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Update

Income Trusts Law

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Department of Finance Releases Conversion Rules for Income Trusts

On July 14, 2008, the Department of Finance ("Finance") released proposed amendments to the Income Tax Act (Canada) (the "Tax Act") to facilitate the conversion of existing income trusts, REITs and other public flow-through entities into corporations on a tax-deferred basis (the "Conversion Rules"). The Conversion Rules fulfil Finance's undertaking to provide existing income trusts with tax efficient structuring options to convert to corporate form in advance of their 2011 taxation year – at which time most income trusts would become subject to a new entity-level tax based on corporate income tax rates. The Conversion Rules address many of the principal substantive and administrative issues that currently arise when structuring a corporate conversion under the Tax Act; however, the Conversion Rules are complex and technical, and Finance has afforded a number of alternatives for completing a conversion. Accordingly, income trusts must carefully consider their particular circumstances, and those of their unitholders, to structure a conversion in a manner that fully benefits from the Conversion Rules.

The Conversion Rules

The Conversion Rules permit two basic tax-efficient conversion strategies. In general, income trusts may convert by either (i) having unitholders directly exchange their income trust units for shares of a public corporation (the "Exchange Method"), or (ii) redeeming the outstanding income trust units by distributing to unitholders the shares of an underlying corporation that directly or indirectly owns the business (the "Distribution Method"). 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 trust. Under either approach, implementation of the conversion transaction will generally require the approval of unitholders holding 66 2/3% of the units. The conversion strategy best suited for a particular income trust will depend on its current structure, its tax attributes and other factors. These conversion strategies are discussed below in further detail.

The Exchange Method

The Conversion Rules include a new automatic rollover provision, whereby a unitholder may exchange all or a portion of its income trust 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 trust was either sold to the public corporation or redeemed or cancelled by the income trust;
- the unitholder disposes of all of their equity during this 60 day period;
- the unitholder receives only shares of the public corporation in consideration for the income trust units that are transferred on a rollover basis, and the fair market value of such shares is equal to the fair market value of such income trust units immediately before the disposition; and

- all of the shares issued to all unitholders on a rollover basis are of a single class.

Unitholders automatically will receive the benefit of a tax-deferred exchange in respect of those units 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 shares equal to the cost amount of their exchanged units. Where desired, other units may be transferred to the corporation on a taxable, or partially tax-deferred, basis.

Following the transfer of all income trust 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 trust 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 of the underlying trusts to flow through to the public corporation (e.g., losses and undeducted financing expenses). 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 trust. In relation to a wind-up of a subsidiary trust, the income trust must be the only beneficiary of the subsidiary trust. In these cases, the provisions require that a subsidiary trust must be wound up before the income trust, and do not appear to permit additional trusts (third tier or fourth tier trusts) to be wound up on a tax-deferred basis;
- where applicable, the income trust 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 the property distributed is shares of a Canadian corporation.

The second provision (the liquidation provision) that allows for a tax-free dissolution applies where the property distributed by the trust(s) is 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 trust 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. In the "second generation" structures that have underlying trusts and partnerships, the business (or the partnership holding the business) would be transferred to a corporation (unless it is already in corporate form), and then the shares of this corporation would be distributed to 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 trust 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 income trusts (and, where applicable, a subsidiary trust) and their unitholders without the need to file any tax elections. The income trust and unitholders are deemed to have disposed of their property for proceeds of disposition equal to their cost amount. The 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 trust (or any subsidiary trusts) to flow through to the corporation.

Additional Planning Considerations

Under either conversion strategy, there are a number of planning considerations for an income trust to consider when contemplating a corporate conversion:

- *Capital Structure:* The Conversion Rules do not require the corporation to have any particular capital structure following the transaction. However, the rollover of units under the Exchange Method requires all shares that are issued on a rollover basis to be of a single class. For example, it appears that both common and preferred shares may not be issued on a full rollover basis under the Exchange Method; however it may be possible to reorganize the share structure after conversion. In addition, it may be possible to issue debt (perhaps subordinated notes) of the public corporation in connection with a conversion. The debt of an underlying corporation may be distributed as a return of trust capital prior to the conversion, or debt of the public corporation may be issued in partial exchange for units under the Exchange Method; the units directly exchanged for debt would not be subject to a rollover (and a gain may therefore arise), but this should not taint the rollover of units that are directly exchanged for shares.
- *Unitholder Losses:* Because the tax-deferred rollover under both the Exchange Method and the Distribution Method is automatic, unitholders wishing to trigger a loss on the exchange of their units should consider selling on the open market in advance of the corporate conversion. Alternatively, if a significant component of the unitholder base has an inherent loss, it may be possible to structure the corporate conversion so that these unitholders have their units redeemed by the income trust (which will trigger the loss), rather than selling their units directly to the corporation (which would be tax-deferred).
- *Public Debt:* In situations where the income trust has issued debt to the public, including convertible debt, it may be necessary for this debt to be assumed by the public corporation in connection with the conversion transaction. In order to provide a full rollover of this debt from the perspective of both the public corporation and the debtholders, it may be important for the conversion to be structured using the Exchange Method so that the continuity provision will be available.
- *Administrative Requirements:* The Exchange Method will require a determination that the fair market value of the outstanding trust units is equal to the fair market value of the shares received in exchange therefor (a fairness or valuation opinion may be desirable).
- *Income Trust Takeovers:* The Exchange Method is not limited to conversion transactions; it may apply where an existing Canadian corporation completes an acquisition of an income trust. However, as noted above, unitholders are only entitled to tax-deferral if the acquiror corporation issues one class of shares as consideration for the trust units (although it appears that the acquiror may have other classes of shares outstanding). In addition, the rules providing for a tax-free dissolution of an income trust structure may apply where a Canadian corporation (public or private) acquires control of an income trust.

- *Acquisition of Control:* The Conversion Rules provide that, in certain circumstances, a distribution of shares by a subsidiary trust to an income trust will not result in an acquisition of control of underlying corporations for purposes of the Tax Act. However, depending on whether the Exchange Method or the Distribution Method is used, certain other aspects of the corporate conversion may result in an acquisition of control of underlying corporations in an income trust structure.
- *Exchangeable Units or Shares:* Although the Conversion Rules do not specifically address the treatment of exchangeable partnership units or shares, these interests may generally be exchanged for shares on a tax-deferred basis using the existing elective provisions of the Tax Act. Particular attention should be given to eliminating any special voting units in an income trust in connection with a corporate conversion since the Conversion Rules generally require a disposition of all capital interests in the trust.
- *Debt Forgiveness:* Provided that the income trust files an election with the Minister, a proposed new rule provides that debt owing from a subsidiary trust to an income trust generally will be deemed to have been settled at its adjusted cost base, so that no debt forgiveness should result even where the debt is "underwater". This new provision does not apply where the issuer of the debt is an underlying corporation. Consideration may be given to whether the Exchange Method may be used to avoid the adverse consequences of debt forgiveness that may otherwise arise on the capitalization of debt of an underlying corporation.
- *Options:* In general, existing employee options may be exchanged for options of the public corporation under both corporate conversion strategies without tax consequences.
- *Synthetic PUC:* Under the Exchange Method, the income trust is required to calculate the "synthetic PUC" of the trust; in general terms, this is equal to the paid-in capital of the trust less any prior returns of capital. As presently drafted, a concern may arise on the subsequent dissolution of the trust using the continuity provision where the income trust units are trading below this "synthetic PUC" calculation.

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 are not available after January 1, 2013. In certain circumstances, tax-deferral under the Exchange Mechanism 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.

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