

Income Trust Conversion Guide

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Introduction

Income trusts have played a relatively unique role in Canadian capital markets over the last few years and, with the recent changes to their tax treatment and the newly proposed “conversion” rules, they promise to do so for at least another few years. This guide sets out a brief discussion of the issues for income trusts, including a review of the newly proposed conversion rules and a discussion of some of the important issues that will need to be considered by income trusts in determining whether, and if so when, to convert to corporate form. Considerations include the loss of the “tax holiday”, the impacts on existing debt and employment arrangements, the new distribution/dividend policy to be adopted and general implementation matters. The conversion rules may also facilitate acquisitions by third parties of income trusts.

The Original Income Trust Advantage

The original advantage of the income trust structure stemmed from its ability to allow all or most of the available cash flow of the underlying business to pass into the hands of the trust unitholders without taxation at the corporate level. This resulted in an increased amount of cash available to unitholders as compared to the same business operating in a corporate structure. The typical income trust achieved this result through the use of one of two structures. Figure 1 is an example of a typical (although simplified) “trust-trust-limited partnership” structure, and Figure 2 is an example of a typical (although simplified) “trust-corporation” structure. In most cases, the structures are in fact more complex variations of these basic structures.

Figure 1.

TRUST-TRUST-LIMITED PARTNERSHIP

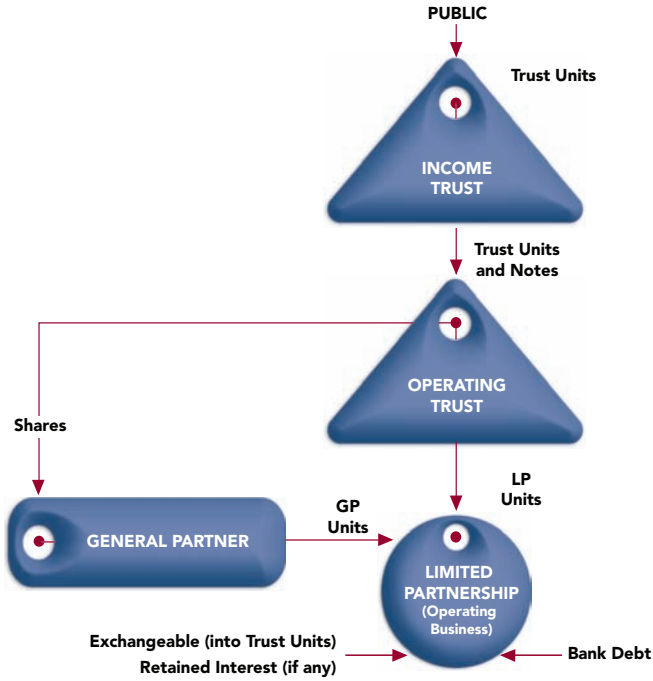
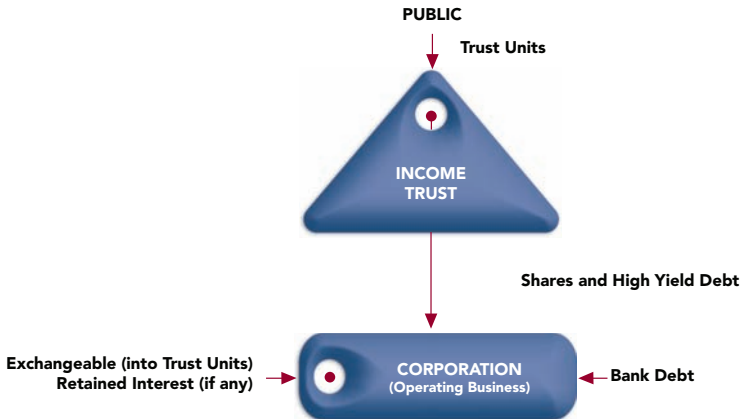


Figure 2.

TRUST-CORPORATION



In each case, the structure was designed to allow the cash flow of the operating business to pass into the hands of the income trust and then its unitholders without material taxation at the operating level. The “trust-trust-limited partnership” structure accomplished this through the use of a limited partnership, a pass-through entity for Canadian income tax purposes that could allocate substantially all of its income from the operating business to the income trust. The “trust-corporation” structure accomplished the same result through the use of a levered corporation, with the amount of high-yield debt generally being sufficient to shield most or all of the expected earnings of the corporation from taxation.

The tax and yield advantages of the income trust structure meant that unitholders were willing to pay a substantial premium, relative to share equity values, to purchase trust units, particularly in a low interest rate environment. Since Canada’s capital markets lack a competing high-yield product like high-yield bonds, income trusts also filled a specific niche. The high multiples at which income trust units typically traded, as well as the demand for income trust products, had an important impact on Canadian capital markets. First, the demand for trusts ensured that a number of smaller Canadian businesses that would not have otherwise had access to the public markets could obtain such access through a trust structure. Second, trusts (and especially quality trusts) had a low cost of capital relative to Canadian corporations. A number of trusts used this low cost of capital to make accretive acquisitions, both within and outside of Canada.

On October 31, 2006, however, the Canadian income trust landscape was radically altered when the Minister of Finance (Canada) announced a dramatic change to the tax treatment of income trusts, with the aim of taxing most trusts at corporate tax rates (a rate of approximately 31.5%) in respect of certain distributions made to unitholders. For new income trusts, the tax would commence immediately. For trusts that were publicly traded as of October 31, 2006, the new tax is to be deferred until 2011, provided that the trust does not engage in “undue expansion” before then. The tax changes, once effective, will essentially eliminate the comparative advantage of the income trust structure. An exemption

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

The Department of Finance (Canada) subsequently provided guidance in mid-December of 2006 on the meaning of undue expansion. Under the guidance, 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 safe harbour is that a trust can 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. The Department of Finance also indicated that the merger of two or more trusts, each of which was publicly traded on October 31, 2006, would not be considered growth, provided that there was no new net addition to equity as a result of the merger. Other guidance, including regarding debt, was also provided.

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;
- Complete a sale, whether to another trust, to management or to a strategic or financial buyer; 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.

Real estate investment trusts (REITs) may also need to restructure to ensure that they can remain as qualifying REITs after 2010. This may, however, be impossible for hotel and senior care REITs.

The initial reaction of many income trusts to the new tax rules was to complete a sale, and to date over 30 Canadian business trusts have

been involved in merger/acquisition transactions. The ongoing challenges facing the debt markets have, however, reduced the attractiveness of this alternative for most trusts. By contrast, as of July 1, 2008, only a handful of income trusts have converted, or formally announced an intention to convert, into corporate form. One likely reason is that until recently, the tax rules required to facilitate a conversion to corporate form in a tax-efficient manner did not exist.

New Tax Rules Proposed to Facilitate Tax-Free Conversions

On July 14, 2008, the Minister of Finance released draft legislative proposals that seek to implement certain measures from the 2008 federal Budget as well as certain previously announced tax changes, including amendments to the rules relating to specified investment flow-through (SIFT) trusts and partnerships that were announced in December 2007. Also introduced were 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. The proposals also allow options to acquire trust units to be “rolled over” for tax purposes to corporate options having the same “in-the-money” amount. The SIFT conversion rules will apply to conversions that are effected after July 14, 2008 and before January 1, 2013 and, on election, may also apply to conversions occurring after December 20, 2007 and prior to July 14, 2008. 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. As the rules are out for comment, it is anticipated that some minor changes may still be made, which may address certain remaining technical issues.

Conversion Methods

The proposed SIFT conversion rules set out two different tax-efficient conversion methods: the “Exchange Method” and the “Distribution Method”. Each is discussed in detail below.

The Exchange Method — Put a Company on Top of the Trust

The SIFT conversion rules generally allow the unitholders of a SIFT trust to transfer their units of the trust to a corporation in exchange for shares of the corporation on a tax-deferred basis. While such a transfer is possible under the current rules of the *Income Tax Act*, the new rules allow this tax-deferred transfer to be effected without the need for a joint election to be filed by the unitholder and the corporation. In addition, the new rules will allow the trust and certain subsidiary trusts to be subsequently wound up into the corporation without adverse tax consequences, and will permit the flow-through of certain tax attributes of the trust and its subsidiary entities to the corporation.

While this 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.

To take advantage of this procedure, the transfer, which must occur before 2013 (thus incentivizing trusts to convert), must result in all unitholders receiving, within a 60-day period, shares of a single class of a corporation as sole consideration for their trust units. As well, the shares offered in exchange must have a value equal to 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. If these conditions are met, tax deferral is automatic and unitholders will 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).

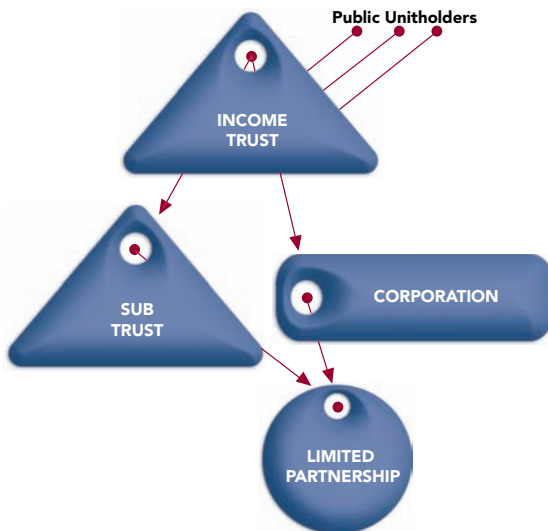
Following this exchange, the income trust and subsidiary trust(s) may then all be wound-up, also by 2013 and within a 60-day period of the first liquidating distribution by a lower level trust. This

method provides for a carry-over to the resulting corporation of certain tax attributes (including amortizable issue expenses, tax losses and Canadian exploration expenses) of the trust. As well, 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. Based on the current conversion rules, it appears that only two layers of trusts will be permitted to be wound-up on a tax-free basis, which, unless amended, may cause difficulties for more complex income trusts that include more than two layers of trusts in their structure.

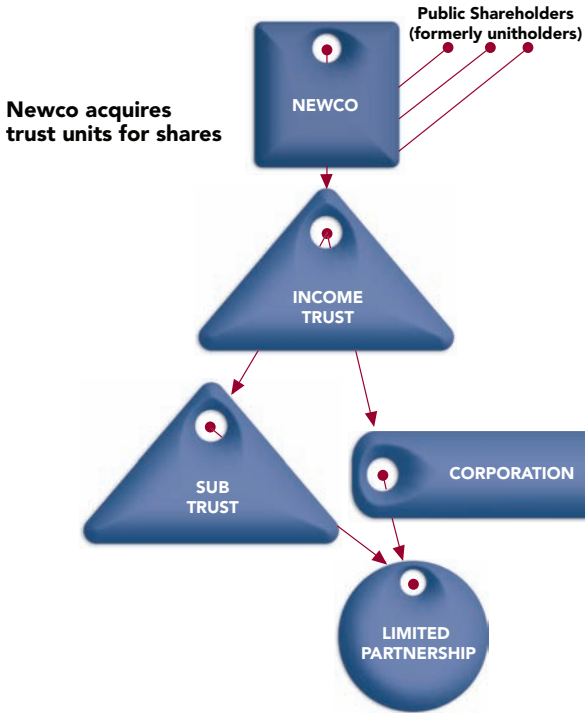
The diagrams below illustrate, on a simplified basis, the various steps in the Exchange Method.

Step 1 (existing structure):

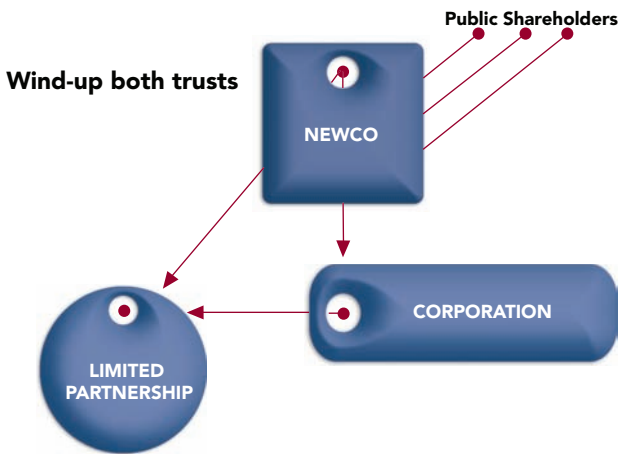
EXCHANGE METHOD



Step 2:



Step 3 (end state):



The Distribution Method – Distribution of the Trust’s Assets

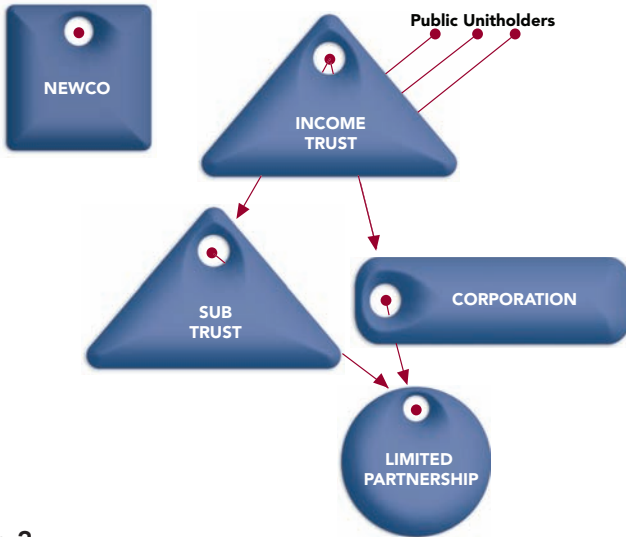
Alternatively, a SIFT trust (or a subsidiary trust of a SIFT trust) whose only asset is shares of a taxable Canadian corporation may wind-up and distribute the shares of the corporation to its beneficiaries on a tax-deferred basis. This entails transferring all of the trust’s assets to a company in return for shares of that company. A 60-day maximum period to distribute the shares is imposed, and the transaction must again occur no later than 2013. In order to be eligible under this rule, all non-share assets of the trust could first be transferred to a new company (on a tax-deferred or “roll-over” basis). Once again, the new rules allow this transaction to be effected and tax deferred at the unitholder level without the need for a tax election to be filed by the unitholder, thus requiring a sale in order for a unitholder to trigger a tax loss.

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. As there is no limitation regarding the shares being of a single class, however, this approach may allow more flexibility if different classes are desired. As well, the absence of the “equal value” requirement and the fact that the 60-day requirement is measured differently, might assist in certain cases, including in facilitating a third party acquisition at a premium.

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

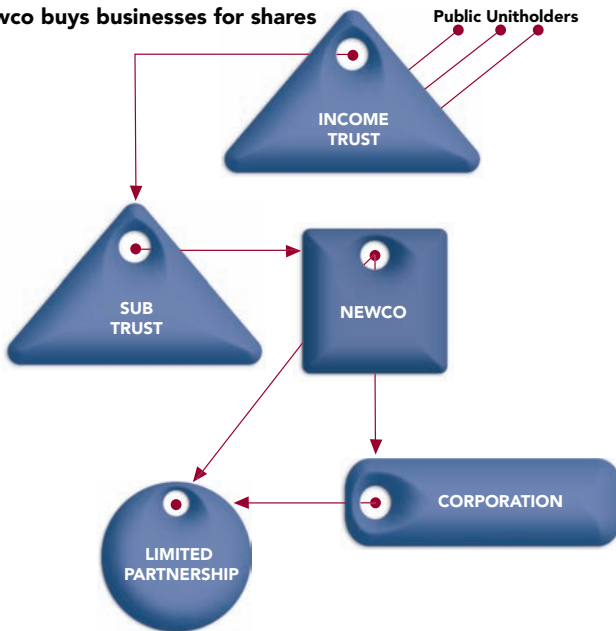
Step 1 (existing structure):

DISTRIBUTION METHOD

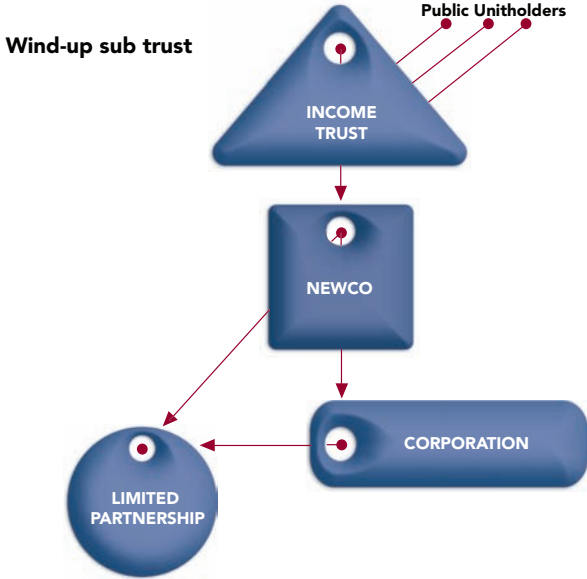


Step 2:

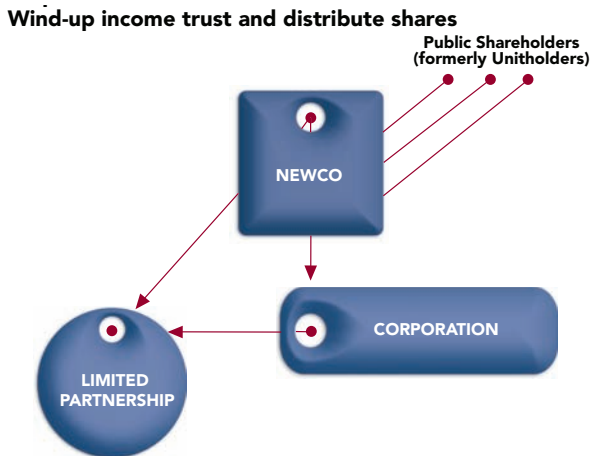
Newco buys businesses for shares



Step 3:



Step 4 (end state):



Conversion Considerations

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. The decision will be influenced by the unique characteristics of the trust such as the trust's size, business, performance, distribution policy and underlying tax situation. Discussed below are some of the principal issues that will need to be addressed in any conversion decision. Although these issues are considered separately, many of them are in practice largely interrelated, and a decision to convert (or not convert) will involve a consideration of all of these issues.

The Loss of the "Tax Holiday"

Perhaps the primary consideration for an income trust in deciding whether to convert into a corporation pre-2011 is the cost to the trust of forgoing the "tax holiday" compared to 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, as 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.
- 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 (and vice versa).

- 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, then this could diminish the value of maintaining an income trust structure.
 - Income trust units have value in the capital markets as yield-paying instruments, and can suffer a correspondingly greater proportionate impact, relative to a corporation, as a result of a reduction in distributions, thereby impacting the trust's cost of capital.
- The capital needs of the trust 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.
 - 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 factors include:

- The investor base of the trust and the dividend policy of the post-conversion corporation.
 - The trustees 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 whether the corporation will pursue a policy of active growth and expansion (i.e., primarily seek to invest earnings in the business of the corporation) or a more “steady state” program (i.e., maintain capital assets, but otherwise distribute available cash to its shareholders).
 - Income trusts are generally high yielding, lower growth investments, and as such have tended to attract a specific investor base (i.e., yield-seeking investors). Conversion to a corporation, particularly if it is accompanied by a change in distribution policy, could therefore create substantial selling pressure, as yield-seeking investors seek to move to higher yielding assets, which could negatively impact the share price of the (post-conversion) corporation.
 - A high-dividend policy post-conversion may enable a premium valuation, thus lowering the cost of capital.
- The level of non-resident ownership of the trust.
 - 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. As a result, most Canadian income trusts limit the level of non-resident ownership at no more than 49.9%. By contrast, corporations are not subject to the same general ownership restriction (although some Canadian companies may be subject to foreign ownership restrictions for regulatory reasons specific to their business).

- All things being equal, the non-resident ownership restriction serves to limit the unitholder base of a trust, thereby adversely impacting liquidity and the trust’s cost of capital. The more non-resident unitholders of a trust, the greater the impact of this limitation.
- The size of the trust.
 - 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). A high-dividend policy might assist to some extent in maintaining investor interest.

Dealing with a Retained Interest

Many income trusts feature “retained interests”; i.e., individual equity interests held by the pre-IPO owners of the underlying business of the trust. These retained interests are, for tax (and other) reasons, 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 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 subordination can be lifted. Note that the specific subordination provisions of each particular trust, if any, need to be carefully considered, as they vary from trust to trust.

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

- Whether the retained interest is also to be “converted”, and if so, at what ratio?
 - If the retained interest is subordinated, and the tests for lifting the subordination have not yet been satisfied, then 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 lifting the subordination.
 - If the retained interest is not converted, then in addition to the structural complications, the tax impact of the conversion of the trust to a corporate form could, if it reduced the future cash available for distribution by the (post-conversion) corporation, negatively impact the retained interest holder by reducing the distributions payable to the former unitholders and potentially making it more difficult for the retained interest holder to meet the applicable performance targets for lifting the subordination. This might have “value” effects that would preclude the Exchange Method and require the Distribution Method.
 - 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 under the

conversion relative to its pre-conversion position.

- What, if any, governance rights the retained interest holder will continue to enjoy following the conversion.
 - A retained interest holder frequently enjoys trustee nomination rights, as well as veto rights over significant transactions. Any conversion transaction would need to consider if these rights would continue post-conversion.
 - In the Exchange Method, given the “equal value” and one share class limits, query whether security holder agreements could be kept in place, or if not then put in place contemporaneously with a conversion into corporate form.

Impact on Existing Debt and Employment Arrangements

A conversion transaction can have a number of consequences for a trust’s (or its subsidiaries’) existing debt (whether bank debt or publicly traded debt, such as convertible debentures) and employment arrangements (i.e., severance packages, employee compensation plans, etc.). These consequences will need to be carefully considered as part of any conversion decision. In particular:

- Will the conversion trigger consent or change of control requirements under existing debt arrangements?
 - Bank debt typically prohibits a change of control and other fundamental transactions without lender consent.
 - Public debt often, but not always, features a “101% put” right 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 on how the conversion is structured, it could trigger this put right.
 - 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 roll-over may not be available for the debt holders.

- 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?
- Will the trust, post-conversion, be able to service its existing debt?
 - The loss of the tax holiday could increase the cash taxes payable by the business, reducing the amount of cash available to service ongoing interest payment obligations.
- Will the trust (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.
- Would the corporation be able to have debt outstanding to its new shareholders at the time of the conversion, or might this be affected by the “anti-avoidance” warnings in the October 31, 2006 announcements?
 - The anti-avoidance messages previously released by the Department of Finance make it unclear whether, in order to produce a more levered company (and thus potentially a more tax-effective investment for, among other others, tax-exempt and foreign investors), a trust could first push out to its unitholders some debt of its operating company owed to the trust, and then engage in a share distribution to unitholders of the trust. “Stapling” or

“clipping” debt to equity seems quite risky, however, and would also lead to increased complexity.

- How will the conversion impact existing management compensation and employment arrangements?
 - The typical income trust tended to focus more on cash distributions 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.
 - The implementation of new equity compensation programs would generally require securityholder approval, and potentially also minority securityholder approval.
 - While options can roll-over, what about other arrangements such as unit appreciation rights, restricted unit rights, deferred unit rights, unit purchase plans, LTIPs and the like?
 - Existing employment agreements will need to be reviewed to determine whether a conversion triggers severance or change of control payment entitlements.

Implementation Matters

In addition to the specific matters noted above, a decision to convert (or not convert) will also involve consideration of a number of general implementation matters. For example:

- In addition to debt and employment arrangements, other contracts of the trust and its subsidiaries will need to be

reviewed to determine if the conversion would raise consent/amendment requirements.

- Accounting implications, including the complexity that will result from the January 1, 2011 replacement of Canadian GAAP by International Financial Reporting Standards (IFRS).
- Will the conversion transaction require regulatory (in addition to stock exchange and securities regulatory approvals)?
- The transaction costs of a conversion, which will likely include legal, accounting and financial advisory fees, as well as unitholder meeting costs. These costs could, for a small trust, be a significant impediment to a conversion decision.

The Role of Advisors

Given the complexity of a conversion decision, the advice of a trust's legal, tax and financial advisors will be critical in assessing if and when to convert into a corporation. Such advisors will assist in reviewing the various implementation issues that would be raised by a conversion decision and in designing the optimal conversion structure.

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. ■

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