

# Update

## Income Trusts Law

November 8, 2006

### Canada to Tax Income Trusts and Publicly Traded Partnerships

On November 7, 2006, Canada's Parliament passed a motion approving the Minister of Finance's proposals to introduce an entity-level tax on distributions from income trusts and certain publicly-listed Canadian partnerships. The proposed rules, which were announced on October 31, 2006, are intended to eliminate the "tax imbalance" created by income trusts and aim to tax such entities in the same general manner as corporations. In doing so, the government sought to stem the tide of corporate conversions to income trusts.

Draft legislation to implement these new rules has not yet been released. The following outline of the proposed rules and related critical questions and planning challenges are subject to the legislative provisions ultimately adopted.

#### Proposed Rules

The proposed tax will apply to "specified investment flow-throughs" ("SIFTs"), which will include most publicly-traded income trusts and partnerships that hold significant investments in Canadian properties. Real estate investment trusts ("REITs") that meet certain tests described below will generally be exempt from the tax, as will income directly received from a trust's foreign subsidiaries that do not carry on business in Canada.

Under the current rules, an income trust that distributes all of its income to its unitholders is not subject to any entity-level tax because the distributions are deductible in computing income. The proposed rules eliminate this deduction for SIFT trusts in respect of distributions

paid out of "non-portfolio earnings". Instead, the SIFT trust will pay tax on these distributions at a special rate based on the federal corporate income tax rate plus a 13% provincial corporate tax, for a 34% total effective rate which will decline to 31.5% in 2011. Canadian unitholders will pay tax on these distributions at the dividend tax rate.

"Non-portfolio earnings" will include income from businesses carried on in Canada, income from "non-portfolio properties" (other than certain dividends) and capital gains realized on the disposition of non-portfolio properties. Non-portfolio properties will generally include significant investments in Canadian resident corporations and trusts, Canadian partnerships, Canadian resource properties, timber resource properties and real property situated in Canada.

The proposed rules do not affect the ability of trusts to distribute "returns of capital". In certain circumstances, this will continue to be a significant distinction between trusts and public corporations, which are generally prevented from making tax-deferred returns of capital. Taxable income not distributed by the trust in the year it is earned will continue to be taxed at the highest individual marginal tax rate.

Under the current rules, partnerships are not subject to income tax; rather the income or losses of a partnership are allocated to its members. Under the proposed rules, a SIFT partnership will be taxed directly on non-portfolio earnings at the same rate as a SIFT trust.

#### Real Estate Investment Trusts

The proposed rules exclude certain REITs from the SIFT definition. This exclusion is intended to give relief to REITs with passive investments in Canadian real estate in recognition of the unique history and role of collective real estate investment vehicles in Canada. To qualify as a REIT, the trust must meet a series of conditions relating to the nature of its income and its investments. The government has indicated that the proposed conditions are similar to the conditions applied to REITs in the United States.

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## Effective Date

SIFTs that begin trading after October 31, 2006 will be subject to the new rules as of January 1, 2007. SIFTs that traded before November 1, 2006 will not be subject to the new measures until their 2011 taxation year. However, the Minister also announced that while there is no intention to prevent existing SIFTs from normal growth, this transitional delay could be foreclosed in the event of inappropriate avoidance techniques, such as the “undue expansion” of an existing SIFT.

## Critical Questions and Planning Challenges

The government proposals leave open a number of critical questions and planning challenges for the income trust sector going forward:

- Certain REITs, particularly those with “operating” components such as senior care and hospitality REITs, may not qualify for the REIT exemption. Such trusts – and REITs established with such components in the future – may need to restructure in order to meet the requirements of the exemption. The evolution of U.S. structures in these areas may be helpful in this regard.
- In certain provinces (such as Alberta), provincial corporate tax rates are less than the notional 13% provincial component of SIFT tax. As a result, corporations may enjoy a marginal rate advantage over income trusts in these provinces.
- Although the proposed rules aim to generally equalize the tax treatment of public corporations and income trusts, a number of corporate reorganization tax rules are available to the former but not the latter. Some income trusts may consider reverting to corporate form before or upon the rules becoming effective in 2011 or at a time thereafter. While mechanisms toward achieving this on a tax-deferred “rollover” basis are currently available, it remains to be seen whether federal and provincial tax authorities will facilitate a “de-conversion” under which the publicly-listed income trust or partnership is eliminated on a tax-deferred “rollover” basis

- Existing income trusts may wish to defer claiming certain discretionary deductions and reserves so as to preserve such tax attributes until the end of the transition period in 2011.
- Non-portfolio earnings do not include income from U.S. or other foreign entities that do not carry on business in Canada. However, where such income is earned through a Canadian subsidiary of the income trust, exempt U.S. source income may inadvertently become non-portfolio earnings subject to SIFT tax. Canadian income trusts with significant U.S. operations may consider restructuring so as to preserve the characterization of U.S. source income. The possibility of successful restructuring will depend upon the particular circumstances and structure of the trust.

The government has stated that the new rules may be changed if there should emerge any structures or transactions that are clearly devised to frustrate the policy objectives that underlie them.

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