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Iranian Investment in Canadian Real Estate

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The robust Canadian real estate market has attracted considerable interest from Iranian investors. Much of this interest has been focused on residential real estate both for personal use and for investment.

In order to maximize the value of their real estate investment in Canada, Iranian investors must consider several issues. Many of these issues center upon the rules governing the taxation of non-residents who invest in Canada.

The following overview will outline some of the more significant Canadian tax issues that Iranian investors should consider when they intend to use the property to generate rental income as opposed to carrying on a business.

Residency

Prior to making a significant investment in Canada, it is important to be aware of the residency criteria for Canadian tax purposes. These criteria will determine how a foreign individual is taxed and can lead to the sudden imposition of unexpected taxes if a foreign individual is found to be resident in Canada.

Residency criteria for tax purposes operate independently of an individual's immigration status. A foreign individual can be deemed to be resident in Canada under Canadian tax law regardless of whether or not the individual has applied for or been granted immigration status in Canada.

Foreign individuals who are considered resident in Canada will be liable for Canadian tax on their worldwide income not merely the income they receive from an investment in Canadian real estate. As such, it is critical that the Canadian residency criteria be reviewed prior to spending time in Canada. Generally, individuals without residential ties in Canada (e.g. their primary home, personal property and social ties are not in Canada) will not be considered resident in Canada. However, under certain conditions, for example if the individual spends more than 182 full or partial days in Canada throughout the year, a foreign individual can be deemed to be resident for Canadian tax purposes.

Ownership

Non-resident individuals may own real estate in Canada through a number of vehicles including directly as individuals, through holding companies or through trusts. Each of these investment vehicles has its own advantages and disadvantages. The choice of vehicle depends on many factors including the particular circumstances of the individual and the treatment of each for Iranian and Canadian tax purposes.

a) Individual Ownership

Canadian real estate can be purchased to generate rental income. Even where purchased primarily for personal use the property might be rented periodically. When a non-resident receives income from real property situated in Canada specific tax rules apply.

Under Canada's *Income Tax Act* (the "*Act*"), tenants are required to withhold 25% of the gross rent paid to a non-resident landlord. The obligation to withhold even applies to tenants who are non-residents of Canada such as a friend from Iran who rents the property from the Iranian owner for a short period of time. This withholding tax is considered a final tax and is not subject to refund regardless of the expenses which have been incurred to earn the income.

Net Income Election

Fortunately, Canadian tax rules allow a non-resident to elect to be taxed on the net rental income instead of the gross rental income. Once this election is made, the non-resident will be liable for the withholding of 25% of a partial net rental income as opposed to the gross rental income. The partial net rental income for withholding purposes is determined after deducting certain expenses incurred to earn that income such as interest, property taxes and property management fees. Capital outlays and non-cash items such as depreciation (known as capital cost allowance under the *Act*) are not considered expenses for the purpose of calculating a non-resident's withholding tax liability though they are for purposes of determining the ultimate Canadian tax liability.

When a net income election is made, the non-resident must ultimately file a Canadian tax return. On this return the non-resident reports the rental income and can deduct all applicable expenses (including depreciation) to arrive at final net rental income. This income is then taxed at the graduated rates that are applicable to individuals in Canada. If the tax owed by the non-resident (as calculated on the return) is less than the amount that has been withheld (25% of the net rental income) the individual will receive a refund from the Canadian government. The Canadian tax owing on this basis will often be less than the 25% withholding tax on the gross rental income. The total Canadian tax on the net rental income could be further reduced if, for example, the property is owned by more than one individual and the income from the property is shared.

It should be noted that under certain circumstances the interest paid by the Iranian property owner to a non-resident of Canada in respect of funds borrowed to purchase the real estate in Canada will be subject to Canadian withholding tax.

b) Ownership through a Canadian Corporation

A Canadian corporation will be taxed as a resident of Canada. It will, subject to certain limitations, be subject to the corporate tax rate that is applicable within the Canadian jurisdiction where the real estate is located.

When funds are removed from the corporation and distributed as a dividend to a non-resident shareholder, a 25% Canadian withholding tax will apply.

A Canadian corporation can be financed with a combination of share capital and interest bearing debt. Interest on the debt used to fund the acquisition of real property will generally be deductible to the Canadian corporation in arriving at its taxable income. However, interest paid on any of the Canadian corporation's indebtedness to the Iranian shareholder that exceeds the corporation's share capital by a ratio of 1.5 to 1 will not be deductible. Interest on the excess debt will be deemed to be a dividend which will be subject to withholding tax. Generally, when interest is paid to a resident of Iran with whom the corporation is not dealing at "arm's length" (as defined in the *Act*) the interest payment will be subject to a 25% Canadian withholding tax. Generally, there is no Canadian withholding tax on interest paid to an arm's length lender.

A Canadian corporation may prove to be a less efficient vehicle from a Canadian tax perspective because of the tax at the corporate level and the withholding tax on dividends distributing profits.

c) Ownership through a Foreign Corporation

Income earned by a foreign corporation from the ownership of Canadian real estate will be taxed in much the same way as a non-resident individual's rental income is taxed though without access to the individual's graduated rates where the net income election is made. However, if it is determined that the foreign corporation is carrying on business in Canada through a permanent establishment, the foreign corporation will be liable for both the tax on its Canadian business income and an additional branch tax of 25%. Branch tax is analogous to the withholding tax on a Canadian corporation's dividend distributions to non-residents but is imposed annually and is not tied to the payment of dividends.

d) Ownership through a Foreign Trust

While Canadian real estate can be owned by a trust resident in Canada it is likely in the case of a resident of Iran that a non-Canadian trust will be used.

The trust will be taxed in much the same way as the individual discussed above. The trust will be subject to withholding tax on the gross rental income and will be entitled to make the net income election. The trust will not, however, be entitled to an individual's graduated rates. Unlike the other investment vehicles considered in this article, the trust will generally have to pay Canadian tax on the increased value of the Canadian real estate every 21 years.

Selling Direct and Indirect Interests in Canadian Real Property

Under Canadian tax law a non-resident is taxable on any income (capital gain) arising out of the disposition of "taxable Canadian property" ("TCP"). TCP includes real property situated in Canada and shares of a company, whether Canadian or foreign, where at any time in the past 5 years more than 50% of the value of the shares was derived from real property in Canada. TCP also includes an interest in certain trusts where the 50% test is met in the previous 5 years.

If a property is considered TCP, the purchaser of the property must, unless a "clearance certificate" has been obtained from the Canadian tax authorities, withhold 25% of the purchase price to satisfy the non-resident vendor's tax obligation. This withholding amount may be significantly higher than the actual tax owed by the non-resident vendor on the capital appreciation of the property that is being sold.

Clearance Certificate

The *Act* requires every non-resident vendor of TCP to apply for a clearance certificate either prior to the sale of the property or within the 10 days following its disposition. To obtain a clearance certificate it will often be necessary for the non-resident to pay the tax that could be owing on the gain and any taxes which may be outstanding on the rental income.

Obtaining a section 116 certificate prior to the closing of a real estate transaction reduces the potential for complications that can delay a sale and ensures significant funds are not withheld by the purchaser.

Sales Tax

When collecting rent from real property situated in Canada a non-resident should also be mindful of commodity taxation. Although the payment of rent for residential real property that is under a long term lease is exempt from Goods and Services and Harmonized Sales Tax ("GST/HST"), the rental of commercial property, the short term rental of residential property and certain services associated with real property are not. Upon the acquisition of commercial real property, the initiation of a short term rental or the provision of services, appropriate steps should be taken to register for GST/HST.

Conclusion

Significant savings can be realized with proper tax planning. As such, in order to realize the full potential of an investment in real estate in Canada, it is essential that Iranian investors understand how Canadian tax rules affect their particular situation.

Small differences in the circumstances of each person can result in significant differences in how a person is taxed. In order to minimize the tax consequences caused by these differences it is essential that professional advice be sought. This advice will enable the identification of the ownership and ongoing investment structure that is best suited to an Iranian individual's own circumstances.

Fasken Martineau Dumoulin LLP has extensive experience in non-resident tax planning and can assist with issues arising from the purchase of real property, or any other tax or business law matter where assistance may be required.

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