Recent Changes in REIT Taxation

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Overview

- Pre-2007 REIT Regime
- Specified Investment Flow-Through (“SIFT”) Rules (originally announced October 31, 2006)
- REIT Exemption – Original Rules and Legislative Changes
- Recent Developments

Overview

- Pre-2007 Regime
  - Basic requirements for mutual fund trust status
  - Market Growth and Developments
  - Rise of income trusts and related tax leakage concerns

Overview

- Specified Investment Flow-Through (“SIFT”) Rules

Overview

- REIT Exemption
  - Original Rules
  - Legislative evolution
  - Key definitions
  - 5 REIT tests and notable changes

Overview

- Recent Developments
  - Stapled Securities Amendments (2013)
  - Cross-Border REITS
    (*e.g.*, Agellan Commercial REIT)
  - Foreign Real Estate Holdings
    (*e.g.*, Dundee International REIT)
  - REIT Spin-Off Transactions (*e.g.*, CT REIT)

Pre-2007 REIT Regime

Historical Background/Context

- REITs first created in the United States in the 1960's through the *REIT Act*
- The REIT industry developed in Canada in the early 1990's with the establishment of "open-ended" real estate mutual funds
- Many of these funds experienced difficulties shortly thereafter, due to a market downturn in real estate prices and a lack of liquidity for purposes of funding redemption/requests
- Many open-ended real estate mutual funds converted to "closed-ended" funds as a result
- Subsequently, "modified" open-ended funds with more issuer-friendly redemption provisions emerged

Canadian REITs Growth in Size and Volume: 1993-2013

	1993	2003	2013
Number of REITs	3	28	48
Number of REITs with market capitalization			
➢ $1 Billion	0	4	17
➢ $3 Billion	0	0	6

What is a Mutual Fund Trust?

- A conventional, *inter vivos* trust that satisfies certain qualifying conditions set out in the *Income Tax Act*
- As of June 2010, almost 35% of Canadian households invested in mutual funds
- Canadians’ mutual fund holdings exceeded $1 trillion as of August 31, 2014

Source: The Investment Funds Institute of Canada

Basic MFT Qualification Requirements
Income Tax Act 132(6)

Six statutory tests must be satisfied for a trust to qualify as a “mutual fund trust” at any particular time:

1. “Trust” test
2. “Unit Trust” test
3. “Resident in Canada” test
4. “Sole Undertaking” test
5. “Prescribed Conditions” test
6. “Ownership” test (not controlled by non-residents)

MFT Benefits/Considerations

- Key Benefits of MFT Status
  - No Part XII.2 tax
(36% tax on certain trusts' "designated income")
  - No alternative minimum tax
- Distributions to Unitholders (s.104(6))
- Losses
- Multiple class unit structures
- Thin-capitalization rule amendments

Rise of Income Trusts

- Initial income trusts were royalty trusts which date back to 1986; REITs emerged in the early 1990s
- Business Income Trusts experienced large growth beginning in 2001, when the interest rate environment declined
- Encompassed a wide range of businesses, in industries that included power, pipelines, telecommunications, newspapers and restaurants
- Typical candidates included businesses with a dominant market position, stable and sustainable cash flows, and limited capital expenditure requirements
- At the beginning of 2001 there were 70 income trusts with an aggregate market capitalization of $14 billion
- By October 2006, there were 245 income trusts with an aggregate market capitalization of $210 billion

Comparative Tax Burdens

	Earned Through a Trust			Earned Through a Public Corporation		
	Individual	Tax-Exempt	Non-Resident	Individual	Tax-Exempt	Non-Resident
Business Income	100	100	100	100	100	100
Less: Corporate Tax (federal & provincial tax, 35%)	-	-	-	(35)	(35)	(35)
Amount Available for Distribution to Investor	100	100	100	65	65	65
Grossed up Dividend (45%)	-	-	-	94	-	-
Less: Personal Tax (46%)	(46)	-	-	(43)	-	-
Less: Withholding Tax (15%)	-	-	(15)	-	-	(10)
Add: Dividend Tax Credit (federal & provinical, 32%)	-	-	-	30		
Amount Retained After-tax	54	100	85	51	65	55
Less: Personal Tax on Pension Distribution (46%)	-	(46)	-	-	(30)	-
Amount Retained After-tax	54	54	85	51	35	45
Overall Effective Tax Rate	**46%**	**46%**	**15%**	**49%**	**65%**	**45%**

Source: Income Trust Report PricewaterhouseCoopers LLP – December 11, 2006

Related Tax Policy Concerns

- In September 2005, the Department of Finance estimated federal tax leakage from income trusts at $255 million
- Estimates for the total tax leakage in 2006 (excluding planned conversion by BCE and Telus) was estimated at $700 million, and with the planned BCE and Telus conversions, $1.1 billion
- In November 2005, dividend tax rates on “eligible dividends” were significantly reduced
- However, income trusts still provided significant tax benefits to tax-exempt investors and non-residents and continued to grow at a rapid rate

Specified Investment Flow-Through (SIFT) Rules

Specified Investment Flow-Through Entity (SIFT) Rules

- October 31, 2006, the Minister of Finance announced SIFT legislation introducing an entity-level tax on publicly traded income trusts and partnerships
- **Key element:** investors taxed in a manner substantially similar to shareholders of a Canadian corporation
- A trust will be a "SIFT trust" where:
  - the trust is resident in Canada
  - investments in the trust are listed or traded on a stock exchange or other public market, and
  - the trust holds one or more non-portfolio properties

SIFT Tax and REIT Exemption

- "**Non-portfolio property**" of a particular entity includes:
  - Securities of a subject entity having a fair market value of (i) greater than 10% of subject entity's "equity value" or (ii) more than 50% of the particular entity's "equity value" or
  - Canadian real or immovable or resource property if total fair market value >50% of entity's "equity value"
- A trust that qualifies as a REIT ("**Qualified REIT**") throughout a particular year is not considered to be a SIFT trust for that year and is not subject to SIFT Tax
- Originally proposed REIT exemption viewed as unduly narrow, and as a result, a number of REITs at the time did not meet the requirements

REIT Exemption

Notable Concerns - Original Rules (2006)

- No "safe harbour" with respect to non-portfolio property which is not "qualified REIT property"
- "Qualified REIT property" only included Canadian real property
- Narrow definition of "rent from real or immovable properties"
- Lack of revenue character presentation under REIT revenue test

Qualification as a REIT – Original Rules

A trust qualified as a REIT in a taxation year if it is *resident in Canada* throughout the taxation year and met the following requirements:

Qualification as a REIT – Original Rules

1. The "**property test**" requires that the trust not hold any non-portfolio property other than "qualified REIT properties" at any time in the taxation year;

Qualification as a REIT – Original Rules

2. The "**95% passive revenue test**" requires that at least 95% of the trust's revenues for the taxation year be derived from:

   a) Rent from real or immovable properties;

   b) Interest;

   c) Capital gains from dispositions of real or immovable properties;

   d) Dividends; and

   e) Royalties.

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Qualification as a REIT – Original Rules

3. The "**75% real property revenue test**" requires that at least 75% of the trust's revenues for the taxation year be derived from:
   a) Rent or mortgage interest from real or immovable properties situated in Canada; and
   b) Capital gains from dispositions of such properties situated in Canada.

Qualification as a REIT – Original Rules

4. The "**real property value test**" requires that the total fair market value of all trust properties, each of which is a real or immovable property situated in Canada, cash, or certain government debt, be at least 75 percent of the trust's "equity value" throughout the taxation year.

Legislative Changes to REIT Exemption

- 2007 saw favourable changes to remove foreign investment restrictions, expand categories of qualifying assets, facilitate rental income earned in trust on trust organization structure and allowing REIT subsidiaries to hold legal title to real property of REIT enacted by S.C. 2009, c.2
- Draft legislation in 2010 proposed amendments that included a non-portfolio property safe harbour, additional permitted non-capital property, and revenue character preservation provisions
- Retroactive effect back to 2006 through taxpayer election

Legislative Changes to REIT Exemption

"*real estate investment trust*", for a taxation year, means a trust that is resident in Canada throughout the taxation year, ***if***

a) at each time in the taxation year the total fair market value at that time of all non-portfolio properties that are qualified REIT properties held by the trust is at least 90% of the total fair market value at that time of all non-portfolio properties held by the trust

b) not less than 90% of the trust's gross REIT revenue for the taxation year is from one or more of the following:

- rent from real or immovable properties
- interest
- dispositions of real or immovable properties that are capital properties
- dividends
- royalties and
- dispositions of eligible resale properties

Legislative Changes to REIT Exemption

c) not less than 75% of the trust's gross REIT revenue for the taxation year is from one or more of the following:

– rent from real or immovable properties
– interest from mortgages or hypothecs on real or immovable properties, and
– dispositions of real or immovable properties that are capital properties

d) at each time in the taxation year an amount, that is equal to 75% or more of the equity value of the trust at that time, is the amount that is the total fair market value of all properties held by the trust each of which is a real or immovable property that is capital property, an eligible resale property, an indebtedness of a Canadian corporation represented by a bankers' acceptance, a property described by paragraph (a) or (b) of the definition "qualified investment" in section 204 or a deposit with a credit union; and

e) investments in the trust are, at any time in the taxation year, listed or traded on a stock exchange or other public market

Legislative Changes to REIT Exemption - Property Test

- **Old Rules** - a trust could only hold non-portfolio property that was "*qualified REIT property*"
- **New Rules** - now allow a trust to hold up to 10% of non-portfolio property that is *not* "qualified REIT property"
- Safe harbour for "bad" property/business activities

Legislative Changes to REIT Exemption - Property Test

"*Eligible Resale Property*"

- Clarification under new rules that "eligible resale property" is included in the definition of "qualified REIT property"
- Includes property that is contiguous to another eligible resale property
- Contiguous property can now be held by an affiliate (and not only by a direct subsidiary of the REIT)
- Holding of contiguous property now must be "ancillary" rather than "necessary and incidental to" the holding of real or immovable property or eligible resale property

Legislative Changes to REIT Exemption - Property Test

"Qualified REIT Property"/Ancillary Property:

- No longer limited to tangible personal property
- Intangible personal property that is ancillary to earning of rent and capital gains such as rent receivables and certain contractual rights can now be Qualified REIT Property
- Only equity interests in an entity and debts are now specifically *ex*cluded

Legislative Changes to REIT Exemption - Property Test

- New rules eliminate any technical concerns where a REIT holds substantial cash on deposit with a single financial institution
- However, no amendment to definition of "real or immovable property" such that securities of a subsidiary must comply with the original four REIT conditions to be "real or immovable property"

Legislative Changes to REIT Exemption – Revenue Tests

- The threshold of the passive revenue test has been reduced from 95% to 90% of the trust's gross REIT revenue
- Clarification (for both revenue tests) as to meaning of "gross REIT revenues"
  - excess of all amounts received or receivable over the cost of any property disposed of by the REIT
  - recapture not included in "gross REIT revenues"
  - losses also not included for purposes of the test
  - certain expenses, such as selling costs, which are not capitalized will not reduce gross REIT revenues

Legislative Changes to REIT Exemption – Revenue Tests

- Both revenue tests provide that revenues derived from rent from real or immovable properties is "good" revenue
- Understood to include similar payments for the use of, or the right to use, real or immovable properties, and payments for services ancillary to the rental of real or immovable properties that are customarily supplied by a landlord to its tenant
- However, still concerns that certain amounts such as lease termination fees and damages for unpaid rent may not qualify for either of the revenue tests
- Although gains from the disposition of eligible resale property now qualify for purposes of the 90% passive revenue test, such gains will still not qualify for the 75% real property revenue test

Legislative Changes to REIT Exemption – Revenue Tests

Flow-through of Revenue Characterization

Clarifications:

- Rule applies to amounts received or receivable and in respect of a security of the source entity that is a share of a corporation, an income or capital interest in a trust or an interest in a partnership
- It is the "character" of revenue, rather than its source, that is retained
- Securities of source entities no longer need to be non-portfolio property (permits flow-through of character for revenues from non-resident entities)
- Rule will not apply to revenue derived from securities of "property management subsidiaries"

Legislative Changes to REIT Exemption – Revenue Tests

The new rules deem certain amounts to have the same character as gross REIT revenue in respect of the underlying real or immovable property that result from:

- Interest-rate hedges in respect of debt incurred to acquire or re-finance real or immovable property, and
- Foreign currency gains in respect of real or immovable property situated in a country other than Canada recognized on:
  - revenue of such non-Canadian real or immovable property
  - debt incurred for the purpose of earning such non-Canadian revenue, or
  - foreign currency hedges

Legislative Changes to REIT Exemption – Other Tests

- The new rules provide that, for purposes of applying the qualifying property value test, real or immovable property is limited to such property that is capital property or eligible resale property
- The new publicly traded test now requires that investments in a REIT be publicly listed or traded on a stock exchange or other public market

Recent Developments

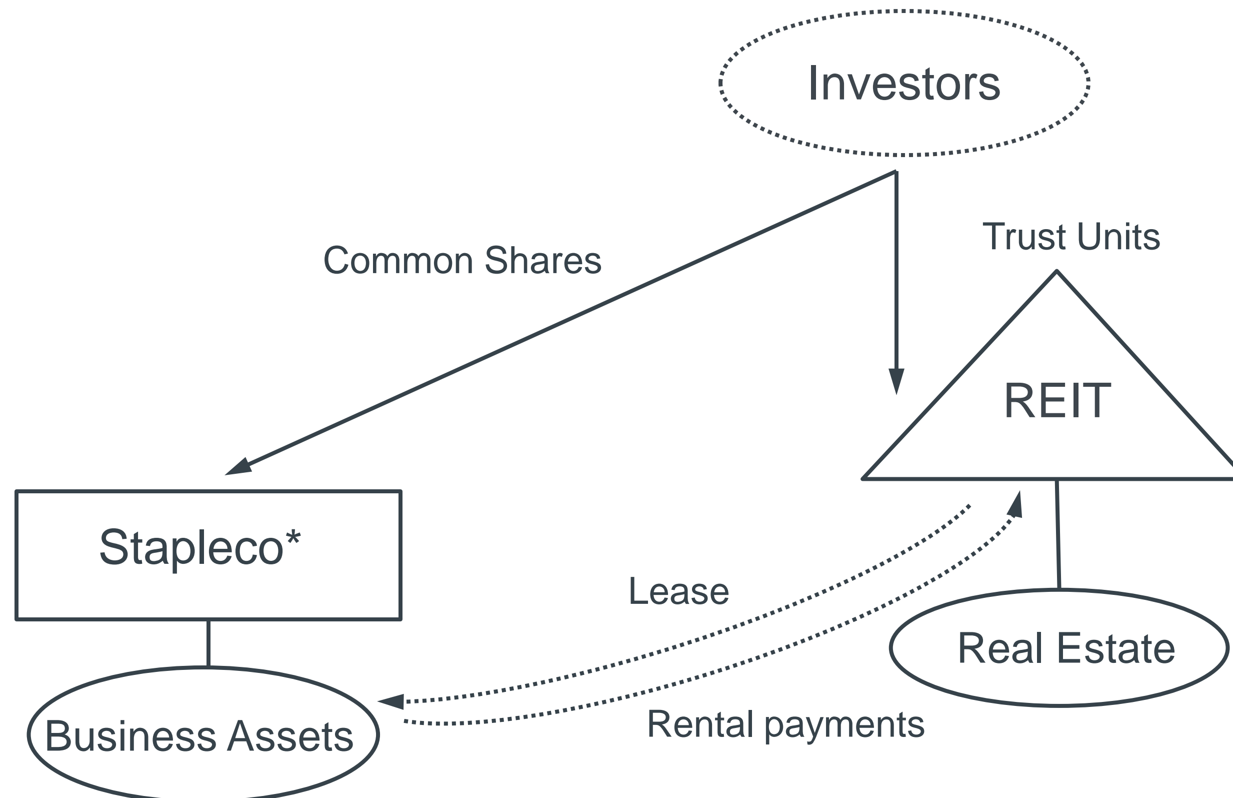
Stapled Securities Amendments

- On July 20, 2011, the Minister of Finance proposed amendments to restrict the use of publicly traded "stapled securities" which were considered to frustrate the policy objectives of the SIFT rules (passed into law by S.C. 2013, c. 40)
- New section 18.3 contains a deduction denial rule for interest and rental payments (in the case of REITs)
- Related anti-avoidance and transition provisions

Stapled Securities

Stapled Security: *defined in general terms as a publicly traded security instrument bundled with one or more other securities in a manner such that each security is not freely transferable or independent of the other*

Stapled Securities
– Example in REIT Context



**Section 18.3 denies rent deductions to Stapleco*

Cross-Border REITs – Recent Activity

- Revenue character preservation rule along with rules regarding foreign exchange gains and hedging gains make it easier for a Canadian REIT to own real property outside of Canada
- REITs that hold exclusively non-Canadian properties do not need to qualify for the REIT exception to the SIFT rules as they hold no “non-portfolio properties”

Cross Border REITs
– Agellan Commercial REIT

- On January 25, 2013, the Agellan Commercial REIT raised $134.6 million by way of IPO
- Agellan is a Canadian income fund that acquired rental real properties in the US and Canada
- Canadian operations were exempt from the SIFT rules under the REIT exemption but significant enough to qualify for the “substantial business activities” exemption from the US inversion rules (*i.e.*, more than 25% of assets, employees and income derived from Canada)

Cross-Border REITs
– Milestone Apartments REIT

- IPO completed in May 2013
- Milestone Apartments REIT indirectly acquired interests in properties located throughout the United States (held through wholly owned, subsidiary limited liability companies and limited partnerships)
- Owns only US property and is consequently outside the scope of the SIFT rules
- US inversion rules applied, but trust qualified as a US REIT (thus avoiding US entity-level tax, provided distribution and other requirements continue to be satisfied)

Foreign Real Estate Holdings
– Dundee International REIT

- Renamed Dream Global REIT – IPO in July 2011 raised $270 million with portfolio consisting of office space, logistics facilities, other commercial properties and residential units in Germany and France
- ***Purpose*** – to provide growing cash flows through investments in real estate outside of Canada and cash distributions on a tax-efficient basis
- Similar structure utilized by Inovalis Real Estate Investment Trust in April 2013
- Foreign country tax minimization strategy (*e.g.*, leverage) is critical

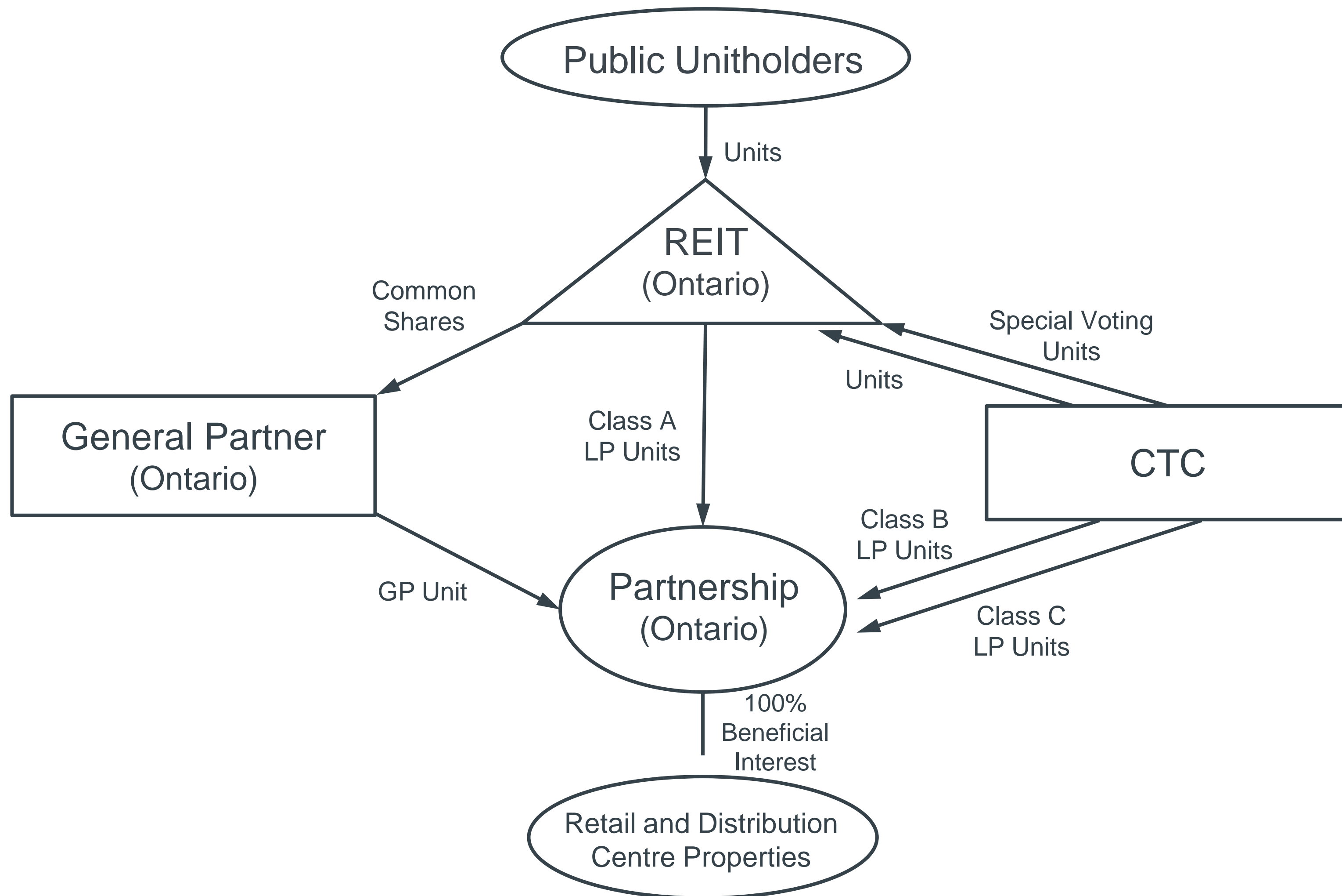
REIT Spin-Off Transactions

- Recent transactions of significance have included:
  - CT (Canadian Tire) REIT
  - Choice (Loblaws) REIT
- Has allowed national retailers to unlock value from their vast real estate portfolios

CT REIT – Business Decision and Tax Benefits

- IPO completed in October 2013
- Raised $263 million and involved 256 Canadian Tire retail properties, along with a distribution centre
- ***Purpose*** – investors provided with monthly cash distributions on a tax-efficient basis, while allowing Canadian Tire to retain control and a significant ownership position
- Properties transferred to a newly formed limited partnership on a tax-deferred basis (s. 97(2)) for partnership units that are exchangeable for CT REIT units

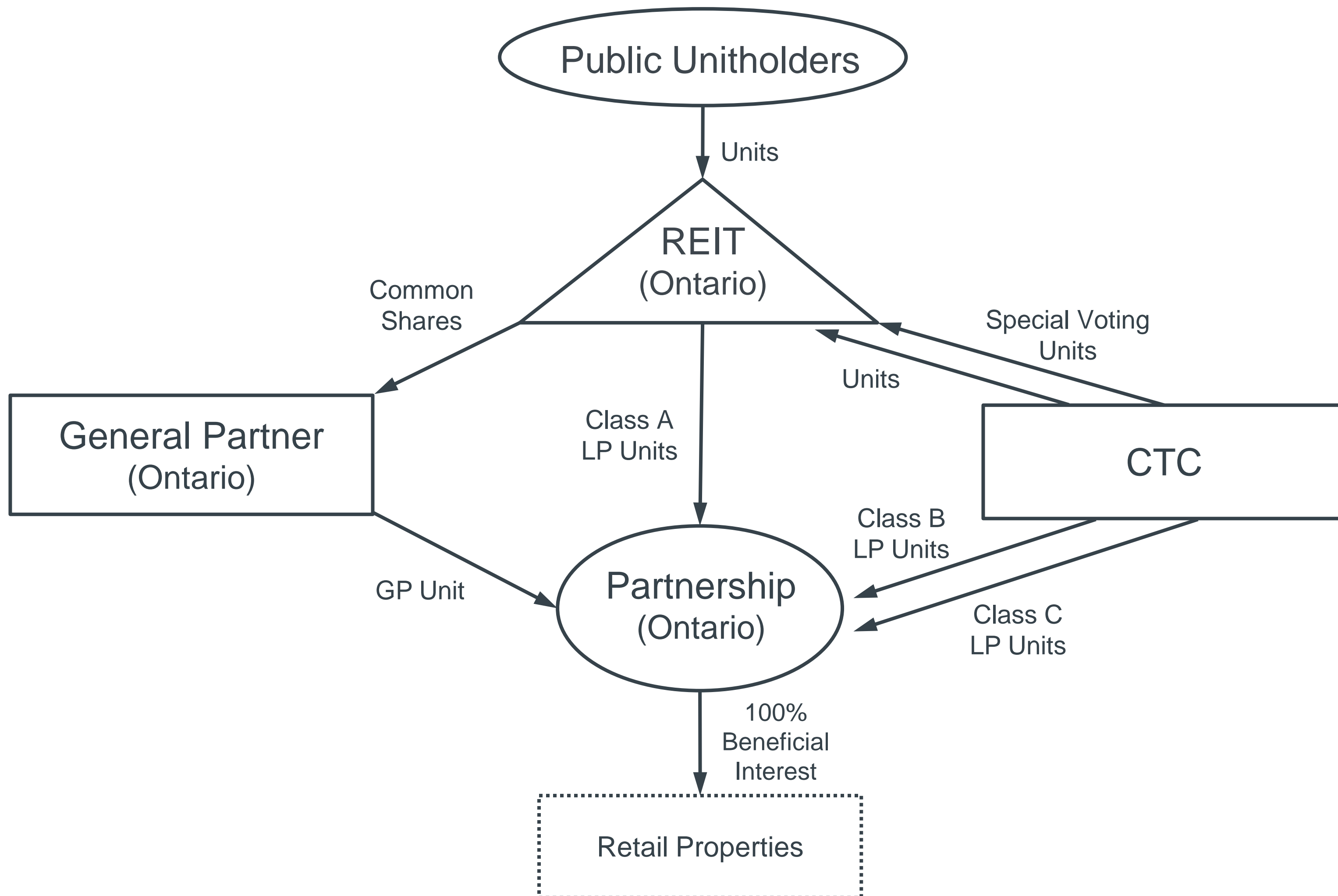
CT REIT – Post-Closing Structure



Choice REIT – Business Decision and Tax Benefits

- IPO completed in in July 2013
- Raised almost $400 million, involving 425 Loblaws retail locations
- ***Purpose*** – to optimize Loblaws real estate holdings and establish a growth-oriented public real estate entity, generating sustainable cash flow and capital appreciation on a tax-efficient basis
- Properties transferred to a newly formed limited partnership on a tax-deferred basis (s. 97(2)) for partnership units that are exchangeable for Choice REIT units

Choice REIT – Post-Closing Structure



Questions?

Thank You!

Notes / Disclosures

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