

Income tax planning and tax accounting considerations for REITs

Recent legislative and accounting developments could have important implications

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A number of recent legislative and accounting developments could have a substantial impact on tax planning and income tax accounting for real estate investment trusts (REITs). REITs and their tax and accounting advisors should familiarize themselves with these developments and their potential impact.

Changes to criteria for qualification of the REIT exception

Federal Bill C-10 (An Act to implement certain provisions of the budget tabled in Parliament on January 27, 2009 and related fiscal measures) received royal assent and became fully enacted for both Canadian and US GAAP purposes during March 2009. Bill C-10 implements some important changes to the criteria for qualifying for the "REIT Exception" from specified investment flow-through ("SIFT") taxation. These changes were first announced in December 2007 and were intended to address certain technical issues that would have made it difficult for many REITs to meet the REIT Exception.

REITs will need to evaluate the potential impact of these changes on their eligibility for the REIT Exception, and the resulting income tax provision implications. In particular, certain REITs may have previously determined that a future income tax provision was required because they did not qualify for the REIT Exception, by virtue of certain fundamental "problem areas" with the original SIFT legislation that have now been amended. With the resolution of these issues, it will be necessary for REITs to complete a more comprehensive analysis of their status to determine whether there are any remaining business arrangements or interpretational uncertainties that continue to affect their REIT Exception status. As a result of the Bill C-10 changes, it may be appropriate for some REITs which had previously accrued income tax provisions in their financial statements for the first quarter of 2009.

New provincial allocation for SIFT tax

REITs that conclude they are still ineligible for the REIT Exception without further restructuring or business changes will need to determine the implications of

changes to the calculation of the provincial component of the SIFT tax. Prior to Bill C-10, the federal SIFT tax rate included a 13% component that was intended to represent an average provincial rate. Under Bill C-10, this 13% component has been eliminated and replaced with a requirement to calculate a provincial tax component in a manner similar to that used in determining the provincial allocation for corporate income tax purposes.

Consequently, starting with the first quarter of 2009, REITs that continue to record a future income tax provision will need to estimate their provincial revenues and employee compensation and the relevant substantively enacted provincial tax rates that are expected to apply when the SIFT tax begins in 2011. Changes to the “substantively enacted” status of future provincial tax rates will need to be monitored each quarter. For example, Ontario’s recent budget announced a reduction on the Ontario general corporate income tax rate from the current 14% to 10% by July 1, 2013, but these rate reductions have not yet been substantively enacted. For US GAAP purposes REITs are required to use fully enacted income tax rates. REITs with a presence in Quebec should also continue to monitor developments in that province’s parallel SIFT taxation regime.

IFRS-related amendments to declarations of trust

REITs will also need to consider the implications of the conversion to International Financial Reporting Standards (“IFRS”) on their income taxes. One area which could have an impact, even before conversion, is the classification of the REIT’s units as equity or liabilities under IFRS (see PwC commentary in the article *IFRS in Canada – Potential IFRS liability treatment for REIT units*, which can be accessed at www.pwc.com/ca/realestate). Based on typical provisions in REIT trust declarations, many REITs would be required to classify their trust units as a liability (and adjust the carrying value of this liability to the market value of the units each period through a charge or credit to income) when they adopt IFRS. To maintain equity accounting treatment, such REITs might need to amend their declarations of trust; for example, to modify provisions such as those which currently require all taxable income to be distributed to unitholders (to ensure that no regular income tax is incurred by the REIT). Such changes would typically need to be approved by unitholders, and REITs might therefore anticipate including these changes on the agenda for their upcoming annual meeting. Although it would be expected that trustees would continue to make sufficient distributions and to allocate all taxable income to unitholders (and the REIT might need to implement certain internal controls procedures to ensure that this result continues), the

elimination of a mandatory requirement to pay a minimum distribution will likely require the REIT to record a future income tax provision under Canadian GAAP (even where the REIT has concluded that it qualifies for the REIT Exception from the SIFT tax). Accordingly, any proposed changes to the declaration of trust should be carefully reviewed from an income tax accounting perspective.

Enactment of rules for conversions of trusts to corporations

Bill C-10 also enacted rules that are intended to facilitate the conversion of income trusts, including REITs, to taxable Canadian corporations. Now that legislation is in place, REITs that expect to be subject to the SIFT tax and that have been considering conversion to corporate form will be able to develop their plans with greater certainty. The general intent of the legislation is to allow conversions to be carried out on a tax-deferred basis for unitholders, and in certain cases to preserve certain tax attributes of the public and subsidiary trust vehicles, such as loss carryforward and unamortized issue cost balances. The legislation will also apply to facilitate certain REIT privatization transactions.

Other PwC information on REITs and the SIFT regime

A number of PricewaterhouseCoopers Tax Memos are available at www.pwc.com/ca/taxmemo that provide more information on the SIFT rules and their application to Canadian REITs.