

Non-Resident Tax and Real Estate Practitioners Liability

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Do you collect and remit rent to a Non-Resident owner of real property in Canada? If you or your company collect rent for a friend, relative or client, who is a Non-Resident, you could be personally or corporately liable for up to 25% of the annual rent.

Background

The Canadian Income Tax Act requires Non-Resident property owners to pay tax on the gross rental income received on their real properties in Canada. This tax is known as **Non-Resident Tax or Withholding Tax**. The statutory rate is generally 25% on taxable amounts, unless reduced to a lesser rate in accordance with the provisions of a bilateral tax treaty. A 25% rate is applicable to residents of Hong Kong, Taiwan, Singapore, Japan and for Non-Residents from Ireland and Iceland the rate is 15%.

There is an exception and relief available to the Withholding Tax requirement on the gross rental income. If certain conditions are met, the Withholding Tax may be assessed against the net rental income instead of the gross rental income. Failure by the Non-Resident to abide by these conditions yields serious consequences for those involved in collecting rent for the Non-Resident.

Undertakings and Filing Requirements

When the tax remittance is based on the *gross rental income*, a Non-Resident has two years from the end of the taxation year in which the rents were received to file a Canadian Section 216 Income Tax Return. Filing the Return will decide the tax payable. If the rental income differs from the estimate, the tax difference is paid or refunded when the tax return is assessed.

To remit tax based on *net rental income* instead of gross income, a Non-Resident may apply annually to Revenue Canada by completing and filing an Undertaking To File An Income Tax Return By A Resident Receiving Rent From Real Property Or Receiving A Timber Royalty (NR6 Form). The form contains estimates of rental income and operating expenses for the property for the calendar year. Allowable operating expenses are legitimate expenses directly related to the property, e.g., property taxes, repairs, maintenance, insurance, management fees and mortgage interest. Only interest on a mortgage taken for the purchase of the same property is deductible. While the Capital Cost Allowance (CCA) can be used to offset rental income it cannot be used to create or increase a

loss from rental income. At the end of each taxation year it is also the responsibility of the *covenantor* to file the NR4B Summary and Supplementary Forms in accordance with Regulation 202 and sub-section 215(3) of the Income Tax Act.

For the NR6 application, under sub-section 216(4) of the Income Tax Act, to be accepted by Revenue Canada the application must be executed first by the owner of the property and by either the tenant, salesperson, management firm or any other Canadian Resident (i.e. *covenantor*). The completion of the NR6 Form in this manner provides Revenue

Canada with a *covenantor* who has agreed to pay the Receiver General any and all outstanding amounts in the event the *covenantor* fails to file an income tax return. A Non-Resident or the *covenantor* will not be allowed to remit on net rental income prior to receiving the approval letter from Revenue Canada. Upon filing the undertaking, both parties covenant that the Non-Resident will file the Canadian Tax Return within six (6) months of the previous taxation year. If the Tax Return is not filed by the Non-Resident by June 30 of the following year, the *covenantor* then automatically becomes liable to pay the full Withholding Tax.

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CALCULATION OF NON-RESIDENT TAX FOR INVESTOR AT 25% RATE

NR6 Application	Rental Income	Monthly NR Tax Deduction
Without approval	All rental income	25% of gross rental income
With approval	Estimated rental income exceed estimated expenses	25% of net rental income
With approval	Estimated rental income less than estimated expenses	No deduction required

Practitioners Liability

Let's examine the liability of a *covenantor* managing or residing in a single-family house owned by a Non-Resident investor and remitting rent directly to the investor. At the 25% rate, assume annual gross rents of \$19,200 with expenses, including mortgage interest, of \$20,000. There is an annual negative cash flow of \$800 resulting in no monthly remittance being paid to Revenue Canada. If the Non-Resident subsequently fails to file his Canadian Tax Return by June 30 of the next year, Revenue Canada would demand payment by the *covenantor* of \$4,800 (25% x \$19,200). Similarly a commercial strip mall with a gross income of \$1,000,000 would generate a financial liability exceeding \$250,000.

To recover unpaid taxes Revenue Canada has, under the Canadian Income Tax Act, various statutory rights. Under these rights Revenue Canada may garnishee salaries, commissions, bank accounts and even have the ability to redirect a tenant's rental payment.

Recovery from the Non-Resident by the *covenantor* is difficult as the *covenantor* has no statutory rights. If the *covenantor* wants to recover the monies paid on behalf of the Non-Resident he will have to proceed with a legal action against the Non-Resident. If he is successful the *covenantor* may register a judgment against the title of the

property if the Non-Resident still owns the property or any other assets that the Non-Resident may still own.

Change In Revenue Canada Policy

On July 13, 1990, there was a subtle amendment introduced to Revenue Canada's policy in dealing with Non-Resident tax returns filed after June 30 each year. This change now prevents Non-Residents that filed late from claiming legitimate expenses after the deadline of June 30. Not only will the Non-Resident investor be subjected to a Withholding Tax on his gross income, he will; be charged interest, be assessed penalties and lose the right to offset operating expenses against income for that year.

It was not until January 1992 that Revenue Canada commenced referring to this change in their policy within their standard approval letter to agents. The new NR6 forms states,

"Note: subsection 216(1) of the Income Tax Act was recently amended. The period for filing the return of income referred to in this undertaking is now limited to six months from the end of the taxation year during which the undertaking was filed."

Current Operational Problems

This policy change is having a serious and direct financial impact

on *covenantors*, both individuals and corporations, who signed the NR6 undertaking.

1. Due to the lateness in advising the *covenantor* that the Non-Resident had not filed previous years returns, the ability of the *covenantor* to recover funds is jeopardized. Some Non-Residents may no longer be clients and some properties may have been sold.
2. Notices of assessments being sent out to *covenantors* that are not valid given the Non-Resident has previously paid or otherwise settled their account with Revenue Canada.
3. Multiple remittance numbers have been issued to individual Non-Residents. It was discovered that remittance account numbers had been issued directly by Revenue Canada to Non-Residents filing their Canadian Tax Returns from offshore. For the same Non-Resident other remittance account numbers had been issued to the *covenantor* at the time the *covenantor* received the Revenue Canada approval letter to remit on "net" instead of "gross" income. As a result the account numbers did not match leaving the *covenantor* with what was perceived to be a client in arrears with Revenue Canada.
4. In pursuing the arrears or outstanding Canadian Tax Returns from Non-Residents, Revenue Canada is directly pursuing the *covenantor* without first attempting to collect all outstanding balances from the Non-Resident.
5. At the time of disposition of real property by a Non-Resident there is no cross referencing with the NR4B forms filed by the *covenantor* to ensure

there are no outstanding tax liabilities. When a Non-Resident disposes of property in Canada the purchaser is only responsible for:

a) withholding and remitting within 30 days taxes of 33 1/3% on the land sale proceeds and 50% on the building or depreciable property sale proceeds, or

b) filing a Clearance Certificate (form T2062) within ten(10) days after the date of completion. Upon receipt of this certificate and appropriate remittance (33 1/3% of the gain, which is the difference between the gross sales proceeds and the adjusted cost base) Revenue Canada will issue a Clearance Certificate (form T2068) to discharge the purchaser's responsibility on any further withholding requirements.

Impact On Investment Climate

Given the probable liability of signing an the NR6 undertaking on behalf of a Non-Resident client we can safely assume this practice will cease almost immediately. All Non-Resident investors will now be taxed at the applicable rate up front on all income producing properties. The Non-Resident investor would however receive a refund if they file their return within a two (2) year period. The problem that arises is that, an immediate 25% reduction in an investors monthly cash flow may render the invest-

ment undesirable and possibly unworkable.

The result is that the present Revenue Canada policy may be deemed to be punitive in nature and is effectively a negative offshore investment strategy!

Relief For Practitioners

Although the concerns of practitioners are being brought forward to Revenue Canada it could be some time before changes are implemented that would bring relief to the practitioner. To enable

the Non-Resident to continue to remit on net rather than gross income, a practitioner might want to consider mitigating alternatives to the proposition of directly executing the NR6 Form as a *covenantor*.

For example, the *covenantor* signing the NR6 Form should be someone in control of the gross rent and payment of operating expenses. However this should not preclude a Non-Resident from appointing as his "Agent of

Record" a Canadian friend or relative, who is willing to assume the role of *covenantor*, from executing the NR6 Form. The following steps should be taken to ensure responsibilities are clear:

- The Non-Resident client's Canadian resident friend should be made fully aware of his responsibilities as a *covenantor* on the NR6 Form at time of execution of the form. He should also provide his full address and phone number to the practitioner.

- The practitioner should complete the operating information required on the NR6 Form and ensure that the *covenantors* address noted therein is c/o the practitioner so all correspondence including assignment of remittance numbers from Revenue Canada is received by the practitioner and he remains knowledgeable.
- Utilizing this method of filing the NR6 Forms, a separate tax remittance account number will be assigned by Revenue Canada to each clients' friend or relative.
- The practitioner will continue to retain and remit the Withholding Taxes to Revenue Canada taking care to ensure that all tax remittances, correspondences and NR4B returns are filed using the individual tax remittance numbers assigned to individual Non-Residents.
- The practitioner should still perform his usual duties of reminding the Non-Residents that their tax returns are to be filed within the prescribed period including confirmations from the clients that their returns have indeed been filed.
- Revenue Canada has recently advised that they now send out reminder notices to the Non-Residents to file their annual Income Tax Returns.

At the time of publication of this article Revenue Canada advises that they have and will continue to accept under the sub-section 216(4) election, the *Agent of Record* as declared on the NR6 Application Form by the Non-Resident and his appointed agent. In the event of a default by the Non-Resident, Revenue Canada would then look towards the designated *Agent of Record* for any shortfalls. It is not clear if Revenue Canada would also pursue the practitioner receiv-

The only effective and long term solution to the practitioners dilemma remains for Revenue Canada to address and correct the inequities

ing the rents and remitting the rental income directly to the Non-Resident.

If required, the foregoing scenario can be modified in accordance with Information Circular 77-16R4 to the effect that the practitioner remits no funds to the Non-Resident but instead remits any and all funds directly to the "Agent of Record". The responsibility for the Withholding Tax then clearly falls on the "Agent of Record"

Another alternative is for the practitioner to continue to execute the NR6 Form as a *covenantor* but with additional protection from the Non-Resident. The *covenantor's* position in this alternative would require the use of retainers, letters of credit and irrevocable power of attorney for the practitioner to act as the non-resident's agent in filing the personal income tax return for the Non-Resident.

In the event the Non-Resident fails to file a return, by say 30 days prior to the June 30 deadline the *covenantor* would retain an accountant to prepare the return. The practitioner acting on behalf of the Non-Resident would then file the required return. This alternative should work as long as the rental property performs along the lines anticipated in the NR6 Form or there is a sufficient float (letter of credit) to cover any shortfall. Unfortunately, should there be a shortfall Revenue Canada will once again look towards the *covenantor* for relief.

Notwithstanding the foregoing and other plausible alternatives, the only effective and long term solution to the practitioners dilemma remains for Revenue Canada to address and correct the inequities in the present situation.

Recommendations To Revenue Canada

Changes to the current situation can be achieved quite readily.

- The first change would eliminate the need for a Canadian resident to undertake to accept full liability on behalf of a Non-Resident in case of non-performance by the Non-Resident .
- The second change would revise the undertaking on the NR6 form to stipulate that the agent shall cooperate with and provide full disclosure to Revenue Canada in case of nonperformance by a Non-Resident.
- The third change would see Revenue Canada, in an arrears or nonpayment situation, serve the tenant in a rental property with a Garnishing Order redirecting the rent to Revenue Canada until such time the outstanding monies have been collected.
- The fourth change would see Revenue Canada proceed directly against the Non-Resident by exercising its statutory right to immediately caveat the property without first commencing a legal action.
- The fifth change would be the implementation of revenue verification upon the sale of real property by Non-Residents to decide if there are outstanding liabilities by the vendor arising from prior non-filing of the Section 216 Income Tax Return. If there is, Revenue Canada would withhold the issuance of a Clearance Certificate (form T2068) until the Purchaser has fulfilled all withholding requirements.

To justify these recommendations it is important to recall that the underlying principle of the Income Tax Act is to tax the net income of the taxpayer. In our present situation Revenue Canada is assessing a third party, the real estate practitioner, who derives no income from the property and has no rights to force a Non-Resident investor to either file taxes, remit funds to Revenue Canada or caveat a property without first proceeding with a legal action. The entity who has the right to enforce the Tax Act should also be the entity that collects the Tax from the reluctant taxpayer.

From the foregoing one may conclude that changes to the Rules and Regulations pertaining to Non-Resident Tax matters is long overdue as it applies to the Real Estate Practitioner. Concerns and/or suggestions should be forwarded to the Finance Committee, House of Commons, Ottawa.

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*** NOTE *** This article deals with both legal and complex tax matters and may not apply to particular facts and circumstances. This material should not be relied upon as a substitute for specialized professional advice concerning any particular matter. Although this material has been carefully researched the reader is urged to contact the International Taxation Office, NR6 Division, Revenue Canada, Ottawa (Tel: 1-800-267-3395) for the latest information pertaining to legislation, rules and regulations for Non-Resident investors.