May 9, 2008

Mr. Brian J. Ernewein
Director
Department of Finance Canada
L'Esplanade Laurier
17th Floor, East Tower
140 O'Connor Street
Ottawa, ON K1A 0G5

Re: Bill C-10: Application to U.S. Real Estate Investment Trusts

Dear Sirs/Mesdames:

Thank you for the opportunity for the Real Property Association of Canada (REALpac) and the National Association of Real Estate Investment Trusts® (NAREIT), to submit this joint letter to comment on certain aspects of Bill C-10 as it relates to non-resident trusts (NRTs) and foreign investment entities (FIEs). NAREIT had previously submitted comments in respect of the August 2, 2001 draft amendments to the Income Tax Act (Canada) (the "Act") relating to the taxation of foreign investment entities by letter dated October 31, 2001 (the Prior Submission).

REALpac is Canada's senior national industry association for owners and managers of investment real estate. Its members include publicly traded real estate companies, real estate investment trusts (REITs), private companies, pension funds, banks and life insurance companies with investment real estate assets each in excess of $100 million. The association is further supported by large owner/occupiers and pension fund advisors as well as individually selected investment dealers and real estate brokerage.

NAREIT is the representative voice for U.S. REITs and publicly traded real estate companies worldwide. Members are REITs and other public businesses that own, operate and finance income producing real estate, as well as those firms and individuals who advise, study and service these businesses. A REIT is a company dedicated to owning, and in most cases operating, income producing real estate, such as apartments, shopping centres, offices and warehouses, as well as the financing of real estate.

NAREIT's principal mission is to communicate about REITs and real estate investment to members, policymakers worldwide, the investment community, the media and the public. NAREIT represents over 132 publicly traded REITs and real estate companies, with an equity capitalization of approximately US $315 billion.

The purpose of this letter is to recommend certain changes to the Act, after identifying a number of issues that were not discussed at length in NAREIT's Prior Submission, one of which results from the growing popularity of widely-held, but non-exchange traded U.S. REITs since the time of the Prior Submission. The Act proposes to impose significant burdens on Canadian investors that invest in certain U.S. REITs, and to impose significant burdens on other U.S. trust REITs, such that Canadian investment in publicly traded and/or widely held U.S. REITs expressly for the opportunity to obtain the legally required, current income distributions fully taxable under

Canadian tax law (and the potential for the excellent return on investment that such distributions would represent) could be negatively affected if the Act's provisions are not clarified as described below.

I. EXECUTIVE SUMMARY

We understand that the Department of Finance's goal in promulgating this legislation has been to prevent inappropriate deferral of non-Canadian income through passive foreign investment. We believe that U.S. REITs should be excluded specifically from the application of this legislation either on a *per se* basis, or through certain clarifications to provisions of the Act, as described below.

A. REITs Should Be Considered *Per Se* "Exempt Foreign Trusts" For Purposes of the Non-Resident Trust Rules

Our understanding is that non-Canadian trusts that meet the definition of "exempt foreign trusts" would be exempt from the Act's proposed taxation on worldwide income of non-resident trusts with Canadian investors. As further described below, because Canadian investment in U.S. business trust REITs does not present an opportunity for tax deferral, these U.S. REITs should be considered *per se* "exempt foreign trusts." In the absence of a *per se* exemption, we recommend that certain clarifications be made to the requirements relevant to "exempt foreign trusts" as described below.

Specifically, "exempt foreign trusts" must meet a number of requirements, including that investors have a "specified fixed interest" (meaning, among other things, that their distributions may not be "discretionary"). Among other things, they must have at least 150 unitholders who have invested $500 each.[1] Like the trustees and directors of most publicly traded and privately held business entities, the trustees of a business trust REIT have discretion as to whether and how much of a distribution to declare and pay. With that said, to maintain its tax status, federal tax law requires both that a U.S. REIT must distribute at least 90% of its taxable income, and that all shareholders of a particular class of REIT stock be treated equally. Trustees have no discretion to distribute a disproportionate amount to shareholders of a particular class of stock.

We recommend that the Act's provisions be clarified to reflect that this type of discretion does not affect the treatment of an investor's interest as a "specified fixed interest." Furthermore, because U.S. law requires U.S. REITs not to be "closely held" (as defined) and requires them to have at least 100 shareholders, it is possible that a trust that meets all of the requirements to be a U.S. REIT, including distributing at least 90% of its taxable income, if not more, may not meet the Canadian requirement of having at least 150 investors. Accordingly, we suggest that the 150 shareholder requirement be reduced to 100 shareholders.

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[1] If not able to meet this condition, we understand that it may be possible for the U.S. trust to file its organizational documents with the Minister of National Revenue. However, as described below under Section III.A.3., this solution is impractical because many U.S. REITs may not even be aware of their Canadian investors, and thus, may not know of the need to make this filing.

B. U.S. Securities and Exchange Commission (SEC)-Registered REITs Should Be Considered Exempt from the FIE Rules

The Act proposes to exempt listed U.S. REITs from the FIE rules. Certain types of non-listed REITs may also be outside the scope of the rules upon meeting specified criteria. As further described below, because U.S. securities law requires U.S. REITs (and other business entities) with more than 500 shareholders and greater than $10 million in assets to register their securities with the U.S. Securities and Exchange Commission (SEC) and to file the same annual and periodic reports (*e.g.*, Forms 10-Q, 10-K, 8-K, etc.) with the SEC as publicly traded companies, SEC-registered REITs are subject to the same level of transparency as publicly traded REITs. Furthermore, U.S. tax law requires the shares of these REITs (and all REITs) to be considered "transferable." Accordingly, we recommend that SEC-registered REITs also be considered exempt from the Act's proposed FIE rules.

II. U.S. REITs AND PROPOSED BILL C-10: BACKGROUND

A. U.S. REITs

As you may recall from NAREIT's Prior Submission, a U.S. REIT is a corporation or business trust[2] (taxable as a corporation under U.S. tax principles)[3] combining the capital of many investors to own, operate or finance income-producing real estate, such as apartments, shopping centers, offices and warehouses, as well as debt instruments secured by mortgages on real property.

The U.S. Congress created the REIT structure in 1960 to make investments in large-scale, significant income-producing real estate accessible to investors from all walks of life. Based in part on the rationale for mutual funds, Congress decided that the only way for the average investor to access investments in larger-scale commercial properties was through pooling arrangements. REITs offer distinct advantages for smaller investors: greater diversification through investing in a portfolio of properties rather than a single building and expert management by experienced real estate professionals.

REITs must comply with a number of requirements, the most fundamental of these are as follows: (1) REITs must pay at least 90% of their taxable income to shareholders; (2) most of a REIT's assets must consist of real estate or debt instruments secured by real estate; (3) REITs must derive most of their income from real estate held for the long term; and (4) REITs must be widely held. Moreover, a U.S. REIT may not be "closely held" (meaning five or fewer

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[2] Although a U.S. REIT can be formed under a U.S. state's law as either as a corporation or business trust, it must be taxable as a domestic U.S. corporation for U.S. tax purposes. Section 856(a)(3), U.S. Internal Revenue Code of 1986, as amended (the Code, and unless otherwise noted herein, any section thereof, a Section). Because the NRT provisions of the Act only addresses investment in non-Canadian trusts, the NRT discussion in this letter will address only Canadian investment in U.S. REITs formed as trusts.

[3] Under U.S. tax principles, all domestic corporations are taxable in the U.S. on their worldwide income. Again, this principle further demonstrates that U.S.REITs cannot be used as a means of tax deferral. They distribute at least 90% of their taxable income to shareholders, and they are subject to U.S. on their worldwide income on whatever taxable income they retain.

individuals may not own more than 50% of the REIT's stock).[4] Furthermore, a U.S. REIT must have at least 100 shareholders.[5]

In exchange for satisfying the above-stated requirements, REITs receive a dividends paid deduction as long as the dividend is not "preferential"[6] so that most, if not all, of a REIT's earnings are taxed only at the shareholder level. On the other hand, REITs pay the price of not having retained earnings available to meet their business needs. To the extent a U.S. REIT retains the up to 10% of its taxable income that it is permitted to retain, it is subject to corporate-level tax at up to the highest corporate-level tax rate on such amount. Distributions of ordinary income by U.S. REITs to Canadian investors is subject to a statutory withholding rate of 30%, which may be reduced by treaty,[7] depending on the type of distribution and the specific type of shareholder.[8] Thus, the 90% distribution requirement, combined with this corporate-level tax on any retained income, and a U.S. withholding tax on distributions outside of the U.S. means that investment in U.S. REITs are hardly an opportunity for tax deferral by foreign (or U.S.) investors.

As of April 30, 2008, there were approximately 149 publicly traded REITs in the United States with an equity market capitalization of approximately $326 billion. In 2007, REITs distributed over $19 billion in dividends to their shareholders.

B. Summary of Bill C-10

1. Non-Resident Trust Proposals

It is our understanding that, under Bill C-10, if there is a Canadian resident contributor to a non-resident trust, that trust may be deemed to be resident in Canada, with the result that the trust would be liable to tax in Canada on its worldwide income and distributions paid by the trust to non-resident beneficiaries would be subject to Canadian withholding tax. For these purposes, a resident contributor is an entity that is resident in Canada and a contributor to a particular trust. A contributor is any entity that has made a contribution to a trust and a contribution is broadly

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[4] Section 856(a)(6).
[5] Section 856(a)(5).
[6] Specifically, the REIT's dividend must be "pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference." Sections 857(a)(1); 562(c). In sum, once a U.S. REIT's distribution is declared, the trustees have no discretion to prefer one shareholder over another shareholder of the same class of stock or one class over another (except to the extent that the terms of the stock so permit it, such as in the case of preferred stock and common stock).
[7] The general statutory withholding rate of 30% on ordinary distributions is reduced to 15% under the U.S.-Canadian tax treaty for U.S. REIT ordinary dividends to individuals who own less than 10% of the REIT stock. Capital gain distributions (*e.g.*, gain from the sale of real estate) by non-listed REITs to any shareholders and by listed U.S. REITs to greater-than-5% shareholders are generally subject to a 35% withholding tax. Capital gain distributions by listed REITs to shareholders that own five percent or less of the REIT's stock are treated as ordinary dividends eligible for the reduced 15% withholding rate.
[8] Distributions to Canadian pension plans and charities are subject to a zero percent withholding tax rate. These entities are not subject to tax under Canadian tax law; thus, the absence of a U.S. withholding tax does not indicate that these entities invest in U.S. REITs as a tax deferral opportunity.

defined to include a transfer of property to the trust (other than an arm's length transfer). An arm's length transfer would not include an acquisition of units from the trust and, therefore, if even a single Canadian resident were to acquire units from a non-resident trust, the non-resident trust may be deemed to be resident in Canada with the potential consequences as described above. It is also our understanding that a trust that is an "exempt foreign trust" will not be deemed to be resident in Canada even if there is a resident contributor to the trust.

a. "Qualifying Investors" Rule: "Specified Fixed Interests"

We understand that paragraph (h) of the definition of "exempt foreign trust" in Bill C-10 is intended to exempt from the rules relating to non-resident trusts commercial trusts such as U.S. real estate investment trusts. With that said, a necessary condition for any trust to be an exempt foreign trust is that the only beneficiaries under the trust must be "qualifying investors" in respect of the trust. A qualifying investor is a beneficiary under the trust whose only interest as a beneficiary is a "specified fixed interest."

There are a number of conditions that must be satisfied in order for an interest in a trust to be a "specified fixed interest." One of these conditions is that no amount of income or capital of the trust that any entity may receive directly from the trust at any time as a beneficiary under the trust may depend on the exercise by any entity of, or the failure by any entity to exercise, a "discretionary" power.[9] As further described below, we are concerned that this requirement for the absence of any discretionary power in respect of the amount of income or capital of the trust that any entity may receive from the trust at any time may disqualify many U.S. REITs from the definition of an exempt foreign trust.

b. At Least 150 Investors

If all beneficiaries of a trust are qualifying investors, the trust may qualify as an exempt foreign trust if it satisfies one of two sets of conditions. The first set of conditions requires that the trust have at least 150 unitholders that hold interests in the trust with a value of at least $500. In addition, no resident contributor to the trust may own more than 10% of the fair market value of all interests in the trust unless the resident contributor is a "specified contributor." If the trust does not have 150 unitholders, then the second set of conditions requires that:

(1) A prescribed form and a copy of the terms of the trust be filed with the Minister of National Revenue,

(2) It must be reasonable to conclude that each Canadian resident contributor to the trust is a "specified contributor", and

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[9] We also note that a similar requirement is contained in the definition of "eligible trust". In order for a trust to be an exempt foreign trust, it must be an eligible trust and, therefore, there appears to be some overlap in the provisions. Accordingly, any suggestions made herein with respect to this requirement apply equally to the similar requirement in the definition of eligible trust.

(3) The trust must not hold any "restricted property."

2. Foreign Investment Entity Proposals

Our understanding is that the Act, among other things, would require a Canadian investor who acquires an interest in an FIE to include an amount in income annually in respect of the investment pursuant to one of three prescribed methods. "Exempt interests" in certain foreign entities would be exempt from the FIE rules. Most interests in REITs that are publicly traded will satisfy the definition of "exempt interest." Presumably, publicly traded U.S. REITs are generally exempt from these rules because such an investment is transparent (due to the requirements that U.S. REITs disclose financial statements and other important information to the public and the U.S. SEC) and, because such REITs are resident in the U.S., is not a means for tax deferral. However, interests in widely-held REITs that are not publicly traded would not automatically be exempt even though as described below, they afford similar transparency.

III. DISCUSSION

A. U.S. Business Trust REITs Should Be "Exempt Foreign Trusts" Under the Proposed Non-Resident Trust Rules

1. U.S. Business Trust REITs Should Be Considered *Per Se* Exempt Foreign Trusts Under the Proposed Non-Resident Trust Rules

As the background information above indicates, U.S. REITs are widely-held entities that must distribute at least 90% of their taxable income or face U.S. tax on any of their income they retain. Because they do not present an opportunity for tax deferral, they should be considered *per se* "exempt foreign trusts" from the Act's proposed non-resident trust rules. We understand that it may be possible to demonstrate that an investment in a U.S. REIT meets the specific criteria proposed in the Act for "exempt foreign trusts,"[10] but from an investor relations perspective, it would be far preferable for U.S. REITs to be *per se* exempt rather than have to explain to investors how they satisfy certain criteria.

In the event it is not possible to treat U.S. REITs as *per se* exempt foreign trusts, we recommend the changes described below.

2. If U.S. REITs Are Not *Per Se* "Exempt Foreign Trusts," Interests in U.S. REITs Should Be Considered "Specified Fixed Interests" Because U.S. REIT Trustees Have No Discretion to Discriminate Among Shareholders of a Particular Class of Stock

In the event that U.S. REITs are not considered *per se* "exempt foreign trusts," Bill C-10 does attempt to provide criteria they may satisfy to meet the "exempt foreign trust" definition. As noted above, one criterion is that the interests in the U.S. REIT be "specified fixed interests," the

[10] As we note below, we do recommend some clarification to this specified criteria.

definition of which provides that no amount of income or capital of the trust that any entity may receive directly from the trust at any time as a beneficiary under the trust may depend on the exercise by any entity of, or the failure by any entity to exercise, a "discretionary" power. We are concerned that the requirement for the absence of any discretionary power in respect of the amount of income or capital of the trust that any entity may receive from the trust at any time may disqualify many U.S. REITs from the definition of an exempt foreign trust.

While U.S. tax law requires a U.S. REIT to distribute at least 90% of its taxable income in order to retain its tax status as a REIT, the declarations of trust for many U.S. REITs provide the REIT with discretion with respect to the exact amount of income to be distributed to beneficiaries at any particular time and, generally, allow the REIT to retain a certain percentage of income in any year at the discretion of the trustee of the REIT. With that said, U.S. tax law also requires that, in order for a U.S. REIT to be able to deduct its distributions from taxable income (thereby shifting the tax on such income to its shareholders), a U.S. REIT's dividend must not be "preferential."

Based on the language of the definition of specified fixed interest, it appears at least arguable that a U.S. REIT trustee's discretion as to the exact amount of each distribution could be interpreted to mean that the interest of a beneficiary in the REIT is not a specified fixed interest. As noted, the definition of specified fixed interest refers to the amount of income or capital of the trust that an entity may receive directly from the trust *at any time*. However, this interpretation cannot be correct because virtually every U.S. business entity retains discretion over the exact amount of distributions to make. It appears that the policy behind the Act's requirement of a "specified fixed interest" is that once a distribution is declared, all members of a particular class should be treated equally. That principle is evident in the requirement that a U.S. REIT's dividend not be preferential. While that may be the intention of the definition, in our view the use of the words "at any time" in the definition of specified fixed interest creates reasonable uncertainty whether this intention is manifested in the definition. Accordingly, we would recommend that revisions be made to the definition of specified fixed interest in order to clarify this intention.

3. The "150 Shareholder" Requirement for Exempt Foreign Trusts Should Be Reduced to "100 Shareholder" Requirement, At Least in the Case of U.S. REIT

Bill C-10 proposes a minimum of 150 shareholders to meet one of the conditions for the definition of "exempt foreign trust." However, under the Code, a trust may qualify as a U.S. real estate investment trust if it has more than 100 unitholders or beneficiaries. Accordingly, many U.S. REITs may not have 150 unitholders and, therefore, in order for such a U.S. REIT to qualify as an exempt foreign trust, the REIT must meet the second set of conditions described above. Ignoring the issues raised by the specified contributor and restricted property requirements, the requirement that the trust file a prescribed form and a copy of the terms of the trust with the Minister of National Revenue could prove to be impractical to satisfy. In many cases, a U.S. REIT may not know that it has a Canadian resident contributor, particularly given the broad definition of contribution in subsection 94(1) of the Act and the broad provisions for indirect contributions in subsection 94(2) of the Act. While the filing requirement may be satisfied by the resident contributor, given that the tax liability is that of the trust, it seems somewhat unreasonable to rely on this filing to protect the trust from potential Canadian tax liability.

Therefore, it is submitted that consideration should be given to reducing the 150 shareholder requirement to 100 shareholders, at least in the case of U.S. REITs, and/or listing as a prescribed trust all trusts that qualify as U.S. REITs. As noted in NAREIT's Prior Submission, U.S. law requires REITs to distribute substantially all of their income and, accordingly, the tax deferral concern that is the basis for the non-resident trust rules is not present in the case of U.S. REITs. While we agree, subject to the comments above, that the definition of exempt foreign trust should exempt most commercial trusts from the rules relating to non-resident trusts, we submit that it would be a helpful development if the Department of Finance adopted the practice of prescribing classes of trusts that should be, in its view, clearly outside the scope of the provisions.

B. U.S. SEC-Registered REITs Should Be Treated Similarly to Listed U.S. REITs Under the Proposed FIE Rules.

As further described below, we recommend that U.S. REITs that are legally required to register their securities with the U.S. SEC be considered similarly to a publicly traded U.S. REIT for purposes of exemption under the proposed FIE rules.

With respect to these proposed FIE rules, we would like to bring to your attention a growing trend in the U.S. REIT market. In the last several years, the popularity of non-publicly traded REITs has increased. Through to the end of September 2007, non-publicly traded REITs had raised $9.3 billion and raised approximately $11.5 billion for the year as a whole. In many cases, these non-publicly traded REITs will have assets in excess of $10 million and more than 500 unitholders or shareholders and, therefore, under U.S. securities laws, they will be required to file annual and other periodic reports with the Securities and Exchange Commission in the United States like publicly listed REITs, including annual reports (Forms 10-K), quarterly reports (Forms 10-Q), and disclosures of material changes (Forms 8-K), among other items, thereby resulting in the same transparency as is the case with publicly listed REITs.

However, because the units or shares of these REITs are not listed on a stock exchange, not publicly traded, and generally may only be acquired from or sold to the REIT in limited circumstances, interests in such REITs will not be exempt interests as defined for purposes of the rules relating to foreign investment entities. These U.S. REITs, like all other U.S. REITs, are still required to distribute substantially all of their income and, therefore, for the reasons outlined above and in our previous submission, we submit that these REITs, as with all other U.S. REITs, should be exempt from the application of these rules.

In our view, we see no reason why widely-held publicly traded REITs should be exempt from the rules while widely-held but non-publicly traded REITs are potentially subject to the rules. As a result, we request that the rules be modified such that these SEC-registered U.S. REITs be treated in a manner similar to widely-held and publicly traded U.S. REITs. An example of how to define these REITs can be found in state legislation in Massachusetts adopted in 2005 [section

22 of Act 163: http://www.mass.gov/legis/laws/seslaw05/sl050163.htm]: a qualified real estate investment trust is "a real estate investment trust under section 856 of the Code . . . that is required to file with the Securities and Exchange Commission annual and other reports as specified in Section 13 or Section 15(d) of the Securities Exchange Act of 1934, as amended."

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Thank you for the opportunity to submit these comments. We would appreciate the opportunity to discuss them with you in further detail if you believe that would be helpful. As we suggested above, we have already heard from a number of our publicly traded REIT members who are concerned about the negative impact of the proposed NRT and FIE rules on their potential Canadian investors so we hope that it will be possible to modify the Act to reflect our comments. Please feel free to contact either Chris Conway of REALpac at (416) 642-2700 ext. 224 or Tony Edwards of NAREIT at (202) 739-9408 to discuss this submission in further detail.

Sincerely,

Chris Conway

Tony M. Edwards

Chris Conway
Vice President, Government Relations
REALpac

Tony M. Edwards
Executive Vice President & General Counsel
NAREIT

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