

STIKEMAN ELLIOTT

# Income Trust Conversion Guide

REVISED 2010 EDITION

STIKEMAN ELLIOTT LLP

# Income Trust Conversion Guide

## Introduction

On October 31, 2006, the Canadian income trust landscape was radically altered when the Minister of Finance (Canada) announced tax changes aimed at taxing most income trusts at corporate tax rates in respect of certain distributions made to unitholders. On July 14, 2008, the Minister of Finance released draft legislation which included two different methods to enable a trust to convert into a publicly traded corporation, generally on a tax-free basis for the trust and its unitholders. Stikeman Elliott LLP published a guide shortly after the release of this draft legislation which discussed the newly proposed conversion rules and some of the issues that a trust would need to consider in determining whether, and if so when and how, to convert to corporate form.<sup>1</sup> The purpose of this updated guide is to identify the material legal issues, from both a tax and non-tax perspective, that an income trust that has decided to convert to corporate form will need to consider. In particular, this guide discusses issues relating to governance, corporate and commercial matters, tax and employment arrangements.

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## Tax Changes for Trusts

The October 31, 2006 announcement by the Minister of Finance marked a dramatic change in the tax treatment of income trusts. Under the new policy, most income trusts would be taxed at corporate tax rates in respect of certain distributions made to unitholders. For new trusts, the tax would take effect immediately. For existing trusts (those that were publicly traded as of October 31, 2006), the new tax would be deferred until 2011, provided that the trust experienced only “normal growth” and did not engage in “undue expansion” before then. The tax changes, once effective, essentially eliminate the comparative advantage of the income trust structure. An exemption

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<sup>1</sup> The conversion rules have been amended since the previous guide was published. The discussion in this publication has been updated to reflect such amendments.

from these tax changes is provided for certain “qualifying” REITs, but this category is very tightly circumscribed.

In mid-December of 2006, the Department of Finance (Canada) provided guidance on the meaning of normal growth, which has since been incorporated by reference into the *Income Tax Act* (Canada) (the Act). Under these so-called “normal growth guidelines”, a trust is allowed to grow by a specified amount that does not exceed the greater of Cdn\$50 million per year, non-cumulative, and a prescribed “safe harbour”, measured by reference to the market capitalization of the trust on October 31, 2006. The net impact of this was to permit a trust to grow by up to the greater of \$200 million and a 100% increase in capital over the four-year transition period, measured from October 31, 2006. Other guidance, including guidance with respect to debt and the merger of two or more trusts, was also provided.

On December 4, 2008, the Department of Finance (Canada) announced changes to the normal growth guidelines to allow a specified investment flow-through (SIFT) trust to accelerate the utilization of the SIFT trust’s safe harbour room so that its normal growth room remaining on December 4, 2008 could be used immediately. This announcement did not change the amount of a SIFT trust’s normal growth room, but rather allows the trust to use its remaining growth room in a single year, instead of staging it (i.e. 20% per year) over the 2009 and 2010 years.

### **Alternatives Available to Income Trusts**

The changes to the tax treatment of income trusts have posed an existential dilemma for income trusts, one that is magnified as we move closer to January 1, 2011. In general, a trust has the following basic alternatives:

- Convert to a corporation;
- Be acquired; or
- Stay the course and, if possible, attempt to position itself so as to maintain as tax-efficient a structure as possible in a post-2010 environment.

The decision as to which of the above-noted alternatives is best suited for a particular income trust depends on a number of considerations. The decision will be influenced by the unique characteristics of the trust, such as its size, business, performance, distribution policy and

underlying tax situation. The remainder of this section addresses some of the key considerations in deciding whether and when to convert to corporate form.

### *The Loss of the “Tax Holiday”*

The primary consideration for an income trust in deciding whether to convert to a corporation pre-2011 may well be the cost to the trust of forgoing the “tax holiday” as weighed against the non-tax benefits that would be realized by assuming corporate form and being immediately subject to tax. Factors that will need to be considered in calculating the value of the “tax holiday” to the trust include:

- The estimated cash taxes (if any) payable by the trust, after 2010, as a trust, compared to the cash taxes that would be payable before and after 2010 if the trust were a corporation. The tax attributes of the trust, such as its available tax loss pools and depreciable assets, may place it in a position to more easily absorb the impact of the proposed changes in the tax rules. Some larger trusts may also have the capacity to increase their leverage through additional debt capitalization, thereby potentially shielding additional income from tax.
- The business performance of the trust and the current (and expected future) level of cash distributions. This will impact the estimated amount of future cash taxes after conversion (or after 2010). To the extent that a trust’s business performance has declined, the potential value of the tax holiday may be reduced.
- Income trust units have value in the capital markets as yield-paying instruments, and can suffer a correspondingly greater proportionate impact, relative to shares of a corporation, as a result of a reduction in distributions, thereby impacting the trust’s cost of capital. Therefore, as a practical matter, if a trust intends to change its distribution policy, whether as a result of changing business performance or for some other reason (such as a change in capital requirements or strategic direction) this could diminish the value of maintaining an income trust structure.

- The capital needs of the business and the extent of available growth opportunities.
- The undue expansion rules limit a trust's ability to raise additional equity capital and/or acquire additional businesses, potentially increasing the cost of capital of the trust and/or restricting the trust's ability to expand its operations, although the acceleration of a trust's ability to use its remaining normal growth room provides some limited flexibility. The impact of the limitations imposed by the undue expansion rules can be magnified if the industry peers of the trust are corporations that are not subject to the same restrictions. The willingness of investors to provide additional capital, and whether this might be improved in one form or another, must also be considered.

### *The Trust's Capital Markets Profile and Distribution Policy*

The capital markets profile of the trust will be relevant to any decision by the trust to convert to a corporation. Relevant considerations include:

- The directors of the corporation will need to determine what the dividend policy of the post-conversion corporation will be (i.e., high dividend, low dividend or no dividend). This ultimately involves a determination of where on the spectrum between pursuing a policy of active growth and expansion (i.e., primarily seek to invest earnings in the business of the corporation) and a more "steady state" program (i.e., maintain capital assets, but otherwise distribute available cash to its shareholders) the corporation will position itself.
- Historically, income trusts have been generally high yielding, lower growth investments, and as such have tended to attract a specific investor base (i.e., yield-seeking investors). While those yields have in many cases moderated in recent years, conversion to a corporation, particularly if it is accompanied by a change in distribution policy, could lead to yield-seeking investors moving to higher yielding assets, which would negatively impact the share price of the post-conversion corporation.
- To the extent the post-conversion corporation's business generates significant free cash flow, a high-dividend policy

post-conversion may enable a premium valuation, thus lowering the cost of capital.

- Unlike income trusts, corporations are not generally subject to restrictions on the level of ownership by non-residents. As a result, the conversion to corporate form may expand the base of potential investors.
- Many smaller trusts (i.e., trusts with a market capitalization of less than \$100 million) did not realistically have access to the public capital markets in a corporate form, as it was their characteristics as income trusts that made them attractive to investors. Given the lack of liquidity in these smaller trusts, as well as their lack of institutional investors (and analyst coverage), there may simply be no demand for such trusts in corporate form. This would exacerbate the shorter-term selling pressures that might otherwise arise as a result of a conversion decision (recognizing, however, that as a result of the changes to the tax regime, there is already diminished, and diminishing, demand for these trusts in any form).
- Although prior to October 31, 2006 there was little difference in the relative liquidity of corporations and trusts, corporations are now significantly more liquid than business trusts. As a result, trusts' access to capital may have deteriorated, affecting the analysis of conversion timing and capital intensive activities.
- Conversions associated with a positive impact on unit price typically have no operational concerns associated with the conversion, have accumulated tax pools sufficient to defer taxes (either organically or by virtue of the participation of a tax-loss vehicle in the conversion) and result in limited changes to their existing distribution policy.

### *Dealing with a Retained Interest*

Many income trusts feature “retained interests”, such as individual equity interests held by the pre-IPO owners of the underlying business of the trust. As further discussed below, the presence of a retained interest will give rise to a number of separate considerations, both from a tax and corporate governance perspective. A retained interest holder frequently has substantial governance rights and protections, including

veto rights over certain kinds of transactions by the trust. As a result, the decision to convert will generally involve consultation with the holder of any retained interest.

### *Existing Debt and Employment Arrangements*

The impact of the conversion on debt arrangements, employment arrangements and other contractual agreements must be considered at an early stage.

The conversion may trigger consent or change of control provisions, such as in the existing credit facilities and other debt arrangements of the trust and entities within its group, or it may require more substantive amendments due to the change in organizational structure. Regardless of the nature of the conversion, the decision to convert will invariably require prior consultation with the trust's bank syndicate, other lenders and other parties to ensure that the intended post-conversion structure is satisfactory to such parties and any modifications necessary to accommodate their concerns can be addressed at an early stage.

In an employment context, depending on whether employment agreements have single-trigger or double-trigger change of control provisions, the conversion may trigger change of control payments.

### **Trust Conversion Methods**

While a conversion by a trust to corporate form could have been achieved under the pre-existing tax rules, such a conversion was cumbersome, as joint tax elections by the trust and its unitholders were required in order for the conversion to be tax-deferred and the pre-existing tax rules did not facilitate the winding-up of the underlying trust structure. On July 14, 2008, the Minister of Finance released draft legislative proposals that, among other things, introduced two different methods to enable a SIFT trust to convert into a publicly traded corporation, generally without material adverse tax consequences for the trust or its unitholders.

#### *Exchange Method*

The first conversion method (the Exchange Method) generally allows the unitholders of a SIFT trust to transfer their units of the trust to a corporation in exchange for shares on a tax-deferred basis, without the need for a joint election to be filed by the unitholder and the corporation. The trust and certain subsidiaries can subsequently be

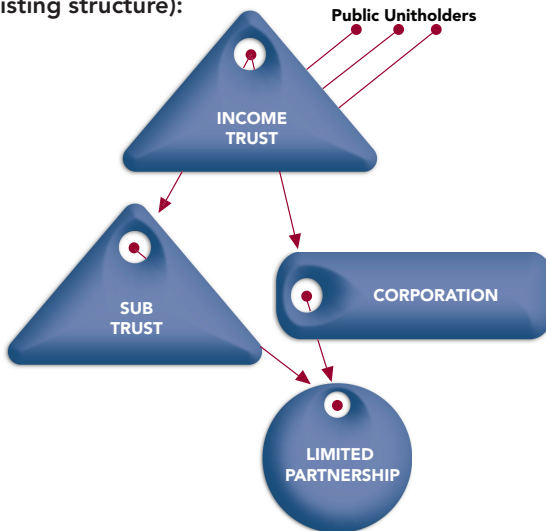
wound-up into the corporation without adverse tax consequences and certain tax attributes of the trust and its subsidiaries can flow through to the corporation.

While the Exchange Method will allow for a tax efficient conversion of an income trust into a public corporation, it should also apply to an acquisition of an income trust by a corporation pursuant to which unitholders of the trust receive shares of the acquiring corporation in consideration for their units, regardless of whether the resulting entity is controlled by the former unitholders of the trust or otherwise.

The diagrams below illustrate, on a simplified basis, the various steps in the Exchange Method.

## EXCHANGE METHOD

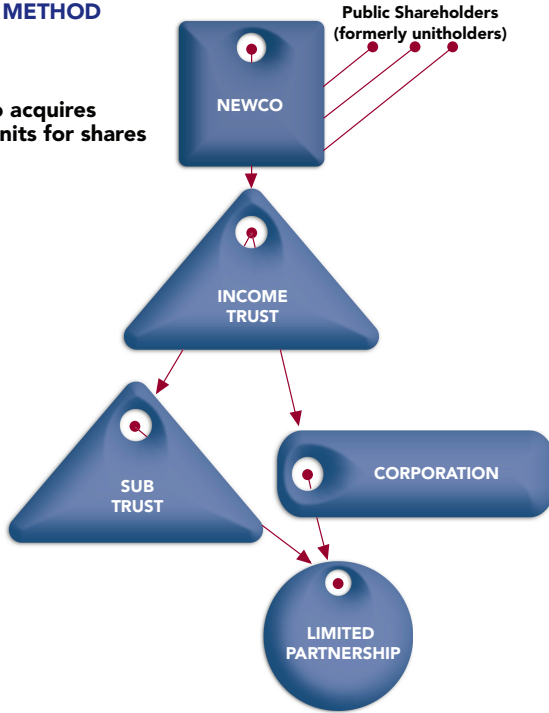
Step 1 (existing structure):



**EXCHANGE METHOD**

**Step 2:**

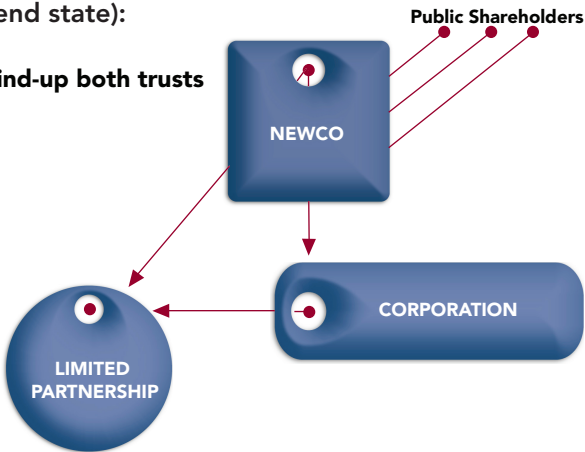
**Newco acquires trust units for shares**



**EXCHANGE METHOD**

**Step 3 (end state):**

**Wind-up both trusts**



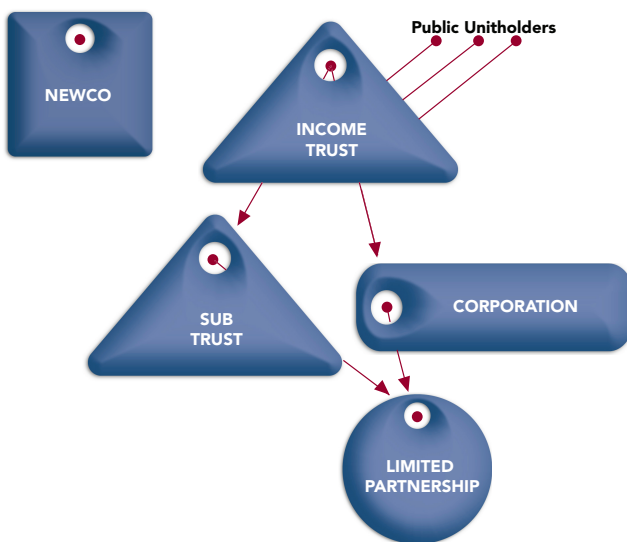
## Distribution Method

The second conversion method (the Distribution Method) allows a SIFT trust (or a subsidiary trust of a SIFT trust) whose only asset is shares of a taxable Canadian corporation to wind-up and distribute the shares of that corporation to the unitholders on a tax-deferred basis. Once again, the new rules allow this transaction to be effected on a tax-deferred basis at the unitholder level without the need for a tax election to be filed by the unitholder. Unlike the Exchange Method, the Distribution Method generally does not result in any carry-over to the resulting corporation of the tax attributes of the trust.

The diagrams below illustrate, on a simplified basis, the various steps in the Distribution Method.

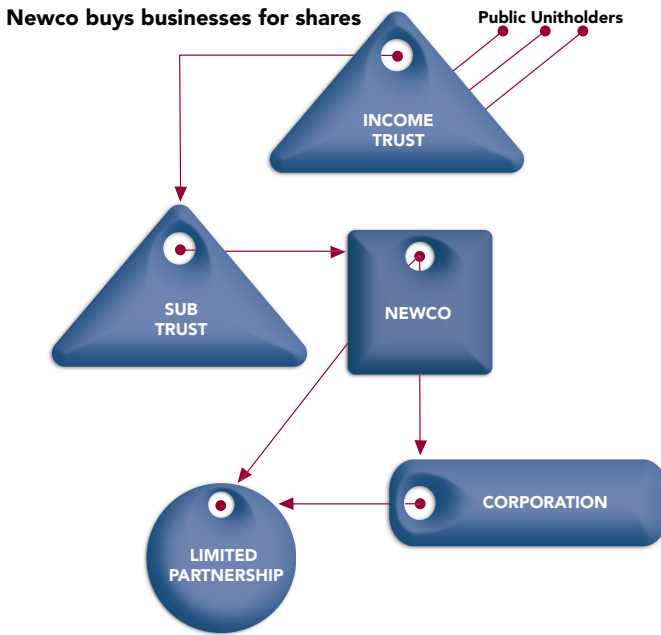
### DISTRIBUTION METHOD

#### Step 1 (existing structure):



## DISTRIBUTION METHOD

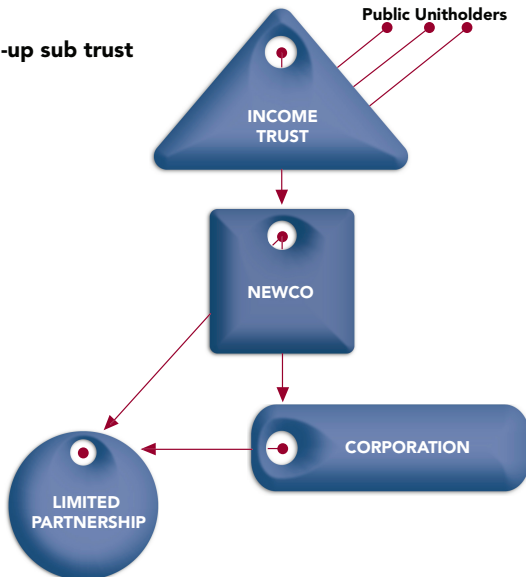
Step 2:



## DISTRIBUTION METHOD

Step 3:

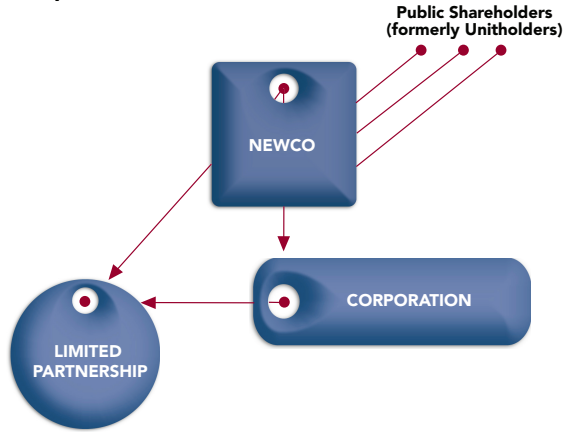
**Wind-up sub trust**



**DISTRIBUTION METHOD**

Step 4 (end state):

**Wind-up income trust and distribute shares**



## Trust Conversions to Date

The following is a list of some of the conversions that have occurred or been announced since October 31, 2006:

Trust	Conversion Method	Date
True Energy Trust	Exchange Method	Scheduled for October 28, 2009
Cathedral Energy Services Income Trust	Undisclosed at date of publication	Scheduled for 2009
Black Diamond Income Trust	Undisclosed at date of publication	Scheduled for 2009
PDM Royalties Income Fund	Exchange Method	Scheduled for October 10, 2009
Algonquin Power Income Fund	Exchange Method	Anticipated on or around October 27, 2009
Alliance Grain Traders Income Fund	Exchange Method	September 15, 2009
Colabor Income Fund	Exchange Method	August 25, 2009
Advantage Energy Income Fund	Distribution Method	July 9, 2009
Home Equity Income Trust	Exchange Method	July 3, 2009
Crescent Point Energy Trust	Exchange Method	July 2, 2009
Ag Growth Income Fund	Exchange Method	June 3, 2009
Total Energy Services Trust	Exchange Method	May 20, 2009
Progress Energy Trust	Exchange Method	January 15, 2009
Superior Plus Income Fund	Distribution Method	December 31, 2008
Bonterra Energy Income Trust	Exchange Method (applied retroactively)	November 12, 2008
BFI Canada Income Fund	Exchange Method	October 1, 2008
Rainmaker Income Fund	Unit redemption (taxable)	August 1, 2008
Aeroplan Income Fund	Exchange Method (applied retroactively)	June 25, 2008
Transforce Income Fund	Share for unit transfer under section 85	May 14, 2008
Trinidad Energy Services Income Fund	Share for unit transfer under section 85	March 10, 2008
Fairborne Energy Trust	Unit redemption (taxable)	December 19, 2007
High Arctic Energy Services Trust	Unit redemption (taxable)	June 29, 2007

## TAX-FREE CONVERSION METHODS

### Checklist of Issues

A decision by a trust to convert into corporate form, and a determination of the most appropriate method to do so, is complex, and involves a number of considerations. Discussed below are some of the principal legal issues that will need to be considered where a trust proposes to convert into corporate form. Although these issues are considered separately, many of them are in practice largely interrelated.

### Tax

#### *Time Limits for Conversion*

The Exchange Method applies to conversions that are effected on or after July 14, 2008 and before January 1, 2013. The Distribution Method applies to distributions made after July 14, 2008 and before January 1, 2013. The 2012 deadline will encourage conversions even if a trust might have tax pools available that would otherwise have allowed it to efficiently exist as a trust post-2012.

Under the Exchange Method, all of the exchanges of trust units for shares of the corporation must occur before 2013 and within a 60-day period, at the end of which all of the equity of the SIFT (defined, essentially, as all of the outstanding units) is owned by the acquiring corporation. The trust and any subsidiary trusts may then be wound-up, within a 60-day period of the first liquidating distribution by the trust or a subsidiary trust.

Under the Distribution Method, a 60-day maximum period to distribute the shares is imposed, and the transaction must again occur before 2013. While both methods impose a 60-day time limit, the time limit is measured differently under each method.

#### *Single Class of Shares*

One of the requirements of the Exchange Method is that the exchange must result in all unitholders receiving shares of a single class in the capital stock of a corporation as the sole consideration for their trust units. After the proposed conversion rules were released, the requirements of the Distribution Method were changed to also provide that the shares distributed must be of a single class in the capital stock of a corporation. However, if multiple classes of shares are desired, it may be possible to carry out a tax-deferred internal

reorganization of the new corporation after the conversion in order to reorganize the single class of shares received on conversion into multiple classes of shares. This reorganization raises a number of corporate and securities laws issues, and as a result might prove difficult to implement, but may be necessary if there is a desire for multiple classes of shares post-conversion.

### *Trust Assets*

The Distribution Method requires that, on the wind-up and distribution of the assets of the trust, the only asset of the trust must be shares of a single class in the capital stock of a taxable Canadian corporation. Any trusts seeking to rely on the Distribution Method will need to ensure that this condition is satisfied. In order to satisfy this condition, any non-share assets of the trust could first be transferred to a new company (on a tax-deferred or “rollover” basis) prior to winding-up the trust. A reorganization of the capital stock of the corporation in which the trust holds shares could be carried out (on a tax-deferred basis) to satisfy the requirement that the shares of such corporation held by the trust are of a single class.

### *Equal Value Requirements*

Under the Exchange Method, the shares of the corporation received on the conversion as consideration by the unitholders must have a value equal to the value of the units exchanged, a requirement that might potentially cause some difficulties depending upon the circumstances, and may lead to the desire for additional financial advisory opinions. The manner in which the market will value the units immediately before, and the shares immediately after, the conversion transaction will need to be assessed and previous conversion transactions, such as those listed in the previous section, may be instructive in this respect. To the extent that the market aligns the price of the units and the shares issued on conversion, the “equal value” requirement may not be a significant issue in certain conversions.

Under the Distribution Method, there is no “equal value” requirement, which may be advantageous in certain circumstances, such as facilitating a third party acquisition at a premium. In addition, if one or more other parties have a retained interest in the trust or its subsidiaries (including quite frequently the operating entity itself), the conversion to corporate form may, depending on the circumstances, either positively or negatively impact the retained interest holder(s). In

light of the “equal value” requirement under the Exchange Method, this, as well as any security holder agreements to which the retained interest holders are a party post-conversion, may preclude the Exchange Method and require the Distribution Method.

### *Options and Other Equity Compensation Arrangements*

The SIFT conversion rules expanded the scope of the rules relating to exchanges of stock options to provide for tax-deferred exchanges of options to acquire trust units for corporate options having the same “in-the-money” amount. In particular, rights to acquire units of the converting SIFT trust can be exchanged on a tax-deferred basis for rights to acquire shares of the corporation used to carry out the conversion. One aspect of the pre-conversion analysis should include confirming that the trust’s option plan satisfies the applicable requirements of the Act, otherwise a tax-deferred exchange will not be available.

While options can roll-over, other equity compensation arrangements, such as unit appreciation rights, restricted unit rights, deferred unit rights, unit purchase plans and LTIPs, are generally not afforded the same tax-deferred treatment on a reorganization.

### *Continuity of Tax Attributes*

On the wind-up of the trust and certain of its subsidiary entities, the Exchange Method allows the flow-through of certain tax attributes (including amortizable issue expenses, tax losses, and resource expenses) of the trust and its subsidiary entities to the corporation. In addition, the “deemed” paid-up capital of the resulting shares for tax purposes will be equal to the amount received by the trust on the issue of the former trust units less all amounts paid as a return of capital on such units. The paid-up capital of former unitholders’ shares of the corporation, which at least initially has a single class of shares in accordance with the requirements of the Exchange Method, is therefore impacted by returns of capital on the units of the trust regardless of whether a unitholder received such returns of capital. However, pursuant to the Act, such returns of capital reduced the adjusted cost base of the units, and such adjusted cost base is deemed to be the adjusted cost base of the former unitholders’ shares of the corporation.

Unlike the Exchange Method, the Distribution Method generally does not result in any flow-through to the resulting corporation of the tax

attributes of the trust. However, it may be possible to utilize some of the trust's tax attributes prior to the conversion. For example, if the trust has assets other than shares of a taxable Canadian corporation, given that only shares of a taxable Canadian corporation can be distributed under the Distribution Method, the additional assets could be transferred into the subsidiary corporation on a partially or entirely taxable basis in order to make use of the trust's tax attributes.

### *Realizing Accrued Losses*

If the conditions of either the Exchange Method or the Distribution Method are met, the conversion transaction is automatically tax-deferred to the unitholders of the trust and the unitholders do not have to file tax elections. Thus, to trigger a tax loss (if applicable) on the conversion, a unitholder will likely have to sell its units, or the resulting shares, on the open market. Alternatively, if a number of unitholders have accrued losses, it may be possible to structure the conversion to allow the losses to be utilized (i.e., by offering to redeem units prior to the conversion).

### *Plans for the Future/Use of Losscos*

One factor in particular that will be relevant in determining the appropriate conversion method is whether the intention is for the trust to continue its business operations, albeit in a different structure, following the conversion or rather cease operations (i.e., as a result of a distribution of the trust's assets to unitholders, a sale of the trust assets, a takeover, or a merger with another entity). For example, if the trust will be acquired by a third-party and the acquisition vehicle is a corporation, the Exchange Method may allow such transaction to occur in a tax-efficient manner (i.e., with the existing corporation acquiring the trust in a transaction in which the unitholders of the trust receive shares of the acquiring corporation in consideration for their units).

In addition, some trusts have converted through the utilization of an existing corporation that has accrued losses (a Lossco), using the Exchange Method or the Distribution Method. Certain conversion transactions that have involved a Lossco have been carried out essentially by having the Lossco take the place of "Newco" in the diagrams representing the Exchange Method and Distribution Method above. Where the losses have arisen from a business that is not similar to the business of the trust, the transaction must be structured to ensure that an acquisition of control does not occur in respect of the Lossco in the course of the steps of the transaction.

Post-conversion, assuming that the transactions are effective, the existing tax losses are then utilized by the business of the converted trust, thereby extending a form of tax shield for the business.

### *Multiple Subsidiary Entities of the Trust*

As previously noted, the conversion rules allow the wind-up of the trust and its subsidiary trusts in a tax-effective manner (after the exchange of units for shares in the case of the Exchange Method). Under the Exchange Method, where there are multiple subsidiary trusts (i.e. third- and lower-tier trusts), the second-tier trust, and any trusts that become a second-tier trust as a result of a wind-up, must be wound-up prior to the wind-up of the parent trust (i.e., the SIFT). Under the Distribution Method, where there are multiple subsidiary trusts, the subsidiary trusts must be wound-up first, from the bottom-up, such that the lowest-tier trust is wound-up first and the parent trust (i.e., the SIFT) is wound-up last.

### *Retained Interests*

Many income trusts feature “retained interests”, which for tax (and other) reasons are often held at a different structural level than the public (i.e., often directly in the underlying operating business), are usually exchangeable for units of the trust, and often carry voting rights at the trust level on an “as if exchanged” basis.

Given the foregoing, a trust with a retained interest raises a number of issues that would need to be addressed in structuring any conversion to corporate form, including the following:

- Whether the retained interest is also to be “converted”, and if so, at what ratio? Note that the Distribution Method requires that the only property being distributed be shares of a taxable Canadian corporation however, there is no requirement that the trust own all of the shares of such subsidiary corporation. Therefore, in a situation involving a “trust on corporation” structure, where a third party has a retained interest in the subsidiary corporation, the requirements of the Distribution Method may still be met.
- If the retained interest is subordinated and the tests for ceasing the subordination have not yet been satisfied, a conversion of the retained interest may disadvantage either the unitholders, who would presumably be diluted by a full conversion of the retained interest, or the retained interest holder, who could potentially lose the ability to meet the

test for terminating the subordination. Either possibility raises potential issues regarding the “equal value” requirement of the Exchange Method.

- What, if any, governance rights will the retained interest holder continue to enjoy following the conversion, and how will these rights be given effect? The presence of these governance rights may require multiple classes of shares (i.e., special shares that are held by the retained interest holder) and/or impact the value of the shares being issued in exchange for units, in either case raising potential issues regarding the availability of the Exchange Method.

### *Convertible Debentures*

A number of income trusts have issued convertible debentures and, in that case, the conversion transaction would need to address this as well, as a tax-deferred rollover may not be available for debentureholders, at least not under the Distribution Method. The provisions in the Act relating to the Exchange Method clearly provide a tax-deferred rollover for holders of debentures or similar obligations of the trust that are assumed by the post-conversion corporation. However, the provisions of the Act are arguably less clear as to whether such a tax-deferred rollover also occurs under the Distribution Method. This lack of clarity may prompt trusts with outstanding debentures, such as convertible debentures, on which there are significant accrued gains to favour the Exchange Method.

### *Non-Resident Unitholders*

Non-residents who dispose of a capital interest in a SIFT trust (determined without reference to the rule that defers application of the SIFT rules until 2011 for existing trusts) will not be subject to the withholding tax and notification requirements in section 116 of the Act where the interest is a unit of a mutual fund trust or if the security is listed on a recognized stock exchange (as defined in the Act) at the time of the disposition.

The tax-deferred nature (for Canadian income tax purposes) of the unit for share exchange under the Exchange Method applies equally to non-resident unitholders.

Part XIII.2 of the Act imposes a 15% income tax on certain distributions paid or credited by mutual funds to non-resident investors. However, Part XIII.2 has been amended so as to exclude

amounts paid or credited as part of the wind-up of a SIFT trust or its subsidiaries under the Distribution Method from the 15% tax.

Under both the Exchange Method and the Distribution Method, shares acquired by a non-resident as consideration on the disposition of trust units will be taxable Canadian property if the units disposed of were taxable Canadian property. Therefore, non-resident holders of such shares may be subject to Canadian income tax, and the withholding and notification requirements in section 116 of the Act, on subsequent transactions involving such shares.

## **Corporate Governance**

### *Retained Interests*

As previously noted, many income trusts feature retained interests, which are usually exchangeable for units of the trust, and often carry voting rights at the trust level on an “as if exchanged” basis. The retained interests also frequently have substantial governance rights and protections, including veto rights over certain kinds of transactions by the trust. Many retained interests are “subordinated” in priority of distributions to the public, and generally cannot be exchanged for trust units during the period of subordination. The subordination typically continues for a specified period of time, and may in certain cases also require that certain cash distribution and/or other performance measures be met by the trust before the subordination ceases. Note that the specific subordination provisions of each particular trust, if any, need to be carefully considered, as they vary from trust to trust.

The presence of a retained interest gives rise to a number of potential issues relating to the Exchange Method and the Distribution Method, as discussed above. In addition, the impact of the conversion transaction on the retained interest holder could potentially give rise to “minority approval” requirements if the retained interest holder, in effect, gains a benefit (or is treated differently, which may give rise to a “deemed” collateral benefit) under the conversion relative to its pre-conversion position.

### *Non-Resident Investors*

A Canadian income trust suffers a substantial tax penalty if it loses its status as a “mutual fund trust” for tax purposes. An income trust

will generally not be considered to be a “mutual fund trust” if it has (among other things) been established or is maintained primarily for the benefit of non-residents. Although there is no “bright line” with respect to the level of non-resident ownership after which a trust will be regarded as being maintained primarily for the benefit of non-residents, out of an abundance of caution a significant number of Canadian income trusts limit the level of non-resident ownership to no more than 49.9%. By contrast, corporations are not generally subject to the same non-resident ownership restriction (although some Canadian companies may be subject to foreign ownership restrictions for regulatory reasons specific to their business).

### *Compensation Arrangements*

The existing compensation arrangements of the trust and the entities in its group, such as certain long-term incentive plans, may not be suitable post-conversion. As a result, new equity compensation programs may be implemented, and the implementation of such programs would generally require securityholder approval and potentially also minority securityholder approval.

## **Debt Arrangements**

### *Consent and Change of Control Provisions*

The terms of the debt arrangements of the trust and the entities within its group must be considered to determine whether the conversion will trigger consent or change of control requirements. Bank debt typically prohibits a change of control and other fundamental transactions without lender consent.

Public debt often, but not always, features a put right (whether based on a premium to the principal amount of the debt (usually 101%) or another metric such as the yield to maturity of a government bond, plus a premium) in favour of the debt holders on the occurrence of a change in control. Depending on the precise language of the put right in question and how the conversion is structured, it could trigger this put right. Most newer convertible debenture indentures specifically exclude transactions undertaken in contemplation of the SIFT rules from being considered a change of control, but older unamended indentures would need to be closely analyzed.

## *Covenants*

In addition, it is necessary to consider whether the business (and/or its lenders) require a different covenant package post-conversion. The trust (and its lenders) will need to consider whether the original covenant package is still workable (in the case of the business) or sufficient (in the case of its lenders) in a post-conversion environment.

## *Servicing Existing Debt Obligations*

The existing debt obligations of the trust and its group of entities must be considered to confirm that such debt obligations can be serviced post-conversion. The conversion to corporate form will result in the loss of the trust's "tax holiday" and as a result the cash taxes payable by the business may increase, reducing the amount of cash available to service ongoing interest payment obligations.

## *Internal Debts*

The debt forgiveness rules in the Act have been amended and will provide relief from the debt forgiveness rules where a subsidiary trust is wound-up into the parent trust (i.e. the SIFT trust) and any debts owing by the subsidiary trust to the parent trust are settled for no consideration or for an amount less than the adjusted cost base of the debt. In such circumstances, an election can be made such that the debt is deemed to have been settled by payment of an amount equal to the adjusted cost base of the debt. As a result, the parent trust should not incur a capital gain or loss and there should be no income inclusion for the subsidiary trust as a result of the debt settlement.

## *Convertible Debentures*

A number of income trusts have issued convertible debentures, and in these cases the conversion transaction needs to address such issuances as well, as a tax-deferred rollover may not be available for the debt holders. The following issues must be considered:

- From a mechanical perspective, what will debentureholders receive on a "post-conversion" exercise of their own conversion rights into equity?
- What will be the likely impact of the income trust conversion, and any related changes, on the post-conversion share price, and how will this in turn impact the convertible debentures?

## **Employment Issues**

The existing management compensation and employment arrangements of the trust and the entities in its group must be considered to determine how the conversion may impact such arrangements.

### *Equity Compensation Plans*

The typical income trust tended to focus more on cash distributions rather than growth, and as a result equity compensation plans often took the form of long term incentive plans (LTIPs), which based entitlements on the level of cash distributions, as compared to option programs, which reward increases in equity value. Although LTIPs were suitable for trusts, they may not provide as meaningful a performance incentive within a corporate structure, and as a result the trust will need to consider whether to redesign its equity compensation programs. As noted above, the implementation of new equity compensation programs would generally require securityholder approval, and potentially also minority securityholder approval.

Depending on the language of the existing compensation arrangements and the structure of the conversion, the conversion transaction itself could trigger the early “vesting” of rights under existing compensation arrangements, which would also need to be considered (and addressed) as part of the pre-conversion analysis.

As previously noted, while options can roll-over for tax purposes, other arrangements such as unit appreciation rights, restricted unit rights, deferred unit rights, unit purchase plans, LTIPs and the like, are generally not afforded the same treatment.

### *Management and Employment Agreements*

Existing employment agreements will need to be reviewed to determine whether a conversion triggers severance or change of control payment entitlements. In addition, such agreements must be considered to determine whether there are assignment or consent requirements or amendments to the terms of the agreements are needed.

While generally not an issue, it is also important to be aware of potential concerns regarding constructive dismissal when a conversion results in any material change to an individual’s terms and conditions of employment.

### *Collective Agreements*

Existing collective agreements must be reviewed to ensure that there are no obligations to consult or notify unions of the change in corporate structure.

### *Non-Competition, Non-Disclosure and Non-Solicitation Agreements*

Existing non-competition, non-disclosure and non-solicitation agreements must be reviewed to determine whether new agreements are required following the change in structure.

### *Compensation Plans and Pension Plans*

All compensation and pension plans should be reviewed to determine what plan amendments will be necessary to reflect the new structure.

## **Procedural and Timing Matters – Plan of Arrangement**

The process for implementing a conversion will, in most circumstances (excluding acquisitions that may be structured as a take-over bid, for example) be by way of a plan of arrangement.

A plan of arrangement is a court sanctioned procedure whereby a corporation may reorganize itself, combine with another corporation or corporations or otherwise effect one or more fundamental changes under the applicable corporate statute. At first blush the application of these principles to a trust conversion might seem inappropriate. However, the courts have given the corporate provisions very broad scope and interpreted them to apply to transactions where a corporate entity is involved, regardless of whether the primary vehicle or entity being reorganized is a non-corporate entity.

### *Arrangement Agreement*

Completing the trust conversion as a plan of arrangement requires the entities involved in the conversion (for instance the Newco, Lossco or third party acquiror) and the trust to enter into an arrangement agreement setting out the terms and conditions upon which the arrangement is to be completed. Where the transaction is part of an acquisition, the process will usually be initiated by the parties entering into a letter of intent or letter agreement pursuant to which the principal terms of the deal, such as exchange ratios for the outstanding securities (if applicable), are established. In such circumstances, the definitive arrangement agreement will in addition deal with such

matters as covenants of the parties, representations and warranties and conditions precedent to the parties' respective obligations under the agreement. In trust conversions that amount to internal reorganizations only, the representations and warranties and conditions precedent will be much reduced.

In addition, the arrangement agreement would have the plan of arrangement appended to the arrangement agreement as a schedule. The plan of arrangement is the document which, when approved by applicable securityholders and the court and filed under the relevant corporate legislation, effects the proposed trust conversion.

### *Information Circular*

The proposed arrangement must then be submitted for approval to the affected securityholders of the corporation or corporations to be arranged and other participating securityholders (in most cases, however, the only securityholder approvals required will be those of the trust), which will require the preparation of a management information circular providing the relevant securityholders with information respecting the proposed arrangement.

### *Unitholder Approval*

Approval of the trust conversion will ordinarily have to be obtained from a majority of at least two-thirds of the votes cast by the unitholders, although the threshold for approval, as well as whether and how the unitholders, other securityholders and creditors of the trust are to be divided into classes for purposes of voting on the trust conversion, is at the discretion of the court. The general approach of the courts is to divide securityholders and/or creditors who are affected differently into different classes for approval purposes.

Although corporate legislation does not require that dissent and appraisal rights be granted to unitholders in connection with a plan of arrangement, in practice such rights are usually granted to unitholders by the court. These rights, if granted and properly exercised, entitle unitholders to dissent from the plan of arrangement and be paid the fair market value of their units.

### *Court Approval*

The court is involved in the arrangement process and must ultimately approve an arrangement. This will require a minimum of two appearances before the applicable court: (a) the first appearance will

be to apply for an interim order pursuant to which the court will give directions on the calling and giving of a notice of meeting of the unitholders, the majority by which the unitholders (and any other securityholders, if necessary) must approve the arrangement and the conduct of the meeting; and (b) the second appearance will follow the holding of the unitholders meeting and obtaining the necessary approvals and will be to obtain the court's final approval of the arrangement.

### *Timing*

Compliance with applicable laws respecting the giving of notice and calling of special securityholders meeting(s) and the time required for preparation of the management information circular will in most circumstances require a minimum of approximately 100 days between the time the trust (and other third parties in the context of a negotiated transaction) has determined to proceed with a trust conversion (or agreed to an acquisition) by plan of arrangement and the effective date of that arrangement. A brief outline of the material action items in that context are as follows, recognizing that estimating the time to complete a trust conversion will be dependent in each case on a number of factors that will be specific to the particular entity involved and which could materially impact this timing:

Internal discussions on trust conversion structure, involvement of external advisors and outline of material considerations, refinement of conversion issues and retained interest holder discussions	Day -45 <sup>2</sup>
Execution of arrangement agreement	Day 1
Notice to Canadian Securities Regulatory Authorities and depository of proposed unitholder meeting	Day 1
Public announcement of transaction	Day 1
Preparation of information circular and related documents	Day 1 - 30 <sup>3</sup>
Application to the court for, and receipt from the court of, interim court order in respect of arrangement (usually approximately two days prior to mailing date)	Day 28
Record date for unitholders entitled to receive materials (applicable law prescribes any time between 30-60 days preceding the date of the meeting)	Day 31

<sup>2</sup> We have inserted a 45 day period of internal and external discussion and refinement as an example only of the time it might take to advance the consideration of the trust conversion strategy to the point of executing the arrangement agreement. The circumstances and complications associated with each trust and its internal structure, unitholder make-up, retained interest holder(s), tax situation and other factors may agitate for a greater period of time.

Printing of information circular and related documents	Day 32
Mailing of information circular and related documents to unitholders (at any time prior to 21 days plus 4 business days prior to unitholder meeting)	Day 36 <sup>4</sup>
Meeting of unitholders	Day 61
Application to court for a final court order approving arrangement	Day 62
Closing of the arrangement (the arrangement becoming effective on the filing of articles of arrangement under the applicable corporate legislation)	Day 62
<b>Total</b>	<b>From ~ 100 Days</b>

### *Additional Considerations*

The completion of a conversion may in certain circumstances constitute a “business combination” pursuant to applicable minority securityholder protection legislation and result in additional obligations being imposed on the trust which would impact the process undertaken and the timing for the completion of the conversion.

Specifically, pursuant to applicable legislation, an issuer undertaking a “business combination”<sup>5</sup> must obtain:

- Minority Approval – the approval of unitholders at a meeting, excluding the votes attaching to securities that are beneficially owned, or over which control or direction is exercised by, the issuer, an interested party, a related party of an interested party and a joint actor of certain parties; and
- Formal Valuation – a formal valuation of the units by an independent valuator, the specifics of which must be disclosed in the information circular delivered to unitholders in connection with their consideration of the plan of arrangement effecting the conversion.

<sup>3</sup> The exact number of days required to prepare the information circular and related documents for use at the unitholder meeting to approve a plan of arrangement will be a function of the complexity of the transaction, the effort of the parties and their counsel and other factors that cannot be anticipated at this time and therefore cannot be specified.

<sup>4</sup> The exact number of days cannot be determined until a specific meeting date is established, as an intervening weekend may necessitate additional calendar days to incorporate the requisite 4 business days prior to the 21st day prior to the unitholder meeting.

<sup>5</sup> A business combination includes an arrangement pursuant to which the interest of a holder of equity securities of the issuer may be terminated without the holder’s consent, regardless of whether that equity security is replaced with another security, subject to certain limited exclusions.

There are exemptions to both the requirement for Minority Approval and the preparation of a Formal Valuation. Those exemptions would be available in most circumstances, though the ultimate determination as to their availability will obviously be context dependent.

### **Additional Matters**

- In addition to debt arrangements and management and employment agreements, all other contracts to which the trust or an entity within its group is a party must be reviewed to determine if any change of control or consent provisions apply, and whether amendments to the terms of the agreements are needed.
- Accounting implications, including the complexity that will result from the January 1, 2011 replacement of Canadian GAAP by International Financial Reporting Standards (IFRS) must be considered.
- Consideration must be given to whether the conversion transaction requires regulatory (in addition to stock exchange and securities regulatory) approvals.
- Consideration must be given to whether unitholders will have rights of dissent under any conversion, and if so the impact on the trust of the exercise of those rights.
- In the event of a conversion, consideration will need to be given by the trust to the timing and payment of its final distributions.
- A conversion transaction will require legal and accounting advisors and, in most cases, financial advisors, and the trust must ensure that all required advisors are retained.
- We expect that the trustees of a trust will usually want to receive a fairness opinion from their financial advisors to the effect that the consideration to be received by unitholders on conversion is fair, from a financial point of view, to the unitholders of the trust. This analysis will usually be made without regard to the tax consequences to individual unitholders of the conversion transaction. As a result, we expect that in most cases the critical component of the analysis will be the net cost to the trust of foregoing the tax holiday and the expected “steady state” market

price of the shares versus the trust units. This analysis may also be influenced, however, by factors unique to the trust, including particular structural concerns (i.e., how any existing retained interest is dealt with under the conversion) and capital markets concerns, such as the resulting corporation's dividend policy, the growth constraints arising as a result of the undue expansion rules and the foreign ownership restrictions applicable to income trusts.

- Value equality opinions (if available) may also be requested in the event a conversion proceeds under the Exchange Method.
- If the “trust conversion” is effected by way of the acquisition of the trust by a third party, then additional regulatory considerations may apply, including approval under the *Competition Act* (Canada) and the *Investment Canada Act* (Canada). ■

October 9, 2009

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