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REFDATE 150123

SUBJECT Oil & gas payments made to U.S. resident

SECTION 2(3), 39(1)(a)(ii), 59(3.2)(c), 66(15), 66.2(1), 66.4(1), 115(1)(a), 115(4), 212(1)(d)(v), 248(1) defn TCP, 253(c)(i), Reg 202(1)(d), Reg 805, Reg 8201, Article V, VI and XIII of Canada-U.S. Tax Convention, s. 5 of ITCIA defn of real or immovable property

Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA.
Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

PRINCIPAL ISSUES: How are payments made by a Canadian oil and gas company to a U.S. resident taxed?
POSITION: If section 805 of the Regulations applies to the periodic royalty payments, the payments are taxable under s. 115 of the Act. Otherwise, they are taxable under s. 212(1)(d)(v) of the Act. There is no relief under the Canada-U.S. Tax Convention from the Part I tax or Part XIII tax payable. When the U.S. resident grants the rights to explore for, drill for or take petroleum, natural gas or related hydrocarbons in Canada to the Canadian company, s. 116 of the Act applies.
REASONS: Application of the Act and the Convention

XXXXXXXXXX 2013-050977

S.E. Thomson

January 23, 2015

Dear XXXXXXXXXX:

Re: Taxation of Payments Made by a Canadian Oil & Gas Company to a U.S. Resident

On October 22, 2013, you asked us how payments made by a Canadian oil and gas company to a U.S. resident are taxed. For purposes of our response,

we have assumed a set of facts that we might find in a typical situation.

A. Assumed facts

Mr. A is a resident of the U.S., and is the freehold owner of land in Canada. Mr. A also owns the rights to explore for, drill for or take oil & gas from the land.

Mr. A grants the right to explore for, drill for or take the oil & gas to a Canadian oil & gas producing company. As consideration, the company pays Mr. A an upfront bonus payment of $100,000, and grants Mr. A the right to receive annual royalties payable out of the production from the oil & gas taken from the land. The fair market value of the right to receive the annual royalties is estimated to be $300,000.

B. Disposition & Acquisition of Canadian Resource Property

By virtue of subsection 2(3) of the Act, a person who is not resident in Canada who

(a) was employed in Canada,
(b) carried on a business in Canada, or
(c) disposed of a taxable Canadian property

in the relevant taxation year or in a previous year is taxable in Canada under Part I of the Act on his taxable income earned in Canada, as computed under Division D of the Act. Division D comprises sections 115 and 116 of the Act.

The term taxable Canadian property ("TCP") is defined in subsection 248(1) of the Act. Pursuant to paragraph (g) of that definition, TCP includes Canadian resource property for purposes of section 2 of the Act.

The term Canadian resource property ("CRP") is defined in subsection 66(15) of the Act. Paragraphs (a) and (d) of the definition read as follows:

(a) any right, licence or privilege to explore for, drill for or take

petroleum, natural gas or related hydrocarbons in Canada,

(d) any right to a rental or royalty computed by reference to the amount or value of production from an oil or a gas well in Canada, or from a natural accumulation of petroleum, natural gas or a related hydrocarbon in Canada, if the payer of the rental or royalty has an interest in, or for civil law a right in, the well or accumulation, as the case may be, and 90% or more of the rental or royalty is payable out of, or from the proceeds of, the production from the well or accumulation,

The definition of CRP is relevant whether or not Mr. A carries on an oil & gas business in Canada. In the transaction with the Canadian oil & gas company, Mr. A has both disposed of CRP (under paragraph (a) of the definition of CRP) (footnote 1), and acquired CRP (under paragraph (d) of the definition of CRP).

When Mr. A acquired the CRP (i.e. the rights to future royalties based on production from the oil & gas property), the fair market value of the rights (estimated at $300,000 in this case) were added to his Cumulative Canadian Oil and Gas Property Expense ("CCOGPE") pool under variable A. The term CCOGPE is defined in subsection 66.4(5) of the Act.

In addition, the proceeds of disposition of the CRP (i.e. the rights to explore for, drill for or take the oil & gas) were subtracted from the CCOGPE pool under variable F. In this case, the proceeds of disposition comprise the $100,000 upfront bonus payment and the $300,000 rights to future royalties based on production from the oil & gas property. Since the $300,000 is both added and subtracted from the CCOGPE pool, in effect, a formal valuation of the right is not required. In other words, since the fair market value of the right to future royalties is both added and subtracted from the pool, the net effect on the pool will be nil regardless of what the fair market value is. As such, in this example, the net adjustment to the CCOGPE pool will be equal to the amount of the upfront bonus payment of $100,000.

Since Mr. A has disposed of TCP, he is taxable under subsection 2(3) of the Act. However, by virtue of subparagraph 39(1)(a)(ii) of the Act, any gain from the disposition of Canadian resource property is not considered to be a capital gain, and Mr. A does not compute a taxable capital gain

under section 38 or paragraph 115(1)(b). Rather, Mr. A may be required to include an amount in income under subparagraph 115(1)(a)(ii) or (iii.1) of the Act, as explained in the next paragraph.

If Mr. A's CCOGPE pool is negative in respect of a taxation year, the excess is deducted from his Cumulative Canadian Development Expense ("CCDE") pool under variable L. The CCOGPE pool will be negative if the subtractions from the pool exceed the additions to the pool. For example, if Mr. A's CCOGPE pool had an opening balance of $25,000, the CCOGPE pool would be in a credit balance of $75,000, computed as follows:

Opening Balance + Rights to Royalties - Proceeds of Disposition = Closing Balance

$25,000 + $300,000 - $100,000 - $300,000 = ($75,000).

The credit balance of $75,000 would be deducted from Mr. A's CCDE pool. The term CCDE is defined in subsection 66.2(5) of the Act. Where the balance of the CCDE pool is negative in respect of a taxation year, the negative balance is added to Mr. A's income for the year pursuant to subsection 66.2(1), paragraph 59(3.2)(c) and subparagraphs 115(1)(a)(ii) or (iii.1) of the Act. Subparagraph 115(1)(a)(ii) applies if the amount required to be included in income is from a business carried on by Mr. A. Subparagraph 115(1)(a)(iii.1) applies to any amount required by paragraph 59(3.2)(c) of the Act to be included in income over and above the amount included in income from a business carried on by Mr. A.

If Mr. A had carried on a business at one or more fixed places of business in Canada that is described in any of paragraphs (a) to (g) of the definition of "principal business corporation" in subsection 66(15) of the Act and Mr. A ceases to carry on the business, subsection 115(4) will apply. Under subsection 115(4), Mr. A will be deemed to have a year end, and will be deemed to have disposed of the CRP immediately before the deemed year end and reacquired the CRP immediately after the deemed year end. See paragraph 14 of IT-420R3, Non-Residents - Income Earned in Canada.

Application of the Canada-U.S. Tax Convention (the "Treaty") -

Disposition of CRP

Paragraph 1 of Article VI [Income From Real Property] of the Treaty states:

Income derived by a resident of a Contracting State from real property (including income from agriculture, forestry or other natural resources) situated in the other Contracting State may be taxed in that other State.

Paragraph 2 of Article VI of the Treaty provides the meaning of "real property" as follows:

For the purposes of this Convention, the term "real property" shall have the meaning which it has under the taxation laws of the Contracting State in which the property in question is situated and shall include any option or similar right in respect thereof. The term shall in any case include usufruct of real property, rights to explore for or to exploit mineral deposits, sources and other natural resources and rights to amounts computed by reference to the amount or value of production from such resources; ships and aircraft shall not be regarded as real property.

The terms "real property" and "immovable property" are defined in section 5 of the Income Tax Conventions Interpretation Act ("ITCIA") for purposes of Canada's tax conventions, as follows:

5. Definitions — Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, in this section and in the convention,

"immovable property" and "real property", with respect to property in Canada, are hereby declared to include

(a) any right to explore for or exploit mineral deposits and sources in Canada and other natural resources in Canada, and

(b) any right to an amount computed by reference to the production, including profit, from, or to the value of production from, mineral deposits and sources in Canada and other natural resources in Canada;

Therefore, if Mr. A has an amount included in income under paragraph 115(1)(a) with respect to the disposition of CRP as described above, the ITCIA and Article VI of the Treaty preserve Canada's right to tax the income without limit.

Withholding and Filing on Disposition of CRP

Mr. A disposed of CRP when he granted the rights to explore for, drill for or take the oil and gas to the Canadian company. As such, the Canadian company is required to withhold under subsection 116(5.3) of the Act. Under subsection 116(5.3) of the Act, the company must withhold 50% of the amount payable for the CRP, less the amount fixed in the certificate of compliance obtained by Mr. A under subsection 116(5.2) if any, and remit the difference to the Receiver General within 30 days.

To obtain a certificate of compliance, Mr. A must file Form T2062A, Request by a Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Canadian Resource or Timber Resource Property, Canadian Real Property (Other than Capital Property), or Depreciable Taxable Canadian Property. For more information, see information circular IC72-17R6, Procedures Concerning the Disposition of Taxable Canadian Property by Non-Residents of Canada - Section 116.

Note that the property disposed of by Mr. A is not "excluded property" as defined in subsection 116(6) of the Act, because it is not "treaty exempt property" as defined in subsection 116(6.1).

Pursuant to paragraph (g) of the definition of TCP in subsection 248(1) of the Act, CRP is also TCP for purposes of section 150 of the Act. Therefore, pursuant to subsection 150(1) of the Act, Mr. A is required to file a T1 General, Income Tax and Benefit Return for Non-Residents and Deemed Residents of Canada for the year in which the disposition occurred. However, Mr. A may be relieved of having to file a T1 if he meets the conditions in subsections 150(1.1) and 150(5) of the Act.

C. Periodic Royalties

The taxation of periodic royalties paid to Mr. A by the Canadian company depends on whether Mr. A carries on a business in Canada. If Mr. A is carrying on business in Canada, he is taxable on the income from his business carried on in Canada pursuant to subparagraph 115(1)(a)(ii) of the Act. Mr. A may deduct such amounts as are relevant in computing his income from the business for the taxation year, including any amount not exceeding 10% of the balance of the CCOGPE pool existing at the end of the taxation year pursuant to subsection 66.4(2) of the Act.

Under paragraph 805(a) of the Regulations, the oil & gas royalties paid to Mr. A are not taxable under Part XIII of the Act if the royalties are reasonably attributable to a business carried on by him through a PE in Canada (footnote 2) . For this purpose, the term "permanent establishment" is defined in section 8201 of the Regulations. Section 8201 of the Regulations provides that the meaning of "permanent establishment" shall be taken from the relevant tax treaty. Therefore, to determine whether Mr. A has a PE in Canada, we look to the definition in Article V of the Treaty.

Therefore, if Mr. A carries on a business through a PE in Canada and the oil & gas royalties are attributable to the PE, Part XIII of the Act does not apply, and the company is not required to withhold tax from the payment. However, the company is required to issue an NR4 to Mr. A, and use the exemption code "Q" to indicate that Mr. A carries on a business in Canada through a PE (footnote 3).

If Mr. A carries on a business described in any of paragraphs (a) to (g) of the definition of "principal business corporation" in subsection 66(15) of the Act, and Mr. A receives royalties in respect of Canadian resource property that are not attributable to that business, the royalties will nevertheless be taxable under Part I of the Act pursuant to subparagraph 115(1)(a)(iii.3). In that case, Part XIII will not apply to the royalties by virtue of paragraph 805(b) of the Regulations (footnote 4) . The company is required to issue an NR4 to Mr. A, and use the exemption code "S" to indicate that Mr. A is exempt as a result of paragraph 805(b) of the Regulations (footnote 5).

Where neither paragraph 805(a) nor (b) of the Regulations apply, the annual royalties paid to Mr. A by the Canadian company are taxable to him

under Part XIII of the Act. In particular, subparagraph 212(1)(d)(v) of the Act provides that every non-resident person shall pay an income tax of 25% on an amount that a person resident in Canada pays to the non-resident person that was dependent on the use of or production from property in Canada.

Under subsection 214(1) of the Act, no deductions may be made from the amount taxable under subparagraph 212(1)(d)(v). Under subsection 215(1) of the Act, the oil & gas producing company must withhold 25% of the amount of the gross royalty, and issue an NR4, Statement of Amounts Paid or Credited to Non-Residents of Canada to Mr. A.

Mr. A cannot elect under section 216 of the Act to file a return under Part I of the Act since section 216 does not apply to amounts received on account of oil & gas royalties. Section 216 applies only to amounts received as rent on real or immovable property in Canada, or as timber royalties.

Mr. A cannot elect under section 217 of the Act to file a return under Part I of the Act since section 217 does not apply to amounts described in paragraph 212(1)(d) of the Act.

Application of the Treaty - Royalties

By virtue of paragraph 6 of Article VII [Business Profits] of the Treaty, Article VII does not apply to items of income that are dealt with separately in other Articles of the Treaty. Article VI of the Treaty applies to the annual oil & gas royalties received by Mr. A since the payments are income from real property. Therefore, Article VII does not apply.

Nor does Article XII apply. Paragraph 2 of Article XII of the Treaty allows for royalties arising in Canada and paid to a resident of the U.S. to be taxed in Canada at a maximum rate of 10% of the gross amount of the royalties, if the U.S. resident is considered the beneficial owner of the royalties. Paragraph 4 of Article XII of the Treaty states:

"The term "royalties" as used in this Article means payments of any kind

received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including motion pictures and works on film, videotape or other means of reproduction for use in connection with television), any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, tangible personal property or for information concerning industrial, commercial or scientific experience, and, notwithstanding the provisions of Article XIII (Gains), includes gains from the alienation of any intangible property or rights described in this paragraph to the extent that such gains are contingent on the productivity, use or subsequent disposition of such property or rights."

The annual royalty payments arising from the oil and gas rights paid by the company to Mr. A are not included in this definition. As a result, they do not qualify for the 10% treaty rate under paragraph 2 of Article XII of the Treaty. Therefore, the company must withhold and remit 25% of the annual royalties paid to Mr. A.

The Treaty does not restrict Canada's right to tax the royalty payments under domestic legislation, whether or not Mr. A carries on an oil & gas business through a PE in Canada. Therefore, there is no relief under the Treaty from the Part I tax or Part XIII tax payable by Mr. A on the periodic oil & gas royalties paid to him by the Canadian company.

If you have any questions regarding the above, please contact Sherry Thomson at (613) 957-2122.

Yours truly,

Olli Laurikainen, CPA, CA
For Director
International Division
Income Tax Rulings Directorate

FOOTNOTES

Note to reader: Because of our system requirements, the footnotes

contained in the original document are shown below instead:

1 See 2014-0532221E5

2 See paragraphs 12 and 13 of IT-420R3, Non-Residents - Income Earned in Canada.

3 See pages 10, 11 and 21 of Guide T4061, NR4 - Non-Resident Tax Withholding, Remitting, and Reporting, 2013 and paragraph 202(1)(d) of the Regulations.

4 See paragraph 18(c) of IT-420R3.

5 Supra, footnote 3.