

In Brief*

Converting from an Income Trust to a Corporation— with Expertise and Experience

Most income trusts should strongly consider converting into a corporation by the end of 2010, but a conversion is a significant event that will have long-term ramifications. It has to be done right. PwC has experience helping many income trusts across the country with their conversion plans.

Challenges

- Effective January 1, 2011, publicly traded income trusts and partnerships (SIFTs) will be subject to a SIFT distribution tax of 16.5% (15% beginning in 2012) plus a provincial tax component (10% in Alberta).
- Undistributed SIFT income will be taxed at higher rates.
- Recently enacted income trust conversion tax legislation allows SIFTs to convert into Canadian corporations on a tax-efficient basis, but the conversion rules are only in effect until December 31, 2012.
- Low natural gas and relatively low oil prices mean that cash is tight for income trusts in the energy sector so many can't afford to be hit with additional taxes.
- Most SIFTs don't have the resources or in-house expertise for this one-time conversion.
- The decision to convert or not convert can be complex and will likely have repercussions that can include a detrimental effect on an income trust's market value if not conducted carefully.

The federal government has sent a definitive message: as of January 1, 2011, publicly traded income trusts will lose the tax advantage that has made this structure so attractive for many Alberta oil and gas businesses since it was introduced in the 1990s. Income trusts will no longer be able to avoid paying a corporate level income tax. Instead, all publicly traded income trusts will have a tax imposed on their distributions of certain types of income to unit holders, who in turn will still have to pay tax on the distributions. Income trusts potentially face their unit holders becoming disgruntled as they see the new distribution tax take a bite out of their distributions. This could result in the income trust's market value shrinking as investors look for options with a higher payout.

That said, the decision to convert is complicated. All short-term and long-term implications have to be considered. A careful plan and process has to be put into place that can address and mitigate any potential complications. As if this weren't enough, these challenges are further sharpened by two major factors: the recession and low natural gas and oil prices have put a strain on the resources available to income trusts; and the mandatory conversion for all publicly traded entities to IFRS by January 1, 2011—the same date on which the SIFT distribution tax takes effect—means that these income trusts will have a lot on their plates in the coming months.

Because of the complexities involved, converting an income trust into a corporation smoothly and effectively can require a wide range of expertise as well as what seems impossible given this is a new and one-time event: the insights and lessons gained from having been there, done that. But it is possible. Publicly traded income trusts facing the decision of whether or not—and how—to convert into a corporation can bring in an objective third party who has the experience of helping other trusts convert as well as in-depth tax knowledge and the expertise needed to take a holistic approach.

Why convert?

- There will no longer be any tax benefit to being an income trust versus a corporation.
- As more trusts start to convert to corporations, remaining income trusts will be isolated and few, potentially making it harder for them to get analyst coverage and access to capital.
- Income trusts with significant foreign ownership will no longer need to worry about losing their “mutual fund trust” status if they convert into corporations.
- To avoid an earlier effective date for the SIFT distribution tax, publicly traded income trusts cannot increase their equity by more than 100% of the trust’s market capitalization on October 31, 2006. Converting to a corporation will eliminate this “normal growth” restriction.

How to convert:

- The process typically takes from three to six months.
- The first step is to model out the consequences of converting into a corporation or remaining a trust past 2010 so you can make an informed decision as to whether or not conversion makes sense for you. For example, if you remain an income trust, will it have a significant impact on your cash flow? Will remaining an income trust restrict your growth potential?
- If converting makes sense, determine the best timing to begin the process. For example, for a trust that has suspended its distributions entirely, retaining an income trust structure makes very little sense, so converting sooner rather than later is likely its best option.
- Design an effective corporate structure for the new entity in order to convert on a tax-effective basis.
- Create a robust package for internal approval from the board of trustees, board of directors, audit committee and ultimately the unit holders.
- Begin the implementation process, working with tax advisors and legal counsel.

Top five benefits of converting

- Access to capital – Corporations will likely have better access to capital than remaining isolated income trusts.
- As a corporation, you can avoid such challenges as the foreign ownership and normal growth limitations currently faced by income trusts.
- Income trust structures are generally more complicated and difficult to manage than corporate structures.
- A corporation’s shares can be used as acquisition currency in a more tax-effective manner than an income trust’s units.
- Early converters have the time to undertake a conversion in the most tax-effective manner.

The PwC advantage: We know how to build value

Value builders

Publicly traded income trusts need third party advice, expertise and experience—which is not easy to find when it comes to income trust-to-corporation conversions. PwC can offer the experience of having helped many other trusts across Canada convert or at least consider their options.

PwC perspective

An income trust is naturally focused only on its own conversion, but PwC can go in with the knowledge acquired from having already helped dozens of income trusts succeed through the process or consider their options. And that starts with deciding whether a conversion is the right option.

“We can help quantify the cost of remaining an income trust beyond 2010 and structure what the conversion would look like,” says Johnson Tai, a PwC tax partner and leader of PwC’s Mergers and Acquisitions tax practice in Calgary.

Tax knowledge.

PwC Perspective: PwC has a dedicated tax team—not only in Alberta but also in major centres across Canada—that has income trust conversions as one of its top areas of focus.

“Because we’ve already helped so many trusts consider their conversion options, we have hands-on experience,” says Tai. “And that means we know that often times the conversion requires a wide range of expertise. It’s not just about tax knowledge or legal knowledge. We can call on the experience of our audit, accounting and advisory folks and this can be invaluable. There are certain accounting issues that can arise in an trust-to-corporation conversion. Our advisory group can help with a valuation if it’s required. These are all inputs that help trusts make the appropriate decisions and implement their conversions without unpleasant surprises.”

PwC can help income trusts assess and plan for the market’s reaction to their conversion.

PwC Perspective: A trust converting to a corporate structure is a big event. The question immediately turns to what is the public market’s reaction going to be? PwC has corporate finance experts within our advisory group whose focus is to assess just that.

“Part of that assessment will come down to whether or not the trust will reduce its distributions as part of the conversion,” says Tai. “Based on our own experience of having taken trusts through the whole process, our corporate finance folks can advise clients on what the likely outcome will be. We can point to specific examples, and say, “When Trust X converted and reduced its distributions, this is what happened to its unit / share price. We can provide that market perspective that the trust itself and some of our competitors may not have.”

Our team

In Calgary, PwC has assembled a team with local, national and global tax experience. We help our clients with every type of tax issue — domestic or international, business or personal — that has direct or indirect tax consequences. With tax laws constantly changing, professional advice is essential. The professionals of PwC's Calgary Tax practice have a breadth of industry and hands-on experience in providing solutions that provide sustainable value to our clients.

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