

## **REAL ESTATE INVESTMENT TRUSTS**

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This article examines the use in Canada of Real Estate Investment Trusts (“REITs”), a vehicle that has its foundations in the United States. Problems with the use of open-ended mutual fund trusts in Canada and the negative experiences of investors in Canadian limited partnership vehicles have led to the extensive use of Canadian REITs as the preferred vehicle to hold pools of Canadian real estate. The market for REITs has developed in the past 10 years. There are over 20 publicly-traded REITs in Canada today dealing with various types of real estate – commercial, industrial, and residential.

In Canada, real estate funds have traditionally been structured as mutual fund trusts for income tax purposes. The following criteria must be satisfied for the trust to be a mutual fund trust:

- (a) the trust meets the definition of a “unit trust”;
- (b) its only undertaking is
  - (i) to invest its funds in property (other than real property);
  - (ii) the acquiring, holding, maintaining, improving, leasing or managing of any real property (or interest in real property) that is capital property of the trust; or
  - (iii) any combination of (i) and (ii) above;
- (c) (i) a class of units qualifies for distribution to the public; or
  - (ii) there has been a lawful distribution in a province to the public of units of the trust and a prospectus, registration statement or similar document was

not required under the laws of the province to be filed in respect of the distribution; and

- (d) there are a minimum of 150 unitholders each owning one block of units (generally 100 units) of the class and the units of the class have a fair market value of at least \$500.

A trust must qualify as a “unit trust” in order to qualify as a “mutual fund trust” under subsection 132(6) of the *Income Tax Act* (Canada) (the “ITA”). Status as a unit trust or a mutual fund trust is relevant for a number of purposes, including paragraph 4900(1)(d) of the *Income Tax Regulations* under which mutual fund trust units are qualified investments for registered retirement savings plans (“RRSPs”), registered retirement income funds (“RRIFs”), registered education savings plans (“RESPs”) and deferred profit sharing plans (“DPSPs”). In addition, mutual fund trusts are exempt from Part XII.2 of the ITA in connection with a tax on distributions to non-resident and tax-exempt beneficiaries.

Prior to 1994, the definition of “unit trust” in the ITA did not permit a closed-ended unit trust to own real property. As a result, the mutual fund trusts which owned real property were structured as open-ended unit trusts; the holder of the units had the right to demand redemption of the units. Given the illiquidity of the underlying asset, real property, this created a crisis for such funds in the early 1990s, when the price of real estate plummeted and investors demanded the redemption of their units. As a result, the real estate investment market lobbied for legislative changes. Changes were introduced in 1994 and the ITA was amended to allow closed-ended unit trusts to own real property situated in Canada. It was at this time that the term “real estate investment trust” or “REIT”, which was borrowed from the U.S., was adopted. However, this term is not specifically used in the ITA.

Paragraph 108(2)(b) of the ITA sets out the requirements which must be met in order for a trust to qualify as a “unit trust”. To be a “unit trust”, a trust must be an *inter vivos* trust and the

interests of the beneficiaries must be described by reference to units. If the units are not redeemable at the demand of the unitholder, then the following criteria must be met:

- (i) the trust must be resident in Canada;
- (ii) the only undertaking of the trust is
  - (A) the investing of its funds in property other than real property,
  - (B) the acquiring, holding, maintaining, improving, leasing or managing of any real property (or an interest in real property), that is capital property of the trust, or
  - (C) any combination of the foregoing;
- (iii) at least 80% of the trust's property consists of certain specified investments, including real property situate in Canada or interests in real property; and
- (iv) at least 95% of the trust's income is derived from, or from the disposition of, the specified investments.

However, paragraph 108(2)(b) of the ITA also requires that units of a closed-ended trust which holds real property must be listed on a prescribed stock exchange in Canada in order for the trust to qualify as a unit trust (stock exchanges listed in section 3200 of the *Income Tax Regulations* are prescribed for this purpose). Trusts that do not hold real property do not have to have their units listed on a Canadian stock exchange.

The advantages of a mutual fund trust are as follows:

- (a) the units are freely tradable;
- (b) the units qualify for investment by RRSPs, RRIFs and DPSPs (collectively, "deferred plans") and RESPs;

- (c) the units are not foreign property for pension plans and deferred plans;
- (d) a mutual fund trust is not taxable if it distributes all of its income and capital gains annually provided that appropriate designations are made;
- (e) the tax on capital gains retained and taxed in the trust, if any, is refunded on the redemption of the units on a formula basis;
- (f) the ability to designate to unitholders an amount which, in general terms, represents future recaptured depreciation;
- (g) the designated income rules in Part XII.2 would not apply (which would give rise to a 36% tax on designated income which includes income from real property in Canada and from dispositions of Canadian real property) to a mutual fund trust;
- (g) a trust is not subject to alternative minimum tax or capital taxes; and
- (h) capital gains retain their character in the hands of the beneficiaries (in Canada, only 50% of a capital gain is subject to tax).

REITs have a long history in the United States dating back to 1960 (legislatively). REITs are specifically provided for in the U.S. Internal Revenue Code and are subject to a myriad of rules and regulations. Investors are typically institutions and retail investors. REITs must be widely held. Separate REITs have been sold for different types of property such as regional shopping centres, community shopping centres, apartments and mobile homes. The appeal of the REIT is diversification, yield enhancement and liquidity for a publicly-traded REIT. Professional property management is required because of legislative restrictions.

A Canadian REIT will be subject to the following Canadian tax consequences:

- (a) capital cost allowance is claimed at the trust level;
- (b) the beneficiaries of the trust are taxable on recaptured depreciation on the sale of the property;

- (c) losses incurred by the trust cannot be flowed through to beneficiaries although losses can be carried back three years or carried forward for up to seven years (proposed legislation will increase the carry forward period to ten years after March 22, 2004). To the extent that a property is expected to generate operating losses or a terminal loss on a disposition, a limited partnership vehicle may be more attractive since losses generally flow-through a limited partnership;
- (d) a trust is subject to the rental property restriction and, therefore, cannot use capital cost allowance to offset other rental income of beneficiaries (interest on funds borrowed to acquire units would be deductible and would not reduce the rental income for CCA purposes);
- (e) a trust can designate net taxable capital gains in favour of beneficiaries (in other words, capital gains retain their character in the hands of the beneficiaries provided proper designations are made);
- (f) a capital gain would be realized by a unitholder if the adjusted cost base of the unit becomes negative as a result of capital distributions. In a partnership, subject to concerns about interest deductibility, proceeds of refinancing generally can be distributed to general partners (but not limited partners or general partners who are not actively engaged in the business of the partnership) who would not be taxable on any resulting negative adjusted cost base as long as they remained in the partnership;
- (g) a trust is not subject to provincial capital tax;
- (h) a trust is not subject to large corporations tax;
- (i) a commercial trust is not subject to the 21 year rule (there is a rule which deems personal trust to have disposed of all of their property on the 21<sup>st</sup> anniversary of the trust);
- (j) a REIT will be an eligible investment for RRSPs, RRIFs, RESPs and DPSPs;

- (k) no rollover is available for the transfer of assets to a commercial trust, a unit trust or a mutual fund trust.

The tax consequences of a non-resident of Canada investing in a REIT are as follows:

- (a) in order to qualify as a mutual fund trust, the trust must be established and maintained primarily for the benefit of Canadian residents. As a result, the declaration of trust for most REITs contains a provision which permits the REIT to redeem units from non-resident holders where the trust becomes aware that non-residents hold 49% or more of its units;
- (b) distributions of income from a REIT to a non-resident unitholder are subject to a 25% withholding tax under paragraph 212(1)(c) of the ITA. However, the rate of withholding is reduced to 15% by Article XXII(2) of the Canada/U.S. Income Tax Convention (the “Treaty”);
- (c) in the past, there has been no withholding tax in respect of the distribution of capital gains from a trust to a non-resident beneficiary. However, pursuant to a proposed amendment to the ITA, mutual fund trusts including REITs, will be required to track capital gains from dispositions of taxable Canadian property (“TCP”). Canadian real property is TCP. As a result, capital gains from dispositions of TCP will be deemed to be distributions of income and subject to withholding tax under paragraph 212(1)(c) of the ITA. This provision is to take effect after March 22, 2004;
- (d) a non-resident is not subject to tax on the disposition of a unit of a REIT provided that the units of the REIT do not constitute TCP to the unitholder. The units will be TCP to the unitholder if in the 60 month period prior to the date of disposition, the non-resident unitholder, together with non-arm’s length persons, owned 25% or more of the issued units of the REIT. If the non-resident would be subject to Canadian tax on the disposition of the unit of the REIT, there will be no relief

from Canadian taxation available under the provisions of the Treaty. Article XIII(3)(b)(iii) defines real property situated in Canada to include an interest in a trust the value of which is derived principally from real property situated in Canada. As a result, a REIT holder resident in the U.S. for whom the REIT units are TCP will be subject to Canadian taxation on the disposition of the units at approximately 16% for a corporate holder and 21% for an individual holder;

- (e) since the REIT units are listed on a prescribed Canadian stock exchange, there is no requirement to obtain a section 116 clearance certificate in respect of the disposition of the REIT units. This is the case even where the REIT units are TCP to the holder.

A concern about the use of a trust vehicle to hold real property is the potential exposure of beneficiaries to the liabilities of the trust. It is unclear in Canadian law whether beneficiaries are liable for debts of the trust. This concern may be addressed by including disclaimers of personal liability of unitholders in all contracts entered into by the trust. Insurance may be acquired to cover other liabilities. However, the Ontario government recently introduced legislation to clarify that the holder of units of a trust which is resident in Ontario and which is a reporting issuer under the *Securities Act* (Ontario) is not liable for the debts of the trust.

Capital cost allowance is claimed at the trust level. The trust indenture or declaration of trust generally requires that the REIT distribute all of its taxable income and capital gains to unitholders in each year. This provision ensures that no tax is payable by the REIT on income or capital gains. However, because of capital cost allowance, which may reduce the taxable income below net revenues, the REIT may make distributions in excess of its taxable income and taxable capital gains. Such distributions are not taxable to the unitholder but reduce the unitholder's adjusted cost base of his or her units. In the event the unitholder's adjusted cost basis in his or her units becomes negative, such amount is treated as a capital gain in the year.

There may be exposure for provincial land transfer tax on a transfer of a unit unless the trust qualifies as a mutual fund trust or unless the unit represents less than a 5% interest in the trust. Land transfer tax will arise on the purchase of real estate by a REIT in those provinces which levy land transfer tax.

The Canadian REITs have copied their American counterparts in terms of management structure, free transferability of units, timing of income distributions and the fact that the units are widely held.

Some of the risks of REIT ownership include vulnerability to escalating interest rates and fluctuation rentals. Losses of a REIT cannot flow through to investors.

The advantages of a REIT may be that it can produce yields that exceed interest and dividend yields together with the prospect for capital appreciation. Canadian REITs have proved to be more popular in Canada than the traditional corporate or limited partnership vehicles for holding real estate. However, where properties are expected to generate losses, limited partnerships continue to be more attractive

The following chart highlights some of the differences between the various vehicles used for holding real estate.

	<b>Limited Partnership</b>	<b>Commercial Trust</b>	<b>Mutual Fund Trust</b>	<b>Corporation</b>
Year End	Choice	Calendar	Calendar	Choice
Rollovers	Yes	No	No	Yes, unless inventory
Flow Through	Yes	Part XII.2	Yes	No
Liquidity	No	Yes	Yes	If public
Exposure for liability	No	Unlikely	Unlikely	No
CCA at vehicle level	Yes	Yes	Yes	Yes
Rental Property Restriction	Yes	Yes	Yes	Unless principal business corporation
Maximum CCA	Interest outside	Interest outside	Interest outside	Interest outside
Recapture	Flow through	Yes	Can designate	Yes
Flow through of losses	Yes	No	No	No
RRSP	If listed units	If registered investment	Yes	If publicly traded
Negative ACB	Not possible for losses because at risk but possible on refinancing	Capital gain	Capital gain	Not Possible
Units must be listed	Possible	No	Yes	Possible