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Income Fund Update: Strategic and Structural Alternatives and the Conversion Rules

Canada's income funds must review their strategic and structural alternatives in light of turbulent market conditions, as well as the looming SIFT tax, which generally will apply to them beginning in 2011. This article will discuss the current challenges facing income funds, review certain of their key alternatives, and explore some of the factors that may influence boards and management in reviewing these alternatives. The article will also provide an overview of the new rules which facilitate the conversion of income funds to corporate form.

Introduction

The tremendous growth enjoyed by the Canadian income fund sector came to an abrupt halt on October 31, 2006 with the surprise announcement by the Department of Finance (Canada) of proposals to tax certain public trusts and limited partnerships (other than qualifying REITs) in the same general manner as corporations. Prior to these proposals, these entities were effectively treated as flow-through entities for Canadian tax purposes and, as such, were not subject to entity level taxation. The proposed rules were intended to eliminate the perceived "tax imbalance" created by income funds and thereby stem the swelling tide of public corporations converting to an income fund structure. In respect of existing income funds that were publicly listed or traded prior to November 1, 2006, these new taxation measures will not be effective until 2011 (the "grandfathering period"), provided that the entity does not exceed certain equity growth limitations during this period (these limitations are discussed in more detail below).

The announcement of these proposals had a swift and significant impact on the Canadian income fund sector. In the following two trading days, the S&P/TSX Income Trust Index dropped by more than 16 per cent. Although most of this value was recovered by June 2007, the government's proposals effectively froze further growth of the sector. Other than a few REITs, no new income fund IPOs or conversions have been announced since the introduction of these proposals. The growth of existing income funds has been restricted by the limitations imposed by the grandfathering rules. Furthermore, the impending change in income funds' tax status, combined with an active M&A market, led to a significant number of Canadian income funds being taken private. Between October 31, 2006 and October 28, 2008, the number of public income funds in Canada decreased from 254 to 190.

Canadian income funds have also suffered from the recent market turmoil. From June 17, 2008 to October 28, 2008, the S&P/TSX Income Trust Index declined by approximately 37 per cent. In many instances, the post-October 31, 2006 value recovery was based on embedded M&A/privatization premiums that have generally disappeared.

In response to current market conditions and the impending end of the grandfathering period, many income funds have initiated a review of their strategic and structural alternatives, including the possibility of converting back to corporate form. Several funds have already converted to corporate form or have announced their intention to do so before the grandfathering period expires.

On July 14, 2008, the Department of Finance (Canada) released draft legislation to facilitate the conversion of income funds into corporations on a tax-deferred basis (the "Conversion Rules"). The Conversion Rules provide income funds (and other publicly listed flow-through entities) with tax-efficient mechanisms to convert to corporate form before they become subject to entity-level taxation. The Conversion Rules address a number of the primary administrative, technical and structural challenges that arise when implementing a corporate conversion using existing tax rules.

While the release of the Conversion Rules may encourage some income funds to consider a corporate conversion prior to 2011, it is expected that other income funds will delay any fundamental structural reorganizations until shortly before the grandfathering period expires. Moreover, certain income funds may decide to retain their current trust structure even after the new entity-level tax becomes effective. Whether it is in the best interests of an existing income fund to convert to corporate form, and the appropriate timing of such conversion, is a complex analysis that will depend on various strategic factors, including the fund's underlying business, its investor base, management's future growth plans and current market conditions.

Development of the Canadian Income Fund Sector

Canadian income funds were first developed in the mid-1980s and initially focussed on owning oil and gas properties (royalty trusts) and real estate (REITs). Commencing in the late 1990s, a growing number of operating businesses in a wide variety of industry sectors were also organized as income funds. The Canadian income fund sector grew from 52 income funds with an aggregate market capitalization of C$20 billion in 2000 to 254 income funds with an aggregate market capitalization exceeding C$218 billion in October 2006. Income fund equity offerings represented approximately 40 per cent of the dollar value of all equity offerings on the Toronto Stock Exchange during 2005. The tremendous growth in the income fund sector was fuelled by investor appetite for meaningful cash distributions, a low interest rate

environment and volatile corporate equity markets after the "dot-com bubble" burst.

The proliferation of income funds in Canada was, in part, attributable to the tax efficiency of the income fund structure. While several different generations of income fund structures were used by Canadian issuers, the principal objective of the structure - to maximize value by distributing pre-tax cash flow to unitholders - remained the same.

Income fund structures generally involved a Canadian resident trust completing a public offering and using the proceeds of such offering to indirectly acquire an interest in an underlying business. While the precise structure of Canadian income funds varied significantly depending on a number of factors, income funds typically adopted one of two general structures.

In "first-generation" corporate-trust structures, the public trust held debt and equity of a subsidiary operating corporation. To the extent possible, interest on this debt would be structured to reduce or eliminate the corporation's tax liability. This would permit the pre-tax cash flow of the operating corporation to be distributed to the income fund, and from the income fund to investors, without the imposition of any corporate (or other entity-level tax). In "second generation" partnership-trust structures, the public trust would (indirectly through a subsidiary trust) hold the operating business in a subsidiary limited partnership. Because the limited partnership was a flow-through entity for Canadian tax purposes, the operating income of the business could flow out to investors, again without the imposition of any entity-level tax. However, as noted above, many Canadian income funds adopted more complex structures to accommodate a number of complex business arrangements.

The Conversion Rules discussed below are intended to facilitate the conversion of all Canadian income funds, regardless of structure.

The New SIFT Tax

Enacted into law on June 22, 2007, the new tax measures apply to specified investment flow-through trusts and partnerships ("SIFTs"). In general, most publicly listed or traded income funds that hold significant investments in Canadian assets will constitute SIFTs. Historically, an income fund that distributed all of its income to unitholders would not be subject to any entity-level tax because the distributions were deductible in computing its taxable income. Once effective, the new rules eliminate this deduction for SIFT trusts in respect of distributions paid out of "non-portfolio earnings". Instead, these distributions generally are subject to tax at the combined federal and provincial corporate tax rates. Unitholders who receive distributions that were subject to the SIFT tax are deemed to have received a taxable dividend from a taxable Canadian corporation, such that Canadian unitholders will be entitled to the enhanced dividend tax credit in respect of such distributions.

For purposes of the new SIFT tax rules, non-portfolio earnings will include income from businesses carried on in Canada, income from "non-portfolio properties" (other than certain dividends) and capital gains realized on the disposition of non-portfolio properties. Non-portfolio properties will generally include significant investments in Canadian resident corporations, trusts and partnerships, Canadian resource properties, timber resource properties and real property situated in Canada.

As noted above, existing income funds that were publicly listed or traded prior to November 1, 2006 will not be subject to the new SIFT tax until 2011, provided that the entity does not exceed certain equity growth limitations during this period. In general, an existing income fund is permitted to issue new equity during the grandfathering period (October 31, 2006 to December 31, 2010) at least equal to its market capitalization, subject to certain annual limitations. Market capitalization for these purposes is defined as the aggregate fair market value of the income fund's publicly traded securities on October 31, 2006.

Strategic and Structural Alternatives

In response to current market conditions and the impending imposition of entity-level tax, many income funds have begun a review of their strategic and structural alternatives. This analysis is often complex — there are a myriad of commercial, capital market and tax related factors that may influence this review. The following sections briefly explore certain of the alternatives available to Canadian income funds and consider some of the factors that may influence the viability and attractiveness of each of these alternatives.

1. Corporate Conversion before 2011

Several income funds have commenced and/or completed the process of converting to a public corporation. The decision to convert depends on, among other strategic factors, the particular income fund's underlying business, its investor base, its tax characteristics, current market conditions and management's future strategy in respect of capital expenditures, acquisitions and distributions. Certain principal considerations that arise in connection with converting before the grandfathering period expires include:

Tax holiday: Existing income funds that convert to corporate form before their 2011 taxation year will forfeit their grandfathered flow-through status. A decision to convert early, and the future cash tax costs of doing so, must be weighed against the perceived non-tax benefits of converting (discussed below). The future tax costs of converting will depend on the income fund's inherent shelter, including tax loss carryforwards and/or tax attributes of its underlying entities (e.g., tax depreciation and other

tax pools), which can be used to offset future taxable income.

Foreign ownership restrictions: Income funds are subject to restrictions in respect of permitted level of foreign ownership. In general, an income fund cannot be considered to have been established or maintained primarily for the benefit of non-residents of Canada, and most income funds restrict non-residents from holding, in the aggregate, 50 per cent or more of outstanding fund units. Income funds with substantial non-resident holders may be willing to convert to corporate form, thereby foregoing the benefits of the extended tax holiday, to attract additional foreign capital.

Normal growth limitations: As discussed above, the grandfathering enjoyed by existing income funds until 2011 from the new SIFT tax is contingent upon the entity not exceeding certain equity growth limitations. Income funds with active acquisition strategies that are approaching their normal growth limitations will likely be more open to early conversion as, once such limits are exceeded, they will no longer be able to benefit from the continued tax holiday.

Distributable cash flexibility: Income funds are generally required to distribute to their unitholders an amount equal to their taxable income in order to preserve the tax efficiency of the flow-through structure. In circumstances in which the income fund does not have sufficient cash (or does not wish to use its cash) to make such distributions, investors will typically have phantom income (i.e., taxable income without a corresponding distribution of cash). Such adverse tax consequences may restrict the ability of an income fund to make discretionary adjustments in its payout levels. By contrast, a public corporation may change its dividend policy without adverse tax consequences. This gives the boards of public corporations more flexibility with respect to their use of cash resources (for example, retaining cash to finance capital expenditures or acquisitions rather than distributing such funds to investors). Accordingly, income funds that are re-evaluating how they use distributable cash generated by their business may consider converting before 2011.

Non-tax considerations: There are a number of non-tax considerations that may lead an income fund to consider converting to corporate form before 2011. For example, it may be easier to raise capital in a corporate structure; corporate shares may be a more readily acceptable acquisition currency; and corporate shares may attract higher valuations (particularly if the income fund sector becomes less liquid).

2. Corporate Conversion as of 2011

It is expected that a number of existing income funds will decide to optimize the tax benefits of their current flow-through structure by waiting until shortly before 2011 to convert to corporate form. In addition to maximizing their tax holiday, other implications for existing income funds of waiting to convert include:

Planning for SIFT tax: Existing income funds may consider implementing planning measures to maximize tax deductions and losses available once they become a taxable corporate entity - for example, by not deducting discretionary items from taxable income, such as tax depreciation, an income fund will create larger deductions in future taxation years.

3. Maintain Trust Status Beyond 2011

Although existing income funds will be taxable in a manner similar to corporations in their 2011 taxation year, there are certain differences between the new tax rules and the corporate tax regime, as further discussed below. A decision to remain in trust form must be made in light of the fact that the Conversion Rules will no longer be available to income funds as of January 1, 2013.

Qualifying REITs: The new SIFT tax rules do not apply to real estate investment trusts that satisfy certain qualifying income and asset tests. Accordingly, it is expected that many existing real estate investment trusts (which are currently grandfathered until 2011) will restructure their affairs to become qualifying REITs to sustain their flow-through status beyond 2011.

Foreign source income: An income fund may be able to structure distributions of foreign-source income without any liability under the new SIFT tax rules. The potential flow-through nature of this income is particularly attractive to non-resident and tax exempt unitholders.

Return of capital: The new taxation measures do not affect the ability of trusts to distribute "returns of capital". In certain circumstances, this will continue to be a significant distinction between trusts and public corporations, which are generally prohibited from making tax-deferred returns of capital.

4. Sale or "Going Private" Transaction

As noted above, many income funds reacted to the new tax proposals by pursuing a sale or "going private" transaction (more than 30 such transactions have taken place since October 31, 2006). However, adverse conditions in global credit markets generally have significantly reduced the number of such transactions over the past year.

It should be noted that the Conversion Rules discussed below are not limited to internal reorganizations; they may apply where an existing Canadian corporation (whether public or private) completes an acquisition of an income fund and may be used by a purchaser to facilitate the acquisition of an income fund on a tax-deferred basis and to rationalize the target corporate structure following the acquisition. However, structuring an income fund merger or acquisition pursuant to the Conversion Rules will give rise to a number of additional considerations including:

Single class of share consideration: Unitholders are only entitled to tax-deferral if the acquirer corporation issues one class of shares as consideration for the income fund units (although it appears that the acquirer may have other classes outstanding). In addition, the acquirer corporation must be a taxable Canadian corporation.

Administrative requirements: In general, an acquirer corporation will be required to obtain a fairness or valuation opinion to ensure that the fair market value of the issued shares equals the fair market value of the fund units acquired, as required by the Conversion Rules.

Effective Date of Conversion Rules

The Conversion Rules apply to conversions that occur after July 14, 2008 and before 2013. Finance intended that these rules would only be transitory and, accordingly, the Conversion Rules will no longer be available as of January 1, 2013. In certain circumstances, tax-deferral under the Exchange Method (as defined below) may also be available in respect of a disposition of units for shares that took place after December 20, 2007 and before July 14, 2008, provided that the corporation files the appropriate tax elections on or before its filing due-date for its taxation year that includes the date that the Conversion Rules receive Royal Assent.

The Conversion Rules

Although an income fund can be converted to corporate form on a tax-deferred basis using existing tax rules, the conversion process under existing rules is complex and administratively challenging, and the resulting corporate structure may be cumbersome. As noted above, the Conversion Rules address many of the principal substantive, technical and administrative issues that would typically arise on a corporate conversion and provide income funds with a number of alternative mechanisms to rationalize their resulting corporate structure on a tax-deferred basis. However, the Conversion Rules are complex and an income fund must carefully consider its particular circumstances, and those of its unitholders, to structure a conversion in a manner that fully benefits from the Conversion Rules.

The Conversion Rules permit two basic tax-efficient conversion strategies. In general, income funds may convert by either (i) having unitholders directly exchange their income fund units for shares of a public corporation (the “Exchange Method”), or (ii) redeeming the outstanding income fund units by distributing to unitholders the shares of an underlying corporation that directly or indirectly owns the business (the “Distribution Method”). The conversion strategy best suited for a particular income fund will depend on its current structure, its tax attributes and other factors.

The Exchange Method

The Conversion Rules include a new automatic rollover provision, whereby a unitholder may exchange all or a portion of its income fund units for shares of a public corporation on a tax-deferred basis, provided that the following conditions are satisfied:

- the disposition takes place during a period of not more than 60 days, at the end of which all of the outstanding equity of the income fund was either sold to the public corporation or redeemed or cancelled by the income fund;
- the unitholder disposes of all of its equity during this 60 day period;
- the unitholder receives only shares of the public corporation in consideration for the income fund units that are transferred on a tax-deferred basis, and the fair market value of such shares is equal to the fair market value of such income fund units immediately before the disposition; and
- all of the shares issued to all unitholders on a tax-deferred basis are of a single class.

For Canadian tax purposes, unitholders will receive the benefit of a tax-deferred exchange automatically in respect of those unit transfers that satisfy the foregoing conditions (i.e., there is no need to file a tax election). Unitholders will be deemed to have disposed of these units for proceeds of disposition equal to the cost amount of their units (such that no taxable gain is realized), and will be deemed to have cost in their new public corporation shares equal to the cost amount of their exchanged units. Where desired, the conversion may be structured to permit a unitholder to transfer other units on a taxable basis (for example, to trigger losses).

Following the transfer of all income fund units to the public corporation (whether or not the transfer was tax-deferred in respect of some or all holders), the Conversion Rules further permit the public corporation to rationalize its corporate structure by dissolving the income fund and any subsidiary trusts on a tax-deferred basis. There are two separate provisions available to effect this rationalization. The first provision (the continuity provision) ties into the rules that permit the tax-deferred dissolution of a corporate subsidiary into its parent, and will generally allow the tax attributes (e.g., losses and undeducted financing expenses) of the underlying trust(s) to flow through to the public corporation. In particular, this provision allows a trust to dissolve and distribute all of its property to its sole beneficiary on a tax-deferred basis if:

- the distribution of property by the trust occurs prior to 2013, and it results in a disposition of all of the interests in the particular trust;
- a Canadian corporation is the only beneficiary of the income fund. In relation to a wind-up of a subsidiary

trust, the income fund must be the only beneficiary of the subsidiary trust. In these cases, the provisions require that the subsidiary trust must be wound up before the income fund, and do not appear to permit additional trusts (e.g., third tier or fourth tier trusts) to be wound up on a tax-deferred basis;
- where applicable, the income fund must be wound up within 60 days after the subsidiary trust is wound up; and
- the trust must file a written election with the Minister where it disposes of property that is shares of a Canadian corporation.

The second provision (the liquidation provision) permitting a tax-free dissolution of an income fund post-conversion applies where the property distributed by the trust(s) consists only of shares of a Canadian corporation, and the trust(s) does not file the election mentioned above. Although the public corporation is entitled to wind-up the underlying trusts on a tax-deferred basis pursuant to this second provision, the existing tax attributes of the trust(s) will not be available to the public corporation.

The Distribution Method

As noted above, the Distribution Method is effected by distributing to unitholders the shares of an underlying corporation in redemption of their units. In some circumstances, the Distribution Method will be the simpler of the two corporate conversion strategies to implement.

For example, under a typical “first generation” corporate-trust structure, the income fund would capitalize the subordinated debt of the operating subsidiary into shares and then distribute all of the shares of the corporation to its unitholders in redemption of their trust units. The Distribution Method may be effected on a tax-deferred basis where:

- the distribution occurs prior to 2013, and it results in a disposition of all of the interests in the particular trust;
- the property distributed to unitholders is shares of a Canadian corporation; and
- where applicable, the subsidiary trust is wound up before the income fund and the reorganization is completed within 60 days after the subsidiary trust is wound up.

The Distribution Method is effected, using the liquidation provision, on a tax-deferred basis for both the income fund (and, where applicable, a subsidiary trust) and its unitholders without the need to file any tax elections. For Canadian tax purposes, the income fund and unitholders are deemed to have disposed of their property for proceeds of disposition equal to their cost amount; unitholders will be deemed to have cost in the new public corporation shares equal to the cost amount of their units. However, the Distribution Method does not allow the tax attributes of the income fund (or any subsidiary trusts) to flow through to the public corporation.

Conversion Procedure

We expect that the Exchange Method will typically be undertaken pursuant to a plan of arrangement, whereas the Distribution Method may be implemented either through a plan of arrangement or a special meeting of the unitholders of the income fund. Under either approach, implementation of the conversion transaction will generally require the approval of unitholders holding 66 2/3 per cent of the units. ■

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