Dispositions of Interests in and Options on Real Property and Shares by Non-Residents of Canada

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PRÉCIS

En vertu du paragraphe 2(3) de la Loi de l'impôt sur le revenu, ainsi que de l'alinéa 115(1)b) et du paragraphe 115(3), les non-résidents du Canada sont imposés sur les gains à la disposition de droits ou d'options sur des biens, entre autres, des biens immeubles et des actions de certaines sociétés. Toutefois, les termes «droit» et «option» n'y sont pas clairement définis. Le *Bulletin d'interprétation* IT-176R2 comprend des exemples de dispositions de droits et d'options par des non-résidents, mais les termes «droit» ou «option» n'y sont pas définis. Dans cet article, l'auteur tente d'établir le sens de ces mots.

L'auteur examine d'abord la définition des mots selon le dictionnaire et il conclut qu'ils peuvent avoir une application très large. Cependant, après l'analyse des causes fiscales et non fiscales dans lesquelles les termes «droit» et «option» ont été examinés, l'auteur soutient que ces termes doivent être interprétés dans un sens restreint. Selon l'auteur, une interprétation étroite du terme «droit» est également conforme aux pratiques administratives de Revenu Canada dans les cas où le mot est utilisé dans d'autres articles de la Loi.

Plus précisément, l'auteur soutient qu'un «droit» devrait être interprété comme comprenant uniquement un droit absolu, inconditionnel et immédiat dans un bien immeuble ou des actions. Dans le cas d'un droit dans un immeuble, l'auteur soutient que tous les exemples cités par Revenu Canada dans le IT-176R2 constituent des droits immédiats et absolus dans un bien immeuble et, par conséquent, qu'ils reflètent une interprétation étroite du terme «droit». Dans le cas de droits dans des actions, l'auteur se demande si la disposition d'une participation financière dans une société, comme dans l'affaire *Kieboom*, peut être considérée comme une disposition d'un droit pour l'application de l'alinéa 115(1)b). L'auteur conclut que cette réponse dépend également de l'interprétation large ou de l'interprétation étroite du mot «droit».

L'auteur examine aussi la modification apportée en 1991 au paragraphe 115(3) et si, par suite de la modification, la disposition de droits indirects par des non-résidents est maintenant assujettie à l'impôt canadien. L'auteur

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analyse les raisons de la modification de 1991 et il conclut qu'il était peu probable que le Parlement ait eu l'intention d'imposer les dispositions de droits indirects faites par des non-résidents. L'auteur soutient, en se fondant sur les règles d'interprétation applicables aux lois fiscales, que toute incertitude doit être résolue en faveur du contribuable.

De plus, l'auteur examine brièvement l'application de l'article 43.1 aux non-résidents. Enfin, il analyse en détail le IT-176R2 et il s'interroge sur certaines des positions administratives de Revenu Canada qui y sont établies.

ABSTRACT

Subsection 2(3) of the Income Tax Act, together with paragraph 115(1)(b) and subsection 115(3), taxes non-residents of Canada on gains from the disposition of interests or options in respect of, inter alia, real property situated in Canada and shares of certain corporations, but does not fully define the words "interest" and "option." *Interpretation Bulletin* IT-176R2 offers examples of dispositions of interests and options by non-residents but does not actually define "interest" or "option." The author attempts in this article to determine the meaning of these words.

The author first considers the dictionary meaning of the words and concludes that they have potentially broad application. After reviewing both non-income tax and income tax cases that have considered the meaning of "interest" and "option," however, the author argues that the words should be narrowly interpreted. The author submits that a narrow interpretation of the word "interest" is also consistent with Revenue Canada's own administrative practices where the word is used in other sections of the Act.

The author takes the position that an "interest" should be construed to encompass only an absolute, unconditional, and immediate interest in real property or shares. With respect to interests in real property, the author argues that all the examples cited by Revenue Canada in IT-176R2 represent examples of immediate and absolute interests in real property and therefore reflect a narrow interpretation of the word "interest." With respect to interests in shares, the author queries whether the disposition of an economic interest in a corporation, such as occurred in the *Kieboom* case, could be regarded as a disposition of an interest for the purposes of paragraph 115(1)(b). The author concludes that this answer too depends on whether the word "interest" is given a broad or a narrow interpretation.

The author also looks at the amendment to subsection 115(3) in 1991 and considers whether, as a result of the amendment, indirect interests disposed of by non-residents are now subject to tax in Canada. The author considers the reason for the amendment in 1991 and concludes that it was unlikely that Parliament intended to tax dispositions by non-residents of indirect interests. The author argues, on the basis of the statutory rules of interpretation applicable to taxing statutes, that any uncertainty should be resolved in favour of the taxpayer.

The author also briefly considers the application of section 43.1 to non-residents. Finally, the author examines IT-176R2 in detail and questions some of Revenue Canada's administrative positions stated therein.

INTRODUCTION

A non-resident of Canada is subject to tax under the Income Tax Act[1] on dispositions of taxable Canadian property.[2] Taxable Canadian property is defined to include real property situated in Canada, shares of certain corporations that are resident in Canada, and an interest in such real property or shares.[3] In addition, real property and shares that are taxable Canadian property are deemed to include options on and, as a result of a 1991 amendment to the Act, interests in such property, whether or not the property is in existence.[4]

A disposition of an option or an interest in real property or shares of certain corporations includes a deemed disposition of such property.[5] The treatment of options is specifically dealt with in the Act.[6] Section 49 provides that the granting of an option to acquire property (other than an option in respect of a principal residence, an option granted by a corporation to acquire securities of the corporation, or an option granted by a trust under which the optionee may acquire units to be issued by the trust) is deemed to be a disposition of a property with an adjusted cost base of nil.[7] If the option is subsequently exercised, the amount paid for the option is added to the proceeds of disposition of the grantor of the option and the granting of the option is deemed not to be a disposition of property.[8]

Recently, Revenue Canada issued *Interpretation Bulletin* IT-176R2.[9] It offers examples of interests in real property and interests in or options on shares but makes no attempt to define these terms. This article considers the meaning of an interest in or an option on real property and shares, and considers whether the 1991 amendment expands the definition of taxable Canadian property to include certain indirect interests in real property and shares.

LEGISLATIVE HISTORY

Before the enactment of subsection 115(3) in 1975, subparagraphs 115(1)(b)(i), (iii), and (iv) read as follows:

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[1] 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] Paragraph 2(3)(c).

[3] Paragraph 115(1)(b) and subsection 248(1).

[4] Subsection 115(3), amended by SC 1991, c. 49, section 86(3), applicable after July 13, 1990.

[5] *Interpretation Bulletin* IT-420R3, "Non-Residents—Income Earned in Canada," March 30, 1992, paragraph 17.

[6] Employee stock options, which are dealt with in section 7, are not considered in this article.

[7] Subsection 49(1).

[8] Subsection 49(3).

[9] *Interpretation Bulletin* IT-176R2, "Taxable Canadian Property—Interests in and Options on Real Property and Shares," April 23, 1993.

> (1) For the purposes of this Act, a non-resident person's taxable income earned in Canada for a taxation year is the amount of his income for the year that would be determined under section 3 if . . .
>
> b) the only taxable capital gains and allowable capital losses referred to in paragraph 3(b) were taxable capital gains and allowable capital losses from dispositions of property each of which was a disposition of a property (in this Act referred to as a "taxable Canadian property") that was
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> (i) real property situated in Canada, or an interest therein, . . .
>
> (iii) a share of the capital stock of a corporation resident in Canada (other than a public corporation), or an interest therein,
>
> (iv) a share of the capital stock of a public corporation, or an interest therein, if at any time during such of the period of 5 years immediately preceding the disposition.

In 1975, the words "or an interest therein" were deleted from subparagraphs 115(1)(b)(i), (iii), and (iv) and inserted in paragraph 115(1)(b) so that, retroactive to 1972, the paragraph read as follows:

> b) the only taxable capital gains and allowable capital losses referred to in paragraph 3(b) were taxable capital gains and allowable capital losses from dispositions of property each of which was a disposition of property or an interest therein (in this Act referred to as a "taxable Canadian property") that was.[10]

At the same time, subsection 115(3) was added to provide that a property described in, inter alia, subparagraphs 115(1)(b)(i), (iii), and (iv) is deemed to include an option in respect of such property, whether or not the property is in existence.[11] Subsection 115(3) was amended in 1991 to include also an interest in such property, whether or not the property is in existence.[12]

RULES OF STATUTORY INTERPRETATION

Other than the partial definition of the term "interest in real property" contained in subsection 248(4), which is discussed more fully below, the words "interest" and "option" are not defined in the Act and have rarely been considered in an income tax context. Generally, a word in the Act must be given its ordinary meaning and must not be given a technical meaning unless it is apparent that the word refers to a technical concept.[13] Where a word has two possible meanings, the more common or predominant meaning will be preferred to the less common meaning in the absence of a contrary indication.[14]

The meaning of a word should be determined from an examination of the context in which it is used in the Act, and it can derive its meaning

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[10] SC 1974-75-76, c. 26, section 74(3).

[11] Ibid., section 74(8), applicable after May 6, 1974.

[12] See supra footnote 4.

[13] See, for example, *Canterra Energy Ltd. v. The Queen*, 87 DTC 5019, at 5022 (FCA).

[14] *The Queen v. Continental Air Photo Ltd.*, 62 DTC 1306, at 1310 (Ex. Ct.).

from other words or phrases used in the same section.[15] Other sections of the Act should also be examined to see what meaning the particular word has in those other sections, and "*prima facie*, the same words in different parts of the same Statute should be given the same meaning unless there is a clear reason for not doing so."[16]

Although the doctrine of "strict construction" of a taxing statute has receded since the Supreme Court of Canada's decision in *Stubart Investments Limited v. The Queen*,[17] the principle remains that where a "taxing statute is not explicit, reasonable uncertainty or factual ambiguity resulting from lack of explicitness in the statute should be resolved in favour of the taxpayer."[18]

OPTIONS

Meaning of Option

There is little, if any, disparity between the technical and ordinary meanings of the word "option." The *Shorter Oxford English Dictionary*, 3d ed., defines an option as:

> The privilege (acquired on some consideration) of executing or relinquishing, as one may choose, within a specified period a commercial transaction on terms now fixed; esp. that of calling for the delivery (*a call*), or making delivery (*a put*), or both (*a double option*), within a specified time, of some particular stock or produce at a specified price and to a specified amount.

Halsbury's Laws of England states:

> A contract of option is one whereby the grantor of the option offers to enter into what may be called a "major" contract with a second person and enters a separate contract to keep his offer open. . . .
>
> With regard to the envisaged major contract, the effect of the contract of option is to create an irrevocable offer and a power of acceptance.[19]

In *Day v. MNR*, the Tax Appeal Board, after citing definitions of the word "option" in the *Shorter Oxford English Dictionary* and *Osborn's Concise Law Dictionary*, stated that an option is an "obligation to hold an offer open for acceptance until the expiration of a specified time."[20]

In *Canadian Long Island Petroleums Ltd. v. Irving Industries Ltd.*, the Supreme Court of Canada stated that "the essence of an option to purchase is that, forthwith upon the granting of the option, the optionee upon the occurrence of certain events solely within his control can compel a conveyance of the property to him."[21] This statement is consistent with

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[15] See, for example, *Sunbeam Corporation (Canada) Ltd. v. MNR*, 62 DTC 1390, at 1393 (SCC), per Martland J.

[16] *The Queen v. Taylor*, 84 DTC 6234, at 6236 (FCTD), per Cattanach J.

[17] 84 DTC 6305.

[18] *Johns-Manville Canada Inc. v. The Queen*, 85 DTC 5373, at 5384 (SCC), per Estey J.

[19] *Halsbury's Laws of England*, 4th ed., vol. 9 (London: Butterworths, 1974), paragraph 235.

[20] 71 DTC 723, at 726.

[21] (1974), 50 DLR (3d) 265, at 277.

previous case law. In *Paterson v. Houghton*, for example, the Manitoba Court of Appeal stated that an option is "a right acquired by contract to accept or reject a present offer within a limited, or, it may be, a reasonable, time in the future."[22]

An option can be distinguished from a conditional contract. In *Re Longlands Farm*,[23] the defendants indicated in writing that they were "agreeable to the purchase" of certain land from the plaintiff, subject to the defendants' obtaining planning permission and resolving questions of title. The plaintiff, in turn, accepted a nominal sum "in consideration of my holding the property for you."[24] The defendants argued that the plaintiff had granted an option to the defendants to purchase the land, which was terminable by the plaintiff on reasonable notice. The plaintiff, however, argued that the document did not create an option to purchase, notwithstanding the nominal payment to the plaintiff, but was a conditional contract that became absolute when the two conditions were satisfied. The court held in favour of the plaintiff, concluding that the agreement was not an option but a conditional contract. If planning permission had been granted and issues as to title resolved, the defendants would have been compelled to purchase the property. The court held that a conditional contract is inconsistent with an option because, under an option, the optionee is free to decide whether it wishes to proceed with a contract but cannot be compelled to do so. The agreement in this case did not qualify as an "option" because it was not an irrevocable offer with a power of acceptance; rather, the defendants were *obligated* to accept the conveyance of the property if the conditions precedent were satisfied.

The question arises whether an option that can only be exercised after some event occurring in the future which is beyond the control of the optionee should be considered an option for the purposes of subsection 115(3). For example, a testatrix may direct her trustees to convey real property to A on receiving notice in writing from A within three months after the death of the testatrix's sister. In a case where this fact situation occurred, it was held that the personal representatives of A could exercise his future option when A died before the testatrix's sister.[25] It appears that, in these circumstances, the future option had absolutely vested in A at the time of the death of the testatrix, and, of course, it was absolutely certain that the future event—that is, the death of the testatrix's sister—would occur. It is unclear whether a disposition of such an absolute future option is caught by subsection 115(3). If the future option were contingent on A's being alive at the time of the sister's death or on some other uncertain event, or if the option vested subject to a complete divestment, the issue arises whether subsection 115(3) would apply to such a future option. These

[22] (1909), 12 WLR 330, at 332.

[23] [1968] 3 All ER 552 (Ch. D.).

[24] Ibid., at 553.

[25] See *Re Avard*, [1947] 2 All ER 548 (Ch. D.).

issues are similar to the issue whether future interests will be caught by subsection 115(1)(b) and are discussed below, under the heading "Interests."

Options on Real Property

In *Placrefid Ltd. v. The Queen*,[26] which is the only decision to date that has considered the meaning of the word "option" for the purposes of subsection 115(3), it was held that an option cannot be granted unless the grantor of the option has a proprietary right to the property in question.

The facts in *Placrefid* were as follows. A corporation that owned real property in Quebec had borrowed money from a company, Mirlaw, on the security of a second hypothec (mortgage) on the property. The corporation defaulted on its obligations under the hypothec. In January 1979 Mirlaw commenced proceedings against the corporation in the Superior Court of Quebec by way of a dation-en-paiement, under which Mirlaw sought to be declared the owner of the property. On February 1, 1979, Mirlaw and Placrefid, a non-resident of Canada, entered into an agreement in principle ("principe d'entente") whereby Mirlaw agreed to give Placrefid the right to acquire 50 percent of whatever interest in the property the Superior Court might award Mirlaw. This agreement in principle was to be incorporated into a final agreement to be signed by the parties. The details of the agreement were worked out in ensuing correspondence and the final agreement was signed. In the meantime, the court declared Mirlaw to be two-thirds owner of the property.

Although the agreement in principle required Mirlaw to obtain judgment on the hypothec, a subsequent letter provided that Mirlaw was in fact not obligated to obtain judgment in or to settle the proceedings. In addition, it was only on the day Mirlaw was awarded title to the property that a clause was added allowing Mirlaw to cancel the agreement on the payment of $250,000 to Placrefid.

Subsequently, pursuant to the cancellation clause, Mirlaw cancelled the agreement and paid Placrefid $250,000. Revenue Canada assessed Placrefid on the basis that it had disposed of an option to purchase real property situated in Canada for $250,000. Revenue Canada appeared to base its assessment on three principal assumptions: (1) that Mirlaw granted Placrefid the right to purchase 50 percent of the property prior to the date it was awarded judgment; (2) that pursuant to that judgment Mirlaw was awarded two-thirds title to the property; and (3) that Mirlaw reserved to itself the right to cancel Placrefid's right to purchase, on the payment of $250,000 to Placrefid, on the date the Superior Court awarded Mirlaw title.

In the Tax Court of Canada, Couture CJTC observed that Mirlaw was not the owner of the property at the time the agreement in principle was entered into. His Honour held that

> the "entente" . . . outlined in correspondence . . . was never in the nature of an "option" in respect of real property . . . and furthermore, could never be.

[26] 92 DTC 6480 (FCTD), aff'g. 86 DTC 1327 (TCC).

> Legally, Mirlaw did not own the property at the time of the negotiations but merely held an hypothec [mortgage] on same and also had instituted an action to be declared its rightful owner.
>
> Until it was declared the owner of the property by a judgment of a competent tribunal it had no proprietary right whatsoever in the said property and, therefore, could not contractually deal with it in any manner whatsoever.
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> Furthermore, Mirlaw was not even obligated to pursue its litigation regarding the property. . . .
>
> *Without any rights in the property, Mirlaw could certainly not grant what the Respondent referred to as an "option" in respect of it*, any more than it could dispose of it, and the Appellant on its part could not acquire any interest or rights in the said property irrespective of how intense its negotiations with Mirlaw were.
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> In my opinion the "entente" between the parties consisted simply of an undertaking on the part of Mirlaw to cause the property to be conveyed to the Appellant in the event that it became the owner. It created a personal obligation for Mirlaw. . . . It was also agreed that this undertaking would lapse if Mirlaw elected to terminate the "entente" [emphasis added].[27]

In the Federal Court—Trial Division, Joyal J quoted from and fully subscribed to the reasoning above, and added:

> In essence, whatever right the defendant acquired through its "option" it was not a *jus in rem* which would have entitled the defendant to specific performance in the event of default.[28]

Although the *Placrefid* case was decided under the laws of Quebec, it is submitted that the decision is consistent with the principle set forth in the *Canadian Long Island Petroleums* case[29]—that is, an optionee must forthwith, on the granting of the option, be entitled to compel conveyance of the property to him. In *Placrefid*, the court held that the agreement between the parties was not an option because Mirlaw was not in a position to convey the property to Placrefid at the time the agreement was entered into.

Options on Shares

Clearly, the principle that was applied in the *Placrefid* case—namely, that without any rights in property, a person may not grant an option in respect of it—should not apply to shares. Subsection 115(3) states expressly that an option in respect of a share will be taxable Canadian property whether or not the share is in existence, and a person cannot have proprietary rights in a property that is not in existence. With the exception of this issue, however, an option in respect of shares should have the same meaning as an option in respect of real property.

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[27] Ibid., at 1333-34 (TCC).

[28] Supra footnote 26, at 6486 (FCTD).

[29] Supra footnote 21.

Allocation Issues

In paragraph 3 of IT-176R2, Revenue Canada indicates that a warrant or other right to acquire a share, or a note or other instrument that is convertible into a share, constitutes an option in respect of a share if it is irrevocable for a specified period of time. A disposition of a convertible debt instrument would therefore also result in a disposition of the option contained in the debt instrument. This treatment, however, raises practical problems as to the value of the conversion feature that is being disposed of. Presumably, only the gain attributable to the conversion feature, and not the gain attributable to the debt itself, would be taxable in Canada in the hands of a non-resident since a debt instrument is not included in the definition of taxable Canadian property. Paragraph 3 of IT-176R2 suggests, however, that the option would encompass the entire convertible debt instrument, provided that the conversion feature was irrevocable for a specified period of time. If, indeed, this were the case, it is arguable that the entire gain on the disposition of the debt instrument, and not just the portion attributable to the conversion feature, would be taxed in the hands of the non-resident.

Assuming, however, that the correct view is that only the conversion feature (that is, the option) is taxable Canadian property, it would be necessary for the non-resident to allocate the proceeds of the disposition between the debt and the conversion feature on disposition. The cost of the debt instrument also would have to be allocated between the debt and the conversion feature to determine the gain attributable to the conversion feature. Revenue Canada has indicated in *Interpretation Bulletin* IT-96R[30] that in the case of a security issued with a conversion feature that is not severable from the security, no portion of the issue price for the security can be allocated to the conversion feature, and, where the security is converted, no allocation of the proceeds of disposition would be made. In a technical interpretation,[31] however, Revenue Canada stated that where a "substantial" amount was paid for the option privilege, it could be argued that a portion of the purchase price was paid for the option. On this basis, it can presumably be argued that all of the proceeds on the sale of the debt instrument should prima facie be allocated to the debt unless there is clear evidence that the conversion feature has some real value.

INTERESTS

Types of Interests

The word "interest" has an extremely broad meaning. The *Shorter Oxford English Dictionary*, 3d ed., defines interest as:

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[30] *Interpretation Bulletin* IT-96R, "Options Granted by Corporations To Acquire Shares, Bonds or Debentures," May 13, 1991, paragraph 6.

[31] Financial Industries Division of the Legislature and Intergovernmental Affairs Branch, December 23, 1991, as reported in Claude Désy, ed., *Access to Canadian Income Tax* (Markham, Ont.: Butterworths) (looseleaf), paragraph C38-123.

> The relation of being objectively concerned in something, by having a right or title to, a claim upon, or a share in. Legal concern in a thing; esp. right or title to property, etc.

Black's Law Dictionary, 6th ed., defines interest as:

> The most general term that can be employed to denote a right, claim, title, or legal share in something. . . .
>
> More particularly, it means a right to have the advantage accruing from anything; any right in the nature of property, but less than title.

A right in a property ordinarily consists of the right to use, enjoy, or alienate the property; looked at negatively, it is a right to exclude others from using, enjoying, or alienating the property. The total collection of interests in a property may be subdivided or qualified in a number of different ways. Interests may be subdivided into legal and beneficial interests, as in the case of a trust. Interests may be subdivided into concurrent interests, as in the case of a joint tenancy or a tenancy in common, or into successive interests, as in the case of a present life estate and a future remainder. Successive interests generally consist of an immediate, or present, interest and one or more future interests. A future interest is an interest in which the right to possession or enjoyment of the property is postponed to a future time. It should be noted that even though a remainderman's right to enjoy the property is postponed until the life tenant's death, the remainderman does have a present right to dispose of his future interest in the property. A future interest may be absolute—that is, absolutely vested—or contingent. An absolutely vested future interest is an interest that cannot be taken away by the occurrence or non-occurrence of a subsequent event. A contingent future interest could disappear on the occurrence or non-occurrence of a subsequent event.

This is only a partial list of the bewildering array of interests into which a property may be subdivided. Adding to the confusion is the fact that the determination of the type of interest in property that has been granted often depends on the construction as a whole of the instrument that creates the interest and on certain rules of construction that relate to the specific conditions or qualifications attached to the interest.

Meaning of "Interest"

It is suggested that the word "interest" in paragraph 115(1)(b) should be construed so as to mean an absolute, unconditional, and perhaps even immediate interest in real property or shares. Had Parliament wished to include future, contingent, or additional interests within the meaning of "interest," it could easily have done so, and indeed has done so in the context of interests in trusts. Subsection 248(25) provides that

> [f]or the purposes of this Act, a person or partnership is beneficially interested in a trust if the person or partnership has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of any discretionary power by any person or persons), to receive any of the income or capital of the trust, either directly from the trust or indirectly through one or more trusts.

Paragraph 108(1)(c) provides that

> "capital interest" of a taxpayer in a trust means
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> (i) in the case of a personal trust or a prescribed trust, a right (whether immediate or future and whether absolute or contingent) of the taxpayer as a beneficiary under the trust to, or to receive, all or any part of the capital of the trust, and
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> (ii) in any other case, a right of the taxpayer as a beneficiary under the trust.

Paragraph 108(1)(b) defines a beneficiary under a trust as including a person beneficially interested therein, thus linking subparagraph 108(1)(c)(ii) to subsection 248(25). Paragraph 108(1)(e) defines an income interest of a trust in terms similar to those of subparagraph 108(1)(c)(i).

It is more the rule than the exception for a beneficiary's interest in a trust to be a contingent interest, a future interest, or an interest conditional on the exercise of the discretion of the trustees. Nevertheless, Parliament felt constrained to clarify the term "beneficiary" by including paragraph 108(1)(b) and subsection 248(25) in the Act. In a non-trust setting, it is not the rule for an interest in real property or shares to be a conditional, a contingent, or a future interest. The presence of such words in parentheses in subsection 248(25) and the absence of such words in paragraph 115(1)(b) implies that Parliament did not intend an interest in paragraph 115(1)(b) to include a future, a contingent, or a conditional interest.

The argument in favour of such a narrow interpretation is supported by the decision of the Exchequer Court of Canada in the case of *MNR v. Shaw Estate*.[32] The issue in that case was whether amounts paid under two insurance policies were to be included in the aggregate net value of the deceased's property passing on death under section 3(1)(j) of the Estate Tax Act. That provision required that "any annuity or other *interest* purchased or provided by the deceased" be included in the computation of the aggregate net value of the property passing on death. The minister included the amount paid under the insurance policies in the deceased's estate and the estate objected. In holding for the estate, the court considered the possible definitions attributable to the word "interest" but concluded that "[section 3(1)(j)] is directed toward the purchase or provision of an 'interest' *as such*, and being a charging provision, it should be strictly construed and should not be extended by such a process of rationalization to embrace every contract creating contractual or statutory rights."[33]

Under real property law, an option creates an equitable interest in real property.[34] In *Frobisher Ltd. v. Can. Pipelines*,[35] the Supreme Court of Canada was asked to consider whether an option to purchase certain min-

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[32] 71 DTC 5041 (Ex. Ct.).

[33] Ibid., at 5046, in footnote.

[34] *Politzer v. Metropolitan Homes Ltd.* (1975), 54 DLR (3d) 376 (SCC).

[35] (1959), 21 DLR (2d) 497 (SCC).

ing claims created an interest in those claims. The majority of the court held that the option did create an interest in the mining claims. Judson J, holding with the majority, stated:

> Does an option to purchase land give rise to an equitable interest in land? The question has usually been considered in connection with conveyances and leases and the rule against perpetuities, and it has been held that the option is too remote if it can be exercised beyond the perpetuity period. The underlying theory is that the option to purchase land does create an equitable interest because it is specifically enforceable. There is a right to have the option held open and this is similar to the right that arises when a purchaser under a firm contract may call for a conveyance. In both cases there is an equitable interest but in the case of the option it is a contingent one, the contingency being the election to exercise the option.[36]

However, the fact that paragraph 115(1)(b) of the Act refers to "property or an interest therein" and subsection 115(3) refers to "property . . . any interest therein or option in respect thereof" suggests that Parliament did not, for the purposes of paragraph 115(1)(b), consider the word "interest" in property to include an option in respect of property. In an opinion dated October 16, 1990, the Reorganizations and Non-Resident Division of Revenue Canada adopted similar reasoning in concluding that the term "real property" in paragraph 85(1.1)(f), as it read at that time, did not include an option in respect of real property, since paragraphs 85(1.1)(a), (b), and (h) all referred to "real property, an interest therein or an option in respect thereof," while paragraph 85(1.1)(f) referred only to "real property."[37]

Interests in Real Property

In paragraph 2 of IT-176R2, Revenue Canada states that an interest in real property includes, for example, a part ownership or a legal share in real property. These appear to represent examples of immediate and absolute interests in real property, since Revenue Canada also gives an inheritance right as a separate example, defining an inheritance right as a remainder interest in real property for which present enjoyment has been postponed until the death of the life tenant. An inheritance right appears to be an example of an absolute future interest, since the conveyance to the remainderman (or his heirs) is assured, even though it is suspended until the death of the life tenant, unless there is an expressly stated intention to the contrary. Revenue Canada's examples thus appear to reflect a narrow interpretation of the word "interest."

In a different but analogous context, Revenue Canada also gives a narrow interpretation to the word "interest" when considering whether a person holding a partnership interest also has an "interest" in any underlying real property owned by the partnership. In a continuing partnership, each partner has a beneficial interest in the property of the partnership. The beneficial interest is said to be several and in the nature of a future interest since it

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[36] Ibid., at 532.

[37] As reported in *Access to Canadian Income Tax*, supra footnote 31, at paragraph C82-041.

takes effect in possession on, but not before, the termination of the partnership. This is because during the currency of the partnership, each partner is entitled to require the partnership property to be applied for the purposes of the partnership and no partner is entitled to the several enjoyment of his share.[38] On the termination of the partnership, the beneficial interest of the partner takes effect, subject, however, to the right of the other partners to have the property of the partnership applied in satisfaction of the debts and liabilities of the partnership. In the absence of an agreement to the contrary, this means that the partner will be entitled to receive only the net proceeds after the payment of the partnership's liabilities.[39] Moreover, insofar as partnership land in particular is concerned, at common law generally the interest of a partner in land that has become partnership property is treated as personal property of the partner and not realty.[40]

Given the nature of this interest, Revenue Canada has been prepared to distinguish between the interest that the partner holds in a partnership and the interest of the partner in the underlying real property owned by the partnership. The issue has arisen in the context of a transfer of real property under section 85. That section prevents a non-resident from disposing of real property or an interest in real property to a taxable Canadian corporation on a rollover basis (except in limited circumstances). Revenue Canada has stated that, for the purposes of section 85, an interest in a partnership is not considered to be an interest in the underlying assets of the partnership. Therefore, Revenue Canada will generally permit a non-resident who holds a partnership interest as capital property to roll over the partnership interest under section 85, even though the assets of the partnership consist primarily of real property.[41]

In *In Re Steed and Raeburn Estates*,[42] a case dealing with the now repealed Succession Duty Act, it was stated that an interest in property for the purposes of that Act must be a proprietary interest. The facts were as follows. Bonnie Steed died domiciled in California and left to her husband, George Steed, her entire estate. At the time of her death, Bonnie had a right to have her sister's estate administered. Bonnie's sister, who died domiciled in British Columbia and left Bonnie everything, was, at the time of her death, entitled to a cash legacy out of her husband's estate. The legacy had not been paid, however, because the bulk of her husband's estate, BC real property, had not yet been sold by the administrator of the

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[38] See Ernest H. Scamell and R.C. I'Anson, *Lindley on the Law of Partnership*, 15th ed. (London: Sweet & Maxwell, 1984), 517.

[39] Ibid. See also Ontario Partnerships Act, RSO 1990, c. P.5, section 39.

[40] See supra footnote 38. See also Ontario Partnerships Act, supra footnote 39, at section 23.

[41] See "Revenue Canada Round Table," in *Report of Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 50:1-68, question 35, at 50:19.

[42] 49 DTC 580 (SCC).

estate. Thus, George Steed, at the time of his death, was indirectly entitled to a cash legacy to be paid from the proceeds of sale of BC real property.

The court (Locke J dissenting) held that George Steed's property interest consisted solely of a right to have his wife's estate administered, and since Bonnie Steed died domiciled in California, that property interest was situated in California and not in Canada. Some members of the court commented on the meaning of "property" in section 2(k) of the Succession Duty Act, which defined property to include

> property, real or personal, movable or immovable, of every description, and every estate and *interest* therein or income therefrom capable of being devised or bequeathed by will or of passing on . . . death [emphasis added].

Kerwin J (Duff CJ concurring) stated:

> in a loose and general way of speaking, George Steed had an interest in the British Columbia real estate . . . but what is referred to in [section 2(k)] is not such a nebulous interest *but a proprietary interest*, either legal or such an equitable one that is recognized by our Courts, and that Steed did not have. All that devolved upon his death was a right to have the estate of Bonnie Steed administered; and that right was a chose in action properly enforceable and therefore situated in California and not in Canada [emphasis added].[43]

In the *Canadian Long Island Petroleums* case,[44] the Supreme Court of Canada considered whether a right of first refusal constituted an interest in real property. If it did, the right would have been void as a violation of the rule against perpetuities. The court held that the right of first refusal did not constitute an interest in real property on the basis that the right was not specifically enforceable at the time the agreement containing the right was executed. The contingency in the right of first refusal clause was resolved solely on the decision of the *other* party to sell, and it was outside the power of the holder of the right to compel the other party to sell the property to him.

In the *Placrefid* case,[45] the Tax Court of Canada held that Mirlaw had no right in the land at the time the "entente" was entered into and that, accordingly, Placrefid could not acquire any interest or rights in the property. This holding was cited with approval by the Federal Court—Trial Division. There is, however, no indication in the reported decisions that the Crown suggested that Placrefid had disposed of an interest in the land. One can speculate as to why the Crown did not argue the point. First, the Crown may have been prepared to concede that if the "entente" did not create an option in the land, it could not have created an interest in the land. Second, it may have felt that Placrefid could have escaped Canadian

[43] Ibid., at 583.

[44] Supra footnote 21.

[45] Supra footnote 26.

tax by relying on the Canada-Switzerland tax convention[46] if the "entente" were considered to create an interest in land, but not an option in land. Subsection 115(3), as it read at the time, did not deem a real property situated in Canada to include an interest in respect of real property. This, however, does not fully explain the Crown's failure to make the argument since the Crown was unwilling to concede that Placrefid was entitled to rely on the Canada-Switzerland tax convention in the first instance.

The Federal Court—Trial Division in *Placrefid* held that the "entente" created only a "personal obligation" for Mirlaw. However, a leasehold interest creates an interest in real property even though it is personal property. In the case of *CTL Uniforms Ltd. v. ACIM Industries Ltd.*,[47] the High Court considered whether a lease of real property was a registerable interest under the Personal Property Security Act (PPSA) of Ontario. The PPSA permitted the registration of a security interest only in respect of personal property. The court held that a lease of real property was personal property. The court referred to the text *Introduction to Real Property Law* by Professor Alan M. Sinclair, wherein the author explained the nature of a leasehold interest:

> As all property was supposed to be either real or personal, and as the leasehold interest was so obviously more connected with land than with chattels, a new category had to be created by the courts to encompass this interest. Partaking of land but not accommodating a real action, it became a hybrid, a chattel real. It was inherently connected with land but it had to be treated on a personal basis as a chattel and so the category of personal property was expanded so as to include chattels real and chattels personal. This classification remains today.[48]

It is worth noting that subsection 248(4) provides specifically that a leasehold interest is an interest in real property. The specific inclusion of a leasehold interest in this category appears merely to confirm the common law. Subsection 248(4) also provides that an interest in real property does not include a security interest in real property, such as a mortgage.

An easement also is an interest in land. Essentially, the holder of the easement (that is, the owner of the dominant tenement) is entitled to compel the use or restrict the use of the real property of the donor of the easement (that is, the servient tenement).[49]

An interest in land also includes a profit à prendre. A profit à prendre gives the holder of the interest the right to take a portion of, or the product of, the real property of the giver.[50] The subject matter of a profit à prendre

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[46] The Convention Between Canada and Switzerland for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, signed at Berne on August 20, 1976.

[47] (1981), 33 OR (2d) 139 (HCJ), aff'd. (1982), 35 OR (2d) 172 (CA).

[48] Ibid., at 146 (HCJ), quoting from Alan M. Sinclair, *Introduction to Real Property Law* (Toronto: Butterworths, 1969), 13.

[49] *Abell v. Municipal Corporation of County of York* (1920), 57 DLR 81 (SCC).

[50] *Cherry v. Petch et al.*, [1948] OWN 378 (HCJ).

could be minerals, gravel, timber, oil and gas, fish, animals, etc. In many cases, a profit à prendre will be a Canadian resource property[51] and will, therefore, be taxed under paragraph 115(1)(a) of the Act when disposed of by a non-resident.

Unlike a leasehold interest, a licence is not an interest in real property but a personal right between the licensor and the licensee.[52] A licence is a right or a privilege to enter upon and use the licensor's land in a certain manner or for a specified purpose. It is often difficult to distinguish between a lease and a licence. As with profits à prendre, many licences of real property in Canada will be Canadian resource properties.

Interests in Shares

There appear to be few, if any, cases decided in Canada that have considered the term "interest in a share." An interest in a share is, of course, routinely divided into a legal interest belonging to a broker and a beneficial interest belonging to the person for whom the broker holds the share, and it is only the beneficial owner who will be taxed under paragraph 115(1)(b) on a disposition of the share.

On the theory that a share is a bundle of rights that entitle the beneficial holder thereof, inter alia, to vote at shareholders' meetings, to receive the property of the corporation on dissolution, or to receive a dividend, it is theoretically possible to subdivide these entitlements and dispose of them individually. Thus, paragraph 115(1)(b) could conceivably apply to non-residents who have entered into "dividend rental arrangements."[53] There is no indication, however, that Revenue Canada would reassess such non-residents on the basis that they had disposed of interests in shares.

In the case of *Kieboom v. MNR*,[54] the Tax Court of Canada held that the taxpayer had disposed of part of the value or economic interest of the taxpayer's shares in a company by causing the company to issue shares to the taxpayer's spouse for nominal consideration. The judge distinguished between a disposition of shares in a company and a disposition of the economic interest of the shares.[55] The taxpayer's "economic interest" in a share was defined to mean the taxpayer's interest in a total of all the rights and privileges that are inherent in the shares. The Tax Court concluded that the taxpayer disposed of a part of those rights and privileges by diluting his shareholdings in the company. Whether or not such an economic interest would constitute an interest for the purposes of paragraph 115(1)(b) will depend on whether "interest" is given a narrow or a wide construction.

Paragraph 3 of IT-176R2 implies that a warrant or other right to acquire a share or a note or other debt instrument that is convertible into a share

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[51] Paragraph 66(15)(c).

[52] *Re BA Oil Co. & Halpert*, [1960] OR 71 (CA).

[53] Subsection 248(1).

[54] 90 DTC 1612.

[55] Ibid., at 1616.

will constitute an interest in a share if the warrant (or other right) does not constitute a true option in respect of the share—that is, if it is not an irrevocable offer to acquire the share within a specified time. It is submitted that this interpretation must be incorrect. If the right to acquire the share were revocable by the grantor of the right at any time, it would appear that no binding contract had been concluded and that, therefore, the grantee of the right would have no entitlement to acquire the share before actually exercising the right.[56]

SUBSECTION 115(3)

Purpose

It has been suggested that the addition of subsection 115(3) to the Act in 1974 was motivated by a concern that non-residents would be able to avoid Canadian tax on capital gains through the use of options in several ways. First, it was arguable that options on taxable Canadian property might not be taxable under paragraph 115(1)(b) even if an option were considered to constitute "an interest" in such property, since subdivision c of part I provided specific treatment for options. Second, options on non-existent taxable Canadian property, such as unissued shares, appeared not to be caught by paragraph 115(1)(b). Third, even if an option on Canadian real property was taxable under the Act, Canada's income tax treaties precluded the imposition of Canadian tax on a non-resident who disposed of movable property, and an option in respect of real property appeared to be movable property.

To address the first and second issues, subsection 115(3) provided that an option would be taxable Canadian property even if the underlying property were not yet in existence. To address the third issue, subsection 115(3) provided that each category of taxable Canadian property included an option on such property. As a result, a disposition of an option held by a non-resident in respect of real property situated in Canada was deemed to be a disposition of real property.[57]

Effect of 1991 Amendment

As previously indicated, in 1991 subsection 115(3) was amended, inter alia, to deem a share described in subparagraph 115(1)(b)(iii) or (iv) to include an interest in such a share.[58] This amendment may have been introduced to allow Canada to tax the disposition of a debt convertible into shares even if the shares did not exist. Revenue Canada had previously accepted that such a disposition was not caught by paragraph 115(1)(b).[59]

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[56] See, for example, the Tax Appeal Board's comments in *Day*, supra footnote 20, at 726-27.

[57] J.S. Peterson, "Canadian Taxation of Non-Residents," in *Report of Proceedings of the Twenty-Sixth Tax Conference*, 1974 Conference Report (Toronto: Canadian Tax Foundation, 1975), 262-74, at 269-70.

[58] See supra footnote 4.

[59] *Interpretation Bulletin* IT-176R, "Taxable Canadian Property," September 2, 1975, paragraph 3.

Revenue Canada's current position is that the amendment to subsection 115(3) considerably extends the scope of property described in subparagraph 115(1)(b)(iv). That subparagraph defines taxable Canadian property to include a share of a public corporation if a non-resident or one or more persons not dealing at arm's length with the non-resident held at least 25 percent of any class of the issued shares of the public corporation in the five years immediately preceding the disposition. In paragraph 4 of IT-176R2, Revenue Canada indicates that it will treat options to acquire shares of a public corporation as having been exercised for the purpose of determining whether the 25 percent ownership test has been met, and that an interest in a share will also be included when the 25 percent test is applied.

Revenue Canada's interpretation appears to be too broad. It is based on the assumption that the words "a property described in subparagraphs 1(b)(i) and (ix) . . . whether or not such property is in existence" in subsection 115(3) refer to two properties in subparagraph 115(1)(b)(iv): (1) "a share of the capital stock of a public corporation if at any time," and (2) "the issued shares of any class of the capital stock of the corporation." It is submitted that only the first property, "a share," is described in subparagraph 115(1)(b)(iv), and that the entire subparagraph is taken up with its description. Subsection 115(3) refers to "a property described in subparagraphs (1)(b)(i) to (ix)," and each of these subparagraphs describes a property in the singular. The phrase "issued shares" is simply a part of the description of the single share described in subparagraph 115(1)(b)(iv). Furthermore, the phrase "issued shares" in subparagraph 115(1)(b)(iv) contradicts the words "whether or not such property is in existence" in subsection 115(3). The legislative history of subparagraph 115(1)(b)(iv) supports the argument that only one property is described in subparagraph 115(1)(b)(iv). As noted above, before the enactment of subsection 115(3), the words "or an interest therein" immediately followed "a share of the capital stock of a public corporation" in subparagraph 115(1)(b)(iv), but they did not modify the phrase "issued shares."

The 1991 amendment to subsection 115(3) did, however, broaden the scope of paragraph 115(1)(b) in two respects. First, because an interest in respect of real property is deemed to be real property, a gain on the disposition of a leasehold interest (or any other interest in real property) by a non-resident may now be subject to tax in Canada as real property and therefore not exempted under a tax treaty. Canada's tax treaties generally exempt gains realized by residents of the other contracting state on dispositions of property other than real property or immovable property. By deeming an interest in real property to be real property, amended subsection 115(3) will generally prevent a resident of a contracting state from relying on the gains exemption in the applicable treaty.

More profoundly, the combined effect of paragraph 115(1)(b) and subsection 115(3) may be to tax non-residents on dispositions of an *interest in an interest* in real property situated in Canada or an interest in a share described in subparagraphs 115(1)(b)(iii) and (iv). This follows from the wording in paragraph 115(1)(b), which provides that taxable Canadian

property includes an "interest in" the property described in subparagraphs (i) to (ix). Subparagraphs (i), (iii), and (iv) refer to real property situated in Canada, shares of a resident corporation other than a public corporation, and shares of a public corporation in certain limited circumstances.

In the *Re Steed* case, it was held that an indirect interest will not constitute an interest in real property because it is too remote. Kellock J stated:

> In my opinion, while "property" is defined by section 2(k) of the [Succession Duty Act] as including every estate and "interest" capable of being devised or bequeathed by will or of passing on death, I see no reason for construing this statute, without more express language, as including an interest in an interest or more remote interests.[60]

It is arguable that the effect of the amendment to subsection 115(3) in 1991 is to catch indirect as well as direct interests. If this is the case, however, it is curious that neither IT-176R2 nor the technical notes released by the Department of Finance in conjunction with the amendment to subsection 115(3)[61] makes any mention of this fact. Absent an amendment to delete the words "or interest therein" from paragraph 115(1)(b), the disposition of more remote interests by a non-resident could be taxable in Canada. So, too, for example, could the disposition by a non-resident of a capital interest in a non-resident trust that owns real property situated in Canada. If this was not Parliament's intention, an amendment to the introductory words in paragraph 115(1)(b) is in order. The *Shaw Estate*[62] case notwithstanding, the deletion of the reference in paragraph 115(1)(b) to "an interest" would clarify that a capital gain on the disposition by a non-resident of an indirect interest in real property or in certain shares is not subject to tax in Canada. Unless the Act is amended, non-resident taxpayers will be forced to rely on the principles of statutory interpretation discussed above.

APPLICATION OF SECTION 43.1

It appears that in the circumstances contemplated by section 43.1, a non-resident will be considered to have disposed of an interest in real property for the purposes of paragraph 115(1)(b). Subsection 43.1(1) provides that where at any time a taxpayer disposes of a remainder interest in real property and retains a life estate in the property, the taxpayer will be deemed to have disposed, at that time, of the life estate in the property for proceeds equal to fair market value and to have reacquired the life estate immediately after that time at a cost equal to the fair market value. It is clear that paragraph 115(1)(b) will apply to deemed dispositions for deemed

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[60] Supra footnote 42, at 589.

[61] Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: the department, May 1991), clause 86; see also Canada, Department of Finance, *Explanatory Notes to Draft Income Tax Amendments* (Ottawa: the department, July 1990), clause 84.

[62] Supra footnote 32.

proceeds.[63] It is also clear that if there is a direct conveyance of real property to a person for a life estate so as to give that person the legal estate, that person has an interest in real property. It may be arguable that where real property is conveyed to a trustee in trust for a person for life, that person does not have an interest in real property but an income interest in a trust,[64] particularly where that person is not entitled to possession of the real property but is entitled only to receive the rents or profits of the real property during the life estate. It seems, however, that subsection 43.1(1) is intended to apply only to a person who holds a fee simple in real property and who carves the fee simple into successive interests. In these circumstances, where a non-resident creates and disposes of a remainder interest in real property that the non-resident absolutely owned and that is capital property, section 43.1 should apply to deem the non-resident to have effectively disposed of the entire ownership interest in the real property for proceeds equal to fair market value for the purposes of paragraph 115(1)(b).

CONCLUSION

Real property and shares that are taxable Canadian property are deemed to include an option or an interest in such property, whether or not the property is in existence. Since "option" is not defined and "interest" is only partially defined in the Act, it is necessary to look to non-income tax cases to determine what these words mean. The case law dealing with options is relatively straightforward. An option is generally defined to be a contract with an irrevocable offer and a power of acceptance. In the income tax context, it was held in *Placrefid* that an option on real property cannot be granted unless the grantor of the option has a proprietary right to the property in question. This is not the case with an option on shares that are taxable Canadian property, because subsection 115(3) specifically provides that an option on shares will be taxable Canadian property even if the shares are not yet in existence.

Revenue Canada takes the position that subsection 115(3) permits it to take into account options that a non-resident holds in public corporations in determining whether the public shares are taxable Canadian property under subparagraph 115(1)(b)(iv). The specific wording of the subparagraph, however, does not appear to support this position. Revenue Canada is also of the view that a debt obligation that is convertible into shares that are taxable Canadian property constitutes an option for the purposes of subsection 115(3). This position raises issues relating to the allocation of both the cost and proceeds in connection with the conversion feature.

It is unclear whether an option that can be exercised only after some event that occurs in the future is caught by subsection 115(3). A similar

[63] See, for example, *Gladden Estate v. MNR*, 84 DTC 1242 (TCC); this issue was not argued on appeal to the Federal Court—Trial Division, 85 DTC 5188.

[64] Such income interest for trust purposes would be treated as a capital interest or an income interest for the purposes of the Act, depending on whether the trust was a personal trust.

issue arises with respect to future interests. The term "interest" is susceptible of broad interpretation. It is submitted, however, that the term should be narrowly construed to mean only an absolute, unconditional, and perhaps even immediate interest in real property or shares that are taxable Canadian property. Had Parliament intended to catch future and contingent or conditional interests, subsection 115(3) could have referred specifically to these interests, as, for example, paragraph 108(1)(c) does with its definition of a capital interest in a trust. In addition, the rules of statutory interpretation applicable to income tax matters favour a narrow interpretation of the term. It is clear, however, that the language is broad enough to catch the disposition referred to in section 43.1.

The amendment to subsection 115(3) in 1991, however, did extend the scope of the provision to include an interest in an interest in taxable Canadian property. It is submitted that this was an unintended consequence that should be corrected by statutory amendment.