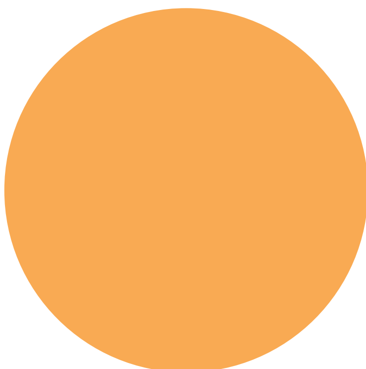
Canadian Income Trusts –

An Attractive Liquidity Option for U.S. Companies



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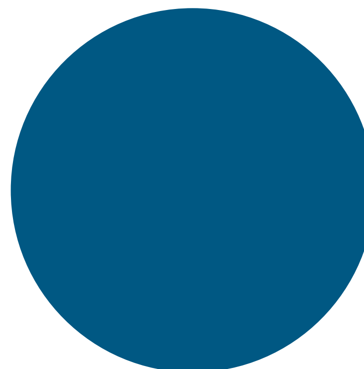

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U.S. companies now have an attractive new way of raising capital and providing liquidity for their stockholders – forming an income trust in Canada.

Yield-hungry investors have purchased over C$9 billion of Canadian income trust units since early 2001, bringing the market capitalization of income trusts on the Toronto Stock Exchange to over C$40 billion. While a broad range of Canadian businesses have raised capital through the income trust vehicle, there is a growing realization that U.S. private companies may provide significant untapped potential for this market.

The favourable valuations applied by the Canadian market to tax efficient income trusts may be very attractive to U.S. private equity funds and other investors seeking to realize all or part of their investment in a business. In addition, U.S. management may welcome the less litigious Canadian securities market environment and find that going public in Canada may be less costly and complex than in the United States.

What is an Income Trust?

An income trust is a trust that invests in assets that produce a stable or predictable stream of income. Like the stock of a public company, the units of the trust are publicly traded on a stock exchange and represent a beneficial interest in the trust with a vote at meetings of unitholders.

Unlike many public companies, income trusts pay out most of their cash flow to unitholders on a regular basis, usually through monthly distributions. The tax efficient structure of an income trust generally allows pre-tax operating income to be distributed to unitholders, reducing or eliminating corporate or asset-level tax.

Types of Income Trust

There are three types of Canadian income trusts:

- royalty (oil and gas) trusts;
- real estate investment trusts (“REITs”); and
- infrastructure and business trusts.

Canadian royalty trusts, which originated in the mid-1980s, focus (with some exceptions) on depleting oil and gas resource properties. They typically distribute most of their operating cash flow to unitholders and rely on the issuance of new trust units to fund the acquisition of replacement properties.

REITs were first established in Canada as “closed end” mutual fund trusts (i.e. mutual fund trusts that are not required to redeem investors’ units on demand) in the mid-1990s, when tax legislation was amended to permit such trusts to hold Canadian real estate. Canadian REITs now own and lease office buildings, shopping centres, industrial properties and apartments, as well as specialty assets like hotels and nursing homes. These properties enable the trust to claim high levels of depreciation for tax purposes, which provides significant tax shelter to unitholders on the distributions they receive from the REIT.

Over the last few years, a third category has emerged as a wide variety of infrastructure and operating businesses have formed income trusts. The industries range from power, pipelines, telecommunications and transportation to customs brokerage, cheque-printing, newspapers, horticulture, fish production, restaurants and pet food.

U.S. Businesses - The Next Wave

Some investment bankers believe that the next wave of income trusts will be cross-border business trusts. The first such trust – Heating Oil Partners Income Fund – went public on the Toronto Stock Exchange in May, 2002. This trust indirectly owns the majority limited partnership interest in a leading U.S. distributor of heating oil to residential and commercial customers. The former limited partners – management and institutional investors – retained a minority interest in the U.S. limited partnership, which is exchangeable at their option into units of the Canadian income trust.

Structuring an Income Trust

There are a variety of ways to structure an income trust. Typically, a new trust is formed in Canada and taken public through an offering of units to the public for cash. The trust invests the cash in shares and subordinated debt of another newly formed Canadian acquisition entity (such as a corporation, limited partnership or trust), which in turn acquires all or part of the outstanding equity interests in the target entity that owns the assets and operates the business. The acquisition and target entities may merge or are otherwise structured so that the target's pre-tax cash flow can be distributed to the income trust. The trust distributes this cash to its unitholders. The trust's interest and dividend income and capital gains will generally be taxed as such in the hands of unitholders.

Creative legal and financial advisors will design the precise structure based on a number of factors, including:

- the nature of the underlying assets;
- the legal form of the target entity (e.g., a corporation or partnership);
- the consideration to be paid to the existing equity owners (e.g., cash, trust units or exchangeable securities);
- the interest in the target entity that existing equity owners wish to retain;
- tax deferral alternatives;
- the leverage of the business, and how much debt is to be repaid or replaced;
- depreciation and amortization considerations; and
- future growth and acquisition strategy.

Cross-border Structures

There are additional Canadian and U.S. considerations in designing a cross-border income trust. For example, a Canadian company may be interposed between the trust and the U.S. acquisition or target entity for a number of reasons, including compliance with Canada's "foreign property" regime and the efficient use of Canada's "foreign affiliate" system which governs the taxation of non- Canadian businesses.

A Canadian cross-border trust may need to be structured as a "fixed investment trust" under U.S. law to avoid U.S. withholding tax on interest payments. "Internal" debt created between the U.S. target and its parent entities to shelter income must be structured so that it is treated as debt for U.S. income tax purposes.

The Process

Given the large number of recent initial public offerings in this sector, experienced underwriters and professional advisors should generally be able to bring an income trust to market quickly and efficiently.

There are three key stages:

- structuring the trust and preparing the preliminary prospectus;
- clearing the prospectus and marketing the offering; and
- closing and listing the income trust.

The whole process generally takes three to four months, although it could take less or more time, depending on the circumstances. The timeline largely depends on how focused and organized the working group (comprising principals and advisors) is during the first stage. Factors that can slow the process down at this stage are the need for unique tax or commercial structures and the lack of historical audited financial statements. The financial statements of a U.S. business to be acquired by an income trust may be prepared in accordance with U.S. generally accepted accounting principles as long as the notes to the statements contain a reconciliation to Canadian generally accepted accounting principles.

It usually takes four to six weeks from filing the preliminary prospectus to clear the prospectus through the provincial securities regulators and file the final prospectus. During this period, the underwriters will conduct "roadshows", meeting institutional and retail investors to market the offering. Immediately prior to filing the final prospectus, the price and size of the offering is set and the underwriting agreement between the trust and the underwriters is signed.

Closing occurs typically within a week or two of filing the final prospectus. Prior to closing, all the material documents relating to the income trust are finalized. These typically include the Declaration of Trust (the charter of the income trust which contains provisions relating to its governance), the shareholders or partnership agreement(s) dealing with the rights between the trust and the remaining equity owners of the target business, and documents relating to the trust's external and internal debt. On closing, the units of the income trust are listed under a designated symbol on the appropriate stock exchange(s).

Why an Income Trust?

The best candidates for an income trust are businesses with a dominant position in their respective markets, stable or predictable cash flows and some potential for growth. These businesses may achieve better valuations as an income trust than under a corporate initial public offering; in fact, a corporate IPO may not be feasible if the business is not perceived as a high-growth investment.

Income trust units generally trade based on cash yield, with lower yields (i.e., higher valuations) applying to higher quality businesses. Other factors that affect valuations include prevailing interest rates and the supply of other available income trust offerings. Valuations can also be improved by structural aspects. For example, a subordination feature attached to units retained by existing equity owners enhances the value of the units offered to the public. Similarly, improving tax efficiency can increase a unitholder's after tax cash flow, thus increasing value.

Yields on recent income trust IPOs have ranged from less than 9% to over 14%. Although slowly rising interest rates and the large recent supply of income trust product have driven investors to increase their yield expectations, many believe that the sector's fundamentals are sound and that the Canadian market continues to have a hearty appetite for income trusts that own appropriate businesses.

As a recent article in Canada's Financial Post newspaper put it: "The Canadian market's infatuation with income trusts is no passing fancy, and might just end up being the saviour of the Toronto Stock Exchange…". The article continues: "There are even some early signs that foreign firms may be lured to list trust units in the Canadian market because of the looser regulations and the fact that they're better known here than in the U.S.…".

[1] Steve Maich, "TSX's Future could lie in Trusts...," *FP Investing*, May 30, 2002, page IN 1.

Goodmans Recent REIT and Income Trust Deals

- Arctic Glacier Income Fund
- BFI Income Fund
- Calloway Real Estate Investment Trust
- Canadian Apartment Properties REIT
- Canadian Real Estate Investment Trust
- Clearwater Seafoods Income Fund
- CPL Long Term Care REIT
- Firm Capital Mortgage Investment Trust
- FP Newspapers Income Fund
- Heating Oil Partners Income Fund
- H&R REIT
- IPC US Income Commercial REIT
- KCP Income Fund
- Menu Foods Income Fund
- Residential Equities REIT
- Retirement Residences REIT
- The Keg Royalties Income Fund

Goodmans LLP, one of Canada's leading business law firms, has played a major role in the development of the income trust sector, acting as counsel on approximately C$ 2 billion of income trust offerings since January 1, 2002.

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