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The Canadian

REIT

Handbook

Goodmans ^{LLP}

SECOND EDITION

Disclaimer

This publication reflects law and practice as of September 2010, with updates as of September 2014 to Chapters 1 and 4 and the Glossary of Terms (including the list of Canadian Public REITs). This publication is intended to provide general information and should not be relied upon as legal or other professional advice. Readers are urged to consult their professional advisors, including accountants, lawyers, and investment advisors.

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Comments

If there are any comments with respect to this publication, please respond in writing to:

Carolyn Lane
VP, Member Engagement & COO
Real Property Association of Canada (REALPAC)
77 King St W
TD North Tower
Suite 4030 PO Box 147
Toronto ON M5K 1H1 Canada
416.642.2700
publications@realpac.ca

With a copy to:
Stephen Pincus
Partner
Goodmans LLP
Bay Adelaide Centre
333 Bay Street, Suite 3400
Toronto, Ontario M5H 2S7 Canada
416.979.2211

About the Author

Goodmans LLP

Goodmans has played a leading role in Canada's REITs and income securities sector for many years and has received wide recognition as "leading the pack" of Canadian law firms in these areas.

Goodmans has acted extensively as counsel on public offerings, mergers and acquisitions and other transactions involving both public and private REITs in Canada. Among other examples, the firm played a key role:

- on Canada's first REIT initial public offering (IPO);
- in creating a structure that opened the REIT sector to operating businesses wishing to securitize their assets;
- on the first offering of preferred units by a REIT in Canada;
- on the first REIT IPO on The Toronto Stock Exchange under the new REIT rules;
- in the development of cross-border REITs and income securities, including the first public offering in the world of a qualifying U.S. REIT by a non-U.S. entity; and
- on Canada's most significant REIT merger, going private and conversion transactions to date.

Please contact Goodmans at:

Bay Adelaide Centre
333 Bay Street, Suite 3400
Toronto, Ontario M5H 2S7 Canada
416.979.2211
goodmans.ca

Contact: Stephen Pincus at spincus@goodmans.ca

Bill Gorman at wgorman@goodmans.ca

About the Publisher

Real Property Association of Canada (REALPAC)

Founded in 1970, REALPAC is the national leadership association dedicated to advancing the long-term vitality of Canada's real property sector. REALPAC champions the industry's contribution to a flourishing Canada, and help strengthen the economy through providing employment, facilitating investment in and development of real estate, protecting the environment and growing strong urban centres nationwide.

With 125+ member companies, REALPAC's members include publicly-traded companies (almost all the REITs in Canada), pension funds, private companies, fund managers, asset managers, developers, government real estate agencies, lenders, banks, life insurance companies, investment dealers, brokerages, consultants/data providers, large general contractors, and international members. Its members represent all asset classes in Canada – office, retail, industrial, apartment, hotel, senior living – from coast, to coast, to coast.

REALPAC has been actively involved in the legislation leading to the creation of the REIT vehicle in Canada, as well as many legislative initiatives aimed at refining the Canadian REIT. This work is ongoing.

REALPAC operates in several areas including advocacy, research, ESG, financial best practices, standard setting, publishing, conferences and networking events.

Please contact REALPAC at:

77 King St W

TD North Tower

Suite 4030 PO Box 147

Toronto ON M5K 1H1 Canada

416.642.2700

realpac.ca

Acknowledgments

Goodmans LLP Contributors:

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REALPAC Editors:

S. Michael Brooks, REALPAC's Chief Executive Officer, recruited Goodmans to undertake the development of the Canadian REIT Handbook, working with Goodmans from the outset settling the scope of the work and broad layout, and worked with Stephen Pincus, Seymour Temkin and other Goodmans lawyers discussing content issues from time to time. Michael read successive drafts of each chapter of The Canadian REIT Handbook and made editorial suggestions as to content and scope.

Carolyn Lane, REALPAC's VP, Member Engagement & COO, was also involved in the project from the outset. She read successive drafts of each chapter, assisted in layout and structure, provided editorial assistance and proofread chapters for style and grammar. She also coordinated the publication of the hardcover and electronic versions of the Handbook. REALPAC would also like to acknowledge the contribution of Andrew Popert of PricewaterhouseCoopers LLP who read the draft for accounting, IFRS, and tax issues and Ciro DeCiantis of Deloitte LLP who provided additional accounting and IFRS input.

Preface

This Handbook is intended for a variety of readers, including real estate owners, managers and operators, potential and seasoned investors, legal, accounting and financial advisors, investment bankers, lenders, and academics. It will be useful as both a quick reference tool and a detailed text, regardless of the reader's level of familiarity with REITs.

The Handbook covers a broad range of topics, including the evolution and history of the Canadian REIT; the trust concept and how it applies to the Canadian REIT; distribution levels, investment guidelines and operating policies; tax considerations; the process of a REIT's initial public offering; acquisition and public financing options; trustees' duties and liabilities and governance standards applicable to REITs; management; ongoing securities law compliance; development arrangements; take-over bids, going-private transactions and related party transactions; and investment considerations. It reflects law and practice as of September 2010.

Canadian REITs have evolved significantly over the past decade. Many external management arrangements have been internalized and new management arrangements developed. The REIT sector has seen mergers, acquisitions, conversions, development programs, creative financing instruments and cross-border structures.

REITs enable thousands of private investors to invest in real estate assets they would otherwise not have access to, along with a significant number of institutional investors. The introduction and passing of the tax legislation, referred to in the Handbook as the "SIFT rules", have made the rules governing publicly traded REITs significantly more complex. At the same time, in restricting the access of non-real estate public entities to tax efficient flow-through structures, the legislation has further enhanced the importance of the public REIT sector to the capital markets.

As the REIT sector continues to grow and new issues emerge, The Canadian REIT Handbook will be updated.

S. Michael Brooks
Chief Executive Officer
REALPAC

Stephen Pincus
Partner
Goodmans LLP

Finance Releases Proposed Amendments to the Qualifying REIT Rules

On December 16, 2010, the Department of Finance ("Finance") announced proposed amendments to the rules in the Income Tax Act (Canada) applicable to real estate investment trusts (the "Qualifying REIT Rules"). The amendments address certain concerns that real estate investment trusts encountered when attempting to restructure their operations to comply with the existing Qualifying REIT Rules. The amendments also clarify, and in some respects restrict, the scope of the existing exception for qualifying real estate investment trusts ("Qualifying REITs").

Background

Qualifying REITs are exempt from the new entity-level tax generally imposed on publicly-traded income funds and partnerships commencing January 1, 2011 (the "SIFT tax"). Public trusts established after October 31, 2006 (and public trusts that exceeded certain equity growth restrictions after that time) are already subject to the SIFT tax rules and, therefore, must be Qualifying REITs in order to avoid the SIFT tax and maintain their "flow through" status for tax purposes.

The exception for Qualifying REITs is in recognition of the unique history and role of collective real estate investment vehicles in Canada. In order to be a Qualifying REIT, a trust must satisfy certain asset and revenue tests at all times throughout its taxation year.

Proposed Amendments

The proposed amendments do not alter Finance's objective of limiting the exception for Qualifying REITs to public trusts with passive real estate holdings. Rather, the proposed amendments clarify and amend certain aspects of the existing Qualifying REIT Rules:

- **Non-Qualifying REIT Assets:** Pursuant to the proposed amendments, each entity in a Qualifying REIT structure will be permitted to own non-Qualifying REIT assets having a value of up to 10% of the fair market value of that entity's non-portfolio property. Under the current rules, there generally is no non-Qualifying REIT assets permitted.
- **Ancillary Property:** The definition of "qualified REIT property" currently includes property that is ancillary to the earning by the entity of rent from real or immovable

properties or capital gains from dispositions of real or immovable properties. Under the proposed amendments, this category of "qualified REIT property" will be restricted to tangible personal property (such as office furniture or computers). Other non-qualifying REIT assets (even if ancillary to the earning of rental income and capital gains) will need to fall within the permitted 10% basket.

- **Gross REIT Revenue:** The proposed amendments clarify the basis on which the Qualifying REIT revenue tests are to be calculated. Such tests will be based on "gross REIT revenue" (which is generally defined to include all amounts received or receivable by the entity on income account, together with capital gains). This amendment confirms that certain potential "revenue" sources, such as recapture, will not be relevant for purposes of the Qualifying REIT revenue tests. It also clarifies that "revenue" is not based on accounting principles.
- **Passive Revenue Test:** At least 95% of the gross REIT revenues of a Qualifying REIT entity must be derived from (i) rent from real or immovable properties, (ii) interest, (iii) capital gains from dispositions of real or immovable properties, (iv) dividends, and (v) royalties. Under the proposed amendments, this 95% passive revenue test will be reduced to 90% and will include gains from the sale of eligible resale properties (as described below) as a permitted source of passive revenue.
- **Character of Revenue:** The proposed amendments clarify that revenue generally maintains its source characterization when distributed from a subsidiary entity to a parent entity (where the parent entity owns a security in the subsidiary entity that is non-portfolio property). This amendment is intended to address certain ambiguities that arose when properties were held through tiers of entities.

The proposed amendments also introduce the following new concepts to the Qualifying REIT Rules:

- **Foreign Currency Fluctuations:** For purposes of the revenue tests, the proposed amendments include in Qualifying REIT revenue certain revenues realized from foreign currency fluctuations relative to the Canadian dollar. Examples include foreign currency fluctuations from: (i) rent from foreign real property, (ii) foreign currency debt incurred to acquire foreign real property for the purposes of earning rental revenue, and (iii) currency hedging contracts in respect of foreign property that can reasonably be considered to have been entered into to reduce the trust's risk to fluctuations in the foreign currency.
- **Eligible Resale Properties:** The proposed amendments generally permit a Qualifying REIT to earn a portion of its revenue from non-capital real or immovable property (i.e., real estate inventory) in certain limited circumstances. Eligible resale property must be contiguous to a capital property of the Qualifying REIT and the holding of such property must be necessary and incidental to the holding of such capital property. One example is where a portion of a commercial development is being severed for the ownership and use of an anchor tenant. The proposed eligible resale property rules are

quite technical and REITs must be careful to appropriately structure any holdings that are intended to qualify under these rules.

However, the proposed amendments also do not address certain notable aspects of the existing Qualifying REIT Rules, including:

- **Rectifying Qualifying REIT Status:** A trust that does not satisfy the Qualifying REIT Rules at any time during the taxation year will be subject to SIFT tax for that taxation year. There is still no ability for a trust to rectify its status in the current taxation year; however, a trust may restructure its affairs to qualify as a Qualifying REIT in a subsequent taxation year.
- **Taxable REIT Subsidiaries:** The proposed amendments do not provide for taxable REIT subsidiaries (as contemplated under the U.S. REIT rules).
- **Exchangeable Units:** The Qualifying REIT exception is still only applicable to trusts. Accordingly, real estate investment trusts that issue exchangeable units of a subsidiary partnership must place limitations on the holders of such units to ensure that the partnership is not subject to entity-level taxation.

Effective Date

The proposed amendments generally are effective as of the 2011 taxation year. Publicly traded trusts also may elect for the proposed amendments to apply for earlier taxation years by filing a notice with the Minister of National Revenue. The proposed amendments are subject to consultation between Finance and interested parties. Further submissions on the proposed amendments are due on January 31, 2011.

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REALPAC

REALPAC
77 King St West
TD North Tower
Suite 4030 PO Box 147
Toronto ON M5K 1H1
Canada

realpac.ca

Goodmans^{LLP}

Goodmans
Bay Adelaide Centre - West Tower
333 Bay Street, Suite 3400
Toronto, ON M5H 2S7

goodmans.ca