

## REAL ESTATE PUBLIC FINANCING IN CANADA

### Comments

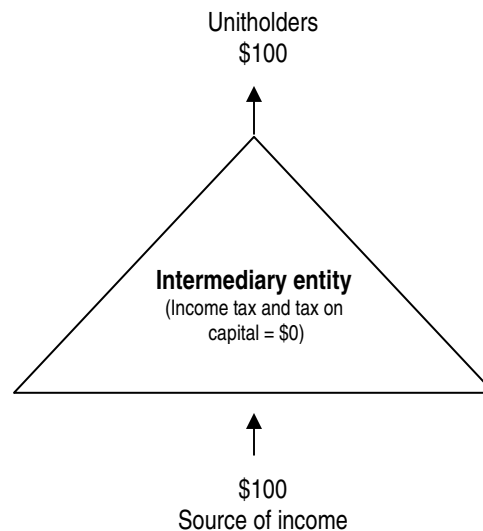
#### Non-REIT Conduits

With the economic recovery, real estate funds are starting to see the light of day which are real estate investment trusts (REITs) as defined in the *Income Tax Act* (the “Act”). Nonetheless, similar to REITs, many of them are conduits for the purpose of Canadian income tax law.

A conduit is an intermediary entity between the source of income and its ultimate beneficiaries. Generally, the entity’s income is not taxed in its hands, but in the hands of its participants. In other words, there is no entity-level tax.

The advantage for someone investing in a conduit is the entity’s tax transparency. As the income earned by the intermediary entity is taxed in the hands of the investor, the investor’s tax status is taken into account. The sources of income are included in the income of each investor and are treated for tax purposes according to their respective tax status or tax situations; for example, that of an individual, company, deferred income plan, agent of the Crown (non-taxable) or a person enjoying tax attributes, such as the availability of tax losses.

A conduit may be one or a combination of the following entities, or result from the tax attributes of the entity. In general, trusts and partnerships are conduits other than those covered by special provisions such as the rules relating to specified investment flow-throughs entities (“SIFT”). Others may also be a conduit if they have on hand certain tax attributes, generally until they are used up.



Note that, by definition, REITs are not SIFTs. REITs are Canadian resident trusts which meet specific conditions relating to their activities and property, namely real estate. They are not subject to the SIFT rules and thus are conduits.

*This Bulletin provides general information on recent developments and should not be viewed as legal advice; no legal steps should be taken on the basis of this Bulletin.*

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### Opportunity funds

Some funds are “opportunity funds”, i.e. their purpose is to take advantage of a specific economic or financial situation. These funds generally seek to take advantage of portfolio distributions and temporary differences between the current price of property and their anticipated price, thereby earning a gain from arbitrage. As a result, its entities are short-lived, i.e. they last for the period needed to carry out their financial strategy. This period is fixed or determined by the trustees or directors at their discretion.

As these funds are short-term, it is not essential that their securities be listed for trading on a stock exchange during the period in which their financial strategy is carried out. In this context, the investors’ investment occurs through the redemption of their units rather than trading on the stock market. This redemption generally takes place after the period required to complete the financial strategy. Alternatively, some provide that their securities will be listed for trading from their inception or later.

In the real estate sector, these are generally portfolios, equity or debt security, entities holding a real estate portfolio or debts relating to property situated in Canada or another country, primarily the United States.

### SIFT regime

The end result of the application of the SIFT tax regime is to make certain sources of income, distributed to the beneficiaries of a trust or which are attributed to the partners of a partnership which are SIFTs, subject to a similar tax regime than the one applicable to Canadian public corporations and their shareholders. More specifically, their income or distributions from their non-portfolio property are subject to tax equal to that applicable to a Canadian corporation’s income. The result is an entity-level tax. These amounts are included in the investor’s income as a taxable dividend in the same manner as a dividend received from a taxable Canadian corporation. This dividend is one which, when received by an individual residing in Canada, generally benefits from the dividend gross-up and tax credit.

A trust residing in Canada to which the SIFT rules do not apply is a conduit. More specifically, its income is subject to income at the maximum marginal rate applicable to individuals. However, if its income is payable to its unitholders, it is taxed in the unitholders’ hands. Generally, trust deeds and the elections made by the trustees ensure that no income is taxable in the hands of the trust.

In the case of a partnership not governed by the SIFT rules, all its income is, under the Act, attributed to its beneficiaries. Its income is therefore taxed in the hands of its unitholders.

### Specified investment flow-throughs

A specified investment flow-through entity is a partnership or trust which, at some point during the year, meets all three of the following conditions<sup>1</sup>:

- i) the trust is resident in Canada or the partnership is a “Canadian resident partnership”<sup>2</sup>;
- ii) “investments” in the trust are listed on a stock exchange or other “public market”; and
- iii) the trust holds one or more “non-portfolio properties”.

A public market includes any trading system or other organized facility through which securities are qualified for public distribution or traded. It does not include a facility that is operated solely to carry out the issuance of a security or its redemption, acquisition or cancellation. For example, a mechanism for redeeming units provided for in a trust deed or partnership is not a public market. A registration system such as FundSERV would also not be considered a public market.

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<sup>1</sup> SIFT status is determined annually.

<sup>2</sup> A partnership is a “Canadian resident partnership” if it meets one of the following conditions: (i) all its partners reside in Canada; ii) it would be resident of Canada, if it were a corporation including when its central management and control are in Canada, or iii) it was formed under the laws of a province.

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The word “investment” in a trust or partnership has a very broad meaning. It includes debt and equity investments. For this purpose, also includes any right, whether absolute or contingent, conferred by the particular entity or by an entity that is affiliated with the particular entity, to receive an amount that can reasonably be regarded as all or any part of the capital, of the revenue or of the income of the particular entity, or as interest paid or payable by the particular entity. A right which replicates a return on, or the value of, a security of the trust or partnership is also an investment.

The income of a SIFT from its non-portfolio properties, distributed or distributable by a trust to its beneficiaries or attributed to the unitholders of a partnership, is covered and subject to the SIFT tax regime. In general terms, a “non-portfolio property” is a prescribed percentage of securities of a subject entity<sup>3</sup>, Canadian real, immovable or resource property<sup>4</sup> or property that the trust or partnership or a person, or a partnership, with whom the trust or partnership does not deal at arm's length uses at that time in the course of carrying on a business in Canada.

In future articles we will discuss trusts and partnerships which are not by definition SIFTs and which are conduits. We will also examine the situation of a SIFT which does not have income from its non-portfolio properties and for which no tax consequence results from its status as a SIFT. Also, we will look at the situation of a corporation whose tax status does not make it a conduit but which, due to some of its tax attributes, is a conduit at least some of the time.

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<sup>3</sup> “Non-portfolio property” of a trust or a partnership means a securities of a subject entity that has a total fair market value that is greater than 10% of the equity value of the subject entity, or securities of the subject entity that, together with all of the securities that the trust or partnership holds of entities affiliated with the subject entity, have a total fair market value that is greater than 50% of the equity value of the trust or partnership.

<sup>4</sup> “Subject entity” means a corporation resident in Canada, a “Canadian resident partnership” or a trust resident in Canada, as well as a non-resident person, or a partnership that is not previously described, the principal source of income of which is in Canada.

<sup>4</sup> Non-portfolio property includes “a Canadian real, immovable or resource property” if at any time in the taxation year the total fair market value is greater than 50% of the equity value of the trust or partnership.