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Introduction

Over the past few years, income funds have become an increasingly popular investment vehicle in Canada. With an aggregate market capitalization of over \$176 billion, the Canadian income fund sector currently represents approximately ten percent of the market capitalization of issuers traded on the Toronto Stock Exchange (TSX).¹ In the first nine months of 2005, income fund initial public offerings (IPOs) on the TSX represented more than double the value of common share IPOs. The decision by Standard & Poor's to include income funds in the benchmark S&P/TSX Composite Index starting in December 2005 reflects the acceptance of this asset class by the capital markets.

The dramatic growth of this sector (from a market capitalization of only \$18 billion in 2000) has been driven by the attractiveness to investors of the comparatively high monthly cash distributions typically paid by income funds, particularly in a low-interest-rate environment and a volatile equity market. Canadian income funds and income securities have been used very effectively by private equity firms, owner/managers and public companies to monetize their interests in businesses and assets located both within and outside Canada.

Income Funds Defined

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.

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

Types of Income Funds

The income fund sector may be broadly divided into three component parts:

- Resource royalty trusts;
- Real estate investment trusts (REITs); and
- Business trusts (including infrastructure, revenue royalty and business trusts).

Canadian resource royalty trusts, which originated in the mid-1980s, focus (with some exceptions) on oil and gas resource properties. These trusts experienced a brief downturn when energy prices slid in the late 1990s but have flourished as energy prices have risen in recent years. Resource royalty trusts 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.

Canadian REITs, which originated in the early 1990s, 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 hotels and nursing and retirement homes. As an owner of real property, a REIT is often able to claim significant amounts of depreciation to offset its taxable income. As a result, a significant portion of many REITs' cash distributions will consist of a tax-deferred return of capital rather than taxable income. While not included in income, returns of capital reduce an investor's adjusted cost basis in their units and, accordingly, are realized for tax purposes when the investor sells the units of the REIT.

Over the last few years, a third category of income funds has emerged and has become the largest component of the income fund sector. These income funds have been formed from a wide variety of operating businesses and infrastructure assets, ranging from power, pipelines, telecommunications and transportation to media, manufacturing, retail and other service industries.

Initially, business income funds focused primarily on mature businesses with predictable ongoing capital expenditure requirements. These businesses are particularly well suited to the income fund structure and may achieve better valuations as an income fund than they would

under a conventional corporate public offering. In fact, an income fund may be the only feasible vehicle through which many low-growth companies may 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.

The Structure of an Income Fund

The basic structure of an income fund is generally the same: a Canadian resident trust is created to indirectly acquire a business or other income-producing assets and funds the acquisition and/or refinancing of the business or assets from the proceeds of a public offering of trust units. However, income funds are structured in a number of different ways, including as a trust owning one or more underlying corporations, or as a trust indirectly owning an underlying partnership.

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 pretax basis. For taxable 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. In addition, an income fund will generally be structured so that its units are an eligible investment for certain tax-exempt holders such as registered retirement savings plans.

Certain other structural features particular to income funds are worth noting. In certain instances, distributions on the retained interest held by the vendors of the business to the income fund will be subordinated to distributions to public investors. This subordination feature should enhance the value of the units offered to the public. Sometimes the subordination will apply for a specified time period, but typically the subordination is removed only if certain performance tests (EBITDA and/or distributable cash) are met by the income fund.

Another typical structural feature is a long-term incentive plan (LTIP) for man-

agement based on increases in distributions or distributable cash following the IPO. A typical LTIP will provide for a portion (usually based on an increasing scale) of this increase to be set aside annually to purchase units of the income fund, which are allocated among management and often vest over a period of time. Sometimes the LTIP will provide for new units to be issued from treasury. The purpose of an LTIP is to align management's interests with those of the unitholders.

Creating Income Funds: IPOs and Conversions

While the vast majority of Canadian income funds have been created to acquire privately owned businesses or assets through IPOs, public company conversions have become increasingly popular. In the first nine months of 2005, 19 public companies have converted into income funds. Conversion to an income fund can provide a public company with an attractive means of maximizing shareholder value, a stronger currency for future acquisitions and enhanced shareholder liquidity. On the announcement of a conversion, there has typically been a significant increase in the trading price of the public company's shares.

Generally, a conversion transaction is effected through a plan of arrangement under the corporate statute applicable to the converting public company. The plan generally requires court and shareholder approval. From an income tax perspective, public company conversions have been structured on a fully taxable basis (in which public company shareholders exchange their shares for income fund units) or on a partially tax-deferred basis, (in which certain shareholders may exchange their shares for exchangeable securities of a corporate or partnership subsidiary of the income fund on a tax-deferred basis). Under existing Canadian tax rules, shareholders cannot transfer shares of a company to an income fund in exchange for units of the income fund on a tax-deferred basis.

Exchangeable securities issued in connection with a public company conversion are structured, to the greatest extent possible, to be economically equivalent to fund units, and will general-

ly be exchangeable into fund units. In certain circumstances, there may be a tension between providing existing shareholders with full tax deferral and implementing a tax-efficient structure. Several conversion transactions have been accompanied by a special cash distribution to shareholders that offset the tax liability realized as a result of structuring the transaction on a taxable basis.

An important securities law issue arises where one group of securityholders is treated differently on the conversion transaction than others of the same class: for example, if certain shareholders are offered a tax rollover and others are not. If a related party is involved, Ontario Securities Commission Rule 61-501 — Insider Bids, Issuer Bids, Business Combinations and Related Party Transactions may require a formal valuation, enhanced prospectus like disclosure and majority of minority approval. Numerous other issues also need to be considered in undertaking a conversion, including: spinning off non-core operations to an entity outside the income fund; a concurrent offering of units or a concurrent senior financing; the repayment of existing debt; a cash distribution to shareholders on conversion; and the treatment of existing stock options.

Limited Liability and Indexation

Until recently, there were no statutory limitations of liability relating to trusts in the laws of the Canadian provinces, (other than Quebec) similar to those protecting shareholders of a corporation and limited partners of a limited partnership. The declaration of trust (the constating document) of an income fund generally states that the trustees (and not the unitholders) have exclusive power and control over the business and affairs of the trust. Accordingly, Canadian counsel who are familiar with income funds generally agree that the risk of personal liability being imposed on unitholders is extremely remote. Nevertheless, in the absence of legislation providing for limited liability, some Canadian institutional investors (such as certain pension plans) refrained from investing or limited their investment in income funds. This issue also delayed the inclusion of income funds in the S&P/TSX Composite Index (the Composite), which is Canada's

premier equity index.

The two Canadian provinces where the majority of Canadian income funds are established (Ontario and Alberta) now have legislation that provides that unitholders of publicly traded income funds are not subject to the liabilities or obligations incurred by the trustees of the fund. Introduction of this legislation removed one of the major hurdles to inclusion of income funds in the Composite and on January 26, 2005, Standard & Poor's announced that income funds would qualify for such inclusion.

Prior to inclusion in the Composite, income funds were listed in three separate indices: the S&P/TSX Capped Income Trust Index, the S&P/TSX Capped Energy Trust Index and the S&P/TSX Capped REIT Index. Following inclusion of income funds, the Composite will be regarded as the broad benchmark index for the TSX. In light of the federal government consultation process described below, there was some concern that Standard & Poor's would postpone the inclusion of income funds in the Composite. However, on October 11, 2005, Standard & Poor's announced that it would proceed with its previously announced schedule to include income funds in two phases: on December 15, 2005, and on March 17, 2006.

Securities Regulatory Developments Policy on Indirect Offerings

In December 2004, the Canadian Securities Administrators (CSA) adopted National Policy 41-201 — Income Trusts and Other Indirect Offerings (the Policy). The Policy was the first Canadian securities regulatory instrument that focused exclusively on the income fund structure, providing guidance and clarification to market participants by expressing the regulators' views on how the existing securities regulatory framework should apply to indirect offerings. The Policy has since had a significant impact on prospectus disclosure.

Vendor Liability

One of the CSA's central concerns, as expressed in the Policy, is that in an indirect offering, persons who benefit from the offering may not be assuming appropriate responsibility for the disclosure in the

prospectus. The Policy reflects the CSA's view that vendors who are heavily involved in the public offering process and who receive significant proceeds should have statutory prospectus liability, and that other "active" vendors should have contractual liability to the issuer (in effect for the indirect benefit of the public investors).

The Policy suggests that parties who receive a significant portion of the proceeds of an income trust offering qualify as "promoters." Under applicable securities laws, persons who qualify as "promoters" in an offering are required to sign the prospectus and thereby assume joint and several liability for prospectus misrepresentations in an amount up to the gross proceeds of the offering.

The Policy also reflects the view that parties who receive proceeds but do not sign the prospectus as promoters are, if they are "active vendors" involved in the offering process, expected to assume (by contract) "appropriate responsibility" for the prospectus disclosure. While the Policy is not precise as to what constitutes "appropriate responsibility," it indicates that examples of circumstances where the CSA has had concerns included situations where a vendor's obligation to indemnify the issuer, if the prospectus contains a misrepresentation, is limited to an amount less than the proceeds received by the vendor or is subject to a deductible or other threshold that precludes claims against the vendors that are not, individually or in the aggregate, above a certain value.

Stability Ratings

Stability ratings are ratings of cash flow stability published by independent rating agencies. The Policy requires that if a stability rating is obtained, the rating must be described on the cover page of the prospectus. However, the Policy stopped short of requiring an income fund that chooses not to obtain a stability rating to disclose its reasons for doing so on the prospectus cover page (this was suggested in an earlier draft of the Policy and was widely opposed during the Policy comment period).

Distributable Cash

The Policy requires certain cover-page prospectus disclosure regarding distributable cash concerning, among other things:

- The nonassured nature of distributable cash (and the risks associated with investments in income fund units) to emphasize that the return on an income trust unit is not comparable to the return on an investment in a fixed-income security;
- That an investment in units is subject to a number of risk factors; and
- That the after-tax return from an investment in units can be made up of both a return on and a return of capital.

The CSA provides further guidance on distributable cash disclosure in the staff notice described below.

Debt Disclosure

The Policy requires that an income trust provide detailed prospectus disclosure of all material debt regardless of whether or not it is short-term in nature. The CSA expects that changes to the income fund's debt, including its nonrenewal or renewal on less favorable terms, be included as a risk factor in the prospectus.

Corporate Governance

The CSA recommends that income trusts describe in their prospectuses how they intend to comply with corporate governance requirements (applicable to all issuers). In addition, the CSA recommends that income trust issuers explain how the rights of unitholders may differ from the rights afforded to shareholders under applicable corporate laws.

Notice on Prospectus Disclosure of Distributable Cash

The calculation of distributable cash is a crucial part of an income fund prospectus because it is at the heart of the pricing of the offering. In August 2005, the CSA issued Staff Notice 41-304 — Income Trusts: Prospectus Disclosure of Distributable Cash (the Notice). The Notice provides guidance on the CSA's expectations about the nature and extent of disclosure necessary to ensure transparency when an income fund issuer presents information about estimated distributable cash in a prospectus.

To achieve adequate transparency, the reconciliation of estimated distributable cash to the most directly comparable GAAP measure should be accompanied by detailed disclosure that:

- Explains the purpose and relevance of the estimated distributable cash information;
- Describes the extent to which actual financial results are incorporated into the reconciliation;
- Explicitly states that the reconciliation has been prepared using reasonable and supportable assumptions, all of which reflect the fund's planned courses of action given management's judgment about the most probable set of economic conditions; and
- Cautions investors that actual results may vary, perhaps materially, from the forward-looking adjustments.

The CSA expects adjustments made in the reconciliation of estimated distributable cash to the most directly comparable GAAP measure to be supported by:

- A detailed discussion of the nature of the adjustments;
- A description of the underlying assumptions used in preparing each element of the forward-looking information and the forward-looking information as a whole, including how those assumptions are supported; and
- A discussion of the specific risks and uncertainties that may affect each individual assumption and that may cause actual results to differ materially from the estimated distributable cash.

The Notice states that if the estimated distributable cash information includes forward-looking adjustments that are based on significant assumptions, and those adjustments materially affect estimated distributable cash, the CSA expects the quantitative reconciliation to begin with a GAAP measure that is derived from a forecast. Such forward-looking adjustments should be integrated into the forecast, and the forecast should be included in the prospectus.

Cross-border Income Funds and Income Securities

In recent years, the Canadian income fund vehicle has been used to take public several non-Canadian businesses or asset portfolios. A key attraction of Canadian income funds for American private equity firms and other vendors as a means of monetizing their assets is the available comparables with favorable valuations in

the Canadian income fund sector. Another important attraction is the ability, in general, to minimize execution risk on a Canadian IPO because the timeline from filing a prospectus to closing is generally much shorter than in the United States.

This vehicle was first used by IPC US Income Commercial REIT in December 2001 for the IPO of a portfolio of real estate assets located exclusively in the United States. During 2002 and 2003 there were a number of cross-border REIT and business income fund IPOs.

In early 2004, a new "income securities" structure was developed for cross-border offerings by American businesses, to be marketed in the Canadian income fund sector. This new structure was designed to address rigorous structural requirements imposed by the auditors and U.S. tax advisers in connection with the underlying U.S. tax planning.

Each income security represents ownership of a common share and a specified principal amount of subordinated notes of a Canadian corporate issuer. The income security components trade together as a single unit but are separable at the option of the holders. Once separated, the common share and note may be traded separately. This gives investors the flexibility of holding either the debt or equity security, or both. The structural requirements typically

include the issuance of a separate tranche of debt (bachelor bonds) to one or more persons who do not hold any of the equity, and the issuance or retention of a tranche of equity (spinster stock) separate from the common stock component of the income security.

To date there have been eight IPOs in Canada of cross-border income securities that have not been registered in the United States, and a number of these entities have completed follow-on offerings.

Federal Government Consultations

On September 8, 2005, the Department of Finance (Canada) released a consultation paper on tax and other issues related to publicly listed flow-through entities such as income trusts and limited partnerships and invited interested parties to make submissions prior to December 31, 2005.

The stated focus of the consultation paper is to assess the tax and economic efficiency implications of flow-through entities to determine whether the current tax system is appropriate or should be modified. Although not an exhaustive list, three possible policy approaches were identified in the consultation paper to address the issues relating to flow-through entities:

- Limiting deductibility of interest expense by operating entities;
- Taxing flow-through entities in a

manner similar to corporations; and

- Making the tax system more neutral with respect to all forms of business organizations by better integrating the personal and corporate tax system.

Following the release of the consultation paper, several executives of major Canadian businesses and financial institutions publicly indicated that they might consider income fund conversions or spin-offs primarily to reduce tax. On September 19, 2005, the Minister of Finance (Canada) announced that he had requested that the Canada Revenue Agency postpone providing advance rulings respecting flow-through entity structures pending the consultations; that the Department of Finance (Canada) is closely monitoring developments in the flow-through entity market with a view to proposing measures in response to the consultations; and that consideration would be given to what, if any, transitional measures were appropriate.

On November 23, 2005, the Minister of Finance issued a press release stating that the consultation process has ended, that the Canada Revenue Agency would resume providing advance tax rulings on flow-through entity structures and that the government would reduce personal income taxes and dividends. The Minister of Finance also confirmed to the press that he is not proposing any tax on trusts. ■

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Partner, Executive Committee Member and Chair of REITs and Income Funds Group. Extensive practice in corporate finance, M&A, private equity, project finance, health care and international transactions. Identified as a leading practitioner in *The Canadian Legal Expert Directory*, Chambers Global's *The World's Leading Lawyers* and PLC's *Equity Capital Markets Handbook*. Has played a leading role in the Canadian income fund sector, including creating the first publicly listed REIT to own operating businesses, the first cross-border REIT, the first cross-border income fund and the first income securities offered solely in Canada, and acting on the largest IPO, the largest bought deal and the first mutually initiated merger in the sector. Director and Chair of Governance Committee of The Canadian Association of Income Funds and Chair of the Canada South Africa Chamber of Business. MBA and LL.B. (Gold Medalist) and an author of *The Canadian REIT Handbook*.



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