

STRUCTURED PRODUCTS BULLETIN

November 2006

IMPACT OF INCOME TRUST TAX PROPOSALS ON INVESTMENT FUNDS IN CANADA

Part II of our tax series on the October 31, 2006 tax proposals

(See also: [Part I: Federal Government Announces Significant Overhaul of Income Trust Taxation Rules](#))

Last week's announcement by the federal Minister of Finance outlining a special tax to be imposed on income trusts (the "Proposals") caused a flurry of activity and speculation in investment managers' boardrooms across the country and dealt a blow to the Toronto Stock Exchange. The newly announced tax will apply to a trust or partnership that is a "specified investment flow-through" (a "SIFT"). SIFTs will be subject to a special tax at a rate equal to the general federal corporate tax rate plus 13% on account of provincial tax in respect of: (i) income from business carried on in Canada and (ii) certain income and capital gains respecting "non-portfolio properties".¹

WHAT IS A SIFT?

A Canadian resident trust or a partnership will normally constitute a SIFT for the purpose of the new tax if it holds one or more "non-portfolio properties" and its units are listed on a stock exchange or other public market. In addition to various types of real property situated in Canada, a "non-portfolio property" is broadly defined to include an investment in a Canadian-resident corporation, trust or partnership² (a "Canadian Issuer") if (i) the investor holds more than 10% of the fair market value of the Canadian Issuer's "equity value"³, or (ii) the investor holds securities of the Canadian Issuer (including securities held in its affiliates) with a fair market value that is greater than 50% of the equity value of the investor itself.

IMPACT ON INVESTMENT FUNDS

Private investment funds, including hedge funds, conventional mutual funds and linked notes, will not fall within the definition of a SIFT since they are not listed on a stock exchange or other public market. Closed-end funds, although exchange-listed, should not generally fall within the definition of a SIFT since they normally are subject to investment restrictions that prevent them from investing more than 10% of their total assets in any one issuer. However, because the definition of "non-portfolio property" is based on the market value of an investment rather than its cost, investment managers of closed-end funds will need to be cautious in managing investment portfolios to ensure that investments do not unexpectedly run afoul of these new limits, which would cause the relevant fund to become a SIFT for at least the applicable taxation year.

The Proposals should not have a significant direct impact on investment funds since they should not themselves be SIFTs. Investment funds that have exposure to income and royalty trusts were, however, affected by the market reaction to the Proposals, as many of these funds have invested in or obtained exposure to investments in income and royalty trusts, which may now be affected by the Proposals. Notably, real estate investment trusts (commonly known as "REITs") that continuously meet certain conditions will not be SIFTs.

As more details of the Proposals are revealed, market values of these investment funds may recover, at least partially, since the Proposals will generally not apply to their current investments before 2011 (issuers that have been publicly traded before November 1, 2006 will not generally be subject to the special tax for taxation years ending before 2011).

¹ Earnings subject to this special tax that are payable to holders of a SIFT will be taxed as though the payment were a taxable dividend from a "taxable Canadian corporation" and will be deemed to be an "eligible dividend" for purposes of the enhanced gross-up and tax credit under the draft legislation released by the Minister of Finance (Canada) on October 16, 2006.

² Under the Proposals, the concept of residence for partnerships is expanded to include not only "Canadian partnerships" as defined in the *Income Tax Act* (Canada), but also partnerships that meet certain "residence-like" criteria (e.g., where the partnership's central management and control is located in Canada).

³ For this purpose, "equity value" is defined to include not only the equity investments in the entity, but also debts and other liabilities, rights to participate in revenues, and options to acquire any equity in the entity.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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