



FARRIS

Income Trust Conversions

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Tax Effective Structuring Options

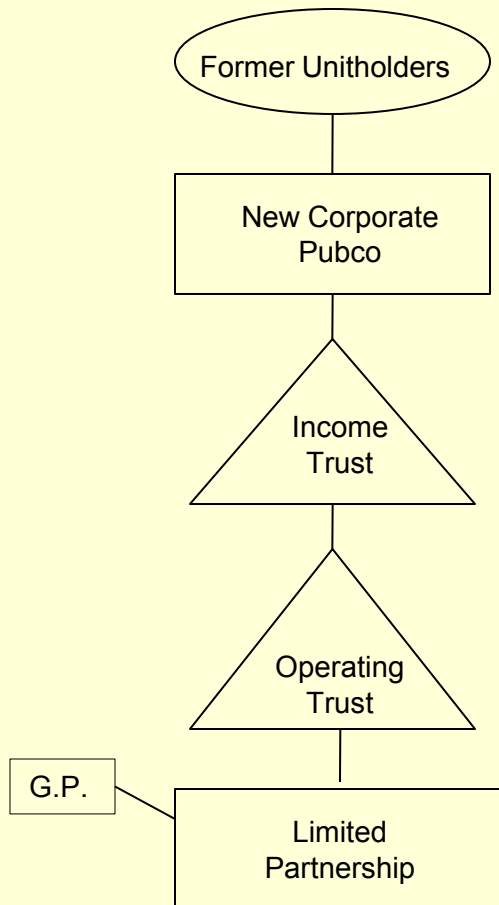
- In its July 14th announcement, the Department of Finance proposed two alternative tax efficient methods of converting an income trust into a corporation
- The proposed legislation provides three new rollover provisions
- Existing income trusts will be subject to entity-level tax at corporate rates beginning in their 2011 taxation year
- Conversions using the new rules must be completed before 2013

Conversions to Date

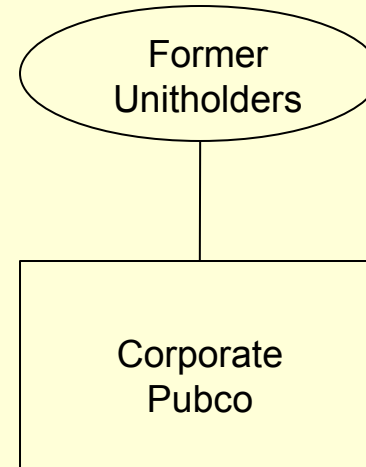
- There have been three conversions to date (i.e., before the new rules) – Aeroplan, Transforce and Rainmaker
- Each has proceeded as a taxable unit-for-shares exchange (with Aeroplan and Transforce also offering a s. 85 election)
- There has been no tax-effective way to windup the income trust (which has therefore remained a subsidiary of the listed corporation)

Post-Conversion Structures

Prior to the New Rules



New s. 88.1 or s. 107(3.1)

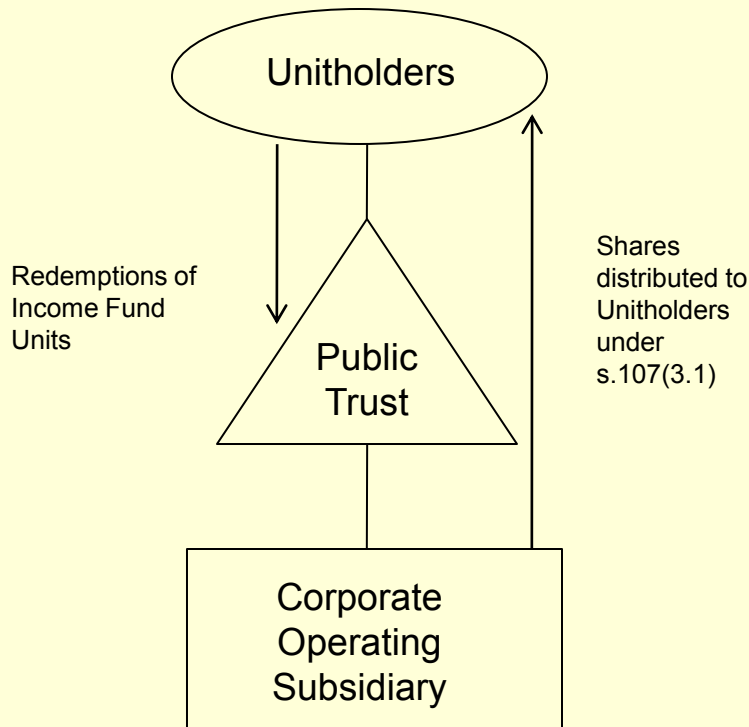


Two Alternative Methods

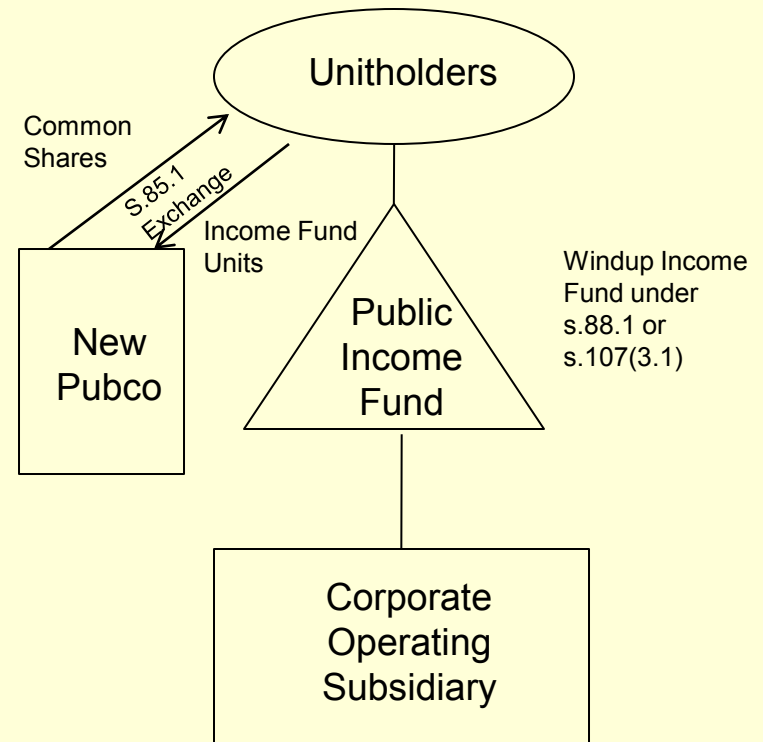
- 1. *Share Distribution Method*** – s. 107(3.1) - Wind up the income trust by distributing the shares of an underlying corporation to its unit holders by way of a redemption of their units on a tax deferred basis
- 2. *Unit for Share Exchange Method*** – s. 85.1(8), plus s. 88.1 or s. 107(3.1) - Unit holders exchange their units for shares of a public company on a tax-deferred basis, followed by the winding up of the trust

Two Alternative Methods

Share Distribution Method



Exchange Method



Share Distribution Method

1. An income trust may distribute shares of a corporate subsidiary pursuant to new s. 107(3.1)
2. Requires that the only property of the income trust be shares of a taxable Canadian corporation
3. This method is available to both ‘first generation’ income trusts (a public income fund with a corporate operating subsidiary)
4. And also to “second and third generation” income trusts (eg. public income funds with an underlying operating partnership owned either directly by the fund or by a trust subsidiary of the fund)

Share Distribution Method – Tax Consequences

1. Income trust deemed to have disposed of the shares for proceeds equal to its cost; unit holder is deemed to have disposed of his units at his cost base and to have acquired the shares at a cost equal to the cost of his units
2. Tax attributes of the trust are lost; e.g. loss carry forwards, tax pools, undeducted financing costs
3. PUC of the shares distributed is the PUC that existed in the shares prior to the distribution

Steps to Convert a First Generation Trust

1. Capitalize the inter-corporate debt of the subsidiary owed to the income fund by converting it to additional equity (or distribute the debt to unitholders prior to the s. 107(3.1) distribution) – may require valuation
2. Simplify the structure so that the only entity owned by the income fund is a corporation
3. If the fund's operating subsidiary is a limited partnership, a reorganization will be required using existing rollover provisions

Steps to Convert a Latter Generation Trust

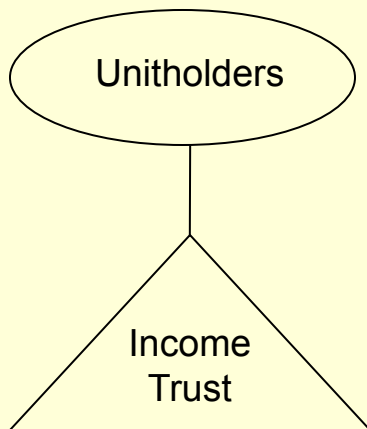
1. If the structure includes a “subsidiary trust”, the assets of this intermediate trust can be distributed to the income trust on a tax deferred basis – special provisions deem there not to be a change of control of the underlying corporation (s. 256(7)) and also permit “under water” debt of the sub-trust to be settled without application of the debt forgiveness rules (s. 80.01)
2. Then, as a second step, these assets are distributed to the unit holders of the income trust – must occur within 60 days of the first distribution
3. Also available if there is a second layer intervening trust but not for three tier structures or where the trusts are only partially owned

Exchange Method

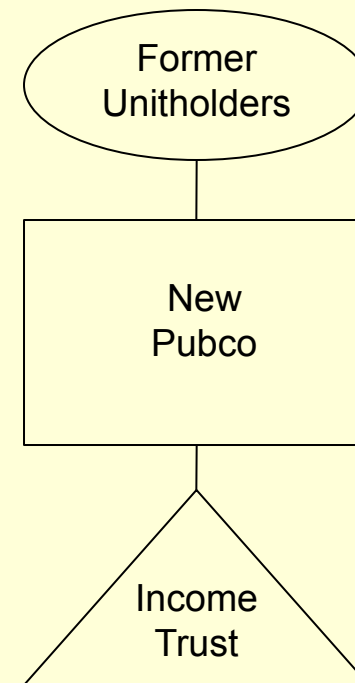
- Either an existing or a new corporation acquires all of the units of the income trust pursuant to s.85.1 – automatic rollover without requirement for individual elections
- Unit holders can receive no consideration in the exchange other than shares
- All of the shares issued in the exchange must be of a single class
- The fair market value of the shares must equal the fair market value of the units

Section 85.1 – Unit-for-Share Exchange

Pre-Exchange



Post Exchange



Second Step Windup

- Once the only beneficiary of the income trust is a corporation, the income trust can be wound up using new s. 107(3.1) or new rules under s. 88.1
- New s. 88.1 (which requires the policy of an election) provides for continuity of “tax attributes” of the income fund; i.e., corporation inherits the loss carry forwards, tax pools, undeducted expenses (except as they may be reduced by application of the change of control rules)
- Assets of income trust deemed to be disposed of for cost; corporation acquires these assets at cost (subject to ability to “bump” the cost of qualifying assets)
- Corporate parent deemed to have disposed of units of income fund at the lesser of cost and “paid up capital” of units (i.e., amount originally received by the fund for the units less capital distributions by the fund) and the distributed shares inherit this PUC

Anatomy of a Typical Conversion

- The typical income trust has a complex structure; e.g., publically listed mutual fund trust; with a subsidiary trust owning interests in a limited partnership which owns an operating business
- Cleaning up this complex structure involves a complex series of reorganizations that generally will be best carried out through a plan of arrangement (POA)
- The POA process should be available so long as there is at least one corporate entity in the structure which is being “arranged”

First step, clean up the subsidiary structure

1. Subsidiary partnerships and corporations can generally be wound up on a tax deferred basis under existing rules
2. An intermediate subsidiary trust can be wound up on a tax deferred basis under amendments to s. 88.1
3. It should be possible to eliminate “under water” inter-corporate debt under existing rules
4. Inter-trust debt can be eliminated under amendments to s. 80.01
5. Exchangeable interests can be rolled under existing s.85(1)
6. Special voting units to be eliminated
7. The income trust must be wound up within 60 days of the windup of its subsidiary trust

Second step - Winding up the income trust under new s. 107(3.1)

1. If the underlying structure can be reorganized down to a single corporate subsidiary, then the simplest way to windup the income trust is to distribute the shares of this corporation to the holders of income trust units by way of redemption of those units
2. The s. 107(3.1) windup does not preserve the tax attributes of the income trust
3. Unitholders get whatever the PUC is of the corporate shares that are distributed

Alternative second step – windup under new s. 88.1

1. First, unit holders exchange their income trust units for shares of a single class of either an existing or a newly established corporation under amendments to s. 85.1
2. The FMV of the shares must equal the fair market value of the income units – this may require valuations where the corporation is pre-existing and has a current business
3. The tax attributes of the income trust are transferred to the corporation – loss carry forwards, undeducted financing expenses, tax basis of assets, resource expenditure pools

Windup under new s. 88.1 - continued

4. Generally, the corporation will assume the income trust's publically traded debt
5. If there is a desire to maintain the leverage of the structure, then the s. 88.1 rollover can be preceded by a distribution of debt (i) by way of a return of capital, (ii) as an exchange of some of the trust units for debt shares on a taxable basis, or (iii) using existing s. 85(1)
6. If some holders of income trust units want to trigger latent losses they can sell into the market prior to the units-for-shares exchange or the income trust can offer a taxable redemption in exchange for shares
7. 60 day deadline to exchange, redeem or cancel the income trust units

Winding up the income fund - comparison of s. 107(3.1) and s. 88.1

	s. 107(3.1) Share Distribution	s. 88.1 Windup
Type of transaction	Tax-deferred distribution of shares of taxable Canadian corporate subsidiary to income trust unit holders by way of redemption of units	Liquidating distribution by the income trust of its assets of all types to a single Canadian corporate parent (similar to a s. 88(1) corporate windup)
Continuity of tax attributes	Tax attributes of the income trust are lost	Loss carry forwards, offering expenses and resource pools transferred to corporation – including ability to ‘bump’
Untoward tax impacts	Non-resident unit holders subject to 15% Part XIII.2 tax on the redemption if the more than 50% of value of units attributable to real property in Canada, Canadian resource property or timber resource property	Taxable distribution if the corporation’s cost of the trust interest is less than both the trust capital (adjusted for returns of capital) and the tax value of the trust’s assets net of its liabilities
Ability to convert to a “leveraged” corporation	Only corporate shares may be distributed to the former holders of income trust units	Under s. 85.1, a portion of the income trust units can be exchanged for shares and debt

Some income trusts may accelerate their conversion

- The new rules facilitate and encourage corporate takeovers of income trusts – s. 85.1 – automatic tax deferred exchanges are now available (no elections)
- The new rules make it easier for income trusts to convert now to access capital markets, to avoid the “normal growth” rules or the mutual fund rules which limit foreign ownership to 50% or to forego regular distributions so as to devote cash to growth
- The market appears to be “over-adjusting” for the loss of flow-through status, so a bump in market valuation may be achieved by converting (earnings v. capitalized distribution valuation model)

Other income trusts may continue to defer conversion

- Income trusts that are delaying conversion to maximize the value of the remaining tax free period will continue to do so
- Income trusts who still expect to be taken private by a private equity or pension fund may wish to retain their current structure
- Income trusts with mainly foreign sources income need not convert
- Income trusts may chose not to convert even after they become taxable in 2011 in order to continue to make tax free distributions of capital
- Other income trusts may defer conversion beyond the end of 2010 because they have sufficient tax shelter to remain non-taxable
- The deadline for tax deferred conversions using the new rules is the end of 2012

Other factors to consider

- Appropriate capital structure – generally, income trusts have conservative debt/equity ratios (1.0 times to 2.0 times)
- Restructuring of management incentive compensation plans – rollover now available for unit option plans – but the new rules do not address the rollover of long term incentive plans (“LTIPs”)
- Dividend policy – Replicate an income trust with a high dividend policy
- “Churn” of investor base
- IFRS – Jan/2011 implementation date
- Tax ramifications to non-resident investors

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