Cross-Border Income Securities

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Income funds have become increasingly popular in Canada in recent years and have become an investment vehicle of choice for many investors. Private and public companies have found the income fund structure to be a very effective way to raise capital, enhance value and provide liquidity for their shareholders.

From a market capitalization of only C$18 billionin 2000, the Canadian income fund sector has grown dramatically, to approximately C$100 billion today. This growth has been driven by the appetite of the market—particularly retail investors who are approaching retirement—for investments that generate regular, stable and relatively high cash distributions, against the backdrop of low interest rates and a volatile equity market.

Building on the success of income funds in Canada, Canadian investment bankers have recently designed a similar financial product for use in the United States and elsewhere. This product combines a dividend-paying common share with a high-yield debt security to provide an income fund–like investment.

These securities are referred to generically as "income securities," but they are branded under a number of acronyms, including:

- IDSs ("income deposit securities");
- IPSs ("income participating securities");
- EISs ("enhanced income securities");
- EYSs ("enhanced yield securities"); and
- IUs ("income units").

Income securities initially trade as a single unit but are separable into their underlying components at the option of the holder.

Income securities may be issued:

- primarily to U.S. investors (but possibly also to Canadian and other investors) by a U.S. company;
- primarily to Canadian investors (but possibly also to U.S. and other investors) by a Canadian company that invests in a business or assets located in the U.S.; or
- to Canadian, U.S. or other investors by a company with a business or assets outside the U.S. and Canada.

It is also possible for income securities to be issued by a Canadian company with a business or assets located in Canada.

This article will focus on the cross-border aspects of income securities offered in Canada. It will first briefly describe what income funds are and then describe the evolution of income securities from income funds. The article will then discuss the anatomy of income securities and some of the key features of an income securities offering.

Income Funds

In general terms, an income fund is a trust that invests in a portfolio of assets or an operating business that is expected to produce a continuous or recurring stream of income. 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.

Like a public corporation that is governed by a board of directors, an income fund is governed by a board of trustees. Although a corporation is an *entity* subject to its incorporating statute and a trust is a *relationship* subject to its declaration of trust and the common law, the governance of publicly listed corporations and income funds is quite similar for most practical purposes.

Unlike many public corporations, however, income funds typically pay out a significant portion of their free cash flow to unitholders on a regular basis, usually through monthly distributions.

Most income funds have a similar basic structure. A Canadian resident trust is created to indirectly acquire a business or other income-producing assets. The trust undertakes a public offering of trust units, the proceeds of which are used to acquire the business or assets and/or repay related debt.

To the greatest extent possible, an income fund will typically be structured so as to effectively pay out to investors the free cash flow generated by the acquired business or assets on a pre-tax basis. For taxable Canadian unitholders, income fund distributions will generally be considered to consist of a combination of ordinary income, dividends, capital gains and tax-deferred returns of capital. As a result, the overall tax rate applicable to these distributions may be significantly lower than the tax rate applicable to other income-producing investments.

In addition, an income fund will generally be structured so that it is a mutual fund trust for Canadian tax purposes and its units (unlike those of a limited partnership, for example) do not constitute foreign property. This makes income fund units eligible for tax-exempt holders, such as registered retirement savings plans, and exempt from the "foreign property" limits imposed on such holders.

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The Evolution of Income Securities

Resource Royalty Trusts

The first Canadian income funds were oil and gas resource royalty trusts, which originated in the mid-1980s. A resource royalty trust generally uses the net proceeds of a public offering of units to acquire a direct royalty interest in resource properties and to acquire shares and debt of the entity that owns these properties. Trust investors receive income in the form of royalties, interest, dividends and returns of capital.

In some cases, the properties will be managed by an external entity (often the former owner of the assets). Since the performance of resource royalty trusts is generally subject to commodity price risk and their underlying assets are often depleting, the yields on these trusts tend to be higher than on other types of income funds.

REITs

In the early 1990s, a second type of income fund emerged in Canada—real estate investment trusts ("REITs"). Today REITs own investments in a wide range of real estate properties, including office buildings, shopping centers, industrial properties and apartments, as well as specialty assets like nursing and retirement homes and hotels. A REIT generally owns real property directly, although some REITs own equity and debt in underlying trusts, partnerships or corporations that own properties. These latter REIT structures are the precursors to the third type of income fund described below, the business income fund.

A REIT may be able to claim significant amounts of depreciation to offset its taxable income and, accordingly, a significant portion of its cash distributions may constitute a tax-deferred return of capital rather than income. While not included in income, returns of capital reduce an investor's adjusted cost base in its units and, accordingly, are realized for tax purposes when the investor sells its REIT units. As a group, REITs with long-term leases and stable distributions generally trade at lower yields than other types of income funds.

Business Income Funds

A third type of income fund has emerged in recent years. These funds have been formed from a wide variety of operating businesses and infrastructure assets ranging from power, pipelines, telecommunications and transportation to telephone directories, cinemas, restaurants and private label products. Generally, funds of this type will own shares and debt in one or more underlying entities that operate the relevant business. Just as REITs that own shares and debt in underlying entities are the structural precursors of business income funds, the latter are the structural precursors of income securities.

Initially, most of the business income funds brought to market were mature businesses with predictable ongoing capital expenditure requirements. These businesses were typically able to achieve better valuations as an income fund than they would have under a conventional corporate public offerings. Indeed, an income fund structure may be the only feasible vehicle through which many low-growth companies can access the capital markets. However, the range of industries represented within the income fund sector continues to expand and some of the most successful income funds have been formed by higher-growth businesses. A number of companies have utilized the income fund structure to pursue strategic objectives, such as growth by acquisition.

Cross-Border Income Funds

Prior to 2001, a number of Canadian-based income funds had made U.S. acquisitions, but there were no Canadian income funds created to invest exclusively in non-Canadian businesses or assets. This changed with the December 2001 initial public offering ("IPO") of IPC US Income Commercial Real Estate Investment Trust, which used the offering proceeds to invest in a portfolio of real estate assets located exclusively in the U.S. The next cross-border IPO, in early 2002, was by Heating Oil Partners Income Fund, which used the proceeds to acquire an exclusively U.S. distribution business. A number of other cross-border income fund IPOs based on the "fixed investment trust" ("FIT") structure used by Heating Oil Partners were completed in 2002 and 2003.

Like domestic Canadian business income funds, this generation of cross-border FIT income funds were structured as trusts holding a combination of equity and debt in one or more underlying entities. Where the U.S. business is operated by a "flow-through" entity, such as a U.S. partnership or limited liability company, this entity is acquired by a Canadian corporation that issues shares and subordinated notes to the Canadian trust. Where the U.S. business is operated by a "C" corporation, the structure is somewhat more complex: the operating company is acquired by a U.S. holding corporation ("Holdco") that issues shares to the Canadian trust; Holdco also owns the common shares of a new Nova Scotia unlimited liability company ("NSULC") which issues subordinated notes to the Canadian trust. NSULC subscribes for preferred shares of Holdco and the dividends on these shares are used to fund the interest payments on the notes held by the Canadian trust.

To the extent that cross-border income funds are FITs, no U.S. withholding tax is payable on the subordinated note interest and the U.S. "earnings stripping rules," which limit interest deductibility, should not apply. On the IPOs of a number of these funds, U.S. tax lawyers provided opinions that the trust should be treated as a FIT and that the subordinated note interest should be deductible for U.S. tax purposes. There is a risk, however, that the Internal Revenue Service ("IRS") could challenge the interest deduction in the case of a particular fund by trying to recharacterize the notes as equity. There are a variety of factors that have been used by U.S. courts to determine whether debt should be recharacterized as equity.

SFG

On September 15, 2003, Specialty Foods Group Income Fund ("SFG") announced that PricewaterhouseCoopers LLP had decided not to serve as the fund's auditors for 2003. Although SFG's press releases said that PWC had not provided a reason for its decision, SFG said it believed the decision was based upon PWC's uncertainty over accounting for the deductibility of the interest paid on the applicable subordinated notes.

Following this announcement, a number of other cross-border funds announced that their auditors had reviewed their tax structures and determined that they would continue as auditors. Further, as noted in the April 29, 2003 prospectus of ACS Media Income Fund, the U.S. Treasury Department and the IRS had discussed the tax consequences of these transactions with certain counsel and had not indicated any intention to issue rulings or regulations that would be relevant to these transactions.

Nevertheless, the SFG announcement created an environment of uncertainty and concern in which it soon became clear that the FIT structure would no longer be readily marketable for cross-border income fund IPOs.

IDSs and IPSs

Meanwhile, Canadian investment bankers were busy adapting the Canadian income fund structure for use by U.S. companies to raise capital primarily from U.S. investors. Historically, income fund–type securities in the U.S. have primarily been associated with real estate (through REITs) and resource properties (through Master Limited Partnerships).

The new structure—which looked somewhat like an income fund without the trust at the top—would enable operating businesses to access capital on a similar basis. Instead of acquiring units of a trust, investors would acquire a unit comprising a combination of the type of equity and debt securities that are held by the trust in the FIT structures described above.

CIBC World Markets Inc. led the first deal using this structure—a US$250 million IPO of "income deposit securities" for Volume Services of America Holdings Inc.—in December 2003. The majority of the investors were located in the U.S., but there was also a Canadian tranche with a listing on the Toronto Stock Exchange.

In April 2004, BMO Nesbitt Burns Inc. led a C$222 million IPO of "income participating securities" for Medical Facilities Corporation marketed to Canadian investors.

Currently, approximately 15 registration statements have been filed for income securities IPOs with the Securities and Exchange Commission ("SEC"). There are also a number of cross-border income securities offerings in the pipeline to be marketed primarily to Canadian investors. BMO Nesbitt Burns Inc. also led a C$320 million IPO of "income participating securities" for Atlantic Power Corporation in November 2004, again marketed primarily to Canadian investors.

Anatomy of Income Securities

Income securities represent a dividend-paying common share and a high-yield interest bearing note, which are clipped together into one unit listed on one or more stock exchanges. In offerings marketed primarily to Canadian investors, the issuer will typically be a Canadian corporation and the securities will be structured so as not to be "foreign property" for Canadian income tax purposes.

The components of the income securities trade together as a single unit but are separable at the option of the holders after a brief period of time, typically 45 days after the IPO. Once separated, the common shares and notes may be traded separately. This may afford investors the flexibility to hold either the debt or equity components, or both. For example, investors who want the high fixed-interest payments might keep the notes and sell the common shares to investors who are more interested in the shares' potential distribution growth and capital appreciation. However, investors are unlikely to separate income securities into their component elements unless there is a liquid market for the separated securities.

The historical cross-border income fund structure was de-

pendent upon the trust qualifying as a FIT for U.S. tax purposes. As a public vehicle, FITs are relatively restrictive. A FIT can only issue one class of securities and is not permitted to vary its investments (i.e., additional investments by the FIT must be made in the same ratio). The elimination of the FIT from the cross-border income securities structure permits the issuer much greater flexibility. In addition, because the income securities structure eliminates the trust as the public entity, the Canadian tax requirement that a majority of unitholders be Canadian residents at all times is not applicable.

The separability of the equity and debt components of income securities increases the confidence of U.S. tax practitioners that the notes should not be recharacterized as equity. A number of other enhancements have evolved on most of the U.S. and cross-border income securities deals currently pending, which are generally required by the major accounting firms as a condition of their acceptance of the issuer as an audit client:

- *Bachelor Bonds.* At least 10% of the notes must be purchased by investors who do not hold common shares, do not intend to acquire common shares and do not intend to sell notes to anyone who holds common shares. These notes—colloquially referred to as "bachelor bonds" because they are not coupled with common shares—have the same terms as notes included in the income securities and are typically sold by way of a private placement.
- *Spinster Stock.* At least 10% of the common shares must be held separately from the notes—hence the label "spinster stock"—for 24 months. Following this period, these shares typically may be exchanged for income securities or put to the issuer for cash proceeds by reference to the value of an income security. Typically, these shares are held by the pre-IPO equity holders as a retained interest, or they may be separately marketed to new investors by way of a private placement. Depending on the transaction, the spinster stock may or may not be subordinated to the income securities.
- *Market for Notes.* The underwriters of the IPO must represent their intent to facilitate a market for the bachelor bonds and, upon separation, the notes and common shares, even though there may be no obligation to do so.
- *Dividend Block.* The issuer is prohibited from paying common share dividends in certain circumstances, including if the notes are in default or interest payments have been deferred. A waiver of a breach of this restriction will generally require the approval of all of the noteholders (i.e., it must be approved by the bachelor bond holders).
- *Pari Passu with Unsecured Creditors.* Generally (subject to commercial or regulatory restrictions), the notes must rank *pari passu* with the unsecured debt (i.e., trade payables) of the operating entities owned by the issuer. In appropriate cases, this is often achieved by the operating entities giving upstream guarantees of the notes.
- *Opinions.* Legal opinions are required under U.S. and, on cross-border deals, Canadian law that the notes are legally enforceable and should not be subject to equitable subordination.

The term of the notes tends to range from ten to 20 years and they are typically redeemable by the issuer over the final three to five years of the term at a reducing premium.

> **There is a risk that the Internal Revenue Service could challenge the interest deduction in the case of a particular fund by trying to recharacterize the notes as equity.**

Cross-Border Income Securities Offerings

The process involved in a cross-border income securities IPO in Canada is similar to that of a Canadian domestic income fund IPO. However, the cross-border aspects and the structural features outlined above introduce some additional complexity and logistics that tend to extend the timeline and increase costs. One key difference is the involvement of an independent financial advisor who is retained to provide opinions concerning the commercial reasonableness of the terms of the notes. These opinions are relied upon by U.S. tax counsel in providing their legal opinions. There is considerable interaction among the issuer, underwriters, counsel, auditors and financial advisor during the process.

Unlike in the U.S., where it may take several months to clear a prospectus through the SEC, in Canada an IPO (including an income securities IPO) may be completed within four to seven weeks of filing a preliminary prospectus. Although prospectus receipts must be obtained from all provinces and territories of Canada where the offering is marketed, there is a streamlined system under which the regulators in the "principal jurisdiction" provide their first comment letter within ten business days of the filing of the preliminary prospectus, and the regulators in the other jurisdictions provide their comments within a further five business day period. Road shows generally commence after the first comment letter is received, although they may commence earlier or later.

There are other differences between undertaking an income securities IPO in Canada and in the U.S. Some companies may be able to undertake a Canadian IPO where they might not have considered going public in the U.S., since the minimum IPO size required to facilitate liquidity after closing tends to be lower in Canada than in the U.S. Conversely, the smaller size of the Canadian market means that there are

limits on the amount of IPO product that can be absorbed at any particular time: this was evident in the fall of 2002, when a glut of IPO product—some of which were larger offerings than the market was ready for—resulted in a number of deals being postponed or canceled.

Most significantly, Canada has a retail and institutional investor community that is familiar with the income fund structure and a universe of more than 160 existing income funds that provide ready comparables for new offerings of income securities.

Although, from a legal point of view, income securities are issued by corporations—not trusts—and are subject to corporate law rather than trust law, from an economic point of view they behave like income fund units and trade as part of the income fund sector.

Conclusion

Strong investor demand for income funds continues to attract U.S. companies to the cross-border income securities structure. Like income funds, income securities can be used for an IPO by a privately-owned business or for a conversion by an existing public company. Often such businesses are owned by private equity funds that need to realize on their investments within a certain time period. Since the Canadian market values income funds and income securities primarily on the basis of their cash distributions, these structures may provide a more attractive exit option than a private sale or a conventional IPO.

Income securities are now primarily being used in Canada for cross-border deals, and it is unlikely that income securities will replace income funds for domestic transactions. While income securities could be used by Canadian companies in appropriate cases, income funds are an established asset class in Canada and are likely to continue to be the primary structure for IPOs by private Canadian companies and conversions by public Canadian companies. ■

The author wishes to thank Jon Northup, Jennifer Sernaker, Seymour Temkin and Bob Vaux of Goodmans LLP for their assistance in the preparation of this article.

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