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Investing in Canadian Real Estate and Lending on the Security of Canadian Real Estate

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INTRODUCTION

This summary highlights some of the issues that non-Canadians encounter when investing in or lending on the security of Canadian real estate. Like any summary, it does not replace legal advice tailored to the specific circumstances of your business.

Canada

Canada is a federal state with legislative authority divided between the federal government, the 10 provinces and three territories. All the provinces (other than Québec) and the three territories derive their laws from the English common law system – like the United States – and there is much uniformity in custom and statute law. In Québec, the *Civil Code* deals with many of the provisions affecting real estate law in a manner different from, for example, the laws of the neighbouring province of Ontario.

Over 85 percent of Canada's population is located in the provinces of Ontario, Alberta, British Columbia and Québec; 38 percent alone in the province of Ontario. Ninety percent of Canada's population is found within 160 kilometres (100 miles) from the United States border, much of which is concentrated in Toronto, Montréal, Calgary and Vancouver.

Investors' Goals

In advising non-Canadians in connection with their Canadian real estate holdings, the goals that we are most often asked to achieve include the following:

- maximizing liquidity,
- minimizing tax costs,
- avoiding or minimizing potential liability,
- achieving an optimal organizational structure,
- avoiding undue complexity, and
- minimizing transaction costs.

These goals must be kept in mind when structuring the investment or lending arrangements.

STRUCTURING THE INVESTMENT

While keeping in mind the goals of the investor, the major issues for structuring are selecting the appropriate investment vehicle and tax considerations.

The Appropriate Investment Vehicle

Joint Venture

An investment may be direct or through a joint venture with an entity based in Canada. There are several advantages to using a joint venture, which include accessing the local participant's expertise and knowledge in the market, as well as certain tax advantages. However, joint ventures also restrict freedom of action. If a joint venture structure is selected, appropriate due diligence with respect to the joint venture participant is advisable.

Joint ventures may be structured as a general partnership, a limited partnership, a corporation, a co-ownership or a trust.

Nova Scotia Unlimited Liability Company

The income tax laws of the United States permit a corporation formed in Canada to be treated as a partnership for US tax purposes if (but only if) the laws of the jurisdiction of the corporation provide that the liability of all the shareholders or members of such corporation is unlimited. Currently, in Canada only a Nova Scotia Unlimited Liability Company (NSULC) is capable of meeting this test (though the Province of Alberta has introduced legislation which will permit the creation of a corporation designed to meet the test). The NSULC will be taxed as a flow-through entity for US tax purposes unless an election is filed requesting that the NSULC be treated as a corporation for US tax purposes and as an ordinary corporate entity fully subject to Canadian corporate tax. US investors in Canadian real estate are attracted to the NSULC concept because it allows for the flow-through of the NSULC's income or loss to its US shareholders without hampering its Canadian tax treatment. The primary disadvantage of the structure is the loss of limited liability protection for shareholders which would otherwise be the case in a typical Canadian corporation.

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Trusts and REITs

Although trusts do not pay capital tax, their income tax rate is higher than that of a corporation. However, trusts are not subject to the restrictions on interest deductibility imposed by Canadian thin capitalization rules (see *Certain Features of the Canadian Tax System* on page 12).

Investment in the units of a Canadian real estate investment trust ("REIT") is generally attractive to a

foreign investor, but no more than 49 percent of all REIT units that may be held by non-residents of Canada.

Certain Features of the Canadian Tax System

In Canada, taxes are imposed on income and capital. In addition, there are real estate taxes, land transfer taxes and registration taxes. There is also a consumption based tax known as the goods and services tax.

The federal government imposes income taxes, goods and services tax, and taxes on capital. Provincial governments tax income and capital and, along with municipal governments, impose taxes on real estate, including taxes on the transfer of real estate and annual property taxes.

The effective Canadian corporate income tax rate is a combination of both federal and provincial income tax rates.

Direct ownership of Canadian real estate by an investor not resident in Canada will lead to taxation of income either on a withholding basis or, if the activity amounts to the carrying on of a business, on a basis generally equivalent to the taxation of a Canadian resident.

There is no consolidated income tax filing for related corporations in Canada and, therefore, every corporation must file a separate tax return based upon its own income.

A source withholding tax of 25 percent on rental payments to non-residents is imposed. There is no reduction of this rate under the Canada US Tax Convention (the "US Treaty").

The withholding tax on interest payments to non-residents is reduced from 25 percent to 10 percent under the US Treaty (see *Income Tax Issues for Lenders* on page 17).

Thin capitalization rules apply to related party debt with a statutorily imposed maximum debt to equity ratio of 2:1.

Capital cost allowance (i.e., tax depreciation) is deductible up to maximum prescribed rates on a discretionary basis.

Non-capital losses may be carried forward 10 years and carried back three years. Capital losses may be carried forward indefinitely and carried back three years, but may only be applied against capital gains and not other income.

Gains on the disposition of direct interests in real estate are subject to taxation.

Capital gains are taxed at one-half the effective level of other earned income.

If the vendor is not a resident of Canada, a clearance certificate is required from the Canadian government pursuant to section 116 of the *Income Tax Act* (Canada) failing which the purchaser may hold back from the closing proceeds an amount equal to 50 percent of the purchase price.

Land Transfer Tax

There are land transfer taxes payable in most provinces upon the transfer of ownership of real property interests. In Ontario and Québec, this land transfer tax is imposed at graduated rates, but for most commercial transactions it is

approximately 1.5 percent of the total consideration for the transfer. The property transfer tax payable in British Columbia upon the registration of a transfer of real property is calculated at 1 percent on the first Cdn $200,000 of fair market value and 2 percent on the balance. While Alberta imposes no land transfer tax, it charges a registration fee for transfers at the rate of 0.1 percent of the value of the real property transferred.

The creation of a lease or the transfer of an interest in a lease of real property will attract provincial land transfer tax on the market value of the property if the term (including renewals) is in excess of 50 years for Ontario, 40 years for Québec, and 30 years for British Columbia. This tax does not apply in Alberta.

There are a number of exemptions from land transfer tax or methods of effecting transfers available in Ontario, Québec and British Columbia to facilitate inter-corporate transfers among affiliates.

Retail Sales Tax

If the purchase of real estate in Ontario and Québec is accompanied by the purchase of certain goods, such as furniture or appliances, retail sales taxes are payable by a purchaser at a rate 8 percent of the value of the tangible personal property acquired. In British Columbia, the rate is 7 percent. This sales tax does not apply in Alberta.

Goods and Services Tax

A goods and services tax (GST) of 7 percent is payable in most provinces on a “supply” of real property in Canada, unless otherwise exempted, under the *Excise Tax Act*. A supply includes the sale of a real property, as well as a lease, licence or other similar arrangement.

Generally, the seller is obligated to collect GST from the buyer of real property. However, the buyer may be

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responsible for paying and remitting the GST in situations where the seller is a non-resident person and the buyer is registered for GST purposes.

A purchaser or tenant that is required to pay GST on the acquisition of an interest in real property may be able to claim input tax credits for the tax paid, which permits the taxpayer to apply for a refund of GST. Input tax credits are available to purchasers or tenants who are registered for GST purposes and who acquire an interest in real property for commercial purposes.

REGULATORY MATTERS

Though investment in real estate will raise certain regulatory issues that must be addressed generally, the *Investment Canada Act* and *Competition Act* matters set out below do not create any substantive obstacles to non-Canadians investing in Canadian real estate.

Investment Canada Act

The *Investment Canada Act* applies to all non-Canadians seeking to acquire control of existing Canadian businesses or to establish new Canadian businesses, whether through the acquisition of assets or shares. Transactions involving investors who are residents of World Trade Organization (WTO) member countries relating to direct acquisitions by or from a WTO investor have a review exemption threshold of Cdn $250 million in 2005, adjusted upward for inflation annually. Indirect acquisitions (share transactions) involving a WTO investor are not reviewable. If the transaction is not reviewable, the transaction will be "notifiable" requiring filing of information about the parties, the nature of the business and the value of the assets with the applicable governmental agency within 30 days after the closing of the transaction.

Competition Act

The *Competition Act* provides for the review certain commercial transactions for potential lessening or preventing of competition in a relevant market. The parties are required to notify the commissioner under the *Competition Act* of certain transactions where any party to the transaction (including its affiliates) has assets in Canada or revenue from sales in or from Canada exceeding Cdn $400 million and where the aggregate value of the assets in Canada or the annual gross revenue in or from Canada exceeds Cdn $50 million. The most recently audited financial statements are used to measure the value of assets and sales. Depending upon the complexity of the transaction, there is a statutorily imposed waiting period of 14 or 42 days. Only if **both** thresholds are exceeded must a pre-merger notification be filed. Usually, upon request, the commissioner will issue a "no action" letter stating that there are no grounds to challenge the proposed transaction. The parties may apply for an advance ruling certificate exempting the transaction from notification and precluding the commissioner from challenging the transaction at a later date. The *Competition Act*'s merger provisions are equivalent to section 7 of the US *Clayton Act*. Pre-merger notification is analogous to the US *Hart-Scott-Rodino Anti-trust Improvements Act*.

THE LEGAL FRAMEWORK

Some highlights of the legal framework for real estate in Canada are set out below:

Land Registration Systems

Title to real estate in Canada is evidenced through a public land registry system. Canada has two systems of land recording:

- A registry system listing a series of transactions in which the purchaser or a lender or its lawyer is responsible for the determination of the quality of title based primarily on priority in time of registration going back a period of years. This registry system is utilized in Québec, parts of Ontario and in a number of other provinces in eastern Canada.

- A land titles system based on the Torrens system of recording is utilized in the balance of Ontario as well as in British Columbia, Alberta and several other provinces in western Canada. Under this system, the quality of the title is determined by the governmental recording authority. Unlike the registry system, which is an inventory of documents, the land titles system produces a statement of title.

In the Torrens system, there is a provincial government guarantee of title as the title appears in the register. If the land registrar considers that a title is qualified in some manner, this would be reflected on the register. The government guarantee does not apply to the registry system. There is public access to both systems and all documents mentioned on the register.

Title Insurance

Title insurance is available from a number of commercial insurers. Title insurance is not yet the norm for commercial purchase or loan transactions in Canada, although it has been used much more frequently in the last few years where there are numerous properties located in many jurisdictions or where there are specific title defects that need to be dealt with.

Title insurance has not yet replaced title opinions in most commercial real estate loan transactions. If title opinions are to be used in lieu of title insurance, the purchaser or a lender would be prudent to confirm the amount of the errors and omissions coverage carried by the law firm rendering the opinion.

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Surveys

Generally, surveys which are created by surveyors in Canada are not carried out to ALTA survey standards. However, surveys must comply with standards set by provincial legislation which are equal to or exceed ALTA survey standards.

Planning Legislation

There are controls on the use of and development of land in Ontario and other provinces. In Ontario, the

Planning Act controls the ability to subdivide property and provides a framework for land use controls (land use powers are largely exercised by municipalities). Section 50 of the Ontario *Planning Act* prohibits any transfer or mortgage of land or any other agreement granting rights in land for a period of 21 years or more unless the land is already described in accordance with a plan of subdivision or the transaction receives the consent of the appropriate governmental body. There are several exemptions, the main one being where the owner purporting to deal with the land is dealing with the entire parcel of land and does not retain ownership or control of any abutting parcel of land following completion of the transaction.

LENDING ON THE SECURITY OF REAL ESTATE

Lenders about to lend on the security of Canadian real estate must consider the issues highlighted below as well as other issues that may be applicable to the particular transaction.

Regulatory Issues for Lenders

Under the *Bank Act*, a foreign entity associated with a foreign bank may make loans to Canadian borrowers provided that such loans are structured so that the foreign entity is not engaging in any business in Canada. Many foreign banks and foreign entities associated with foreign banks make such cross-border loans. Procedures have been developed to address these *Bank Act* requirements.

Mortgage brokers legislation requires registration of mortgage brokers carrying on business in Canada. Certain lenders are exempt, mainly financial institutions governed by other legislation, such as banks and trust companies. Other lenders will need to explore the ways of complying with the legislation.

Legislation Relating to Interest Rates

Section 4 of the *Interest Act* requires that wherever any interest is, by a written contract *other than a mortgage on real property*, made payable at a rate per day, week, month or any rate for any period less than a year, no interest beyond 5 percent per annum is chargeable unless the contract contains an express statement of the yearly rate to which the other rate is equivalent. Where interest is based on a 360-day year or some other period of less than a year, a statement setting out the equivalent annual rate is commonly included to ensure compliance with this requirement.

Section 6 of the *Interest Act* requires that where payments of principal and interest are "blended" (i.e., where a set amount is payable each month with the interest component decreasing as the principal component increases), the mortgage loan documentation must state the interest chargeable on principal calculated yearly or half-yearly, not in advance. Failure to do so results in no interest at all being chargeable.

Section 8 of the *Interest Act* provides: “No fine, penalty or rate of interest shall be stipulated for…on any arrears of principal or interest secured by mortgage on real property that has the effect of increasing the charge on the arrears beyond the rate of interest payable on principal money not in arrears.” This Section applies to mortgage loans where, for example, the interest rate is increased if there is a payment default of principal or interest. This Section is not limited to increases in interest, but includes fines and penalties, such as a “bonus” of three months’ interest following default or if enforcement proceedings are taken. Despite this Section, mortgage lenders are allowed to assess late payment charges if such amounts are administrative charges which represent a fair and reasonable pre-estimate of the additional administrative costs incurred by the mortgagee upon default. Generally, amounts determined on a percentage basis are more likely to be considered a penalty than amounts expressed as a flat dollar amount.

Section 10 of the *Interest Act* provides that if the mortgage is given by a person other than a corporation, the mortgage is open for repayment after five years with the payment of three months’ interest.

Section 347 of the *Criminal Code* prohibits any agreement containing an interest rate that is more than 60 percent per year. Interest is defined as including the aggregate of all charges and expenses, including a fee, fine, penalty, commission or other similar charge or expense, paid or payable for the advancing of a credit, but does not include such items as insurance charges, overdraft charges or amounts on account of property taxes.

Income Tax Issues for Lenders

If a lender has a “permanent” establishment in Canada and carries on business in Canada, it will be subject to pay Canadian income tax. Conversely, a non-resident lender with no Canadian presence who lends to a Canadian borrower will not be subject to pay Canadian income tax on its business profits, even though some of its profits may be generated in Canada.

Mortgage brokers legislation requires registration of mortgage brokers carrying on business in Canada.

The Canadian government imposes a withholding tax of 25 percent on most payments of interest by Canadian residents to foreign lenders. Bilateral treaties between Canada and the lender’s country may help by setting a lower withholding tax rate (as is the case with

the United States and Germany, where the rate is lowered to 10 percent).

There are limited exemptions from Canadian withholding tax on the payment of interest. For example, there is no withholding tax on interest payable by a resident Canadian corporation to an arm's length non-resident lender, provided that that no more than 25 percent of the principal amount of the loan is due in the first five years of the term of the loan, except in certain circumstances, such a default in the scheduled payment of interest or principal.

The Canadian government has taken the administrative position that the exemption also applies if the borrower is a partnership all members of which deal at arm's length from the lender and are corporations resident in Canada, non-resident corporations whose business is carried out principally in Canada, or a combination of both. The exemption is not available in connection with loans to non-Canadian corporations or to individuals or trusts, including REITs.

Mortgage Lender's Default Remedies

Where a mortgagor has defaulted under its obligations in a mortgage, the mortgage lender has a variety of remedies, including:

(a) beginning a foreclosure action;
(b) selling the property in a judicially supervised sale action; or
(c) accepting a voluntary transfer of the property from the borrower.

Generally speaking, bankruptcy proceedings in Canada are more "lender friendly" than in the United States.

Additionally, in the province of Ontario a mortgagee has a private power of sale right given by statute law and contained in most mortgage documentation.

In conjunction with the foregoing remedies, a mortgagee may take possession or control of the mortgaged property:

(a) privately;
(b) by Court order;
(c) through a privately appointed receiver pursuant to the provisions of the mortgage; or
(d) through a court-appointed receiver or interim receiver.

Additionally, in most provinces the mortgagee may obtain judgement against the mortgagor and/or any guarantor for the amount due on the mortgage debt.

Bankruptcy Proceedings in Canada
Generally speaking, bankruptcy proceedings in Canada are more "lender friendly" than in the United States and the stay periods imposed are generally shorter. Canadian courts have been very sensitive to the need for quick proceedings to preserve value for creditors. There is no "cram-down" of dissenting secured creditors. Generally speaking, in Canadian bankruptcy proceedings there are fewer classes of creditors. There is judicial reluctance to give veto rights to a small class of creditors.

If a tenant becomes bankrupt, the trustee in bankruptcy has the power to disclaim (terminate) the lease and the landlord has very limited rights to recover against the estate of the bankrupt. This is similar to the restrictions on the rights of commercial landlords that exist pursuant to the *Bankruptcy Code* of the United States.

CONCLUSION
Topics highlighted in this publication are a sampling of the issues of interest to investors in Canadian real estate or to investors in mortgages secured by Canadian real estate. ★

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Blake, Cassels & Graydon LLP is one of Canada's pre-eminent national business law firms, with 500 lawyers in offices in Toronto, Montréal, Calgary and Vancouver, Ottawa, New York, Chicago, London and Beijing. The Blakes National Real Estate Group is one of the largest and most comprehensive real estate groups of any law firm in Canada, comprised 35 lawyers and 20 law clerks or paralegals.

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