THINKING ABOUT REAL ESTATE IN CANADA? PRACTICAL CONSIDERATIONS FOR STRUCTURING A PRIVATE REIT

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These are uncertain times – The public markets have recently rallied, but there remains perceived geographic, public market and other instabilities and uncertainties related to COVID-19. So, it is natural to think about investing in Canadian real estate. If you are a manager of private capital thinking about raising money for a real estate investment trust ("**REIT**")[1], here are some practical considerations:

Identifying your investors – Are your targeted investors institutional, retail or a combination? Traditionally, many Canadian private REITs initially target retail investors with the hope that as assets of the REIT grow and the REIT demonstrates consistent returns to unitholders that the REIT will start to attract institutional investment. The type of investor a REIT is seeking should dictate its terms and structure, particularly with respect to desired liquidity and whether units of the REIT will be eligible to be held by investors in registered plans under the *Income Tax Act* (Canada) (the "**ITA**"), both factors which are important to retail investors. In contrast, institutional investors often seek preferential returns over retail investors, investment oversight rights of REIT management or other bespoke rights depending on the investment strategy of the institution.

Identifying Asset Class – REITs should clearly identify their target asset class so it can be effectively communicated to investors. Canadian private REITs, especially in the early stages, tend to pursue niche sectors compared to larger and public REITs which are often diversified. Whether the target asset class is commercial, industrial, retail, retirement, student housing or other, identifying and clearly communicating it to investors is a crucial component of the REIT's narrative and appeal to investors and will enable sales teams to effectively market the units of the REIT.

Accredited Investors or Offering Memorandum Prospectus Exemption – As with any non-prospectus offering of securities, in order to sell units of a private REIT, the REIT must rely on a prospectus exemption under National Instrument 45-106 – *Prospectus Exemptions* ("**NI 45-106**"). For private REITs, the two most frequently relied upon prospectus exemptions are the "offering memorandum" exemption (the "**OM Exemption**") and the "accredited investor" exemption (the "**AI Exemption**"). Each of the foregoing prospectus exemptions have different benefits as follows:

Accredited Investor:

(i) investors under the AI Exemption are typically higher net worth investors than those who may only meet the threshold to invest under the OM Exemption (depending on the jurisdiction in Canada) and are likely to invest higher amounts of capital. The amount that an accredited investor can invest in a private REIT is unlimited. There are many ways to qualify as an accredited investor, the most typical being (a) having financial assets net of any related liabilities that exceeds $1 million, (b) having net assets that exceeds $5 million or (c) net income that exceeds $200,000 or exceeds $300,000 combined with a spouse in the 2 most recent calendar years and reasonably expects to exceed that net income level in the current calendar year;

(ii) the REIT is not required to prepare and deliver audited annual financial statements to holders of securities of the REIT (although many will still voluntarily elect to do so);

(iii) there is no requirement to prepare and circulate an offering document to investors although REITs offering units to accredited investors typically do prepare "freestyle" offering memorandums in a form not prescribed by securities regulators; and

(iv) less continuous disclosure obligations than a REIT relying on the OM Exemption resulting in comparably lower ongoing compliance costs.

Offering Memorandum Investor:

(i) investors under the OM Exemption typically have a lower net worth than accredited investors and depending on the jurisdiction in Canada are subject to caps on how much capital they can invest. For example, in Ontario under the OM Exemption an "eligible investor" is able to invest up to $30,000 or $100,000 if such investor receives suitability advice from a registrant whereas a "non-eligible investor" can only invest up to $10,000. There are many ways to qualify as an "eligible investor," the most typical being an individual having (a) net assets either alone or with their spouse that exceeds $400,000, or (b) net income that exceeds $75,000 or exceeds $125,000 combined with a spouse in the 2 most recent calendar years and who, in either case, reasonably expects to exceed that net income in the current calendar year;

(ii) the REIT is required to prepare and deliver audited annual financial statements to unitholders;

(iii) the REIT must prepare and circulate an "offering memorandum" in the prescribed form under NI 45-106 (which is more work than the offering documents under the AI Exemption); and

(iv) Depending on the jurisdiction in Canada, REITs offering units under the OM Exemption are subject to certain continuous disclosure obligations thereby increasing the REIT's ongoing compliance costs.

Captive or Third Party Dealer?

REITs are typically considered by securities regulators to be in the business of trading, and therefore, REIT units must be sold by a registered securities dealer or an exempt market dealer (a "Dealer"). REIT's can pay a third party Dealer a commission from the funds raised by such Dealer from the sale of the REIT's units or management of the REIT can seek to register a "captive" Dealer, which is typically an affiliated entity of the REIT controlled by management of the REIT. Often captive Dealers charge the related REIT very low commissions allowing the REIT to retain nearly all funds raised from the sale of its units. Comparative projections have to be considered net of all fees to determine whether a captive Dealer or a third party Dealer will generate higher sales from REIT units.

One of the added benefits of a captive Dealer is that the investors in the REIT do not become clients of the third party Dealer who could possibly market other investment opportunities to such REIT investors, which may have an impact on the likelihood of future investments in the REIT by such investors.

Fees

Private REITs offer great flexibility with respect to how management fees and other amounts payable to management are structured and the quantum of such fees/amounts. The amount and characterization of such revenue streams (e.g., as asset acquisition fees, management fees, disposition fees, a carried interest in an underlying partnership, etc.) should be determined by REIT management at the time the REIT is established, or as may be adjusted from time-to-time thereafter pursuant to the constating documents of the REIT. These determinations should be based on what REIT management and Dealers selling REIT units believe to be marketable. We recommend that REIT management "shop" varying fee structures and amounts to third party Dealers and potential larger initial investors to gain a solid understanding of the potential range of fees the market may find acceptable for their product.

Redemptions

The units of a private REIT must generally be redeemable on demand in order for the REIT to qualify as a "unit trust" and a "mutual fund trust" for purposes of the ITA. Notwithstanding the foregoing, private REITs generally have some flexibility with respect to how redemptions are structured, including the amount of units that may be redeemed during a specified time, any penalties associated with early redemptions and the limited circumstances when the REIT may suspend redemptions for a limited period of time (for example, in order to maintain its status as a "mutual fund trust" under the ITA or to permit the orderly sale of certain illiquid assets to fund redemptions).

While permitting redemptions is a necessary requirement to qualify as a "unit trust" and "mutual fund trust" for tax purposes, the trust indenture should permit management to manage operating outflow of cash and redemptions to preserve REIT capital and prevent a potential "run on the bank" given the possible illiquid

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nature of the REITs underlying assets. One such common technique employed to manage cash flow is to empower the REIT with the authority, in certain situations, to satisfy redemption demands with in-kind distributions of property, including debt instruments issued by subsidiaries of the REIT. The distribution of such debt instruments better enables management to manage cash outlays in times of illiquidity and volatility, while satisfying the criteria in the ITA that the units be redeemable on demand.

Units in a private REIT cannot generally be traded on a stock exchange or other "public market" for purposes of the Tax Act. Accordingly, investors seeking to liquidate an investment position or otherwise dispose of units are generally required to redeem units pursuant to the above redemption mechanics.

Identifying Long Term Strategy

REIT management should determine the "exit strategy" of the REIT to ensure that the REIT is structured in a way to facilitate these goals. Whether the exit strategy is to maintain status as a private REIT, publically list the units of the REIT or amass sufficient assets under management to attract a larger institutional buyer for the portfolio, structuring with foresight enables these goals in a cost effective and efficient manner.

Selected Tax Considerations

Although REITs are not technically tax-exempt vehicles, they are typically administered to ensure that all of the taxable income of the REIT is distributed to unitholders as distributions of cash, units or other in-kind distributions. The effect of such distribution policies is that the income of such a REIT would be taxable in the hands of the unitholders rather than at the REIT level. This effective flow-through character of a private REIT's taxable income can be particularly valuable if unitholders are tax-exempt entities such as "Registered Retirement Savings Plans" (RRSPs), "Registered Retirement Income Funds" (RRIFs), "Tax-Free Savings Accounts" (TFSAs) or other registered plans for purposes of the ITA (collectively, "**registered plans**").

REITs are typically structured in a manner that permits them to qualify as "mutual fund trusts" for purposes of the ITA. Such mutual fund status confers a number of benefits both to the REIT and to investors. In particular, a private REIT would typically need to qualify as a mutual fund trust in order for its units to be "qualified investments" for a registered plan under the ITA. Among other criteria, a fund must have at least 150 unitholders, each with a prescribed minimum investment, to qualify as a mutual fund trust. For newly formed REITs that otherwise qualify as a mutual fund trust and satisfy the 150 unitholder criteria within 90 days of their first year-end, an election may be filed that deems the REIT to have retroactively satisfied the 150 unitholder criteria from the time of formation.

As noted above, private REITs are typically empowered with the authority to satisfy redemption demands, under prescribed conditions, with in-kind distributions of debt instruments issued by a subsidiary of the REIT.

However, in most circumstances, such debt instruments will not be “qualified investments” for purposes of a registered plan, such that the receipt of such debt instruments by a registered plan could give rise to penalty taxes. Accordingly, investors holding units of a REIT through a registered plan may prefer to defer any such redemptions until the REIT is in a position to satisfy redemption demands with cash.

If you have any questions regarding structuring a Canadian REIT, members of McMillan’s Capital Markets Group, Private Equity Group and Tax Group would be pleased to assist you.

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[1] A private REIT refers to a REIT whose units are not publicly traded on a stock exchange or other public market.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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