Goodmans LLP Update

Tax Law

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Finance Releases Proposed Amendments to the Qualifying REIT Rules

On December 16, 2010, the Department of Finance ("**Finance**") announced proposed amendments to the rules in the *Income Tax Act* (Canada) applicable to real estate investment trusts (the "**Qualifying REIT Rules**"). The amendments address certain concerns that real estate investment trusts encountered when attempting to restructure their operations to comply with the existing Qualifying REIT Rules. The amendments also clarify, and in some respects restrict, the scope of the existing exception for qualifying real estate investment trusts (“**Qualifying REITs**”).

Background

Qualifying REITs are exempt from the new entity-level tax generally imposed on publicly-traded income funds and partnerships commencing January 1, 2011 (the "**SIFT tax**"). Public trusts established after October 31, 2006 (and public trusts that exceeded certain equity growth restrictions after that time) are already subject to the SIFT tax rules and, therefore, must be Qualifying REITs in order to avoid the SIFT tax and maintain their "flow through" status for tax purposes.

The exception for Qualifying REITs is in recognition of the unique history and role of collective real estate investment vehicles in Canada. In order to be a Qualifying REIT, a trust must satisfy certain asset and revenue tests at all times throughout its taxation year.

Proposed Amendments

The proposed amendments do not alter Finance's objective of limiting the exception for Qualifying REITs to public trusts with passive real estate holdings. Rather, the proposed amendments clarify and amend certain aspects of the existing Qualifying REIT Rules:

- *Non-Qualifying REIT Assets*: Pursuant to the proposed amendments, each entity in a Qualifying REIT structure will be permitted to own non-Qualifying REIT assets having a value of up to 10% of the fair market value of that entity's non-portfolio property. Under the current rules, there generally is no non-Qualifying REIT assets permitted.
- *Ancillary Property*: The definition of “qualified REIT property” currently includes property that is ancillary to the earning by the entity of rent from real or immovable properties or capital gains from dispositions of real or immovable properties. Under the proposed amendments, this category of “qualified REIT property” will be restricted to tangible personal property (such as office furniture or computers). Other non-Qualifying REIT assets (even if ancillary to the earning of rental income and capital gains) will need to fall within the permitted 10% basket.
- *Gross REIT Revenue*: The proposed amendments clarify the basis on which the Qualifying REIT revenue tests are to be calculated. Such tests will be based on "gross REIT revenue" (which is generally defined to include all amounts received or receivable by the entity on income account, together with capital gains). This amendment confirms that certain potential "revenue" sources, such as recapture, will not be relevant for purposes of the Qualifying REIT revenue tests. It also clarifies that “revenue” is not based on accounting principles.
- *Passive Revenue Test*: At least 95% of the gross REIT revenues of a Qualifying REIT entity must be 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. Under the proposed amendments, this 95% passive revenue test will be reduced to 90% and will include gains from the sale of eligible resale properties (as described below) as a permitted source of passive revenue.
- *Character of Revenue*: The proposed amendments clarify that revenue generally maintains its source characterization when distributed from a subsidiary

entity to a parent entity (where the parent entity owns a security in the subsidiary entity that is non-portfolio property). This amendment is intended to address certain ambiguities that arose when properties were held through tiers of entities.

The proposed amendments also introduce the following new concepts to the Qualifying REIT Rules:

- *Foreign Currency Fluctuations*: For purposes of the revenue tests, the proposed amendments include in Qualifying REIT revenue certain revenues realized from foreign currency fluctuations relative to the Canadian dollar. Examples include foreign currency fluctuations from: (i) rent from foreign real property, (ii) foreign currency debt incurred to acquire foreign real property for the purposes of earning rental revenue, and (iii) currency hedging contracts in respect of foreign property that can reasonably be considered to have been entered into to reduce the trust's risk to fluctuations in the foreign currency.
- *Eligible Resale Properties*: The proposed amendments generally permit a Qualifying REIT to earn a portion of its revenue from non-capital real or immoveable property (i.e., real estate inventory) in certain limited circumstances. Eligible resale property must be contiguous to a capital property of the Qualifying REIT and the holding of such property must be necessary and incidental to the holding of such capital property. One example is where a portion of a commercial development is being severed for the ownership and use of an anchor tenant. The proposed eligible resale property rules are quite technical and REITs must be careful to appropriately structure any holdings that are intended to qualify under these rules.

Certain Implications

- *Working Capital Adjustments and Other Contractual Rights*: Under the existing rules, where a third party becomes indebted to the Qualifying REIT in connection with the acquisition or disposition of property (e.g., pursuant to a working capital adjustment or other contractual right), it could be argued that the receivable held by the REIT was a Qualifying REIT asset (assuming it was otherwise non-portfolio property). By narrowing the scope of ancillary Qualifying REIT assets to tangible personal property, these interests may be non-Qualifying REIT assets. Given the ownership restrictions on non-Qualifying REIT assets, it should be considered whether limitations are necessary on these contingent rights, and the commercial consequences of such limitations.
- *Vendor Take-Back Mortgages*: The limitations on ancillary Qualifying REIT assets may prevent Qualifying REITs from offering vendor take-back mortgages when disposing of property. If the mortgage constitutes non-portfolio property, it will be considered a non-Qualifying REIT asset (and, therefore, subject to the 10% ownership restrictions). Previously, it could be argued that the mortgage was ancillary to earning capital gains from the disposition of real property.
- *Development Structures*: The proposed amendments will enable Qualifying REITs to finance development projects with mezzanine loans in certain limited circumstances. The Qualifying REIT Rules, however, generally do not accommodate common development structures historically used by real estate investment trusts. Careful structuring of development arrangements is necessary where the Qualifying REIT will exceed its ownership threshold for non-Qualifying REIT assets.
- *Interest Rate Derivatives*: The proposed amendments include certain revenues from foreign currency derivatives as Qualifying REIT revenue; however, there is no similar relief for revenues from interest rate hedging contracts. Qualifying REIT's that are entering into interest rate derivatives must carefully consider the asset and revenue tests in the Qualifying REIT Rules.
- *Real Estate Inventory*: Although the proposed amendments permit a Qualifying REIT to earn a portion of its revenue from the sale of eligible resale properties, the ownership of eligible resale property is not considered to be a Qualifying REIT asset. Accordingly, the value of a Qualifying REIT's eligible resale property (and all other non-Qualifying REIT assets) must be less than 10% of the fair market value of its non-portfolio property.

The proposed amendments also do not address certain notable aspects of the existing Qualifying REIT Rules, including:

- *Rectifying Qualifying REIT Status*: A trust that does not satisfy the Qualifying REIT Rules at any time during the taxation year will be subject to SIFT tax for that taxation year. There is still no ability for a trust to rectify its status in the current taxation year; however, a trust may restructure its affairs to qualify as a Qualifying REIT in a subsequent taxation year.
- *Taxable REIT Subsidiaries*: The proposed amendments do not provide for taxable REIT subsidiaries (as contemplated under the U.S. REIT rules).
- *Exchangeable Units*: The Qualifying REIT exception is still only applicable to trusts. Accordingly, real estate investment trusts that issue exchangeable units of a subsidiary partnership must place limitations on the holders of such units to ensure that the partnership is not subject to entity-level taxation.

Effective Date

The proposed amendments generally are effective as of the 2011 taxation year. Publicly traded trusts also may elect for the proposed amendments to apply for earlier taxation years by filing a notice with the Minister of National Revenue. The proposed amendments are subject to consultation between Finance and interested parties. Further submissions on the proposed amendments are due on January 31, 2011.

For further information, please contact:

Maureen Berry
mberry@goodmans.ca 416.597.4287

Alan Bowman
abowman@goodmans.ca 416.597.4209

Jarrett Freeman
jfreeman@goodmans.ca 416.849.6023

Jon Northup
jnorthup@goodmans.ca 416.597.4228

Stephen Pincus
spincus@goodmans.ca 416.597.4104

Mitchell Sherman
msherman@goodmans.ca 416.597.4189

Carrie Smit
csmit@goodmans.ca 416.597.4230