

Specified Investment Flow-Throughs (SIFTs): Draft Legislation

On December 21, 2006, the Minister of Finance released for comment draft legislation concerning the taxation of Specified Investment Flow-Through (SIFT) trusts and SIFT partnerships. These proposals were originally announced on October 31, 2006 in the government's *Tax Fairness Plan* and discussed in our *Tax Memo* "Déjà vu All Over Again – New Tax Regime for Income Trusts and Publicly Listed Partnerships" (November 2, 2006) at www.pwc.com/ca/taxmemo.

Although the brief draft legislation provides some additional technical detail and clarification, no significant policy changes from the October announcement are apparent. The press release accompanying the draft legislation again refers to corporate tax avoidance and an unacceptable shift of tax burden to hard-working Canadians as the key driving motivation behind the tax proposals. Not everyone shares that view, as noted in a recent PricewaterhouseCoopers report (at www.pwc.com/ca – search for "Income Trust Report").

Key Elements of the Draft Legislation

The key elements of the draft legislation are as follows:

- SIFTs include trusts and partnerships that are resident in Canada, listed on a public market and hold one or more non-portfolio properties.
- Non-portfolio properties are entities in which the SIFT holds a significant interest.
- Real estate investment trusts (REITs) that earn passive income will be excluded from the proposed tax.
- Non-portfolio earnings of a SIFT are subject to a new tax ("Distribution Tax") that equals the general federal corporate income tax rate, plus a 13% levy in lieu of provincial tax and territorial tax, to be allocated to those jurisdictions.
- Non-portfolio earnings include income from businesses carried on in Canada, income from non-portfolio properties and taxable capital gains from dispositions of non-portfolio properties.
- Distributions of non-portfolio earnings less the related Distribution Tax will be treated as taxable dividends in the hands of the recipient beneficiaries or partners.
- The Distribution Tax will not apply to SIFT trusts or SIFT partnerships that were publicly listed on October 31, 2006 until their first taxation year ending in 2011.

For more information on the tax proposals, please see the *Tax Memo* referred to above.

Draft Legislation – Technical Highlights

Adjusted cost base

The adjusted cost base of a beneficiary's capital interest in a trust is reduced by trust distributions payable to the beneficiary, except to the extent that the distribution was included in the beneficiary's income. Also excluded from the reduction will be any amounts deemed by the new rules to be a dividend received by the beneficiary.

Deemed dividend distributions are eligible dividends

Eligible dividends paid by a corporation qualify for the new enhanced dividend tax credit. To achieve this, the definition of “eligible dividend” is amended to include the deemed dividend distributions of SIFT trusts and SIFT partnerships. In most cases, corporate investors will be unable to determine the amount of eligible dividends they received until they obtain the annual tax reporting information from the SIFT (see below under “Deemed dividend: non-deductible distributions amount”). If the investor is a Canadian-controlled private corporation, this information will affect the balance in its general rate income pool (GRIP) account.

Defined terms: non-portfolio earnings and properties

Defined terms, including “non-portfolio earnings” and “non-portfolio properties,” appear to be consistent with the October release. For further details, please see the November 2, 2006 *Tax Memo* mentioned on page 1.

Non-deductible distributions amount

A SIFT trust is denied a deduction for any non-portfolio earnings distributed to its beneficiaries. The definition of this “non-deductible distributions amount” limits the deductible amount of distributions to the trust’s gross income in excess of its non-portfolio earnings.

Distribution Tax calculation

The provision that applies the top personal tax rate to the taxable income of an *inter vivos* trust has been amended to adjust the tax rate to the net corporate tax rate in respect of the amount of taxable SIFT trust distributions, which are computed as:

$$\text{Taxable SIFT trust distributions} = \frac{\text{Non-deductible distributions}}{1 - \text{the net corporate tax rate}}$$

This calculation grosses up the non-deductible distributions (which are treated as taxable dividends) to a pre-tax amount, for purposes of computing the Distribution Tax.

Deemed dividend: non-deductible distributions amount

A SIFT trust’s non-deductible distributions amount is deemed to be a taxable dividend received by the

beneficiaries. The allocation of the dividend to each beneficiary is determined by a formula that pro-rates the non-deductible distributions amount for the taxation year to each beneficiary, based on the beneficiary’s share of amounts payable to all beneficiaries in the taxation year.

The dividend is deemed to be paid when the distribution becomes payable to the beneficiary. As a result, each distribution may contain a dividend component. This timing is problematic, because the non-deductible distributions amount and the total deemed dividend can be calculated only annually, after the end of the SIFT’s taxation year. For withholding tax purposes, the SIFT trust is deemed to be a corporation resident in Canada that paid the dividend. Fortunately, as long as trust distributions and dividends are subject to the same rate of withholding tax (e.g., 15% under the Canada-U.S. Tax Treaty), the inability to determine the dividend amount until after the end of the taxation year should not create practical problems.

Amounts payable to beneficiary

An amount will be payable to a beneficiary only if it was actually paid in the year or if the beneficiary was entitled in the year to enforce its payment. This rule is amended to expand its application to several new provisions.

Partnerships and the proposed Part IX.1 tax

Part IX.1 tax is introduced to extend the Distribution Tax to SIFT partnerships. Part IX.1 tax is imposed on a SIFT partnership’s non-portfolio earnings (the lesser of the partnership’s income for tax purposes and its non-portfolio earnings). The tax rate is the net corporate tax rate (federal corporate tax rate less the general rate reduction and provincial abatement) plus the 13% provincial/territorial tax factor. The difference between the amount subject to Part IX.1 tax and the tax payable is deemed to be a dividend received by the partnership.

No separate provincial/territorial tax

An amendment ensures that a SIFT trust will not be subject to a separate provincial or territorial tax in respect of its non-deductible distributions (because the non-deductible amount will be subject to the 13% provincial tax factor). Nothing explains how the 13% tax on both SIFT trusts and SIFT partnerships is to be transferred from the federal government to the provinces or territories, which apparently is to be subject to negotiation. (A more transparent approach consistent with established tax

principles would have been to allocate the 13% provincial tax to provinces and territories in which the SIFT maintained permanent establishments.)

What's Missing?

Bounds on growth or expansion

Missing from the draft legislation is any reference to the possibility of a SIFT trust or SIFT partnership becoming subject to the proposed tax before its 2011 taxation year as a consequence of "undue" growth or expansion. That possibility was mentioned in the October release and had been the subject of many submissions to the Department of Finance.

On December 15, 2006, the Minister of Finance announced guidance on what would be acceptable growth. The effective date of 2011 will not be accelerated if the increase in equity capital of a SIFT entity does not exceed the greater of \$50 million and a "safe harbour" amount.

The safe harbour amount is a percentage of the value of the SIFT's equity as at October 31, 2006, and effectively allows a SIFT to double its equity capital, phased in as follows:

	Percentage of October 31, 2006 equity value
2007	40%
2008	60%
2009	80%
2010	100%

The December 15, 2006 announcement indicates that "new equity" includes both equity units and debt that is convertible into such units. In addition, the following will not be considered equity growth:

- replacing debt that existed on October 31, 2006 with new equity;
- new non-convertible debt;
- issuance of equity to satisfy pre-October 31, 2006 exchange or conversion rights; and
- mergers or reorganizations of SIFTs (to the extent that no net addition to equity results).

Conversions of a SIFT to a corporation

Also missing from the draft legislation is any mention of the government's intention, as announced on December 15, 2006, to allow the conversion of a SIFT to a corporation on a tax-deferred basis.

There appears to be no compelling reason for a SIFT to ever subject itself to the proposed new taxes, so many SIFTs can be expected to convert voluntarily into corporate form before 2011. SIFTs will effectively become high-dividend paying corporations. The regular corporate tax rules provide much more certainty and flexibility than the proposed SIFT tax regime. For example, the standard corporate reorganization rules (tax-deferred property transfers, business combinations, wind-ups, etc.) are not available to SIFT trusts. On the other hand, a SIFT with high foreign source income may prefer to retain its current flow-through structure.

Anti-avoidance rules

The draft legislation contains no specific anti-avoidance rules. The October proposals stated that the government would react to new structures or transactions that frustrated its policy objectives. Some have anticipated measures to prevent the increased use of corporate debt or stapled units consisting of both equity and debt. It remains to be seen whether such structures will become more common as SIFTs convert into perhaps more highly levered public corporations.

Considerations for Existing Flow-Through Entities

In response to the draft legislation, existing flow-through entities should consider:

- updating financial projections to determine the effect of the tax on distributions starting in 2011;
- implementing internal restructurings to minimize the effect of the proposed tax, such as ensuring that foreign source income (which is not subject to the tax) retains its status as foreign source income earned directly by the SIFT;
- financial statement implications, including the need to account for future taxes and potentially write-down the value of intangible assets;
- the effect on financial ratios and bank covenants, some of which may have to be renegotiated;
- alternative sources of capital for both refinancing and expansion purposes;
- strategic alternatives of converting to a corporate structure or privatizing, to better pursue business objectives; and
- alternative forms of financing, such as convertible debt or stapled units of debt and equity.

For more information

The new tax regime for SIFTs is complex and will have significant consequences for these entities and their investors. For help understanding the implications of the new rules, please contact your PricewaterhouseCoopers adviser or any of the individuals listed below.

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