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Update

Income Trusts/REITs Law

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Department of Finance Releases Revised Income Trust/REIT Rules

On March 27, 2007, the Department of Finance released, as part of its 2007 Budget implementation package, revised draft legislation implementing the proposed entity-level tax on certain publicly listed (or traded) trusts and partnerships. The changes made from the draft legislation initially introduced on December 21, 2006 appear to be primarily intended to address certain technical deficiencies that prevented most real estate investment trusts ("REITs") from qualifying for the proposed exemption from this tax. The revised legislation also explicitly incorporates the "normal growth" limitations on transitional relief released by the Department of Finance on December 15, 2006. The mechanics of the proposed tax remain substantively similar to the initial proposals.

Transitional Relief and "Normal Growth"

The revised legislative proposals do not extend the four year transitional period provided to trusts and partnerships that were publicly listed (or traded) as of October 31, 2006. However, these proposals now expressly incorporate the "normal growth" guidelines released by the Department of Finance on December 15, 2006. Accordingly, the proposed tax will apply to a trust or partnership that was publicly listed (or traded) on October 31, 2006 commencing on the earlier of (i) its 2011 taxation year and (ii) any taxation year in which the trust exceeds "normal growth" as determined by reference to the normal growth guidelines, as amended from time to time, unless that excess arose as a result of a prescribed transaction (no transactions are prescribed at this time). Unfortunately, there continues to be significant uncertainty with respect to certain aspects of the normal growth guidelines. Moreover, the proposed legislation appears to permit the Department of Finance to amend these guidelines (and therefore the availability of transitional relief) at will.

A further anomaly arises with respect to entities that qualified for the REIT exemption as of October 31, 2006. The four year transitional relief is only available in respect of an entity that is a SIFT on October 31, 2006 (see definition below). A qualifying real estate investment trust (a "Qualifying REIT") is excluded from the definition of a SIFT. Accordingly, if an entity that was a Qualifying REIT on October 31, 2006, subsequently loses its Qualifying REIT status, it is not entitled to the benefit of the four year transitional relief and would become subject to the proposed tax immediately. It is unclear whether this result was intended.

Real Estate Investment Trusts

The proposed tax applies to "specified investment flow through" entities ("SIFTs"), which include most publicly listed (or traded) trusts and partnerships that hold significant investments in Canadian properties. However, Qualifying REITs are exempt from this tax. In general, a REIT will be a Qualifying REIT (and therefore not subject to the proposed tax) in respect of a particular taxation year if it satisfies each of the following conditions throughout the year:

- the trust at no time in the taxation year holds any "non-portfolio property", other than "qualified REIT properties" (this includes real and immovable property and securities in an entity that itself satisfies these four conditions);
- at least 95 per cent of the trust's revenues for the taxation year are derived from: (i) rent from real or immovable properties, (ii) interest, (iii) capital gains from dispositions of real or immovable properties, (iv) dividends, and (v) royalties;
- at least 75 per cent of the trust's revenue for the taxation year are derived from: (i) rent from real or

immovable properties situated in Canada, (ii) mortgages on real or immovable properties situated in Canada, and (iii) taxable capital gains from dispositions of real or immovable properties situated in Canada; and

- at no time in the taxation year is the total fair market value of (i) real or immovable properties situated in Canada, (ii) cash, or (iii) certain government debt, held by the trust less than 75 per cent of the trust's equity value.

Qualifying REITs must satisfy these conditions at all times throughout the taxation year. However, because the conditions are applied on an annual basis, a REIT that fails to qualify for the exemption in a particular taxation year can be restructured to achieve Qualifying REIT status in a subsequent taxation year.

The REIT proposals continue to apply on an entity-by-entity basis, not on a consolidated basis. In order for a trust to be a Qualifying REIT, each of its underlying entities (whether corporations, trusts or partnerships) must separately satisfy the four REIT conditions.

Key Amendments to the REIT Exemption

The revised proposals clarify the underlying policy intent of the REIT exemption and address a number of technical concerns that arose with respect to the December 21, 2006 proposals.

- *Operating REITS*: REITs with operating components, such as hotels and seniors housing, will not be Qualifying REITs. In fact, payments for the occupation or use of a hotel room or other similar lodging facility are explicitly excluded from the definition of "rent from real or immovable property". However, these REITs may be able to restructure in order to meet the requirements of the REIT exemption. While the revised proposals do not include the U.S. concept of a "taxable REIT subsidiary" that the industry was hoping for, the evolution of U.S. seniors housing REITs and Australian stapled unit structures may be helpful in this regard.
- *Permitted Rental Income*: "rent from real or immovable properties" is defined to include not only rent or similar payments, but also payments for services ancillary to the rental of real or immovable property and customarily supplied or rendered in connection with the rental of such properties.
- *Excluded Rental Income*: the following types of payments are expressly excluded from qualifying as "rent from real or immovable properties":

  -payments for any other types of services provided to the tenants of such properties;

  -fees for managing or operating such properties;

  -payments for the occupation of, use of, or right to use a room in a hotel or other similar lodging facility; and

  -rent based on profits (it is unclear whether this would also include rent based on gross revenues).
- *Internal Management Entities*: The revised proposals permit a Qualifying REIT to own securities in an internal management company provided that all or substantially all of the revenues of the entity are derived from maintaining, improving, leasing or managing real or immovable property of the Qualifying REIT. However, as currently drafted, this exception may not be available where the management entity is not directly owned by the property owner or provides services to a number of entities within the REIT structure.
- *Third Party Management Fees*: third party management fees will not be qualifying income for either the 95 per cent or the 75 per cent income tests.
- *Nominee Corporations:* REITs commonly use nominee corporations to hold legal title in their underlying properties. The revised proposals explicitly permit nominee corporations by including in the definition of "qualifying REIT property" securities in an entity that only holds legal title (and property that is ancillary to the earning of rental income or capital gains).
- *Gross vs. Net Income*: the revised proposals confirm that the 95 per cent and 75 per cent income tests are determined with respect to "revenue" rather than "profit". The December 21, 2006 proposals referred to "income".

- *Ancillary Assets*: Under the revised proposals, Qualifying REITs can own land, buildings and other depreciable property that is ancillary to the ownership or utilization of such buildings (e.g., parking lots). The December 21, 2006 proposals did not permit trusts to hold property that was depreciable at more than 5%.
- *Geographic Limitations*: The geographic limitations with respect to property situated in Canada have been retained.

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