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Canada Proposes Amendments to the Taxation of SIFTs, REITs and Publicly Traded Corporations

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On July 20, the Department of Finance announced proposed amendments to Canada's *Income Tax Act* with respect to specified investment flow-through entities (SIFTs), real estate investment trusts (REITs) and publicly traded corporations. The amendments deal with four main matters, of which the most significant is that of stapled securities. Two other matters relate to generally relieving or clarifying amendments to the definition of "excluded subsidiary entity" and the definition of "non-portfolio property" as it applies to a corporation. The fourth matter relates to the instalment regime applicable to SIFTs.

Stapled Securities

In the October 31, 2006, SIFT announcement,[1] the Department indicated that if structures or transactions emerged that were clearly devised to frustrate the policy objectives behind the SIFT measures, any aspect of those measures may be changed with immediate effect. Yesterday's announcement deals with structures involving stapled securities which, in the Department's view, offend the policy objectives behind the SIFT measures. The stapled securities structures have arisen with regard to SIFTs, REITs and publicly traded corporations.

A stapled security structure involves two separate securities that are "stapled" together so that they are generally not freely transferable independently of each other. The simplest example involves a publicly traded corporation that has common shares and debt securities of itself "stapled" together and that trade as one unit on a stock exchange. The stapled security structure in this example eliminates the necessity of an income trust vehicle: the shares and debt of the corporation trade as one unit and are held directly by the public so that the same interest deduction is available to the corporation and there is no income trust vehicle that would be subject to the original SIFT rules.

This is no doubt the kind of structure the Department was concerned about in 2006 and yesterday's announcement addresses this particular example. Under the proposed amendments, the interest expense on the debt portion of the stapled security would not be deductible to the corporate issuer. The proposed amendments would also apply to stapled securities that are issued by different entities in the same group (e.g., the

[1] On this date, the Minister of Finance announced proposals to change the income tax rules applicable to income trusts and publicly traded partnerships.

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parent issues the share or other equity component and a subsidiary entity issues the debt component).

The proposed amendments also appear to deal with stapled securities issued by different entities that may not necessarily be in a parent/subsidiary relationship. For example, an entity that qualifies as a REIT may have issued units that are stapled together with the units or shares of another entity (another trust or a corporation), but there is no direct relationship between the issuing entities (except that their securities are stapled and so held by the same persons). The non-REIT entity in that case may, for example, pay rent to the REIT entity, which rent would ordinarily be deductible to the non-REIT entity. Under the proposed amendments, any amount that is paid or payable by the other entity (or its subsidiaries) to the REIT (or its subsidiaries, and including "back-to-back" intermediary arrangements) will not be deductible in computing the income of the payer for income tax purposes.

The proposed amendments to stapled securities are generally applicable to amounts paid or payable on or after July 20, 2011, subject to a transition period for an entity if stapled securities of the entity were issued and outstanding on July 19, 2011. If the stapled securities include securities that were also issued and outstanding and stapled securities of the entity on October 31, 2006, the transition period would start on July 20 and end on January 1, 2016. Otherwise, the entity's transition period would start July 20, 2011, and end on July 20, 2012. The transition period may be cut short and end on the earliest day after July 20, 2011 on which either a security of the entity becomes a stapled security of the entity (for example, an additional offering of the stapled securities) or a stapled security of the entity is materially altered.

Definition of "Excluded Subsidiary Entity"

The SIFT rules apply to publicly traded trusts or partnerships. However, expansive rules may in certain circumstances treat an otherwise privately owned trust or partnership as a SIFT. The concept of excluded subsidiary entity was introduced to generally exempt a privately owned trust or partnership from the application of these expansive SIFT rules. In its current form, the definition of "excluded subsidiary entity" contains two main conditions that must be satisfied. The first is that the entity's "equity" (including certain types of debt) must not be listed or traded on a stock exchange or other public market. The second is that the entity's equity must not be held by any person or partnership other than certain qualifying holders. The list of qualifying holders currently includes only REITs, SIFTs and taxable Canadian corporations (and certain other entities that are themselves excluded subsidiary entities). The list of qualifying holders currently does not, for example, include individuals, tax-exempt entities or non-residents. Accordingly, a single non-qualifying holder of an interest in a private partnership would make that partnership not an excluded subsidiary entity under the current rules.

The definition of "excluded subsidiary entity" is proposed to be amended in a relieving way to expand the range of qualifying interest holders in such an entity to any person or partnership provided that the person or partnership holds an appropriate interest in the entity. In particular, the person or partnership must not hold any security or right in the entity that is, or includes a right to acquire, (i) any security of any entity that is listed or traded on a stock exchange or other public market, or (ii) any property whose amount or fair market value is determined primarily by reference to any security listed or traded on a stock exchange or other public market. The relieving rule would therefore include as qualifying interest holders in the entity an individual, a tax-exempt entity or a non-resident person provided that the securities or rights held by that person in the entity are not of the kind described in (i) or (ii). This proposed amendment is deemed to have come into force on October 31, 2006 but, in certain circumstances, an entity can elect to have this change apply to it only for taxation years that begin after July 20, 2011.

Definition of "Non-Portfolio Property"

One of the requirements for an entity to be a SIFT is that it must hold non-portfolio property. The term "non-portfolio property" is currently defined in relation to property owned by a trust or partnership. Non-portfolio property includes a holding in another entity (a "subject entity") that exceeds certain concentration limits such as where the property represents more than 10% of the equity value of the underlying subject entity. A subject entity is a trust, partnership or corporation other than an entity that is a portfolio investment entity. A "portfolio investment entity" is an entity that does not at that time hold any non-portfolio property. Under the current rules, it is clear that a corporation can be a portfolio investment entity. However, in determining whether the corporation owns non-portfolio property, as noted, the current rules define "non-portfolio property" only in relation to property owned by a trust or partnership. The Department announced that measures would be introduced that would clarify that non-portfolio property of a corporation has the same meaning as it does in respect of property of a trust or partnership. The announcement indicated that this was consistent with Canada Revenue Agency's current application of the SIFT regime and that this change would provide greater certainty as to which corporations qualify as portfolio investment entities. This proposed amendment would apply to taxation years that end after July 20, 2011.

Tax Instalments for SIFTs

Yesterday's announcement proposes that the current monthly instalment regime for the payment of taxes by a public corporation be modified so that SIFTs are subject to the same monthly instalment rules that apply to public corporations (SIFTs are currently subject to the more relaxed instalment rules that apply to individuals, including that payments be made on a quarterly basis).

It should be noted that yesterday's announcement was accompanied by only a "backgrounder" and was not accompanied by draft legislation. The Department of Finance indicated that such legislation will be introduced at the earliest opportunity. T

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