REIT & greet, Real estate income trusts are all the rage in both investment and commercial property circles. Lawyers in both disciplines need to know all about REITs – but they also need to know about the risks that come with them.

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You've read about them in the business section of the newspaper and heard about them on investment phone-in shows. If you've got a broker, chances are she's told you all about them. They're REITs (Real Estate Investment Trusts), and they're the hottest real property/ investment vehicle around. They come in all shapes and sizes: hotels, retirement homes, office buildings, retail properties, even some or all of the above.

But for all the hoopla, there are just 20 REITs active in Canada. And the fact is, not everyone is entirely enamoured with them. While their devotees describe them with words like "solid," "attractive" and "sensibly constructed," their detractors say they're unreliable investment vehicles, artificially created merely to get around corporate tax. But this debate is nothing new: REITs have been both popular and controversial before.

Déja vu

To understand the antecedents of today's REITs, you have to go back to the mid-1990s. "The 'second coming' [of REITS] began in 1995 – as opposed to 'partnerships' in the 1980s – when real estate mutual funds bumped into difficulties with the slide in the real estate sector," explains Patricia Koval, a partner in the corporate finance and securities area at Torys in Toronto.

"These mutual funds were structured in a way that didn't make sense, since they had a redemption price based on an appraisal price that was maybe a year old," she says. "The structure really didn't work for a sector such as real estate that has its ups and downs in popularity. So most of the relatively successful mutual funds converted into REITs.

"Other corporations followed, and we now see a nicely filled-out sector with its own S&P/ TSX Canadian REIT index." "Nicely filled-out" doesn't do justice to the sector: those 20 Canadian REITs have a combined market capitalization in the neighbourhood of $10 billion, and still growing.

"I think the future of REITs is very positive," says Michael Brooks, a lawyer and the Executive Director of the Canadian Institute of Public and Private Real Estate Companies, an association of the largest owners, developers and managers of commercial real estate in Canada. CIPPREC's members include publicly traded and large private companies, banks, brokerages, Crown corporations, investment dealers, life insurance companies, pension funds and real estate investment trusts; their total holdings are currently around $70 billion.

"The income trust structure is a natural fit for mature, stable, income-producing assets such as real estate," he says. "I see almost no risk of a bubble happening today such as happened in the early '90s."

Still, there is unease among some investors who remember the 1990s, when the real property mutual fund bubble burst and real estate began a dramatic slide in both value and popularity. A lot of investors lost a lot of money, and as a result, the very thought of the real estate industry raising billions in capital from investors still provokes skepticism among more than a few.

"Yes, there are investors who remember the early 'real estate partnerships,' and later the real estate mutual funds in which they or their friends lost money," acknowledges Koval. "But I truly think that the REIT structure is much cleaner, simpler and stable."

Why couldn't the same thing happen today? "First, CEOs can't bet the farm anymore," says Brooks. "They're hamstrung by the declarations of trust and their obligations to keep washing the cash out the door. Secondly, there are limits on the amount of debt, a maximum of 50 to 60 percent debt on the assets, and the maturities on that debt are staggered.

"And here's another reason: today's banks are much more cautious and impose a discipline on the entire real estate market, corporate as well as REITs." For these reasons, Brooks thinks the market is older and wiser the second time around, and that fears of a repeat collapse are groundless.

Dissenting voices

Not everyone agrees. "The general phenomena of income trusts, including REITs, has been sparked by a loophole in the tax law that lets entities avoid paying corporate tax," says Jim Stanford, an economist with the Canadian Auto Workers in Toronto.

"This is nothing more than a clever utilization of the tax loophole," says Stanford. "I mean, you know the history of trusts – they were meant for charities and families and to protect your assets for your kids."

A dissenting voice in what he calls "a frenetic, useless bubble," Stanford predicts the day will come when that bubble bursts. "In the future – and I'm not saying when – the bottom is going to fall out of the markets for all these income trusts," he says.

"I say this for two reasons. Number one, people are making a good return on these, due to the loophole, and so their [unit] price gets bid up. This doesn't make sense, especially when you're talking real estate. This is absolutely no different than any other 'boom and bust' cycle.

"Number two, when you take this to the extreme, conceivably the whole Canadian economy could be turned into income trusts, as people create them to avoid paying corporate tax," he says. "How long do you think it's really going to be before the government moves to close this loophole?

"It will take some serious thinking about the legalities and tax implications, but I believe that the government will ultimately act," Standford warns. "Just how many billions of tax dollars do you think the government is going to watch floating away?"

Stanford questions the numbers that have been suggested and embraced by investors at a time when the stock market generally has fallen out of favour. "I'll tell you one thin about these trusts – they're making a lot of money for lawyers and all those investment people where nothing else is happening," he says.

Statistical arguments

Stanford has figures to back up his contention that income trusts are fuelling an otherwise dormant market. During the first half of 2003, 22 IPOs worth $1.5 billion were successfully brought to market. That was down from 30 offerings (worth $2.3 billion) at the same point last year. The IPO market is clearly slower than it was a year ago.

Yet "almost half of the number of offerings that have come to the market so far this year are income trusts, says Eric Slavens, IPO Leader of PricewaterhouseCoopers in Canada. "Without these, there would have been little appreciable IPO activity." In fact, income trusts constituted 80% of the gross value of the IPOs.

Still, Slavens points out that the impact of income trusts on the 2003 IPO market is actually less than it was a year ago. "During the first six months of 2003, the value of income trusts was $1.2 billion. Last year at this time, the value of income trusts was $2.1 billion, or 94% of the total value of IPOs." Of particular note, only one of those trusts was a REIT.

Koval doesn't buy the argument that REITS are just another bubble waiting to burst. "This is an equity investment in a vehicle that invests in real estate. It's configured as a trust, as a more tax-efficient product. Unlike some other income trusts, REITs are not extensively levered. They operate in the same way that many of the old real estate corporations used to operate.

"REITs do have some limitations on their borrowing, as well as limitations on development activity," she agrees. "But they are in fact a superior vehicle for attracting taxable investment money. You get the investment in the real estate vehicle, but you also get the benefit of a flow-through income structure and you effectively flow through the depreciation. I think REITs are here to stay."

A tight market

Whatever their reliability, REITs and income trusts generally have become a huge growth area for corporate and commercial real estate lawyers. The bad news for law firms seeking a piece of the action, though, is that the legal work for this market has already been mostly cornered.

Much of the REITs work in Canada has been taken over by a few firms with the cross-disciplinary expertise to handle these complex investment vehicles in-house. Most discussions of which firms handle REITs begin and end with Torys and Goodmans, with Stikeman Elliot the major player in the Quebec market.

"REIT work is very, very mind-intensive," says Stephen Pincus, a partner and head of the Trusts Department at Goodmans. "It also involves input from a real spectrum of lawyers within the firm – corporate finance, real estate, mergers & acquisitions, and others. The number of specialties required to complete this complicated vehicle limits the number of firms that can handle it."

In Quebec, says Anthony Penhale of Stikeman Elliot's Corporate/ Commercial Group (Securities Regulation) in Montreal, "I think the underwriters are turning to players who have already handled these types of investments. Capital markets want firms that have experience on the execution side."

Stikemans probably handles most of the REITs in Quebec, Penhale confirms. "I'd say we have participated in what I think are nine out of ten publicly issued income trusts in this province, including two REITs. … There are real estate issues, tax issues, environmental and other issues to consider."

CIPPREC's Michael Brooks agrees that it probably will be slim pickings for mid-size firms. Most lawyers, he says, will come across REITs in everyday leases and purchase-and-sale transactions, where they're acting for the other side or for a lender. "In those situations, it's really important for the lawyer to understand how a REIT is different than a company," he notes. "Most lawyers are familiar with buying or selling, leasing or lending to a company, but a trust is a different animal.

"REITs don't pay capital tax, so if you're a lawyer acting for a tenant, your costs just went down a little, maybe 30 cents a square foot," Brooks explains. "You can strike out the capital tax clause. Another important distinction is that REITs don't want to give warranties and covenants, and they generally will prohibit you from suing the REIT itself or their unit holders."

This fall, CIPPREC will release the *Canadian REIT Handbook* (authored by Goodmans), a publication that Brooks says "is a very detailed handbook that will really help lawyers in their commercial real estate practices."

A REITs primer (sidebar insert on p. 37)

Pronounced "reets," their full name is Real Estate Investment Trusts. REITs are publicly traded equity investments that invest primarily in income-producing real estate assets.

Professionally managed, these investments are constructed on a flow-through structure, required to distribute virtually all distributable income to unitholders on a monthly or quarterly basis. Therefore, a REIT itself is not subject to tax. Instead, the income is taxed in the hands of its unitholders.

For the unitholder, distributions are made up of a combination if income (taxed in the year it is received) and, usually, a return of capital (the tax is deferred until the year of disposition and at the lower capital gains tax rate).

Many REITs specialize in a specific sector, such as hotels, retirement homes, office buildings, residential homes, industrial and retail properties. Others include a variety of some or all of these income-producing real estate assets.

Legislative Limbo, An income trust liability bill left on the order paper when the Ontario legislature rose could hold the key to a REITs market explosion. (sidebar insert on p. 42)

At the end of June, the Ontario legislature rose for its summer break and an eventual fall election, leaving bills, including one with the potential for a great impact on REITs.

Left hanging was the *Trust Beneficiaries Liability Act 2003*, which would limit the liability of beneficiaries of business trusts in Ontario. According to the Canadian Institute of Public and Private Real Estate Companies (CIPPREC), due to the remote possibility of this liability, both Standard & Poors and the TSX "refused to admit income trusts into the main index until the liability issue is statutorily protected. REITS were put into their own index."

If this Act fails to pass, warns CIPPREC, the growth of income trusts will be stunted in Ontario. In fact, should provinces such as Alberta pass similar legislation, REITs head offices and employees could soon decamp for Western Canada. The Business Trusts Sub-committee of the Ontario Bar Association's Business Law Section strongly endorsed CIPPREC's proposal.

Although the bill had passed second reading by June, reports Michael Brooks, Executive Director of CIPPREC, there had been a general expectation that it would be passed before the recess. Now, he notes, the bill will be subject to the vagaries of the political system, including the election scheduled for October 2.

"We do believe it will be passed eventually, whatever government is in power," he says. "It's just that we had hoped to see it passed sooner rather than later. I think it would have been really good for driving the REIT market."

Observers say passage of the bill could help lawyers who advise underwriters and issuers, since new IPOs could result and investment capital would find its way into these investments. Whether it would have opened the floodgates for pension fund investment is another matter. Certainly, it would have eased the way for fund managers to consider REITs as possible investments, says Eric Slavens, IPO Services Leader for PricewaterhouseCoopers in Canada.

"It's really [pension funds'] mandate to be almost risk-free, so as long as there is a potential for liability, some of them are going to stay away from the REIT market," he says.

"I do think that if this bill passes, it could only be helpful," he adds. "After all, pension funds tend to be long-term investment, so these could be very attractive for them."

According to Slavens, though, the big question is: "Should the bill pass, will it create a real pop in the market? Will [pension funds] be the new driver of these investments? You've got to remember how astute and professional these pension fund managers are. They don't often buy at the top of the market. They may wait, for example, until the cycle changes. They aren't going to pour money into [REITs] just because the potential for liability is removed.

"But opening the door to them to invest in REITs can only prove good for REITs, in both the short and long term."

Patricia Koval, Torys Toronto (photograph on p. 37)

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