

## More Tinkering with the SIFT Rules

The Specified Investment Flow-Through (SIFT) rules, originally announced on October 31, 2006, and enacted in June 2007, impose a tax on distributions paid by publicly traded trusts and partnerships. The tax does not apply until 2011 for SIFTs that:

- existed on October 31, 2006; and
- comply with specific growth guidelines, as set out in a December 15, 2006 Department of Finance (Finance) press release.

In response to questions on the interpretation and scope of certain aspects of the SIFT rules, Finance announced proposed technical amendments in a Backgrounder on December 20, 2007. Draft legislation implementing these amendments has not been released.

### Scope of the SIFT Rules

The following changes to the scope of the SIFT rules clarify certain interpretive matters and amend several aspects of the SIFT rules.

#### Subsidiary entities

While it appeared the SIFT rules were intended to tax only publicly traded trusts and partnerships, a literal reading of the definition suggested that they could apply to private entities owned entirely or partly by publicly traded entities, for example a partnership between a private company and a public company or a subsidiary partnership within an income trust or public company structure. The SIFT definition will be amended to exclude trusts and partnerships whose equity:

- is not publicly traded; and
- is owned by a SIFT, a REIT, a taxable Canadian corporation, another entity meeting this test or any combination of these types of entities.

However, to ensure a corporate level of tax on the income of these subsidiary entities, partnerships and trusts with any individual or tax-exempt partners and beneficiaries will not be carved out of the SIFT definition. Because there are strong arguments that subsidiary entities should not generally be within the current SIFT definition in any case, it will be interesting to see whether the SIFT definition will be further amended to expressly characterize as SIFTs subsidiary entities that do not fit the new exclusion.

#### Publicly traded debt

Under the current rules, a private trust or partnership with publicly traded debt will be considered a SIFT. Amendments to the rules exclude publicly traded debt that is at least 90% held by non-affiliated entities and is not "equity-like": for example, is not convertible into equity.

## Non-portfolio property (NPP)

To be a SIFT, a publicly traded trust or partnership must hold non-portfolio property (NPP). NPP includes an interest of more than 10% in another entity, or in securities in another entity worth more than 50% of the equity value of the SIFT itself. The definition of NPP will be amended to exclude a “portfolio investment entity” that holds no NPP.

Canadian real or resource property can also be NPP if the value of all such properties exceeds 50% of the equity value of the SIFT. An amendment is proposed to exclude shares of taxable Canadian corporations and interests in SIFTs from the definition of Canadian real or resource property. This change will ensure that portfolio investments (holdings of less than 10% representing under 50% of the value of the trust or partnership and that are not used in the course of carrying on a business in Canada) in these entities will not be aggregated and result in the trust or partnership being designated as a SIFT.

## Changes Affecting REITs

The proposals also address some of the technical questions that have been raised by REITs (Real Estate Investment Trusts) in attempting to qualify for exclusion from SIFT status (the “REIT Exception”):

- **Canadian content** – Currently, a REIT must hold more than 75% of its equity value in the form of Canadian real estate and derive more than 75% of its revenues from Canadian real estate. This geographic requirement will be removed from both of these tests.
- **Subsidiary trusts** – A REIT must derive more than 75% of its revenue from:
  - real estate rent;
  - real property mortgage interest; and
  - capital gains from real property dispositions.

Because many REITs carry on these activities through intermediary trusts, an amendment to the REIT definition will ensure that the character of the income does not change simply because it is paid through an intermediary trust.

- **Short-term investments** – To ensure that short-term holdings of cash-like investments will not cause a REIT to cease to satisfy the 75% asset test, the list of qualifying assets will be amended to include bank deposits, bankers’ acceptances and, possibly, other types of highly liquid short-term investments.
- **Nominees** – A REIT can hold only NPP that is itself qualified REIT property. Securities of an entity that holds legal title to properties of the REIT are qualified REIT property. This definition will be amended to

permit the “nominee” corporation to hold legal title to property held by another subsidiary of the REIT.

The proposals affecting REITs are generally welcome. They clarify several issues and remove the geographic investment requirement. However, there has been no real expansion in the scope of the REIT definition. In particular, the rules have not been expanded to encompass hotel or nursing home REITs. On the technical front, holding any NPP (even of nominal value) that is not qualified REIT property will cause a REIT to fail to satisfy the REIT Exception. In this regard, a *de minimus* test and/or curative provision would be desirable. REITs will have to continue to carefully monitor their status.

## Tax-deferred Conversions of SIFTs into Corporations

On December 15, 2006, Finance indicated that it would consider a rule to permit the tax-deferred conversion of a SIFT into a corporation. Further details are expected shortly.

Over the past year many SIFTs have been privatized as trustees and investors try to maximize shareholder value. The growth limits imposed by Finance have also contributed to this privatization wave, as management teams seek to raise capital and pursue expansion opportunities.

We remain convinced that few SIFTs will remain in existence in their current form by 2011. Larger SIFTs probably will convert into public corporations. Smaller SIFTs, especially those with higher debt levels or higher payout ratios, likely will be privatized. Only SIFTs that provide high levels of tax shelter or whose income is primarily foreign-source (and are therefore not subject to the distributions tax) are likely to survive in their current form. However, even those SIFTs should consider their viability as public entities and their ability to attract capital.

## Other PwC Tax Memos on SIFTS

The following PricewaterhouseCoopers *Tax Memos*, available at [www.pwc.com/ca/taxmemo](http://www.pwc.com/ca/taxmemo), provide more information on the SIFT rules:

- “Déjà vu All Over Again – New Tax Regime for Income Trusts and Publicly Listed Partnerships” (November 2, 2006) – discusses the October 31, 2006 proposals; and
- “Specified Investment Flow-Throughs (SIFTs): Draft Legislation” (January 9, 2007) – discusses draft legislation released on December 21, 2006 that implements the October 31, 2006 proposals.

## For More Information

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

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