Comité mixte sur la fiscalité de l'Association du Barreau canadien et de l'Institut Canadien des Comptables Agréés

L'Institut Canadien des Comptables Agréés, 277, rue Wellington Ouest, Toronto (Ontario) M5V 3H2
L'Association du Barreau canadien, 865, avenue Carling, bureau 500, Ottawa (Ontario) K1S 5S8

Le 28 janvier 2011

Monsieur Brian Ernewein
Directeur, Division de la législation de l'impôt
Direction de la politique de l'impôt
Ministère des Finances du Canada
L'Esplanade, Tour est, 17e étage
140, rue O'Connor
Ottawa (Ontario) K1A 0G5

Objet : Projet de loi du 16 décembre 2010 – Sociétés de placement immobilier (SPI)

Monsieur,

Veuillez trouver ci-joint notre mémoire portant sur le projet de mesures législatives du 16 décembre 2010 visant la modification des règles applicables aux sociétés de placement immobilier (le « **projet de loi** »). Nous sommes très reconnaissants d'avoir l'occasion de commenter le projet de loi.

Nous sommes heureux de constater que le projet de loi tient compte de certaines préoccupations de nature pratique auxquelles sont confrontées les sociétés dans le cadre d'une restructuration de leurs activités afin de se conformer aux règles applicables aux SPI. Nous sommes d'avis que notre mémoire, qui porte sur certaines des difficultés techniques que présentera la mise en œuvre du projet de loi, se conforme aux objectifs en matière de politique des règles applicables aux SPI. Nous nous ferons un grand plaisir de discuter des questions que nous abordons dans notre mémoire avec vous et les membres de votre ministère dans les meilleurs délais.

Plusieurs membres du Comité mixte, ainsi que des membres de l'Institut Canadien des Comptables Agréés et de l'Association du Barreau canadien qui ont de l'expérience en matière de SPI ont participé à des discussions au sujet de notre mémoire et ont collaboré au processus de rédaction, notamment :

Janice Russell
Jon Northup
Jim Cruickshank
Jarrett Freeman
Shawn Porter
Ron Richler
Antony Schiefer
Lorne Shillinger
Ron Wilson

En espérant que vous trouverez nos commentaires utiles, nous vous prions d'agréer, monsieur, l'expression de nos sentiments sincères.

D. Bruce Ball
Président, Comité sur la fiscalité
Institut Canadien des Comptables Agréés

Elaine Marchand
Présidente, Section du droit fiscal
Association du Barreau canadien

Submission of the Joint Committee on Taxation
of the Canadian Bar Association and the Canadian Institute of Chartered Accountants
regarding the December 16, 2010 Draft Legislation

TABLE OF CONTENTS

1. Qualified REIT Property ("QRP") 1
   A. Scope of Real or Immoveable Property 1
   B. Ancillary Property 1
2. Sources of Revenue – Look-Through Rule 3
   A. Amounts Paid 4
   B. Liabilities 4
   C. Dividends / Interest – Management Business 4
   D. Foreign Real Property Structures 5
   E. Partnerships 6
3. Eligible Resale Property ("ERP") 6
   A. Level of Ownership 6
   B. Meaning of ERP 7
   C. Sale of ERP 7
4. Currency Fluctuations and Proposed Subsection 122.1 (1.3) 7
   A. Foreign Source 7
   B. Interest Rate Derivatives 8
   C. QRP 8
   D. Level of Ownership 8
5. Miscellaneous 10
   A. Meaning of Rent 10

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants is pleased to provide you with this written submission on the December 16, 2010 draft legislative proposals (the "**Draft Legislation**") to amend the rules applicable to real estate investment trusts.

Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the *Income Tax Act* (Canada) as proposed to be amended under the Draft Legislation.

1. Qualified REIT Property ("QRP")

A. Scope of Real or Immoveable Property

See discussion below regarding Eligible Resale Property under heading 3.B – "Meaning of ERP".

B. Ancillary Property

The proposed amendment to paragraph (d) of QRP limits the permitted scope of property ancillary to the earning of rent from, and capital gains from the disposition of, real or immoveable properties ("**Ancillary Property**") to tangible personal property. Under the current rules, Ancillary Property is not limited to tangible personal property and, in certain circumstances, will include intangible personal property (such as a receivable, prepaid expense, bank deposit or other contractual entitlement).

Where a REIT carries on the business of renting property, all of its assets generally will be used in the course of carrying on that business and, accordingly, will constitute "non-portfolio property" ("**NPP**"). Thus, under the Draft Legislation, all of its assets that are intangible personal property will be NPP that is not QRP.

In light of the foregoing, we submit that the proposed amendment to paragraph (d) of QRP to restrict the scope of Ancillary Property to tangible personal property produces a number of anomalous results. Intangible assets that arise in connection with ordinary course activities will no longer constitute QRP and, accordingly, may cause a REIT to lose its status as a "real estate investment trust". Furthermore, even in situations where a REIT is not considered to carry on a business of renting property, we submit that this amendment imposes limitations on the ability of a REIT to negotiate for standard contractual rights in its ordinary course commercial transactions (e.g., the acquisition and disposition of real property), as such rights could give rise to a security (liability) in the contractual counterparty the value of which exceeds 10% of the counterparty's equity value and therefore constitutes NPP. Although one might not normally expect that these types of assets would be so significant that they could cause a REIT (or its subsidiary) to exceed its Permitted NPP Basket (as defined below), the common use of special purpose entities to hold individual properties, typically for commercial reasons, could give rise to a scenario where the Permitted NPP Basket is easily exceeded by a particular entity. Certain examples of the issues that could arise are provided below:

Cash: As a result of the proposed amendment to paragraph (d) of QRP, where a REIT carries on a business of renting property, cash on deposit with a financial institution and

other short term money-market securities will be NPP that is not QRP. Such assets are not tangible personal property. Even if a REIT does not carry on business, it appears that cash on deposit is a "security" of the financial institution and may in certain circumstances constitute NPP. For example, in connection with a public offering or other financing, or after a disposition, a REIT (or its subsidiaries) may have cash on deposit with a single financial institution that represents more than 50 percent of the "equity value" of the entity; this investment, even if short-term, would constitute NPP that is not QRP. Moreover, such significant cash holdings would exceed the proposed basket in paragraph (a) of the definition of "real estate investment trust" for NPP that is not QRP (the "**Permitted NPP Basket**") with the result that the REIT would not be able to qualify as a "real estate investment trust" in the year in which such financing or disposition took place. We submit that cash and other short term money-market securities that are Ancillary Property should not be required to fit within a REIT's Permitted NPP Basket. We note that there appears to be an unintended inconsistency between the definition of QRP (as proposed to be amended) and paragraph (d) of the definition of "real estate investment trust", which permits a REIT to include in determining whether it satisfies the "equity value" test, indebtedness of a Canadian corporation represented by a bankers' acceptance, property described by either paragraph (a) or (b) of the definition of "qualified investment" in section 204 and deposits with a credit union.

Tenant Receivables: A REIT may, in the ordinary course, be owed amounts from its tenants in respect of rent. Although rent from real or immoveable property is a permitted revenue source under the revenue tests in paragraphs (b) and (c) of the definition of "real estate investment trust", a receivable from a tenant is not tangible personal property and therefore may be NPP that is not QRP. For example, the receivable may be an asset used in the course of carrying on a REIT's business or could exceed 10% of the equity value of the tenant (depending on the quantum of the receivable and the financial condition of the tenant). We submit that a REIT should not be required to rely on the Permitted NPP Basket where it holds NPP as a result of intangible rights arising from a permitted revenue source.

Purchase Price Adjustments: When a REIT purchases or disposes of real property, the purchase agreement typically will include a purchase price adjustment to account for customary matters in a real estate transaction, such as rents received and expenses incurred up to closing. Purchase price adjustments may also arise as a matter of commercial negotiation. If the purchaser or vendor of the real property, as the case may be, becomes indebted to the REIT as a result of the purchase price adjustment, the receivable may constitute NPP to the REIT. The fair market value of the liability arising from the purchase price adjustment may exceed the REIT's Permitted NPP Basket, particularly where it is desirable to use a single purpose entity to purchase or dispose of the property. Consequently, the proposed amendment to paragraph (d) of QRP may impose limitations on the ability of a REIT to negotiate for standard commercial rights arising in the ordinary course of its rental activities. We submit that this is inconsistent with the policy objectives of the REIT rules.

Indemnities and Other Contractual Rights: Similarly, indemnity provisions and other contractual rights in agreements to purchase or dispose of real property may result in a REIT acquiring a receivable of an entity that is NPP. As above, the fair market value of the security arising as a result of the REIT's indemnification rights could exceed its Permitted NPP Basket. Consequently, the proposed amendment to paragraph (d) of QRP may restrict or discourage a REIT from negotiating such standard contractual rights. We submit that these limitations are inconsistent with the policy objectives of the REIT rules.

Foreign Currency and Other Derivatives: See discussion below under heading 4.C – "QRP".

We believe that the concept of Ancillary Property, as currently drafted, adequately addresses the concerns raised herein and enables a REIT to effectively carry on its ordinary course rental activities. The Canada Revenue Agency (the "**CRA**") has previously stated that something is ancillary where it is "subordinate to or dependent upon".[1] We believe this is a sufficient restriction to protect the policy intent of the REIT rules; the facts and circumstances of each situation must be reviewed to determine if a particular asset is held in a manner that is truly ancillary to the REIT's ordinary course activities of earning rental revenue and capital gains.

Recommendation:

We recommend that the proposed amendment to paragraph (d) of QRP be withdrawn.

If there is a particular concern identified by the Department of Finance ("**Finance**") with a specific category of intangible personal property, we recommend that these securities be expressly excluded from paragraph (d) of QRP as currently drafted, rather than limiting its scope to tangible personal property. We do not believe that there is a valid policy distinction between tangible personal property and intangible personal property as general categories in this regard.

2. Sources of Revenue – Look-Through Rule

Proposed subsections 122(1.1) and 122(1.2) (the "**Look-Through Rule**") generally re-characterize the particular revenue source of an amount payable by a subsidiary entity to a parent entity where such amount (i) was payable in respect of a "security" that was NPP, and (ii) can reasonably be considered to have become payable out of the subsidiary entity's "gross REIT revenue" from a particular source. The Look-Through Rule replaces and broadens the scope of the current re-characterization rule in paragraph (a)(iii) of "rent from real or immoveable property", which generally was limited to distributions of rental income from a trust. Because the Explanatory Notes reference only tiered-trusts, we have set out below our suggested amendments to clarify the scope and application of the Look-Through Rule.

[1] See paragraph 6 of Interpretation Bulletin IT-195R4 – Meaning of Rent.

A. Amounts Paid

As proposed, the Look-Through Rule applies to an amount that has become "payable" in respect of a security that is NPP. However, the definition of "gross REIT revenue" refers to amounts that are received or receivable in the taxation year (depending on the method regularly followed by the particular entity).

Recommendation:

To avoid any uncertainty, we recommend that the Look-Through Rule apply to amounts that are "paid" in addition to amounts that become payable.

B. Liabilities

The Look-Through Rule appears to apply to payments of interest on a liability that is NPP. In circumstances where a REIT holds a liability of a subsidiary entity that is NPP but does not have a significant equity investment in that entity, the REIT would often not have the ability to obtain information from the subsidiary entity necessary to determine the underlying revenue source for purposes of applying the Look-Through Rule. There are also certain circumstances in which a liability may become NPP to the creditor without the knowledge of the creditor (for example, where the creditor is unable to determine the "equity value" of a debtor, and therefore is unable to determine whether the "security" constitutes NPP of the debtor because it exceeds 10% of the debtor's "equity value").

Recommendation:

We recommend that the scope of the Look-Through Rule be limited to circumstances in which the REIT has a sufficient equity investment in the subsidiary entity. More specifically, we recommend that the application of Look-Through Rule apply to securities of a subsidiary entity that are NPP (including liabilities) but only in situations where the parent entity holds a "security" of the subsidiary entity that satisfies any of paragraphs (a) to (c) of "equity" and that security is in and of itself NPP. In most cases, the Look-Through Rule would then apply where the parent entity owns an equity security of a subsidiary entity representing more than 10 percent of the subsidiary entity's "equity value".

C. Dividends / Interest – Management Business

Paragraph (b) of QRP generally permits a REIT to hold securities of an internal management entity. As currently drafted, dividends (including dividends from an internal management corporation) are a permitted revenue source for purposes of the proposed 90% revenue test in paragraph (b) of the definition of "real estate investment trust". However, as a result of the proposed Look-Through Rule, dividends from an internal management corporation generally would be re-characterized as revenue from the management entity's particular source (i.e., revenue from a management business). Therefore, the dividend would not be a permitted revenue source for purposes of the proposed 90% revenue test. We submit that it is inappropriate for shares of an internal management corporation to be a permitted asset, but for dividends paid in respect of those shares to not be a permitted revenue source for purposes of the proposed 90% revenue test. The same issues arise with respect to the receipt of interest on debt of an internal management corporation.

Recommendation:

We recommend that amounts that are paid or become payable in respect of securities of an entity that satisfies paragraph (b) of the definition of QRP be excluded from the application of the Look-Through Rule.

A more general alternative approach to ensure that the Look-Through Rule does not have the effect of levitating "bad" revenue (and, therefore, in effect, re-characterizing "good" revenue as "bad" revenue) would be to limit the application of the Look-Through Rule to revenue sources that are specifically described in paragraphs (b) and (c) of the definition of "real estate investment trust". This alternative would avoid the levitation of "bad" revenue (e.g., management fees) but would allow the re-characterization of "good" revenue where beneficial (i.e., dividends could be re-characterized as rent from real or immoveable property).

D. Foreign Real Property Structures

We understand that in practice REITs generally use two basic structures to hold foreign real property: directly, or, more commonly, indirectly through a combination of Canadian and/or foreign entities. The latter structure may be adopted for commercial, regulatory and tax planning and compliance reasons. However, where a REIT indirectly holds foreign real property through foreign entities, the Look-Through Rule generally will not apply because it requires that the security of the subsidiary entity be NPP. Securities of a foreign entity generally are not NPP because the entity is not a "subject entity". Even where a Canadian corporation (i.e., a "subject entity") is interposed in the foreign structure to hold securities of a foreign entity, the Canadian corporation likely would be a "portfolio investment entity" (as it does not itself own any NPP), such that its securities are excluded from the definition of NPP.

Recommendation:

Having regard to the foregoing and the intent of the Look-Through Rule, we believe that the source characterization of a REIT's "gross REIT revenue" from foreign sources should be the same regardless of whether it owns foreign real property directly or indirectly. Accordingly, if the Look-Through Rule is limited to NPP, we believe that this determination should be made for purposes of the Look-Through Rule, through any number of entities in a chain of entities, as though each entity in the foreign ownership chain was a "subject entity" and as though its activities and real estate were located in Canada. We note that this suggestion is consistent with the previous amendments to the REIT rules to remove the references to "situated in Canada" throughout the definition of "real estate investment trust". We believe that the neutrality in respect of the location of real property assets currently reflected in the REIT rules should be extended to the Look-Through Rule.

An alternative conceptual approach that Finance may wish to consider would be to exclude all foreign properties and revenues entirely from the asset and revenue tests. The REIT rules are intended to be an exception to the application of the SIFT rules. Because the SIFT rules do not generally apply to foreign assets and revenues, it is consistent with the policy of the SIFT rules that foreign holdings and revenues should have no affect (positive or negative) on the manner in which the REIT rules are applied to Canadian properties and revenues.

E. Partnerships

Under the current REIT rules, each partner of a partnership is considered to earn its portion of the partnership's "gross REIT revenue" for purposes of the revenue tests in paragraphs (b) and (c) of the definition of "real estate investment trust". This interpretation was recently confirmed by the CRA in Technical Interpretation 2010-0369251E5.[2] We believe that this is the correct approach because otherwise there would be significant uncertainty in applying the revenue tests to revenue earned through partnerships.

However, it is unclear whether the Look-Through Rule is intended to apply to debt and equity securities of a partnership. One could argue that subsection 122.1(1.1) is not satisfied, at least in respect of equity securities, because it requires an amount that has become payable by the subsidiary entity to be included in computing the parent entity's "gross REIT revenue" for the taxation year – a parent entity would normally include its share of "gross REIT revenues" of a subsidiary partnership in its "gross REIT revenue" regardless of the amount, if any, that was distributed by the partnership to the parent entity.

Recommendation:

As discussed above, we believe that the current look-through approach adopted by the CRA operates properly in the context of the REIT rules, and therefore there is no need for the Look-Through Rule to apply to debt or equity securities of a partnership. Accordingly, for purposes of clarification, we recommend that the Look-Through Rule be amended to codify that it does not apply to debt or equity securities of a partnership and that the Explanatory Notes be amended to specifically recognize the current approach so that the CRA's interpretation will continue.

3. <u>Eligible Resale Property ("ERP")</u>

A. Level of Ownership

A property will only be ERP if it is held by an entity in which a publicly-traded trust holds a security. This requirement means that property held by a lower-tier entity in which a REIT holds an indirect interest will not be ERP. For example, a limited partnership the units of which are held by a subsidiary trust of a publicly-traded trust cannot hold ERP. This is a concern because it is common for some REITs to hold property indirectly through several tiers of entities. We do not see a policy reason for restricting lower-tier entities from holding ERP.

Recommendation:

The definition of ERP should be amended so that lower-tier entities in which a REIT holds an indirect interest can hold ERP.

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[2] For purposes of the leasing property rules, the CRA has similarly stated that where the corporation has an interest in a partnership, the "gross revenue" of the partnership, to the extent of the corporation's profit sharing percentage thereof, flows through to the "gross revenue" of the corporation (see paragraph 10 of Interpretation Bulletin IT-443).

B. Meaning of ERP

The requirements in paragraphs (a) and (b) of the ERP definition appear overly restrictive given the policy decision to exclude ERP from QRP. For example, although the backgrounder mentions that a REIT may acquire property for resale in the condominium and foreclosure contexts, it is not clear that all such property will qualify as ERP. To illustrate, it is questionable whether every condominium is contiguous to real or immovable property; rather, some condominiums may be contiguous to other condominiums. Further, the requirement that ERP must be "necessarily" held may be impossible to meet – a precondition to the proposed disposition of ERP will be that it is not *necessary* to hold the property.

Recommendation:

We recommend the removal of paragraph (a), and the amendment of paragraph (b) of the ERP definition to delete the concept of "necessary". Accordingly, real property inventory would be ERP if it is "incidental" to the holding of capital property of the REIT or another subsidiary entity. Similar to the discussion above respecting Ancillary Property, the incidental nature of ERP should be sufficient to preserve the integrity of the REIT rules.

As an alternative, if Finance believes that the more stringent conditions should be maintained, we request that ERP be included in QRP so that a REIT does not have to rely on the Permitted NPP Basket to own ERP. Even in this circumstance, we believe that the concept of "necessary" must be relaxed to recognize the inevitable sale of ERP.

C. Sale of ERP

As drafted, the proceeds from the disposition of ERP, rather than the gain, will be included in "gross REIT revenue". However, only gains from dispositions of ERP are a permitted revenue source for purposes of the proposed 90% revenue test in paragraph (b) of the definition of "real estate investment trust". As a result, the recovery of invested capital will give rise to "bad" revenue. We believe this result is inappropriate and also creates an inconsistency between dispositions of ERP and dispositions of property held on capital account for purposes of determining a REIT's "gross REIT revenue".

Recommendation:

We recommend a revision to the definition of "gross REIT revenue" so that only the gain from the disposition of ERP is included. The result will be that the same amount will be added to both the numerator and the denominator in applying the revenue test in paragraph (b) of the definition of "real estate investment trust".

4. <u>Currency Fluctuations and Proposed Subsection 122.1 (1.3)</u>

A. Foreign Source

Proposed subsection 122.1(1.3) applies for purposes of the definition of "real estate investment trust" to determine whether an amount included in "gross REIT revenue" is "from a particular source that is in respect of real or immovable property situated in a country other than Canada". However, the definition of "real estate investment trust" does not require this

particular determination. Rather, in addition to the source of revenue, the definition of "real estate investment trust" requires a determination of the character of any particular revenue (i.e., rent "from" real or immovable property). As currently drafted, it is not evident that proposed subsection 122.1(1.3) appropriately deals with the character of revenue.

Recommendation:

We recommend a rewording of subsection 122.1(1.3) so that the subsection more closely corresponds to the definition of "real estate investment trust".

B. Interest Rate Derivatives

As drafted, subsection 122.1(1.3) only addresses the treatment of transactions undertaken to reduce foreign currency risk. However, REITs may also use derivatives to hedge their exposure to interest rate fluctuations so as to reduce the risks relating to their real property holdings and associated financing. We believe that it is similarly appropriate, and consistent with the policy objectives of the REIT rules, to allow REITs to treat revenue from such derivative arrangements as qualifying REIT revenue.

Recommendation:

We recommend a revision to subsection 122.1(1.3) to provide favourable treatment for revenue from interest rate swaps and other derivatives used by REITs to mitigate interest rate risk in respect of their real property holdings and associated financing.

C. QRP

Foreign currency hedges described in subsection 122.1(1.3) may be NPP if, for example, they are used in the course of carrying on a business in Canada. These hedges will not be QRP if the proposal to restrict paragraph (d) of the definition of QRP to tangible personal property is maintained and therefore they must be held by a REIT within its Permitted NPP Basket. However, the fair market value of these hedges may fluctuate significantly; this introduces a potentially significant risk that a trust holding such hedges will not qualify as a "real estate investment trust".

Recommendation:

We recommend a modification to subsection 122.1(1.3) to deem the foreign currency hedges described in that subsection to be QRP. If our recommendation in B above is accepted, we recommend that the interest rate swaps and other derivatives referred to in B also be deemed to be QRP.

D. Level of Ownership

Subject to the comments above, subsection 122.1(1.3) appears to work well where the owner of foreign real or immovable property directly realizes the foreign exchange gain (whether that entity is the REIT or other entity in the REIT group, foreign or domestic, that complies with paragraphs (a) through (d) of the definition of "real estate investment trust"). However, as discussed above, most REITs hold their non-Canadian real or immovable

properties, directly or indirectly, in non-Canadian subsidiaries to comply with local ownership restrictions and tax laws and to minimize administrative and compliance burdens.

A parent entity typically provides debt and equity financing to its non-Canadian subsidiaries to acquire non-Canadian real or immovable properties. Where the inter-group debt is denominated in the currency of the foreign jurisdiction, foreign exchange gains on that debt may not be re-characterized under proposed subsection 122.1(1.3). Such foreign exchange gains may be realized on the debt receivable by the parent entity or the debt payable by the non-Canadian subsidiary. Where the gain is realized by the parent entity on the debt receivable, the parent entity will not have "incurred" the debt, as required under subparagraph 122.1(1.3)(a)(ii); the application of subsection 122.1(1.3) is unclear in these circumstances. .

For commercial reasons, it is often also desirable for different tranches of debt (whether borrowed from a third party or loaned internally) to be incurred by different entities such that the borrower may not be the owner of the foreign real property. For example, it is possible that the real property would be owned by a lower-tier entity limited partnership or limited liability company that, itself, would be owned by one or more limited partnerships or LLCs that have borrowed funds to contribute capital, directly or indirectly, to the property owner. In these circumstances, the application of proposed subsection 122.1(3), including, in particular, the "source" or "character" for the purposes of the re-characterization, is unclear.

In addition, foreign currency hedging contracts may be entered into by the foreign real property owner or by an entity (including the REIT) higher in the ownership chain. For example, a REIT may directly hedge its foreign currency exposure on US dollar rental revenues, even though it will receive the cash proceeds in the form of dividends and interest from a foreign subsidiary (the underlying proceeds of which are derived from rent from foreign real property). The source of the foreign exchange gain realized by the REIT is unclear in these circumstances and will depend on the interaction between the Look-Through Rule and proposed subsection 122.1(1.3) – the gain may be a dividend or rent from foreign real property.

Recommendation:

We recommend that the application of proposed subsection 122.1(1.3) to tiered structures be clarified. In particular, we recommend that the proposed subsection be revised to include foreign exchange gains on debt (whether third party or internal loans within the group) and on foreign currency hedging contracts, to the extent that such debts or hedging contracts reasonably relate, directly or indirectly, to real or immoveable property situated in a country other than Canada. For clarification, this rule should apply to foreign exchange gains on loans receivable and hedging contracts held directly by a Canadian parent entity even in situations where the foreign real property is held indirectly through a chain of lower-tier entities. To the extent that real or immoveable property situated in a country other than Canada produces rent from real or immoveable property, proposed section 122.1(1.3) should specifically characterize any such foreign exchange gains as rent from real or immoveable property (assuming the Look-Through Rule is expanded to foreign entities in the manner suggested above, the interaction between proposed 122.1(1.3) and the Look-Through Rule would need to be considered).

5. Miscellaneous

A. Meaning of Rent

The definition of "rent from real or immovable properties" includes rent or similar payments for the use of, or right to use, real or immovable properties. This may not be sufficiently broad to capture common items received in respect of rent, such as lease termination fees or receipt of damages for unpaid rent.

Recommendation:

We recommend that the definition of "rent from real or immoveable property" be broadened to conform to amounts covered in the preamble to subsection 212(1), namely to include amounts "on account or in lieu of" rent.