Dispositions of Property by Non-Residents: Tax Deferral by Ministerial Discretion

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PRÉCIS

Aux termes des conventions fiscales qu'il a conclues, le Canada se réserve le droit d'imposer les gains découlant des aliénations de biens situés au Canada, effectuées par des non-résidents. En vertu de l'article 115.1 de la Loi de l'impôt sur le revenu, il est permis à un non-résident participant à une réorganisation de société, à une restructuration ou à une opération entre parties liées, si elle est libre d'impôt ou avec report d'impôt dans son pays de résidence, de demander le report de l'impôt sur certains gains pour les années d'imposition commençant après 1984. Les biens admissibles à ce traitement comprennent les biens en immobilisation, y compris les biens en immobilisation amortissables, les avoirs miniers canadiens, les avoirs miniers étrangers, les biens en immobilisation admissibles et les biens en inventaire par ailleurs assujetti à un impôt canadien. Le report d'impôt canadien peut être obtenu en faisant la demande au ministre, aux termes de l'article 115.1 et d'une disposition pertinente d'une convention, visée par le règlement 7400. Jusqu'à maintenant, seuls le paragraphe 8 de l'article XIII de la convention Canada-États-Unis en matière d'impôts de 1980 et le paragraphe 6 de l'article 13 de la convention Canada-Pays-Bas de 1986 ont été désignés à cet égard.

ABSTRACT

Canada's income tax treaties reserve the right for Canada to tax gains on dispositions by non-residents of property situated in Canada. Effective for taxation years commencing after 1984, section 115.1 of the Income Tax Act permits a non-resident involved in a corporate organization, reorganization, or related-party transaction that occurs on a tax-free or tax-deferred basis in the non-resident's country of residence to apply for deferral of Canadian tax on certain gains. Property qualifying for such treatment includes capital property (including depreciable capital property), Canadian resource property, foreign resource property, eligible capital property, and inventory otherwise subject to taxation in Canada. Deferral of Canadian tax may

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be obtained by application to the minister pursuant to section 115.1 and to an applicable treaty provision prescribed in regulation 7400. To date, only article XIII(8) of the Canada-US income tax convention (1980) and article 13(6) of the Canada-Netherlands income tax convention (1986) have been prescribed for this purpose.

INTRODUCTION

Non-residents of Canada are taxed on their income from employment in Canada, profits from carrying on business in Canada, and gains arising from the disposition of taxable Canadian property.[1] Non-residents are also taxed on a withholding basis on passive payments emanating from Canada that are not reasonably attributable to the carrying on of a business in Canada.[2] These withholding taxes are subject to rate reductions or exemptions pursuant to bilateral tax conventions.

Most western industrialized countries permit some form of relief from double taxation for their resident taxpayers earning income from abroad. This relief takes the form of a foreign tax credit ("the credit method"), exemption of certain foreign incomes ("the exemption method"), or a combination of the two.

To obtain domestic tax relief for foreign taxes paid, the taxpayer must have a taxable event in both the domestic tax jurisdiction and the relevant foreign tax jurisdiction in the same taxation period; in other words, there must be tax symmetry and simultaneity. Furthermore, the taxes must be paid in the two jurisdictions in or with respect to the same taxation period. If the foreign and domestic tax liabilities arise in different taxation periods, generally no current tax relief will be available in the domestic tax jurisdiction of the taxpayer.

Consider, for example, a reorganization of a non-resident corporation that holds property in Canada. Under the tax law of the corporation's country of residence, the reorganization may take place on a tax-deferred basis; however, because the corporation owns property in Canada, the reorganization may result in a taxable event in Canada, giving rise to a tax liability. Usually the taxing jurisdiction in which property is situated imposes tax in any period in which there is a change in legal ownership. This is a reasonable basis on which to enforce its source-based tax claim, because after the property is disposed of, the taxpayer may have no further connection with the jurisdiction. If in a later period the non-resident corporation disposes of the Canadian property to an arm's-length purchaser, the gain will be fully taxable in the corporation's domestic tax jurisdiction, perhaps without regard to taxes previously paid in Canada in respect of the reorgan-

[1] Subsection 2(3) and section 115 of the Income Tax Act, RSC 1952, c. 148, as amended by SC 1970-71-72, c. 63, and as subsequently amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[2] Part XIII, containing sections 212 to 218.

ization. Although the country of residence may permit a carryforward of foreign tax credits, the disposition may occur after the expiry of the carry-forward period. In these circumstances, double taxation can arise.

In 1987, section 115.1 was added to the Income Tax Act to provide relief from this type of double taxation.[3] Section 115.1 gives effect to relieving provisions contained in tax treaties prescribed in regulation 7400.[4] To date, only provisions in the treaties with the Netherlands and the United States have been prescribed. Section 115.1 is effective for taxation years commencing after 1984, coincident with the coming-into-force rules of article XIII(8) of the Canada-US treaty, which was the first of Canada's tax treaties to which section 115.1 applied.

This article provides a detailed analysis of the operation of section 115.1. It examines the relevant provisions of the Canada-US treaty and the Canada-Netherlands treaty. It also identifies several of the difficulties in the application of section 115.1. The article concludes that the tax relief provided by section 115.1 is welcome and should be extended to other treaties.

OVERVIEW

Section 115.1 provides an opportunity for a non-resident who disposes of assets situated in Canada, in the course of a qualifying transaction that occurs on a tax-free or tax-deferred basis in the country of residence, to obtain similar tax treatment of the transaction in both countries. In effect, section 115.1 achieves tax symmetry and tax simultaneity by allowing the taxpayer to redefine both the character and the timing of the transaction for Canadian tax purposes.

The minister of national revenue ("the minister") may agree, pursuant to section 115.1 and the prescribed treaty provision, to defer any Canadian taxation of a gain arising from the disposition of property until such time as the property is sold at arm's length and the gain is recognized in the non-resident's country of residence. This deferral mechanism enables the non-resident taxpayer to claim a foreign tax credit under the tax law of its country of residence for the Canadian taxes that become payable in the year of the arm's-length disposition.

There are two prerequisites to this treatment. First, the minister must agree to the deferral pursuant to a prescribed tax treaty provision.[5] Second,

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[3] Section 115.1 was added by SC 1987, c. 46, section 42(1), applicable to taxation years commencing after 1984.

[4] Regulation 7400(1)(a) prescribes article XIII(8) of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocol signed at Ottawa on June 14, 1983 and the protocol signed at Washington on March 28, 1984 (herein referred to as "the Canada-US treaty"). Regulation 7400(1)(a) also prescribes article 13(6) of the Convention Between Canada and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at The Hague on May 27, 1986 (herein referred to as "the Canada-Netherlands treaty").

[5] Paragraph 115.1(a).

the non-resident vendor and the purchaser must jointly elect in prescribed form[6] and within the prescribed time[7] in accordance with the terms and conditions required by the minister.[8]

The application need not be made in respect of the total gain otherwise arising in Canada. There appears to be provision in the legislation for the minister, the non-resident vendor, and the purchaser to agree to an amount that is less than the full amount of the gain from the disposition of the property.[9]

The relevant provisions of the Canada-US and Canada-Netherlands treaties operate on a reciprocal basis. Therefore, these provisions will provide relief for Canadian residents undertaking rollover transactions involving specified property situated in the United States or the Netherlands. For example, a Canadian resident may seek to take advantage of a subsection 85(1) rollover to transfer to a taxable Canadian corporation eligible property[10] located in a foreign jurisdiction, electing the proceeds to be an amount between the cost amount and the fair market value of the property transferred. If the property is located in the United States or the Netherlands, the subsection 85(1) rollover should be effective. If the property is located in another foreign jurisdiction, which does not normally permit a tax deferral for this type of transaction, the Canadian resident may be subject to double taxation on the transaction, barring relief under a treaty between Canada and the foreign jurisdiction in question.

ANALYSIS OF SECTION 115.1

Taxpayers Covered

Section 115.1 applies where a non-resident person[11] (individual, trust, or corporation) or partnership[12] disposes of property in a taxation year to

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[6] The prescribed form is form T2024, "Election by a Non-Resident Under Section 115.1 and a Prescribed Tax Treaty Provision To Avoid Double Taxation on a Gain from a Disposition."

[7] The prescribed period is specified in regulation 7400(2) and discussed briefly in the next section of this article, under the heading "The Application for Deferral."

[8] Paragraph 115.1(b). See the subsequent discussion under the heading "Conditions of the Minister."

[9] Paragraphs 115.1(c) and (d).

[10] Subsection 85(1.1) defines "eligible property" for purposes of subsection 85(1) to include capital property (other than real property owned by a non-resident), real property owned by a non-resident insurer under certain conditions, Canadian resource property, foreign resource property, eligible capital property, inventory (other than real property), and certain securities and debt obligations of insurers or moneylenders.

[11] Subsection 248(1) defines "non-resident" to mean "not resident in Canada." Although subsections 250(1) to (5) provide special rules for determining residence of both individuals and corporations, generally residence is considered to be a question of fact. *Interpretation Bulletin* IT-221R2, February 3, 1983, discusses Revenue Canada's views of the factors relevant in determining an individual's residence.

[12] The Act does not define a "partnership" for Canadian income tax purposes. The existence of a partnership is generally viewed as a question of fact.

another person or partnership. The reference to partnerships appears to have been intended to prevent double taxation of partnership transactions and reorganizations that would otherwise be tax-exempt to a non-resident member of a partnership. Canadian tax law does not provide rules for determining the residence of partnerships because partnerships are not viewed as being taxpayers for most tax purposes. In contrast, a partnership for US tax purposes might be a taxpayer under US tax law.[13]

Revenue Canada has indicated that none of the section 115.1 applications involving partnerships that have been submitted to date have been approved. Revenue Canada is concerned about situations where a partnership with non-resident partners deals indirectly in Canadian real estate. Some of the partnership applications under section 115.1 appear to be designed to circumvent the Canadian tax that would otherwise be payable on gains from the disposition of real estate by a non-resident.

The Application for Deferral

A non-resident can apply to the minister for deferral of tax by making the request in a letter that describes in detail the organization, reorganization, or other transaction involving a disposition of property in Canada, and also sets out the foreign tax effects of the transaction. Revenue Canada has indicated that the department may request as well a letter from the foreign tax authorities confirming the tax-deferred treatment of the transaction in their tax jurisdiction.

The letter requesting the deferral must be accompanied by the prescribed election form (T2024) submitted jointly by the non-resident vendor and the purchaser. The form requires identification of the vendor, the purchaser, the property disposed of, and the prescribed treaty provision. Other forms that may be required are those applicable under section 116 where a clearance certificate is required by the vendor,[14] and the prescribed forms under section 85 where this provision is applicable to the property in respect of which the deferral is requested.

The application may be made at any time if the vendor and the purchaser have filed a waiver in respect of the disposition for the purposes of subparagraph 152(4)(a)(ii) (discussed below) or, in any other case, within three years of the date of mailing of a notice of an original assessment or a notification that no tax is payable for the taxation year in which the vendor

[13] Section 701 of the Internal Revenue Code of 1986, as amended (herein referred to as "IRC"), treats a partnership as an income-reporting entity rather than as a taxable entity unless the partnership has more attributes of a corporation than attributes of a partnership. In such a case, the partnership will be classified as an association and will be taxed as a corporation.

[14] Section 116 includes provisions permitting a non-resident person disposing of taxable Canadian property to apply for a clearance certificate for withholding tax purposes. This section also sets out mandatory compliance requirements for such dispositions and imposes a withholding requirement on the purchasers.

disposed of the property.[15] In other words, the application must be made before the transaction becomes statute-barred under the Act.[16]

Conditions of the Minister

The minister requires all taxpayers to elect to waive the reassessment limitation in respect of the year of disposition[17] as a condition to a section 115.1 application. Presumably, the taxpayers making the election will limit the waiver to the event for which tax deferral is being sought and its related effects. The filing of the waiver appears to permit the minister to ensure that he can revert to the original Canadian tax assessment position[18] if subsequent events appear to disentitle Canada to taxation rights otherwise reserved under domestic laws affected by the relevant treaty.

The minister also requires that sufficient assets remain in Canada to ensure collection by Revenue Canada of the tax ultimately payable. Revenue Canada has suggested that security arrangements not dissimilar from those required under section 116 may be required.

The Deferral

Section 115.1 provides that the amount that the non-resident vendor, the purchaser, and the minister have agreed upon in the election in respect of the disposition of the property shall be deemed to be the vendor's proceeds of disposition of the property and the purchaser's cost of the property for Canadian income tax purposes. Special rules are provided for depreciable capital property of a prescribed class, non-depreciable capital property, Canadian resource property, foreign resource property, eligible capital property, and inventory.

Paragraph 115.1(d) contains a special rule that applies to depreciable property of a prescribed class where, at the time of the disposition, the vendor's capital cost of the property exceeded the amount agreed upon by the vendor, the purchaser, and the minister under the general rule. This rule

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[15] Regulation 7400(2).

[16] The minister is granted a "normal reassessment period" of three years from the date of mailing of a notice of an original assessment, or of a notification that no tax is payable in respect of the particular year, except that in the case of a mutual fund trust or a corporation other than a Canadian-controlled private corporation, the period is extended to four years: subsection 152(3.1). The four-year extension was recently introduced by SC 1990, c. 39, section 38(1). It remains to be seen whether regulation 7400(2) will be amended to provide the extension to the same taxpayers for the purposes of section 115.1.

[17] See supra footnote 16 for the definition of the normal reassessment period. The prescribed waiver form is form T2029, "Waiver in Respect of the Normal Reassessment Period."

[18] Subparagraph 152(4)(a)(ii) permits the minister, at any time, to reassess or make additional assessments, or to assess tax, interest, or penalties under part I of the Act where a waiver has been filed within the prescribed period. The prescribed period for form T2029 is three years from the date of mailing of a notice of an original assessment or a notification that no tax is payable for the taxation year in which the vendor disposed of the property: regulation 7400(2)(a).

requires that, for the purposes of sections 13 and 20 and the regulations under paragraph 20(1)(a),

- the capital cost of the property to the purchaser is deemed to be equal to the capital cost of the property to the vendor immediately prior to the disposition, and
- the excess of the vendor's capital cost over the agreed amount is deemed to have been allowed to the purchaser as capital cost allowance.

By virtue of this special rule, taxpayers cannot convert what would otherwise be recaptured capital cost allowance into a capital gain, by utilizing the deferral provision and "stepping down" the capital cost of the property to the purchaser for capital gains purposes. The purchaser inherits a tax liability in respect of the recapture of capital cost allowance when, if ever, realized. It should be emphasized that this special rule applies only for purposes of sections 13 and 20 and the regulations under paragraph 20(1)(a); it does not apply for capital gains purposes. Paragraph 115.1(d) represents a standard restriction in rollovers.

Paragraph 115.1(e) provides for continuity of the cost of the property so that the deferred income or gain is ultimately included in the purchaser's income for Canadian tax purposes. This rule applies to non-depreciable capital property, Canadian resource property, foreign resource property, eligible capital property, and inventory.

Consequential Changes to the Regulations

The enactment of section 115.1 necessitated a number of consequential changes to the regulations. Any transactions for which tax relief pursuant to section 115.1 has been obtained after 1984 should be reviewed to ensure that appropriate capital cost allowance treatment is afforded the property, consistent with the changes to the regulations. These changes may affect previous capital cost allowance claims, the classification of certain depreciable capital property, the character of the property to the transferee relative to that to the transferor, and whether the specific property must be included in a separate class or whether it may be pooled with other assets of that class. The regulations affected are as follows:

- regulation 1100(2.2)(a), the half-year rate rule;
- regulation 1100(19)(a), the leasing property rule;
- regulation 1101(1ad)(a), the rental property rule;
- regulation 1102(14)(a), the character and class maintenance rule; and
- regulation 2400(3)(b), the investment property rule for insurers.

ARTICLE XIII(8) OF THE CANADA-US TREATY

For article XIII(8) to apply to a US resident, the US resident must alienate property situated in Canada. The term "alienation" means a sale, exchange, or other disposition or deemed disposition of property that is a taxable event under the taxation laws of Canada and the United States. Deemed disposi-

tions appear to include those arising from changes in the use of assets, gifts, distributions, and changes in certain debts. The alienation of property contemplated by article XIII(8) must occur in the course of a corporate organization, reorganization, amalgamation, division, or similar transaction. Furthermore, profit, gain, or income related to the alienation must not be recognized for the purposes of taxation in the country of residence of the taxpayer—the United States, in the context of this discussion. Note that this provision cannot apply, for example, where a US resident is afforded non-recognition treatment automatically in Canada but not in the United States. In other words, it cannot work in reverse.

The treaty provision permits the US resident ("the person who acquires the property") to request the Canadian competent authority to defer the recognition of profit, gain, or income regarding the property, for the purpose of taxation in Canada, until such time and in such manner as may be stipulated in an agreement between the acquiror of the property and the Canadian competent authority. The competent authority is not required to agree to the deferral upon request but may do so at its discretion.

Example

Assume that a US corporation ("US Parent") holds all the shares of another US corporation ("US Sub"). US Sub holds real property situated in Canada and all the shares of a taxable Canadian corporation ("Can Sub"). If US Sub is wound up into US Parent, a deemed disposition of the Canadian real estate and the shares of Can Sub occurs by virtue of subsection 69(5) and subparagraphs 115(1)(a)(iii), (b)(i), and (b)(iii) of the Act. Under IRC section 338(h)(10), the liquidation may be either a full or partial non-recognition transaction for US tax purposes.

Under article XIII(8) of the Canada-US treaty, US Parent is the acquiror (the purchaser) of the property, and it is the acquiror (purchaser) that may apply to the minister of national revenue for permission to defer Canadian tax on any gain otherwise arising. However, as noted earlier, the application for deferral under section 115.1 requires that the purchaser (US Parent) and the vendor (US Sub) jointly file an election in respect of the deferral. Also as noted earlier, the minister requires US Parent and US Sub jointly to file a waiver of the normal reassessment period. The minister may then agree to treat US Sub's proceeds of disposition of the Canadian real estate as its cost amount, which in turn is deemed to be the cost of the real estate to US Parent for Canadian tax purposes. The minister may further agree to treat the proceeds of disposition of the shares of Can Sub as US Sub's adjusted cost base of those shares.

If the property is depreciable capital property, its tax basis to the purchaser will be preserved by virtue of paragraph 115.1(d). That is, the undepreciated capital cost and capital cost to US Parent for Canadian tax purposes will be the same as those of US Sub immediately before the sale (subject to the parties' agreeing to recognize partial recapture, in which case proceeds will otherwise be in excess of undepreciated capital cost to the vendor). Para-

graph 115.1(e) ensures that the character of the property in Canada to US Parent is the same as it was for US Sub immediately before the disposition.

It is expected that the competent authority of each contracting state will exercise its discretionary authority in this instance only to the extent necessary to avoid double taxation of income otherwise arising, without regard to section 115.1. Therefore, for example, the US competent authority may agree to defer recognition of gain with respect to the transaction if the alienator would otherwise recognize gain for US tax purposes and not recognize gain under Canadian tax law in a converse situation. This provision, however, applies only if the alienation resulting in that gain clearly qualifies under article XIII(8).

ARTICLE 13(6) OF THE CANADA-NETHERLANDS TREATY

Article 13(6) of the Canada-Netherlands treaty is identical to article XIII(8) of the Canada-US treaty, except that the Netherlands treaty provision does not contain the explicit statement that the competent authority may agree to a deferral "in order to avoid double taxation." The omission appears to imply a potentially broader basis for deferral than is provided in the Canada-US treaty.

OTHER ISSUES

The Consideration

None of section 115.1, article XIII(8) of the Canada-US treaty, and article 13(6) of the Canada-Netherlands treaty deals with the Canadian tax treatment of the consideration given by the purchaser to the vendor. In discussions with Revenue Canada, it was indicated that the tax cost of the consideration for Canadian tax purposes may be a part of the agreement arrived at by the vendor, the purchaser, and the minister pursuant to section 115.1.

There are, however, circumstances in which agreement may not be reached and the minister may deny the request for tax deferral. Consider, for example, a US corporation that is carrying on business in Canada through a permanent establishment in Canada, and decides to transfer the Canadian branch to a separate US corporation. For US tax purposes, the transfer can take place on a tax-deferred basis under IRC section 351; however, for Canadian tax purposes, it will be a taxable event. That is, any capital gain on capital property, recaptured capital cost allowance on depreciable capital property, income on inventory, and negative balance of cumulative eligible capital will be recognized in Canada in the year of transfer. Furthermore, part XIV tax may apply on the reduction of the US parent corporation's net investment in Canada.

Revenue Canada is concerned that if, in this situation, deferral of Canadian tax is granted pursuant to section 115.1, Canada may not be capable of enforcing its tax claim under the section 115.1 agreement on a subsequent sale of the US transferee's shares by the US parent. Canada would not have access to the information necessary to monitor such holdings and hence might not be aware of a subsequent sale. Moreover, even if the US parent

corporation in this example agreed to subject itself to tax on a subsequent sale, Canada may have no jurisdiction to collect tax on a gain on shares of a US corporation unless such shares were viewed as real property pursuant to article VI of the Canada-US treaty.[19]

"Profit, Gain or Income" Limitation

Article XIII(8) of the Canada-US treaty provides that where profit, gain, or income arises in respect of a qualifying transaction and it is not recognized for tax purposes in the non-resident's country of residence, the competent authority of the other contracting state may agree to defer recognition of such profit, gain, or income for tax purposes in that state, in order to avoid double taxation. This provision appears to empower the competent authority to defer recognition of profit, gain, or income only to the extent necessary to eliminate double taxation. As noted previously, article 13(6) of the Canada-Netherlands treaty could have broader application since it omits the reference to the avoidance of double taxation.

The concept of profit, gain, or income appears, in the case of the Canadian competent authority, to be profit, gain, or income as computed for Canadian tax purposes; it is not profit, gain, or income as computed for US or Netherlands tax purposes. In the case of capital transactions, reference must be made to paragraph 39(1)(b) of the Act in determining gain for this purpose.

Oil and Gas Example

Anomalous results can occur with respect to Canadian resource properties. Consider, for example, the case of a US or Netherlands corporation carrying on an oil and gas exploration and development business in Canada through a branch in Canada. If the corporation is reorganized on a tax-free basis for US or Netherlands tax purposes, the Canadian tax results can be punitive. This may be the case even within the scope of relief possible under section 115.1, in combination with the limitations imposed for relief under article XIII(8) of the Canada-US treaty and article 13(6) of the Canada-Netherlands treaty.

For Canadian tax purposes, oil and gas property acquisition costs, exploration expenses, and development expenses are accumulated in pools known as cumulative Canadian oil and gas property expense (CCOGPE),[20] cumulative Canadian exploration expense (CCEE),[21] and cumulative Canadian

[19] Article VI of the Canada-US treaty reserves the right of Canada to tax income derived from real property situated in Canada. Article XIII(3) broadens the definition of "real property situated in the other Contracting State" to include "[a] share of the capital stock of a company, the value of whose shares is derived principally from real property situated in Canada; and . . . an interest in a partnership, trust, or estate, the value of which is derived principally from real property situated in Canada."

[20] Defined in paragraph 66.4(5)(b).

[21] Defined in paragraph 66.1(6)(b).

development expense (CCDE),[22] respectively. When Canadian resource property[23] that is oil and gas property is sold, the proceeds are first applied to reduce the CCOGPE account. Any negative CCOGPE balance is then applied to reduce the CCDE pool. Any negative CCDE balance then becomes income. If the vendor is a "principal business corporation,"[24] it will be required to deduct the CCEE account to the extent of its income. If the vendor is not a principal business corporation, the CCEE pool may be deducted without restriction.

In this resource property example, the non-resident "vendor" will be required to utilize its CCOGPE, CCDE, and (possibly) CCEE tax pools before profit, gain, or income will be recognized for Canadian tax purposes. As noted above, profit, gain, or income for Canadian tax purposes is the base available to the minister for purposes of granting deferral and avoiding double taxation. In this case, deferral may be of limited assistance in avoiding future potential double taxation. Furthermore, the inability of section 115.1, in conjunction with the prescribed treaty provisions, to deal with this type of basis or tax pool reduction may indirectly cause acceleration of Canadian tax on the future resource income of a non-resident taxpayer.

Query whether or not it is arguable that for treaty purposes the reduction of resource pools is equivalent to profit, gain, or income, under the doctrine that treaties must be interpreted broadly and liberally in accordance with their spirit.

The Replacement Property Election

Where an alienation occurs and the vendor acquires further property, qualifying as "replacement property,"[25] in the same taxation year, is the vendor required to avail himself of the replacement property election[26] to reduce his profit, gain, or income, prior to determining the amount for purposes of applying for tax relief pursuant to section 115.1? In other words, in computing profit, gain, or income for Canadian tax purposes, and for the purposes of article XIII(8) of the Canada-US treaty and article 13(6) of the Canada-Netherlands treaty, must the alienator take advantage of all other Canadian tax and income deferral opportunities?

Revenue Canada has suggested that it would not be necessary for the taxpayer to seek other elective reliefs, otherwise available, prior to determining Canadian profit, gain, or income for purposes of applying for tax deferral pursuant to section 115.1, article XIII(8) of the Canada-US treaty, and article 13(6) of the Canada-Netherlands treaty.

[22] Defined in paragraph 66.2(5)(b).

[23] Defined in paragraph 66(15)(c).

[24] Defined in paragraph 66(15)(h).

[25] Defined in subsection 44(5).

[26] See subsections 44(1) to (7), 13(4), and 13(4.1).

Enforceability of Agreement

Revenue Canada is concerned about its ability to enforce an agreement arrived at by the vendor, the purchaser, and the minister. This concern exists notwithstanding the power of the minister to require security arrangements in particular circumstances.

There are three elements to a successful application for deferral of tax pursuant to section 115.1:

1) compliance with section 115.1;

2) compliance with article XIII(8) of the Canada-US treaty or article 13(6) of the Canada-Netherlands treaty; and

3) the conclusion of an agreement in respect of the deferral among the vendor, the purchaser, and the minister.

One concern of Revenue Canada is whether a non-resident taxpayer that is party to a section 115.1 agreement and subsequently undergoes a change of ownership will adhere to the agreement. Another concern is the ability of the taxpayer to transfer assets, previously subject to a section 115.1 agreement, outside a corporate group under common control. There is also concern that the taxpayer could avoid tax in Canada, pursuant to a tax treaty or by virtue of the inability of Canada to enforce its claims relative to the treaty.

These concerns evolve out of uncertainty regarding the legal status, under domestic private and public law, as well as international law, of a section 115.1 agreement. Such an agreement is based upon a domestic tax provision with reciprocity in the tax law of the treaty partner, as well as the tax treaty itself. A central question, then, is whether a section 115.1 agreement has priority over the non-resident taxpayer's domestic tax law and the tax treaty.

Perhaps because of these concerns, to date the minister has been very cautious about granting a tax deferral under section 115.1.

Revenue Canada's Risk of Loss

In undertaking a section 115.1 agreement, the minister assumes the risk that the profit, gain, or income in respect of which tax is deferred may disappear in the future. That is, the value of the property subject to the section 115.1 agreement may decline, possibly to a loss position. Revenue Canada has acknowledged that there is nothing in section 115.1 to prevent such an occurrence and that there is potentially the risk that the tax deferred may not be collectable.

CONCLUSION

Article XIII(8) of the Canada-US treaty and article 13(6) of the Canada-Netherlands treaty, in combination with section 115.1 of the Act, provide for similar tax treatment by Canada of certain transactions in respect of which tax may be deferred in a non-resident taxpayer's country of residence. The effect of the treaty provisions and section 115.1 is to establish the degree

of tax symmetry and tax simultaneity required to avoid double taxation of the proceeds of disposition arising from such transactions.

We are only beginning to explore transnational transactions to which section 115.1 may apply. As discussed in this article, anomalous situations may arise where the deferral cannot completely mitigate the incidence of international double taxation.

It is understood that section 115.1 is currently under review by the Department of Finance, in the light of Revenue Canada's recent experience with its application. Furthermore, the enforceability of claim issue is being reviewed by the Department of Justice.

The promulgation of section 115.1 has created new interest in reciprocal provisions under US and Netherlands tax law, whereby US and Netherlands tax relief may be obtained by Canadian residents consistent with Canadian corporate reorganization rules.

It is hoped that we may look forward to broader application of section 115.1 with a greater number of Canada's tax treaty partners.