Income Funds

RECENT DEVELOPMENTS OF IMPORTANCE

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Searching for Yield: Canadian Income Securities in a Post-Income Fund Environment

The October 31, 2006, announcement by the Department of Finance (Canada) that publicly traded income funds (other than qualifying real estate investment trusts ("Qualifying REITs")) would be subject to tax in the same manner as corporations effectively ended the Canadian income fund era. At the time of the announcement, there were more than 250 publicly traded income funds (including REITs) with an aggregate market capitalization in excess of C$218 billion. During the previous decade, the Canadian income fund sector had grown exponentially and had provided many Canadian (and some international) issuers with an attractive alternative to maximize value by going public in Canada.

While the tax rules applicable to income funds have changed, the factors that drove their growth have not gone away: demand from investors – particularly retail investors – for high yield investment opportunities fuelled by a low interest rate environment, equity market volatility and the income needs of baby boomer retirees. On the contrary, the 2008 financial crisis heightened retail investors' concerns with volatility and interest rates dropped to record lows. Investors' quest for yield continues to have a significant impact on capital market offerings in Canada. In many circumstances, the offering of yield-oriented securities provides an attractive alternative for new issuers seeking to maximize value and existing issuers seeking to lower their cost of capital.

This article will briefly survey certain yield-oriented securities that may be offered by existing and potential issuers looking to raise capital in the Canadian capital markets.

Background

Canadian income funds were first developed in the mid-1980s and were initially focused on 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 also organized themselves as income funds. From 2000 to 2005, the number of income fund issuers and the market capitalization of the sector increased by more than five times and 10 times, respectively. By 2005, income fund equity offerings represented approximately 40 per cent of the dollar value of all equity offerings on the Toronto Stock Exchange (the "TSX").

The income fund structure enabled cash-flow producing issuers (as compared to growth oriented common share corporations) to maximize value by distributing pre-tax cash flow to investors. The proliferation of income funds in Canada was, in large part, attributable to the tax efficiency of the structure. While several different generations of income fund structures were used, the principal objective of each structure – to maximize value by distributing pre-tax cash flow to unitholders – remained the same. In general terms, the income fund structure involved a Canadian resident trust using the proceeds of a public offering to indirectly acquire an interest in an underlying business. The acquired business was either held in "flow-through" form or internally leveraged with debt to ensure that the underlying entities were subject to a minimal amount of entity-level taxation. The income fund itself was not subject to tax provided that it distributed all of its taxable income to unitholders each year.

The new tax enacted on income funds, which came into law on June 22, 2007, generally restricts income funds from deducting certain income distributions to unitholders. In particular, the new tax prevents a specified investment flow-through trust (a "SIFT") from deducting distributions derived from its "non-portfolio earnings".

For purposes of the new rules, a SIFT is broadly defined to include most income funds (other than Qualifying REITs, as further discussed below, and certain funds of funds) and "non-portfolio earnings" includes all income and capital gains derived from assets used to carry on business in Canada and significant investments in Canadian entities. If subject to SIFT tax, an income fund will pay tax on its non-deductible distributions at the combined federal and provincial corporate tax rate (28.5 per cent as of January 1, 2011, for a business resident in Ontario). Unitholders who receive non-deductible distributions from a SIFT 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, as discussed further below. A parallel regime applies to publicly traded partnerships (albeit without an equivalent exception for Qualifying REITs).

For most income funds, the application of this new tax was deferred until the 2011 taxation year (subject to certain limitations on growth during the interim period). As the grandfathering period is set to expire, the vast majority of income funds have converted to corporate form, announced their intention to do so, or have been acquired and taken private. The new SIFT tax is designed to tax income funds and public corporations in a similar manner. As described above, the entity-level tax rate and the taxation of distributions from public corporations and SIFTs generally will be the same. While there are certain circumstances in which it may be advantageous for an income fund to remain a taxable SIFT beyond January 1, 2011, for most issuers the tax advantages of the income fund structure will disappear. From a commercial perspective, there are at least three common reasons why income funds have decided to convert (or have already converted) to corporate form:

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(i) Greater distributable cash flexibility. SIFTs that do not distribute their taxable income to unitholders will be subject to entity-level tax at rates that greatly exceed the general corporate tax rate. Accordingly, trustees must continue to actively manage their distributable cash when considering future acquisitions and capital expenditure requirements. On the other hand, corporate dividend policies are discretionary, providing directors' greater freedom to allocate free cash flow without similar adverse tax consequences.

(ii) Broader investor base. Income funds are structured to qualify as "mutual fund trusts" for Canadian federal income tax purposes. Among other requirements, a mutual fund trust cannot be established or maintained primarily for the benefit of non-residents. Accordingly, most income funds restrict non-resident ownership to less than 50 per cent of the issued units. The same restrictions do not apply to taxable corporations.

(iii) Improved investment profile. As corporations are more easily understood by investors, converting to corporate form may enhance an issuer's access to capital. In addition, corporate shares (rather than trust units) may be a more readily accepted acquisition currency.

In light of the foregoing, most remaining income funds are expected to convert to corporate form in conjunction with the expiration of the grandfathering period. To date, at least 56 income funds have already converted to corporate form, and at least an additional 58 income funds have announced their intention to do so on or around January 1, 2011. To facilitate these conversions, the Department of Finance (Canada) enacted new rules to enable both the exchange of trust units for common shares and the rationalization of the resulting corporate structure to occur on a tax efficient basis (the "Conversion Rules").

Forms of Income Securities

Since the October 31, 2006, announcement of the SIFT tax rules, no new income funds (other than Qualifying REITs) have been taken public in Canada. However, as noted above, investors' quest for yield continues to shape capital market offerings in Canada. In the post-income fund era, investors have found such yield in several different forms of income securities.

Dividend Paying Common Shares

New common share issuers that offer competitive dividends yields have been able to successfully access the Canadian initial public offering ("IPO") market. Recent examples of dividend paying common stock IPOs include Leisureworld Senior Care Corporation, the third largest licensed operator of long term care housing in Ontario (IPO completed in March 2010) and Tricon Capital Group Inc., an asset manager focused on the residential real estate development industry (IPO completed in May 2010).

As of January 1, 2011, converted income funds will represent a significant percentage of dividend paying corporations on the TSX. Many income funds that have converted, or that intend to convert, to a corporate structure have announced that they will continue to pay regular distributions (in the form of common share dividends). The quantum of dividends (and the timing of payment) will depend on the particular characteristics of the converted entity, including the performance of its underlying business and the availability of tax attributes to shelter corporate level income (although many issuers have announced their intention to reduce the level of distributions paid to reflect, among other factors, the impact of corporate taxes).

It is generally anticipated that most dividends paid by public corporations will consist of "eligible dividends". However, public corporations need to carefully manage their affairs to ensure that they do not inadvertently generate certain types of income that cannot be distributed as such. Upon receipt of an eligible dividend, certain investors, such as Canadian individuals, are entitled to an enhanced dividend tax credit that is designed to fully integrate the amount of tax paid at the corporate level; that is, for taxable Canadian individuals, the after-tax yield currently realized on income distributions by income funds will be similar to the after-tax yield on eligible dividends (where the quantum of the dividend is simply reduced to reflect corporate tax rates). However, for other investors, such as tax-exempt investors (including tax deferred plans and pension funds) and non-resident investors, the after-tax yield realized from eligible dividends is significantly less than the yield currently realized from income fund distributions (again, assuming that the quantum of the dividend is reduced to reflect corporate tax rates); these investors are not taxable in Canada and, therefore, are not entitled to the enhanced dividend tax credit.

Cross Border Issuers — High Dividend Common Shares

In recent years, US-based businesses have increasingly looked to the Canadian capital markets for liquidity and growth capital. In appropriate circumstances, and with proper tax structuring, a Canadian high dividend common share structure may provide owners of US-based businesses with a path to liquidity at an attractive valuation. Like income funds, this cross-border high dividend common share structure seeks to enhance value by maximizing cash available for distribution for investors and minimizing tax leakage. The structure may provide a tax-efficient means for US-based businesses to fill a portion of the void left by the end of the income fund era.

In most respects, a cross-border high

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dividend common share is similar to an ordinary dividend paying share: the issuer is a Canadian corporation listed on the TSX which declares eligible dividends to its shareholders on a regular basis (typically quarterly). However, the fact that the issuer's underlying business is carried out primarily, if not exclusively, outside of Canada offers the opportunity to adopt certain cross-border tax planning that would not be available in respect of a purely Canadian business.

Distributions by a high dividend common share issuer will consist of common share dividends from a Canadian public corporation, which generally should be eligible for the enhanced dividend tax credit. Dividends paid by the issuer to US taxable investors will be subject to a 15 per cent Canadian withholding tax (which amount will generally be credible against the investor's US tax liability). Dividends paid to US tax exempt investors should not be subject to Canadian withholding tax.

In general terms, the underlying structure involves a Canadian corporation using the proceeds of a public offering to indirectly acquire, through a US holding company, a US based business which generates significant free cash flow. The acquisition is financed with common shares, as well as preferred shares that are subject to a repurchase agreement. The preferred shares, when viewed together with the repurchase agreement, are a hybrid tax instrument. From a Canadian tax perspective, dividends paid on the preferred shares generally should be considered to have been paid out of non-taxable exempt surplus (provided that such dividends are generated from active business activities in the US) or pre-acquisition surplus of the underlying US entities — neither of which gives rise to current Canadian tax payable. From a US tax perspective, dividends on the preferred shares should be considered to be deductible interest payments, which will reduce or eliminate the US federal income tax payable (although the US earnings stripping rules will limit the permitted aggregate interest deduction to approximately 50 per cent of the target's EBITDA). Furthermore, as a result of recent changes to the Canada-US tax treaty, such interest payments will not be subject to US withholding tax (though dividends paid on the common shares of the US holding company will be subject to withholding tax at a rate of five percent to the extent they are paid out of the earnings and profits of the US holding company; amounts in excess of earnings and profits will not be subject to withholding tax).

Similar to previous cross-border yield-oriented structures, the high dividend common share structure has been designed to maximize cash available to pay dividends to investors by minimizing entity-level taxation. However, the simplicity of the capital structure of the Canadian issuer provides greater flexibility as the target business develops. The robustness of the high dividend common share structure enables the issuer to consider the full spectrum of capital market alternatives as it pursues subsequent offerings and future acquisitions.

Unconverted Income Funds

A minority of income funds have announced their intention not to convert to a corporate structure (at least for the time being) and accordingly will become taxable SIFTs as of 2011. The principal tax advantage of being a SIFT (as compared to a public corporation) is that a trust can continue to return capital to unitholders in the ordinary course in a tax efficient manner. Returns of capital distributed by a trust to a Canadian investor are not taxable, although the unitholder is required to reduce its tax cost in the trust by the amount of the distribution. If the resulting tax cost becomes negative, the unitholder will be deemed to have a capital gain equal to the negative amount, and its tax cost will be reset to zero. Otherwise, any tax consequences are deferred until the units are sold. In contrast, distributions of capital by a public corporation in the ordinary course will be deemed to constitute taxable dividends. Public corporations are only permitted to return capital in very limited and extraordinary circumstances (such as share redemptions and capital reorganizations).

Income funds that currently make significant capital distributions, and that are projecting sufficient tax shelter going forward, may conclude that, in most respects, they will continue to enjoy the benefits of their current structure, despite becoming taxable SIFTs on January 1, 2011. In other words, even though the entity will be subject to the new SIFT tax rules, it will not pay a material amount of SIFT tax where its tax attributes (tax depreciation, financing costs, etc.) offset its income. For example, certain acquisitive REITs may be able to preserve their historical yields without complying with the technical (and continuous) requirements under the Qualifying REIT rules (described below) by becoming taxable SIFTs in 2011.

Unconverted income funds should, however, bear in mind that the Conversion Rules are available only until January 1, 2013. After this time, SIFTs will lose the ability to use these rules to facilitate their conversion to corporate form. While income funds can be converted to corporate form without using the Conversion Rules, there may be a significant administrative burden of ensuring that the conversion takes place on a tax-deferred basis for unitholders (such as individual tax elections) and the resulting structure may be more cumbersome.

Qualifying REITs

The REIT sector has recently experienced a surge of activity, both for existing and new issues. Since January 1, 2010, four IPOs of REITs have been completed, representing more than C$600 million of new equity capital. One example is NorthWest Real Estate Investment

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Trust, whose portfolio of properties is focused on medical and related healthcare services (IPO completed in March 2010). Existing REIT issuers have also taken advantage of investors' demand for quality yield and have issued more than C$3.5 billion in follow-on offerings of REIT units and convertible debentures in the twelve months to September 2010. In addition, the S&P/TSX REIT Index has appreciated more than 18 per cent from January 1, 2010, to October 15, 2010 (and more than 42 per cent in 2009).

The recent expansion of the REIT sector has been facilitated by the exclusion of Qualifying REITs from the SIFT tax regime. The Department of Finance's rationale for exempting Qualifying REITs from SIFT tax was in recognition of the importance of pooled investment vehicles in passive real estate. However, a Qualifying REIT for tax purposes is significantly narrower than what a layperson might consider to constitute a REIT. In fact, when the Qualifying REIT exception was first announced, most publicly listed REITs did not qualify for the exception from SIFT tax. Consequently, many REITs have or are restructuring their operations and streamlining certain activities in order to become Qualifying REITs prior to the expiration of the grandfathering period. Qualifying REITs that satisfy the tests described below, at all times throughout a taxation year, will not be subject to entity-level taxation in such year.

In general, a REIT will be a Qualifying REIT (and therefore not subject to SIFT tax) in respect of a particular taxation year if, at all times throughout its taxation year, it satisfies each of the following conditions:

- 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);
- 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;
- at least 75 per cent of the trust's revenues for the taxation year are derived from: (i) rent from real or immovable properties, (ii) mortgages on real or immovable properties, and (iii) taxable capital gains from dispositions of real or immovable properties; and
- at each time in the taxation year, at least 75 per cent of the total fair market value of the trust's equity value is derived from (i) real or immovable properties, (ii) cash and certain cash equivalents, or (iii) certain government debt.

As noted above, Qualifying REITs must satisfy these conditions at all times throughout the taxation year. Since 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. In addition, the Qualifying REIT rules apply on an entity-by-entity basis, rather than on a consolidated basis. Accordingly, each underlying entity (whether a corporation, trust or partnership) of a Qualifying REIT generally must separately satisfy the four REIT conditions.

REITs that wish to achieve Qualifying REIT status may need to alter or discontinue certain activities that historically supported current yields. In particular, revenues derived from third party management fees and operating components, such as hotels and seniors housing, are not considered to be qualifying revenue for purposes of the revenue tests described above. Accordingly, "operating REITs" as currently structured will not be Qualifying REITs. However, even though the Qualifying REIT rules do not contain the US concept of a "taxable REIT subsidiary", it may still be possible for operating REITs to restructure their affairs in a manner consistent with the Qualifying REIT rules — the evolution of US seniors housing REITs and Australian stapled structures may be helpful in this regard.

In addition to the equity offerings within the REIT sector described above, certain REITs have recently announced proposed plans for a new form of security, preferred units. For technical tax reasons, income funds had historically limited public equity issuances to ordinary common units (convertible debentures were also popular with income funds and REITs). However, a structure is now in place to facilitate the issuance of preferred equity by a publicly traded trust.

The terms of the preferred units are expected to mirror, in many respects, the terms of the rate-reset preferred shares recently issued by financial institutions, as discussed further below. Of notable difference is that unlike rate-reset preferred shares, distributions on the preferred units are expected to be comprised of an income and capital component, in the same relative proportions as paid out to holders of ordinary common units — potentially providing investors with an increased after-tax yield. Preferred REIT Units have proven popular securities in other jurisdictions including the US.

Convertible Debentures

Convertible debentures have been a popular source of financing for public issuers for a number of years and are again proving so — in part because Canada has yet to develop a significant retail market for high yield debt. Since January 1, 2010, more than C$3 billion has been raised by public issuers (corporations, income funds and REITs) in Canada through the issuance of convertible debentures. In general terms, a convertible debenture is a debt instrument that offers investors a fixed interest coupon with the potential for equity upside. Convertible debentures are convertible, at the holder's option, into

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securities of the issuer. The rate of conversion is set out in the terms of the instrument. In some cases, convertible debentures are callable by the issuer, usually at a premium to their issue price. The exchange of the debenture into securities of the issuer should take place on a tax-free basis where the issuer is a corporation. In these circumstances, the holder's tax cost of the convertible debenture becomes its tax cost of the shares.

A convertible debenture may be attractive to investors seeking to mitigate the risks of an equity investment, or supplement the benefits of a debt investment. Convertible debentures also offer investors the potential of receiving different sources of income from a tax perspective throughout the life of the investment.

Preferred Shares

In recent years, Canadian corporations and financial institutions have raised significant equity capital through the issuance of preferred shares. In 2009, more than C$9.5 billion of preferred shares were offered by Canadian issuers; as of September 30, 2010, an additional C$4.85 billion has been raised. Preferred shares are particularly attractive for Canadian banks, because these instruments can be designed to qualify as Tier 1 capital for purposes of satisfying their regulatory capital requirements.

Most of this recent wave of preferred share offerings have been structured as rate-reset preferred shares. Rate-reset preferred shares are issued in perpetuity with a fixed dividend for an initial five-year term, which is set at a spread over the prevailing yield on five-year Government of Canada bonds. At the end of the initial five-year period, the holder can either enter extend for a subsequent five-year period with a fixed coupon rate (with the yield set at the then prevailing five-year Government of Canada bond rate plus the original spread) or convert to a five-year floating-rate preferred share with the yield set as the sum of the yield on three-month T-bills plus the original spread. This process is repeated every five years unless the issuer calls the shares. Rate-reset preferred shares are redeemable at the option of the issuer on every reset date, and outstanding issues are generally callable at any time at a premium. While these preferred shares are not retractable by the holder, liquidity should be available in the secondary markets.

Rate-reset preferred shares offer investors an alternative to fixed rate perpetual preferred shares or non-dividend paying shares. In today's low interest rate environment, rate-reset preferred shares are designed to manage interest-rate and inflation risk. In addition, investors should be entitled to exchange preferred shares at each five-year interval without adverse tax consequences.

Conclusion

Capital market offerings in Canada continue to be shaped by investor demand for yield. With the income fund era coming to an end and interest rates remaining close to historical lows, there are a number of forms of income securities available to new and existing issuers to access Canada's capital markets. In this regard, proper structuring and advice is critical to optimizing cash flow available for distribution, thereby maximizing the value of yield-oriented securities. ■

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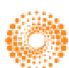

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