INCOME FUNDS: RECENT DEVELOPMENTS OF IMPORTANCE

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CANADIAN INCOME FUNDS: PROPOSED TAX CHANGES AND OPPORTUNITIES FOR ACQUISITIONS[1]

Introduction

On October 31, 2006, the Department of Finance (Canada) announced proposals to tax publicly listed or traded trusts and partnerships (other than qualifying real estate investment trusts) in the same general manner as corporations. Trusts and partnerships that were publicly listed or traded before November 1, 2006 will generally not be subject to the new measures until 2011, provided such trusts do not exceed certain growth limitations (new publicly listed or traded trusts and partnerships are subject to these measures commencing January 1, 2007). The initial announcement was followed by the release of "normal growth" guidelines on December 15, 2006, draft legislation on December 21, 2006 and revised draft legislation on March 27, 2007.

These tax proposals have had dramatic effects on the Canadian income fund sector and arguably have reshaped the investment landscape in Canada. Fuelled by investors' appetite for regular and meaningful cash distributions, particularly in a low-interest rate environment with volatile equity markets, income funds had become a significant component of Canadian capital markets. The aggregate market capitalization of the income fund sector grew from $18 billion in 2000 to over $200 billion at the end of October 2006, representing approximately 11 per cent of the market capitalization of all issuers traded on the TSX. In the 48 hours following the October 31, 2006 announcement, the S&P/TSX Capped Income Trust Index lost approximately 16 per cent of its value. Although prices have rebounded somewhat since the initial announcement, analysts expect a permanent correction to income fund valuations. The pricing pressure on many income funds—particularly those with smaller market capitalizations—may provide an opportunity for private equity and other buyers to acquire income funds or their underlying businesses at attractive prices. A number of income funds have recently initiated reviews of their strategic alternatives.

This article will explore the proposed tax changes and certain implications thereof, including implications for real estate investment trusts and cross-border income funds. It will conclude with a brief discussion of the key considerations that may arise in connection with acquiring an income fund.

Income Funds

The basic structure of an income fund involves a Canadian resident trust being created to indirectly acquire a business or other income-producing assets. The acquisition is typically funded from the proceeds of a public offering of trust units. Excluding the application of the proposed tax rules, income funds are typically structured to permit the distribution to investors on a regular basis of pre-tax cash flow (i.e., without any entity-level tax).

Like the stock of a public company, the units of an income fund are publicly traded on a stock exchange and represent a beneficial interest in the income fund with a vote at meetings of unitholders. Income funds are governed by a board of trustees, which functions in a manner similar to that of the board of directors of a public corporation.

The Canadian income fund sector may be broadly divided into three groups:

- Resource royalty trusts, which originated in the mid-1980s and generally focus on oil and gas resource properties.
- REITs, which originated in the early 1990s and own investments in a wide range of real properties, as well as specialty assets like hotels and nursing and retirement homes.
- Business income funds, which over the last few years have emerged as the largest component of the income fund sector. These have been formed from a wide variety of operating businesses and infrastructure assets, ranging from power, pipelines and transportation to media, retail and other service industries. Initially, business income funds focused on mature, low-growth businesses with predictable ongoing capital expenditure requirements, but more recently have also been formed around higher-growth businesses.

Background to Proposed Tax Changes

According to the Department of Finance, the proposed rules are intended to restore balance to Canada's tax system by taxing income funds in a similar manner to corporations. In doing so, the government sought to stem the tide of corporate conversions to income funds. The following outline of the proposed rules and their implications is subject to the proposals ultimately being adopted.

Draft Legislation

The revised draft legislation released on March 27, 2007 adopted the principles expressed in the initial October 31, 2006 announcement without significant substantive change. The proposed tax will apply to "specified investment flow-throughs" ("SIFTs"), which will include most publicly listed or traded income funds and partnerships that hold significant investments in Canadian assets.

Under the current rules, an income fund that distributes all of its income to its unitholders is not subject to any entity-level tax because the distributions are deductible in computing its income. The proposed rules eliminate this deduction for SIFT trusts in respect of distributions paid out of "non-portfolio

earnings." Instead, SIFT trusts will pay tax on these distributions at a rate of 34 per cent in 2007, declining to 31.5 per cent in 2011 (these rates include a 13 per cent component in lieu of provincial tax). 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 qualify for the enhanced dividend tax credit.

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.

The proposed rules 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. Taxable income that is not distributed by the trust in the year it is earned will continue to be taxed at the highest individual marginal tax rate.

The government proposals raise a number of questions and implications for income funds including:

- Existing income funds may wish to defer claiming certain discretionary deductions and reserves so as to preserve such tax attributes until the end of the transition period in 2011.
- In certain provinces, provincial corporate tax rates are less than the notional 13 per cent provincial component. Corporations will enjoy a marginal rate advantage in those provinces.
- Non-portfolio earnings do not include income from US or other foreign entities that do not carry on business in Canada. However, where such income is earned through a Canadian subsidiary of an income fund, exempt US source income may inadvertently become non-portfolio earnings subject to SIFT tax. Canadian income funds with significant US operations may consider restructuring so as to preserve the characterization of US source income. The possibility of successful restructuring will depend upon the particular circumstances and structure of the fund.

Transitional Relief and "Normal Growth"

Trusts and partnerships that were publicly listed or traded before November 1, 2006 are not subject to the new tax rules until 2011. However, in his initial announcement, the Minister of Finance indicated that while there was no intention to prevent "normal growth" during the transition period, this relief could be foreclosed in the event of inappropriate avoidance techniques, such as the "undue expansion" of an existing trust. On December 15, 2006, the Department of Finance released guidance on the concept of "normal growth". These guidelines have now been incorporated by reference into the March 27, 2007 draft legislation. Accordingly, the proposed tax will apply to a trust or partnership that was publicly listed or traded on October 31, 2006 commencing on the earlier of (i) its 2011 taxation year and (ii) any taxation year in which the trust exceeds "normal growth" as determined by reference to the normal growth guidelines, as amended from time to time, unless that excess arose as a result of a prescribed transaction (no transactions have yet been prescribed).

The guidelines establish objective tests with respect to how much existing income funds are permitted to grow during the next four years without jeopardizing their transitional relief. In general, income funds are permitted to issue new equity in each of the four transition years equal to the greater of $50 million and a percentage of the trust's market capitalization at the end of trading on October 31, 2006 (the "Safe Harbour Amount"):

Period	Safe Harbour Percentage
2006/2007	40%
2008	20%
2009	20%
2010	20%

For purposes of determining the Safe Harbour Amount, market capitalization is equal to the value of an income fund's issued and outstanding units on October 31, 2006. This calculation does not include debt or securities exchangeable/convertible into fund units.

The Safe Harbour Amount is cumulative to the extent that it is not fully utilized in a given year, but the $50 million limit is not. Therefore, income funds with a market capitalization of $250 million or more may double their equity over the next four years, while income funds with a smaller market capitalization may grow between $200 million and $250 million.

The guidelines permit an income fund to undertake certain financing activities that will not count towards its equity growth limits. These include (i) issuing non-convertible debt, (ii) issuing equity to repay debt of the trust that was outstanding as of October 31, 2006, (iii) issuing equity in satisfaction of the exercise of rights outstanding as of October 31, 2006 (for example, outstanding exchangeable securities or convertible debt), and (iv) the merger of two or more trusts that were publicly-traded before November 1, 2006 to the extent that there is no net addition to equity.

The Department of Finance also stated in the guidelines that it intends to permit income funds to convert to corporations without tax consequences to investors. While mechanisms to achieve this on a tax-deferred "rollover" basis are currently available, both the process and the resulting structure may be cumbersome and less than fully tax-efficient. It remains to be seen whether the Department will introduce rules to facilitate conversions to corporate form.

There continues to be significant uncertainty with respect to certain aspects of the "normal growth" guidelines. Moreover, the proposed legislation appears to permit the Department of Finance to amend these guidelines (and therefore the availability of transitional relief) at will.

REITs

A "real estate investment trust," as defined in the revised draft legislation (a "Qualifying REIT"), is not a SIFT trust and, therefore, is excluded from the proposed new tax. This exclusion is intended to give relief to REITs with passive investments in Canadian real estate in recognition of the unique history and role of collective real estate investment vehicles in Canada. Qualifying REITs must satisfy the following conditions throughout a taxation year:

a) the trust at no time in the taxation year holds any "non-portfolio property," other than "qualified REIT properties" (this includes real and immovable property and securities in an entity that itself satisfies these four conditions);

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b) at least 95 per cent of the trust's revenues for the taxation year are derived from: (i) rent from real or immovable properties, (ii) interest, (iii) capital gains from dispositions of real or immovable properties, (iv) dividends, and (v) royalties;

c) at least 75 per cent of the trust's revenues for the taxation year are derived from: (i) rent from real or immovable properties situated in Canada, (ii) mortgages on real or immovable properties situated in Canada, and (iii) taxable capital gains from dispositions of real or immovable properties situated in Canada; and

d) at no time in the taxation year is the total fair market value of property held by the trust that is (i) real or immovable properties situated in Canada, (ii) cash, and (iii) certain government debt less than 75 per cent of the trust's equity value.

Qualifying REITs must satisfy these conditions at all times throughout the taxation year. However, because the conditions are applied on an annual basis, a REIT that fails to qualify for the exemption in a particular taxation year can be restructured to achieve Qualifying REIT status in a subsequent taxation year.

The revised draft legislation clarified the underlying policy intent of the REIT exemption and addressed a number of technical concerns:

- *Operating REITS*: REITs with operating components, such as hotels and seniors housing, will not be Qualifying REITs. Payments for the occupation or use of a hotel room or other similar lodging facility are explicitly excluded from the definition of "rent from real or immovable property." However, these REITs may be able to restructure in order to meet the requirements of the REIT exemption. While the revised proposals do not include the US concept of a "taxable REIT subsidiary", the evolution of US seniors housing REITs and Australian stapled unit structures may be helpful in this regard.
- *Entity-By-Entity Basis:* The REIT proposals apply on an entity-by-entity basis, not on a consolidated basis. In order for a trust to be a Qualifying REIT, each of its underlying entities (whether corporations, trusts or partnerships) must separately satisfy the four REIT conditions.
- *Permitted Rental Income:* "rent from real or immovable properties" includes rent or similar payments and services ancillary to the rental of real or immovable property and customarily supplied or rendered in connection with the rental of such properties. However, the following types of payments are expressly excluded from qualifying as "rent from real or immovable properties":
  - o payments for any other types of services provided to the tenants of such properties;
  - o fees for managing or operating such properties;
  - o payments for the occupation of, use of, or right to use a room in a hotel or other similar lodging facility; and
  - o rent based on profits.
- *Internal Management Entities:* a Qualifying REIT may own securities in an internal management company provided that all or substantially all of the revenues of the entity are derived from maintaining, improving, leasing or managing real or immovable property of the Qualifying REIT (including properties the trust holds together with one or more other persons or partnerships). However, as currently drafted, this exception may not be available where the management entity is not directly owned by the property owner or provides services to a number of entities within the REIT structure.
- *Nominee Corporations:* REITs commonly use nominee corporations to hold legal title in their underlying properties. The revised proposals explicitly permit nominee corporations.
- *Third-Party Management Fees:* third-party management fees will not be qualifying income for either the 95 per cent or the 75 per cent revenue tests.

Cross-Border Income Funds and Income Securities

It would appear that the policy concerns of the Canadian government relating to the "tax imbalance" created by income funds do not apply to cross-border income funds. In particular, the tax leakage concerns that arose relate to Canadian business income that would otherwise be taxable in Canada if held in ordinary corporate form. In contrast, cross-border income fund and income securities transactions result in additional foreign income being subject to Canadian tax. Accordingly, the proposed legislation does not appear to apply to income directly received from a trust's foreign subsidiaries that do not carry on business in Canada.

Cross-border income fund and income securities structures have been developed to permit cash-generating US businesses to go public in Canada in a tax-efficient manner that satisfies the rigorous standards of auditors and US tax advisers. If properly structured, these structures should not be subject to Canadian tax under the new rules.

Acquiring Income Funds

In some ways, acquiring a Canadian income fund is the same as acquiring a Canadian public company, as Canadian securities laws apply equally to all reporting issuers regardless of their form.

However, one of the most important differences between income funds and public companies from a mergers and acquisitions perspective is that income funds are not subject to corporate law. This can have important consequences for the way income fund acquisitions are structured. Since there is no overriding statutory framework, an income fund's declaration of trust ("DOT")—the document that governs how the trust will operate—must be examined closely to understand potential structuring opportunities and limitations.

Take-over Bid Process

To acquire an income fund by take-over bid, an acquiror makes a public offer to purchase all of the outstanding units of the fund by mailing a take-over bid circular to the fund's unitholders. The take-over bid may be done on a friendly basis (in which case there will often be a negotiated support agreement between the acquiror and the income fund) or as an unsolicited bid.

Under Canadian securities laws, among other things, a take-over bid must:

- be open for acceptance for at least 35 calendar days;
- offer the same consideration to all unitholders; and
- not be subject to a financing condition.

To acquire any units not tendered to a bid, the acquiror must undertake a second-step transaction:

- if at least 90 per cent of the outstanding units are tendered, most DOTs allow the acquiror to complete an acquisition of the remaining units without further approval or action from the remaining unitholders—this mirrors the compulsory acquisition rights generally available to acquirors under corporate statutes; or
- if less than 90 per cent of the outstanding units are tendered, the acquiror could attempt to squeeze out minority unitholders by amending the DOT to allow for the redemption of their units.

Amending a DOT to effect a second-step transaction requires unitholder approval. The specific approval threshold will be set out in the DOT. Most DOTs require the approval of at least 66 2/3 per cent of the outstanding units voted on the proposed amendment. Canadian securities laws also typically require that the amendment be approved at a unitholder meeting by a "majority of the minority." Units acquired under the bid can usually be counted toward the required minority approval.

Some DOTs provide that amendments may be approved by a written resolution signed by the holders of at least that number of units required to approve the amendment at a meeting. In these circumstances, subject to the receipt of certain regulatory approvals, a take-over bid for an income fund could provide that tendering to the offer is also approval of any DOT amendments necessary to complete a second-step transaction. This mechanism is not available in public company take-over bids because a written shareholder resolution would have to be signed by all of the target's shareholders. It can significantly accelerate completion of a second-step transaction.

Some buyers prefer single-step acquisition structures because acquiring less than 100 per cent of the target entity (as is the case, at least initially, under a take-over bid) complicates financing arrangements and limits access to the target's balance sheet. The presence of a publicly-traded minority interest can also restrict the acquiror's ability to operate the acquired business for its own benefit. In other cases, the acquiror may insist on a single-step transaction for tax reasons.

A single-step acquisition of an income fund may be structured in a number of ways, including:

- a recapitalization transaction pursuant to which all of the units of the income fund (other than units owned by the acquiror) would be redeemed; or
- a sale of all or substantially all of the trust's assets to the acquiror.

Such acquisitions require the target's cooperation and are generally implemented pursuant to an acquisition agreement between the acquiror and the target.

A DOT will typically require the approval of at least 66 2/3 per cent of the outstanding units voted for the single-step acquisition. If the acquiror has a preexisting ownership position in the target fund, "majority of the minority" approval would also be required. These approvals would be obtained at a unitholder meeting called to consider the transaction. A detailed proxy/information circular describing the transaction would be prepared and delivered to unitholders before obtaining the approval. Unlike shareholders, unitholders who object to such a transaction generally do not have dissent or appraisal rights or access to an "oppression" remedy.

Certain Structuring Considerations

The tax consequences of a transaction structure—to the acquiror, the unitholders and the underlying business itself—will often be a determining factor in structuring an income fund acquisition. Tax planning opportunities and issues associated with an income fund acquisition are often complex and should be dealt with early in the planning stages of any transaction.

In many cases, the initial sponsors of an income fund and subsequent vendors of assets to the income fund retain an interest in the business owned by the fund, usually represented by securities of an operating subsidiary that are convertible into units of the fund. Retained interest holders may have special approval rights or veto powers that could prevent an acquisition from proceeding without their consent, giving them significant leverage. It may also be impossible for an acquiror to force retained interest holders out of the income fund structure in connection with an acquisition of the fund. As a result, the presence of a retained interest may significantly complicate an income fund acquisition and should be carefully considered in structuring a transaction.

Trustees' Duties

In responding to an acquisition proposal, the trustees of an income fund are generally subject to similar fiduciary duties and responsibilities as the directors of a corporation. Among other things, this means that once they have decided to sell the fund, trustees must attempt to maximize unitholder value.

In exercising these duties, trustees can generally respond to an unsolicited offer by engaging in similar defensive tactics as would be available to the directors of a corporation. This may include implementing a unitholder rights plan (a "poison pill"). However, it is difficult for directors or trustees to "just say no" to a hostile bid, as Canadian securities regulators will generally require that unitholders ultimately be given an opportunity to accept or reject an offer. Accordingly, rights plans will not be permitted to remain in place indefinitely.

Regulatory Requirements

The regulatory approval requirements that arise in connection with the acquisition of a Canadian income fund are similar to those that arise in connection with the acquisition of a Canadian company. These might include prenotification and/or clearance under the *Competition Act* (Canada) and, if the acquiror is a non-Canadian, the *Investment Canada Act*.

Canadian securities laws generally allow accumulation of up to 20 per cent of the outstanding units of an income fund. Any offer to acquire units that would result in the acquiror and any "joint actors" collectively owning 20 per cent or more of the outstanding units will, subject to certain exceptions, require the acquiror to make a take-over bid to all unitholders.

No public disclosure of an ownership position in an income fund is required in Canada until the acquiror (together with any joint actors) owns 10 per cent or more of the outstanding units. Once the acquiror crosses the 10 per cent threshold, immediate public disclosure of the ownership position and investment intent is required. As long as the acquiror owns more than 10 per cent of the outstanding units, it will be required to provide ongoing public disclosure of all trades in units of the fund. In addition, any acquisition of an income fund by a 10 per cent unitholder or other "insider" will be subject to the going-private transaction rules of Canadian securities regulators, which in some circumstances could require the acquiror to obtain an independent valuation of the fund and/or "majority of the

minority" approval for the transaction. As a result, in many cases potential acquirors limit toehold positions to less than 10 per cent. ■

1 The authors would like to thank Jarrett Freeman of Goodmans LLP for his assistance in the preparation of this article.