

# *The Real Estate Review* Winter 2012

## In this issue

- 1 To 2015... and beyond
- 3 How digital media and the mobile consumer is transforming the way we do business  
Not taking advantage is a disadvantage
- 5 Financial reporting for real estate investment funds  
Different roads can lead to the same destination
- 9 Stapled security tax proposals
- 11 June 2011 federal budget  
What does it mean for the real estate industry?
- 13 Commodity tax update





## Editor's note

New challenges to the global economic recovery continue to arise on what seems like a daily basis. Economic growth is decelerating in key markets around the globe and macroeconomic indicators remain mixed at best. The recent financial market disruption reflects the markets' realization that the medium term world economic growth outlook is weaker than had been previously believed. The US has shown signs of slouching toward a double dip recession which would significantly impair world trade volumes and thus economic growth, particularly in the world's exporters (Germany, the Nordics, Asia). The Eurozone's sovereign debt issues, which have widened to engulf the entire continent and will likely lead to a European recession in 2012, have increasingly become a political issue rather than an economic one as markets lose patience with the fragmented and reactive response from Eurozone policymakers. There is even concern whether China will be able to sustain its reported growth rates in the face of global economic weakness as it battles inflation at home. The aggregate effect of all these forces on the global economy, and its impact on real estate pricing and valuations, is unprecedented volatility and uncertainty, causing real estate capital to flow to safe havens such as prime trophy assets and secondary assets that tend to remain resilient in the face of weak demand such as non-discretionary retail and multi-family housing.

With that backdrop, in this edition of The Real Estate Review, Tim Wilson outlines 10 trends that will shape the real estate industry over the next half decade. Jennifer Lee takes a closer look at one of those trends: the impact that social media is having on the way we work and live, and its role in the real estate industry. We also provide an update on tax developments with a specific focus on recently enacted legislation affecting stapled securities and review financial reporting considerations for real estate investment funds attracting global pools of capital from countries with different accounting regimes.

As always, we welcome your questions, feedback and ideas for future editions.

**Tony Cocuzzo**  
Partner

# To 2015... and beyond

By Tim Wilson

Sovereign debt issues, disappointing economic indicators and global market volatility make forecasting the outlook for the economy, including the real estate industry, a daunting task. However, notwithstanding this unprecedented degree of uncertainty, there are a few trends we expect to see shape the real estate industry over the next half decade regardless of the near term prospects for the broader economy. We will take this opportunity to highlight these trends and their implications for various real estate sectors.

## Greening technologies and, quite possibly, greening legislation



Sustainability of commercial real estate will continue to become increasingly relevant; in fact, it has already become a key criterion for certain tenants in their leasing decisions, a trend that will only become more pronounced as "Generation-Y" users of space, and the heightened expectations they bring to social responsibility and sustainability matters, become a larger and more influential component of the workforce. The need for more energy efficient buildings and building systems will also be fueled by the potential resource scarcity resulting from the emergence of Asian economies, and the attendant impact on commodity prices, as well as government policy setting. Even if demand for space stagnates as a result of a sustained period of slow growth, these factors will drive capital investment in the form of refurbishments to green the existing stock of commercial real estate.

## Alternative workplace strategies



Alternative Workplace Strategies (AWS) that reduce the footprint per employee and result in flexible, "use as you need" formats will continue to increase in popularity. Users, and by extension landlords, of office space will need to provide workplaces that allow for 24/7, high connection and collaborative workspaces suited to Gen-Y work habits. In addition to fitting with demographic trends, the move to AWS also aligns with greening trends (e.g., reduced commuting through tele-presence) and allows for cost efficiencies. For office landlords, providing state of the art, green environments that allow for AWS will be particularly important in a period where competition among landlords is high, although this will likely have a longer term impact on overall demand. Meeting this challenge will require landlords to balance the demand for modern workplace environments with flexible design layouts that can be reconfigured into more traditional formats, particularly given the nearly four generations currently in the workforce.

## Social media and mobile applications



As discussed in more detail later in this newsletter, mobile applications will increasingly become part of marketing, maintaining and servicing commercial and residential real estate. Retail landlords will work closely with tenants to re-define the retail customer experience in a way that leverages social media and mobile applications. At the same time, growth in on-line retail will continue (via mobile applications and traditional web-sites) fueling demand for warehouse space. Increasingly, mobile applications will continue to change the way landlords respond to tenant service requests and perform maintenance activities and the way that space (e.g., residential apartments) is marketed.

### Impact of demographics on residential



An increased propensity to rent by two significant demographic groups, baby-boomers and Gen-Y, will benefit multi-family landlords. Renting will become attractive to retiring/empty-nest baby boomers seeking the flexibility of renting and ability to access the wealth tied up in their homes. Gen-Y will rent longer than earlier generations and stay within urban centers both for access to amenities and as an expression of social conscience. Lifestyle communities that incorporate retail, community and work will be attractive to both groups. Successful development of these mixed-use communities may require partnerships between real estate developers with specializations in different asset classes.

### Global shift of power to emerging markets



Economic influence will continue to migrate from the world's existing economic engines to emerging markets, even if the pace of growth in China and India begins to slow due to stagnation of the US and/or European economies and domestic inflation in those countries. This shift in influence is expected to impact global real estate capital flows. Real estate investors in mature economies may seek to monetize portfolios and redeploy capital to higher-growth portfolios in emerging economies to maximize returns over the medium to long-term. On the flip side, investors in emerging economies may wish to invest in real estate in mature economies to increase the security of their new wealth. The result will be even more inter-connectedness of the global economy.

The inflationary impact of the demand from emerging economies on global commodity prices will impact the demand for certain space in North America. An increase in energy costs will contribute to demand for warehouse space in infill locations adjacent to major population centers. Also, relative to other real estate sectors, demand for industrial space may be positively affected by growth in domestic manufacturing triggered by a weak American dollar, increased international transportation costs and government policy (e.g., "buy American").

### Corporate outsourcing – "extended enterprise"



An increased focus on core competencies coupled with a shift toward hyper-specialization will drive an off-loading of back office tasks (e.g., lease administration, property or fund accounting, accounts receivable and payable) to specialized knowledge workers, possibly even offshore to emerging markets such as India which provide access to a large and highly educated English-speaking workforce at a comparatively low cost. The emergence of a new business model for commercial real estate owners/investors could lead to reduced overheads, increased standardization and speed of delivery, and a new source of demand for office space from which to deliver these services.

#### Other considerations

- US households have continued to de-lever, reducing income available for consumption. At the same time, Canadian household debt has continued to grow. Notwithstanding the relative strength of Canadian economic fundamentals, a Canadian de-leveraging will likely follow with resulting impacts on the demand for retail and residential real estate.
- While there has been some indication that underwriting standards for debt securitization deals are relaxing, higher capital requirements and stricter underwriting standards by residential mortgage lenders do not appear to show any signs of being relaxed which provides a favorable outlook for the US apartment rental sector.
- Recapitalization of the real estate industry will continue. Notwithstanding sovereign debt concerns in Europe and the US, a substantial amount of capital has been built up on corporate balance sheets. A portion of this will be required to fund the equity infusions required to refinance the significant CMBS maturities in the coming years.
- New capital requirements and regulations will require banks to reduce real estate exposure in Europe, creating refinancing challenges for owners of European real estate and opportunities for unregulated investors to facilitate the de-leveraging of European assets.

# How digital media and the mobile consumer is transforming the way we do business

## Not taking advantage is a disadvantage

*By Jennifer Lee*

Digital media isn't going away. It's going every way. All the way. We live in a highly and perpetually connected world where business is being driven by mobile consumer trends that are facilitated by digital media. And the definition of "mobility" is no longer simply that you can take your computer with you – the key selling point when laptop popularity and advertising were at their apex. Mobility now encompasses what you can do when you get where you're going. For consumers, this has meant an exploding universe of networking possibilities and mobile applications that enable everything from consulting knowledgeable online communities about your purchases; to 2D barcodes that provide critical product and pricing information through your mobile device; to extended product selection ("extended shelf"). For owners of commercial real estate across sectors, a digital media strategy is key to remaining competitive.

### **Catalyst for digital media growth –**

#### **The mobile consumer**

In 2011, the sale of smartphone devices outpaced laptop purchases. This is a significant trend, and tells us that the mobile consumer is becoming increasingly mainstream. These mobile consumers are not just the "propeller heads" as one would expect – data is increasingly showing that all age brackets and all income levels are adopting the mobile lifestyle. Many commercial real estate owners and their leasing teams realize that these trends aren't just relevant for young consumers and are taking advantage of cutting edge sales concepts and technologies that have emerged from the consumer retail market. Digital media has many real estate applications – existing and on-the-way – and companies that don't take advantage and develop a digital media strategy are putting themselves at an ever increasing disadvantage.

### **Leverage digital media to improve business and enhance operations**

#### **Social media**

When most people think of digital media, they think of social media – the many online networks and communities such as Facebook and Twitter – that form a vast connectivity platform for exchanging ideas, commenting on issues, critiquing products, lobbying governments and much more. But businesses in all industries clearly see the value in social media advertising, as Facebook advertising revenues continue to rise and social networking in general leads all online categories in advertising.

The commercial real estate industry is not immune to the potential negative impacts of social networking communities; conversely, it can not overlook the substantial potential benefits. A simple Google search yields links to numerous forums, sub-forums and threads dedicated to real estate, where information and opinions about commercial developers, agents and investments circulate at light speed. When potential tenants or investors contact a landlord, chances are they've done a good deal of their research already. In such an environment, good word-of-mouth is gold while negative commentary can be damaging and difficult to correct. At the very least, all companies should monitor their perceived profile, advertise on appropriate social networks and consider maintaining their own network presence – even their own networks.



### Mobile workforce and operational efficiency

More important to retailers than social media in the digital media spectrum is the potential for digital mobility to revolutionize the way mobile employees, such as sales and operations teams, go about their respective jobs.

- **Sales force** – If you're a commercial real estate broker or a developer with a dedicated sales or leasing team, you know the challenges your teams face dealing with massive amounts of information and complex databases while remaining client and sales focused. Several mobile applications can simplify their jobs and increase productivity. There are cell phone apps that allow would-be tenants or purchasers to take a cell phone picture of a barcode on a "for sale" or "for rent" sign, then download information linked to that unique property; LoopNet.com allows commercial real estate professionals iPhone access to hundreds of thousands of real estate listings on the spot; other apps let them view floor plans, call up virtual tours and access a range of sales support information.
- **Maintenance and operations** – Keeping properties maintained and running smoothly is another focus of commercial real estate companies where mobile applications can play a part. Maintenance staff members face a range of information, navigation and communication issues as they move from site to site while doing their work. Imagine apps that allow a maintenance person to photograph a broken window or missing siding, enter it online along with relevant specifications, then schedule a repair. Maintenance jobs move more quickly, tenants are more satisfied and your operations team has an improved tool set to work with.

When it comes to these types of specialized apps, the only limitations are available technology and the ability to identify and address specific needs. With a proper digital media strategy, you can not only seek out – even develop – the apps you need, but you can also determine how to best integrate them into your overall business plan.

### The mobile consumer in retail

As mobile applications originally developed as social and consumer tools, it may not come as a surprise that retail landlords are leading the way in the use of mobile applications. In Toronto, Yorkdale mall's iPhone app offers a great example of how a development can create a digital strategy to attract customers and increase tenant satisfaction:

**Yorkdale on iPhone**

- Check out the latest promotions
- Enter the contest
- Treat yourself with valet parking
- Find a parking space fast
- Mall hours a touch away




By simplifying the experience of going to a mega-mall as much as possible – then adding promotions and contests – Yorkdale created a digital consumer package that benefits consumers, the development and tenants.

### Reaping the benefits means building a strategy

All industries – from banking to sports to healthcare – are exploring the mobile space. Developing a digital strategy that is working for you is the first step. A much bigger leap into the future lies in developing a digital media strategy that drives tangible revenues or reduces costs for your organization by increasing operational efficiencies or improving the tenant experience. This is particularly hard to do from within your own industry, particularly if that industry is still developing its digital character. It's critical to look cross-industry and know what tools and approaches are succeeding right now and then rethink and repurpose strategies from other industries, such as consumer retail, which is leading the way in innovation and success. Today, digital mobility equals business mobility. It's critical for commercial real estate companies to stay in the race.

# Financial reporting for real estate investment funds

## Different roads can lead to the same destination

*By David Machazire*

The increasing flow of capital to North American real estate from diverse global pools of investors who operate in different geographies and regulatory landscapes is likely to create financial reporting challenges for private Canadian investment funds and their managers because investors may require multiple reporting frameworks. For example, a private Canadian real estate fund that might be financed by an investment consortium or “club” that includes a Canadian private equity firm that requires financial statements in accordance with Accounting Standards for Private Enterprises (“ASPE”), a Canadian public company or a sovereign wealth fund that requires fund financial statements to be compliant with International Financial Reporting Standards (“IFRS”) and a US based private or public company that requires a US GAAP financial package. This example illustrates a situation where a detailed understanding of multiple financial reporting frameworks would be necessary for a Canadian investment fund to satisfy its investors. Furthermore, to the extent that the fund’s investors have the ability to choose from either ASPE, US GAAP or IFRS, knowledge of the key differences between these reporting frameworks would empower the fund manager to determine the right solution, and ideally only one solution, for the fund and its investors.

This discussion addresses some key considerations for managers of private real estate investment funds. The focus is on ASPE, US GAAP and IFRS because profit-oriented enterprises that are domiciled in Canada generally only have the option to present their stand-alone financial statements in one or more of these frameworks, depending on the circumstances. It is noted that there are other defined bases of accounting that are generally less prevalent among Canadian real estate funds but which may be required. For example, a fund that is owned by a US public pension fund may follow National Council of Real Estate Investment Fiduciaries (“NCREIF”) Guidelines or CICA Handbook S. 4600; “Pension Plans” might apply to a fund that is owned by a Canadian pension plan.

### **Investment company accounting**

Canadian investment funds that previously reported under CICA Accounting Guideline 18; “Investment Companies” (“AcG-18”) can continue reporting on that basis since AcG-18 has been carried forward under ASPE, provided of course that the fund continues to possess the attributes of an investment company as set forth in AcG-18. This specialized basis of accounting, which includes a requirement to carry net investments in real estate at fair value, is also substantially harmonized with ASC 946; “Investment Companies” (“ASC 946”) under US GAAP, with one significant exception; the Canadian requirements to qualify as an investment company are generally seen as more rigid than the US requirements. Most notably, there are subtle differences in the definition of an investment company under AcG-18 compared to ASC 946 that could lead to differences in the scope of the two standards. Specifically, AcG-18 prescribes that “an investment company or its affiliates cannot be involved in the day-to-day management of investees, affiliates of investees, or other investment assets”. In that context, if a fund’s general partner manages any of the real estate properties, that fund would likely not qualify as an investment company under ASPE even if the fund meets all the other attributes prescribed in AcG-18. In fact, even if the general partner hired a third party property manager to look after the fund’s properties, the investor could still be viewed as being responsible for the day-to-day management – they have simply delegated that activity to a third party in the same way they would to an employee but have presumably retained decision making authority over the activities of the manager as it relates to the fund’s assets and could replace the third party manager if they so desired. Conversely, similar language is not found in ASC 946. Consequently, a fund that is disqualified from investment company accounting under ASPE because it has failed a single factor by virtue of the fund’s general partner involvement in the day to day management of the fund’s real estate properties, could still qualify for investment company accounting under US GAAP if it is determined that the collective weight of the other factors that point to the fund being an investment company.



The lack of more detailed guidance in AcG-18 and ASC 946 regarding the determination of whether an fund meets the definition of an investment company requires the application of significant judgment by fund managers in assessing the appropriate accounting basis for funds that might fall within the “gray area” of having some degree of involvement in at least one activity that would disqualify a fund from investment company accounting, but overall the fund appears to meet all other criteria.

**IFRS considerations**

Notwithstanding the issues noted above, a private real estate fund that meets the definition of an investment

company under both AcG-18 and ASC 946 could produce a set of financial statements that is substantially compliant for both US GAAP and ASPE purposes. And, while IFRS currently does not have a single standard for investment companies that is analogous to AcG-18 and ASC 946, it does provide real estate investment funds with accounting policy choices that would enable them to achieve substantially the same financial reporting outcome under IFRS as would have been achieved under investment company accounting. To illustrate this point, the summary table included herein highlights the IFRS policy choices that could be made by fund managers to achieve the greatest consistency with investment company accounting under ASPE and US GAAP.

Topic	Investment company accounting (ICA)	IFRS	Policy can be similar?
Real estate investments	All real estate investments are presented at fair value, regardless of form of ownership i.e., fee simple interest property is measured at fair value	IAS 40, Investment Property, provides policy choice to measure investment properties at fair value or cost basis; if cost basis is selected, fair value must be disclosed in notes	<b>Yes</b> (via IFRS policy choice)
Debt facilities used to finance acquisition of real estate	Debt held by the Real Estate Investment Fund (REIF) is stated at amounts payable, reflecting principal amounts due plus interest accrued up to balance sheet date net of any deferred financing costs. Alternatively, an entity can elect to measure the debt at fair value under the fair value option.	Similar to US GAAP, debt associated with investment properties can be carried at amortized cost or designated by the entity as a financial liability at fair value through profit or loss if the criteria in IAS 39, Financial Instruments: Recognition and Measurement, are met	<b>Yes</b> (via IFRS policy choice for fair value)
Consolidation	Consolidation of controlled entities is required in some but <i>not all</i> circumstances. The following are examples under US GAAP: <ul style="list-style-type: none"> <li>• A REIF may only consolidate a subsidiary that is also an investment company or is a subsidiary that is an operating entity that provides services to the REIF parent e.g., advisor/transfer agent (“service provider”).</li> <li>• Direct fee simple interests in property financed with debt held by a parent REIF that is an investment company (or by its investment company consolidated subsidiary) will result in the presentation of gross asset and gross debt (with such debt measured at amortized cost, unless fair value option is elected) in balance sheet. Gross rental income and expenses will be reflected in the P&amp;L.</li> <li>• Conversely, a non-investment company that owns direct fee simple interests in property and debt held by a parent company that is an investment company (or by its investment company consolidated subsidiary) should be measured at fair value and presented as one line item “real estate investments” in balance sheet. P&amp;L will reflect change in fair value of investments and dividends received.</li> </ul>	All controlled entities/subsidiaries of REIFs should be consolidated under IFRS.	<b>Yes</b> (for investment co. subsidiaries, “service provider” subsidiaries and direct fee simple interest property and related debt of investment co. parent or subsidiary)  <b>No</b> (for other non-investment co. subsidiaries there would be a gross vs. net presentation difference)

Topic	Investment company accounting (ICA)	IFRS	Policy can be similar?
Associates	<p>Investments by REIF in associates that are not “service providers” are accounted for at fair value and not equity method.</p> <p>Limited exception allows equity accounting only when investee is a “service provider” to the REIF parent (e.g., advisor/transfer agent).</p>	<p>IAS 31, Interests in Joint Ventures, and IAS 28, Investments in Associates, indicate that proportionate consolidation or equity accounting should not be applied for investments in joint ventures or associates of venture capital organizations, mutual funds, unit trusts and similar entities when upon initial recognition the investments are designated as fair value through profit or loss or are classified as held for trading and accounted for in accordance with IAS 39.</p> <p>Under ASPE/US GAAP various kinds of investment companies exist, including venture capital investment companies, mutual funds and unit trusts. Hence it is likely that REIFs that qualify for ICA under can apply fair value for interests in joint ventures and associates.</p> <p>REIF that qualifies to apply the fair value option for associates can measure all associates at fair value if the REIF designates the associates as financial instruments under the fair value option through the IAS 28 scope exemption.</p>	<p><b>Yes</b> (via IFRS policy choice for fair value)</p>
Accounting for jointly controlled entities	<p>Similar to associates (see above joint venture interests would be accounted for at fair value) with the exception of joint venture operating entities that provide services (service providers) to which the equity method is applied.</p>	<p>Generally, a REIF can choose to use either the equity method or proportionate consolidation to account for all jointly controlled entities under IAS 31. Alternatively a REIF can choose to early adopt IFRS 11 which prescribes the equity method. (IFRS 11 becomes mandatory for fiscal years beginning after December 15, 2012).</p> <p>However, as noted above, if the REIF investor is an investment company under US GAAP, the joint venture interest can be measured at fair value via the policy option available for investment companies under IAS 28 and 31.</p>	<p><b>Yes</b> (via IFRS policy choice for fair value)</p>
Financial assets (investments)	<p>All investments are valued at fair value</p>	<p>REIFs typically designate their investments as financial instruments at fair value through profit and loss under the fair value option.</p>	<p><b>Yes</b> (via IFRS policy choice for fair value)</p>
Receivables	<p>Presented at net realizable value (dividends and interest, investment securities sold)</p>	<p>Same as ASPE/US GAAP</p>	<p><b>Yes</b></p>

Topic	Investment company accounting (ICA)	IFRS	Policy can be similar?
Notes payable and other borrowings	Notes payable to banks, including bank overdrafts and other debt held by a parent REIF should be stated at amounts payable, net of unamortized premium or discounts. Alternatively, the fair value option can be applied.	Measured at amortized cost, using the effective interest rate method. Such liabilities are not typically designated as financial liabilities at fair value through profit or loss as the requisite criteria in IAS 39 are not met	<b>Yes</b> (via IFRS policy choice for fair value)
Interest and dividend income	Interest is recognized on an accrual basis per the effective interest method. Dividends are recognized when the right to receive payment is established	Same as ASPE/US GAAP	<b>Yes</b>
Schedule of investments	Disclosure of a schedule of investments is required under US GAAP, but is not required by ASPE.	Disclosure schedule is not required for investment properties but permitted and is typically presented by REIFs. If presented, comparatives are required for all periods presented	<b>Yes</b> (via policy choice to disclose)

### Recent standard setting developments

On August 25, 2011, the International Accounting Standards Board (IASB) has issued Exposure Draft ED/2011/4 *Investment Entities* which proposes exempting investment companies meeting certain criteria be exempt from consolidation. Investment entities would be required to measure their investments (including those in associates and joint ventures) at fair value through profit and loss in accordance with IFRS 9 *Financial Instruments* and to provide additional disclosures to enable users of its financial statements to evaluate the nature and financial effects of its investment activities.

The proposals do not permit a parent of an investment entity to retain fair value accounting applied by its subsidiary, unless the parent itself qualifies as an investment entity, i.e., the parent would consolidate all entities in the group.

In anticipation of the new IFRS, the Canadian Accounting Standards Board decided in January 2011 to defer the mandatory IFRS changeover date for publicly accountable

investment companies in order to allow the IASB's proposed exemption from consolidation for investment companies to be in place prior to adoption of IFRS by investment companies in Canada.

Although the exposure draft does not indicate an application date, it is likely to be aligned with that of IFRS 10 *Consolidated Financial Statements* being financial periods beginning on or after 1 January 2013.



# Stapled security tax proposals

*By Frank Balanza and Gordon Dunn*

On July 20, 2011 the Minister of Finance of Canada announced proposed changes to the Specified Investment Flow-Through ("SIFT") tax rules in response to the government's concern over recent transactions involving publicly-traded stapled securities, and to address certain other technical issues in the SIFT rules brought to the government's attention by taxpayers and their advisors. Stapled securities are two legally separate equity investments that are not transferable separately, and typically trade together under one trading symbol.

One proposal will apply to stapled securities issued by a Real Estate Investment Trust ("REIT"), or its subsidiary, where one or more of the stapled securities is listed or traded on a stock exchange or other public market. Where, for example, units of a REIT can be transferred only together with an interest in another entity (i.e., a stapled security), the proposal is that "any amount (including, but not limited to rent) that is paid or payable by the other entity (or its subsidiaries) to the REIT (or its subsidiaries) will not be deductible in computing the income of the payer for income tax purposes".

This proposal is grandfathered from application for one year following the date of the Minister's July 20, 2011 announcement if the stapled securities were not issued until after October 31, 2006, and until January 1, 2016 if the stapled securities were outstanding on October 31, 2006. There is also grandfathering relief for certain stapled security transactions that were in progress at the date of the announcement where the parties to the transaction were obligated to complete the transaction pursuant to a written agreement, and for stapled securities issued as payment for an obligation in existence at the date of the announcement on a stapled security. This grandfathering relief can be lost if the stapled security is materially altered.

The SIFT rules which were announced by the government on October 31, 2006 introduced a tax on publicly traded trusts and partnerships to "level the playing field" with publicly traded corporations. However, REITs which qualify under specific criteria in the Income Tax Act are exempt from this SIFT tax ("the REIT Exemption"). Stapled security REITs are generally set up to have the activities which would disqualify the REIT from the REIT Exemption transferred to a separate legal entity ("stapled entity") whose securities are stapled to the REIT units. The stapled entity pays rent, and perhaps other amounts, to the REIT for the use of the REIT's real estate and other services in the stapled entity's operations. The rent payment would generally be deductible and would shelter taxable income in the stapled entity which would generally be subject to tax. The proposal announced on July 20, 2011 would deem the rent payment to be non-deductible by the stapled entity, increasing its current tax burden and reducing its cash flow. However, the proposals do not appear to have a consequential adjustment to the rent income earned by the REIT resulting in a potential for double taxation.

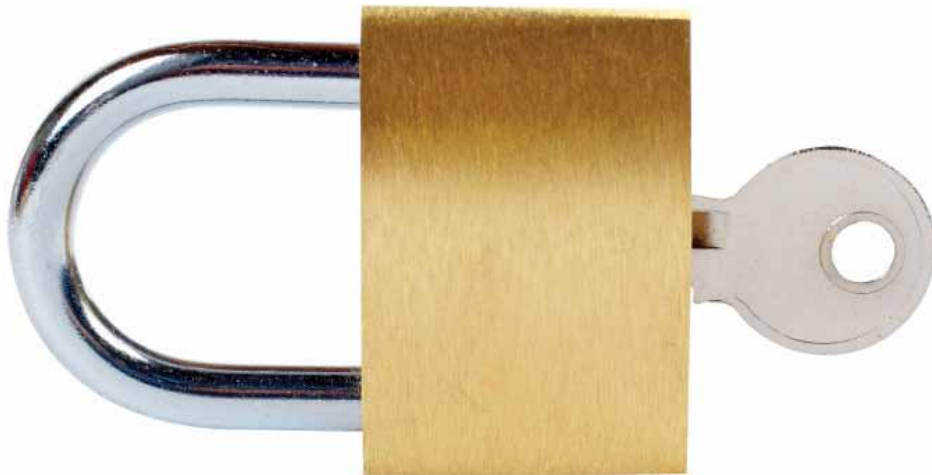
The announcement of a direct legislative response to the stapled security planning that has occurred in the REIT sector was a surprise to many in the tax community given that the legislation only appears to apply to a relatively small number of entities. It is possible that the government chose a legislative response as a deterrent to other REITs which may have been considering the use of stapled securities. In addition, the grandfathering period of only one year for those REIT stapled structures which were created after October 31, 2006 is viewed by many to be insufficient. The announcement on July 20, 2011 had an immediate, significant and adverse impact on the unit price of REITs that currently have stapled units outstanding. Although the government has indicated that these proposals reinforce its intention to attack planning aimed at circumventing the SIFT tax rules, these proposals may be seen by many as being overly harsh on those REITs that were using stapled securities to conform to the REIT Exemption which the government had provided when the SIFT tax rules were introduced in 2006. It will be interesting to see whether further consultation with the government in addressing some of the above-mentioned concerns will yield any changes to the proposed rules when the legislation is eventually introduced, which the government indicates will be "at the earliest opportunity".

The announcement also includes the following proposals not specifically applicable to REITs:

- to make any interest on a debt portion of a stapled security non-deductible for income tax purposes with the same grandfathering rules as for the REIT proposal discussed above
- to “clarify” that the non-portfolio property definition applies to corporations in the same manner that it applies to trusts and corporations, applicable for taxation years that end after July 20, 2011
- expand the list of equity holders allowed for an entity to be an “excluded subsidiary entity” to include persons or partnerships unless that person or partnership owns securities of the entity which include a right to acquire a publicly traded security or a property that the fair market of which is determined primarily by a publicly traded security
- that SIFTs be subject to the corporate installment rules rather than the installments rules for individuals, as is currently the case, for taxation years that begin after July 20, 2011

---

Stapled security REITs are generally set up to have the activities which would disqualify the REIT from the REIT Exemption transferred to a separate legal entity (“stapled entity”) whose securities are stapled to the REIT units.



# June 2011 federal budget: What does it mean for the real estate industry?



*By David Nielsen*

The Minister of Finance tabled a post-election Federal budget on June 6, 2011 (the "June Budget"). The June Budget reintroduced measures that were proposed in the Minister's pre-election budget, which had been released on March 22, 2011, and also introduced certain additional proposals.

### **Corporate income tax rates**

The June Budget did not introduce any new federal corporate income tax rate changes. The prior general corporate tax rate reductions remain in place and provide for the general rate decreasing from 18% in 2010 to 16.5% in 2011, and to 15% for 2012.

### **Partnerships**

The June Budget reintroduced the prior proposal aimed at eliminating the income deferral opportunity for corporate partners which arises where the corporate partner's taxation year differs from the fiscal year of the partnership. The proposal is effective for taxation years of corporate partners that end after March 22, 2011.

The proposals are to apply to a corporate partner (other than a professional corporation) for a corporation's taxation year where:

- The corporation is a partner in a partnership at the end of the taxation year;
- The partnership's last fiscal period that began in the corporation's taxation year ends in a subsequent taxation year of the corporate partner; and
- The corporate partner, alone or together with affiliated or related persons, is entitled to more than 10% of the income of the partnership (or assets of the partnership on wind-up) at the end of the last fiscal period of the partnership that ended in the corporation's taxation year.

Where the conditions are met, the corporate partner will be required to recognize income from the partnership on an accrual basis for the Stub Period. Measures will permit the additional *Qualifying Transitional Income (QTI)* arising in the first taxation year to be included in the corporate partner's income during the next five taxation years



using effective reserve and inclusion rates of 15%–2012; 20%–2013; 20%–2014; 20%–2015; and 25%–2016. Partnerships are often used in structuring transactions in the real estate industry, and therefore taxpayers should consider what tax planning may be available to maximize the QTI reserve in the first taxation year to benefit from the transitional income inclusions.

A one-time election will be available to partnerships to select a new fiscal period so that it aligns with the taxation year of one or more of its corporate partners provided certain criteria are met. Where the election would result in two partnership fiscal periods ending in a corporate partner's first taxation year ending after March 22, 2011, provisions will allow the corporation to include the income from the second fiscal period in the QTI to be included in income over the next five years.

Corporate partners will be required to use a formulaic approach to accrue income where the partnership's fiscal period does not coincide with the corporation's taxation year-end. Corporations may choose to designate an accrual that is lower than the amount determined under the formula. However, if the designated amount is less than both the amount calculated under the formula and the actual pro-rated income for the stub period, there will be an additional income inclusion to the corporate partner.

Multi tiered partnerships that have different fiscal period ends will be required to have the same fiscal period. A one-time election will be permitted to allow all the partnerships to select a common fiscal period end; otherwise the fiscal period will default to a calendar year starting in 2011. Transitional measures are also available in respect of *Additional Transitional Income* (ATI) arising in multi-tiered partnerships.

Special measures also are included for partnerships that incur Canadian exploration expenses, Canadian development expenses, Canadian oil and gas property expenses, or foreign resources expenses.

#### **Deemed dividend – Stop loss provisions**

The June Budget introduced measures to expand the "stop-loss" rules that restrict losses on certain dispositions

of shares. The current stop loss provisions may operate where a corporation resident in Canada has redeemed, acquired or cancelled a share of the corporation and a dividend is deemed to have been paid. Generally a corporate shareholder is permitted a deduction for dividends received. The shareholder is also deemed to have disposed of the share for proceeds equal to the amount paid less the amount of the deemed dividend (i.e., amount paid less the tax paid-up capital of the share). Where the reduced proceeds are below the shareholder's adjusted cost base, a loss may arise. The existing tax *stop-loss rules* may operate to reduce the amount of the loss where the deemed dividend received is deductible from the income of the corporate shareholder. The existing stop loss rules do not apply unless the shareholder, together with non-arm's length persons, owned 5% or less of the issued and outstanding shares, and the shareholder held the shares for at least 365 days before the disposition.

The June Budget introduced measures to restrict a loss from arising where any deemed dividend that is received by a corporation that is allowed to claim a deduction from income in respect of the dividend. These measures will also apply where the shares are held directly or indirectly through a trust or partnership, but would not apply if the shareholder and the payer are both private companies (other than financial institutions).

The June Budget measures are to apply to share redemptions that occur on or after March 22, 2011.

#### **Joint ventures – Change in fiscal periods**

The Canada Revenue Agency (CRA) has announced that with the June Budget proposals regarding partnership fiscal periods, taxpayers who have entered into joint ventures will no longer be able to rely on the CRA's existing administrative position that allows for the computation of income as if the joint venture had a separate fiscal period. Following the enactment of the June Budget partnership proposals, the CRA will provide transitional relief to taxpayers who have relied on the CRA's existing administrative position. The CRA will consult affected taxpayers and their advisors before releasing detailed guidance in writing.

# Commodity tax update

By Craig Robertson

## **GST/HST/QST reminder:**

### **The case of the disappearing ITC/ITR...**

A number of recent experiences have shown that Canada Revenue Agency and the Quebec Ministère du Revenu are taking advantage of ways to deny input tax credits (ITCs) and input tax refunds (ITRs) because technical formalities were not met – even where the tax expense clearly relate to commercial real estate. These situations are low-hanging fruit for CRA and Quebec auditors. With their updated technology they are better equipped to focus in on these areas and we expect them to become even more aggressive. The victims of this will often be companies with complex organization charts containing numerous entities.

### **A few situations to watch for**

#### **1. ITC/ITR documentary requirements not satisfied**

Auditors can and do deny ITCs and ITRs on the sole basis that the invoice or other document the registrant is relying on, does not meet the formal requirements – and they have the support of the Courts in doing this. For example, an invoice may be addressed to the wrong entity within a group of companies – or not to the recipient by the correct name. Or the invoice may have the wrong registration number of the supplier – or an invalid number. We recommend that clients implement processes to verify documentary requirements are met, including verifying supplier registration numbers on CRA's and Quebec's websites.

#### **2. Claiming ITCs or ITRs in the wrong entity – Multi-tiered structures**

Upper-tier entities in partnership or trust structures generally cannot claim ITCs because for GST/HST purposes as they do not have any "commercial activity" since their partnership or trust interests are "financial instruments". Unfortunately, this is sometimes not taken into account when decisions are made between which entities management services should be charged, or transaction fees should be borne.

Another common mistake is to claim ITCs or ITRs by the bare trustee of properties, to simplify administration for the participating investors or enhance cash flow and funding of a development project. CRA's often-stated policy is that this is not acceptable, and increasingly we see auditors auditing and denying the ITCs and ITRs.

There are solutions in each of these situations – use of a limited partnership or joint venture instead of a co-ownership, or management or representative agreements. But these solutions need to be implemented in advance – and not once an auditor has identified the issue and proposed denying the ITCs or ITRs.

## **What's new? Provincial harmonization**

### **"Recaptured" ITCs – A reminder**

"Large businesses" (revenues over \$10 million annual) are subject to RITCs on four categories of expenditure: electricity and heating fuels; most telecommunication services; new motor vehicles under 3,000 kg and related maintenance and fuel (but excluding diesel); and meals and entertainment. The RITCs must be reported by electronic filing, and must be identified and accounted for specifically on the return. The CRA has announced that it is focusing enforcement on this area, and that many companies are still having difficulty with the compliance. There are specific penalties for non-reporting – or even not reporting as prescribed.

### **Quebec's "harmonization"**

Although the QST has been partially "harmonized" with the GST since 1995, it has been separately administered by the Quebec Ministère du Revenu (who also administers the GST for Quebec-resident businesses). And in certain significant respects the QST rules differ from the GST – notably the treatment of financial services (zero-rated, not exempt) and restricted input tax refunds (permanent, not temporary as under the HST).

In their respective 2011 Budgets, Quebec and the Federal Governments have announced that they are negotiating the further "harmonization" of the QST with the HST. When the agreement is concluded and implemented, financial services will become exempt (which will impact ITR entitlements of for certain real estate entities, notably REITs) but presumably restricted ITRs such as on electricity and heating fuel, will also be phased out. In exchange, the Federal Government will give Quebec a \$2.2 billion support payment to parallel the transitional support payments received by the other "harmonizing provinces". Stay tuned for further developments.



# Contacts

## National Real Estate leaders

### Ciro DeCiantis

National and Toronto Real Estate Industry Leader  
416-601-6237  
cdeciantis@deloitte.ca

### Sheila Botting

National Leader, Deloitte Real Estate  
416-601-4686  
sbotting@deloitte.ca

## National Sector and Service Leaders

### Eddy Burello

Construction, development, and engineering  
416-643-8728  
eburello@deloitte.ca

### Crawford Hastings

Enterprise Risk Services  
416-775-7273  
crhastings@deloitte.ca

### Raymond Pineda

Consulting  
416-643-8945  
rpineda@deloitte.ca

### Tony Cocuzzo

Commercial and Investment Property, Audit  
416-601-6432  
acocuzzo@deloitte.ca

### David Nielsen

Tax  
416-601-6470  
danielsen@deloitte.ca

## Regional leaders

### British Columbia

#### Kathleen Blom

604-640-3024  
kblom@deloitte.ca

### Saskatchewan

#### Gary Thiel

306-565-5237  
gthiel@deloitte.ca

### Québec

#### Gaetan Bisson

514-393-7095  
gbisson@deloitte.ca

### Rick Bublitz

604-539-3636  
rbublitz@deloitte.ca

### Manitoba

#### Keith Pitzel

204-944-3638  
kpitzel@deloitte.ca

### Manon Morin

514-393-5255  
mmorin@deloitte.ca

### Alberta

#### Tom Senyk

403-267-0641  
tsenyk@deloitte.ca

### Ontario

#### David Mason

613-751-6685  
davmason@deloitte.ca

### Steeve Talbot

418-624-5381  
sttalbot@deloitte.ca

### Dave M. Wilson

780-421-3792  
davemwilson@deloitte.ca

### Atlantic

#### Dwayne MacKay

902-721-5508  
dwmackay@deloitte.ca

If you have any questions, comments or would like to contribute ideas, please send us an email at [carealestate@deloitte.ca](mailto:carealestate@deloitte.ca)

## [www.deloitte.ca](http://www.deloitte.ca)

Deloitte, one of Canada's leading professional services firms, provides audit, tax, consulting, and financial advisory services through more than 8,000 people in 56 offices. Deloitte operates in Québec as Samson Bélair/Deloitte & Touche s.e.n.c.r.l. Deloitte & Touche LLP, an Ontario Limited Liability Partnership, is the Canadian member firm of Deloitte Touche Tohmatsu Limited.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see [www.deloitte.com/about](http://www.deloitte.com/about) for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.