause capitalization of general corporate borrowings to development properties by the allocations described above.

For income tax purposes, whether funds borrowed have been used to earn income from a business or property (as required for deductibility by paragraph 20(1)(c)) is determined by tracing the funds. To the extent that interest on general borrowings has been capitalized for accounting purposes to development projects, it may be possible to argue that subsections 18(2) and 18(3.1) should not apply. Interest on specific construction financing, however, must be capitalized for income tax purposes.

**Borrowing Costs — Paragraphs 20(1)(e) and 20(1)(e.1)**

**General Rule**

Expenses incurred in the course of issuing securities and borrowing money are deferred and amortized over five years.

Amortization of borrowing costs is not elective. If not claimed, such amount is permanently lost.

Amortization is prorated on the number of days for short taxation years. The half-year rule does not apply.
Look for strange hybrids such as a payment to maintain a ceiling on the interest rate on a floating rate loan for a period of time to be invoked at the borrower’s option over a defined period (i.e., an interest rate insurance policy).

An unamortized balance is written off when the debt is repaid unless:

■ The balance is part of a series of borrowings and repayments (paragraph 20(1)(e)(v));
■ The balance is repaid with a unit, interest or share or debt obligation of the taxpayer.

On the dissolution of a partnership, an unamortized balance is deductible by the partners over the remainder of the five-year period (but reduces the ACB of the partnership interest under paragraph 53(2)(c)(x)).

**Ongoing costs**

Expenses that relate solely to the year are deductible in the year (under paragraph 20(1)(e.1)), such as:

■ Service fees
■ Commitment fees
■ Standby charges.

**Borrowing costs to secure financing for construction activities**

In the CRA’s view, the deductibility of borrowing costs to secure financing for construction activities is subject to construction period restrictions in subsection 18(3.1).

The amount of financing expense to capitalize in a taxation year under subsection 18(3.1) is equal to the amount of the financing expense that is deductible in the taxation year (i.e., a financing expense of $50,000 would be deductible under paragraph 20(1)(e) over a five-year period and subsection 18(3.1) would apply to capitalize $10,000 in each of the five years).

Borrowing costs relating to financing for servicing land are likely to receive the same treatment as borrowing costs for construction activity.

Borrowing costs to arrange permanent financing — unrelated to the construction — are not subject to subsection 18(3.1).

Loan guarantee fees which are paid to the guarantor either periodically during the term of the loan or as a one-time payment at the commencement of the loan and which are incurred in the course of borrowing money and not otherwise deductible are deductible under subparagraph 20(1)(e)(ii).

An election to capitalize borrowing costs to depreciable property is available under section 21.

The CRA’s positions in this area are outlined in Interpretation Bulletin IT-341R4, “Expenses of issuing shares, units in a trust, interests in a partnership or syndicate and expenses of borrowing money”, dated February 26, 2007.

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66 When a taxpayer refinances a debt with the same financial institution, the original debt will be repaid with new debt. Therefore, the taxpayer must continue to amortize the original financing costs.


68 Technical Interpretation 2002-0175705, “Loan guarantee”
Penalties, Bonuses and Rate-Reduction Payments — Subsection 18(9.1)

When a payment relating to borrowed money is made to a person or a partnership in the course of carrying on a business or earning income from property:

- As consideration for a reduction in the interest rate being charged on a debt obligation ("a rate reduction payment"), or
- As a penalty or bonus paid because of the early repayment or partial repayment of the debt obligation before its maturity,

the payment will have to be treated as interest expense over the term of the original borrowing for income tax purposes only to the extent that:

- The payment can reasonably be considered to relate to an amount that would otherwise have been paid or payable by the taxpayer as interest in a future taxation year on such debt, and
- The payment does not exceed the value, at the time of the payment, of the future interest obligation (i.e., it cannot exceed the present value of the future interest obligation).

The payment should be deducted on a present-value basis (i.e., to reflect the interest that would have been paid over time).

As a practical matter, given the difficulty in determining the present-value amounts and given that only the timing of deductions is affected, straight-line amortization is often used because the ultimate impact is not significantly different.69

Deductibility of penalties and rate reduction payments exceeding the present value of interest otherwise payable is governed by case law. If they are related to capital borrowings, they may be non-deductible but may qualify for amortization as financing costs under paragraph 20(1)(e).

A taxpayer may switch the method of amortization in mid-stream, provided that it is reasonable in the circumstances, does not result in any undue tax advantage, and is in accordance with GAAP and the Act.70

In certain circumstances, subsection (9.2) rather than 18(9.1) may apply to rate reduction payments.71

Subsection 18(9.1) requires that where the taxpayer has incurred a penalty on the early repayment of a debt in full, the amortization of the payment is deemed to be interest on a debt obligation:

a) Where the original proceeds of the debt were used for business purposes other than to acquire property incurred for the same purpose of the original debt obligation; and

b) Where the original proceeds were used to acquire property, to the extent that the property, or the substituted property (in the case of a disposition) is used by the taxpayer in the year for the purpose of earning income therefrom.

While (a) above is generally not thought to be an issue for taxpayers, (b) may be a problem where the taxpayer has repaid the debt as a result of the disposition of the property and the taxpayer uses the proceeds for general business purposes (but not necessarily to acquire another property). The CRA has issued some technical interpretations that suggest that, in this situation, the penalty will not be deductible. However, the context of the interpretations seems to be directed to individual taxpayers.

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when the proceeds are not used to acquire income producing property or for another income-earning purpose.

When a corporation (or other entity) that is otherwise carrying on a business of renting property disposes of a property, the substituted property is the money received on the disposition. Provided that the money is used for the purpose of earning income, or for another deductible purpose, then the penalty should be deductible under subsection 18(9.1).

A payment made to obtain an extension of the term of a debt obligation or as consideration for the substitution or conversion of a debt obligation into another debt obligation or into a share is specifically excluded from the ambit of subsection 18(9.1). The CRA has stated that this exclusion includes a refinancing with the same lender or a different lender. Such expenses may be deductible under paragraph 20(1)(e) if it can be considered to be incurred in connection with the financing and not the settlement of the old debt.

**Interest Prepayments — Subsections 18(9.2) to (9.8)**

The rules for interest prepayments should be considered when holders of long-term debt obligations provide borrowers with an option, exercisable within a defined period after issue, to make a prepayment of interest for future years (e.g., a corporation borrows $1 million for 99 years and in Year 10 prepays the interest obligation for years 11 to 99).

In short, the prepayment, equal to the present value of the future interest obligations, effectively repays a portion of the principal amount of the obligation. The economic effect is the conversion of non-deductible principal repayments into deductible interest expense.

Under subsection 18(9.2), the lump sum is to be treated as a payment of principal and the amount of interest deductible is based on what the interest would have been on the lower deemed principal balance.

These calculations can be complicated and it is advisable to involve professional advisors early in the process.

These rules only apply to taxpayers that are corporations, partnerships or trusts.

**Novation**

When terms of a loan agreement have been altered so that there is effectively a new agreement, the implications of subsection 18(9.3) should be considered. Debt forgiveness issues under section 80 may also arise, as well as the potential for capital gains or losses when the loans are denominated in foreign currency.

The CRA has stated in *Interpretation Bulletin* IT-448, "Dispositions — Changes in Terms of Securities" dated June 6, 1980, that the following changes regarding the debt obligation (unless carried out under an authorizing provision in its original terms) are considered to be so fundamental to the holder’s economic interest in the property that they almost invariably precipitate a disposition:

- A change from interest-bearing to interest-free or vice versa
- A change in repayment schedule or maturity date\(^{72}\)
- An increase or decrease in the principal amount
- The addition, alteration or elimination of a premium payable upon retirement
- A change in the debtor, or

\(^{72}\) Exceptions to the general rule are made when the degree of change is minimal and of little relative importance in the circumstances.
■ The conversion of a fixed-interest bond to a bond for which interest is payable only to the extent that the debtor has made a profit, or vice versa.

The CRA’s position has created some controversy and confusion. In Income Tax Technical News No. 14 dated December 9, 1998, the CRA clarified its position and stated that, if a debt obligation is renegotiated otherwise than as provided for in its original terms, the determination of whether a change in its terms is a substitution of a debt obligation for another should be made in accordance with the law of the relevant jurisdiction.

Interest and Property Taxes on Vacant Land

Subsection 18(2)

Subsection 18(2) overrides paragraph 20(1)(c) to prohibit a deduction on account of or in lieu of:

■ Interest on debt relating to the acquisition of land, and
■ Property taxes in respect of land

Unless the land can reasonably be considered to have been, in the year:

■ Used in the course of a business other than a business in which, in the ordinary course, land is held for resale or development carried on by the taxpayer, or
■ Held primarily for the purpose of gaining or producing income of the taxpayer from the land.

Subsection 18(2) applies to “land” which is defined for this purpose and does not include:

a) Any property that is a building or other structure affixed to land,
b) The land subjacent to such buildings or other structures, or

■ A parking area, driveway, yard or garden necessary for the use of such buildings or other structures and that is contiguous to the land described in (b), except land used for the provision of parking facilities for a fee or charge.

Therefore, for example, interest on borrowed funds to acquire land for the development of single family housing may be deductible upon the commencement of construction on the building site.

Relief is allowed in the form of a deduction to the extent that gross revenue from the land for the particular year exceeds the total of all amounts deducted in computing income from the land for that year (i.e. the net operating income from the land). Income from the sale of land is excluded from this determination.

For this purpose, the CRA stated that the determination of net operating income from the land should include the deduction of expenses of representation under paragraph 20(1)(cc) and site investigation costs under paragraph 20(1)(dd).

Corporations whose principal business is the leasing, rental or sale of real property (or the development of real property for leasing, rental or sale) are entitled to claim a

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Paragraph 18(2)(b) only restricts the deduction for property taxes paid to a municipality or province in Canada. The paragraph specifically excludes i) income and profits taxes (which presumably are not otherwise deductible), and ii) taxes computed by reference to the transfer or property (e.g., land transfer taxes) (as such taxes are likely capital in nature).

Paragraph 18(2)(c).

Paragraph 18(2)(d).

The CRA states at paragraph 7 of Interpretation Bulletin IT-153R3, “Land Developers — Subdivision and Development Costs and Carrying Charges on Land,” dated October 7, 1991 “A taxpayer is considered to have acquired a “building or other structure” within subparagraph 18(3)(a)(i) at the time when site development begins on land that has been unequivocally committed to use as a building site and providing the taxpayer proceeds in an orderly and continuous fashion towards completion of construction. There must be no undue delay.”

deduction equal to the lesser of their base level deduction and actual interest and property taxes capitalized under subsection 18(2).  

Under subsection 18(2.2), the base level deduction of a corporation is the amount that would be the amount of interest, computed at the prescribed rate in Regulation 4301 – Benefits, for the year in respect of a debt of $1 million outstanding throughout the year (see the example below).

The $1 million is to be allocated among associated corporations by filing a prescribed form (T2005); otherwise, the Minister is permitted to make the allocation under subsection 18(2.4).

Partnerships are not eligible for the base level deduction even where all the members are corporations and the business of the partnership and its members is real estate development.

Subsection 18(2) applies until construction commences, after which subsection 18(3.1) applies.

Interest on debt relating to the acquisition of land is defined in subsection 18(3) as:

- Interest that may reasonably be considered as interest on borrowed money relating to the acquisition of land, and
- Interest on borrowings to acquire land to assist:
  - a non-arm's-length person
  - a corporation of which the taxpayer is a specified shareholder (i.e., by virtue of owning 10% or more of any class of shares), or
  - a partnership in which the taxpayer has a 10% interest, or more;

  unless the assistance is in the form of a loan and a reasonable interest rate is charged.

Regarding interest on money borrowed to service land, the CRA’s view is that the acquisition of land includes installation of services.

An alternative position is that interest on money borrowed to service land is not interest relating to the acquisition of land. Interest on money borrowed for land servicing that does not create a building or other structure may not be subject to capitalization under subsection 18(3.1).

A taxpayer may defer the deduction of interest and property taxes by treating them as an addition to the cost of land inventory, provided the taxpayer does so on a consistent basis.

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78 Paragraph 18(2)(f).
79 This amount has not been indexed for inflation since subsection 18(2.2) was implemented in 1988.
80 Paragraph 18(2.5) requires a corporation whose taxation year is less than 51 weeks to prorate the base level deduction based on the proportion that the number of days in the corporation’s taxation year is of 365.
82 A “specified shareholder” is defined in subsection 248(1) and includes a shareholder that holds 10 percent or more of the issued shares of any class of the capital stock of the corporation (with rules to include shares held directly or indirectly by related persons).
83 Pursuant to the subsection 18(3) definition of “interest on debt relating to the acquisition of land”.
84 Technical Interpretation 2002-0141827, “Costs – land development”.
86 IT-153R3 at paragraph 6.
Base Level Deduction — Example

Assumptions

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<td>Net revenue from land</td>
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<tr>
<td>Base level deduction ($1,000,000 × 1.00%)</td>
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</tr>
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<td>Interest and property taxes</td>
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</tr>
<tr>
<td>December 31, 2011 fiscal year end</td>
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</tr>
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Application of subsection 18(2)

<table>
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<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
<tbody>
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</tr>
<tr>
<td>Minus: Net revenue from land</td>
<td>15,000</td>
</tr>
<tr>
<td>Base level deduction</td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td>25,000 (A)</td>
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</tbody>
</table>

Amount added to cost $1,975,000

Average prescribed rate used is 1.00%

2011 rates

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<tr>
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<th>Rate</th>
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<tr>
<td>Second</td>
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<tr>
<td>Third</td>
<td>1.00%</td>
</tr>
<tr>
<td>Fourth</td>
<td>1.00%</td>
</tr>
<tr>
<td>Average</td>
<td>1.00%</td>
</tr>
</tbody>
</table>

Treatment of Deductions Denied Under Subsection 18(2)

Costs denied under subsection 18(2) are added to the ACB of land that is capital property (paragraph 53(1)(h)) and the cost of land that is inventory (subsection 10(1.1)).

Denied costs are also added to ACB of:

- Shares when the taxpayer is a specified shareholder\(^{87}\) of the corporation owning the land (see paragraph 53(1)(d.3))
- Partnership interests when the interest expense is incurred by a partner holding a 10% or greater interest (see subparagraph 53(1)(e)(xi)).

Interest capitalized to the ACB of shares or a partnership interest is also capitalized to the underlying land held by the corporations\(^{88}\) or partnership.\(^{89}\)

Timing of Application of Subsection 18(2)

Subsection 18(2) applies until construction begins. During the construction period, subsection 18(3.1) applies to restrict the deduction of interest and property taxes.

Subsection 18(2) does not apply in a year in which the land is used in a business. Therefore, if construction begins on land during a year and is completed in the same year

\(^{87}\) Supra note 43.
\(^{88}\) Paragraph 53(1)(b).
\(^{89}\) Paragraph 10(1.1)(a).
and if the completed property is used in a business in the same year, then subsection 18(2) should not apply in that year.90

Payment of property taxes by a tenant on leased vacant land is rent paid and is therefore fully deductible by the tenant. However, the CRA’s view is that subsection 18(2) applies to deny the deduction to the tenant.

Construction Period Costs

Cost accumulation in accounting records

Common classification stages during the construction period are:

■ Land under development
■ Property under construction
■ Income-producing property or completed inventory.

Review costing records for:

■ Assets other than the building, e.g., paving and equipment that are not part of the building
■ Deductible items, e.g., landscaping on capital properties, demolition of a building91 being used to earn income as capital property, and operating or marketing costs.

Building costs are accumulated with varying levels of detail, depending on the accounting system. Site investigation costs, architects’ fees, interest and property taxes, financing costs, and other fees may be incurred while the property is classified as land held for development.

As the project moves through the construction phase, additional costing detail is maintained. Initial marketing, tenant inducements, interest and property taxes, development fees, architects’ costs, and construction costs may be incurred.

Once construction is complete, for accounting purposes, the property may be reclassified as income-producing properties allocated between land and building.

Accounting records should be reviewed in detail in both the land under development and property under construction categories to determine which, if any, costs may be identified as soft costs or deducted as incurred. Once construction has commenced, accounting records and contractor invoices should be reviewed in detail to identify deductible soft costs and costs that may be classified as other than building, such as paving, landscaping, furniture or equipment. (See Appendix A.)

Subsections 18(3.1) and (3.2)

Under subsection 18(3.1), a current-period deduction is denied for:

■ Costs reasonably attributable to the period of construction, renovation or alteration of building, and relating to the construction, renovation or alteration of a building, (i.e., a two-part test), and
■ Costs relating to ownership, during that period, of land subjacent or contiguous to the building, including contiguous land used/intended to be used as parking area, driveway, yard, garden or similar use. Side-yards or set-backs required for

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90 Paragraph 18(2)(c).
91 Where a taxpayer acquires land with a building with the intent to demolish the building in the near future, any proceeds allocated to the building and the demolition cost (net of any salvage value) generally form part of the cost of the land to the taxpayer.
construction or zoning may be excepted (subject to the limitations on subsection 18(2) discussed above).

Denied costs are typically added to the cost of the building.92

Subsection 18(3.1) does not restrict the deduction of interest and realty taxes for land on which a building is being constructed by an arm's-length person (i.e., when a building is on leased land, the landowner is able to deduct interest and property taxes).

Under paragraph 18(3.2)(b), in determining the amount to be capitalized, interest on debt is capitalized when the borrowed funds were used to assist, directly or indirectly, the construction, renovation or alteration of a building or the purchase of land by:

- A non-arm's-length person
- A corporation in which the taxpayer was a specified shareholder93 (10% or more of any class of shares), or
- A partnership in which the taxpayer had a 10% or greater interest in the profit or loss.

These provisions also apply when interest is incurred in Canada to assist directly or indirectly a foreign subsidiary to construct a building on purchased land in the foreign country.

The limitation on the deductibility of interest in paragraph 18(3.2)(b) does not apply when the assistance is in the form of a loan bearing interest at a reasonable rate as the interest on that loan will be subject to subsection 18(3.1).

If the cost is incurred by a specified shareholder of a corporation or a partner with a 10% or greater interest in a partnership, the denied cost is capitalized to the shares of the corporation94 or the interest in the partnership95 and to the underlying land held by the corporation or partnership.

In a tiered partnership structure, special care must be exercised to ensure that the application of subsection 18(3.1) does not result in the capitalization of certain development period costs without a corresponding addition to the cost basis of an interest in one or more partnerships in the tier since the capitalization provisions may only apply to a taxpayer's interest in the top tier partnership.

Deductions Not Affected by Subsection 18(3.1)

Deductions not affected by subsection 18(3.1) include:

- CCA (subject to available-for-use rules, though subsection 20(28) overrides these rules and permits the deduction of net rental income)
- Outlays or expenses that would otherwise be deductible but for subsection 18(3.1) in respect of a building are deductible where the building generates income, but only to the extent of the taxpayer’s income from the building for the year96
- Landscaping costs
- Disability-related modifications to buildings
- General and administrative expenses, accounting and bookkeeping expenses, advertising costs or current insurance expenses incurred to rent or sell a building

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92 Paragraph 18(3.1)(b) provides that where an otherwise deductible amount is denied pursuant to subsection 18(3.1), that amount is added to the capital cost of a building. There is no provision to add amounts denied under subsection 18(3.1) to land.

93 Supra note 43.

94 Pursuant to paragraph 53(1)(d.3).

95 Pursuant to subparagraph 53(1)(e)(xi).

96 Subsection 20(29) allows a taxpayer to deduct costs deferred under subsection 18(3.1) to the extent the taxpayer earned income from renting the property.
Any other cost not attributable to the period of construction, renovation or alteration of a building, such as:
- representation expenses (only if incurred prior to the period of construction, in the CRA’s view)
- site investigation costs
- borrowing costs to arrange permanent financing
- tenant inducement costs
- leasing commissions
- interest on borrowings to pay rent on leased land
- construction period soft costs to the extent of net rental income from the building (before CCA) (because subsection 20(29) overrides subsection 18(3.1) to allow their deduction)

The CRA has indicated that costs that are not otherwise capital in nature may not be subject to the limitations in subsection 18(3.1).

Construction Period
The construction period may commence when:
- Site development commences\(^97\) if construction proceeds without delay
- Further services are installed or footings poured if site development was done earlier
- Excavation for the footings begins.\(^98\)

Under subsection 18(3.3), completion is the earlier of the day of actual completion and the day all or substantially all of the building is used for its intended purpose.

“All, or substantially all” may mean nearly 100% (90% based on CRA guidelines).

**KPMG Observations**

*Once the building is complete or all or substantially all of the building is used for its intended purposes, it appears that costs that are not capital in nature may be deductible as incurred.*

**Note:** This or any other planning idea should only be acted on with appropriate professional advice after a thorough examination of the particular situation.

Marketing Costs
For accounting purposes, marketing costs relating to property under construction may be capitalized and carried in the balance sheet as costs included in:
- Land under development (as inventory and for capital investment purposes)
- Building under construction, or
- Housing inventory under construction.

For tax purposes, when there is no enduring benefit to the costs incurred and they do not relate to the acquisition of tangible property, these costs may be deductible because they are:


\(^98\) Paragraph 8 of IT-153R3, supra note 57. There is support in the Act for the assertion that the construction of a building commences when the footings or other base support is installed. Paragraph 18(3.5)(b) provides transitional rules for the initial application of subsection 18(3.1).
Period costs of a recurring nature with an immediate and short-lived benefit
Not of a capital nature because capital property is not acquired or created
Not subject to the limitations in subsection 18(2) because they are not interest or property taxes
Not subject to the limitations in subsection 18(3.1) because they are not related to the construction, renovation or alteration of a building.

Costs to look for include:

- Media advertising
- Brochures
- Signs
- Sales office operating costs.

Costs that may have to be included in inventory or deducted on a deferred basis (generally over the life of the development project if inventory of the taxpayer, or as CCA under the applicable class if used for multiple development projects) are:

- Model home furnishings
- Sales office construction.

**Soft Cost Deductions**

**Landscaping — Paragraph 20(1)(aa)**

Landscaping costs are specifically excluded from the subsection 18(3.1) construction period limitations.

Amounts must be paid in year for landscaping around a building or other structure of the taxpayer used primarily in a business. The amounts must not be applicable to inventory, the building must be owned, and the work must be done with aesthetic considerations in mind (see Interpretation Bulletin IT-296, “Landscaping and Grounds”). Examples include amounts paid for:

- Planting trees and flower beds and laying sod
- Changing the contour or slope of the land
- Landscaping courtyards within a building
- Related professional fees such as landscape architects and other consultants.

However, amounts paid in the year for greens, tees and fairways of a golf course should constitute a surface construction similar to those listed in paragraph (c) of class 17 and depreciated for tax purposes at a declining balance rate of 8%. The CRA confirmed this treatment in Income Tax Technical News No. 20, dated June 14, 2001.

**Representation Costs — Paragraph 20(1)(cc)**

To qualify as soft cost deductions, amounts for representation costs must be paid in the year by the taxpayer.

Representations relating to a business carried on by the taxpayer must be made to a government body or agency to obtain a license, permit, franchise or trademark.

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100 Paragraph 2 of IT-296.
Expenses of representation are not specifically excluded from subsection 18(3.1). To be deductible, the representation costs should not relate to the period of construction, renovation or alteration of a building. Based on the CRA’s comments that site development usually starts with the installation of services, expenses of representation must arguably be incurred before the construction period since they are typically incurred to obtain permission to start the construction, renovation or alteration of the building. However, any expenses of representation that are incurred during the construction period should generally be capitalized under subsection 18(3.1).

Eligible costs include:

- Legal fees and other representative’s fees to assist with re-zoning submissions and obtaining permits
- Architects’ and engineering fees incurred for the purpose of making representations for zoning amendments
- Salaries and other expenses of employees whose primary duties are to lobby the government.

**Alternative election**

In lieu of deducting the full amount of representation costs, an election is available to claim a 10-year straight-line deduction under subsection 20(9).

The election is made by filing a letter with the Minister specifying the amount. For corporations, a certified copy of the resolution of the directors authorizing the election is also required (see Regulation 4100).

The deduction is not prorated for short taxation years.

**Recapture on depreciable property**

When representation costs, in whole or in part, qualify both as a deduction under paragraph 20(1)(cc) and as the capital cost of “depreciable property” (i.e., representation to acquire a franchise), subsection 13(12) provides that any such amount that is on account of the capital cost of depreciable property and deducted under paragraph 20(1)(cc) shall be deemed to have been allowed as CCA under paragraph 20(1)(a).

The result of this rule is that a double deduction is not available (i.e., as a paragraph 20(1)(cc) deduction and as CCA) and, if the depreciable property is later disposed of for proceeds in excess of the UCC, the excess proceeds will be subject to “recapture” under subsection 13(1).

**Site Investigation Costs — Paragraph 20(1)(dd)**

To qualify as a site investigation cost, the amount must be incurred to investigate the suitability of a site for a building to be used in connection with a business carried on by the taxpayer. The amount must be paid in the year by the taxpayer.

This deduction does not apply to inventory.

Qualifying expenditures include costs incurred in the course of investigating a site, such as:

- Surveying
- Soil testing

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101 The CRA states in document no. 2000-0001737, dated May 12, 2000, that costs incurred in making a representation to the Ontario Municipal Board regarding the rezoning of property are deductible under paragraph 20(1)(cc).


103 Pursuant to subsection 20(9), the taxpayer may elect to deduct one-tenth of the cost in the first year and an equal amount in each of the next nine taxation years.
- Architects’ and engineers’ reports
- Fees to establish relevant municipal by-laws
- Financial feasibility studies.\(^\text{104}\)

These costs are subject to construction period restrictions in subsection 18(3.1).

**Utilities Service Connections — Paragraph 20(1)(ee)**

To qualify as utilities service connection costs, amounts must be paid in the year to an arm’s-length person and relate to a connection to a place of business for the supply of services by the arm’s-length person who made the connection.

The cost of most connections does not qualify if they are installed by contractors other than the utility (other than sewer connections).

Expenditures must not be for the acquisition of property\(^\text{105}\) or for goods or services to be supplied by means of the connection.

These costs are subject to the construction period restrictions in subsection 18(3.1).

**Disability-Related Modifications — Paragraph 20(1)(qq)**

Paragraph 20(1)(qq) permits the deduction of prescribed renovation or alteration costs paid relating to eligible disability-related modifications to a building.

The amount must be paid in the year.

The building must be primarily used to earn income from a business or property.

Prescribed renovations or alterations include installation of interior and exterior ramps and hand-activated power door openers, widening of doorways, and modifications to bathrooms for the benefit of individuals who have a severe and prolonged mobility impairment.\(^\text{106}\)

The building need not be owned by the taxpayer making the expenditure.

The deduction of these costs is not affected by subsection 18(3.1) construction period limitations.

**Disability-Related Equipment — Paragraph 20(1)(rr)**

Paragraph 20(1)(rr) permits the deduction of prescribed disability-specific devices or equipment.

The amount must be paid in the year.

The deduction includes amounts paid for prescribed devices or equipment acquired primarily to assist individuals who have a sight or hearing impairment.

Prescribed devices include Braille panels and audio indicators in elevators, visual fire alarm indicators, telephone devices and listening devices for people with a hearing impairment, and disability-specific computer software and hardware attachments (see Regulation 8801).

The deduction of these costs is affected by subsection 18(3.1) construction period limitations.

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\(^{105}\) For example, an amount paid to install wires, pipes, or conduits of electricity, gas, telephone service, water or sewers on the taxpayer’s property that become property of the taxpayer after the installation does not qualify.

\(^{106}\) Regulation 8800.
Demolition Costs

Where a taxpayer acquires land with a building with the intent to demolish the building in the near future, any purchase price allocated to the building, and the demolition costs (net of any salvage value), generally form part of the cost of the land to the taxpayer.\(^{107}\)

Consider a situation in which a building that had value to the vendor is demolished by the purchaser shortly after acquisition.\(^{108}\) The purchaser may have acquired the land and building for an amount greater than what it would have paid for a comparable parcel of land with no building. In this case, the building is not depreciable property to the purchaser, and the cost of the building is excluded from class 1. However, the building is capital property to the purchaser. When the building is demolished, the purchaser may recognize a capital loss.\(^{109}\)

Where a taxpayer acquires land with a building and operates the building for a period of time after acquisition, it is a question of fact whether the taxpayer acquired the building to earn income from it. If the facts show that the taxpayer’s intent was to earn income from the building for a period of time, then the building may be considered to have been acquired by the taxpayer for the purpose of earning income, and the cost of the building will form part of the depreciable capital cost of the building to the taxpayer.

When the building is subsequently demolished, the taxpayer’s proceeds of disposition are nil. However, whether the taxpayer may claim a terminal loss depends on whether the taxpayer or a non-arm’s-length person owns the land subjacent to, or immediately contiguous to and necessary for the use of, the building.\(^{110}\) If the taxpayer retains the land for future use, then the taxpayer is deemed to have proceeds of disposition of nil (that is, the actual proceeds), plus half the amount by which the greater of the cost amount of the building and its FMV immediately before disposition exceed the proceeds of nil.\(^{111}\) Effectively, the terminal loss is reduced to reflect the capital gain inclusion rate. The deductible terminal loss may be claimed against ordinary income.

If the taxpayer or a non-arm’s-length person disposes of the land that is subjacent to, or immediately contiguous to and necessary for the use of, the building during the year in which the building is demolished, the proceeds of disposition of the building are increased by the lesser of any terminal loss on the building and any capital gain on the land. The proceeds of disposition of the land are reduced by the same amount.\(^{112}\) This adjustment reduces the terminal loss on the building by the capital gain on the land. No adjustment results if a capital gain is not realized on the land.

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107 Regulation 1102(1)(c) deems an amount not to be included in a CCA class where the property was not acquired by the taxpayer for the purpose of gaining or producing income.

108 Paragraph 7 of Interpretation Bulletin IT-220R2, “Capital Cost Allowance—Proceeds of Disposition of Depreciable Property,” dated May 25, 1990, suggests that where the purchase and sale agreement between a vendor and purchaser is silent as to the allocation of the purchase price between land and building, section 68 may apply to allocate a portion of the purchase price to the building where the building had value to the vendor, even if it had no value to the purchaser.

109 Pursuant to subparagraph 39(1)(b)(i), a taxpayer may not claim a capital loss on depreciable property. Since the building was deemed by Regulation 1102(c) not to be depreciable property of the taxpayer, the taxpayer may be entitled to a capital loss on the demolition of the building.

110 If the building is pooled with other buildings, either because it was previously included in class 3 of the taxpayer or because the capital cost of the building was less than $50,000, then a terminal loss may only be available, subject to subsection 13(21.1), if it is the last building in that pool.

111 Pursuant to paragraph 13(21.1)(b).

112 Pursuant to paragraph 13(21.1)(a).
Soft Cost Deductions and CCA for Post-1989 Costs — Subsections 20(28) and 20(29)\textsuperscript{113}

Example

Building not complete (less than 90%)

- Rental income for the year: $200,000
- Construction period soft costs: $150,000
- CCA (ignoring available-for-use rule): $120,000

**Soft cost deduction (subsection 20(29))**

Lesser of:

- Soft costs: $150,000 (A)
- Rental income (before CCA): $200,000

**CCA deduction (subsection 20(28))**

Lesser of:

- CCA otherwise: $120,000
- Rental income (before CCA): $200,000
- Less subsection 20(29) deduction: $50,000 (B)

Total deduction (A & B): $200,000

Rental Property CCA Restriction — Regulation 1100(11)

Rental property of a taxpayer or partnership is:

- A building owned by a taxpayer or partnership or a leasehold interest in real property if the leasehold interest is property of Class 1, 3, 6 or 13 and is owned by the taxpayer or partnership, and
- The property was used by a taxpayer or partnership principally (i.e., more than 50%) to earn gross revenue that is rent (see Regulation 1100(14)).

CCA on rental properties cannot exceed:

- Net income for the year from renting or leasing rental property before any CCA deductions
- The partner's share of net income of the partnership before CCA.

If the restriction applies, total CCA on rental properties cannot exceed net rental income.

Annual allowable CCA can be taken on any of the rental properties as long as the aggregate CCA does not exceed the aggregate net rental income of those properties.

**Exceptions – Regulation 1100(12)**

The rental property restriction does not apply to:

- A life insurance corporation
- A corporation whose principal business was the leasing, rental, development or sale of real property it owns
- A partnership each member of which was a corporation described above.

\textsuperscript{113} Based on the wording of subsection 20(29), it overrides subsection 20(28). The deduction under subsection 20(29) is limited to the income of the taxpayer before a deduction under subsection 20(28) or subsection 20(29), while the deduction under subsection 20(28) is limited to the income of the taxpayer before the deduction under subsection 20(28) only.
CCA restrictions must be considered when:

- A partnership, trust, or individual is involved
- A corporation has incidental rental operations.

**Historical Note**

*In Fredette (2001 DTC 621) and Rousseau Houle (2001 DTC 250), the TCC held that placing rental property in a partnership to circumvent Regulation 1100(11) by deducting interest at the partner level avoided this rule and that the GAAR did not apply.*

*However, the 2004 federal budget “clarified” that the GAAR applies beyond the Income Tax Act to a misuse or abuse of the Income Tax Regulations, Income Tax Application Rules (ITAR) and Canada’s income tax treaties. This “clarification” was retroactive to September 13, 1988 and overruled Fredette and Rousseau Houle.*

**Treatment of Grants and Assistance**

**Government assistance**

When the government provides funding to a taxpayer for the acquisition or construction of property, the treatment of the government funding received by the taxpayer must be considered. Two options are available: (1) take the assistance into income, or (2) reduce the capital cost of the property by the amount of the funding received.114

Subsection 13(7.1) provides that where a taxpayer received or is entitled to receive assistance from a government in respect of, or for the acquisition of, depreciable property, whether as a grant, subsidy or as any other form of assistance, the capital cost of the depreciable property to the taxpayer at any particular time shall be deemed to be the amount, if any, by which the total of the capital cost of the property to the taxpayer, otherwise determined, exceeds the total of the amount of assistance the taxpayer has received or is entitled, before the particular time, to receive.

Similar rules in subsection 53(2)(c) reduce the ACB of capital property by the amount of government assistance received or receivable.

Subsection 13(7.1) clearly provides that the starting point for the determination of capital cost of the property is determined without reference to subsection 13(7.4) (e.g., paragraph 13(7.1)(c))115.

For example, funding provided by the Ontario Ministry of Health and Long-Term Care for the new construction of long-term care facilities may be considered government assistance subject to subsection 13(7.1), which must be applied to reduce the capital cost of the related building.

Alternatively, subsection 13(7.4)116 is an elective provision, within strict time limits, to reduce the capital cost of depreciable property for assistance received that would otherwise be included in taxable income under paragraph 12(1)(x). Note that paragraph 12(1)(x) does not apply to the extent that the particular amount otherwise reduces the capital cost of the property (e.g., under subsection 13(7.1)). There is no prescribed form; the election is made by attaching a signed letter to the applicable income tax return.117

The related depreciable property must be acquired in the year or in the three taxation years preceding the year or in the immediately following taxation year.

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115 The November 1985 technical notes read as follows:

“Subsection 13(7.1) is amended by adding a reference in paragraph (c) thereof to new subsection 13(7.4) to avoid a circularity problem in determining the order of adjustments to be made in determining the capital cost of depreciable property. Accordingly the capital cost of depreciable property will be adjusted under subsection 13(7.1) before any adjustment is made under subsection 13(7.4).”

116 Subsection 13(7.4) is consequential upon the enactment of paragraph 12(1)(x) in 1986.

117 See paragraph 12 of Interpretation Bulletin IT-273R2.
Similar rules in subsection 53(2.1) enable a taxpayer to elect to reduce the ACB of capital property for assistance received that would otherwise be included in taxable income under paragraph 12(1)(x).

Change in Use of Property

Personal Use versus Commercial Use

Where a taxpayer holds property that is used for the purpose of gaining or producing income (an “income earning purpose”) and at a later time uses it for some other purpose, the taxpayer is deemed to have disposed of the property at that later time for proceeds equal to its FMV at that later time and immediately thereafter reacquired it at a cost equal to that FMV. These rules do not apply where there is change from one income earning purpose to a different income earning purpose.

On the reverse, where the use of a property changes to an income earning purpose, the property is also deemed to be disposed of and reacquired at its FMV at that later time. For depreciation purposes, however, the capital cost of the property is the lesser of the FMV of the property at that later time and the actual cost of the property to the taxpayer, plus one-half of the excess of such FMV over that actual cost plus twice any capital gains exemption claimed under section 110.6 in respect of such excess.

An election is available under subsection 45(2) to defer the application of the deemed disposition and reacquisition rules when the use of a property changes to an income earning purpose. This election is often made to allow the property to qualify as the taxpayer’s principal residence for up to four taxation years during which the election remains in force and the taxpayer is resident, or deemed to be resident, in Canada.

The deemed disposition rules also apply where there has been a change of use of a property that is partially used for an income earning purpose based on the cost of the income earning component relative to the cost of the whole property. The increase or decrease in the income earning portion will trigger a deemed disposition for the increase or decrease as the case may be.

Change in Commercial Use

Where capital property used for an income earning purpose is converted into inventory of a business, or vice-versa, there are no specific rules in the Act which provide for a deemed disposition. CRA has in the past suggested that such the conversion of capital property to inventory or vice versa will not constitute a "disposition" for tax purposes, but the taxpayer would have a “notional disposition” which would reset the notional cost basis of the property without triggering immediate tax consequences. In particular, it is CRA’s view that the notional gain or loss will only be triggered in the year in which the property is actually sold at which point the determination of the nature of the gain or loss would be made in view of the notional disposition. Hence, according to CRA, it will be necessary to report the notional sale on account of capital and the actual sale on account of inventory which may give rise to both a capital gain or loss as well as an income gain.

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118 Paragraph 13(7)(a) and subsection 45(1).
120 Subsection 45(1).
121 Paragraph 13(7)(b).
123 See paragraphs 13(7)(c) and 13(7)(d) for depreciation purposes and paragraphs 45(1)(b) and 45(1)(c) for capital gains purposes.
or loss as the case may be depending on the particular circumstances and in view of how real estate values fluctuated during the relevant holding periods.

**Tax-Deferred Rollovers into Development Partnerships**

A taxpayer holding capital property with an accrued capital gain may transfer the property into a partnership for development. The property becomes inventory to the partnership. Upon electing to defer the gain pursuant to a subsection 97(2) election, it would appear that the accrued capital gain may become an income gain when such “deferred gain” is allocated to a member of the development partnership.\(^{125}\)

**Real Property Consolidation**

Where one or more divided interests in real property are consolidated under applicable property laws resulting in one or more persons holding undivided interests in the property immediately after consolidation, it is unclear whether a “disposition” would result from the consolidation. There are no specific provisions under the Act which would result in a deemed disposition and hence it would appear that it is a question of fact whether consolidation could give rise to a disposition. In the context of a single person holding two divided interests that are subsequently consolidated under applicable property laws into a single parcel of land, it may be argued that a disposition has not taken place within the meaning of subsection 248(1) given that the taxpayer would not be entitled to any proceeds of disposition.

**Partition and Subdivision of Real Property**

A partition is a subdivision of the property itself among the co-owners. For example, land may be divided into separate distinct parcels with each co-owner exchanging an undivided interest in the entire lands for full ownership of a distinct parcel of land.

Subsection 248(20) – partition of property – applies where the FMV of the separate parcel of property received by a co-owner upon partition is less or greater than the FMV of the co-owner’s previous interest.

Subsection 248(21) – subdivision of property – applies when a co-owner receives, upon the partition of property, title to a separate parcel of property the FMV of which equals the FMV of the co-owner’s previous interest.\(^{126}\)

Where more than one property is acquired under one deed, the CRA has expressed a view that such properties would be considered one property for purposes of the partitioning rules even if the properties were not adjacent.\(^{127}\)

**Partition of real property**

Where property owned by two or more persons is the subject of a partition, notwithstanding any retroactive or declaratory effect of the partition, each person who had an interest in the property immediately before the partition, is deemed not to have disposed of that interest at the time of partition to the extent that the FMV of the interest immediately before partition is equal to the FMV of that interest immediately after the partition.\(^{128}\)

If the FMV of the taxpayer’s interest in the property before the partition does not equal the FMV after the partition, a deemed disposition may result in a taxable gain.

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\(^{128}\) Subsection 248(20).
This partition rule does not apply to fungible tangible property (i.e. freely exchangeable property that has physical substance and which generally excludes land).

For this purpose, where an interest in the property is an undivided interest, the FMV of that interest is deemed to be equal to that proportion of the FMV of the property at that time that the interest is of all the undivided interests in the property.

**Subdivision of real property**

Where a property that was owned by two or more persons is subdivided in a manner that each person has a new interest the FMV of which immediately after the subdivision is equal to the FMV of the interest held by that person immediately before the subdivision, the general partition rules described above do not apply and the new interest is deemed to be a continuation of that person’s undivided interest in the property immediately before subdivision.\(^{129}\)

For this purpose, subdivisions of a building or of a parcel of land that are established in the course of or in contemplation of a partition and that are co-owned by the same persons shall be regarded as one property.

If an interest or a right in the property is or includes an undivided interest or right, the FMV of the interest or right shall be determined without regard to any discount or premium that applies to a minority or majority interest or right in the property.

**Tenant and Leasing Issues**

**Tenant Inducements**

Tenant inducements are alternative arrangements between landlords and tenants under which landlords provide incentives for tenants to enter into leases. Generally, on a present-value basis, both parties will be in the same financial position as if no inducement had been given.

In general, the tenant trades higher future rents for a rent-free period or cash, such that the present value of the higher future rent equals the cash inducement received or the present value of the rent deferral.

**Payments to tenants**

Payments to tenants may include:

- Direct cash payment for the tenant to use at its discretion
- Compensation for moving costs and costs of cancelling prior leases
- Cash payments in connection with the construction/fixturing of the space (i.e., a fixturing allowance).

The landlord’s contribution may have an upper limit.

**Payments to third parties**

Payments to third parties may include:

- Direct payment to third parties in connection with improvements to premises
- Direct payments by the landlord to the tenant’s prior landlord as a result of the assumption of the tenant’s prior lease obligation.

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\(^{129}\) Subsection 248(21).
Other potential inducements

Other potential inducements may include:

- Rent-free periods
- Below-market rents during all or part of the lease term
- Loans at less than market interest rates.

Treatment of Inducements

GAAP and REALpac provide that tenant inducements should be deferred and amortized over the lease term.

The CRA allows tenant inducements to be treated as follows:

- Capital expenditures
- Amounts deductible over the lease term, or
- Amounts deductible as incurred in limited circumstances. ¹³⁰

To be deductible in the year incurred:

- Payments must arise under the lease
- There must be an identifiable benefit to the landlord in the period the inducement payment is made, and
- Payments must not be for capital improvements to the building.

In light of the SCC decisions in Canderel¹³¹ and Toronto College Park¹³², tenant inducements with respect to buildings with multiple tenants should generally be deductible in the year incurred for most real estate landlords that incur such costs in the ordinary course of their operations.

For buildings with a single tenant, tenant inducements should generally be amortized over the lease term to provide a more accurate matching of revenue and expenditure, as the expense can be viewed as incurred with the specific purpose of producing an identifiable future income.

State of the Law

Tenant inducements are not specifically addressed in the Act. Their deduction for tax purposes arises from the inclusion of the costs in the determination of profit.

The REALpac Handbook requires deferral and amortization of tenant inducements over the period of the lease.

Canderel and College Park cases

In the Canderel and Toronto College Park decisions, the SCC determined that, in the circumstances in those cases, tenant inducements paid were “running expenses” whose expenditure could not be related to any particular item of revenue. The benefits of the expenditures were realized in the year incurred. The amounts were therefore considered deductible in the year paid. The court decided that deducting the expenditures in the years incurred provided an accurate picture of profit for the year in accordance with “well-accepted business principles”, and that the onus was on the CRA to prove its proposed treatment provided a more accurate picture of profit.

¹³¹ Canderel Limited v. The Queen, 98 DTC 6100 (SCC).
¹³² Toronto College Park Limited v. The Queen, 98 DTC 6088 (SCC).
The CRA has stated that it does not feel the Canderel and College Park decisions have changed the law regarding deductibility of tenant inducements but indicated that it will follow the decisions in identical fact situations.  

For tenant inducements that should not otherwise be capitalized to the building, when amounts are deducted in the year paid, the onus is on the CRA to show that amortization, rather than the immediate deduction, presents a more accurate picture of profit.

**Amortized tenant inducements**

The CRA has indicated that it will administratively allow landlords to amortize inducements over the term of the underlying lease.

When tenant inducements are amortized, the unamortized balance can be deducted if the tenant vacates before the end of the lease term or if the landlord sells the property.

**Treatment of other inducements**

The excess of rent paid by the landlord under a lease for a tenant's prior premises over the rent received for the new premises is deductible as incurred over the term of the new lease.

Loans at below-market interest rates result in lower income to the landlord. Inclusion of the loan in the lease may be advisable to ensure the landlord can deduct interest on amounts borrowed to on-lend to the tenant.

**Treatment of inducements to renew a lease**

The CRA has stated that there is no compelling reason to distinguish the treatment of costs related to an initial lease from those relating to the re-leasing of space. Based on the Federal Court of Appeal decision in Canderel, the CRA stated in 1996 that such inducement payments are clearly related to particular items of income and that the amortization method is the only method acceptable for income tax purposes. Although there has been no subsequent statement on the treatment of inducement payments to re-lease space, the lower court decision in Canderel was reversed by the SCC in 1998 and CRA issued Income Tax Technical News ITTN-16 on March 8, 1999 stating:

> “Yes, given the Supreme Court’s pronouncement, the Department accepts that the matching principle is not a rule of law although it remains an important consideration in the determination of the most accurate picture of profit.

> It is critical to note that the particular findings of fact in Canderel regarding benefits generated by the inducement payments played a significant role in the Supreme Court's decision that the payments were running expenses to which the matching principle did not apply.

> Before these decisions, determining whether or not an outlay was a running expense was a difficult judgment based on the particular facts and this remains the case today. These cases do not mean that all instances of tenant inducement payments would be deductible up front. A difficult decision has to be made whether the expenditure is incurred for the specific purpose of earning an identifiable item of revenue which results in the application of the matching principle or whether there are sufficient current benefits from the expenditure to justify treatment as a running expense.”

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133 Income Tax Technical News ITTN-16 dated March 8, 1999 – The CRA allowed a “catch-up deduction” for tenant inducement expenditure costs incurred in 1995 and 1996. When these costs would be eligible for immediate deduction under the Canderel criteria, the CRA permitted a deduction of the remaining unamortized balance of tenant inducement costs in the first tax return filed after February 1998.


Therefore, consistent with the treatment of an inducement for the initial lease of space, the treatment of an inducement for the re-leasing of space should result in an accurate picture of profit for the year in accordance with well-accepted business principles. Therefore, depending on the particular facts, the taxpayer should be entitled to deduct such cost as a running expense or defer and amortize it over the term of the related lease.

Is a tenant inducement a matchable expenditure?

The tax treatment of tenant inducement payment may be impacted by the matchable expenditure rules in section 18.1 which were added in 1998 and applicable to expenditures made after November 17, 1996.

These provisions restrict the deductibility of certain otherwise deductible “matchable expenditures” incurred in respect of a “right to receive production” by pro-rating the deductibility of such amount over the economic life of the related right. The intent of these rules generally is to restrict the use of royalty-type arrangements to effect tax-assisted financing by structuring the arrangements as tax shelters or as debt substitutes.

Section 18.1 will not apply to improvements that are otherwise capitalized to Class 1.

Where an amount was paid as an inducement to a tenant to enter into a lease, the CRA expressed the view136 that a lease for the use of property would be considered a “right to receive production” since the lessor “has a right under the lease in which it is entitled to an amount all or a portion of which is computed by reference to the use of property, or revenue, and the amount is in respect of another taxpayer's (the tenant's) activity”. Although a question of fact, the CRA also expressed the view that a tenant inducement payment "could well qualify" as a matchable expenditure.

Under a standard fixed rent lease, a landlord is entitled to receive an amount (rent) computed by reference to the use of property (the leased premises) but it may be argued that the amount should not be considered to be in respect of another person's activity, property or business — rather the amount of rent is in respect of the use of the landlord’s own property. On this basis, the tenant inducement payment may not be a matchable expenditure and may not be impacted by these rules.

The particular lease reviewed by the CRA contained a participating rent clause, which provided that a portion of the monthly rents were computed as a percentage of the tenant's monthly revenue. Under a participating lease, the CRA could argue that the amount of rent is in part computed by reference to the tenant's revenue, and thus the amount of rent, while payable for the use of the landlord's property, could be considered to be in respect of another taxpayer's (i.e. the tenant's) activity or business. Similarly, it is conceivable that under a sublease or other similar arrangement, the sublease may fall within the wording of these rules on the basis that the rent amount received by the sub-lessor from the sub-tenant may be in respect of the lessor's property in which the sub-lessor has a leasehold interest.

It is noteworthy that the CRA's written assessing practice on the deductibility of tenant inducement payments was issued after the enactment of the matchable expenditure rules and after the above technical interpretation yet made no mention of these rules. In determining the tax treatment of a tenant inducement payment, the industry generally follows CRA’s guidance issued on December 6, 2000.

Leasing Commissions

The CRA’s position is to treat leasing commissions the same as lease inducements (1989 Corporate Management Tax Conference). The CRA is moving closer to GAAP, which recognizes a leasing commission as an initial direct cost of a specific lease which

is deferred and amortized over the term of the lease (including renewal options that the lessee is reasonably certain to exercise).\textsuperscript{137}

An alternative position was to treat leasing commissions as a period cost, fully deductible in the year incurred (see \textit{Baker Lovick}, 91 DTC 1041 (TCC) and \textit{Cummings}, 81 DTC 5207 (FCA)).

In light of the \textit{Canderel} and \textit{Toronto College Park} decisions, lease commissions may be deductible when incurred. The CRA has not yet come to a conclusion on how to treat these types of cases.\textsuperscript{138}

For buildings with a single tenant, leasing commissions should generally be amortized over the lease term to provide a more accurate matching of revenue and expenditure, as the expense can be viewed as incurred with the specific purpose of producing an identifiable future income. However, there may be facts and circumstances when lease commissions for a single tenant building may be fully deductible in the year incurred.

**Landlord Lease Cancellation Payments – Paragraph 20(1)(z) and 20(1)(z.1)**

Payments to a tenant to allow the landlord to break a lease are not currently deductible by the landlord (see paragraph 18(1)(q)).

If the landlord continues to own the property, the payment is amortized over the remaining term of the lease, including renewal terms (not exceeding 40 years) (see paragraph 20(1)(z)).

If the landlord disposes of the property, 50% of the unamortized payment is deductible (see paragraph 20(1)(z.1)).

**Lease Cancellation Receipts**

When a landlord receives a payment from a tenant to cancel the tenant's lease obligations, the landlord has to include the amount received in income.\textsuperscript{139}

When amounts included in income under paragraph 12(1)(a) relate to goods or services that will be provided after the end of the year or rent for periods after the end of the year, a reserve of a reasonable amount, i.e., the part of the rent received in advance that relates to a period after the end of the tax year, is available under subsection subparagraph 20(1)(m)(iii) (see \textit{Interpretation Bulletin IT 261R, “Prepayments of Rent”}).

Because the landlord has no further obligation to provide facilities, a paragraph 20(1)(m) reserve would not be available for lease cancellation receipts, such that the net amount has to be included in income.

**Inducement Receipt – Tenant Treatment – Paragraph 12(1)(x)**

Paragraph 12(1)(x) requires the recipient of a tenant inducement payment to include the amount in income (see \textit{Ikea Ltd. v The Queen} (98 DTC 6092)).

If an inducement is attributable to leasehold improvements or fixtures, a subsection 13(7.4) election can be made to reduce the capital cost of the related depreciable property.

\textsuperscript{137} This position is confirmed in the REALpac IFRS and ASPE handbooks.

\textsuperscript{138} Technical Interpretation 9805135, “Lease inducement payments”. In CRA document no. 9805135, dated March 18, 1998, the CRA commented that it is still assessing the cases. In subsequent technical interpretations, the CRA has not commented on the tax treatment of lease commissions.

\textsuperscript{139} It is unclear whether the amount will be included in income pursuant to paragraph 12(1)(a) or (x). However, this should not be relevant to the landlord, since a reserve pursuant to paragraph 20(1)(m) (in the case of an inclusion under paragraph 12(1)(a)) is not available because there is no further obligation to provide space to the tenant. Paragraph 4 of \textit{Interpretation Bulletin IT 359R2, “Premiums and Other Amounts with Respect to Leases,”} dated December 20, 1983, states only that the receipt of a lease cancellation payment is always income to the taxpayer.
Repayment of Inducements

A deduction is allowed for the repayment of an amount previously included in income under paragraph 12(1)(x).

If the repayment previously applied to reduce the capital cost of related depreciable property under the subsection 13(7.4) election, the repayment is added back to the capital cost of such depreciable property.

Free Rent

Economically, there should be no difference to the landlord and the tenant between a lease inducement and a rent-free period. The present value of the amount received by the landlord over the lease term should be the same under both scenarios, but the timing of the cash flow may differ.

Rent-free periods

Rent-free leases allow the tenant a rent holiday for some portion of the lease term, usually the beginning. The lease is normally structured so that the tenant does not have a legal obligation to pay rent during the rent-free period.

Similarly, stepped rent allows the landlord to increase rent in stages over the term of the lease (for inflation or otherwise).

Since no rent is receivable by the landlord for the rent-free period, no amount is included in income for tax purposes. Consistently, the tenant has no expense for tax purposes during the rent-free period (see Buck Consultants Limited v. R. 2000 D.T.C. 6015).

For accounting purposes, rent is usually recognized evenly over the entire term of the lease, so that rental income includes amounts not yet received or receivable.

The difference between the treatment for tax and accounting would only provide the landlord with a timing benefit because the same amount of income would be recognized for both over the lease term. However, if a tenant’s tax position can accommodate a reduction of its rent expense for a period of time, a rent-free period may be a negotiable alternative to a cash inducement.

Rental Income from Stepped Rent Leases

For all existing leases, the rent to be received over the remaining term of the leases should be accounted for on a straight-line basis.

An “accrued rent receivable/payable” is recorded from the tenants for the current difference between the straight-line rent recorded as rental revenue and the rent that is contractually due from the tenant.

For an operating lease, the recognition of rental income and expense under CICA Handbook sections 3065.28 and 3065.55 requires the use of the straight-line basis “unless another systematic and rational basis is more representative of the time pattern” of the user’s benefit. This position is confirmed in the REALpac IFRS and ASPE handbooks.

Similar to free rent, the tenant does not have a legal obligation to pay the “accrued rent receivable”, and so the rental income for accounting purposes should include amounts not yet received or receivable. Since no rent is receivable by the landlord, no amount would have to be included in income for tax purposes.\(^{140}\)

Percentage Rents

The tenant’s obligation for percentage rent under the lease arises monthly based on the prior month’s sales.

If a landlord has collected more percentage rent than a tenant owes, the landlord will recognize a liability on its books.

The net credit is included in income for tax purposes (see paragraph 12(1)(a)). Because no future service is to be provided, no reserves are available, and so the landlord will have an inclusion in income. However, a deduction is available when the landlord refunds the credit balance to the tenant.

Deferred Major Repairs

Deferred major repairs are repairs that are charged to tenants through common area maintenance (CAM) billings.

For tax purposes, such costs are generally repairs and maintenance and are deductible in the year incurred.

Deferred major repairs that are capital in nature should generally be classified and/or depreciated according to the nature of the expenditure.

However, when deferred recoverable costs are considered capital in nature, an argument exists that the tax and accounting treatments should be the same. For accounting purposes, the expenditures may be amortized over the terms of the leases and charged back to the tenants as recoverable costs. Based on Canderel, one can argue that amortization may present a more accurate picture of profit as the amortized costs are directly matched to the revenue from tenant recoverables.

Green Buildings Tax Incentives

Summary of Class 43.1 and 43.2

Certain asset classes may qualify for accelerated CCA. Assets that do not qualify for the accelerated CCA are included in the respective CCA class depending on the type of the asset (e.g., building, equipment, furniture).

Note that the information below includes the proposed amendments to the Act and the Regulations.141

Class 43.1 in Schedule II to the Regulations provides a 30% accelerated CCA (on a declining balance basis) for certain energy conservation equipment. The property must be situated in Canada and cannot be reconditioned or remanufactured equipment.

Class 43.2 in Schedule II to the Regulations provides accelerated CCA (50% per year on a declining-balance basis) for specified clean energy generation equipment acquired after February 22, 2005 and before 2020. The class incorporates by reference a detailed list of eligible equipment that generates energy in the form of electricity or heat, by:

- Using a renewable energy source (e.g., wind, solar, small hydro)
- Using waste fuel (e.g., landfill gas, wood waste, manure) or
- Making efficient use of fossil fuels (e.g., high efficiency cogeneration systems, which produce electricity and heat simultaneously).

The eligibility criteria for these classes are generally the same except that cogeneration systems that use fossil fuels must meet a higher efficiency standard in the case of fossil fuel for Class 43.2 than for Class 43.1.

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141 Alberta and Quebec may not follow these federal rules.
Note that the accelerated depreciation is available if the equipment was used by either
the taxpayer or by a lessee of the taxpayer.

In 2010, Class 43.1 was expanded to include a broader range of heat recovery
equipment\textsuperscript{142} and distribution equipment used in district energy systems\textsuperscript{143} for eligible
assets that were newly acquired after March 4, 2010. The 2011 Budget further expands
Class 43.1 to include equipment that generates electricity using waste heat.

The 2012 Federal Budget proposes a number of changes to the accelerated CCA
provisions for clean energy generation equipment:

\begin{itemize}
  \item The current requirement that the heat energy generated from waste-fuelled thermal
  energy equipment must be used in an industrial process or a greenhouse will be
  removed. As a result, such equipment will be able to be used in a wider range of
  applications, including space and water heating.
  \item Class 43.2 will be expanded to include equipment that is part of a district energy
  system that distributes thermal energy primarily generated by waste-fuelled thermal
  energy equipment (that is itself eligible for inclusion in Class 43.2)
  \item Waste-fuelled thermal energy equipment included in Class 43.2 or a cogeneration
  system included in Class 43.1 or 43.2 will be allowed to use waste fuels from the
  residue of plants.
  \item Equipment using eligible waste fuels will not be eligible under Class 43.1 or Class
  43.2 if environmental laws and regulations are not complied with at the time the
  equipment first becomes available for use.
\end{itemize}

These measures apply to assets acquired on or after March 29, 2012 that have not been
used or acquired for use before this date.

\textbf{Solar Heating Equipment}\textsuperscript{144}

Solar heating equipment includes:

\begin{itemize}
  \item Active solar heating equipment including above ground solar collectors, solar energy
    conversion equipment, solar water heaters, energy storage equipment, control
    equipment and equipment designed to interface solar heating equipment with other
    heating equipment, or
  \item Equipment that is part of a ground source heat pump system that transfers heat to or
    from the ground or groundwater, and at the time of installation meets the standards
    set by the Canadian Standards Association for the design and installation of earth
    energy systems. Equipment includes piping (above and below ground), energy
    conservation equipment, energy storage equipment, control equipment and certain
    other interface equipment.\textsuperscript{145}
\end{itemize}

The equipment cannot be part of the building (other than a solar collector that is not a
window and that is integrated into a building), equipment used to heat water in a
swimming pool, energy equipment that backs up the above noted equipment, nor
equipment that distributes heated or cooled air or water in a building.

\textsuperscript{142} The amendment removes the restriction that requires the recovered heat to be reused in a process of the same type that
generated it.
\textsuperscript{143} Includes specified distribution equipment which the taxpayer uses to provide district heating or cooling through the use of
thermal energy.
\textsuperscript{144} Class 43.1(d)(i).
\textsuperscript{145} This applies to equipment acquired after May 2, 2010.
\textsuperscript{146} This applies to equipment acquired between March 19, 2007 and February 25, 2008 read “Equipment that is part of a ground
source heat pump system that is used primarily for the purpose of heating a liquid or gas used directly in an
industrial process or in a greenhouse, including underground piping, energy conversion equipment, energy storage
equipment, control equipment”. This applies to equipment acquired between February 26, 2008 and May 2, 2010
however underground piping is replaced by piping (including above and below ground).
Wind Turbines

Wind turbines:
- Must be a fixed location device that is used primarily for the purpose of generating electrical energy.
- Must consist of a wind-driven turbine, electrical generating and related equipment including:
  - controls, conditioning and battery storage equipment;
  - support structures;
  - a powerhouse complete with other ancillary equipment; and
  - transmission equipment.
- Do not include:
  - distribution equipment,
  - auxiliary electrical generating equipment,
  - electrical generating equipment acquired after February 27, 2000 that was not used prior to February 28, 2000, and
  - production and distribution equipment of a distributor of water or steam used for heating or cooling.

Fixed Location Photovoltaic Equipment

Fixed location photovoltaic equipment:
- Must be fixed to a location and used for the purpose of generating electrical energy from solar energy.
- Includes inverters, controls, conditioning, battery storage equipment, support structures and transmission equipment but not a building or a part of a building, distribution equipment, or auxiliary electrical generating equipment.

Geothermal Energy

Geothermal energy equipment:
- Includes above ground equipment used primarily for the purpose of generating electrical energy from geothermal energy, including such equipment that consists of piping (both above and below ground), pumps, heat exchangers, steam separators, electrical generating equipment and ancillary equipment used to collect the geothermal heat.
- Does not include buildings, transmission equipment, distribution equipment, equipment designed to store electrical energy.

CCA Restriction

For passive investors, CCA on specified energy property cannot exceed:
- Net income for the year from specified energy property (before CCA); and, if applicable,

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146 Class 43.1(d)(v).
147 Class 43.1(d)(vi).
148 Class 43.1(d)(vii).
149 In 2010, paragraph 43.1(d)(vii) was amended to include piping (including above or below ground piping, and the cost of drilling a well, or trenching, for the purpose of installing that piping). Applies to acquisitions made after May 2, 2010.
■ The partner’s share of net income of the partnership from specified energy property.

Specified energy property of a taxpayer or a partnership is generally property of Class 34 acquired by the owner after February 9, 1988 and property of Class 43.1, 43.2, 47 and 48.

No such restriction generally applies if the property is used by the owner primarily for the purpose of gaining or producing income from a business in Canada, or if the property is leased in the ordinary course of carrying on a business of the owner in Canada to a person that is carrying on a business in Canada.

Air and Density Rights

A developer may acquire rights to the air space above a property or piece of land. The reasons for acquiring the air rights may be to allow for the construction of a building or structure in the air space, or to have the ability to negotiate with a municipality to transfer surplus density from one site to another so as to maximize the permitted density in the desired site.

For tax purposes, a developer who acquires air rights has acquired “property” as defined in subsection 248(1) because air rights are integral to the use and enjoyment of the land itself. The air rights acquired would generally be either capital property or inventory to the developer. This determination would depend on the purpose for which such rights are acquired and would likely follow the treatment to the development of the project in question.

Acquisition of Air Rights

Inventory

If air rights are considered inventory, they would not be depreciable property by reason of Regulation 1102(1)(b).

Capital property

If air rights are considered capital property to the developer, they would not be depreciable property since air rights are intangible property for which there is no prescribed CCA class. However, it could be argued that air rights could form part of the cost of capital property because they enhance an existing asset (either land or building). In allocating air rights to land or building, it could be argued that the air rights were acquired in order to construct a particular building, and, accordingly, the cost of the rights can be added to the capital cost of the building. In other cases, it may be more appropriate to add the cost of the air rights to the land. Further, a taxpayer who leases air rights for a specified period could record the cost of obtaining the air rights for this period as a leasehold interest in Class 13.

Eligible capital expenditure

Air rights could be considered to be an eligible capital expenditure (ECE) that can be amortized according to the rules in section 14 and paragraph 20(1)(b). 75 per cent of the costs may be amortized on a declining balance basis at a rate of 7 per cent per year. For example, if the taxpayer who acquires the air rights does not own the underlying land or building, the taxpayer’s acquisition cost of the air rights is generally an eligible capital expenditure as defined in subsection 14(5). The CRA has also indicated that an amount

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151 Cadillac Fairview Corporation Limited v. The Queen, 97 DTC 405 (T.C.C.) and Sun Life Assurance Company of Canada v. The Queen, 97 DTC 422 (T.C.C.) present a conflicting view and cast doubt on this argument.
paid by a taxpayer for the right of access to, or over, land owned by another person qualifies as ECE.152

Disposition of Air Rights

The tax treatment of the gain or loss on the disposition of air rights would depend on the characterization of the air rights when they were acquired by the taxpayer (i.e., inventory, capital property or ECE).

If the air rights were considered to form part of the land or building, but the land or building itself has not yet been disposed of, the sale of the rights would be a partial disposition of the underlying property. The vendor would be required to determine the appropriate portion of the original tax cost of the underlying property, for example, by comparing the FMV of the property with air rights to the FMV of the property without the air rights. Such calculated tax cost would then be reported against the proceeds receivable for the disposition of the air rights.

If the air rights were originally considered as inventory to the vendor, the vendor would record the tax gain or loss as business income or loss.

An easement is commonly granted to the purchaser of air rights. Administratively, the CRA states in Document 2008-0296741E5, “Proceeds from Easement on Land”, dated December 17, 2008, that, in the event of a partial disposition of property, the CRA will accept an amount equal to the proceeds from such disposition as being the reasonable portion of the ACB of the whole property attributable to the partial disposition provided that:

- The area or the portion of the property that was expropriated or in respect of which an easement was granted is not more than 20% of the area of the total property, and
- The amount of the compensation received is not more than 20% of the amount of the ACB of the property.

This administrative position may also be applied to the disposition of air rights on the basis that it is a partial disposition of the underlying property.

Density Rights

Density rights are restrictions on the size or height of buildings. They are usually established by municipal by-laws, and some planning statutes allow density rights to be transferred between sites on municipal approval. A developer may agree with the municipality to build a higher density building than otherwise permitted in one site by reducing or eliminating the density of another property owned by the same developer. These rights can also be acquired from third parties with municipal approval.

The tax consequences of density transfers between taxpayers are basically the same as discussed for air rights; however, the cost to a developer of acquiring density rights is allocable to the land only and not the building, since such rights determine what a landowner can do with the land. These rights would continue to exist if the building was demolished and the land left vacant, or another building constructed on the site.

The tax determinations related to the acquisition and disposition of air rights and density rights depend greatly on the specific facts and should only be acted on with appropriate professional advice.

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Tax Considerations on Disposition of Real Property

General Considerations

Gains accrued up to December 31, 1971
Watch for V-day values of land and building (i.e., properties held on December 31, 1971 and continuously thereafter). Unrealized gains accrued up to December 31, 1971 are exempt from capital gains tax.

Recapture/terminal loss
The lesser of proceeds and original capital cost is credited to the applicable UCC pool. If the UCC pool has a net positive balance and no assets remain in that UCC pool, there is a terminal loss (see subsection 20(16)). If the UCC pool has a negative balance, even if assets remain, there will be recaptured depreciation (see subsection 13(1)).

Suspended losses on prior transfers to non-arm's-length parties
Watch for assets that have been transferred between non-arm's-length entities. Any losses on such a transfer may have been deferred by the original transferor. These losses will become deductible to the original transferor on the ultimate disposition of the property to an arm's-length party.

Replacement property rules for rental properties
Relieving provisions that would otherwise allow a deferral of capital gains and recapture of CCA when a taxpayer voluntarily replaces a capital property are not available for rental properties. However, the rules could apply for an involuntary disposition as a result of a fire, condemnation, flooding, or expropriation.

Mortgage repossession
When a mortgagor repossesses a property, the mortgagee is deemed to realize proceeds of disposition in the amount of the outstanding mortgage at the time of the repossession. Proceeds also include any other debts, such as second or third mortgages, for which the lender has no recourse.

Allocating Gross Proceeds between Land and Building
The allocation of proceeds between land and building may be specified in the purchase and sale agreement. The Supreme Court decision in Golden v. R (86 DTC 6138), demonstrates that considerable latitude will be given to allocations decided between arm’s length parties when there is evidence of “hard bargaining”153.

If an allocation is not specified in the purchase and sale agreement, consider the following alternatives:

■ Allocate a portion of gross proceeds to the land based on comparable vacant land and allocate the balance of gross proceeds to the building.
■ Follow the allocation used on the property tax assessments.
■ Follow the allocation used for accounting purposes (if the method is reasonable).
■ Follow the allocation used on the original acquisition of the property.
■ Allocate 10% to 35% of gross proceeds to land, depending on location, with better properties having a larger portion allocated to land. Note, however, that certain facts may require an allocation that falls outside of this range.

 Allocation under subsection 13(21.1)

If the amount of the disposal proceeds allocated to a building is less than the building’s UCC, subsection 13(21.1) may re-determine the proceeds allocable to building if a capital gain is recognized on the land.

In this situation, building proceeds will be the lesser of:

A. the excess of the total combined FMV of the land and building over the lesser of the FMV of the land and the original cost of the land; and

B. the greater of:
   i. the FMV of the building immediately before the disposal date; and
   ii. the lesser of the UCC and original cost.

 Example of subsection 13(21.1) allocation

To illustrate, consider the following example: Taxpayer A disposes of a rental property to Taxpayer B for proceeds of $1.7 million. In the purchase and sale agreement, both taxpayers have agreed to a 25/75 split between land and building, respectively. Taxpayer A’s land ACB is $300,000, building ACB/capital cost is $1.6 million, and building UCC is $1.45 million

Taxpayer A’s income/loss before the application of subsection 13(21.1):

■ Taxpayer A’s Capital Gain = (25% × $1,700,000) - $300,000 = $125,000
■ Taxpayer A’s Terminal Loss = (75% × $1,700,000) - $1,450,000 = ($175,000)

The building proceeds will be deemed to be the lesser of the following two amounts:

■ Total FMV ($1,700,000) less Land ACB ($300,000) = $1,400,000, and
■ The greater of Building FMV ($1,275,000) and Building UCC ($1,450,000)

Therefore, after the reallocation under subsection 13(21.1), Taxpayer A’s capital gain will be reduced to nil and Taxpayer A’s terminal loss will be reduced to $50,000 from $175,000.

 Capital Gains Reserve — Subparagraph 40(1)(a)(iii)

Subparagraph 40(1)(a)(iii) allows a taxpayer to claim a discretionary reserve for capital gains realized during a taxation year when a portion of the sales proceeds is not due until after the end of the taxpayer’s taxation year.

The capital gains reserve must be reasonable and is subject to a minimum recognition of at least 1/5th of the capital gain in each taxation year, on a cumulative basis. The capital gains reserve in any particular taxation year is calculated as follows:

The lesser of:

(i) \[
\frac{\text{Amount not yet due}}{\text{Gross proceeds}} \times \text{Total capital gain}
\]

(ii) \[
\text{Total capital gain} \times \left(\frac{4 - \# \text{ of preceding taxation years ending after the disposition}}{5}\right)
\]

Total capital gain = Gross proceeds less ACB of asset less selling costs

Under subparagraph 40(1)(a)(ii), a taxpayer must add back any reserve claimed in a prior taxation year.
The reserve is no longer available if the uncollected portion of the proceeds of disposition (e.g., mortgage receivable) has been transferred to a third party. 154

A capital gains reserve is not allowed if:

- The vendor was not resident in Canada or was exempt from tax at the end of the year or at any time in the immediately following year
- The purchaser is a corporation that controlled or was controlled by the vendor, or
- The purchaser is a partnership in which the vendor was, immediately after the sale, a majority interest partner. 155

**Income Reserve for Property Sold — Paragraph 20(1)(n)**

A discretionary reserve is permitted when an amount has been included in computing the taxpayer’s income for the year or a preceding taxation year for property sold in the course of the business when a portion of the gross proceeds is payable to the taxpayer after the end of the year.

A reasonable reserve can be calculated as follows:

\[
\text{Gross profit} \times \frac{\text{Amount due after end of taxation year}}{\text{Gross selling price}} = \text{Reasonable reserve}
\]

Gross profit is determined using the tax cost of the property and is not reduced by selling costs.

Paragraph 20(8)(b) limits the period for which a reserve can be claimed to not more than 36 months after the sale of the property.

Subparagraph 12(1)(e)(ii) requires a taxpayer to include any prior year reserve claimed under paragraph 20(1)(n) in its taxable income for the current taxation year.

Administratively, the CRA permits a reserve to be claimed when the due date has been extended. However, the due date must be extended by the end of a taxation year and preferably before the original due date of the debt.

Reserves may not be claimed if the vendor was not resident in Canada or if the vendor was exempt from tax at the end of the year or at any time in the immediately following year. 156

A proposed amendment to subsection 20(8)157 provides that a reserve will not be available to a taxpayer in certain non-arm’s-length situations. A reserve is not available if the purchaser of the property was:

- A corporation directly or indirectly controlled by the taxpayer,
- A corporation directly or indirectly controlled by a person or group of persons that also controlled the taxpayer,
- A corporation that controlled the taxpayer, or
- A partnership in which the taxpayer was, immediately after the sale, a majority interest partner.

If enacted, this amendment will apply to all property sold by a taxpayer after December 20, 2002.

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155 Paragraph 40(2)(a).
156 Paragraph 20(8)(a), included in the July 16, 2010 draft legislation.
157 Paragraphs 20(8)(c) and (d). The purpose of the proposed amendments is to deny a reserve when a taxpayer triggers the gain on a disposition within a controlled group and then disposes of the property to an arm’s-length party in a cash transaction.
Paragraphs 20(1)(n) and 20(1)(l) reserves are claimed independently of each other. (The CRA has challenged this treatment based on the view that the gross margin should be reduced by the amount of a paragraph 20(1)(l) reserve in the reserve formula.)

When a partnership that was claiming a reserve under paragraph 20(1)(n) dissolves and subsection 98(5) applies (the business of the partnerships carried on as sole proprietorship), the former partner who carries on the proprietorship may continue to claim the reserve, provided the sole proprietor is responsible for the original obligations.158

Characterization of Gain From Sale on Account of Income or Capital

In paragraph 3 of Interpretation Bulletin IT-218R,159 the CRA lists the factors that the courts have considered when determining whether gains from the sale of real estate are on account of income or capital. These factors are summarized as follows:

- The taxpayer’s intention, both primary and secondary, for the real estate at the time of its purchase and the feasibility of the intention
- The extent to which the intention was carried out
- Evidence that the intention changed after the purchase of the real estate
- The location and zoned use of the real estate
- The nature of the taxpayer’s business
- The extent to which borrowed money was used to finance the acquisition of the real estate and the terms of the financing arranged, if any
- The length of time the real estate was held
- Whether other persons share interests in the real estate
- The occupation of the other persons who have an interest in the real estate, their stated intentions and their conduct
- Factors that motivated the sale of the real estate
- Evidence of extensive experience in real estate.

While the courts have considered all of the above factors, the question of motive or intention has been developed the most. In addition to the consideration of the taxpayer’s whole course of conduct while possessing the real estate, the taxpayer’s intention generally influences the court’s finding.

Doctrine of secondary intention

The doctrine of secondary intention is summarized in paragraph 5 of IT-218R as follows:

A taxpayer’s intention at the time of purchase of real estate is relevant in determining whether a gain on its sale will be treated as business income or as a capital gain. It is possible for a taxpayer to have an alternate or secondary intention, at the time of acquiring real estate, of reselling it at a profit if the main or primary intention is thwarted. If this secondary intention is carried out any gain realized on the sale usually will be taxed as business income.

To be successful under this principle, the Minister must specifically allege that a secondary intention to sell the land in question for a profit was a motivating factor when the property was purchased.

Case law not helpful

Generally, case law is not helpful in determining capital versus income treatment of a gain on the sale of real estate since each case is fact-specific and the outcome is determined based on the taxpayer’s conduct and intentions while possessing the property.

Sale of Condominium Units

Generally, condominium developers allow purchasers to occupy condominium units prior to the registration of the building under the relevant condominium statute. This practice generally involves two closings: one at the time the purchaser occupies the unit (the first closing date) and another at the time of registration of the building (the second closing date).

As set out in Income Tax Technical News No. 8, dated October 17, 1996, in light of the decision in 141224 Canada Ltd. v. The Queen, the CRA’s view is that, if the vendor does not have the right to the payment of the sale price before the second closing date, the amounts do not have the characteristics of revenue. Thus, these amounts are not taxable until they are legally receivable.

However, if the seller has a legal right to receive the proceeds at the first closing date, the CRA’s view is that the income from the sale of the condominiums should be reported at the first closing date.

For financial statement reporting, a corporation generally recognizes its profits from the sale of condominium units using either the percentage-of-completion method or once the purchaser has paid all amounts due on closing and has the right to occupy the unit.

If the percentage-of-completion method is adopted, revenue is recognized when the following five criteria are met:

1. Construction is beyond a preliminary stage
2. The buyer is committed to the extent of being unable to require a refund, except for non-delivery of the unit
3. Sufficient units have already been sold to assure that the entire property will not revert to rental property
4. Sales price is assured
5. Aggregate sales proceeds and costs can be reasonably estimated.

Disposition of Land for No Proceeds

The CRA has stated that where parties contract in the normal course of business and property is transferred between the arm’s length parties for consideration that is considerably less than FMV, there is a general inference that the transaction is in the nature of a barter transaction. For the purpose of computing income to the taxpayer at the time of the disposition, the value of what is received has to be taken into consideration.

However, the CRA also expressed the view that they would not challenge the tax treatment when land is transferred by a developer to a municipality in order to obtain a development permit, and any costs incurred for such land are transferred to other lands.
Disposition of a Partnership Interest to a Tax-exempt Entity – Subsection 100(1)

Subsection 100(1) must be considered on the disposition of a partnership interest to any tax-exempt person.\textsuperscript{165} A taxpayer’s taxable capital gain in this situation would not be calculated under section 38, but would be deemed to be the sum of:

1. 50\% of the capital gain reasonably attributable to the increase in the value of the partnership capital property, other than depreciable capital property, and
2. the remaining portion of the capital gain.

The purpose of subsection 100(1), therefore, is to ensure that a portion of the gain, to the extent it represents income that would be fully taxable if the partnership property (e.g., depreciable property or inventory) were sold instead of the partnership interest, is taxed as ordinary income and not as a capital gain. This provision should not change the computation of the taxable capital gain realized on the disposition of a partnership interest to a tax-exempt person, if all the property of the partnership is non-depreciable capital property.

The 2012 Federal Budget proposes to apply section 100 to the sale of a partnership interest to a non-resident person. In addition, section 100 will expressly apply to an indirect transfer of a partnership interest to a non-resident person or a tax-exempt entity. However, this proposal will not apply to the disposition of an interest to a non-resident person if the partnership, immediately before and immediately after the acquisition by the non-resident person, uses all of the property of the partnership in carrying on business through a permanent establishment in Canada.

This measure applies to dispositions of interests in partnerships that occur on or after March 29, 2012, except for arm’s-length dispositions made before 2013 where the taxpayer is obligated pursuant to a written agreement entered into before March 29, 2012.

In a real estate context, where little recapture is triggered on the sale of the underlying depreciable property to the partnership, it may be advisable to sell the depreciable assets separately and pay the tax on recapture. This preliminary asset transaction is protective and removes a risk that the capital gain applicable to the depreciable property could be taxed as ordinary income if subsection 100(1) applied.

Development Project Costs/Costs to Complete

For large, multiple-phase real estate development projects, such as residential land and housing developments, it is common that substantial costs are incurred after sales are recorded on initial phases. Costs to complete include subdivision amenities (e.g., landscaping, parks, recreation centres) and common costs that are not specific to individual residential lots (e.g., grading roads, utilities and sewers, streetlights).

In determining cost of sales for accounting purposes, real estate developers generally budget and accrue for all direct development costs and the allocable portion of all common project costs (incurred to the date of sale and estimated to be incurred in the future when the entire development is complete).

For income tax purposes, real estate developers generally deduct costs to complete on an accrual basis when such costs can be estimated with a reasonable degree of accuracy. The costs to complete represent future services to be rendered to the

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\textsuperscript{165} A tax-exempt person for the purpose of subsection 100(1) is any person that is exempt from tax under section 149.
land/house buyer under the terms of the purchase agreement in order to finish the development project.

Where land is sold in the course of carrying on a business and the proceeds of disposition are in part payment for the land sold and in part a prepayment for future services, the CRA has stated at the Revenue Canada Round Table at the 1989 Canadian Tax Foundation Annual Conference that a reserve under paragraph 20(1)(m) may be available provided the following conditions are met:

■ The costs to be incurred by the taxpayer after the taxpayer's fiscal year end can be identified.
■ The revenue related to the services has actually been received by the taxpayer prior to his fiscal year end.
■ The revenue related to the services has been included in the taxpayer’s income pursuant to paragraph 12(1)(a).

Costs to complete which cannot be reasonably estimated or which are uncertain would generally be viewed as contingent and not deductible for income tax purposes (see paragraph 18(1)(e)).

Real Property Inventory Valuation

Real property inventory that is not held in an adventure or concern in the nature of trade is valued at the lower of acquisition cost and FMV under subsection 10(1).

Where a taxpayer has "written down" real property inventory on the basis that the FMV is lower than cost, the CRA interprets "cost" within the context of subsection 10(1) as being the original cost. Accordingly, it is the view of the CRA that any subsequent increase in FMV should be reflected in the valuation of inventory in subsequent years unless subsequent FMV exceeds original cost in which case the original cost should be used for inventory valuation.166

Alternatively, Regulation 1801 permits valuation of all inventory at FMV. This alternative advances the recognition of profit and may be useful if the taxpayer has losses that are about to expire.

Rules concerning the valuation of inventory effectively override the capitalization requirements found in subsections 18(2) and 18(3.1). As such, when inventory is not held in an adventure or concern in the nature of trade, interest and property taxes capitalized to inventory can be effectively written off if the FMV of the inventory has declined.

Subsection 10(2.1) requires that the same method of inventory valuation be used, unless authorized by the Minister.

Inventory that is held in an adventure or concern in the nature of trade is valued at its acquisition cost under subsection 10(1.01).

KPMG Observations

A taxpayer who has recognized the impaired value of significant land inventory may consider the transfer of the land inventory to another person or partnership167. In this manner, the transferee acquires the land inventory at a new cost amount and the historical cost of the transferor should no longer be relevant for income tax purposes. If the carrying cost of the land is equal to its FMV, the taxpayer should be able to transfer...


167 Under paragraph 96(1)(a), the income of a partnership for income tax purposes is computed as if the partnership was a separate person.
the land inventory in a non-arm’s length transaction at FMV to another corporation within
the group. If the transfer wishes to transfer the land inventory under a protective tax
election, the property could be transferred to a partnership under a subsection 97(2)
election.

Other transaction costs including land transfer taxes should be considered.

Note: This or any other planning idea should only be acted on with appropriate professional advice after a thorough
examination of the particular situation.

Income of Contractors

The policy for contractors’ income recognition for tax purposes applies to any prime
contractor or sub-contractor who is engaged in the construction of a building, road, dam,
bridge or similar structure and does not retain title to the structure constructed.168

The general rules for contractors’ income recognition cover the following types of
construction contracts:

■ Cost-plus
■ Unit-price
■ Fixed-fee
■ Fixed-total-price (also known as firm-price, fixed-price or lump-sum contracts).

General Rules — Income

The amount of a progress billing, less the holdback if any, becomes receivable and must
be included in the contractor's income when the purchaser or the purchaser's architect or
engineer approves the progress bill for payment.

The aggregate of the holdbacks becomes receivable and must be included in the
contractor's income on the day that is the later of:

■ The day on which the architect or engineer issues the final certificate of job
  completion, and
■ The day of expiration of the lien period as stipulated in the applicable provincial
  statute.

The CRA will allow a contractor to choose to report income for tax purposes by including
all amounts that have been billed to the purchaser, even though not approved for
payment, provided that the contractor does so consistently from year to year.

When no construction contract exists or when the terms of a contract do not require
formal approval of progress billings, the amount billed, net of holdbacks if any, will be
considered receivable and included in the contractor's income.

Any amount actually received in the course of business by a contractor must be included
in the contractor’s income for the taxation year under paragraph 12(1)(a).

If the receivable amount relates to a payment in advance for work to be performed at a
later date, a reserve under paragraph 20(1)(m) is available, provided that the costs to be
incurred after the contractor's fiscal year-end can be identified.

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168 See IT-92R2 Income of Contractors for further details
General Rules — Expenses

All costs incurred in a taxation year by a contractor in the performance of a contract are deductible in computing income for the year, even though part of the revenue relating to work completed may not be included in income until a subsequent year.

Costs incurred in the year in the performance of a contract include:

- The cost of materials for a contract that have been delivered to the job site, whether put in place or not
- All other direct and general costs and expenses
- The gross amount, less holdback if any, of progress billings rendered by a subcontractor to the contractor that have been approved for payment
- The aggregate of holdbacks withheld from payments made by a contractor to a subcontractor that are paid or payable in the year by the contractor in accordance with the terms of the appropriate provincial statute or, in the absence of any such statute, the terms of the subcontract itself.

A cost is not considered to have been incurred in the performance of a contract in the year and is not deductible in the year when it is, for example:

- The cost of materials that have been merely ordered for future delivery
- The cost of materials and supplies that are described in a contractor's inventory, including those earmarked for a specific contract but not delivered to the job site
- A holdback withheld by a contractor from a subcontractor if the contractor's liability to the subcontractor in respect thereof has not been established by the issuance of a required certificate by an architect or engineer
- The gross amount of a billing rendered by a subcontractor to a contractor that requires, but has not received, approval prior to payment.

Fixed-Total-Price Contracts (Use of “Completion Method”)

When contracts may reasonably be expected to be completed within two years of their commencement, the CRA allows the taxpayer to take the whole revenue (including holdbacks) from each contract into income in the year in which construction is physically completed.

The CRA accepts the date on which the final engineer's or architect's certificate is issued as the date of physical completion.

When the contractor and the owner are not dealing at arm's length, any unusual delay in the issuance of certificates is examined when deciding the date of completion.

Additions to a job requiring extra work that postpone completion of the job from one taxation year to a later one should be treated as a separate contract.

The contractor is required to adopt the completion method for all short-term contracts and is required to use the same method consistently from year to year.

- The method may be changed to the general method of reporting income but cannot revert to the completion method in a future year.
- The method may be changed from the general method to the completion method, provided the contractor has never previously adopted the completion method.

A contractor using the completion method must defer claiming all the direct costs of that contract incurred in a previous year to the year in which a short-term contract is completed.
A loss on a short-term contract is taken into account only in computing the income of the year in which the contract is physically completed. No provision is allowable in a year prior to that of completion for an anticipated loss on the contract.

**Construction Subcontractor Payment Reporting**

Section 238 of the Regulations requires a person or a partnership, whose business income is derived primarily (more than 50%) from construction activities, to file an information return, reporting all payments made in the course of construction activities. The CRA refers to this reporting as the Contract Payment Reporting System. Payments of less than $500 in the year to a subcontractor do not have to be reported.

“Construction activities” include the erection, excavation, installation, alteration, modification, repair, improvement, demolition, destruction, dismantling or removal of all or any part of a building, structure, surface or subsurface, construction, or any similar property. Ongoing maintenance is not included.

The CRA has stated that “derived primarily from those [construction] activities” could be interpreted broadly to include a real estate developer that derives more than 50% of its business income from the construction of buildings or condominium units for sale.169

This reporting excludes:

- Goods for sale
- Lease payments
- Wages paid to employees
- Payments made to non-residents for property income under Part XIII of the Act, and
- Payments for services rendered outside Canada by non-resident persons.

This reporting includes amounts “paid or credited” and therefore includes the fair market value of bartered goods and/or services. GST, HST and provincial sales taxes may be included in the total reported amount of payment.

The reporting period may be on a calendar year or fiscal year basis, but the payments must be reported on Form T5018 within 6 months from the end of the reporting period. Once a reporting period has been chosen, it can only be changed with the authorization of the Minister of National Revenue.

A penalty of $25 per day, with a minimum penalty of $100 up to a maximum of $2,500 can be levied for each failure to file a T5018 information return.

**Financial Difficulties**

Various provisions in the Act can apply when a debt owing is forgiven by the creditor. These provisions apply in the following order:

1. Section 78 – Unpaid Amounts — The most relevant part of this section in a real estate context is subsection 78(1), which can apply when a deductible expense (e.g., interest) is owing to a non-arm’s-length person and remains unpaid. It provides that the debtor will have an income inclusion of such an unpaid amount in the third year after the expense was incurred, unless an election is made in the debtor’s return of income for that year to have the unpaid amount recharacterized as a loan.

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Subsection 78(2) applies to cause an income inclusion when a corporation owes an amount to a non-arm’s-length party in respect of a deductible expense at the time the corporation is wound up.

Subsection 78(4) applies to deny a deduction for remuneration expense when it is unpaid for more than 179 days after the year in which the remuneration expense was incurred.

2. Subsections 6(1) and (15) — These subsections apply to deem an employment benefit when an employee’s debt to his or her employer is forgiven.

3. Subsections 15(1) and (1.2) — These subsections apply to cause an income inclusion where a shareholder’s loan is forgiven.

4. Section 9 — This section applies where the debtor is required to include the forgiven amount in income for accounting purposes.

5. Section 79 — Discussed in detail below

6. Section 80 — Discussed in detail below

Section 79 – Foreclosure/Repossession

Section 79 – Debtor’s proceeds on foreclosure/repossession

Section 79 applies when a creditor acquires property from:

- a debtor, or
- a purchaser under a conditional sales agreement who has failed to pay an amount owing to him or her.

The acquisition may take place by means of:

- a foreclosure order obtained through a court
- repossession under a conditional sales agreement
- a quit claim.

Section 79 does not apply where the creditor purchases property from the debtor merely in anticipation of the debtor’s default or where the debtor’s property is disposed of to a third party pursuant to a power of sale.

The acquisition of the property by the creditor results in a disposition to the debtor, and subsection 79(3) contains a formula that determines the debtor’s proceeds on such disposition. In general terms, the debtor’s proceeds are equal to the amount of debt (including interest) owing on the property that ceases to be owing as a consequence of the property being surrendered.

Section 79.1 — Creditor’s cost of property acquired on foreclosure/repossession

Section 79.1 sets out the tax consequences to a creditor where property has been acquired or reacquired as a consequence of a debtor’s failure to pay an amount owing to the creditor.

In general, the creditor’s deemed purchase price of the property acquired equals the principal amount owed by the debtor less any reserves (e.g., paragraph 20(1)(n), paragraph 40(1)(a)(iii)) claimed by the creditor with respect to the property in the immediately preceding year.

The amount of a reserve from the prior year to be included in current-year income is reduced by the amount of such reserve that is applied against the creditor’s cost of property reacquired.

There is a potential trap regarding a vendor take-back mortgage on inventory property. Where a vendor take-back mortgage has been accepted as consideration for the sale of
a property and, in the same year, the creditor repossesses the property, the creditor is not able to claim or reserve on the sale. Accordingly, the creditor may end up in the anomalous situation of having to recognize a gain for tax purposes without actually realizing an economic gain. However, where the property was capital property to the creditor, subsection 79.1(5) will adjust the original proceeds of disposition by the amount of the unpaid proceeds at the time of reacquisition. No such relief exists for inventory property.

Section 80 – Debt Forgiveness

The debt forgiveness provisions in section 80 apply when a commercial debt obligation is settled for an amount less than the principal.

A commercial debt obligation is a debt obligation for which interest was actually paid or payable, or, if interest were paid or payable under a legal obligation, such interest would have been deductible in determining taxable income earned in Canada.

When the terms of a debt are changed so dramatically that a new obligation has been constructively created, section 80 can apply.

The excess of principal and interest over the settlement amount is a “forgiven amount”.

Inventory debt

When a debt in connection with inventory is forgiven (i.e., a trade debt), section 80 does not apply if the forgiven amount is otherwise included in income. Case law in this area is conflicting and the facts should be considered carefully.

Application of the forgiven amount

The forgiven amount is applied to the following tax attributes in order, until absorbed:

- Non-capital losses of the taxpayer (see subsection 80(3))
- Capital losses (see subsection 80(4))
- UCC of depreciable capital property (see subsection 80(5))
- Unamortized cumulative eligible capital (see subsection 80(7))
- ACB of non-depreciable capital property (see subsection 80(9))
- ACB of certain shares and debt (see subsection 80(10))
- ACB of certain shares, debt and partnership interests of related entities (see subsection 80(11))
- Capital losses realized in the year of forgiveness (see subsection 80(12)).

Income inclusion

If any unapplied forgiven amount remains after the above applications, an amount is included in the taxpayer’s income (subsection 80(13)).

The income inclusion would be 50% of the unabsorbed forgiven amount plus 50% of any reduction under subsection 80(11) not applied to the tax attributes of the related entities.

The income inclusion is generally limited to twice the FMV of the taxpayer’s net assets (an insolvency exception).

Section 61.3 allows a reduction in the amount otherwise included in income under subsection 80(13). The reduction is the subsection 80(13) inclusion less twice the taxpayer’s net assets, determined by deducting its liabilities from the FMV of its assets.

Assuming a 50% tax rate, a sale of all of the remaining assets would generate just enough cash to pay the tax resulting from the debt forgiveness inclusion. The formula in
section 61.3 assumes that the ACB of assets will have been ground to zero through application of the forgiven amount.

Section 61.3 does not apply when property was transferred in the 12-month period before the year-end, or the corporation became indebted in that period when one of the reasons for the transfer or the indebtedness was to increase the amount of the reduction.

**Transfer of forgiven amount to related person**

Section 80.04 allows a debtor to transfer the remaining unapplied forgiven amount (immediately before the income inclusion but after the application of subsections 80(5) to (10)) to certain related persons. The transferred amount becomes a forgiven amount of the transferee to which section 80 applies. The transfer of unapplied forgiven amounts avoids any income inclusion in the debtor’s hands and applies the forgiven amount to the tax attributes of the transferee.
Non-Residents Investing In Canadian Real Estate

Common Ownership Structures

Common ownership structures for non-residents investing in Canadian real estate include corporations, partnerships or trusts.

Advantages
- Income tax rate should be lower than the Canadian income tax rate payable by a trust.

Disadvantages
- Subject to thin capitalization rules if property income is earned.\(^{170}\)

\(^{170}\) Technical Interpretation 9638945.
Advantages

- Income is taxed only at Canadian marginal tax rates (i.e., as low as 15% federally plus relevant provincial tax).
- Losses of the partnership flow through to the investor (subject to the at-risk rules).
- No thin capitalization restrictions.
- If certain financial thresholds are not met[^171], a partnership information return is not required.

Disadvantages

A capital gain is triggered when the cost basis of the limited partnership interest becomes negative.

[^171]: A partnership information return is required if at the end of the fiscal period, the partnership has an absolute value of revenues plus an absolute value of expenses more than $2 million, or has more than $5 million in assets.
Advantages
■ No withholding taxes on interest if certain conditions are met.
■ Capital distributions are not subject to withholding tax.
■ No thin capitalization restrictions.
■ Income tax should be nominal in earlier years as most of the income is sheltered by interest on debt of the Foreign Trust.
■ No branch tax.

Disadvantages
■ Alternative minimum tax may apply.
■ Losses cannot be allocated to the beneficiary.
■ Where the central management and control of the Foreign Trust can be considered to be exercised in Canada, the Foreign Trust may be deemed to be resident in Canada. \(^{172}\)

Business Income vs. Property Income

The starting point for the Canadian tax analysis of a non-resident’s investment in Canadian real estate is to determine whether the real estate investment will give rise to income from a business carried on in Canada or income from property. This determination is a question of fact (not a question of law).

\(^{172}\) Garron Family Trust (Trustee of) [St. Michael Trust Corp.] v. The Queen 2010 DTC 5189 (FCA). On June 23, 2011, leave to appeal was granted by the Supreme Court of Canada.
Two general tests have emerged from case law:

- **Range of services** — An assessment of the extent of services offered by the owner and whether such services are over and above those normally associated with the use of the property.
- **Level of activity** — An assessment of the amount of activity of the owner and implications of rental relative to other activities and income of the owner.

According to the CRA, important factors to consider include:

- The degree of activity expended by the taxpayer in earning the income (i.e., time, attention and labour)
- The extent and nature of the services provided to the tenants.

The real estate owner’s delegation of its management and supervision to an agent/property manager does not alter the nature of the rental income (i.e., for purposes of the business vs. property determination, the CRA will consider the activities to have been carried on by the owner).

The CRA appears to generally assume that rental income is income from property unless the facts suggest otherwise.

See *Interpretation Bulletins* IT-420R3, “Non-residents – Income Earned in Canada” and IT-434R, “Rental of Real Property by Individual”.

### KPMG Observations

*A head-lease arrangement can be used to increase the likelihood that rental income will be considered property income when such characterization benefits the non-resident.*

### Business Income

Non-residents carrying on a business in Canada are subject to Canadian Part I income tax on the income earned in Canada and may also face the tax implications outlined below.

**Branch tax**

If the non-resident is a corporation, branch tax also applies on amounts not reinvested in businesses carried on in Canada.

Just as distributions of profit earned by a Canadian resident corporation are subject to non-resident withholding tax, branch tax applies to the after-tax profits earned by a branch of a non-resident corporation earning business income in Canada. The Canada-US tax treaty\(^\text{173}\) exempts the first $500,000 (Cdn) of profits from branch tax and reduces the normal tax rate to 5% (from 25%).

**Waiver for withholding tax**

While normally non-resident withholding tax is required to be paid on rents paid to a non-resident, a tenant is not required to withhold tax on its payments to a non-resident, where a waiver under Regulation 805 is obtained from the CRA.

The waiver is granted at the discretion of the CRA once it is satisfied that an amount is not taxable under Part XIII (i.e., the non-resident is carrying on a business in Canada through a permanent establishment (PE)).

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**Capital tax**

Non-resident corporations may be subject to provincial capital tax on capital employed in Canada. The legal classification of a non-resident entity is determined under Canadian legal principles, subject to relevant treaty provisions.

**Income tax rates**

2011 tax rates range as follows:

- Corporate: 26.5% - 32.5% + branch tax (higher if provincial abatement is not available)
- Individual: 19% - 50%
- Trust: 39% - 50%

**Property Income**

**Tax on gross rents**

A non-resident that earns rental income in Canada that is not considered to be earned from carrying on a business is subject to a 25% withholding tax under Part XIII (unless reduced by a tax treaty) on the gross amount of rents paid or credited, pursuant to paragraph 212(1)(d).

Tenants making such rental payments to the non-resident are required to withhold and remit the tax to the CRA under subsection 215(1); however, often this responsibility (but not the obligation) is assumed by a property manager. If the tenant made the rental payments without withholding the tax, the agent is liable to withhold and remit the tax on behalf of the non-resident per subsection 215(3).

Withholding tax on rents must be remitted to the CRA on or before the 15th day of the month following the month in which the tenant paid its rent.

**Tax on net rents/Filing Canadian tax returns**

A non-resident can file Form NR6, “Undertaking to File an Income Tax Return by a Non-Resident Receiving Rent from Real Property or Receiving a Timber Royalty” with the CRA and file a Canadian income tax return under subsection 216(4) to have tax computed on the net rental income at normal tax rates.

Form NR6 is due on or before the first day of each taxation year or when the first rental payment is due.

After Form NR6 is approved by the CRA, the non-resident is allowed to remit withholding tax based on the budgeted “net rents available” (i.e., net rental income before CCA) instead of the gross rental income.

The subsection 216(4) return must be filed within six months from the end of the non-resident’s taxation year. The difference between the actual tax payable, which is computed based on net rental income (after CCA), and tax withheld throughout the year, which is based on budgeted “net rents available”, results in a balance owing or a refund, as applicable.

If a non-resident does not file Form NR6, withholding taxes must be calculated based on 25% of the gross rent. However, the non-resident still has the option to file an income tax return pursuant to subsection 216(1) within two years after the end of the taxation year to have the final tax liability computed on net rental income for the applicable year and recover excess tax paid.
Branch tax

If the non-resident is a corporation, branch tax does not apply to income from property or the taxable capital gain on the disposition of real or immovable property situated in Canada that is not used by the taxpayer in a business carried on in Canada.

Partnership implications

Non-resident partners

A partnership that is not a Canadian partnership is deemed to be a non-resident person when a person resident in Canada pays an amount to the partnership for purposes of withholding tax under the Act (subsection 212(13.1)).

Accordingly, certain types of payments (e.g., rent, interest, dividends) made to such a non-Canadian partnership may be subject to Part XIII withholding tax. As the Act does not provide any look-through relief for any Canadian partners of such a partnership, this leads to the anomalous requirement that Part XIII tax be withheld in respect of the portion of the payment applicable to not only the non-resident partner(s) but also the Canadian partner(s).

This interpretation was confirmed by the CRA in paragraph 7 of Interpretation Bulletin IT-81R, “Partnerships—Income of Non-Resident Partners,” dated May 6, 1976, in which the CRA indicated that any such tax withheld in respect of the Canadian resident would be credited against the Canadian resident's tax otherwise payable. However, the CRA may grant relief from the requirement to withhold in respect of the Canadian partner(s) with a written request for withholding relief.

For partnerships, each non-resident partner is required to file Form NR6.

Use of losses

Net losses from rental operations (that is filed as property income) can only offset income from the same year from other Canadian real estate. Unused losses are not available for carryforward for the purpose of calculating income under subsection 216(1).

Provincial tax

If the non-resident corporation does not have a PE in Canada, double tax may arise as the provincial abatement for federal tax purposes is only available if the non-resident has a PE in Canada. Land itself may not constitute a PE under Regulation 400. Without a PE, the provincial abatement will not be available for federal tax purposes yet provincial tax may still apply.

Income tax rates

2011 tax rates:

- Corporate 26.5% (higher if provincial tax also applies)
- Individual 22% - 43%
- Trust 43%

Interest

Withholding Tax

Paragraph 212(1)(b) provides generally that a withholding tax of 25% (unless reduced by a tax treaty) shall be paid on (i) interest paid by “a person resident in Canada” to a non-arm's-length non-resident, or (ii) participating interest paid to a non-resident. Prior to January 1, 2008, paragraph 212(1)(b) was much broader in scope and applied to all cross border interest payments including interest paid to an arm’s-length non-resident. Exceptions, however, were available in certain circumstances.
Participating debt interest is defined in subsection 212(3).

Withholding tax is also required when a non-resident pays interest to another non-arm’s-length non-resident in the following situations:

- When interest on a mortgage secured by real property situated in Canada is paid, to the extent the interest is deductible in computing the non-resident person’s taxable income (see paragraph 212(13)(f))
- When a partnership pays or credits an amount to a non-resident person, the partnership shall, in respect of the portion that is deductible, be deemed to be a person resident in Canada (see paragraph 213(13.1)(a))
- When the interest is deductible by the payer in computing its income from a business carried on principally in Canada (see subsection 212(13.2)).

Withholding tax deducted from interest payments must be remitted to the CRA on or before the 15th day of the month following the month in which the non-resident withheld the tax (i.e., the time of the interest payment).

Pursuant to the 5th Protocol of the Canada-US Tax Treaty, which was ratified on December 15, 2008, the rate of withholding tax applicable to interest paid to non-arm’s-length non-residents is reduced to 0% for 2010 and onwards.

Prior to the elimination of withholding tax on arm’s-length interest (other than participating debt interest) paid after 2007 to a non-resident, the CRA allowed limited relief from withholding tax on interest paid on certain debts owed to non-residents by corporations. When debt meeting the criteria is owed by a partnership and all partnership members are corporations, the interest on the debt was also exempt from withholding tax (see paragraph 212(1)(b)(vii) as it applied before 2008 and Interpretation Bulletin IT-361R3, “Exemption from Part XIII Tax on Interest Payments to Non-Residents”).

Thin Capitalization Rules

The thin capitalization rules are intended to prevent non-resident shareholders from excessive financing of Canadian operations with debt, the interest on which is deductible from the Canadian tax base, rather than financing with equity (i.e., shares).

The deduction for interest on debt owing to certain “specified non-residents” (SNR) is disallowed when the corporation’s debt-to-equity ratio in relation to the SNR exceeds 2:1. The International Advisory Panel, which produced its report to the government in December 2008, recommended that the debt-to-equity ratio be revised to 1.5:1. This recommendation was implemented in the 2012 Federal Budget.

SNRs are non-residents or non-resident owned investment corporations which, alone or together with non-arm’s-length persons, own either:

- 25% or more of the voting shares of the corporation, or
- Shares having a FMV of 25% or more of the FMV of all the issued and outstanding shares of the corporation.
The portion of the interest disallowed as a deduction is determined as follows:

\[
\frac{\text{Average o/s interest-bearing debt to SNR}}{2 \times \text{the company’s interest expense bearing debt to SNR \times \text{equity in relation to SNR relating to debt}}}
\]

The 2012 Federal Budget proposes to reduce the debt-to-equity ratio to 1.5:1 for all corporate taxation years that begin after 2012.

Debt only includes interest-bearing debt, the interest of which would otherwise be deductible to the taxpayer (i.e., notwithstanding subsection 18(4)).

The average outstanding debt to a SNR is calculated as the average of the highest amount of debt owing to a SNR for that month of all calendar months ending in the taxation year.

Equity includes:

- The retained earnings (excluding deficits) at the beginning of the year
- The average contributed surplus at the beginning of each calendar month ending in the taxation year contributed by SNR shareholders
- The average of the paid-up capital of the corporation at the beginning of each calendar month ending in the taxation year of all shares of all classes owned by SNR shareholders of the corporation.

In addition, the 2012 Federal Budget proposes a number of changes to the thin capitalization rules.

- These rules will be expanded to apply to debts owed by partnerships of which a Canadian resident corporation is a member. In this situation, the debt of the partnership will be allocated to its Canadian resident corporate members based on their proportionate interest in the partnership. These debts will then be included in the corporation’s debt-to-equity ratio under the thin capitalization rules. Where this calculation results in an amount of non-deductible interest that is related to the debt allocated from the partnership, an amount equal to the interest on the portion of the allocated partnership debt that exceeds the permitted debt-to-equity ratio will be required to be included in computing the income of the Canadian resident corporate member. The inclusion will be treated as either business or property income determined by the source against which the interest is deductible at the partnership level. This measure is applicable in respect of debts of a partnership that are outstanding during corporate taxation years that begin on or after March 29, 2012.

- The disallowed interest expense from the application of the thin capitalization rules will be recharacterized as a dividend for non-resident withholding tax purposes. This recharacterization includes an amount that is required to be included in computing the income of a corporation in respect of a disallowed interest expense of a partnership. This measure applies to taxation years that end on or after March 29, 2012.

- Any disallowed interest expense of a corporation will be allocated to SNRs in proportion to the corporation’s debt owing in the taxation year to all SNRs, including debts owing by the partnerships of which a corporation is a member. Withholding tax will then apply to the deemed dividend allocation. Withholding taxes on deemed dividends are due when applicable withholding taxes on interest payments are otherwise due. The corporation may allocate the disallowed interest expense to the latest interest payments made to any particular SNR in the taxation year. Where the interest expense has not been paid by the end of the taxation year, the disallowed interest expense will be deemed to have been paid as a dividend to that SNR at the end of the taxation year.
■ The thin capitalization rules will not include the interest expense of a Canadian-resident corporation that relates to interest that is taxable to the Canadian resident corporation as Foreign Accrual Property Income of a controlled foreign affiliate of the corporation. The potential for double taxation is thereby eliminated. This measure applies to taxation years of a Canadian resident corporation that end on or after March 29, 2012.

Capitalized Interest Not Subject to Non-resident Withholding Tax

Interest paid to non-arm’s-length non-residents is generally subject to withholding tax (subject to the exemptions under the 5th Protocol to the Canada-US Treaty).

Non-residents may have an opportunity to avoid withholding and remitting tax in certain circumstances before potential legislative amendments are introduced, based on the TCC decision in Easter Law Trust (2004 TCC 689). This or any other planning idea should only be acted upon with appropriate professional advice after a thorough examination of the particular situation.

In this case, a non-resident taxpayer was involved in a Canadian real estate development joint venture project. The CRA assessed the non-resident taxpayer Part XIII withholding tax at 25% on $2.4 million of interest paid to a non-resident lender. This interest was capitalized by the taxpayer as required during the construction period.

The TCC found that the taxpayer was not liable for the Part XIII tax because the capitalized interest was not deducted in computing the taxpayer's taxable income but was instead included in the taxpayer's cost of goods sold.

The TCC found that an amount included in the cost of inventory is a component of the taxpayer's gross profit but is not considered to be "deductible" from taxable income earned in Canada for purposes of subsection 212(13.2).

Non-Resident Disposition of Canadian Real Property

For dispositions after March 4, 2010, TCP as defined in section 248 generally includes the following:

■ Canadian real or immovable property;
■ Canadian business property used in carrying on a business in Canada;
■ Designated insurance property belonging to an insurer;
■ Shares of corporations that are not listed on a designated stock exchange, an interest in a partnership, or an interest in a trust, if at any time in the previous 60 month period, more than 50% of the fair market value of the shares or interest was derived from one or any combination of the following sources\(^\text{174,175}\):
  ■ Canadian real or immovable property;
  ■ Canadian resource property;
  ■ Timber resource property; and
  ■ Options or interests in any of the above.

\(^{174}\) At the CRA Round Table at the 2011 Canadian Tax Foundation Annual Conference, the CRA stated whether a share derives its value principally from real or immovable property situated in Canada should be made by reference to the value of the properties of the company without taking into account its debts or other liabilities. This new gross asset value test will initially be applied to dispositions of properties acquired after 2011 and generally for dispositions of property after December 31, 2012.

\(^{175}\) When a non-resident disposes of shares of a parent corporation that has a subsidiary, the FMV of the shares of the subsidiary must be determined. Amendments are proposed in August 27, 2010 draft legislation to ensure that the indirect look-through rule does not extend through shares or other interests that are not themselves taxable Canadian property (for example, when the parent corporation holds shares of a Canadian public company which are not TCP).
 Shares of corporations listed on a designated stock exchange, a share of a mutual fund corporation or unit of a mutual fund trust, that at any time in the previous 60 month period satisfied both of the following conditions:

- 25% or more of the issued shares of any class, or 25% or more of the issued units, belonged to the taxpayer and persons with whom the taxpayer did not deal at arm's length; and
- More than 50% of the fair market value of the shares or interest was derived from one or any combination of the following sources:
  - Canadian real or immovable property;
  - Canadian resource property;
  - Timber resource property; and
  - Options or interests in any of the above.

 An option or interest in any property listed above (whether or not the property exists). Recaptured CCA and capital gains earned by non-residents on dispositions of TCP are taxable in Canada.

When TCP is acquired from a non-resident, the purchaser is required to withhold 25% of the gross proceeds for non-depreciable capital property (50% of gross proceeds for inventory and depreciable property) unless the purchaser has taken steps to establish that the vendor has paid the tax or provided security for the tax.

**Section 116 Certificate of Compliance**

To provide the purchaser with evidence to eliminate or reduce his or her withholding obligation, the vendor will have to apply to the CRA for a Section 116 Certificate of Compliance by filing Form T2062, “Request by a Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Taxable Canadian Property”. Form 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” will also have to be prepared and filed for the disposition of depreciable TCP.

Forms T2062 and T2062A require the non-resident vendor to state the name and address of the purchaser, the date of the transaction, a description of the property, and the expected gain and recapture of CCA as a result of the disposition.

The request may be made in advance of the transaction or no later than ten days after the transaction.

Before the CRA will issue a certificate of compliance, the non-resident vendor is required to make payment or post security on account of tax. The amount of payment/security for capital gains is equal to 25% of the capital gain. The amount of payment/security for recaptured CCA is computed at the non-resident federal tax rates applied to the amount of recapture.

Failure to comply with section 116 may result in a penalty pursuant to subsection 162(7) plus any applicable interest, and/or imprisonment.

A Part I return must be filed for the year of disposition to report the amount of the actual capital gain from the disposition. Some non-residents may also have to file a subsection 216(1) return to report the amount of CCA recapture from the disposition and any rental income earned from TCP during the year.

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176 At the CRA Round Table at the 2011 Canadian Tax Foundation Annual Conference, the CRA stated that both tests must be satisfied at the same time when determining whether a share listed on a designated stock exchange is TCP at any particular time during the 60-month period.
Dispositions of taxable Quebec property as defined in section 1094 of the Quebec Taxation Act are subject to an additional withholding of 12%.

As a result of recent legislative changes (subsections 116(5.01) and (5.02)), the section 116 certificate of compliance procedures have been simplified for post-2008 dispositions.

The legislative changes provide that the requirement to withhold tax and obtain a clearance certificate will be eliminated where:

■ the purchaser has made reasonable efforts to determine that the vendor is a resident of a country that has a tax treaty with Canada;

■ the gain on the disposition is exempt from tax under a tax treaty with Canada; and

■ a notice setting out the particulars of the transaction is filed with the CRA by the purchaser within 30 days of the disposition. This notice obligation can be satisfied by submitting Form T2062C, “Notification of an Acquisition of Treaty-Protected Property from a Non-Resident Vendor”.

However, transactions involving real estate (the disposition of either the real estate or an entity which derives its value from real estate) will not qualify for the simplified procedures.

Non-Resident Tax Compliance

When rental income is considered income from property and the non-resident wishes to reduce withholding tax on rent receipts, the non-resident must file forms and returns according to the following schedule:

Before the beginning of year — Form NR6 is filed as an undertaking that the non-resident will file a tax return. Form NR6 includes an estimate of net rental income, excluding depreciation and other non-cash expenses.

Within three months after end of the calendar year — Form NR4 is filed to report the amount of non-resident withholding tax credited to the non-resident during the calendar year.

Within six months after year-end — A section 216 return is filed to report the actual rental income earned in Canada as though the non-resident were a person resident in Canada and to pay tax under Part I on that income. The difference between the Part XIII withholding tax remitted (Form NR4) and the Part I income tax liability (section 216 return) will result in a refund or balance owing to the non-resident.

The appropriate income tax returns must be filed as follows:

Individuals Form T1159 (simplified T1 personal income tax return)
Corporations T2 return
Trusts T3 return
Services Rendered in Canada

Under Regulation 105, every person who pays a fee, commission or other amount to a non-resident person for services rendered in Canada of any nature whatever is required to withhold and remit 15% of such a payment to the CRA.

If the service is rendered in Quebec, a further 9% must be withheld and remitted.

The Canadian tax withheld on payments to non-residents does not represent the final Canadian tax liability but is considered to be a tax instalment of the non-resident. As such, non-residents must determine whether they are taxable in Canada and are required to file a tax return after the end of each calendar year.

The CRA may grant a waiver when it is established that a non-resident is not subject to Canadian tax or, if it is, when the ultimate tax liability would be lower than the withholding tax.
US Vacation Property

Canadians holding US real estate, shares in US corporations, or other “US situs” assets at the time of their death are generally subject to US estate tax at rates of up to 35% of the gross value of such assets. The Treaty significantly reduces the US estate tax impact for many Canadians holding US property — generally those with total estates under US $5 million (or $10 million if married and property transferred to a spouse on death). The current rates and exemption amounts are set to expire at the end of 2012. The Canada-US Treaty does not provide complete relief for larger estates as the maximum credit must be pro-rated by the value of the individual’s US estate over the value of his or her worldwide estate. Canadians are also generally subject to US gift tax if they gratuitously transfer certain US situs assets.

The first step for Canadians who own or are acquiring US real estate is to determine the potential exposure to US estate tax. In many cases, there will be no or limited exposure on the death of the first to die. In cases where the exposure is significant, the following alternatives should be considered for the ownership of the property. Some structures can be used for property already owned and others only for new purchases.

The following section reviews some planning ideas to minimize the exposure to US estate tax for Canadians who are not US citizens. These or any other planning ideas should only be acted upon with appropriate professional advice after a thorough examination of a particular situation.

Ownership by Spouse with Lower Net Worth

An individual Canadian resident with an estate valued at less than US $5 million will not be subject to US estate tax. The formula in the Treaty pro-rates the credit with the result that there is no US estate tax liability if the Canadian decedent has worldwide assets of less than $5 million in 2011 and 2012. Transfers of assets between spouses can be undertaken to ensure that the spouse acquiring the US property has worldwide assets below the threshold. The Canadian attribution rules must be taken into consideration when transferring assets between spouses. The spouse acquiring the property should use their own funds (not funds gifted from the spouse) in order to avoid potential gift tax.

Joint Ownership

Where property is held as joint tenants with right of survivorship probate is avoided on the death of the first joint tenant to die. For US estate tax purposes property held as joint tenants is deemed to be 100% owned by the first joint tenant to die unless the executor can prove that the surviving joint tenant paid for their interest with their very own funds. This rule does not apply if the property is owned by spouses who are both joint tenants. If each spouse paid for their share of the property with their own funds then only their share will be subject to estate tax on the death of the first to die. The survivor will own the entire property after the death of the first to die and may need to undertake some additional planning at that time.

Split Interest

A technique to reduce exposure to the US estate tax is split interest ownership of the property. Under such an arrangement, an individual would acquire a life interest in US property, and his or her children would acquire the remainder interest in the property. The children must have their own funds to invest (not gifted from their parents). On the death of the individual, there would be no estate tax on the life interest, since the life interest
would have no value upon death. However, should the children die while holding a remainder interest, the estate tax would be assessed on the value of the remainder interest. The children may consider obtaining term life insurance to fund any estate tax exposure.

A split interest arrangement usually may result in significant complexities. However, the tax savings may be worthwhile for certain family situations.

**Non-recourse Debt Financing**

A non-recourse mortgage outstanding on US real estate reduces the value of the property included in an individual’s taxable estate. A non-recourse mortgage is one that entitles the lender to have recourse only against the property mortgaged. If an individual defaults on payment, the mortgaged property can be seized, but there will be no further liability if the value of the property does not satisfy the debt. Most US lenders are reluctant to provide a mortgage on a non-recourse basis to Canadians and will only lend 50% of the value of the property. Consequently, it may be necessary to seek other sources of financing.

One possible source of non-recourse financing may be a spouse. For example, assume a wife has $1,000,000 of cash available for investment. Instead of investing directly, she could loan her husband $1,000,000 on a non-recourse basis to acquire a property with a value of $2,000,000 (the remainder of the funds coming from him). Should he die, the net value subject to estate tax would be $1,000,000, since he will deduct the non-recourse debt from the value of the property situated in the US. If she dies, there will be no value in the estate since the loan is not property situated in the US.

In order to be respected as true debt, the debt should be registered and have commercial characteristics such as a market rate of interest and repayment terms. The loan to value ratio must also reflect arm’s length standards. An estate return filed on death would report the debt and may be subject to IRS scrutiny.

Additional planning is necessary to minimize the tax inefficiency of the husband making a non-deductible interest payment to his wife who is subject to Canadian tax on that interest received.

With non-recourse debt, the principal amount of the debt generally decreases while the value of the property generally increases. Consequently, as the property appreciates in value and/or the principal of the debt is repaid, the exposure to US estate tax increases.

**Canadian Trust**

A properly structured Canadian trust can be used to acquire a US property. The trust should be established long before the property is acquired in order to avoid US gift tax. The settlor of the trust cannot be a beneficiary of the trust. The spouse can have a life interest with the children as remainder beneficiaries. The settlor has to settle the trust and cannot reclaim such cash or property. The value of the property would not be included in the settlor or the spouse’s estate for US estate tax purposes provided that they had no rights to the capital of the trust.

**Partnership Structure**

Although this is an unsettled area of tax law, it is arguable that an interest in a Canadian limited partnership holding personal-use US real property is not property situated in the US and therefore may shelter the Canadian partner from US estate tax.
The partnership structure has the following advantages over a corporate structure:

- The Canadian shareholder benefit rules under subsection 15(1) do not apply to partnerships.
- The income of the partnership is considered to be that of its partners and thus the partners would be subject to lower Canadian taxes compared to owning the property in a corporation. Combined Canadian and US corporate tax on the earnings (i.e., on investment income, rental income and any potential capital gains) and personal tax on dividends paid from the corporation currently exceeds the personal tax on an individual’s direct US holdings. Income tax integration does not work precisely for foreign investment earnings.
- The individual partners benefit from the lower US federal tax rates on long term capital gains. The lower capital gains rates do not apply to corporations.

Reverse Hybrid Structure

The term “reverse hybrid” refers to an entity that is treated as a partnership in Canada but which has elected to be taxed as a corporation for US tax purposes. This structure provides additional comfort over the Canadian partnership structure as shares of a foreign (non-US) corporation are not considered property situated within the US; neither the “shares” of the “entity” nor any assets held by the entity should be subject to US estate tax provided the entity is the legal and beneficial owner of the property.

In order to make this election, the partnership must have some business activities beyond just the holding of personal-use real estate. One of the attractive features of this strategy is that, since the partnership will continue to be recognized as a partnership for Canadian tax purposes, the Canadian partner will not have a “shareholder benefit” (as this only applies to shareholders of a corporation). However, since the partnership will be considered a corporation for US tax purposes, the tax arising from the sale of the property will not be eligible for the lower individual long term capital gains tax rates.

Under certain circumstances it may be possible to elect “corporate status” for US tax purposes after the date of death of the partner; this will allow individual income tax rates on the sale of the property before death and also provide insulation from the estate tax upon death. This is a complex strategy that requires extreme care in both planning and implementation and should only be pursued with professional tax advice.

Single-Purpose Corporations

Before 2005, US vacation property was often held in a single-purpose Canadian corporation. A single-purpose corporation (SPC) is an undefined term used by the CRA to describe a corporation the shareholders of which will not be subject to the shareholder benefit rules under subsection 15(1). This relief was formerly available to Canadian corporations whose only objective is to hold a residential real property in the US provided certain strict rules were met.177

As announced in Income Tax Technical News No. 31R2, effective January 1, 2005, the CRA changed its administrative policy of not assessing a taxable benefit. The CRA said the policy was no longer needed since changes to the Canada-US tax treaty have mitigated certain US estate tax problems that the policy was designed to prevent by allowing the US applicable credit amount for residents of Canada.

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The new policy applies for:

■ Any new property acquired by an SPC
■ A person who acquires shares of an SPC, unless the shares are acquired due to the
death of the individual’s spouse or common-law partner.

The old administrative policy continues to apply:

■ To any renovation or addition to a dwelling that was acquired before January 1, 2005;
  and/or,
■ To a dwelling that was under construction on December 31, 2004 (a dwelling is
  considered to be under construction when the foundation or other support has been
  put in place). This transitional relief is not provided if vacant land was acquired but
  the foundation or other support was not put in place or if land with an existing building
  was acquired before January 1, 2005 with the intention to demolish the existing building
  and construct a new dwelling on the land.

The CRA will not extend this grandfathering rule where the shares of the single purpose
  corporation are transferred between spouses due to divorce or marriage breakdown.178

**Life Insurance**

Life insurance is one way of funding the potential estate tax liability. The life insurance
proceeds would not be subject to US estate tax but the proceeds would be included in
the worldwide assets of the decedent which impacts the calculation of estate tax. Life
insurance premiums are generally not deductible for income tax purposes.

Capital Tax

Capital tax is effectively a tax on a corporation’s long-term assets, determined by reference to the corporation’s liabilities and shareholder’s equity.

A reduction in a corporation’s taxable capital, generally known as an investment allowance, is allowed for investments in, and loans to, other corporations to reflect amounts included in the liabilities and shareholders equity and the taxable capital of those investee corporations.

The capital tax base varies by jurisdiction. A capital deduction or exemption is available in some jurisdictions and, in most cases, must be allocated among associated companies. As of 2011, capital tax has been eliminated at the federal level and for all provinces except for Nova Scotia, and there are currently plans to phase out capital tax for Nova Scotia as well. The capital tax rates and capital deduction or exemption for 2011 are:

<table>
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<th>2012</th>
<th>2013</th>
<th>Capital Deduction/ Exemption</th>
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<td>Nova Scotia179</td>
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<td>0.1%/0.05%</td>
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<td>$5 million</td>
</tr>
</tbody>
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General

Under subsection 181.2(3), a corporation’s taxable capital includes:

- The amount of capital stock, retained earnings, contributed surplus and any other surpluses (excluding accumulated other comprehensive income)180 at the end of the year
- The amount of reserves for the year, except to the extent they were deducted in computing income under Part I of the Act
- The amount of its deferred unrealized foreign exchange gains at the end of the year
- The amount of all loans and advances to the corporation at the end of the year
- The amount of all indebtedness of the corporation at the end of the year represented by bonds, debentures, notes, mortgages, bankers acceptances, or similar obligations
- The amount of any dividends declared but not paid by the corporation before the end of the year
- The amount of all other indebtedness (excluding indebtedness in respect of a lease) of the corporation at the end of the year that has been outstanding for more than 365 days before the end of the year, and

Where the corporation was a member of a partnership at the end of the year, the proportion of the partnership’s paid up capital is based upon the share of income allocated to the corporation (see below for more details).

Under subsection 181.2(4), a corporation’s investment allowance includes:

- A share of another corporation
- A loan or advance to another corporation (other than a financial institution)
- A bond, debenture, note, mortgage, hypothecary claim, or similar obligation of another corporation (other than a financial institution)

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179 If taxable capital is less than $10 million, the tax rate is 0.2% and a $5 million capital deduction is allowed. If taxable capital is greater than $10 million, the 0.1% rate applies and no capital deduction is permitted. The capital tax rate is scheduled to be reduced by 0.1% annually on July 1st for corporations with taxable capital under $10 million and reduced by 0.05% for corporations with taxable capital over $10 million. Capital tax is scheduled to be eliminated by July 1, 2012.

180 CRA Views, Conference 2008-0285381C6
- The amount of any long-term debt of a financial institution
- The amount of any dividend receivable on a share of the capital stock of another corporation
- The amount of any loan or advance to, or a bond, debenture, note, mortgage, hypothecary claim, or similar obligation of, a partnership where all members throughout the year were other corporations not exempt from tax under Part I.3

Where the corporation was a member of a partnership at the end of the year, the proportion of the partnership’s investment allowance is based upon the share of income allocated to the corporation (see below for more details).

“Netting” of Certain Loans and Advances

Administratively, the CRA permits netting loans and advances when a debtor has a legal right to offset or eliminate the obligation due to a creditor by applying an amount of an obligation due to the debtor by the same creditor, and the parties must intend to act on that right.181

Deferred Revenue

The CRA’s LCT position – Document 9410460

Deferred revenues are considered to be advances for purposes of paragraph 181.2(3)(c) and therefore must be included in taxable capital. The availability of reserves for income tax purposes does not affect amounts included under paragraph 181.2(3)(c). Even though paragraph 181.2(3)(b) addresses reserves and excludes amounts deductible for income tax purposes, the inclusion under paragraph 181.2(3)(c) causes deferred revenues to be included as taxable capital.

Technically, amounts that would be included in taxable capital as advances could also be included as reserves. However, subsection 181(4) would apply to ensure any amount would only be included in taxable capital once.

Security deposits and prepaid rent are also considered by the CRA to be advances under paragraph 181.2(3)(c).

Deferred revenue that does not represent an advance is excluded from taxable capital. For example, amounts reflected in a corporation’s “deferred revenue”, using the percentage of completion or completed contract methods of accounting for long-term construction contracts that have been billed but not received, do not constitute reserves and are not included in taxable capital. However, amounts received under such contracts are considered advances and are included in computing capital.182

Accounting Treatment vs. Legal Form

When a term derives its meaning primarily from accounting (e.g., reserves, provisions, allowances, other surpluses, retained earnings and deferred tax),183 the accounting meaning will prevail.

For loans, advances and leases, the legal meaning should prevail. Legal form must be considered to determine whether to include an item in the capital tax base. GAAP is then used to determine the amount of the item to be included in the capital tax base.

Items that are different in accounting and legal form include leases (discussed below) and holdbacks payable (which are considered a reserve).

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182 Technical Interpretation 2002-0163545.
183 Technical Interpretation 2002-0149177.
Capital Lease Obligations for Accounting Purposes

A capital lease is not included in taxable capital if it is treated as an operating lease for income tax purposes. A lease is included in the determination of taxable capital if it is treated as a purchase for income tax purposes.

The CRA takes the position that the legal nature of the agreement governs the tax treatment. If an arrangement is legally a lease, the obligation should be excluded from taxable capital. If the transaction is legally a conditional sale, the obligation would be included in taxable capital.

Bank Overdraft

The TCC decided in Canada Forest Products Ltd. v. The Queen (2004 DTC 405) that outstanding cheques are not included in taxable capital for LCT. The court relied on the legal meaning of “loan” rather than the GAAP meaning. Therefore, although outstanding cheques are included in liabilities for accounting purposes, it was determined that no true liability to the bank existed at year-end. Therefore, outstanding cheques may be excluded from taxable capital.

Partnerships/Unincorporated Joint Ventures

Each corporate partner must include, in the computation of taxable capital, its share of liabilities and other amounts of a partnership or joint venture that would otherwise be included in taxable capital/paid-up capital.

Taxable capital is generally apportioned using the profit-sharing ratio of the fiscal period of the partnership/joint venture, ending within the taxation year-end of the corporate partner.

Taxable capital is measured at the close of the taxation year of the corporate partner. When the fiscal period of the partnership/joint venture does not coincide with that of the corporate partner, administratively, the corporate partner may include the taxable capital of the partnership/joint venture fiscal period ending within the taxation year-end of the corporate partner.

The equity interest in a partnership/joint venture is not an eligible investment. A corporate partner may claim an eligible investment for its share of the qualifying investments of the partnership.

If the partnership/joint venture and the corporate partner do not have coterminous year-ends, contributions to and withdrawals from the partnership/joint venture will create advances receivable from/payable to the partnership/joint venture on the financial statements of the corporate partner. Such stub period transactions are not loans and advances but equity account transactions. Accordingly, such stub period amounts should not be treated as either taxable capital or eligible investments for capital tax purposes.

Investment Allowance — Debts of Eligible Partnerships

Paragraph 181.2(4)(d.1) includes in a corporation’s investment allowance a loan or advance to a partnership when, throughout the relevant taxation year, all the members of the partnership are other corporations (other than financial institutions) that are not tax-exempt under Part I.3.

The current legislation does not permit a corporation to claim an investment allowance for advances or loans to second or lower-tiered partnerships, since one or more members of such partnerships are obviously not corporations.
It was suggested that an investment allowance should be available in some situations involving multiple tiered partnerships. Specifically, an investment allowance should be available for loans and advances to a partnership if all the non-corporate members are themselves partnerships that, either directly or through further layers of partnerships, are made up of corporations ("eligible partnerships"). In other words, an eligible partnership would be a partnership where all the members are corporations or other eligible partnerships. The carrying value of any loan or advance to an eligible partnership would be included in computing the investment allowance of a corporation.

Finance is prepared to recommend an amendment to paragraph 181.2(4)(d.1), effective for 2004 and subsequent taxation years, that would include in the investment allowance the debt of eligible partnerships. Other related recommendations are as follows:

- An eligible partnership could have no member that is a financial institution\(^{184}\) or that is a corporation exempt from tax under Part I.3 (unless the corporation is exempt because it is non-resident and does not carry on business in Canada through a PE).
- A partnership would be required to maintain its status as an eligible partnership throughout the taxation year in which a corporation seeks to include its debt to the partnership in its investment allowance calculation.
- For purposes of including amounts in capital under paragraph 181.2(3)(g) for a loan or an advance to an eligible partnership, the fiscal year-end of any intervening or higher-tier partnership would be deemed to be the same as that of the debtor partnership.

**Interprovincial Capital Tax Considerations**

Corporations are subject to provincial income tax and capital tax if they have a PE in a given province.

When a corporation has PEs in more than one province, income and capital are allocated to the provinces in which it has activities using the formula based on salaries, wages, and revenues attributable to the PEs.

Consider the case of *W.E. Roth Construction Limited v. The Minister of Finance (Ontario)*.

The taxpayer owned and managed rental real estate properties in Ontario and Alberta. In Ontario, the employees were responsible for providing management services to the taxpayer. In Alberta, separate corporations provided management services to the taxpayer and the taxpayer paid fees for such services to the management corporations.

The court held in favour of the Minister, finding that, since it was the practice of the taxpayer to contract the management of the Alberta properties to management services corporations rather than have employees manage the properties, the services provided were not services normally performed by employees of the taxpayer.

It was the modus operandi of the establishment in question that was important. That the same services were provided by employees in Ontario was of no significance to the court.

In this area, caution is advised as the CRA has enforcement activities targeting aggressive inter-provincial tax planning including efforts to shift income (and the capital tax base) between provinces to reduce or avoid paying provincial taxes.

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184 The July 16, 2010 draft legislation proposes to amend paragraph 181.2(4)(d.1) such that certain financial institutions would not be excluded from the partnership when the corporate partners deal at arm’s length.
Acquisition Issues

Common income tax planning on acquisitions can have negative capital tax implications. For example, the use of an acquisition company followed by a merger between the acquisition corporation and the target corporation is used for various income tax planning reasons.

The amalgamated company's capital tax base will generally be increased, because of accounting rules, by the difference between the FMV of the target company shares acquired and the shareholders' equity of the target company prior to acquisition.
Goods and Services Tax/Harmonized Sales Tax

Overview and General Principles

The Goods and Services Tax/Harmonized Sales Tax (GST/HST) legislation contains many provisions specific to the acquisition, development, rental and sale of real property.

A common misconception is that most supplies of real property are GST/HST-exempt. In fact, the general rule is that all supplies of real property in Canada are taxable, even where made by a non-resident, unless a specific exemption is provided in Schedule V to the Excise Tax Act (the ETA), the GST/HST legislation.

Generally, only “used” residential property and most supplies of real property made by charities, non-profit organizations, universities, schools and hospital authorities are specifically exempt under the ETA.

Supplies of real property by individuals are also exempt, subject to a variety of exceptions.

As of August 1, 2011, GST and HST apply to real property located in the various Canadian provinces and territories as follows:

- British Columbia (B.C.): HST at 12%
- Ontario: HST at 13%\(^{185}\)
- New Brunswick: HST at 13%
- Nova Scotia: HST at 15%
- Newfoundland and Labrador: HST at 13%

The above provinces are referred to as the “harmonized provinces”.\(^ {186}\)

GST at 5%\(^ {187}\) applies to real property located elsewhere in Canada.

B.C. – Transition from HST to GST and PST

As noted above, B.C. adopted the HST effective July 1, 2010. However, a subsequent referendum resulted in a decision to return to the GST and provincial sales tax (PST) structure effective April 1, 2013. On February 17, 2012, some proposed transitional rules were announced while others should be released later. As such, the proposed transitional rules are generally not reflected in this chapter. However, a summary of the proposed transitional rules is available at the end of the chapter (see “B.C. – Transition from HST to GST and PST”).

Any person receiving revenues from taxable supplies of real property (or any other taxable supplies) exceeding $30,000 per year is required to register for GST/HST.

\(^{185}\) Ontario adopted the HST effective July 1, 2010. At the time of writing, there is no indication that the tax will be rescinded.

\(^{186}\) In September 2011, Quebec also announced its intention to harmonize the Quebec Sales Tax with the federal GST, effective January 1, 2013. However, it appears that Quebec will stop short of fully adopting a single, harmonized sales tax, but instead will continue to run two parallel value-added taxes, with the QST referred to as the “Amended QST”. The QST applies generally to the same GST-taxable property (i.e., goods, real estate and intangibles) and services. As of January 1, 2012, the QST rate is 9.5%.

\(^{187}\) HST and GST rates as of August 1, 2011. Historical rates are:

- January 1, 1991 – June 30, 2006: GST 7%; HST 15%
- July 1, 2006 – December 31, 2007: GST 6%; HST 14%
purposes. (However, revenues from sales of capital real property are excluded when calculating this $30,000 GST/HST registration threshold.)

Some examples of exempt supplies of real property:

- Sales of "used" (i.e., previously occupied) residential property
- Sales of most personal-use property when the vendor is an individual (note that most time-share property, if placed in a rental pool, becomes taxable when resold)
- Long-term residential leases (more than one month)
- Low-cost (less than $20 per day) residential rental accommodation (e.g., rooming houses)
- Condominium or co-op fees or common expenses
- Transfers of farmland by farmers to a related individual
- Most supplies of real property by charities, non-profit organizations, universities, schools and hospital authorities.

Different forms of ownership of real property (e.g., partnerships, joint ventures, co-ownerships) have different results in terms of which entity must register and account for the GST/HST.

Special Case — Partnerships

A partnership is a "person" for GST/HST purposes. As such, the partnership registers for GST/HST, rather than the partners.

The partnership, rather than the individual partners, is considered to be engaged in commercial activity relating to the partnership’s property and is required to register for GST/HST purposes, account for tax on taxable supplies and claim input tax credits (ITC).

For GST/HST registration to be available, the entity must be a partnership at law, not a joint venture.

Anything done by a partner in his or her capacity as such is deemed to have been done by the partnership, not the partner. Consequently, partners are not required to register separately for GST/HST purposes (unless otherwise engaged in commercial activity).

The related-party election to relieve the GST/SHT on supplies between members of closely related groups has been extended to include partnerships under certain circumstances.

Special Case — Joint Ventures

A joint venture is not a "person" for GST/HST purposes, and so it cannot register for GST/HST in its own right.

Under the normal GST/HST rules, each participant in a joint venture engaged in commercial activity must register for GST/HST, account for the tax charged on its pro-rata share of supplies made by the joint venture and claim ITCs on its pro-rata share of purchases made by the joint venture.

The administrative burden of having to account for GST/HST individually can be relieved by all of the parties making the "GST/HST joint venture election" to have the "operator" of the joint venture account under its own GST/HST registration number for all GST/HST in respect of purchases and supplies made by the operator on behalf of the participants.

The party that will act as the "operator" of the joint venture must be a "participant" therein; however, it is not required to have an actual financial interest in the joint venture.
Administratively, the CRA considers a "participant" to be a person who does not have a financial interest in the joint venture, but who is designated as the operator of the joint venture under a written agreement, and is responsible for the managerial or operational control of the joint venture. Therefore, a third party management company that does not have a financial interest in the joint venture can be appointed as the operator and handle the joint venture’s GST/HST accounting on behalf of the other parties.

(It is the CRA’s policy that a bare trustee cannot act as the operator of a joint venture. As discussed in the “Special Cases – Trusts/Nominee Corporations” section below, a bare trustee cannot register for GST/HST purposes because it has no commercial activities. A trustee that has independent or discretionary powers and responsibilities is not a bare trust. However, the "operator" of a joint venture must be responsible for managerial or operational control of the joint venture.)

Another advantage to making the joint venture election is that GST/HST will not apply to the revenues distributed to the participants by the operator, to reimbursements to the operator for expenses incurred on behalf of the participants, or to the fees payable to the operator for operating the joint venture.

However, the joint venture election may not preclude the participants from having to register and account for GST/HST on the initial acquisition of real property. Based on the wording of the legislation, and on the CRA’s published administrative material, the joint venture election for real property can only cover post acquisition real property activities on the basis that the actual acquisition of the real property itself is not among the “prescribed activities” to which the joint venture election applies.

**KPMG Observations**

The CRA’s published administrative material also states that where the joint venture agreement clearly indicates that the activities of the joint venture include the acquisition of the real property by the operator on behalf of the participants, the operator is deemed to have acquired the real property. Consequently, to avoid the administrative burden of requiring the participants to register solely for the purposes of accounting for GST/HST on the acquisition of the property, the joint venture agreement should provide that the operator’s duties include the acquisition of the property.

Only the following real estate-related activities, which are prescribed by regulation, qualify for the joint venture election:

- Construction of real property, including feasibility studies, design work, development activities and tendering of bids, when undertaken to further a joint venture for the construction of real property.
- Exercising the rights and privileges, or performing the duties and obligations, of ownership of an interest in real property, including related construction or development activities whose purpose is to derive revenue from the property by sale, lease, etc., except if the property is non-residential real estate and one of the joint venture participants, or a related person, uses part of the property otherwise than in commercial activities, and does not pay rent at FMV.
- Marketing by the joint venture operator, under an agreement between the operator and a participant, of the participant’s share of the output of the joint venture, provided that the output arises from an activity conducted under a written joint venture agreement.
- Transporting natural gas liquids by means of a pipeline that operates as a common carrier of natural gas liquids.

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188 GST/HST Policy Statement P-106, “Administrative Definition of a "Participant" in a Joint Venture”.
189 The first three have been in place since January 1, 1991. The remaining 13 were added in March 2011, retroactive to either January 1, 1991, June 1, 1991 or September 1, 1991.
- Operating an electricity generation facility.
- Operating an electrical power transmission line.
- Processing the output of the exploration or exploitation of a timber resource, including any jointly conducted exploration or exploitation activity of which the output is processed under a joint venture agreement, and the marketing of the related processed or unprocessed output.
- Producing and marketing fertilizer.
- Waste disposal, including the associated collection and transportation.
- The exercise of rights or privileges, or the performance of duties or obligations, of ownership of an interest in an animal for the purposes of deriving revenue from prizewinning, stud service fees or sale.
- Road maintenance, other than exempt maintenance.
- Operating and maintaining the North Warning System.
- Operating a farming business within the meaning of the *Income Tax Act*.
- Producing liquid methanol from natural gas.
- Generating and recording seismic data.
- Operating a lumber, plywood, shake and shingle, pulp, paper or similar wood processing facility.

It is not necessary to file the joint venture election with the CRA; the election is made by all parties and retained on file for audit purposes.

Joint venture participants that make the GST/HST joint venture election are jointly and severally liable with the operator for GST/HST obligations in relation to the joint venture’s activities.

A new participant that acquires an interest in an existing joint venture is deemed to have made the joint venture election that was made by the original participants; a new election form is not required.

Note that the requirement to recapture the provincial component of ITCs on certain “specified expenses”, discussed below under “Temporary Partial Recapture of Input Tax Credits (RITC), also applies where a participant in a joint venture is a large business that has made the joint venture election with the operator. If the operator acquires or brings into Ontario a restricted item on behalf of the participant, the operator would be considered to be a large business for the purposes of that acquisition or bringing in, and the “recaptured input tax credit” rules would apply.

### KPMG Observations

*Based on verbal discussions with a senior CRA Headquarters Rulings official, the amount of the recapture is proportional to the large business participant’s interest in the joint venture, unless the operator itself is a large business. In the latter case, the recapture would be for the full amount of the provincial component of the ITC claimed.*

### Special Case — Co-ownerships

A co-ownership is not a “person” for GST/HST purposes. As such, a co-ownership cannot register for GST/HST purposes in its own right.

GST/HST registration is at the level of the co-owners/tenants-in-common.
If a co-ownership makes taxable supplies of the property held in the co-ownership, the tenants-in-common are normally required to register for GST/HST purposes and remit tax and claim ITCs on a pro-rata basis proportional to their interest in the co-ownership.

Although this policy may create a significant administrative burden, there is no provision in the ETA to simplify the accounting for GST/HST unless the co-ownership is in fact a joint venture.

**Special Case — Trusts/Nominee Corporations**

A trust is a "person" for GST/HST purposes and is subject to GST/HST registration if it is engaged in commercial activity. However, the CRA distinguishes between a "true trust" and a "bare trust" for GST/HST registration purposes.

**True trust**

The CRA considers that a “true trust” exists if independent decision-making powers and responsibilities relating to the management and administration of the trust property, such as the authority to contract, lease or sell, are given to the trust.

In such cases, the trust itself is considered to be engaged in commercial activities relating to any taxable supplies related to the trust property. A supply made by the trustee of the trust property will be an activity of the trust, not the trustee or the beneficial owners of the trust property.

The “true trust” is required to register for GST/HST purposes, collect and remit GST/HST on taxable supplies, and is entitled to claim ITCs on costs relating to making such supplies.

**Bare trust**

On the other hand, the CRA considers a trust to be a "bare trust" if the beneficial owner retains the powers and responsibilities to manage and/or dispose of the trust property, with the sole duty of the trustee or nominee corporation being to convey legal title to the trust property according to the instructions of the beneficial owner.

In such cases, the beneficial owner, rather than the bare trust or nominee corporation, is involved in any commercial activities relating to the trust property and will thus be required to register and account for GST/HST.

If the bare trust/nominee corporation has no activity other than the holding of legal title, it cannot register for GST/HST purposes because it is not engaged in commercial activity relating to the trust property. (See comments in the “Special Cases – Joint Ventures” section above concerning the CRA’s policy regarding the use of a bare trust/nominee corporation as the “operator” of a joint venture.)

When there is more than one beneficial owner of commercial real property held in a bare trust, each would be required to account for the GST/HST and to claim ITCs on costs proportional to its interest in the trust property. These beneficial owners should consider making a joint venture election to simplify the GST/HST administration (see “Special Cases — Joint Ventures” above).

**HST Transitional Rules – B.C. and Ontario**

Special rules apply for determining whether the 5% GST, or the 12% HST (B.C.)\(^{190}\) /the 13% HST (Ontario) applies to transactions that straddle the July 1, 2010 HST

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\(^{190}\) B.C. will transition from HST back to GST and PST effective April 1, 2013. Some proposed transitional rules have been announced while others will be released later. As such, the proposed transitional rules are generally not reflected in this chapter. However, a summary of the proposed transitional rules is available at the end of the chapter (see “B.C. – Transition from HST to GST and PST”).
implementation date. A full discussion of these rules is beyond the scope of this
Handbook. The discussion below is confined to the HST transitional rules for supplies of
real property. For the transitional rules that apply to other types of supplies, please refer
to CRA Info Sheets GI-053 to GI-059.

1. Taxable Leases of Commercial Real Property

The B.C. and Ontario HST transitional rules for commercial leases apply based on the
earlier of the date the lease payment becomes due, and the date it is paid without having
become due.

HST generally applies to any lease payment that becomes due, or is paid without having
become due, on or after July 1, 2010, to the extent that the lease payment is attributable
to a lease interval, or any part of a lease interval, that begins on or after July 1, 2010.
However, if a lease interval begins before July 2010 and ends before July 31, 2010, HST
does not apply to the lease payment, but the 5% GST would apply.

HST also applies to a lease payment that becomes due, or is paid without having
become due, during the period after April 2010 and before July 2010, to the extent that
the lease payment is attributable to a lease interval or any part thereof that begins on
or after July 1, 2010 (other than a lease interval that begins before July 2010 and ends
before July 31, 2010).

2. Taxable Sales of Bare Land, or of Property with an Existing (Non-Residential)
   Building or Other Facility – B.C. and Ontario

For sales of real property other than housing, the date the agreement of purchase and
sale is entered into does not affect the application of the HST. There is no grandparenting
provision for sales of non-residential real property, as there is for certain sales of housing.
Grandparenting in respect of housing is discussed below.

If either ownership or possession of (non-exempt) bare land transfers to the purchaser
before July 2010, HST does not apply to the sale, but GST at 5% applies to the sale.

If both ownership and possession of (non-exempt) bare land transfer to the purchaser on
or after July 1, 2010, HST applies to the sale.

3. Sales of New Housing Other than Condominium Units – Ontario

The basic transitional rule provides that the 5% GST applies to sales of new homes if
either title or possession is transferred to the purchaser before July 1, 2010. The 13%
HST applies if both title and possession are transferred after June 30, 2010, unless the
sale is grandparented as discussed below.

If the agreement of purchase and sale was signed before June 19, 2009, and possession
and title transfer to the purchaser after June 30, 2010, the sale is grandparented, and is
subject to only the 5% GST.

A mechanism of transitional tax adjustments and transitional rebates may also apply.
These are discussed in the “Special Measures – Ontario and B.C. HST – Transitional Tax
and Transitional Rebates” section below.

4. Sales of New Condominium Units – Ontario

The basic transitional rule provides that the 5% GST applies to sales of new
condominium units if either possession (first closing) or ownership (second closing) is
transferred to the purchaser before July 1, 2010. The 13% HST applies if both
possession and ownership are transferred after June 30, 2010, unless the sale is
grandparented as discussed below.

If the agreement of purchase and sale was signed before June 19, 2009, and possession
and ownership transfer to the purchaser after June 30, 2010, the sale is grandparented,
and is subject to only the 5% GST.
A mechanism of transitional tax adjustments and transitional rebates may also apply. These are discussed in the “Special Measures – Ontario and B.C. HST – Transitional Tax and Transitional Rebates” section below.

5. **Sales of New Housing Other than Condominium Units – B.C.**

The basic transitional rule provides that the 5% GST applies to sales of new homes if either title or possession is transferred to the purchaser before July 1, 2010. The 12% HST applies if both title and possession are transferred after June 30, 2010, unless the sale is grandparented as discussed below.

If the agreement of purchase and sale was signed before November 19, 2009, and possession and title transfer to the purchaser after June 30, 2010, the sale is grandparented, and is subject to only the 5% GST.

A mechanism of transitional tax adjustments and transitional rebates may also apply. These are discussed in the “Special Measures – Ontario and B.C. HST – Transitional Tax and Transitional Rebates” section below.

6. **Sales of New Condominium Units – B.C.**

The basic transitional rule provides that the 5% GST applies to sales of new condominium units if either possession (first closing) or ownership (second closing) is transferred to the purchaser before July 1, 2010. The 12% HST applies if both possession and ownership are transferred after June 30, 2010, unless the sale is grandparented as discussed below.

If the agreement of purchase and sale was signed before November 19, 2009, and possession and ownership transfer to the purchaser after June 30, 2010, the sale is grandparented, and is subject to only the 5% GST.

A mechanism of transitional tax adjustments and transitional rebates may also apply. These are discussed in the “Special Measures – Ontario and B.C. HST – Transitional Tax and Transitional Rebates” section below.

7. **Self-Supply of New Multiple-Unit Rental Properties (Apartment Buildings) – Ontario and B.C.**

There is no grandparenting rule for the self-supply of new multiple-unit rental properties. (The self-supply rules are discussed in the section, “Completion – Residential Property” below.)

If possession or use of the first unit in a substantially completed rental apartment building is given to an individual after June 2010, for occupancy as a place of residence under a lease, licence or similar arrangement, HST at the relevant rate (12% or 13%) applies to the deemed sale (i.e., the self-supply) by the builder/landlord, based on the FMV of the entire building.

A transitional rebate may be available to the builder/landlord. This rebate is discussed in the “Special Measures – Ontario and B.C. HST – Transitional Tax and Transitional Rebates” section below.

8. **Sale of New Multiple-Unit Rental Properties (Apartment Buildings) – Ontario and B.C.**

Again, there is no grandparenting rule for sales of multiple-unit rental properties.

The transitional rule provides that the 5% GST applies if either title or possession is transferred before July 2010. If both title and possession are transferred after June 2010, the sale is subject to HST at the rate that applies in the province in which the building is situated.
A transitional rebate may be available to the builder. This rebate is discussed in the “Special Measures – Ontario and B.C. HST – Transitional Tax and Transitional Rebates” section below.

**GST/HST Place of Supply Rules – Real Property and Services in Relation to Real Property**

As a result of B.C. and Ontario adopting the HST effective July 1, 2010, significant changes were made to the “place of supply” rules, which determine whether GST or HST applies to any given supply of property or services. A full discussion of all of these rules is beyond the scope of this Handbook. The discussion that follows focuses on the place of supply rules for real property, and for services in respect of real property.

The place of supply rules discussed below (as well as the rules for other types of supplies not discussed here, such as goods and general services) apply to supplies made on or after May 1, 2010, as well as to supplies made after February 25, 2010 and before May 1, 2010, unless any part of the consideration became due or was paid before May 1, 2010.

(i) **Supplies of Real Property – Sale or Lease**

A supply of real property by sale, lease or rental is considered to be made in the province in which the property is situated. It will therefore be subject to GST/HST according to the rate in effect in that province.

For example, if an Ontario company sells a commercial building in Ontario to a purchaser in B.C., the sale would be subject to the 13% Ontario HST.

Assume that a Quebec company leases a commercial building situated in Ontario, and another situated in Quebec, to a B.C. company. Each building is considered to be a separate supply, made for the portion of the total consideration reasonably attributable to the building situated in each province. The lease of the building situated in Ontario would be “made in Ontario” and subject to HST at 13%, whereas the lease of the building situated in Quebec would be “made in Quebec” and subject to GST at 5%.

(ii) **Supplies of Services in Relation to Real Property**

Supplies of services in relation to real property (e.g., property management services) are subject to GST/HST based on where the property, or the greatest portion of the property, is situated. For example, an Ontario property manager that manages properties only in Quebec will charge 5% GST.

Where the service is in relation to real property situated in more than one province, the services are subject to GST/HST based on where the greatest proportion of the property is situated. If the property to which the service relates is situated primarily (> 50%) in the HST provinces, the service is subject to HST rather than GST, and at the rate applicable in the province where the greatest proportion of the property is situated. For example, property management services provided in relation to real property situated 60% in Ontario and 40% in Quebec will be considered to be “made in Ontario” for HST purposes, and subject to 13% HST on the entire amount.

However, if the greatest proportion of the real property is situated equally in two or more HST provinces, but not “primarily” in any single HST province, HST applies at the rate that is highest among those HST provinces. For example, assume that a property management company provides property management services for buildings situated

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191 All of the rules, with examples of their application, can be found in the CRA’s Technical Information Bulletin B-103, “Place of Supply Rules for Determining Whether a Supply is Made in a Province”.

192 The QST applies generally to the same GST-taxable property (i.e., goods, real estate and intangibles) and services. As of January 1, 2012, the QST rate is 9.5%.
40% in B.C., 20% in Alberta and 40% in Ontario. The real property is situated primarily (80%) in the HST provinces, the greatest proportion of the real property is situated equally in two HST provinces, and the highest rate among those two provinces is 13%. The supply is considered to be “made in Ontario”, and the property management company will charge HST at 13% on the entire charge, i.e., in relation to the buildings in all three provinces.

Finally, if the services relate to real property situated primarily in the non-HST provinces, or situated equally in non-HST and HST provinces, the supply will be subject to the 5% GST. For example, services relating to two identical buildings, one in Quebec and the other in Ontario, would be “made in Quebec” for GST/HST purposes, and the property manager would charge 5% GST on the full amount.

Acquisitions

Purchase of Bare Land

The purchase of bare land is generally subject to GST/HST. However, if the vendor of such land is an individual (including a trust, all of the beneficiaries of which are individuals), charity, non-profit organization, university, school or hospital authority, the supply is exempt, subject to certain exceptions.

Ultimately, only the vendor can determine with certainty whether GST/HST applies.

Purchase of an Existing Building or Other Facility

The purchase of property with an existing building or other facility (other than a residential property) is generally subject to GST/HST.

Again, however, if the vendor is an individual, charity, non-profit organization, university, school or hospital authority, the acquisition may be exempt.

The purchase of residential property is generally exempt if it is currently occupied as a place of residence or was last so used.

However, the purchase of new residential property is taxable.

Used residential property that has been substantially renovated, and non-residential property that has been converted into residential use, may also be taxable.

Mixed Purchase

In certain situations, the purchase of a single legal parcel of property may be partly taxable and partly exempt.

For example, a building that includes both residential and commercial rental units will be taxable (for the commercial units) and exempt (for the residential units).

In such cases, GST/HST is payable only on the consideration attributable to the taxable portion of the property.

Accounting for GST/HST on Taxable Purchases

The general rule under the ETA is that the supplier making a taxable supply collects the GST/HST from the purchaser and remits it to the CRA.

This rule does not apply when a person purchasing taxable real property is registered for GST/HST purposes, unless the purchaser is an individual and the property being acquired is a residential complex (or a cemetery plot). Note that it is not sufficient for the purchaser to have applied for registration or to be required to be registered. The purchaser must in fact be registered effective as of the date of acquisition, otherwise the vendor must collect the GST/HST.
The general rule also does not apply when the vendor of the property is a non-resident. In these cases, the purchaser self-assesses the GST/HST payable and reports it on its GST/HST return for the period in which the taxable purchase is made.

To the extent that the purchaser is entitled to claim an ITC or rebate for some or all of the GST/HST payable, the purchaser claims that amount on its GST/HST return as well, so that only the net amount of GST/HST, if any, is remitted to the CRA.

**KPMG Observations**

To protect itself, the vendor should obtain a warranty from the purchaser that it is registered for GST/HST purposes, backed up by an undertaking to indemnify the vendor against any amounts for which the vendor may later become liable if, in fact, the criteria for the purchaser to self-assess the GST/HST, rather than paying it to the vendor, were not met. The vendor should also request a copy of the purchaser’s letter from the CRA confirming its GST/HST registration, and verify using the CRA’s web-based “GST/HST Registry” (http://www.cra-arc.gc.ca/esrvc-srvce/tx/bsnss/gsthstrgstry/menu-eng.html) that the purchaser’s registration is valid as of the closing date of the transaction.

**Recovering GST/HST on Taxable Real Property Purchases**

GST/HST-registered purchasers of taxable real property that self-assess the GST/HST payable may be able to offset that tax by claiming an ITC for the tax payable.

Generally, developers of real property (commercial and residential) are entitled to claim a full ITC for the GST/HST payable on any taxable purchase of real property, such that there is no net tax cost or cash flow effect in accounting for GST/HST on the purchase.

Individuals and persons acquiring property for use in exempt activities (e.g., financial institutions) may not be entitled to claim an ITC for the GST/HST payable. Generally, the extent to which an ITC is available depends on the extent to which the property is used in the purchaser’s commercial activities.

When real property is acquired (other than by a financial institution (FI) or a public sector body (PSB) for use exclusively (generally, 90% or more) in commercial activities, a full ITC is available.

When the use of the property (other than property of an FI or a PSB) in commercial activities is more than 10% but less than 90%, the ITC that can be recovered is equal to the percentage to which the property is used in commercial activities. When use in commercial activities is 10% or less, no ITC is recoverable.

**ITC rules for financial institutions**

Special ITC recovery rules apply to FIs.

Beginning in 2008, FIs are subject to new and very complex rules for calculating the ITCs to which they are entitled. A discussion of these rules is beyond the scope of this handbook.

**ITC rules for public sector bodies**

Special ITC recovery rules also apply to PSBs.

Absent the special election discussed below, ITC recovery on the acquisition of capital real property by a PSB is “all or nothing”, and is based on a “primary use” test. If real property is acquired primarily (greater than 50%) for use in the PSB’s commercial activities, a full ITC is available, otherwise, no ITC at all is available.

Thus, if the PSB acquired the real property for use otherwise than primarily (i.e., 50% or less) in commercial activities, no ITC can be claimed, even if the PSB uses the property 50% in commercial activities.
Most supplies of real property (e.g., leases, sales) by a PSB are exempt of GST/HST, and therefore as noted above, the PSB cannot claim any ITCs in respect of the expenses relating to the property unless it is used primarily (greater than 50%) in the PSB’s commercial activities. However, a PSB can file a special election (the Section 211 election) for its supplies of real property to be treated as taxable, rather than exempt. The effect of making the Section 211 election is that the supply (e.g., the lease) of the real property by the PSB would be taxable, rather than exempt, and the PSB would be entitled to claim ITCs based on the actual percentage of use of the property in commercial activities, as long as that use is at least 10%.

For example, assume that a PSB owns a 4-storey building. The PSB uses the top three floors in its own activities and leases the ground floor to a dry cleaning business. Under the normal rules, this supply by the PSB would be exempt, so the PSB would not charge GST/HST to the dry cleaner on the lease charges. Since the building is not used 50% in commercial activities, the PSB cannot claim any ITCs in respect of its expenses relating to the ground floor.

However, if the PSB made the Section 211 election in respect of the building, the lease would become taxable and the PSB would charge GST/HST to the dry cleaner. (The dry cleaner would be entitled to a full offsetting ITC.) The building would now be used 25% in the PSB’s commercial activities (i.e., the extent of the ground floor), since the lease is now taxable. The PSB would now be entitled to claim ITCs for 25% of the GST/HST it incurs on expenses attributable to the ground floor (electricity, other utilities, maintenance, etc.).

Certain PSBs are entitled to claim partial rebates of the GST/HST that cannot be claimed as an ITC. Specific details concerning the rebate percentages available to the various categories of PSBs for the GST, and the federal and provincial components of the HST, are beyond the scope of this handbook.

**Provincial Sales Tax and Acquisitions of Real Property**

Land and buildings are not subject to provincial sales tax (PST). However, where some portion of the purchase price is allocated to tangible personal property (e.g., furnishings in a rental property), the PST implications need to be considered since such assets are generally subject to PST.

This area is complicated by the fact that the three provinces that still have PST systems193 are not uniform in what they consider to constitute real property, and, in some cases, they have deemed certain items that would otherwise be real property at law to be tangible personal property for PST purposes.

Therefore, in a real property acquisition (and sale), it is important to determine what that particular province considers to be real property, which is not subject to PST, and what it considers to be tangible personal property, which may be subject to PST.

**Development Costs**

Generally, the development of land for residential or commercial purposes is a commercial activity for GST/HST purposes and any GST/HST incurred on the development and construction costs will be fully recoverable as an ITC.

Exceptions to this general rule include the development of personal use property by an individual, and persons developing property for use in exempt activities (other than residential developments discussed below).

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193 As of August 2011, these are Saskatchewan, Manitoba and Prince Edward Island. B.C. intends to re-instate the PST system on April 1, 2013.
As outlined in the next section, there is also a temporary exception to this general rule for full ITC recovery in respect of certain expenses incurred in Ontario and B.C.

Temporary Partial Recapture of Input Tax Credits

Ontario and B.C. adopted the HST on July 1, 2010\(^{194}\). For the first eight years of the HST, however, “large businesses”\(^{195}\) in Ontario and B.C. are required to ‘recapture’ (repay) the provincial component (7% in B.C., 8% in Ontario) of the ITCs they claim on specific categories of expenses (“specified expenses”) incurred in B.C. and Ontario. This is known as the RITC requirement.

This is a two-step process: the full ITC is claimed, including on any specified expenses, and then the ITC claimed for the provincial portion of the HST paid on specified expenses is repaid. Both steps are performed in the GST/HST return for the same reporting period. It is important to note that it is not sufficient to simply forego claiming the provincial portion of the ITC in relation to specified expenses; the “claim and repay” process must be followed.

The specified expenses to which the RITC requirement applies are the following:

- Energy (e.g. electricity, natural gas, steam), except for use directly in the production of goods for sale (note that real property is not a ‘good’);
- Telecommunication services, except Internet and toll-free services;
- Licensed motor vehicles weighing under 3,000 kg., and parts and services acquired within 21 months of the vehicle’s acquisition, other than for routine repair/maintenance;
- Fuel (other than diesel fuel) for use in motor vehicles (recaptured in Ontario only); and
- Meal and entertainment expenses.

However, the RITC requirement does not apply to “specified goods” or services that a large business acquires solely for resupply (e.g. sale or lease), or to property to be manufactured into other goods for sale by the large business.

The RITC requirement also applies to the ITC claimed for allowances paid and expenses reimbursed to employees.

A large business that brings “specified goods” into Ontario or B.C. from another province or country is generally required to self-assess the provincial component of the HST. For example, if a large business purchased a passenger car in Alberta and brought it into Ontario, the large business would self-assess the 8% provincial component of the 13% Ontario HST.

The RITC regime is to be temporary. For the first five full years of the HST (July 1, 2010 – June 30, 2015), 100% of the provincial component of the ITC claimed on “specified expenses” must be recaptured. Beginning July 1, 2015, the RITC requirement will be phased out in 25% increments over 3 years, and eliminated completely as of July 1, 2018.\(^{196}\)

For full details concerning the mechanics of the RITC regime in B.C. and Ontario, please refer to the CRA’s Technical Information Bulletin B-104, “Temporary Recapture of Input Tax Credits in Ontario and British Columbia”.

\(^{194}\) B.C. will transition from HST back to GST and PST effective April 1, 2013. Some proposed transitional rules have been announced while others will be released later. As such, the proposed transitional rules are not generally reflected in this chapter. However, a summary of the proposed transitional rules is available at the end of the chapter (see section “B.C. – Transition from HST to GST and PST”).

\(^{195}\) Canadian-source revenues from taxable supplies made by the person and its associates > $10 million p.a. Note that the RITC regime does not apply to public service bodies, e.g., non-profit organizations, charities, municipalities, school authorities, hospital authorities, public colleges, or universities.

\(^{196}\) For full details, see Ontario Information Notice No. 5, B.C. HST Notice No. 4, and the CRA’s Technical Information Bulletin B-104.
Completion – Non Residential Property

No particular GST/HST consequences arise on the completion of the development of a property that is not a residential property.

Completion – Residential Property

The completion of the construction of residential real property may trigger a GST/HST liability for the builder, depending on whether the completed property will be sold or used in exempt activities of rental or leasing (see below).

If the property is sold, the sale is taxable and the builder must collect GST/HST from the purchaser (unless the purchaser is registered for GST/HST and not an individual, in which case the purchaser must self-assess the GST/HST).

If the property is leased or rented as a place of residence, then the builder becomes liable for GST/HST under the so-called “self-supply rule” or the “self-assessment requirement”.

The purpose of the “self-supply” rules is to eliminate any advantage that may exist for someone that builds residential accommodation for the purpose of renting it out versus someone who purchases (and pays GST/HST on) new residential accommodation for the same purpose.

In the first situation, without the “self-supply” rules, the builder would be at a competitive advantage because the salary, financing and profit components of the property would have escaped GST/HST, while these same costs would form part of the GST/HST base for new residential accommodation that was purchased from a third party.

Completion of Construction – Single-Unit Residential Complex (House) For Sale

No GST/HST remittance liability is triggered for the builder until the house is actually sold to a purchaser, unless the builder occupies it first as his or her place of residence, in which case the builder must self-assess and remit GST/HST based on the FMV of the house at that time (see next section).

When the house is sold, GST/HST applies to the sale price of the house, with a “New Housing Rebate” available to the purchaser to partially offset the GST/HST cost provided that the relevant conditions are met. For a discussion of the rebate amounts and mechanics, please see the section “GST/HST Rebates” at the end of this “Completion – Residential Property” section.

The GST/HST becomes payable on the earlier of the date ownership of the house is transferred to the purchaser and the date possession of the house is transferred to the purchaser under the purchase and sale agreement.

The rebate application must be filed within two years of the date that ownership of the house is transferred to the purchaser.

Completion of Construction – Residential Condominium Unit for Sale

Essentially the same rules apply to residential condominium units as to individual houses — each condominium unit is treated as a separate residential property.
However, the timing of the GST/HST liability on the sale of a condominium unit is different.

Normally, GST/HST is collectible on a supply of real property once either possession or ownership of the property is transferred to the purchaser.

A different rule applies to condominiums: When possession of a condominium unit is transferred before registration of the condominium, the GST/HST liability is postponed until the ownership is transferred as well. However, once the condominium complex is registered, if 60 days go by without ownership (of the sold condominium unit) being transferred, the GST/HST liability arises at that point.

GST/HST applies to the sale price of the unit and the “New Housing Rebate” is available to the purchaser to partially offset the GST/HST cost. For a discussion of the rebate amounts and mechanics, please see the section “GST/HST Rebates” at the end of this “Completion – Residential Property” section.

The rebate application must be filed within two years of the date that ownership of the unit is transferred to the purchaser.

The self-supply rules that apply to the completion of the construction of rental buildings are not triggered if the rental of the building or a unit in it is made under an agreement to purchase the building or a unit.

However, if the purchase agreement is terminated, the builder is deemed to have sold and repurchased the property under taxable conditions at the time the agreement is terminated and to have collected GST/HST on the sale and paid GST/HST on the repurchase, based on the FMV of the property at that time.

The builder is therefore required to self-assess GST/HST in such cases, but any subsequent sale of that unit would be exempt as real property on which GST/HST has already been paid.

**Completion of Construction — Single-Unit Residential Complex (House) or Residential Condominium Unit for Rental**

When a house or condominium unit is substantially complete and rented as a place of residence, the builder must self-assess and remit GST/HST based on the FMV of the house/unit at the time the house is occupied as a place of residence. (As noted, the self-supply rule does not apply if the rental is made pursuant to an agreement to purchase the house/unit.)

A partial rebate of the GST/HST may be available to the builder if the house/unit is rented for occupancy by an individual as his or her primary place of residence, provided that the relevant conditions are met. For a discussion of the rebate amounts and mechanics, please see the section “GST/HST Rebates” at the end of this “Completion – Residential Property” section.

The rebate application must be filed within two years of the date the house/unit is substantially complete.

When the builder is an individual (registered for GST/HST and engaged in the business of building residential properties) and the builder occupies the house/unit as his/her place of residence, the builder must self-assess and remit GST/HST based on the FMV of the house/unit at the time the builder first occupies it, unless the builder did not claim an ITC in respect of the construction of the house/unit. A rebate as noted above may be available for a portion of the GST/HST self-assessed.

The FMV determination should be based on a professional appraisal or by comparison with the sale price of similar properties.
The lease of the house/unit to the tenant is exempt, as will be any subsequent lease or sale of the house/unit (unless the house/unit is substantially renovated prior to its sale).

Completion of Construction — Rental Apartment Building

Once a rental apartment building is substantially completed (see below), the builder must generally self-assess GST/HST on the FMV of the entire building at the time that possession or use of the first unit is given to an individual for occupancy as a place of residence under a lease, licence or similar arrangement.

“Substantial completion” generally occurs before occupancy is given to the first individual.

For GST/HST purposes, the CRA considers “substantial completion” to mean that the construction is at a stage of completion (generally, 90% or more) so that an individual can reasonably inhabit the premises, even though minor repairs, adjustments, upgrades, etc. may still be outstanding.

Notwithstanding the above, substantial completion is deemed to occur when 90% of the units in the complex are occupied, thereby triggering the GST/HST self-assessment requirement at that time.

However, if possession or use is given to the first tenant before substantial completion, the GST/HST self-assessment liability does not arise until the time of substantial completion.

A partial rebate of the GST/HST may be available to the builder to the extent the apartments are or are expected to be occupied by individuals as their primary place of residence for at least one year, provided that the relevant conditions are met. For a discussion of the rebate amounts and mechanics, please see the section “GST/HST Rebates” at the end of this “Completion – Residential Property” section.

The rebate application must be filed within two years of substantial completion.

Completion of Construction — Rental Residential Condominium Building

The GST/HST self-supply rules apply on the completion of construction of a rental residential condominium building as well but on a unit-by-unit basis, not on the entire building at once.

The builder is liable to self-assess GST/HST on the FMV of each unit and its related land and common areas at the later of the time that the unit is substantially completed and the time possession or use of the unit is given to the tenant.

A partial rebate of the GST/HST may be available to the builder to the extent the unit is expected to be occupied by an individual as their primary place of residence for at least one year, provided that the relevant conditions are met. For a discussion of the rebate amounts and mechanics, please see the section “GST/HST Rebates” at the end of this “Completion – Residential Property” section.

The rebate application must be filed within two years of the date the tax was required to be self-assessed.

The FMV determination should be based on a professional appraisal or by comparison with the sale price of similar properties.

Any subsequent lease or sale of the unit will be GST/HST-exempt.

Completion of Construction – Owner Built Homes

Individuals who construct or substantially renovate their own primary residence (or hire someone else to do so) qualify for a rebate of a portion of the GST/HST paid on the land and the construction materials and services, provided that the relevant conditions are met. For a discussion of the rebate amounts and mechanics, please see the section “GST/HST Rebates” at the end of this “Completion – Residential Property” section.
The rebate application must be filed within two years of the earlier of substantial completion and first occupancy.

**GST/HST Rebates**

When the GST was introduced in 1991, it provided for a rebate of a portion of the tax payable on new residential housing below a certain price threshold. This rebate of the federal GST has been maintained through the introduction of the HST in 1997, and the adoption of the HST by Ontario and B.C. in 2010.

Ontario and B.C. also introduced a rebate for a portion of the provincial component of the HST on new residential housing. However, the amounts and the thresholds for the rebate of the provincial component of the HST differ considerably both from that of the federal component, and also from one another.

The amounts and thresholds for the new housing rebate of the GST or the 5% federal component of the HST, and for the B.C. and Ontario components of the HST, are summarized in the table below.

Specifically, the jurisdictions differ in the percentage of tax rebated, the maximum dollar amount rebated, and whether the rebate is phased out beyond a certain price threshold. While the amount of the federal rebate is 36% of the GST or the federal component of the HST, B.C. and Ontario are more generous, with rebates of 71.43% and 75% of the B.C. and Ontario components of the HST, respectively, up to a maximum. Furthermore, while the federal rebate is gradually reduced to $0 after the maximum rebate ($6,300) is reached, the provincial rebates are not phased out once the maximum rebate amount ($26,250 in B.C., $24,000 in Ontario) has been reached.

<table>
<thead>
<tr>
<th>Type of Housing</th>
<th>Rebate</th>
</tr>
</thead>
<tbody>
<tr>
<td>House for Sale</td>
<td>36%. Maximum rebate $6,300 then phased out&lt;sup&gt;200&lt;/sup&gt;.</td>
</tr>
<tr>
<td>7% B.C. Component of HST</td>
<td>71.43%. Maximum rebate $26,250. No phase-out. No maximum price threshold</td>
</tr>
<tr>
<td>8% Ontario Component of HST</td>
<td>75%. Maximum rebate $24,000. No phase-out. No maximum price threshold</td>
</tr>
<tr>
<td>Residential Condo Unit for Sale</td>
<td>36%. Maximum rebate $6,300 then phased out&lt;sup&gt;201&lt;/sup&gt;.</td>
</tr>
<tr>
<td>71.43%. Maximum rebate $26,250.</td>
<td></td>
</tr>
<tr>
<td>71.43%. Maximum rebate $26,250.</td>
<td></td>
</tr>
<tr>
<td>71.43%. Maximum rebate $26,250.</td>
<td></td>
</tr>
<tr>
<td>House or Residential Condo Unit</td>
<td>36%. Maximum rebate $6,300 then phased out&lt;sup&gt;202&lt;/sup&gt;.</td>
</tr>
<tr>
<td>Unit for Rental</td>
<td>71.43%. Maximum rebate $26,250. No phase-out. No maximum price threshold</td>
</tr>
<tr>
<td></td>
<td>75%. Maximum rebate $24,000. No phase-out. No maximum price threshold</td>
</tr>
</tbody>
</table>

<sup>197</sup> The rebate for the B.C. provincial component of the HST may still be claimed even though the price or FMV exceeds the maximum threshold amount for a rebate of any amount of the 5% federal component of the HST.

<sup>198</sup> B.C. will transition from HST back to GST and PST effective April 1, 2013. B.C. proposes to enhance the new housing rebates where HST is payable between April 1, 2012 and March 31, 2013. For a summary of the proposed transitional rules and the enhanced new housing rebates, see section “B.C. – Transition from HST to GST and PST” at the end of this chapter.

<sup>199</sup> The rebate for the Ontario provincial component of the HST may still be claimed even though the price or FMV exceeds the maximum threshold amount for a rebate of any amount of the 5% federal component of the HST.

<sup>200</sup> The full rebate (36% of the GST, or the 5% federal component of the HST, to a maximum of $6,300) is available for houses costing $350,000 or less. For houses costing more than $350,000, the GST/federal rebate is gradually phased out, so that no rebate is available for houses costing $450,000 or more.

<sup>201</sup> The full rebate (36% of the GST, or the 5% federal component of the HST, to a maximum of $6,300) is available for condominium units costing $350,000 or less. For units costing more than $350,000, the GST/federal rebate is gradually phased out, so that no rebate is available for units costing $450,000 or more.

<sup>202</sup> The full rebate (36% of the GST, or the 5% federal component of the HST, to a maximum of $6,300) is available for houses/units having an FMV of $350,000 or less. For houses/units whose FMV is more than $350,000, the GST/federal rebate is gradually phased out, so that no rebate is available for houses/units with an FMV of $450,000 or more.
### Special Measures – Ontario and B.C. HST-Transitional Tax and Transitional Rebates

The implementation of the HST in Ontario and B.C. on July 1, 2010 required special measures in the area of the construction and sale of new residential housing, to prevent both loss of tax, and double tax. These measures take the form of a “Transitional Tax” (B.C.) or “Transitional Tax Adjustment” (Ontario) (collectively referred to below as “Transitional Tax Adjustment” or “TTA”), and “PST Transitional New Housing Rebates”. Both measures are discussed below, and summarized in tables at the end of this section.

#### Transitional Tax Adjustment (“TTA”)

The TTA applies when newly constructed or substantially renovated grandparented housing is sold in Ontario or B.C. (See discussion above under “HST Transitional Rules” for conditions under which a sale of new housing is grandfathered.) The TTA is designed to prevent loss of tax.

The builder is not required to collect the provincial component of the HST on the sale of grandfathered housing, even though both ownership and possession are transferred to the purchaser after June 2010. Only the 5% GST applies to the sale. In theory, PST should have applied to all of the materials used in the construction; however, the builder did not pay PST on materials purchased after June 30, 2010, and the builder can claim ITCs to recover the HST paid on such materials. As a result, some of the tax burden is “missing” from the cost of grandfathered housing.

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<table>
<thead>
<tr>
<th>Type of Housing</th>
<th>Rebate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental Apartment Building</td>
<td>36%. Maximum rebate $6,300 per rental unit then phased out^203.</td>
</tr>
<tr>
<td></td>
<td>71.43%. Maximum rebate $26,250 per rental unit. No phase-out. No maximum FMV threshold</td>
</tr>
<tr>
<td></td>
<td>75%. Maximum rebate $24,000 per rental unit. No phase-out. No maximum FMV threshold</td>
</tr>
<tr>
<td>Rental Residential Condominium Building</td>
<td>36%. Maximum rebate $6,300 per rental unit then phased out^204.</td>
</tr>
<tr>
<td></td>
<td>71.43%. Maximum rebate $26,250 per rental unit. No phase-out. No maximum FMV threshold</td>
</tr>
<tr>
<td></td>
<td>75%. Maximum rebate $24,000 per rental unit. No phase-out. No maximum FMV threshold</td>
</tr>
<tr>
<td>Owner-Built Home</td>
<td>36%. Maximum rebate $6,300 then phased out^205.</td>
</tr>
<tr>
<td></td>
<td>71.43%. Maximum rebate $17,588 if HST was not paid on land, or if land is leased. Maximum rebate $26,250 if HST was paid on land. No phase-out. No maximum FMV threshold</td>
</tr>
<tr>
<td></td>
<td>75%. Maximum rebate $16,080 if HST was not paid on land, or if land is leased. Maximum rebate $24,000 if HST was paid on land. No phase-out. No maximum FMV threshold</td>
</tr>
</tbody>
</table>

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^203 The full rebate (36% of the GST, or the 5% federal component of the HST, to a maximum of $6,300) is available for rental units having an FMV of $350,000 or less. For rental units with an FMV between $350,000 and $450,000, the GST/federal rebate is gradually phased out. No rebate is available for rental units having an FMV of $450,000 or more.

^204 The full rebate (36% of the GST, or the 5% federal component of the HST, to a maximum of $6,300) is available for units having an FMV of $350,000 or less. For units whose FMV exceeds $350,000, the GST/federal rebate is gradually phased out. No rebate is available for units having an FMV of $450,000 or more.

^205 The full rebate (36% of the GST, or the 5% federal component of the HST, to a maximum of $6,300) is available where the FMV of the land and building is $350,000 or less. Where the FMV exceeds $350,000, the rebate is gradually phased out, so that no rebate is available where the FMV of the land and building is $450,000 or more.

^206 B.C. will transition from HST back to GST and PST effective April 1, 2013. Some proposed transitional rules have been announced while others will be released later. As such, the proposed transitional rules are not generally reflected in this chapter. However, a summary of the proposed transitional rules is available at the end of the chapter (see section “B.C. – Transition from HST to GST and PST”).
The B.C. and Ontario governments consider that the PST component of the cost of a home is approximately 2%. This is reflected in the TTA calculation, which is essentially a “top up” to bring the total PST paid by the builder to 2% of the sale price of the home.

Since the provincial component of the HST does not apply to the sale of grandparented housing, the TTA is intended to approximate the amount of the Ontario or B.C. PST that the builder would otherwise have paid on construction materials purchased after June 2010 under the PST regime, where the construction of the housing straddles the July 1, 2010 implementation date.

The mechanics for calculating the TTA for a single unit house differs from that for a residential condominium unit or a condominium complex.

(i) TTA Calculation for Grandparented Sale of Single Unit House

The more complete the house on July 1, 2010, the more PST the builder has already paid on the materials. Consequently the amount of PST to be “topped up” is less. Conversely, if the house was less than 10% completed as of July 1, 2010, the full amount of TTA must be paid.

The table below provides the different rates of the TTA according to the degree of completion of the construction of a house as of July 1, 2010:

<table>
<thead>
<tr>
<th>Degree of Completion of Construction or Substantial Renovation as of July 1, 2010</th>
<th>Transitional Tax Adjustment Rate as a Percentage of Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 10%</td>
<td>2.0% of Consideration</td>
</tr>
<tr>
<td>Equal to or greater than 10% and less than 25%</td>
<td>1.5% of Consideration</td>
</tr>
<tr>
<td>Equal to or greater than 25% and less than 50%</td>
<td>1.0% of Consideration</td>
</tr>
<tr>
<td>Equal to or greater than 50% and less than 75%</td>
<td>0.5% of Consideration</td>
</tr>
<tr>
<td>Equal to or greater than 75% and less than 90%</td>
<td>0.2% of Consideration</td>
</tr>
<tr>
<td>Equal to or greater than 90%</td>
<td>0.0% of Consideration</td>
</tr>
</tbody>
</table>

However, where the consideration is less than what the FMV of the house would have been on the day the builder and purchaser entered into the written agreement of purchase and sale, had the housing been substantially complete on that date, the consideration for purposes of calculating the TTA will instead be “bumped” to that FMV.

(ii) TTA Calculation for Grandparented Sale of Residential Condominium Unit or Condominium Complex

The TTA calculation for a grandparented sale of a newly constructed or substantially renovated residential condominium unit or condominium complex differs from the TTA calculation for a grandparented house, in that the TTA does not vary according to the degree of completion. The TTA for a grandparented condominium unit/complex is always equal to 2% of the total consideration payable for the unit or complex.

However, for purposes of calculating the TTA, the consideration is “bumped” and deemed to be equal to the FMV, where the consideration payable for the unit or complex is less than the FMV of the housing on July 1, 2010, as if the housing had been substantially completed on that date.

The builder is entitled to claim a “PST transitional new housing rebate” if the construction of the condominium complex is at least 10% complete as of July 1, 2010 (see the section below on PST transitional new housing rebates).

The builder is considered to have collected the TTA, even though the builder does not actually collect it from anyone, and is required to include the TTA in the builder’s net tax calculation for the HST reporting period which includes the day that is:
■ in the case of a detached house, semi-detached house, rowhouse or residential condominium unit, the earlier of the day ownership or possession of the housing is transferred to the purchaser under the written agreement of purchase and sale for the housing

■ in the case of a condominium complex, the earlier of the day ownership of the complex is transferred to the purchaser and the day that is sixty days after the day the complex is registered as a condominium.

The TTA does not apply to sales of traditional apartment buildings, duplexes, owner-built homes, mobile homes or floating homes.

Ontario PST Transitional New Housing Rebate

The Ontario PST Transitional New Housing Rebate is designed to prevent double tax. It applies to sales of new housing that was not grandfathered because it was not sold under an agreement entered into before June 19, 2009, and is therefore subject to HST.

The Ontario PST Transitional New Housing Rebate also applies to rental housing. The builder of newly constructed or substantially renovated rental housing such as a single detached house, semi-detached house, attached house (row house), duplex, residential condominium unit, traditional apartment building or an addition to an apartment building is entitled to claim an Ontario PST Transitional New Housing Rebate where the construction or substantial renovation of the housing straddles the July 1, 2010 implementation date, and the HST is payable in respect of a self-supply of the housing. This is the case where possession of the housing, or a unit in the housing, is first given to an individual after the construction or substantial renovation is substantially completed and after June 2010, for occupancy as a place of residence. The construction or substantial renovation of the housing must be at least 10% complete as of July 1, 2010 for the builder to be entitled to claim this rebate.

Where the construction period straddles the July 1, 2010 HST implementation date, the builder will have paid non-recoverable PST on construction materials purchased before July 1, 2010. As noted above, the PST content of new housing is approximately 2% of its price. Therefore, depending upon the degree of completion of the housing on July 1, 2010, up to 2% of its sale price will be refunded under this rebate. The more complete the new housing is on July 1, 2010, the more PST was paid on construction materials, and therefore the higher the PST Transitional New Housing Rebate.

Two methods are available for calculating the Ontario PST content of new housing:

■ 2% of the selling price; or

■ $45 per square metre of interior floor space completed as of July 1, 2010.

The table below provides the different rates of the Ontario PST Transitional New Housing Rebate according to the degree of completion of the construction of housing as of July 1, 2010:

<table>
<thead>
<tr>
<th>Degree of Completion of Housing as of July 1, 2010</th>
<th>% of Estimated Ontario PST Content Rebated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 10%</td>
<td>0%</td>
</tr>
<tr>
<td>Equal to or greater than 10% and less than 25%</td>
<td>25%</td>
</tr>
<tr>
<td>Equal to or greater than 25% and less than 50%</td>
<td>50%</td>
</tr>
<tr>
<td>Equal to or greater than 50% and less than 75%</td>
<td>75%</td>
</tr>
<tr>
<td>Equal to or greater than 75% and less than 90%</td>
<td>90%</td>
</tr>
<tr>
<td>Equal to or greater than 90%</td>
<td>100%</td>
</tr>
</tbody>
</table>
In the case of a new single home purchased by an individual, the individual can either claim the Ontario PST Transitional New Housing Rebate from the CRA, or assign it to the builder.

Note that where the builder of a residential condominium unit or condominium complex was required to pay the Transitional Tax Adjustment (discussed above), the builder is entitled to claim the Ontario PST Transitional New Housing Rebate to offset a portion of the TTA paid.

To obtain the Ontario PST Transitional New Housing Rebate, a builder must first obtain from the Ontario Ministry of Revenue a “Letter of Good Standing”, certifying that the builder has no outstanding provincial debts. This letter, which is valid for one year, must be attached to the first rebate application that the builder files with the CRA.

B.C. PST Transitional New Housing Rebate

The B.C. PST Transitional New Housing Rebate is designed to prevent double tax. It applies to sales of new housing that was not grandparented because it was not sold under an agreement entered into before November 19, 2009, and is therefore subject to HST.

The B.C. PST Transitional New Housing Rebate also applies to rental housing. The builder of newly constructed or substantially renovated rental housing such as a single detached house, semi-detached house, attached house (row house), duplex, residential condominium unit, traditional apartment building or an addition to an apartment building would be entitled to claim a B.C. PST Transitional New Housing Rebate where the construction or substantial renovation of the housing straddles the July 1, 2010 implementation date, and the HST is payable in respect of a self-supply of the housing (i.e., possession of the housing, or a unit in the housing, is first given to an individual after the construction or substantial renovation is substantially completed, and after June 2010, for occupancy as a place of residence). The construction or substantial renovation of the housing must be at least 10% complete as of July 1, 2010 in order to be entitled to claim this rebate.

Where the construction period straddles the July 1, 2010 HST implementation date, the builder will have paid non-recoverable PST on construction materials purchased before July 1, 2010. As noted above, the PST content of new housing is approximately 2% of its price. Therefore, depending upon the degree of completion of the housing on July 1, 2010, up to 2% of its sale price will be refunded under this rebate. The more complete the new housing is on July 1, 2010, the more PST was paid on construction materials, and therefore the higher the PST Transitional New Housing Rebate.

Two methods are available for calculating the B.C. PST content of new housing:

- 2% of the selling price; or
- $60 per square metre of interior floor space completed as of July 1, 2010.
The table below provides the different rates of the B.C. PST Transitional New Housing Rebate according to the degree of completion of the construction of new housing as of July 1, 2010:

<table>
<thead>
<tr>
<th>Degree of Completion of Housing as of July 1, 2010</th>
<th>% of estimated B.C. PST Content Rebated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 10%</td>
<td>0%</td>
</tr>
<tr>
<td>Equal to or greater than 10% and less than 25%</td>
<td>25%</td>
</tr>
<tr>
<td>Equal to or greater than 25% and less than 50%</td>
<td>50%</td>
</tr>
<tr>
<td>Equal to or greater than 50% and less than 75%</td>
<td>75%</td>
</tr>
<tr>
<td>Equal to or greater than 75% and less than 90%</td>
<td>90%</td>
</tr>
<tr>
<td>Equal to or greater than 90%</td>
<td>100%</td>
</tr>
</tbody>
</table>

In the case of a new single home purchased by an individual, the individual can either claim the B.C. PST Transitional New Housing Rebate from the CRA, or assign it to the builder.

Note that where the builder of a residential condominium unit or condominium complex was required to pay the Transitional Tax Adjustment (discussed above), the builder is entitled to claim the B.C. PST Transitional New Housing Rebate to offset a portion of the TTA paid.

To obtain the B.C. PST Transitional New Housing Rebate, a builder must first obtain from the B.C. Ministry of Finance a “Letter of Good Standing”, certifying that the builder has no outstanding provincial debts. This letter must be attached to the first rebate application that the builder files with the CRA.

Summary Tables

The following tables summarize the Transitional Tax Adjustment and the PST Transitional New Housing Rebate measures as they apply to sales of new single homes and new condominium units purchased by an individual in B.C. and Ontario, as well as the tax (GST or HST) that applies to the sale, and the federal and provincial new housing rebates available to the purchaser.
### BC HST and Transitional Rules for New Housing – At a Glance

**Examples for Agreements of Purchase and Sale of New Single Homes and Condominiums Between Individual Purchasers and Builders**

<table>
<thead>
<tr>
<th>Agreement entered into on</th>
<th>Possession transferred</th>
<th>Ownership transferred</th>
<th>Tax applicable</th>
<th>New Housing Rebate – B.C. Portion</th>
<th>New Housing Rebate – Federal GST portion</th>
<th>Transitional Tax Adjustment (TTA) (for grandfathered sales) to “bump” PST content to 2% of consideration</th>
<th>B.C. PST Transitional Housing Rebate to remove PST embedded in price</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>New Single Home Purchased By Individual</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>November 18, 2009 or earlier</td>
<td>After June 2010</td>
<td>After June 2010</td>
<td>5% GST (Grandfathered)</td>
<td>No B.C. HST</td>
<td>Yes if lower than pricing threshold</td>
<td>Yes – Paid by Builder; not charged to Purchaser (for home completed in full or in part after June 2010)</td>
<td>No</td>
</tr>
<tr>
<td>November 19, 2009 or later</td>
<td>After June 2010</td>
<td>After June 2010</td>
<td>12% HST</td>
<td>Yes – 71.43% of B.C. portion to max. $26,250</td>
<td>Yes if lower than pricing threshold</td>
<td>No</td>
<td>Yes – To be claimed by Individual – File claim with CRA or through Builder</td>
</tr>
<tr>
<td>November 19, 2009 or later</td>
<td>Before July 1, 2010</td>
<td>Before July 1, 2010</td>
<td>5% GST</td>
<td>No</td>
<td>Yes, if lower than pricing threshold</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td>November 19, 2009 or later</td>
<td>Before July 1, 2010</td>
<td>After July 1, 2010</td>
<td>5% GST</td>
<td>No</td>
<td>Yes, if lower than pricing threshold</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td><strong>New Condominium Purchased By Individual</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>November 18, 2009 or earlier</td>
<td>After June 2010</td>
<td>After June 2010</td>
<td>5% GST (Grandfathered)</td>
<td>No B.C. HST</td>
<td>Yes if lower than pricing threshold</td>
<td>Yes – Paid by Builder; not charged to Purchaser 2% of consideration, regardless of percentage of completion</td>
<td>Yes, if TTA payable – To be claimed by Builder only</td>
</tr>
<tr>
<td>November 19, 2009 or later</td>
<td>After June 2010</td>
<td>After June 2010</td>
<td>12% HST</td>
<td>Yes – 71.43% of B.C. portion to max. $26,250</td>
<td>Yes if lower than pricing threshold</td>
<td>No</td>
<td>Yes – To be claimed by Builder only</td>
</tr>
<tr>
<td>November 19, 2009 or later</td>
<td>Before July 1, 2010</td>
<td>Before July 1, 2010</td>
<td>5% GST</td>
<td>No</td>
<td>Yes, if lower than pricing threshold</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td>November 19, 2009 or later</td>
<td>Before July 1, 2010</td>
<td>After July 1, 2010</td>
<td>5% GST</td>
<td>No</td>
<td>Yes, if lower than pricing threshold</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>
### Ontario HST and Transitional Rules for New Housing – At a Glance

Examples for Agreements of Purchase and Sale of New Single Homes and Condominiums Between Individual Purchasers and Builders

<table>
<thead>
<tr>
<th>Agreement entered into on</th>
<th>Possession transferred</th>
<th>Ownership transferred</th>
<th>Tax applicable</th>
<th>New Housing Rebate – Ontario Portion</th>
<th>New Housing Rebate – Federal GST portion</th>
<th>Transitional Tax Adjustment (TTA) (for grandfathered sales) to “bump” PST content to 2% of consideration</th>
<th>Ontario RST Transitional Housing Rebate to remove PST embedded in price</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>New Single Home Purchased By Individual</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>June 18, 2009 or earlier</td>
<td>After June 2010</td>
<td>After June 2010</td>
<td>5% GST (Grandfathered)</td>
<td>No Ontario HST</td>
<td>Yes if lower than pricing threshold</td>
<td>Yes – Paid by Builder; not charged to Purchaser (for home completed in full or in part after June 2010)</td>
<td>No</td>
</tr>
<tr>
<td>June 19, 2009 or later</td>
<td>After June 2010</td>
<td>After June 2010</td>
<td>13% HST</td>
<td>Yes – 75% of Ontario portion to max. $24,000</td>
<td>Yes if lower than pricing threshold</td>
<td>No</td>
<td>Yes – To be claimed by Individual – File claim with CRA or through Builder</td>
</tr>
<tr>
<td>June 19, 2009 or later</td>
<td>Before July 1, 2010</td>
<td>Before July 1, 2010</td>
<td>5% GST</td>
<td>No</td>
<td>Yes, if lower than pricing threshold</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td>June 19, 2009 or later</td>
<td>Before July 1, 2010</td>
<td>After July 1, 2010</td>
<td>5% GST</td>
<td>No</td>
<td>Yes, if lower than pricing threshold</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td><strong>New Condominium Purchased By Individual</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>June 18, 2009 or earlier</td>
<td>After June 2010</td>
<td>After June 2010</td>
<td>5% GST (Grandfathered)</td>
<td>No Ontario HST</td>
<td>Yes if lower than pricing threshold</td>
<td>Yes – Paid by Builder; not charged to Purchaser 2% of consideration, regardless of percentage of completion</td>
<td>Yes, if TTA payable – To be claimed by Builder only</td>
</tr>
<tr>
<td>June 19, 2009 or later</td>
<td>After June 2010</td>
<td>After June 2010</td>
<td>13% HST</td>
<td>Yes – 75% of Ontario portion to max. $24,000</td>
<td>Yes if lower than pricing threshold</td>
<td>No</td>
<td>Yes – To be claimed by Builder only</td>
</tr>
<tr>
<td>June 19, 2009 or later</td>
<td>Before July 1, 2010</td>
<td>Before July 1, 2010</td>
<td>5% GST</td>
<td>No</td>
<td>Yes, if lower than pricing threshold</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td>June 19, 2009 or later</td>
<td>Before July 1, 2010</td>
<td>After July 1, 2010</td>
<td>5% GST</td>
<td>No</td>
<td>Yes, if lower than pricing threshold</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>
For Further Reference

The following CRA publications should be consulted for specific details, questions and answers, and examples of the application of the transitional measures discussed above:

- GI-077 — Harmonized Sales Tax: Purchasers of New Housing in Ontario
- GI-078 — Harmonized Sales Tax: Purchasers of New Housing in British Columbia
- GI-079 — Harmonized Sales Tax: Ontario New Housing Rebate
- GI-080 — Harmonized Sales Tax: British Columbia New Housing Rebate
- GI-083 — Harmonized Sales Tax: Information for Builders of New Housing in Ontario
- GI-084 — Harmonized Sales Tax: Information for Builders of New Housing in British Columbia
- GI-088 — Harmonized Sales Tax: Stated Price Net of GST/HST New Housing Rebates and the Ontario RST Transitional New Housing Rebate
- GI-089 — Harmonized Sales Tax: Stated Price Net of GST/HST New Housing Rebates and the British Columbia PST Transitional New Housing Rebate
- GI-091 — Harmonized Sales Tax: Information for Landlords of New Rental Housing
- GI-093 — Harmonized Sales Tax: Ontario New Residential Rental Property Rebate
- GI-094 — Harmonized Sales Tax: British Columbia New Residential Rental Property Rebate
- GI-095 — Harmonized Sales Tax: Information on the Transitional Tax Adjustment for Builders of Housing in Ontario and British Columbia
- GI-096 — Harmonized Sales Tax: Provincial Transitional New Housing Rebates for Housing in Ontario and British Columbia
- GI-098 — Harmonized Sales Tax: Resales of New Housing in Ontario and British Columbia
- GI-099 — Builders and Electronic Filing Requirements
- GI-101 — Harmonized Sales Tax: Information for Non-registrant Builders of Housing in Ontario, British Columbia and Nova Scotia
- GI-105 — How to Determine the Percentage of Completion for Purposes of the Provincial Transitional New Housing Rebates and the Transitional Tax Adjustment in Ontario and British Columbia
- GI-118 — Builders and GST/HST NETFILE
- RC4052 — GST/HST Information for the Home Construction Industry

B.C. – Transition from HST to GST and PST

As noted above, B.C. will transition from an HST to a GST and provincial sales tax (PST) structure effective April 1, 2013. On February 17, 2012, the B.C. and federal governments announced some proposed transitional rules for transactions that straddle April 1, 2013. B.C. also announced enhanced rebates for new housing where HST becomes payable from April 1, 2012 to March 31, 2013.

Generally, the HST will continue to apply if tax becomes payable, or is paid without having become payable, before April 1, 2013.

For the sale of a single home, the GST/HST becomes payable on the earlier of the date ownership of the house is transferred to the purchaser and the date possession of the
For the sale of a condominium unit where possession of the unit is transferred before the condominium complex is registered as a condominium, the GST/HST becomes payable on the earlier of the date ownership is transferred and 60 days after the complex is registered as a condominium.

**New enhanced rebates**

B.C. announced new relief measures for purchasers and builders of new homes. The B.C. new housing rebate threshold will be increased to $850,000, where HST becomes payable from April 1, 2012 to March 31, 2013. As such, qualifying newly built homes will be eligible for a provincial HST rebate of up to $42,500 (previously $26,250). The new rental housing rebate will also be enhanced to the same limit of $42,500.

Also, B.C. proposed that purchasers of new secondary vacation and recreational homes outside the Greater Vancouver and Capital Regional Districts priced up to $850,000 will be eligible to claim a provincial grant of up to $42,500 effective April 1, 2012.

**April 1, 2013 – Temporary transitional provincial tax and housing transitional rebates**

B.C.’s portion of the HST will no longer apply to newly built homes where construction begins on or after April 1, 2013. Builders will once again pay 7% PST on their building materials. On average, about 2% of the home’s final price will again be embedded PST.

For newly built homes, where construction began prior to April 1, 2013 but ownership and possession is transferred after March 31, 2013, the purchaser will pay the GST but not the 7% provincial portion of the B.C. HST. However, purchasers will be required to pay a temporary transitional provincial tax of 2% on the full house price. Builders that are required to self-assess GST on a self-supply made on or after April 1, 2013 and the construction or substantial renovation of the housing is more than 10% completed as of April 1, 2013 may also have to pay the temporary transition provincial tax of 2%.

Builders will receive temporary housing transition rebates to offset PST on materials to help prevent double-tax on homebuyers.

**Double straddling transactions**

Special transitional rules are proposed for some sales of new housing that are still subject to the original transitional rules of July 1, 2010 (i.e., transactions called “double-straddling transactions”). Such sales include the sale of new housing under a sale agreement entered into before November 19, 2009 or housing construction that began before July 1, 2010 and for which ownership and possession transfer will transfer after March 31, 2013.

**Builder disclosure requirements**

The proposed transitional rules also include new requirements for builders to make certain disclosures to purchasers and to the CRA. B.C. also proposes two new penalties on builders for failing to comply with the new disclosure requirements: (1) up to 1% of home price to a maximum of $10,000 per home and (2) up to 4% of the home price to a maximum of $40,000 per home.

**Ongoing Operations**

**Lease/Rental of Commercial Real Property**

The leasing of non-residential real property (other than by certain PSBs) is a commercial activity. As such, if the lessor exceeds the $30,000 “small supplier” threshold, it is required to register for and collect GST/HST on the lease charges.
An ITC is available to the lessee, depending on the extent to which the lessee uses the property in its commercial activities, as discussed above in the section titled “Recovering GST/HST on Taxable Real Property Purchases”.

**Tax planning for closely related corporate groups and partnerships**

Certain corporations can elect with other closely related corporations or with qualifying partnerships for leases and rentals of real property made between them not to be subject to GST/HST, thus removing the requirement to account for GST/HST on the rental or lease of real property within a closely related group.

For this election to be available, all of the parties must be registered for GST/HST purposes and in a position to have recovered full ITCs for their lease of the property if GST/HST were charged.

As such, FIs and PSBs and any other persons engaged in exempt activities generally cannot enter into this related party GST/HST-relieving election. However, FIs may make an alternative election within a related group of corporations that includes the FI.

**Additional Rents**

Additional rents (e.g., percentage rents) are regarded as additional consideration for the supply of the leased premises and are subject to GST/HST.

Additional rent payments are often generated by the lessee, but the lessor is responsible for accounting for the GST/HST on them, and should ensure that the lessee adds the GST/HST to the amount paid.

The lessee is entitled to recover an ITC proportional to its commercial use of the leased property.

Property taxes (which are GST/HST-exempt) and utility charges are often re-billed to lessees as additional rent. These charges lose their exempt status when the lessor re-charges them to the lessee. As such, they become additional rent on which the lessor must collect GST/HST, even though the lessor itself may not have paid GST/HST on these amounts.

**KPMG Observation**

As discussed above, “large businesses” in B.C. and Ontario are temporarily required to recapture (repay) the provincial component of the ITC that they claim for the HST they incur on certain expenses. Energy is among these expenses. Energy, such as electricity, natural gas, etc. is often charged back by landlords to commercial tenants as additional rent. Therefore, when calculating the energy expenses to be charged to tenants in B.C. and Ontario, landlords should also take into account the RITC. Otherwise, the RITC on such expenses will represent an added energy expense to the landlord.

*Note*: This or any other planning idea should only be acted on with appropriate professional advice after a thorough examination of the particular situation.

**Tenant Inducements**

**Cash inducement**

When a lessor pays a cash inducement to a lessee for entering into the lease, the CRA considers the lessee to have made a GST/HST-taxable supply of a service to the lessor of agreeing to lease the premises, for which the cash inducement represents consideration.

Thus, the lessee must remit GST/HST on the amount of the cash payment and the lessor is entitled to claim a corresponding ITC.
**Leasehold improvements**

When the lessor reimburses the lessee for leasehold improvements, the reimbursement again represents consideration for a supply made by the lessee to the lessor. As such, the lessee must remit GST/HST on the amount of the reimbursement, with an ITC available to the lessor. The lessee can claim an ITC for the GST/HST paid in undertaking the improvements.

Alternatively, the lessor may pay for the leasehold improvements directly, in which case the lessor will be entitled to recover the GST/HST payable on the improvements. In this case, no GST/HST arises between the lessor and lessee.

**Free or reduced rent**

When an inducement takes the form of a period of free or reduced rent, the lessor collects GST/HST only on the amount of rent actually paid, provided that the free or reduced rent periods are contemplated by the lease agreement.

If the lessor and lessee are not operating at arm’s length and the lessee is using the property in whole or in part in GST/HST-exempt activities, GST/HST is deemed payable on the FMV of the lease.

**Lease/Rental of Residential Real Property**

Residential property (e.g., apartments, condominiums, houses, rooming houses) leased or rented for a period of at least one month’s continuous occupancy as a place of residence or lodging by the same individual is GST/HST-exempt.

Residential property leased or rented for less than a month, when the consideration is $20 or less per day, are also exempt (i.e., rooming houses, daily or weekly rentals).

Otherwise such short term rentals (e.g., hotel rooms) are taxable.

**KPMG Observation**

Where management or administration services are provided in respect of residential real property, non-recoverable GST/HST can be minimized by moving the employees that provide the management services into the entity that owns the exempt real property. Since management/administration fees are subject to GST/HST whereas salaries are not, such a restructuring would reduce the amount of non-recoverable GST/HST incurred by the entity that owns the real property.

**Lease Termination Payments**

A rental agreement may include a clause requiring the lessee to pay an amount to the lessor for terminating the lease early.

If the lease is taxable (i.e., for commercial property), any payment for the breach of the lease by the lessee is generally deemed to include GST/HST.

The lessor must therefore remit the “tax fraction” of the lease termination payment to the CRA. Where the lease is subject to the 5% GST, the amount to remit is 5/105ths of the termination payment. Likewise, if the lease payment was subject to the 12%, 13% or 15% HST, the amount to remit would be 12/112ths, 13/113ths, and 15/115ths, respectively, of the termination payment.

The lessee can claim an ITC for the GST/HST deemed to be included in the lease termination payment.

The lessor should bear this rule in mind when determining the amount of any lease termination payments to include in the lease agreement.
Maintenance, Repairs and Improvements

Charges for maintenance, repairs and improvements to real property are generally subject to GST/HST regardless of whether the property is commercial or residential.

Generally, the GST/HST incurred on such costs for commercial properties is fully recoverable as an ITC. No ITC can be claimed for costs incurred for residential rental properties.

The ITC recovery rules for maintenance and repair costs differ from those for "improvements", as follows:

An ITC for the GST/HST paid on general repairs, maintenance or services for real property is determined based on the percentage to which the repair, maintenance or service is used in the purchaser’s commercial activities.

Special rules apply to the recovery of GST/HST paid on "improvements" to real property.

For GST/HST purposes, an improvement is a cost that is capitalized as part of the property's adjusted cost base for income tax purposes.

The amount of GST/HST that can be recovered on the cost of capital real property improvements is based on the extent to which the underlying property, not just the improvement, is used in commercial activity.

For example, a landlord owns a three-storey building with leased commercial premises on the ground floor (i.e., a commercial activity) and above it two storeys of residential rental accommodation (i.e., an exempt activity).

The property is therefore used 33% in commercial activity and 67% in exempt activity. Therefore, the ITC available on the cost of an improvement to the property would be limited to 33% of the GST/HST paid, even if the improvement related solely to the commercial portion of the property.

However, the GST/HST incurred on any repairs to the commercial portion of the building would give rise to a full ITC, provided that the repairs do not qualify as an improvement.

Substantial Renovation of Residential Property

A "substantially renovated" residence or condominium unit is treated as a newly constructed residence/unit for GST/HST purposes.

For a renovation to be "substantial", all or substantially all (generally, 90%) of the interior of the building, excluding the foundation, exterior walls, interior supporting walls, floors, roofs and staircases, must have been removed or replaced; essentially, the existing building must have been gutted.

Note that the concept of a "substantial renovation" for GST/HST purposes can differ significantly from what is commonly thought of as a "renovation", which generally implies gutting followed by rebuilding. However, a residence/unit that has only had its interior elements removed as described above qualifies as "substantially renovated" for GST/HST purposes, even though it has simply been gutted with no further work done. Consequently, a residence/unit that has been gutted is considered to be "substantially renovated", and its sale will be subject to the rules outlined below.207

When the substantially renovated residential property is sold, it is subject to GST/HST, with a rebate possibly available to the purchaser for a portion of the GST/HST paid, subject to the normal rules. For a discussion of the rebate amounts and mechanics,

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207 Refer to the CRA’s Technical Information Bulletin B-092, "Substantial Renovations and the GST/HST New Housing Rebate" for a full discussion of the CRA’s administrative policy in this area.
please see the section “GST/HST Rebates” at the end of this “Completion – Residential Property” section.

If the renovator rents the renovated property as a place of residence instead of selling it, the renovator must self-assess and remit GST/HST based on the FMV of the substantially renovated property under the “self-supply” rules discussed above.

Similarly, if the renovator is an individual who is a GST/HST registrant and occupies the property as his or her place of residence, the self-supply rules will apply unless the builder did not claim an ITC for the costs incurred in substantially renovating the property.

Depending upon the particular circumstances, a rebate may be available for a portion of the GST/HST incurred in the course of a substantial renovation.

A sale of a substantially renovated residential property to which the self-supply rules have applied would be exempt as “used” residential property.

Non-Substantial Renovation of Residential Property

A special “self-supply” rule applies to persons that sell or lease residential property and that carry out a renovation that is not “substantial” as defined above (the “renovator”).

This rule is to ensure that renovators that use their own labour pay the same amount of GST/HST as those that use only third-party contractors.

The renovator is required to self-assess GST/HST on non-GST/HST-bearing renovation costs (excluding debt service costs), such as wages, salaries and employee benefits paid to the renovator’s own employees that are involved with the renovation work, or on costs paid to non-GST/HST-registered small suppliers, when the costs would be included in the building’s ACB for income tax purposes.

The renovator cannot claim ITCs for the self-assessed GST/HST since the sale or rental of the non-substantially renovated property is an exempt supply for GST/HST purposes.

Ordinary repair and maintenance costs do not trigger this self-supply rule because they would not be included in the building’s ACB.

Conversion of Commercial Property to Residential Use

A person that converts non-residential or commercial property (e.g., a warehouse) into a residence without constructing or substantially renovating it is deemed to be a “builder” of the residential complex for GST/HST purposes and the conversion is deemed to be a “substantial renovation”.

Consequently, the “self-supply” rules are triggered and the person is required to self-assess GST/HST based on the FMV of the converted property if it is rented or leased or to collect GST/HST on the property if it is sold.

Excluded from the self-assessment requirement is an individual who converts commercial real property to a place of residence of the individual, a related person or the individual’s former spouse or common-law partner.

Also excluded from this self-assessment requirement is a personal trust that acquires the property to hold or use exclusively as a residence for an individual who is a beneficiary of the trust.

The self-supply rule is triggered when property is converted from commercial to residential use to ensure that this converted residential complex is treated the same way for GST/HST purposes as a newly constructed or substantially renovated residential complex.

Depending on the circumstances, a rebate may be available for a portion of the GST/HST incurred in the course of the conversion from commercial to residential use. For a discussion of the rebate amounts and mechanics, please see the section “GST/HST Rebates” at the end of this “Completion – Residential Property” section.
Disposition (Sale) of Real Property

Residential Property

Generally, a sale of a residential complex is GST/HST-exempt if it is currently occupied as a place of residence or it was last used as a place of residence.

Commercial Property

Unlike sales of used residential property, which are generally GST/HST-exempt, sales of commercial real property are generally taxable, regardless of whether the property is new or used.

The assignment of a leasehold interest is a sale of real property but, if the assignee is registered for GST/HST purposes, the assignor is not required to collect and remit the GST/HST. Instead, the assignee self-assesses and remits the applicable tax to the extent that an ITC is not recoverable by the assignee.

If the commercial property is sold together with all of the other assets of a business, an election can be made for GST/HST not to apply to the transaction, provided that the purchaser is registered, or required to be registered, for GST/HST purposes.

Mixed Residential and Commercial Property

When “mixed-use” property with a residential and a non-residential component is sold or leased, the ETA deems there to be two separate supplies: the supply of the residential property and of the non-residential property.

For example, in a sale of an apartment building with a first-floor shopping mall, the first floor would be one supply, subject to GST/HST with an ITC recoverable by the purchaser of the building. The remaining residential floors would be a separate supply, normally GST/HST-exempt as a sale of used residential rental property.

Key Terms

Certain terms specifically defined in the ETA are commonly encountered when dealing with real property.

Builder

The term “builder”, which has an extended definition in the ETA, is relevant for determining the GST/HST status of a supply of residential housing.

The GST/HST rules are intended to tax newly constructed residential property only once, with subsequent sales being exempt. This intention is achieved by providing a GST/HST exemption for sales of residential property by a person who either is not a “builder” of the property, or is a builder to whom the self-supply rules have previously applied for that property.

In simple terms, a builder is a person who has built a new home for sale. When the builder sells the home, GST/HST must be collected and remitted but ITCs are available to recover GST/HST paid on construction costs before the sale. If the builder rents out or moves into the home instead of selling it, the self-supply rules will trigger GST/HST, while a subsequent sale will be exempt. A person who builds a new home purely for personal use is not a builder. Instead, the person is simply a consumer.

“Builder” has the following meanings for GST/HST purposes:

- A person who has an interest in real property and who carries on, or engages someone else to carry on, the construction or the substantial renovation of a residential complex on that property
- A person who acquires an interest in a residential complex before the construction or substantial renovation is finished
- A person who supplies a mobile home or floating home before it has been occupied as a place of residence
- A person who acquires an “unused” residential complex to resell or to rent out, or
- A person who owns and converts non-residential real property into a residential complex without constructing or substantially renovating the complex.

However, the following are not builders for GST/HST purposes:
- Individuals who construct or substantially renovate a property for personal use
- Individuals who supply a mobile home or a floating home otherwise than in the course of a business or of an adventure or concern in the nature of trade, or
- Persons whose only interest in a residential complex is the right to acquire it.

**Commercial Activity**

“Commercial activity” triggers a GST/HST registration requirement unless the person is a small supplier (i.e., the person makes less than $30,000 in taxable supplies per annum).

A person who is engaged in a commercial activity in Canada is generally required to register for GST/HST purposes, collect and remit tax, and is entitled to recover any GST/HST paid on supplies acquired for consumption, use or supply in the course of its commercial activities.

Commercial activity is generally:

- a business
- an adventure or concern in the nature of trade
- any supply, including lease or rental, of real property (other than supplies that are specifically exempt) as well as anything done by the supplier in the course of, or in connection with, the making of the supply.

The inclusion of supplies of real property in the definition of commercial activity makes all supplies of real property, even those made by an individual that is not otherwise carrying on a business, subject to GST/HST unless the supply is specifically exempt (or the property is outside Canada).

An individual, personal trust or partnership of individuals does not have to have a “reasonable expectation of profit” from a supply (including lease or rental) of real property to be engaged in commercial activity with respect to the property.

As an exception, a person whose only commercial activity is the sale of real property, otherwise than in the course of a business, is not required to register, even though the sale is still taxable and GST/HST must still be remitted.
Appendix A – Tax Treatment of Real Estate Project Costs

This schedule is intended to serve only as a guide and should be used in conjunction with the Canadian Real Estate Tax Handbook. The actual tax treatment of any specific cost may vary depending on the taxpayer's particular circumstances and on the reasonableness of the expenditures incurred. This guide and any other planning idea should only be acted on with appropriate professional advice after a thorough examination of the particular situation.

<table>
<thead>
<tr>
<th>Cost Description</th>
<th>Resale Properties</th>
<th>Rental Properties/Capital Properties</th>
<th>Income Tax Act Section Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Architect’s fees</td>
<td>Include in cost</td>
<td>Capitalize as part of property costs</td>
<td>9(1); 18(1)(b)</td>
</tr>
<tr>
<td>2. Blueprints</td>
<td>Include in cost</td>
<td>Capitalize as part of property costs</td>
<td>9(1); 18(1)(b)</td>
</tr>
<tr>
<td>3. Building permits</td>
<td>Include in cost</td>
<td>Capitalize as part of property costs</td>
<td>9(1); 18(1)(b)</td>
</tr>
<tr>
<td>4. Buy-back fees — fee to ensure investment is paid back in certain circumstances</td>
<td>Include in cost</td>
<td>Capitalize as part of property costs</td>
<td>9(1); 18(1)(b)</td>
</tr>
<tr>
<td>5. Cash-flow and other revenue guarantee fees</td>
<td>Not applicable</td>
<td>Deduct as operating expense over the guarantee period</td>
<td>18(1)(a)</td>
</tr>
<tr>
<td>6. Cleaning of completed units after construction has been completed</td>
<td>Deduct as operating expense or cost of sale</td>
<td>Deduct as operating expense</td>
<td>18(1)(a)</td>
</tr>
<tr>
<td>7. Clean-up of site after construction has been completed</td>
<td>Deduct as operating expense or cost of sale</td>
<td>Deduct as operating expense</td>
<td>18(1)(a)</td>
</tr>
<tr>
<td>8. Clearing or levelling land</td>
<td>Include in cost</td>
<td>Deduct as operating expense, capitalize as part of building costs or capitalize as part of land&lt;sup&gt;208&lt;/sup&gt;</td>
<td>20(1)(a); 20(1)(aa)</td>
</tr>
<tr>
<td>9. Deferred recoverable expenditures</td>
<td>Not applicable</td>
<td>Deduct as operating expense, amortize over term of related lease or capitalize to building [or leasehold improvement], depending on the nature of the expenditure</td>
<td>18(1)(a); 20(1)(a)</td>
</tr>
<tr>
<td>10. Demolition costs (building)</td>
<td>Include in cost&lt;sup&gt;209&lt;/sup&gt;</td>
<td>Deduct as operating expense if the old building was used for a long period to earn income; alternatively, capitalize to the cost of the new building</td>
<td>9(1); 18(3.1)</td>
</tr>
</tbody>
</table>

<sup>208</sup> The CRA’s view in Interpretation Bulletin IT-485, “Cost of Clearing or Levelling Land” is that, where depreciable property of more than one class is built on the land or where part of the land is either used for extensive landscaping or is not put to use, a reasonable division of the costs should be made between each depreciable property, landscaping and land. The portion applicable to the landscaping is deductible and the portion applicable to each depreciable property is capitalized to the respective class if construction commences without undue delay; otherwise, the costs are capitalized to land.

<sup>209</sup> See Interpretation Bulletin IT-485.
<table>
<thead>
<tr>
<th>Cost Description</th>
<th>Resale Properties</th>
<th>Rental Properties/Capital Properties</th>
<th>Income Tax Act Section Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>11. Disability-related modifications/equipment</td>
<td>Include in cost</td>
<td>Deduct as operating expense</td>
<td>20(1)(qq); 20(1)(rr)</td>
</tr>
<tr>
<td>12. Engineering fees</td>
<td>Include in cost</td>
<td>Capitalize as part of property costs</td>
<td>9(1); 18(1)(b)</td>
</tr>
<tr>
<td>13. Environmental land cleanup costs</td>
<td>Include in cost</td>
<td>Capitalize as part of the capital cost of land</td>
<td>18(1)(b)</td>
</tr>
<tr>
<td>14. Equipment rental during construction</td>
<td>Include in cost</td>
<td>Capitalize as part of property costs</td>
<td>9(1); 18(1)(b)</td>
</tr>
</tbody>
</table>
| 15. Financing costs, 
  ■ application fee                                         | Amortize over five years | Amortize over five years | 20(1)(e) |
|  ■ commitment or standby fee                           | Amortize over five years | Amortize over five years | 20(1)(e) |
|  ■ consulting fee                                      | Amortize over five years | Amortize over five years | 20(1)(e) |
|  ■ finder’s fee                                        | Amortize over five years | Amortize over five years | 20(1)(e) |
|  ■ guarantee fee                                       | Amortize over five years | Amortize over five years | 20(1)(e) |
|  ■ mortgage insurance fee                              | Amortize over five years | Amortize over five years | 20(1)(e) |
|  ■ legal fee                                           | Amortize over five years | Amortize over five years | 20(1)(e) |
|  ■ processing fee                                      | Amortize over five years | Amortize over five years | 20(1)(e) |
|  ■ letter of credit fee                                | Amortize over five years | Amortize over five years | 20(1)(e) |
| 16. General and administrative expenses not specifically identifiable with a real estate development project | Deduct as operating expense | Deduct as operating expense | 9(1); 18(1)(b) |
| 17. Golf courses, greens, tees and fairways           | Include in cost   | Capitalize as surface construction under Class 17  | 20(1)(a) |

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209 The CRA states at paragraph 6 of IT-48S that the costs of demolishing a building incidentally acquired on obtaining a site, less the amount of any salvage, forms part of the cost of the land.

210 Subsection 13(21.1) must also be considered, which may limit the terminal loss recognized on the demolition of a building.


212 A standby charge, guarantee fee, registrar fee, transfer agent fee, filing fee, service fee or any similar fee that relates solely to the year is deductible in the year under paragraph 20(1)(e.1).

213 If the financing costs relate to securing financing for construction, then the costs should be capitalized during the period of construction under subsection 18(3.1). However, only the amount that is deductible in the taxation year should be capitalized (i.e., for a $500 financing expense deductible over five years, only $100 would be capitalized in each of the five years during the period of construction). See Technical Interpretation 2004-0056861E5, “Financing costs”.

214 Interpretation Bulletin IT-341R4, “Expenses of Issuing or Selling Shares, Units in a Trust, Interests in a Partnership or Syndicate and Expenses of Borrowing Money,” dated February 26, 2007 indicates at paragraph 17 that an amount paid to the guarantor of a loan on a periodic basis during the continuance of the loan, or as a one-time payment at the commencement of the loan is a deductible expense under subparagraph 20(1)(e)(ii).


216 In Income Tax Technical News No. 20, the CRA indicates that greens, tees and fairways of a golf course meet the characteristics of surface construction as outlined in The Queen v. Mont-Sutton Inc. (99 DTC 5733).
<table>
<thead>
<tr>
<th>Cost Description</th>
<th>Resale Properties</th>
<th>Rental Properties/Capital Properties</th>
<th>Income Tax Act Section Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>18. Guaranteed completion fee — undertaking by promoter to cover additional operating costs which may arise on account of delays in construction</td>
<td>Deduct as operating expense</td>
<td>Deduct as operating expense</td>
<td>18(1)(a)</td>
</tr>
<tr>
<td>19. Insurance — fire and other insurance</td>
<td>Include in cost unless it relates to general asset stewardship that would normally recur year-to-year (i.e., insurance on head office)</td>
<td>Capitalize as part of property costs during construction period unless it relates to general asset stewardship that would normally recur year-to-year (i.e., insurance on head office)</td>
<td>9(1); 18(9)</td>
</tr>
<tr>
<td>20. Interest re:</td>
<td>Include in cost, net of rental income</td>
<td>Capitalize as part of land costs, net of rental income</td>
<td>18(2)</td>
</tr>
<tr>
<td>■ vacant land</td>
<td>Deduct as operating expense</td>
<td>Deduct as operating expense</td>
<td>20(1)(c) [not denied by 18(2) or 18(3.1)] 18(3.1) to 18(3.4); 20(29) 20(1)(c) 20(1)(e)(ii.2) 18(9.1) 9(1); 40(1)</td>
</tr>
<tr>
<td>■ servicing vacant land</td>
<td>Include in cost</td>
<td>Capitalize as part of building costs</td>
<td>18(9.1)</td>
</tr>
<tr>
<td>■ during construction – attributable to construction and related land</td>
<td>Deduct as operating expense</td>
<td>Deduct as operating expense</td>
<td>18(9.1)</td>
</tr>
<tr>
<td>■ after construction</td>
<td>May be deductible</td>
<td>May be deductible</td>
<td>18(9.1)</td>
</tr>
<tr>
<td>■ participating debt</td>
<td>Deduct over remaining term of debt using present value amortization method; alternatively, straight-line</td>
<td>Deduct over remaining term of debt using present value amortization method; alternatively, straight-line</td>
<td>18(9.1)</td>
</tr>
<tr>
<td>■ rate reduction payment</td>
<td>Deduct over eliminated term of debt using present value amortization method; alternatively, straight-line</td>
<td>Deduct over eliminated term of debt using present value amortization method; alternatively, straight-line</td>
<td>18(9.1)</td>
</tr>
<tr>
<td>■ early debt repayment penalty (other than refinancing)</td>
<td>Deduct as cost of sale</td>
<td>Deduct as cost of sale</td>
<td>18(9.1)</td>
</tr>
<tr>
<td>■ early debt repayment penalty on sale of property</td>
<td>Amortize over five years</td>
<td>Amortize over five years</td>
<td>18(9.1)</td>
</tr>
<tr>
<td>■ early debt repayment penalty on debt rescheduling or restructuring</td>
<td>Deduct based on a notional reduced principal calculation</td>
<td>Deduct based on a notional reduced principal calculation</td>
<td>18(9.1)</td>
</tr>
<tr>
<td>■ prepaid interest</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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217 See paragraph 5 of Interpretation Bulletin IT-104R3, “Deductibility of Fines or Penalties”.
218 May be partly deductible under the “Base Level Deduction” rule.
<table>
<thead>
<tr>
<th>Cost Description</th>
<th>Resale Properties</th>
<th>Rental Properties/Capital Properties</th>
<th>Income Tax Act Section Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>21. Improvements/construction by tenant on leased property</td>
<td>Not applicable</td>
<td>Capitalize as leasehold improvement under Class 13, unless building or other structure, then Class 1</td>
<td>20(1)(a); Reg1102(5)</td>
</tr>
<tr>
<td>22. Land servicing</td>
<td>Include in cost</td>
<td>Capitalize as part of land costs</td>
<td>18(3.1)</td>
</tr>
<tr>
<td>23. Landlord leasing costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Tenant inducements:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ initial lease expense</td>
<td>Not applicable</td>
<td>Deduct over term of related lease or deduct as operating expenses</td>
<td>18(1)(a)</td>
</tr>
<tr>
<td>■ re-leasing to new or existing tenant</td>
<td>Not applicable</td>
<td>Deduct over term of related lease or deduct as operating expense</td>
<td>18(1)(a); 18(9)</td>
</tr>
<tr>
<td>(b) leasing commissions/fees and other leasing costs</td>
<td>Not applicable</td>
<td>Same as tenants inducements</td>
<td>18(1)(a)</td>
</tr>
<tr>
<td>(c) Tenant improvements</td>
<td>Not applicable</td>
<td>Same as tenants inducements</td>
<td>18(1)(a)</td>
</tr>
<tr>
<td>(d) Landlord lease cancellation payments</td>
<td>Not applicable</td>
<td>Amortize over the remaining term of the lease, including renewal terms (not exceeding 40 years)</td>
<td>20(1)(z)</td>
</tr>
<tr>
<td>■ if landlord continues to own property</td>
<td>Not applicable</td>
<td>50% of unamortized payment deductible</td>
<td>20(1)(z.1)</td>
</tr>
<tr>
<td>■ if landlord disposes of property</td>
<td>Not applicable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24. Landscaping</td>
<td>Inventory as part of property costs per Qualico Developments Limited (84 DTC 6119)</td>
<td>Deduct amounts paid in the year for the landscaping of grounds around a building or other structure owned by the taxpayer, which may include expenditures for lawns, trees, shrubs, etc., expenditures for changing the contour of the land, and fees paid to a professional landscape architect</td>
<td>20(1)(aa)</td>
</tr>
</tbody>
</table>

219 The CRA states, in Income Tax Technical News #25, that where evidence shows, as it did in Sherway Centre Limited (2003 DTC 5082), that the participating payments are intended to increase the interest rate of the loan to the prevailing market rate, the payments will be considered to be interest.

220 The Supreme Court decisions in Canderel Ltd. (98 DTC 6100) and Toronto College Park Ltd. (98 DTC 6088) support the deductibility of lease costs.

221 The CRA has taken the position that to be deductible, an expenditure must meet the facts of Canderel creating a more accurate picture of profit for the year in accordance with “well-accepted business principles”, i.e., the payment must arise under the lease, there must be an identifiable benefit to the landlord in the period incurred (over and above the rental revenue from the particular lease), and the payment must not be for capital improvements to the property.
### Appendix A – Tax Treatment of Real Estate Project Costs

<table>
<thead>
<tr>
<th>Cost Description</th>
<th>Resale Properties</th>
<th>Rental Properties/Capital Properties</th>
<th>Income Tax Act Section Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>25. Legal fees</td>
<td>Include in cost</td>
<td>Deduct if pertaining to rental operations; capitalize as part of property costs if pertaining to the acquisition of property</td>
<td>18(1)(a); 18(1)(b)</td>
</tr>
<tr>
<td>26. Marketing and advertising</td>
<td>Deduct as operating expense</td>
<td>Deduct as operating expense</td>
<td>18(1)(a)</td>
</tr>
<tr>
<td>27. Modifications made to meet building code requirements (e.g., smoke detectors, sprinklers, improved lighting in garages)</td>
<td>Include in cost</td>
<td>Capitalize as part of property costs</td>
<td>9(1); 18(1)(b)</td>
</tr>
<tr>
<td>28. Playground equipment</td>
<td>Include in cost</td>
<td>Capitalize as part of property cost – generally Class 8</td>
<td>20(1)(a)</td>
</tr>
</tbody>
</table>
| 29. Property taxes:  
(a) Regular – vacant land  
– during construction  
– after construction  
(b) Levies – vacant land | Include in cost  
Include in cost  
Deduct as operating expense  
Include in cost | Capitalize as land cost  
Capitalize as building cost  
Deduct as operating expense  
Include in cost | 18(2)  
18(3.1)  
18(1)(a)  
9(1); 18(1)(b) |
| 30. Representation costs | Include in cost | Deduct amounts paid for expenses incurred by making representations to a government or agency of a government in Canada concerning a business carried on by the taxpayer, including any representation made for the purpose of obtaining a license, permit, franchise or trademark relating to such business | 20(1)(cc) |
| 31. Roads, sidewalks, bridges, parking areas and similar surface construction on land not owned (off-site costs) | Include in cost | Capitalize as depreciable property to prescribed class (Class 1 if bridge, otherwise generally Class 17) | 13(7.5) |
| 32. Sales commission on acquisition of real property | Include in cost | Capitalize as part of property costs | 9(1); 18(1)(b) |

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**Notes:**

222 May be partly deductible under “Base Level Deduction” rule.

223 The decisions in *Metropolitan Properties Co. Ltd.* (85 DTC 5128), *Edmonton Plaza Hotel (1980) Ltd.* (87 DTC 5371), *MHL Holdings Ltd.* (88 DTC 6292) and *Stursberg* (90 DTC 1159) held that levies are added to cost. The Federal Court of Appeal decision in *Urbandale Realty Corporation Limited* (2000 DTC 6118), however, allowed the deduction of levies under pre-1988 legislation, contradicting the decision in *Metropolitan Properties*.

224 Whether the rental property is a business or an investment property is a question of fact that depends on the nature and extent of services provided to the tenants.
<table>
<thead>
<tr>
<th>Cost Description</th>
<th>Resale Properties</th>
<th>Rental Properties/Capital Properties</th>
<th>Income Tax Act Section Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>33. Sales commission on disposition of real property</td>
<td>Deduct as operating expense in the year incurred and services rendered</td>
<td>Deduct as cost of sale</td>
<td>9(1); 18(1)(b)</td>
</tr>
<tr>
<td>34. Service fee — provision of accounting, administration, off-site supervisory</td>
<td>Deduct as operating expense if expenditures relate to general corporate governance</td>
<td>Deduct as operating expense if</td>
<td>18(1)(a)</td>
</tr>
<tr>
<td>and management services</td>
<td>or asset stewardship that recur year-to-year unless they are identifiable with</td>
<td>expenditures relate to general</td>
<td></td>
</tr>
<tr>
<td></td>
<td>one or more specific projects during the period of construction</td>
<td>corporate governance or asset</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>stewardship that recur year-to-year</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>unless they are identifiable with</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>one or more specific projects during</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>the period of construction</td>
<td></td>
</tr>
<tr>
<td>35. Site investigation</td>
<td>Include in cost</td>
<td>Deduct amounts paid in the year</td>
<td>20(1)(dd)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>for investigating the suitability</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>of a site for a building or other</td>
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<tr>
<td></td>
<td></td>
<td>structure planned for use by the</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>taxpayer in connection with a</td>
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</tr>
<tr>
<td></td>
<td></td>
<td>business carried on by the</td>
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</tr>
<tr>
<td></td>
<td></td>
<td>taxpayer, if incurred before</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>construction commences</td>
<td></td>
</tr>
<tr>
<td>36. Small tools</td>
<td>Capitalize as Class 12 if under $200; otherwise generally capitalize as Class 8</td>
<td>Capitalize as Class 12 if under</td>
<td>29(1)(a)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$200; otherwise generally</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>capitalize as Class 8</td>
<td></td>
</tr>
<tr>
<td>37. Utility service connections</td>
<td>Include in cost</td>
<td>Capitalize as part of building</td>
<td>20(1)(ee)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>costs incurred during construction;</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>otherwise deduct amounts paid by</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>taxpayer directly to entity</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>supplying the service for the</td>
<td></td>
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<td></td>
<td></td>
<td>connection if the service connection</td>
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<td></td>
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<td>is to the property line of the</td>
<td></td>
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<td></td>
<td></td>
<td>taxpayer's place of business and</td>
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<td></td>
<td></td>
<td>ownership of the connection does</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>not pass to the taxpayer</td>
<td></td>
</tr>
<tr>
<td>38. Warranty</td>
<td>Deduct as operating expense or cost of sale when not contingent</td>
<td>Not applicable</td>
<td>18(1)(e)</td>
</tr>
</tbody>
</table>
### Appendix B – Common Canadian Ownership Structures

This schedule is intended to serve only as a guide and should be used in conjunction with the Canadian Real Estate Tax Handbook. This guide and any planning idea should not be acted on without appropriate professional advice after a thorough examination of the particular situation.

<table>
<thead>
<tr>
<th></th>
<th>Canadian Controlled Private Corporation</th>
<th>Joint Venture/Co-ownership</th>
<th>Private Partnership/Private Limited Partnership</th>
<th>Private Inter Vivos Trust</th>
<th>SIFT Partnership</th>
<th>SIFT Trust</th>
<th>Real Estate Investment Trust (REIT)</th>
<th>Mutual Fund Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Taxation</strong></td>
<td>Subject to tax Taxed as separate person Taxed at 28% as at July 1, 2011 in Ontario on active business income in excess of $500,000</td>
<td>Not subject to tax Income is calculated and taxed at the participant level</td>
<td>Not subject to tax Income is calculated at partnership level Income is allocated and taxed at partner level</td>
<td>Subject to tax Taxed as a separate person Taxed at highest marginal rate (approximately 46.41% for Ontario in 2011) on income not distributed to beneficiaries</td>
<td>Subject to tax Taxed as a separate person Taxed at 28% as at July 1, 2011 in Ontario on income distributed to public unit holders</td>
<td>Subject to tax Taxed as a separate person Exempt from SIFT tax on income not distributed to public unit holders (i.e., approx. 46.41% in Ontario)</td>
<td>Subject to tax Taxed as a separate person Taxed at highest individual rate on income not distributed to public unit holders (i.e., approx. 46.41% in Ontario)</td>
<td></td>
</tr>
<tr>
<td>Income Distribution</td>
<td>Canadian Controlled Private Corporation</td>
<td>Joint Venture/Co-ownership</td>
<td>Private Partnership/Private Limited Partnership</td>
<td>Private Inter Vivos Trust</td>
<td>SIFT Partnership</td>
<td>SIFT Trust</td>
<td>Real Estate Investment Trust (REIT)</td>
<td>Mutual Fund Trust</td>
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</tr>
<tr>
<td>Taxed as dividends (determination must be made as to whether these are eligible dividends)</td>
<td>Income (loss) retains its character at the participant level</td>
<td>Income (loss) allocated retains its character at the partner level</td>
<td>Dividends and capital gains distributed to beneficiaries retain their character</td>
<td>Income allocated to the public unit holder is deemed to be an eligible dividend paid by the SIFT Partnership</td>
<td>Income distributed to the public unit holder is deemed to be an eligible dividend paid by the SIFT Trust</td>
<td>Dividends and capital gains retain their characteristics</td>
<td>All other amounts considered “other property income” received from a trust</td>
<td>Dividends and capital gains retain their characteristics</td>
</tr>
<tr>
<td>No deduction for dividends paid in calculating the corporate income</td>
<td></td>
<td></td>
<td>All other amounts considered “other property income” from owning an interest in the trust</td>
<td>Trust receives a deduction in calculating its income for amounts paid or payable to beneficiaries</td>
<td></td>
<td>All other amounts considered “other property income” received from a trust</td>
<td>Trust receives a deduction in calculating trust income for amounts paid or payable to beneficiaries</td>
<td></td>
</tr>
<tr>
<td>Ownership Structure</td>
<td>Year-end</td>
<td>Capital Tax</td>
<td></td>
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</tr>
<tr>
<td>Canadian Controlled Private Corporation</td>
<td>Any year-end date allowed</td>
<td>By July 1, 2012, corporations other than financial institutions are no longer subject to capital tax in any province</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Joint Venture/Co-ownership</td>
<td>For taxation years ending after March 22, 2011, each participant must include its share of income from a joint venture based on its own fiscal period</td>
<td>Corporate participants are subject to provincial capital tax based on their proportionate share of the taxable capital of the joint venture or co-ownership</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Partnership/Private Limited Partnership</td>
<td>Any year-end is allowed if all partners are corporations Otherwise year-end must be December 31 For taxation years ending after March 22, 2011, a corporate partner with a significant interest in a partnership must comply with rules which limit the tax deferral if the fiscal period of the partnership is different than the corporate partner’s taxation year</td>
<td>Corporate partners are subject to provincial capital tax based on their proportionate share of the taxable capital of the partnership</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Inter Vivos Trust</td>
<td>Inter vivos trust must have December 31 year-end</td>
<td>Not subject to capital taxes directly</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SIFT Partnership</td>
<td>Any year-end is allowed</td>
<td>Corporate partners are subject to provincial capital tax based on their proportionate share of the taxable capital of the partnership</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SIFT Trust</td>
<td>Year end must be December 31 May elect to have a December 15 taxation year-end</td>
<td>Not subject to capital taxes directly</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate Investment Trust (REIT)</td>
<td>Year-end must be December 31 May elect to have a December 15 taxation year-end</td>
<td>Not subject to capital taxes directly</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mutual Fund Trust</td>
<td>Year end must be December 31st May elect to have a December 15th taxation year end</td>
<td>Not subject to capital taxes directly</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liability</td>
<td>Canadian Controlled Private Corporation</td>
<td>Joint Venture/Co-ownership</td>
<td>Private Partnership/Private Limited Partnership</td>
<td>Private Inter Vivos Trust</td>
<td>SIFT Partnership</td>
<td>SIFT Trust</td>
<td>Real Estate Investment Trust (REIT)</td>
<td>Mutual Fund Trust</td>
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</tr>
<tr>
<td>Liability</td>
<td>Shareholders are not exposed to the liabilities of the corporation</td>
<td>Participants are severally liable based on their proportionate share of the liabilities of the joint venture or co-ownership</td>
<td>Partners are jointly and severally liable, except that limited partners are only liable to the extent of their partnership capital</td>
<td>It is uncertain if beneficiaries are exposed to the liabilities of the trust</td>
<td>Partners are jointly and severally liable, except that limited partners are only liable to the extent of their partnership capital</td>
<td>Pursuant to the Trust Beneficiaries Liability Act, 2004, the beneficiaries of a trust are not liable for any act, default, obligation or liability of the trust or any of its trustees if: The trust is a reporting issuer under the Securities Act (Ontario); and The trust is governed by the laws of Ontario</td>
<td>Pursuant to the Trust Beneficiaries Liability Act, 2004, the beneficiaries of a trust are not liable for any act, default, obligation or liability of the trust or any of its trustees if: The trust is a reporting issuer under the Securities Act (Ontario); and The trust is governed by the laws of Ontario</td>
<td></td>
</tr>
</tbody>
</table>

Pursuant to the Trust Beneficiaries Liability Act, 2004, the beneficiaries of a trust are not liable for any act, default, obligation or liability of the trust or any of its trustees if:
- The trust is a reporting issuer under the Securities Act (Ontario); and
- The trust is governed by the laws of Ontario.
## Appendix B – Common Canadian Ownership Structures

<table>
<thead>
<tr>
<th>Recipient Treatment</th>
<th>Canadian Controlled Private Corporation</th>
<th>Joint Venture/Co-ownership</th>
<th>Private Partnership/Private Limited Partnership</th>
<th>Private Inter Vivos Trust</th>
<th>SIFT Partnership</th>
<th>SIFT Trust</th>
<th>Real Estate Investment Trust (REIT)</th>
<th>Mutual Fund Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the shareholder itself is a CCPC, it pays no tax on the dividends it receives unless it is a portfolio dividend or if the payor corporation receives a dividend refund. If the shareholder is an individual, the dividend is subject to a gross-up and dividend tax credit treatment, amount of gross-up and tax credit depends on whether the dividend is an eligible dividend.</td>
<td>Income retains its character and is taxed at participants’ applicable rate based on the type of income earned by the joint venture/co-ownership.</td>
<td>Income retains its character and is taxed at the partner’s applicable rate based on the type of income earned by the joint venture/co-ownership.</td>
<td>Income maintains its character as dividends, capital gain or other property income. Taxed at applicable rates based on type of income.</td>
<td>If the unitholder is a CCPC, it pays tax under Part IV on the eligible dividend it receives, unless it is “connected” with the payor. If the unit holder is an individual, the dividend is subject to a gross-up and dividend tax credit treatment as an eligible dividend.</td>
<td>If the unitholder is a CCPC, it pays tax under Part IV on the eligible dividend it receives, unless it is “connected” with the payor.</td>
<td>Income maintains its character as either dividends, capital gain or other property income. Taxed at applicable rates based on type of income.</td>
<td>Income maintains its character as either dividends, capital gain or other property income. Taxed at applicable rates based on type of income.</td>
<td></td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Ownership Structure</th>
<th>Residency</th>
<th>Tax Incentives</th>
<th>TFSA/RRSP Eligibility</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Private Corporation</strong></td>
<td>Generally, where incorporated, but may be taxed in other jurisdictions</td>
<td>Small business deduction (SBD) on active business income Investment income of private corporations may be taxed at favourable rates if dividends paid</td>
<td>Yes, with ownership restrictions</td>
</tr>
<tr>
<td><strong>Joint Venture/Co-ownership</strong></td>
<td>None</td>
<td>Corporate partners entitled to SBD and treat income as if they earned it directly</td>
<td>No</td>
</tr>
<tr>
<td><strong>Private Limited Partnership</strong></td>
<td>None, however, to be a “Canadian Partnership”, all of the partners must be resident in Canada</td>
<td>Corporate partners entitled to limited SBD and treat income as if they earned it directly</td>
<td>No</td>
</tr>
<tr>
<td><strong>Private Inter Vivos Trust</strong></td>
<td>Where majority of trustees are resident SCC is considering if the “central management and control” doctrine should apply to trusts</td>
<td>None</td>
<td>No</td>
</tr>
<tr>
<td><strong>SIFT Partnership</strong></td>
<td>None</td>
<td>None</td>
<td>Yes, if units are publicly listed on a designated stock exchange, with ownership restrictions</td>
</tr>
<tr>
<td><strong>SIFT Trust</strong></td>
<td>Where majority of trustees are resident SCC is considering if the “central management and control” doctrine should apply to trusts</td>
<td>None</td>
<td>Yes, if units are publicly listed or distributed, with ownership restrictions</td>
</tr>
<tr>
<td><strong>Real Estate Investment Trust (REIT)</strong></td>
<td>Where majority of trustees are resident SCC is considering if the “central management and control” doctrine should apply to trusts</td>
<td>None</td>
<td>Yes, if units are publicly listed or distributed, with ownership restrictions</td>
</tr>
<tr>
<td><strong>Mutual Fund Trust</strong></td>
<td>Where majority of trustees are resident SCC is considering if the “central management and control” doctrine should apply to trusts</td>
<td>None</td>
<td>Yes, if units are publicly listed or distributed, with ownership restrictions</td>
</tr>
<tr>
<td>Common Canadian Ownership Structures</td>
<td>Allocation of Business Income from Multiple Jurisdictions</td>
<td>Property Rollovers</td>
<td></td>
</tr>
<tr>
<td>-------------------------------------</td>
<td>------------------------------------------------------</td>
<td>------------------</td>
<td></td>
</tr>
<tr>
<td>Canadian Controlled Private Corporation</td>
<td>Based on permanent establishment Allocation calculated using both gross revenue and wages attributable to a permanent establishment</td>
<td>Tax-deferred transfer of capital property (not inventory) into a corporation may be available Tax-deferred roll out only to Canadian corporate parent on winding up</td>
<td></td>
</tr>
<tr>
<td>Joint Venture/Co-ownership</td>
<td>Based on permanent establishment Allocation calculated using both gross revenue and wages attributable to a permanent establishment</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Private Partnership/Private Limited Partnership</td>
<td>Based on permanent establishment Allocation calculated using both gross revenue and wages attributable to a permanent establishment</td>
<td>Tax-deferred transfer of capital property and inventory into a partnership may be available Tax-deferred roll out may be available on the dissolution of a partnership if each partner receives an undivided interest in each asset of the partnership or one partner purchases the other partners partnership interest</td>
<td></td>
</tr>
<tr>
<td>Private Inter Vivos Trust</td>
<td>Based on permanent establishment Allocation calculated using both gross revenue and wages attributable to a permanent establishment</td>
<td>Tax-deferred distribution of property may be available to a capital beneficiary of a personal inter vivos trust</td>
<td></td>
</tr>
<tr>
<td>SIFT Partnership</td>
<td>Based on permanent establishment Allocation calculated using both gross revenue and wages attributable to a permanent establishment</td>
<td>Tax-deferred transfer of capital property and inventory into a Canadian partnership may be available Tax-deferred roll out may be available on the dissolution of a Canadian partnership if each partner receives an undivided interest in each asset of the partnership</td>
<td></td>
</tr>
<tr>
<td>SIFT Trust</td>
<td>Based on permanent establishment Allocation calculated using both gross revenue and wages attributable to a permanent establishment</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Real Estate Investment Trust (REIT)</td>
<td>Based on permanent establishment Allocation calculated using both gross revenue and wages attributable to a permanent establishment</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Mutual Fund Trust</td>
<td>Based on permanent establishment Allocation calculated using both gross revenue and wages attributable to a permanent establishment</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Canadian Controlled Private Corporation</td>
<td>Joint Venture/Co-ownership</td>
<td>Private Partnership/Private Limited Partnership</td>
</tr>
<tr>
<td>----------------------</td>
<td>----------------------------------------</td>
<td>---------------------------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>GST/HST²²⁵</td>
<td>GST/HST registration required if engaged in commercial activity</td>
<td>A co-ownership is not a “person” for GST/HST purposes; therefore a co-ownership cannot register for GST/HST purposes in its own right. GST/HST registration is at the level of the co-owners/tenants-in-common. If a co-ownership makes taxable supplies of the property held in the co-ownership, the tenants-in-common are normally required to register for GST/HST purposes and remit tax and claim ITCs on a pro-rata basis, proportional to their interest in the co-ownership. Although this may create a Partnership is a “person” for GST/HST purposes and must register for GST/HST in its own name and account for GST/HST. Partners not required to register Partnership, not partners, considered to be engaged in commercial activity and make supplies. Trust is a “person” for GST/HST purposes and subject to GST/HST registration if engaged in commercial activity. The CRA distinguishes between “true trust” and “bare trust.” True trust: trust is person engaged in commercial activity relating to trust property and registers for GST/HST purposes. Bare trust: cannot register for GST/HST purposes; beneficial owners required to register as engaged in commercial activity involving trust.</td>
<td>Partnership is a “person” for GST/HST purposes and subject to GST/HST registration if engaged in commercial activity.</td>
</tr>
</tbody>
</table>

²²⁵ For simplicity, “GST” is used herein to refer to both the Goods and Services Tax and the Harmonized Sales Tax.
### Appendix B – Common Canadian Ownership Structures

<table>
<thead>
<tr>
<th></th>
<th>Canadian Controlled Private Corporation</th>
<th>Joint Venture/Co-ownership</th>
<th>Private Partnership/Private Limited Partnership</th>
<th>Private Inter Vivos Trust</th>
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<th>SIFT Trust</th>
<th>Real Estate Investment Trust (REIT)</th>
<th>Mutual Fund Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>significance in administrative burden, there is no provision in the ETA to simplify the accounting for GST/HST unless the co-ownership is in fact a joint venture</td>
<td>property</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>Subject to minimum tax in Ontario</td>
<td>Losses cannot be allocated from a corporation to its shareholders</td>
<td>Losses can be allocated to the participants of a co-ownership or joint venture</td>
<td>Need at least two partners to form a partnership</td>
<td>Subject to 21-year deemed disposition rule</td>
<td>Need at least two partners to form a partnership</td>
<td>Losses cannot be allocated to the beneficiaries of a trust</td>
<td>Not subject to 21-year deemed disposition rule</td>
</tr>
<tr>
<td></td>
<td>Losses cannot be allocated from a corporation to its shareholders</td>
<td>Need at least two partners to form a partnership</td>
<td>Losses can be allocated to partners, however, in the case of a limited partner, the amount of the loss allocated is limited to the partner’s “at-risk” amount</td>
<td>Subject to minimum tax</td>
<td>Losses cannot be allocated to the beneficiaries of a trust</td>
<td>Not subject to minimum tax</td>
<td>Losses cannot be allocated to the beneficiaries of a trust</td>
<td>Not subject to minimum tax</td>
</tr>
<tr>
<td></td>
<td>Not subject to the 21-year deemed disposition rule</td>
<td>Losses cannot be allocated to the beneficiaries of a trust</td>
<td>Not subject to the 21-year deemed disposition rule</td>
<td>Losses cannot be allocated to the beneficiaries of a trust</td>
<td>Not subject to minimum tax</td>
<td>Not subject to minimum tax</td>
<td>Losses cannot be allocated to the beneficiaries of a trust</td>
<td>Not subject to minimum tax</td>
</tr>
<tr>
<td></td>
<td>Not subject to 21-year deemed disposition rule</td>
<td>Not subject to minimum tax</td>
<td>Not subject to minimum tax</td>
<td>Losses cannot be allocated to the beneficiaries of a trust</td>
<td>Not subject to minimum tax</td>
<td>Not subject to minimum tax</td>
<td>Losses cannot be allocated to the beneficiaries of a trust</td>
<td>Not subject to minimum tax</td>
</tr>
</tbody>
</table>
## Appendix C – Non-Resident Investment in Canada – Tax Rates and Considerations

### Property Income — 2011

<table>
<thead>
<tr>
<th></th>
<th>Non-resident Corporation</th>
<th>Non-resident Partnership</th>
<th>Non-resident Trust</th>
<th>Canadian Corporation</th>
<th>Canadian Partnership</th>
<th>Canadian Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Federal Tax</strong></td>
<td>26.5%</td>
<td>Tax rates depend on Canadian tax status of each partner</td>
<td>42.92% (29% × 48% surtax)</td>
<td>16.5%</td>
<td>Tax rates depend on Canadian tax status of each partner</td>
<td>29%</td>
</tr>
<tr>
<td><strong>Provincial Tax</strong></td>
<td>N/A</td>
<td>Tax rates depend on Canadian tax status of each partner</td>
<td>N/A</td>
<td>10% to 16%</td>
<td>Tax rates depend on Canadian tax status of each partner</td>
<td>10% to 21%</td>
</tr>
<tr>
<td><strong>Combined Rate</strong></td>
<td>26.5%</td>
<td>Tax rates depend on Canadian tax status of each partner</td>
<td>42.92%</td>
<td>26.5% to 32.5%</td>
<td>Tax rates depend on Canadian tax status of each partner</td>
<td>39% to 50%</td>
</tr>
<tr>
<td><strong>Branch Tax</strong></td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Capital Tax</strong></td>
<td>N/A</td>
<td>Would depend on the status of the partner(s). May apply to corporate partners</td>
<td>N/A</td>
<td>0.0% to 0.2% (depending on province)</td>
<td>Depends on status of the partner(s). May apply for corporate partners</td>
<td>N/A</td>
</tr>
</tbody>
</table>

---

226 Defined in subsection 102(1), a “Canadian partnership” is a partnership all of the members of which are resident in Canada. This status could apply in the context of a non-resident investment if the non-resident(s) joins the partnership via a Canadian legal entity (e.g., a Canadian corporate or trust).
<table>
<thead>
<tr>
<th>Non-resident Corporation</th>
<th>Non-resident Partnership</th>
<th>Non-resident Trust</th>
<th>Canadian Corporation</th>
<th>Canadian Partnership</th>
<th>Canadian Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMT</td>
<td>N/A</td>
<td>Depends on partner</td>
<td>Yes</td>
<td>N/A</td>
<td>Depends on partner</td>
</tr>
<tr>
<td></td>
<td></td>
<td>AMT may apply if interest, CCA and/or other tax preference items exceed rental income or partnership income allocated to an individual or trust that is a “specified member” of the partnership</td>
<td>AMT may apply if interest, CCA and/or other tax preference items exceed rental income or partnership income allocated to an individual or trust that is a “specified member” of the partnership</td>
<td>AMT may apply if interest, CCA and/or other tax preference items exceed rental income or partnership income allocated to an individual or trust that is a “specified member” of the partnership</td>
<td></td>
</tr>
<tr>
<td>Thin Capitalization Rules</td>
<td>2:1 debt-to-equity limitation</td>
<td>Depends on partner</td>
<td>N/A</td>
<td>2:1 debt-to-equity limitation</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>Per Technical Interpretation 9638945, subsection 18(4) applies to a corporation that elects under section 216</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Withholding Tax on Dividends</td>
<td>N/A</td>
<td>Depends on partner</td>
<td>N/A</td>
<td>5% – 25% Treaty benefits may be denied by the 5th Protocol, commencing January 1, 2010, on certain flow-through entities</td>
<td>Depends on partner</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>N/A</td>
</tr>
<tr>
<td>Withholding Tax on Interest</td>
<td>Non-resident Corporation</td>
<td>Non-resident Partnership</td>
<td>Non-resident Trust</td>
<td>Canadian Corporation</td>
<td>Canadian Partnership</td>
</tr>
<tr>
<td>-----------------------------</td>
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<td>----------------------</td>
</tr>
<tr>
<td>N/A</td>
<td>Under revised paragraph 212(1)(b), withholding tax is no longer applicable to non-participating interest paid to an arm’s-length party</td>
<td>N/A</td>
<td>N/A</td>
<td>0% to 25%</td>
<td>0% to 25%</td>
</tr>
<tr>
<td></td>
<td>If non-arm’s-length loan is secured by real property situated in Canada, withholding tax will apply (treaty-specific)</td>
<td></td>
<td>Pursuant to the 5th Protocol, withholding tax on interest to non-arm’s-length parties resident in the US is eliminated for 2010 and subsequent years</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Pursuant to the 5th Protocol, withholding tax on interest to non-arm’s-length parties resident in the US is eliminated for 2010 and subsequent years</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Withholding Tax on Rent</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Disposition of Property</td>
<td>Recapture of CCA 50% capital gains subject to income tax Section 116 certificate of compliance required on disposition of assets</td>
<td>Recapture of CCA 50% capital gains subject to income tax Section 116 certificate of compliance required on disposition of assets</td>
<td>Recapture of CCA 50% capital gains subject to income tax Section 116 certificate of compliance required on disposition of assets</td>
<td>Recapture of CCA 50% capital gains subject to income tax</td>
<td>Recapture of CCA 50% capital gains subject to income tax</td>
</tr>
<tr>
<td>Carryforward of Non-capital Losses</td>
<td>Non-resident Corporation</td>
<td>Non-resident Partnership</td>
<td>Non-resident Trust</td>
<td>Canadian Corporation</td>
<td>Canadian Partnership</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>--------------------------</td>
<td>-------------------------</td>
<td>-------------------</td>
<td>---------------------</td>
<td>---------------------</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>N/A (partners able to carryforward)</td>
</tr>
<tr>
<td>If the principal business is real estate, the corporation may claim CCA in excess of net rental income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Compliance in addition to annual tax return (not intended to be an exhaustive list)</th>
<th>Non-resident Corporation</th>
<th>Non-resident Partnership</th>
<th>Non-resident Trust</th>
<th>Canadian Corporation</th>
<th>Canadian Partnership</th>
<th>Canadian Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>NR6 filing: Section 216 election</td>
<td>NR6 filing: Section 216 election</td>
<td>NR6 filing: Section 216 election</td>
<td>NR6 filing: Section 216 election</td>
<td>NR4 filing for dividends and possibly interest</td>
<td>NR4 filing may apply regarding interest paid to a non-resident</td>
<td>NR4 filing may apply regarding interest paid to a non-resident</td>
</tr>
<tr>
<td>Rents subject to monthly withholding tax</td>
<td>Rents subject to monthly withholding tax</td>
<td>Rents subject to monthly withholding tax</td>
<td>Rents subject to monthly withholding tax</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Section 116 certificate of compliance required on disposition of assets</td>
<td>Section 116 certificate of compliance required on disposition of assets</td>
<td>Section 116 certificate of compliance required on disposition of assets</td>
<td>Section 116 certificate of compliance required on disposition of assets</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other</th>
<th>Non-resident Corporation</th>
<th>Non-resident Partnership</th>
<th>Non-resident Trust</th>
<th>Canadian Corporation</th>
<th>Canadian Partnership</th>
<th>Canadian Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain is triggered when the cost base of a limited partnership interest becomes negative</td>
<td>Property can be transferred to a taxable Canadian corporation on a tax-deferred basis</td>
<td>Property can be transferred to a “Canadian partnership” on a tax-deferred basis</td>
<td>Property can be transferred to a taxable Canadian corporation on a tax-deferred basis</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CCA may create a loss if a principal business real estate corporation; simple to administer</td>
<td>Capital gain is triggered when the cost base of a limited partnership interest becomes negative</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## Business Income — 2011

<table>
<thead>
<tr>
<th></th>
<th>Non-resident Corporation</th>
<th>Non-resident Partnership</th>
<th>Non-resident Trust</th>
<th>Canadian Corporation</th>
<th>Canadian Partnership</th>
<th>Canadian Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Federal Tax</strong></td>
<td>16.5%</td>
<td>Tax rates depend on</td>
<td>29%</td>
<td>16.5%</td>
<td>Tax rates depend on</td>
<td>29%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Canadian tax status of</td>
<td></td>
<td></td>
<td>Canadian tax status of</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>each partner</td>
<td></td>
<td></td>
<td>each partner</td>
<td></td>
</tr>
<tr>
<td><strong>Provincial Tax</strong></td>
<td>10% to 16%</td>
<td>Tax rates depend on</td>
<td>10% to 21%</td>
<td>10% to 16%</td>
<td>Tax rates depend on</td>
<td>10% to 21%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Canadian tax status of</td>
<td></td>
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<td>Canadian tax status of</td>
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<td></td>
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<td>each partner</td>
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<td>each partner</td>
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<td>Since income is</td>
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<td>Since income is</td>
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<td>business income, it</td>
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<td>business income, it</td>
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<tr>
<td></td>
<td></td>
<td>is taxed in province</td>
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<td></td>
<td>is taxed in province</td>
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<td></td>
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<td>from which it was</td>
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<td>from which it was</td>
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<td></td>
<td></td>
<td>derived</td>
<td></td>
<td></td>
<td>derived</td>
<td></td>
</tr>
<tr>
<td><strong>Combined Rate</strong></td>
<td>26.5% to 32.5%</td>
<td>Tax rates depend on</td>
<td>39% to 50%</td>
<td>26.5% to 32.5%</td>
<td>Tax rates depend on</td>
<td>39% to 50%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Canadian tax status of</td>
<td></td>
<td></td>
<td>Canadian tax status of</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>each partner</td>
<td></td>
<td></td>
<td>each partner</td>
<td></td>
</tr>
<tr>
<td><strong>Branch Tax</strong></td>
<td>0% to 25%</td>
<td>Depends on tax status</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td></td>
<td>of partners</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Branch tax will equal the</td>
<td>lesser of 25% or the</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>lesser of 25% or the</td>
<td>dividend withholding tax</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>dividend withholding tax</td>
<td>rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>rate</td>
<td>Under certain treaties</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>the rate is reduced to</td>
<td>the rate is reduced to</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5%</td>
<td>5%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Canada-US Treaty</td>
<td>Canada-US Treaty</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>exempts the first</td>
<td>exempts the first</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$500,000 of net after-tax</td>
<td>$500,000 of net after-tax</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>earnings that are not</td>
<td>earnings that are not</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>reinvested in the</td>
<td>reinvested in the</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Canadian branch</td>
<td>Canadian branch</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Capital Tax</strong></td>
<td>0.0% to 0.2% (depending on</td>
<td>Depends on tax status</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>province)</td>
<td>of partners</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(depending on province)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>AMT</th>
<th>Non-resident Corporation</th>
<th>Non-resident Partnership</th>
<th>Non-resident Trust</th>
<th>Canadian Corporation</th>
<th>Canadian Partnership</th>
<th>Canadian Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N/A</td>
<td>Depends on partner AMT may apply if interest, CCA and/or other tax preference items exceed rental income or partnership income allocated to an individual or trust that is a “specified member” of the partnership.</td>
<td>Yes AMT may apply if interest, CCA and/or other tax preference items exceed rental income or partnership income allocated to an individual or trust that is a “specified member” of the partnership.</td>
<td>N/A</td>
<td>Depends on partner AMT may apply if interest, CCA and/or other tax preference items exceed rental income or partnership income allocated to an individual or trust that is a “specified member” of the partnership.</td>
<td>Yes AMT may apply if interest, CCA and/or other tax preference items exceed rental income or partnership income allocated to an individual or trust that is a “specified member” of the partnership.</td>
</tr>
<tr>
<td>Thin Capitalization Rules</td>
<td>N/A</td>
<td>Depends on partner</td>
<td>N/A</td>
<td>2:1 debt-to-equity limitation</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Withholding Tax on Dividends</td>
<td>N/A</td>
<td>Depends on partner</td>
<td>N/A</td>
<td>5% to 25% Treaty benefits may be denied by the 5th Protocol, commencing January 1, 2010, on certain flow-through entities.</td>
<td>Depends on partner</td>
<td>N/A</td>
</tr>
<tr>
<td>Withholding Tax on Interest</td>
<td>Non-resident Corporation</td>
<td>Non-resident Partnership</td>
<td>Non-resident Trust</td>
<td>Canadian Corporation</td>
<td>Canadian Partnership</td>
<td>Canadian Trust</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>--------------------------</td>
<td>-------------------------</td>
<td>-------------------</td>
<td>---------------------</td>
<td>---------------------</td>
<td>-----------------</td>
</tr>
<tr>
<td>0% to 25%</td>
<td>0% to 25%</td>
<td>0% to 25%</td>
<td>0% to 25%</td>
<td>0% to 25%</td>
<td>0% to 25%</td>
<td>0% to 25%</td>
</tr>
<tr>
<td>Under revised paragraph 212(1)(b), withholding tax is no longer applicable to non-participating interest paid to an arm’s-length party.</td>
<td>Under revised paragraph 212(1)(b), withholding tax is no longer applicable to non-participating interest paid to an arm’s-length party.</td>
<td>Under revised paragraph 212(1)(b), withholding tax is no longer applicable to non-participating interest paid to an arm’s-length party.</td>
<td>Under revised paragraph 212(1)(b), withholding tax is no longer applicable to non-participating interest paid to an arm’s-length party.</td>
<td>Under revised paragraph 212(1)(b), withholding tax is no longer applicable to non-participating interest paid to an arm’s-length party.</td>
<td>Under revised paragraph 212(1)(b), withholding tax is no longer applicable to non-participating interest paid to an arm’s-length party.</td>
<td>Under revised paragraph 212(1)(b), withholding tax is no longer applicable to non-participating interest paid to an arm’s-length party.</td>
</tr>
<tr>
<td>Subsection 212(13.2), interest deducted in computing business income may be subject to withholding. If non-arm’s-length loan is secured by real property situated in Canada, withholding tax will apply (treaty-specific)</td>
<td>Subsection 212(13.2), interest deducted in computing business income may be subject to withholding. If non-arm’s-length loan is secured by real property situated in Canada, withholding tax will apply (treaty-specific)</td>
<td>Subsection 212(13.2), interest deducted in computing business income may be subject to withholding. If non-arm’s-length loan is secured by real property situated in Canada, withholding tax will apply (treaty-specific)</td>
<td>Subsection 212(13.2), interest deducted in computing business income may be subject to withholding. If non-arm’s-length loan is secured by real property situated in Canada, withholding tax will apply (treaty-specific)</td>
<td>Subsection 212(13.2), interest deducted in computing business income may be subject to withholding. If non-arm’s-length loan is secured by real property situated in Canada, withholding tax will apply (treaty-specific)</td>
<td>Subsection 212(13.2), interest deducted in computing business income may be subject to withholding. If non-arm’s-length loan is secured by real property situated in Canada, withholding tax will apply (treaty-specific)</td>
<td>Subsection 212(13.2), interest deducted in computing business income may be subject to withholding. If non-arm’s-length loan is secured by real property situated in Canada, withholding tax will apply (treaty-specific)</td>
</tr>
<tr>
<td>Pursuant to the 5th Protocol, withholding tax on interest to non-arm’s-length parties resident in the US is eliminated for 2010 and subsequent years</td>
<td>Pursuant to the 5th Protocol, withholding tax on interest to non-arm’s-length parties resident in the US is eliminated for 2010 and subsequent years</td>
<td>Pursuant to the 5th Protocol, withholding tax on interest to non-arm’s-length parties resident in the US is eliminated for 2010 and subsequent years</td>
<td>Pursuant to the 5th Protocol, withholding tax on interest to non-arm’s-length parties resident in the US is eliminated for 2010 and subsequent years</td>
<td>Pursuant to the 5th Protocol, withholding tax on interest to non-arm’s-length parties resident in the US is eliminated for 2010 and subsequent years</td>
<td>Pursuant to the 5th Protocol, withholding tax on interest to non-arm’s-length parties resident in the US is eliminated for 2010 and subsequent years</td>
<td>Pursuant to the 5th Protocol, withholding tax on interest to non-arm’s-length parties resident in the US is eliminated for 2010 and subsequent years</td>
</tr>
<tr>
<td></td>
<td>Non-resident Corporation</td>
<td>Non-resident Partnership</td>
<td>Non-resident Trust</td>
<td>Canadian Corporation</td>
<td>Canadian Partnership</td>
<td>Canadian Trust</td>
</tr>
<tr>
<td>--------------------------</td>
<td>--------------------------</td>
<td>--------------------------</td>
<td>-------------------</td>
<td>----------------------</td>
<td>----------------------</td>
<td>-----------------</td>
</tr>
<tr>
<td><strong>Withholding Tax on Rent</strong></td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>While withholding tax is not applicable to rents earned by a non-resident that is carrying on a business of earning rental income, a Regulation 805 waiver should be obtained</td>
<td>While withholding tax is not applicable to rents earned by a non-resident that is carrying on a business of earning rental income, a Regulation 805 waiver should be obtained</td>
<td>N/A</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Disposition of Property</strong></td>
<td>Recapture of CCA 50% capital gains subject to income tax Section 116 certificate of compliance required on disposition of assets</td>
<td>Recapture of CCA 50% capital gains subject to income tax Section 116 certificate of compliance required on disposition of assets</td>
<td>Recapture of CCA 50% capital gains subject to income tax Section 116 certificate of compliance required on disposition of assets</td>
<td>Recapture of CCA 50% capital gains subject to income tax</td>
<td>Recapture of CCA 50% capital gains subject to income tax</td>
<td>Recapture of CCA 50% capital gains subject to income tax</td>
</tr>
<tr>
<td><strong>Carryforward of Non-capital Losses</strong></td>
<td>Yes</td>
<td>N/A</td>
<td>Yes</td>
<td>Yes</td>
<td>N/A (partners able to carryforward)</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>If the principal business is real estate, the corporation may claim CCA in excess of net rental income</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

227 February 13, 2003 draft regulations eliminate the waiver requirement.
<table>
<thead>
<tr>
<th>Compliance in addition to annual tax return (not intended to be an exhaustive list)</th>
<th>Non-resident Corporation</th>
<th>Non-resident Partnership</th>
<th>Non-resident Trust</th>
<th>Canadian Corporation</th>
<th>Canadian Partnership</th>
<th>Canadian Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reg. 805 waiver While withholding tax is not applicable to rents earned by a non-resident that is carrying on a business of earning rental income, a Regulation 805 waiver should be obtained. Section 116 certificate of compliance required on disposition of assets.</td>
<td>Reg. 805 waiver While withholding tax is not applicable to rents earned by a non-resident that is carrying on a business of earning rental income, a Regulation 805 waiver should be obtained. Section 116 certificate of compliance required on disposition of assets.</td>
<td>Reg. 805 waiver While withholding tax is not applicable to rents earned by a non-resident that is carrying on a business of earning rental income, a Regulation 805 waiver should be obtained. Section 116 certificate of compliance required on disposition of assets.</td>
<td>NR4 filing for dividends and possibly interest</td>
<td>NR4 filing may apply regarding interest paid to a non-resident</td>
<td>NR4 filing may apply regarding interest paid to a non-resident</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>Capital gain is triggered when the cost base of the limited partnership interest becomes negative</td>
<td>Property can be transferred to a taxable Canadian corporation on a tax-deferred basis CCA may create a loss if a principal business real estate corporation; simple to administer</td>
<td>Property can be transferred to a “Canadian partnership” on a tax-deferred basis Capital gain is triggered when the cost base of the limited partnership interest becomes negative</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
# Appendix D – Income Tax Rates – Corporations 2011-2012

Income tax rates for general corporations—2011-2012

Federal income tax rates for income earned by a general corporation

### Effective January 1, 2011

<table>
<thead>
<tr>
<th></th>
<th>General M&amp;P Income</th>
<th>General Active Business Income</th>
<th>Investment Income^2</th>
</tr>
</thead>
<tbody>
<tr>
<td>General corporate rate</td>
<td>38.0 %</td>
<td>38.0 %</td>
<td>38.0 %</td>
</tr>
<tr>
<td>Federal abatement</td>
<td>(10.0)</td>
<td>(10.0)</td>
<td>(10.0)</td>
</tr>
<tr>
<td></td>
<td>28.0</td>
<td>28.0</td>
<td>28.0</td>
</tr>
<tr>
<td>M&amp;P deduction^3</td>
<td>(11.5)</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Rate reduction^4</td>
<td>0.0</td>
<td>(11.5)</td>
<td>(11.5)</td>
</tr>
<tr>
<td></td>
<td><strong>16.5</strong></td>
<td><strong>16.5</strong></td>
<td><strong>16.5</strong></td>
</tr>
</tbody>
</table>

### Effective January 1, 2012

<table>
<thead>
<tr>
<th></th>
<th>General M&amp;P Income</th>
<th>General Active Business Income</th>
<th>Investment Income^2</th>
</tr>
</thead>
<tbody>
<tr>
<td>General corporate rate</td>
<td>38.0 %</td>
<td>38.0 %</td>
<td>38.0 %</td>
</tr>
<tr>
<td>Federal abatement</td>
<td>(10.0)</td>
<td>(10.0)</td>
<td>(10.0)</td>
</tr>
<tr>
<td></td>
<td>28.0</td>
<td>28.0</td>
<td>28.0</td>
</tr>
<tr>
<td>M&amp;P deduction^3</td>
<td>(13.0)</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Rate reduction^4</td>
<td>0.0</td>
<td>(13.0)</td>
<td>(13.0)</td>
</tr>
<tr>
<td></td>
<td><strong>15.0</strong></td>
<td><strong>15.0</strong></td>
<td><strong>15.0</strong></td>
</tr>
</tbody>
</table>

- See end notes for the actual dates on which these rates and other rate changes are effective.
- All rates must be prorated for taxation years that straddle the effective date of the changes.
- To determine whether these rates are substantively enacted, see the “Substantively Enacted Income Tax Rates” tables ([http://www.kpmg.com/ca/en/issuesandinsights/articlespublications/pages/taxrates.aspx](http://www.kpmg.com/ca/en/issuesandinsights/articlespublications/pages/taxrates.aspx)).
### Provincial income tax rates for income earned by a general corporation

**Effective January 1, 2011**

<table>
<thead>
<tr>
<th></th>
<th>General M&amp;P Income</th>
<th>General Active Business Income</th>
<th>Investment Income¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia²</td>
<td>10.0%</td>
<td>10.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Alberta</td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>10.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Manitoba</td>
<td>12.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Ontario⁶</td>
<td>10.0</td>
<td>12.0/11.5</td>
<td>12.0/11.5</td>
</tr>
<tr>
<td>Québec</td>
<td>11.9</td>
<td>11.9</td>
<td>11.9</td>
</tr>
<tr>
<td>New Brunswick²</td>
<td>11.0/10.0</td>
<td>11.0/10.0</td>
<td>11.0/10.0</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>16.0</td>
<td>16.0</td>
<td>16.0</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>16.0</td>
<td>16.0</td>
<td>16.0</td>
</tr>
<tr>
<td>Newfoundland</td>
<td>5.0</td>
<td>14.0</td>
<td>14.0</td>
</tr>
</tbody>
</table>

**Effective January 1, 2012**

<table>
<thead>
<tr>
<th></th>
<th>General M&amp;P Income</th>
<th>General Active Business Income</th>
<th>Investment Income¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia²</td>
<td>10.0%</td>
<td>10.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Alberta</td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>10.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Manitoba</td>
<td>12.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Ontario⁶</td>
<td>10.0</td>
<td>11.5</td>
<td>11.5</td>
</tr>
<tr>
<td>Québec</td>
<td>11.9</td>
<td>11.9</td>
<td>11.9</td>
</tr>
<tr>
<td>New Brunswick²</td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>16.0</td>
<td>16.0</td>
<td>16.0</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>16.0</td>
<td>16.0</td>
<td>16.0</td>
</tr>
<tr>
<td>Newfoundland</td>
<td>5.0</td>
<td>14.0</td>
<td>14.0</td>
</tr>
</tbody>
</table>
Combined federal and provincial income tax rates for income earned by a general corporation

**Effective January 1, 2011**

<table>
<thead>
<tr>
<th>Province</th>
<th>General M&amp;P Income</th>
<th>General Active Business Income</th>
<th>Investment Income²</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia⁵</td>
<td>26.5%</td>
<td>26.5%</td>
<td>26.5%</td>
</tr>
<tr>
<td>Alberta</td>
<td>26.5</td>
<td>26.5</td>
<td>26.5</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>26.5</td>
<td>28.5</td>
<td>28.5</td>
</tr>
<tr>
<td>Manitoba</td>
<td>28.5</td>
<td>28.5</td>
<td>28.5</td>
</tr>
<tr>
<td>Ontario⁶</td>
<td>26.5</td>
<td>28.5/28.0</td>
<td>28.5/28.0</td>
</tr>
<tr>
<td>Québec</td>
<td>28.4</td>
<td>28.4</td>
<td>28.4</td>
</tr>
<tr>
<td>New Brunswick³</td>
<td>27.5/26.5</td>
<td>27.5/26.5</td>
<td>27.5/26.5</td>
</tr>
<tr>
<td>New Brunswick²</td>
<td>27.5/26.5</td>
<td>27.5/26.5</td>
<td>27.5/26.5</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>32.5</td>
<td>32.5</td>
<td>32.5</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>32.5</td>
<td>32.5</td>
<td>32.5</td>
</tr>
<tr>
<td>Newfoundland</td>
<td>21.5</td>
<td>30.5</td>
<td>30.5</td>
</tr>
</tbody>
</table>

**Effective January 1, 2012**

<table>
<thead>
<tr>
<th>Province</th>
<th>General M&amp;P Income</th>
<th>General Active Business Income</th>
<th>Investment Income²</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia⁵</td>
<td>25.0%</td>
<td>25.0%</td>
<td>25.0%</td>
</tr>
<tr>
<td>Alberta</td>
<td>25.0</td>
<td>25.0</td>
<td>25.0</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>25.0</td>
<td>27.0</td>
<td>27.0</td>
</tr>
<tr>
<td>Manitoba</td>
<td>27.0</td>
<td>27.0</td>
<td>27.0</td>
</tr>
<tr>
<td>Ontario⁶</td>
<td>25.0</td>
<td>26.5</td>
<td>26.5</td>
</tr>
<tr>
<td>Québec</td>
<td>26.9</td>
<td>26.9</td>
<td>26.9</td>
</tr>
<tr>
<td>New Brunswick³</td>
<td>25.0</td>
<td>25.0</td>
<td>25.0</td>
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<tr>
<td>New Brunswick²</td>
<td>25.0</td>
<td>25.0</td>
<td>25.0</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>31.0</td>
<td>31.0</td>
<td>31.0</td>
</tr>
<tr>
<td>Prince Edward Island</td>
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<td>31.0</td>
<td>31.0</td>
</tr>
<tr>
<td>Newfoundland</td>
<td>20.0</td>
<td>29.0</td>
<td>29.0</td>
</tr>
</tbody>
</table>
Income tax rates for general corporations — 2011-2012

Notes

(1) The federal and provincial tax rates shown in the tables apply to income earned by corporations other than Canadian-controlled private corporations (CCPCs). A general corporation typically includes public companies and their subsidiaries, that are resident in Canada and Canadian-resident private companies that are controlled by non-residents.

For tax rates applicable to CCPCs, see the tables entitled “Income Tax Rates for Canadian-Controlled Private Corporations (CCPCs)” and the related notes.

(2) The federal and provincial tax rates shown in the tables apply to investment income earned by general corporations other than capital gains and dividends received from Canadian corporations. The rates that apply to capital gains are one-half of the rates shown in the tables. Dividends received from Canadian corporations are deductible in computing regular Part I tax, but may be subject to Part IV tax, calculated at a rate of 33 1/3%.

(3) Corporations that derive at least 10% of their gross revenue for the year from manufacturing or processing goods in Canada for sale or lease can claim the manufacturing and processing (M&P) deduction against their M&P income.

(4) A general tax rate reduction is available on qualifying income. Income that is eligible for other reductions or credits, such as small business income, M&P income, and investment income subject to the refundable provisions, is not eligible for this rate reduction.

The corporate income tax rate began decreasing in 2008 and will continue to decrease until it reaches a target rate of 15% as of January 1, 2012. The corporate income tax rate decreased to 16.5% (from 18%) on January 1, 2011, and will further decrease to 15% on January 1, 2012. The rate reduction therefore increased to 11.5% (from 10%) on January 1, 2011 and will further increase to 13% on January 1, 2012.

(5) British Columbia decreased its general corporate income tax rate to 10% (from 10.5%) as of January 1, 2011.

(6) Ontario’s general corporate income tax rate started decreasing on July 1, 2010 and was to continue to decrease each July 1 thereafter until it reaches a target rate of 10% on July 1, 2013. The rate decreased to 11.5% (from 12%) on July 1, 2011. The rate was to further decrease as follows: 11.5% to 11% in 2012, and to 10% in 2013. The 2012 Ontario budget has proposed to freeze the rate at 11.5% until the budget is balanced.

(7) New Brunswick’s general corporate income tax rate reduced to 10% (from 11%) on July 1, 2011. The rate was to further decrease to 8% effective July 1, 2012, but current legislation has repealed that reduction and the rate will remain at 10% in 2012.
### Income tax rates for Canadian-controlled private corporations (CCPCs)-2011-2012

#### Federal income tax rates for income earned by a CCPC

**Effective January 1, 2011**

<table>
<thead>
<tr>
<th></th>
<th>Small Business Income up to $400,000</th>
<th>Active Business Income between $400,000 and $500,000</th>
<th>General Active Business Income</th>
<th>Investment Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>General corporate rate</td>
<td>38.0%</td>
<td>38.0%</td>
<td>38.0%</td>
<td>38.0%</td>
</tr>
<tr>
<td>Federal abatement</td>
<td>(10.0)</td>
<td>(10.0)</td>
<td>(10.0)</td>
<td>(10.0)</td>
</tr>
<tr>
<td>Small business deduction5</td>
<td>(17.0)</td>
<td>(17.0)</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Rate reduction6</td>
<td>0.0</td>
<td>0.0</td>
<td>(11.5)</td>
<td>0.0</td>
</tr>
<tr>
<td>Refundable tax7</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>6.7</td>
</tr>
<tr>
<td>11.0</td>
<td>11.0</td>
<td>16.5</td>
<td>34.7</td>
<td></td>
</tr>
</tbody>
</table>

**Effective January 1, 2012**

<table>
<thead>
<tr>
<th></th>
<th>Small Business Income up to $400,000</th>
<th>Active Business Income between $400,000 and $500,000</th>
<th>General Active Business Income</th>
<th>Investment Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>General corporate rate</td>
<td>38.0%</td>
<td>38.0%</td>
<td>38.0%</td>
<td>38.0%</td>
</tr>
<tr>
<td>Federal abatement</td>
<td>(10.0)</td>
<td>(10.0)</td>
<td>(10.0)</td>
<td>(10.0)</td>
</tr>
<tr>
<td>Small business deduction5</td>
<td>(170)</td>
<td>(170)</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Rate reduction6</td>
<td>0.0</td>
<td>0.0</td>
<td>(13.0)</td>
<td>0.0</td>
</tr>
<tr>
<td>Refundable tax7</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>6.7</td>
</tr>
<tr>
<td>11.0</td>
<td>11.0</td>
<td>15.0</td>
<td>34.7</td>
<td></td>
</tr>
</tbody>
</table>

- See end notes for the actual dates on which these rates and other rate changes are effective.
- All rates must be prorated for taxation years that straddle the effective date of the changes.
- To determine whether these rates are substantively enacted, see the “Substantively Enacted Income Tax Rates” tables (http://www.kpmg.com/ca/en/issuesandinsights/articlespublications/pages/taxrates.aspx).
- For details of other tax and tax rate changes, see the Federal and Provincial Budgets page (http://www.kpmg.com/ca/en/whatwedo/tax/pages/budget.aspx).
Provincial income tax rates for income earned by a CCPC¹

**Effective January 1, 2011**

<table>
<thead>
<tr>
<th>Province</th>
<th>Small Business Income up to $400,000²</th>
<th>Active Business Income between $400,000 and $500,000²</th>
<th>General Active Business Income³</th>
<th>Investment Income⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia⁸</td>
<td>2.5%</td>
<td>2.5%</td>
<td>10.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Alberta</td>
<td>3.0</td>
<td>3.0</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Saskatchewan⁹</td>
<td>4.5/2.0</td>
<td>4.5/2.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Manitoba</td>
<td>0.0</td>
<td>12.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Ontario¹⁰</td>
<td>4.5</td>
<td>4.5</td>
<td>12.0/11.5</td>
<td>12.0/11.5</td>
</tr>
<tr>
<td>Québec</td>
<td>8.0</td>
<td>8.0</td>
<td>11.9</td>
<td>11.9</td>
</tr>
<tr>
<td>New Brunswick¹¹</td>
<td>5.0</td>
<td>5.0</td>
<td>11.0/10.0</td>
<td>11.0/10.0</td>
</tr>
<tr>
<td>Nova Scotia¹²</td>
<td>4.5</td>
<td>16.0</td>
<td>16.0</td>
<td>16.0</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>1.0</td>
<td>1.0</td>
<td>16.0</td>
<td>16.0</td>
</tr>
<tr>
<td>Newfoundland¹³</td>
<td>5.0/4.0</td>
<td>5.0/4.0</td>
<td>14.0</td>
<td>14.0</td>
</tr>
</tbody>
</table>

**Effective January 1, 2012**

<table>
<thead>
<tr>
<th>Province</th>
<th>Small Business Income up to $400,000²</th>
<th>Active Business Income between $400,000 and $500,000²</th>
<th>General Active Business Income³</th>
<th>Investment Income⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia⁹</td>
<td>2.5/0.0%</td>
<td>2.5/0.0%</td>
<td>10.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Alberta</td>
<td>3.0</td>
<td>3.0</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Saskatchewan⁹</td>
<td>2.0</td>
<td>2.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Manitoba</td>
<td>0.0</td>
<td>12.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Ontario¹⁰</td>
<td>4.5</td>
<td>4.5</td>
<td>11.5</td>
<td>11.5</td>
</tr>
<tr>
<td>Québec</td>
<td>8.0</td>
<td>8.0</td>
<td>11.9</td>
<td>11.9</td>
</tr>
<tr>
<td>New Brunswick¹¹</td>
<td>4.5</td>
<td>4.5</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Nova Scotia¹²</td>
<td>4.0</td>
<td>16.0</td>
<td>16.0</td>
<td>16.0</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>1.0</td>
<td>1.0</td>
<td>16.0</td>
<td>16.0</td>
</tr>
<tr>
<td>Newfoundland¹³</td>
<td>4.0</td>
<td>4.0</td>
<td>14.0</td>
<td>14.0</td>
</tr>
</tbody>
</table>
Combined federal and provincial income tax rates for income earned by a CCPC¹

Effective January 1, 2011

<table>
<thead>
<tr>
<th>Province</th>
<th>Small Business Income up to $400,000²</th>
<th>Active Business Income between $400,000 and $500,000²</th>
<th>General Active Business Income³</th>
<th>Investment Income⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia⁸</td>
<td>13.5%</td>
<td>13.5%</td>
<td>26.5%</td>
<td>44.7%</td>
</tr>
<tr>
<td>Alberta</td>
<td>14.0</td>
<td>14.0</td>
<td>26.5</td>
<td>44.7</td>
</tr>
<tr>
<td>Saskatchewan⁹</td>
<td>15.5/13.0</td>
<td>15.5/13.0</td>
<td>28.5</td>
<td>46.7</td>
</tr>
<tr>
<td>Manitoba</td>
<td>11.0</td>
<td>23.0</td>
<td>28.5</td>
<td>46.7</td>
</tr>
<tr>
<td>Ontario¹⁰</td>
<td>15.5</td>
<td>15.5</td>
<td>28.5/28.0</td>
<td>46.7/46.2</td>
</tr>
<tr>
<td>Québec</td>
<td>19.0</td>
<td>19.0</td>
<td>28.4</td>
<td>46.6</td>
</tr>
<tr>
<td>New Brunswick¹¹</td>
<td>16.0</td>
<td>16.0</td>
<td>27.5/26..5</td>
<td>45.7/44.7</td>
</tr>
<tr>
<td>Nova Scotia¹²</td>
<td>15.5</td>
<td>27.0</td>
<td>32.5</td>
<td>50.7</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>12.0</td>
<td>12.0</td>
<td>32.5</td>
<td>50.7</td>
</tr>
<tr>
<td>Newfoundland¹³</td>
<td>16.0/15.0</td>
<td>16.0/15.0</td>
<td>30.5</td>
<td>48.7</td>
</tr>
</tbody>
</table>

Effective January 1, 2012

<table>
<thead>
<tr>
<th>Province</th>
<th>Small Business Income up to $400,000²</th>
<th>Active Business Income between $400,000 and $500,000²</th>
<th>General Active Business Income³</th>
<th>Investment Income⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia⁸</td>
<td>13.5/11.0%</td>
<td>13.5/11.0%</td>
<td>25.0%</td>
<td>44.7%</td>
</tr>
<tr>
<td>Alberta</td>
<td>14.0</td>
<td>14.0</td>
<td>25.0</td>
<td>44.7</td>
</tr>
<tr>
<td>Saskatchewan⁹</td>
<td>13.0</td>
<td>13.0</td>
<td>27.0</td>
<td>46.7</td>
</tr>
<tr>
<td>Manitoba</td>
<td>11.0</td>
<td>23.0</td>
<td>27.0</td>
<td>46.7</td>
</tr>
<tr>
<td>Ontario¹⁰</td>
<td>15.5</td>
<td>15.5</td>
<td>26.5</td>
<td>46.2</td>
</tr>
<tr>
<td>Québec</td>
<td>19.0</td>
<td>19.0</td>
<td>26.9</td>
<td>46.6</td>
</tr>
<tr>
<td>New Brunswick¹¹</td>
<td>15.5</td>
<td>15.5</td>
<td>25.0</td>
<td>44.7</td>
</tr>
<tr>
<td>Nova Scotia¹²</td>
<td>15.0</td>
<td>27.0</td>
<td>31.0</td>
<td>50.7</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>12.0</td>
<td>12.0</td>
<td>31.0</td>
<td>50.7</td>
</tr>
<tr>
<td>Newfoundland¹³</td>
<td>15.0</td>
<td>15.0</td>
<td>29.0</td>
<td>48.7</td>
</tr>
</tbody>
</table>

Income tax rates for Canadian-controlled private corporations (CCPCs) — 2011-2012

Notes

(1) The federal and provincial tax rates shown in the tables apply to income earned by a Canadian-controlled private corporation (CCPC). In general, a corporation is a CCPC if the corporation is a private corporation and a Canadian corporation, provided it is not controlled by one or more non-resident persons, by a public corporation, by a corporation with a class of shares listed on a designated stock exchange, or by any combination of these, and provided it does not have a class of shares listed on a designated stock exchange.

For tax rates applicable to general corporations, see the table entitled "Income Tax Rates for General Corporations" and the related notes.

(2) See the table entitled “Small Business Income Thresholds for Canadian-Controlled Private Corporations (CCPCs)” and related notes for changes in the federal and provincial small business income thresholds for 2011 to 2013.

For 2010 and subsequent years, Manitoba and Nova Scotia’s provincial small business income thresholds are the only thresholds below the federal amount. For these provinces, a median tax rate applies to active business income between the provincial and federal threshold. The median tax rate is based on the federal small business rate and the applicable provincial general active business rate. For example, in 2011, Nova Scotia’s combined rate on active business income between $400,000 and $500,000 is 27% (i.e., 11% federally and 16% provincially).

(3) The general corporate tax rate applies to active business income earned in excess of $500,000. See the table entitled “Small Business Income Thresholds for Canadian-Controlled Private Corporations (CCPCs)” for changes in the federal and provincial small business income thresholds for 2011 to 2013.

CCPCs that earn income from manufacturing and processing (M&P) activities are subject to the same rates as those that apply to general corporations. See the table entitled “Income Tax Rates for General Corporations” and the related notes.

(4) The federal and provincial tax rates shown in the table apply to investment income earned by a CCPC, other than capital gains and dividends received from Canadian corporations. The rates that apply to capital gains are one-half of the rates shown in the table. Dividends received from Canadian corporations are deductible in computing regular Part I tax, but may be subject to Part IV tax, calculated at a rate of 33 1/3%.

(5) Corporations that are CCPCs throughout the year may claim the small business deduction (SBD). In general, the SBD is equal to 17% of the least of three amounts — active business income earned in Canada, taxable income and the small business income threshold.

(6) A general tax rate reduction is available on qualifying income. Income that is eligible for other reductions or credits, such as small business income, M&P income and investment income subject to the refundable provisions, is not eligible for this rate reduction. A “personal services business” will also not be eligible to claim the general tax rate reduction effective for taxation years that begin after October 31, 2011 under the draft technical amendments released by the Department of Finance on October 31, 2011.

The corporate income tax rate began decreasing in 2008 and will continue to decrease until it reaches a target rate of 15% as of January 1, 2012. The corporate income tax rate decreased to 16.5% (from 18%) on January 1, 2011, and will further decrease to 15% on January 1, 2012. The rate reduction therefore increased to
11.5% (from 10%) on January 1, 2011 and will further increase to 13% on January 1, 2012.

(7) The refundable tax of 6 2/3% of a CCPC’s investment income and capital gains, as well as 20% of such income that is subject to regular Part I tax, is included in the corporation’s Refundable Dividend Tax on Hand (RDTOH) account. When taxable dividends (eligible and non-eligible) are paid out to shareholders, a dividend refund equal to the lesser of 331/3% of the dividends paid or the balance in the RDTOH account is refunded to the corporation.

(8) British Columbia decreased its general corporate income tax rate from 10.5% to 10% as of January 1, 2011. The province’s 2011 budget confirmed that the small business rate will be reduced from 2.5% to 0% by April 1, 2012.

(9) Saskatchewan reduced its small business income tax rate to 2% (from 4.5%) effective July 1, 2011.

(10) Ontario’s general corporate income tax rate started decreasing on July 1, 2010 and was to continue to decrease each July 1 thereafter until it reaches a target rate of 10% on July 1, 2013. The rate decreased to 11.5% (from 12%) on July 1, 2011. The rate was to further decrease as follows: from 11.5% to 11% in 2012, and to 10% in 2013. The 2012 Ontario budget has proposed to freeze the rate at 11.5% until the budget is balanced.

(11) New Brunswick’s general corporate income tax rate reduced to 10% (from 11%) on July 1, 2011. The rate was to further decrease to 8% effective July 1, 2012, but current legislation has repealed that reduction and the rate will remain at 10% in 2012.

The province’s 2011 budget also confirmed the commitment to reduce the small business rate by half (from 5% to 2.5%). The small business rate will reduce to 4.5% (from 5%) effective January 1, 2012. No timetable for further rate reductions is known at this time.

(12) Nova Scotia’s small business rate decreased to 4.5% (from 5%) on January 1, 2011. The rate will further decrease to 4% on January 1, 2012. The 2012 Nova Scotia budget proposes to reduce the rate to 3.5% effective January 1, 2013.

(13) Newfoundland’s small business rate decreased to 4% (from 5%) for taxation years beginning on or after April 1, 2010.
Appendix E – Capital Tax Rates – General Corporations

<table>
<thead>
<tr>
<th></th>
<th>Saskatchewan&lt;sup&gt;229&lt;/sup&gt;</th>
<th>Manitoba&lt;sup&gt;230&lt;/sup&gt;</th>
<th>Ontario&lt;sup&gt;231&lt;/sup&gt;</th>
<th>Québec&lt;sup&gt;232&lt;/sup&gt;</th>
<th>Nova Scotia&lt;sup&gt;233&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Taxable</td>
<td>Taxable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Capital</td>
<td>Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$&lt; 10 million</td>
<td>$&gt; 10 million</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>— —/0.2%</td>
<td>0.15/—%</td>
<td>0.12%</td>
<td>0.30/0.20%</td>
<td>0.15/0.10%</td>
</tr>
<tr>
<td>2011</td>
<td>— — —</td>
<td>—</td>
<td>—</td>
<td>0.20/0.10</td>
<td>0.10/0.05</td>
</tr>
<tr>
<td>2012</td>
<td>✓ ✓ ✓ ✓</td>
<td>✓ ✓ ✓ ✓</td>
<td>✓ ✓ ✓ ✓</td>
<td>✓ ✓ ✓ ✓</td>
<td>0.10/—</td>
</tr>
<tr>
<td></td>
<td>— $10 million</td>
<td>$5 million</td>
<td>Nil</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital deduction</td>
<td>$10 million</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>or exemption&lt;sup&gt;235&lt;/sup&gt;</td>
<td>Nil</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

<sup>228</sup> In general, these capital tax rates apply to corporations other than insurance companies and financial institutions (banks, loan and trust companies, and certain credit unions and corporations dealing in securities).

<sup>229</sup> Saskatchewan’s capital tax was eliminated on July 1, 2008. Large resource companies and resource trusts in Saskatchewan are subject to a capital tax surcharge. This surcharge rate is 3%. The surcharge is applied to the value of the corporation’s or trust’s resource sales less its regular capital tax liability.

<sup>230</sup> Manitoba companies primarily engaged in manufacturing and processing activities are not subject to capital tax for fiscal years ending after July 1, 2008. For fiscal years beginning after January 1, 2010, capital tax for corporations with taxable capital (net of the $10 million deduction) of $10 million or less was eliminated. For corporations with taxable capital (net of the $10 million deduction) exceeding $11 million, the capital tax rate is 0.2% for fiscal years beginning after January 1, 2010. There is a notch provision capital tax rate of 2.2% for taxable capital (net of the $10 million deduction) between $10 and $11 million. For corporations with taxable capital (net of the $10 million deduction) exceeding $11 million, capital tax was eliminated after December 31, 2010.

<sup>231</sup> Ontario companies primarily engaged in manufacturing and resource activities are not subject to capital tax. For other corporations, the capital tax rate was eliminated on July 1, 2010. Prior to the elimination of the capital tax, Ontario’s capital deduction had to be shared among associated corporations with permanent establishments in Canada based on their proportion of the group’s taxable paid-up capital.

<sup>232</sup> Québec’s capital tax was eliminated on January 1, 2011 (for certain manufacturing corporations, the capital tax was eliminated for taxation years ending after March 13, 2008). The capital tax credit, which is conditional on the existence of the tax on capital, was also eliminated on January 1, 2011. Corporations are therefore no longer entitled to the capital tax credit for taxation years beginning after December 31, 2010. Prior to the province’s elimination of the capital tax, a $1 million capital deduction was available. The capital deduction was reduced by one dollar for every three dollars by which an associated group’s paid-up capital for the preceding year exceeded the deduction.

<sup>233</sup> Nova Scotia’s capital tax rates began decreasing on July 1, 2009 and will continue to decrease by 0.10% (if taxable capital is less than $10 million) and by 0.05% (if taxable capital is $10 million or more) each July 1 until the capital tax is eliminated on July 1, 2012.

<sup>234</sup> The tax rate changes all apply as of January 1 of the year indicated, with the exception of Manitoba’s and Nova Scotia’s. Manitoba’s tax rate changes apply to fiscal years beginning after January 1 of the respective year. Nova Scotia’s tax rate changes take effect on July 1 each year. The rates must be prorated for taxation years that straddle the effective date of the changes.

<sup>235</sup> In the table, the “✓” mark indicates that the applicable rate is the same as that indicated above.

The capital deduction or exemption must be allocated among associated or related companies.

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### Appendix F– Provincial Land Transfer Taxes and Registration Fees

<table>
<thead>
<tr>
<th></th>
<th>Legislation</th>
<th>Property Value</th>
<th>Rate of Tax or Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Columbia</td>
<td>Property Transfer Tax Act</td>
<td>Up to $200,000</td>
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<td>All values</td>
<td>$50 + 0.02%</td>
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<td>501–8,400</td>
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<td>General</td>
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<td></td>
<td>Up to $55,000</td>
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<tr>
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<td>55,001–250,000</td>
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<td></td>
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</tr>
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<td></td>
<td></td>
<td>Single Family Residence(s)</td>
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<td></td>
<td></td>
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<td>55,001–250,000</td>
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<td>250,001–400,000</td>
<td>1.5%</td>
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<td>Over 400,000</td>
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</table>

236 The rates of tax shown in the table are graduated rates. For example, the land transfer tax levied on the transfer of a property in Manitoba valued at $150,000 is calculated as $70 + (0.5% × 60,000) + (1.0% × 60,000) = $970.

237 British Columbia land transfer tax on registered transfers or grants of land, based on the value of the property being transferred. Exemptions may apply to certain mortgages, leases under 30 years, amalgamations, first-time buyers of qualifying residential property, transfers of farmland to related individuals or family farm corporations, transfers of a principal residence or certain recreational residences between related individuals, transfers to registered charities of land used for charitable purposes, and transfers between minors and the Public Guardian and Trustee. A refund of land transfer tax may be available where both land transfer and provincial sales taxes have been paid.

238 Alberta and Saskatchewan levy a registration fee on transfers of interests in land, mortgages and other charges based on the value of the property being transferred. The fees indicated in the table apply to transfers of land. The fees applicable to mortgages and other charges generally differ from the land transfer fee.

239 Manitoba levies land transfer tax on registered transfers of land based on the value of the property being transferred. Exemptions may apply to certain mortgages, leases, windups of wholly-owned subsidiaries, transfers of farmland, and conveyances of title between spouses.

240 Ontario levies land transfer tax (OLTT) on dispositions of beneficial interests in land, whether or not the transfer is registered, based on the value of the consideration furnished. Exemptions may apply to certain mortgages, leases under 50 years, certain unregistered dispositions, transfers of farm land between family members, certain transfers of land from an individual to a Family Business Corporation, and certain transfers of land by registered charities after March 25, 2010. A deferral and ultimate cancellation of land transfer tax is available on certain transfers between affiliated corporations. A rebate, to a maximum of $2,000, is available to first-time buyers of newly constructed homes and first-time buyers of resale homes.

241 In addition to OLTT, Municipal Land Transfer Tax (MLTT) is levied on dispositions of beneficial interests in land located in the City of Toronto with closing dates on or after February 1, 2008. Exemptions apply to a transferee which is the Crown or a Crown Agency, certain Ontario government bodies, school boards, universities, colleges, hospitals and nursing homes. All conveyances exempt from OLTT are also exempt from MLTT. A rebate to a maximum of $3,725 is available to first-time buyers of both new and existing residential properties.
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<thead>
<tr>
<th>Province</th>
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<th>Property Value</th>
<th>Rate of Tax or Fee</th>
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<td>An Act Respecting Duties on Transfers of Immovables</td>
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<td>50,001–250,000</td>
<td>1.0</td>
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<td>Land Registration Act</td>
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<td>Lands Protection Act</td>
<td>All values, if over $30,000</td>
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<td>All values</td>
<td>$0 to $450 + 1.0%</td>
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<td>Registration of Deeds Act</td>
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<td>$100</td>
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242 Québec levies land transfer tax on registered transfers of immovable property based on the greatest of the consideration furnished, the consideration stipulated, and the fair market value of the property. Exemptions may apply to certain mortgages, leases under 40 years, transfers between family members and closely related corporations, where the transferee is a public body and where both the transferor and transferee are registered charities.

243 New Brunswick levies land transfer tax on registered transfers of land based on the greater of the value of the property being transferred and the value of consideration furnished. Exemptions may apply to certain mortgages and leases under 25 years.

244 Nova Scotia levies land transfer tax on deeds transferring land if required by municipal by-law, based on the rate stipulated by the municipality and the value of the property being transferred. Exemptions may apply to certain mortgages, leases under 21 years, and transfers between family members.

245 Prince Edward Island levies a registration fee on applications for land-holding permits by resident corporations, or non-resident individuals or corporations, for the purchase of land if the aggregate land holdings exceed five acres or includes shore frontage exceeding 165 feet. The minimum fee is $550. The fee, however, is limited to $550 on certain transfers between non-resident related persons and corporations. Registration of a deed transferring real property is subject to real property transfer tax based on the greater of the consideration for the transfer and the assessed value. Exemptions may apply to property if the greater of these two amounts does not exceed $30,000, to first-time home buyers of a principal residence if the greater of these two amounts does not exceed $200,000, to certain transfers between family members, to certain mortgages and to transfers of property to the Crown, municipality or to a non-profit organization.

246 Newfoundland levies a registration fee on transfers of interests in land, mortgages and other charges, based on the value of the property being transferred.
Appendix G– KPMG Contacts

If you require more information on the matters discussed in this publication, please contact us. We welcome the opportunity to meet with you to discuss how we can best assist you.

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<th>Position</th>
<th>Contact Numbers</th>
<th>Email Address</th>
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