

REIT Update

The evolving SIFT regime and its effect on the Canadian REIT industry

November 2008

The Canadian specified investment flow-through (SIFT) taxation rules impose a “corporation-like” tax on certain income distributions paid by publicly listed trusts and partnerships. SIFTs that existed on October 31, 2006 and stay within certain “normal growth guidelines” published by the Department of Finance (Finance) can be exempt from this tax until 2011. Certain REITs (Real Estate Investment Trusts), however, qualify for an ongoing exclusion from SIFT status provided certain tests are met (the “REIT Exception”).

Draft income tax legislation released by the Department of Finance (Finance) in July 2008 contain a number of provisions intended to facilitate the conversion of SIFT trusts into corporations, either directly or through tax-efficient acquisitions by other entities, and other provisions (first proposed in December 2007) that modify or clarify certain aspects of the SIFT rules, in particular as they affect the REIT Exception.

Accordingly, Canadian REITs that intend to continue as public entities now have a number of choices to make regarding their taxation status.

Attempt to meet and maintain eligibility for the REIT Exception, to remain as a flow-through vehicle for tax purposes.

Qualification for the REIT Exception for a year requires that a number of complex, technical tests be met by the REIT at all times throughout the year. The rules contain no *de minimis* exceptions or curative mechanisms to correct

minor or inadvertent failures. Accordingly, REITs will need to undertake a systematic review of all aspects of their internal investment structure, the nature of each item of revenue and expense, and all assets held within any entity in the REIT to determine whether and to what extent changes are required. Furthermore, REITs will need to design and implement new internal controls and other procedures to ensure that their status is carefully monitored on an ongoing basis. In particular, any proposed investments or changes to existing business agreements will need to be assessed in light of their potential impact on the REIT Exception.

Proposals contained in the July 2008 draft legislation address a number of technical issues that would have made it difficult for certain REITs to meet the REIT Exception. For example:

- a. the “Canadian content” restriction will be removed, allowing the REIT to invest in real estate located anywhere in the world;
- b. subsidiary trust structures will be accommodated;
- c. the rules will clarify that subsidiary trusts and partnerships will not be considered SIFTs, provided that they are not publicly traded and that they are owned by some combination of SIFTs, REITs, taxable Canadian corporations or partnerships whose ultimate members are all one of these entities; and

- d. greater flexibility will be permitted regarding the use of “nominee” corporations to hold legal title to properties and regarding certain “near-cash” investments that will satisfy the 75% asset test.

A number of problem areas remain, however, that in certain cases could cause a REIT to fail the REIT Exception or make the determination uncertain, such as:

- a. making certain loans to private development partners or accepting “vendor take-back” debt on sale transactions;
- b. determining whether revenues are from services “ancillary” to the rental of real property and “customarily” supplied or rendered in connection with such rental activities—some parking lot revenue, for example, might not meet this test;
- c. determining whether certain property owned by an entity within the REIT structure and used in carrying on a business by the entity is “ancillary” to the earning of rent from real property or of revenue from services described in b. above; and
- d. certain property dispositions that might be considered to be on income account.

Accept treatment as a SIFT trust.

Some REITs will simply not be able to meet the REIT Exception, in its current form, such as hotel or nursing home REITs. Other REITs might determine that the cost of restructuring or establishing systems to monitor and manage ongoing compliance with the technical tests is prohibitive.

For REITs that have significant tax shelter (from a combination of capital cost allowance, interest expense, unit issue cost amortization, and similar costs, for example) or income from foreign sources might project that their income subject to the SIFT tax will remain low such that the impact on distributable cash will be modest. The trust structure, in contrast to a corporate form, would

then continue to permit the tax-efficient distribution of cash flow to investors.

Convert into a taxable Canadian corporation.

Finally, certain REITs that are unable or choose not to meet the REIT Exception might prefer to convert to a corporation, especially where their available tax shelter is relatively low. In particular, certain REITs might find that their ability to raise capital, or to retain internally generated cash, for acquisitions or development projects means that they are best suited to operate in corporate form.

The July 2008 draft legislation proposes a number of rules that will facilitate the conversion of a REIT into a corporation. A number of different methods could be employed, depending on business as well as income tax objectives, but flexibility exists to, for example, permit unitholders to choose whether to defer or realize accrued gains/losses on their units.

These proposed rules will, however, be temporary in that they require conversion transactions to be undertaken prior to 2013. Accordingly, REITs that will not be able to qualify for the REIT Exception will need to carefully consider whether the SIFT regime will be the most appropriate long-term structure, as it might be more difficult (or at least, more costly for unitholders) to convert to corporate form thereafter.

Other PwC information on REITs and the SIFT regime

A PricewaterhouseCoopers real estate tax professional can help you better understand the implication of the choices to your organization. Please contact Chris Potter by telephone, at 416 218 1468, or by email, at chris.j.potter@ca.pwc.com, for more information.

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