

Tax Memo

Income Trust Conversion Rules Enacted

This *Tax Memo* describes the key changes to the tax rules related to conversion of an income fund into a taxable Canadian corporation. It compares tax legislation that recently received royal assent to the first draft (July 2008), which was described in an earlier *Tax Memo*, "Tax Planning for Income Trust Conversions and Acquisitions."

History

After several draft versions, the tax legislation for the conversion of an income fund into a taxable Canadian corporation received royal assent on March 12, 2009. The "Conversion Proposals" were first released as draft legislation on July 14, 2008. Revisions were released on November 28, 2008, to address some, but not all, concerns raised with the July Conversion Proposals. The November 28 revisions died when Parliament was prorogued in December 2009. On February 2, 2009, the Conversion Proposals were reintroduced, with only minor revisions, as part of the Notice of Ways and Means Motion to implement the federal budget of January 27, 2009.

For a broader summary of the key business, strategic and tax issues facing income trusts, see *Income Trusts: Planning for 2011 and Beyond*, a PricewaterhouseCoopers publication, available at www.pwc.com/ca/incometrusts.

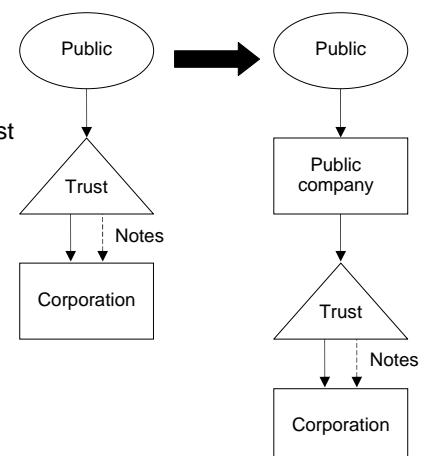
Conversion Rules

The conversion rules contain three key tax-deferred rollover provisions for converting an income trust into a corporation: the Exchange Method, the Trust Wind-up and the Redemption Method.

1. Exchange Method: Subsections 85.1(7) and (8)

The Exchange Method permits a trust unitholder to automatically exchange income trust units for shares of a taxable Canadian corporation. The exchange does not require the filing of a tax election. The final version of the Exchange Method rules reflects the following key changes:

- The elective tax-deferred rollover provisions in subsections 85(1) and (2) will override the Exchange Method. Permitting subsections 85(1) and (2) to override subsection 85.1(8) will give income trusts added flexibility in planning their conversion to a corporation.

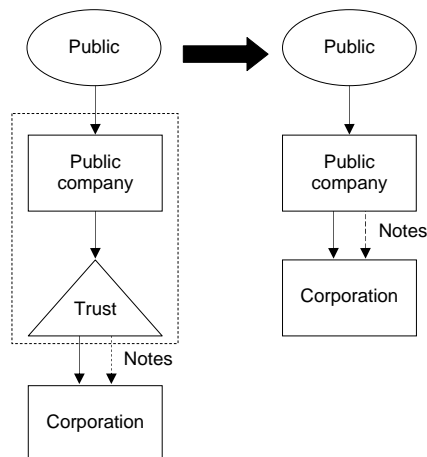


- If, immediately following an exchange, the fair market value of the taxable Canadian corporation shares received exceeds the fair market value of that taxpayer's income trust units when transferred, the taxpayer will be deemed to receive a taxable benefit equal to the excess amount. A taxpayer will also be deemed to receive a benefit if the fair market value of the taxable Canadian corporation shares received is less than the fair market value of the income trust units when transferred and the intent was to transfer the excess value to a person not at arm's length with the taxpayer.
- The requirement that only one class of shares can be issued by the taxable Canadian corporation to all unitholders as part of an Exchange Method transaction was not removed. Taxable Canadian corporations requiring more than one class of shares to be held by shareholders who participated in the exchange will have to change their capital structure after the conversion in a secondary transaction.
- The existing automatic share-for-share exchange rules permit a taxpayer to realize a loss on the exchange of shares of a taxable Canadian corporation for shares of another taxable Canadian corporation. Despite being similar (i.e., being unit-for-share), the Exchange Method does not permit a taxpayer to realize a loss. In fact, in anticipation of tax loss planning, the Conversion Proposals included a new stop-loss rule to prevent a corporate unitholder from realizing a loss on the unit-for-share exchange.

The stop-loss rule suspends the loss until specific conditions are met (i.e., the shares received are sold to a third party). This stop-loss rule does not apply to individual unitholders of an income trust. However, the final version of the rules also introduced a superficial loss rule to prevent individual unitholders from realizing a loss. This rule denies a loss to an individual on the unit-for-share exchange. An individual taxpayer will add his or her superficial loss to the tax cost of the share consideration received.

2. Trust Wind-up: Section 88.1

Section 88.1 is a provision that permits a taxable Canadian corporation ("Public company" in the following diagram) to wind up a wholly-owned trust and wholly-owned subsidiary trust on a tax-deferred basis. This provision is elective if the property distributed is shares of a taxable Canadian corporation.



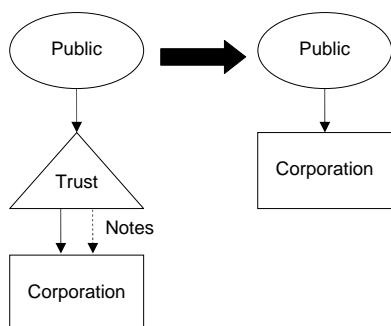
The final version of the rules included the following revisions to section 88.1:

- The taxable Canadian corporation will not realize a gain on the disposition of its trust units on a wind-up of the trust under section 88.1. That section was changed to deem the proceeds of disposition of the trust units to equal their cost base, ensuring no gain results when these units are disposed of on the winding up. Previously, a formula-driven approach was used to calculate the proceeds of disposition, yielding an inappropriate gain in certain circumstances.
- A distribution of a corporate subsidiary of a trust will result in an acquisition of control of the subsidiary by the corporate beneficiary of the trust. For the purpose of the subsection 88(1) wind-up rules, the acquisition of control is deemed to occur when the corporate beneficiary becomes the majority interest beneficiary of the trust.

Other expected changes to the Trust Wind-up rules were not included in the final rules. In particular, section 88.1 applies only to first and second-tier trusts. This section was not expanded to include wind-ups of third and lower-tier trusts. The Redemption Method (discussed next) does permit a tax-effective way to eliminate lower-tier trusts, but without the benefits provided by section 88.1.

3. Redemption Method: Subsection 107(3.1)

Subsection 107(3.1) is an automatic provision under which a trust can distribute shares of a taxable Canadian corporation to its unitholders on a tax-deferred basis.



The final version of the Redemption Method rules included the following revisions:

- Non-resident unitholders will not be subject to withholding tax on a Redemption Method distribution. This change is welcome as any withholding obligation on non-cash distributions would have required an additional use of cash for income trusts.
- Debt obligations of a trust assumed by a taxable Canadian corporation as part of a Redemption Method transaction are deemed to be a debt of the taxable Canadian corporation. Previously, how these debts would transfer was not clear.
- Unlike a Trust Wind-up under section 88.1, the Redemption Method can be used to dissolve third- and lower-tier trusts tax-free.
- A requirement was added that only one class of shares can be distributed by a trust. This change makes the Redemption Method consistent with the single share class requirement under the Exchange Method.

Normal Growth Guidelines

In the explanatory notes to the November 28, 2008 draft tax legislation, the Department of Finance updated its position on the normal growth guidelines for income trusts. No subsequent updates have been released.

Income trusts can now use remaining growth room any time, rather than staging this growth over 2009 and 2010. This change allows an income trust to issue new equity to bring its cumulative equity outstanding to twice the amount of its equity market capitalization at October 31, 2006.

The Department of Finance also clarified that equity issued by lower-tier trusts (trusts without public unitholders) will count towards a parent income trust's growth room if the equity issued is convertible into equity of the public income trust or reasonably regarded as funded by the issuance of equity in the public income trust.

Acquiring Income Trusts

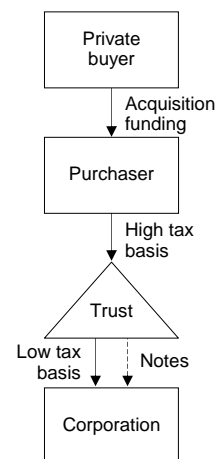
An alternative to converting an income fund into a public corporation is privatization. The income trust market has seen a number of privatization transactions by strategic and private equity investors since the specified investment flow-through (SIFT) rules were introduced on October 31, 2006. These acquisitions are expected to continue up to 2011. As well, legacy business owners who used income funds to take their businesses public may consider reverting back to private ownership as an alternative to remaining in the public market.

Although existing tax rules permit an income trust privatization, in certain situations the conversion rules should simplify the tax analysis required to privatize an income trust.

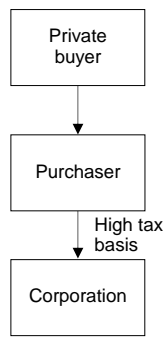
Acquiring income trust units – cash consideration

A unit acquisition is generally preferred by vendors (the public unitholders) because in most cases it should give rise to capital gains or losses. However, this acquisition alternative makes the purchaser the sole beneficiary of the income trust. Usually the purchaser will want to unwind this trust structure. The conversion rules could be used to do so, as follows:

- The purchaser can use section 88.1 to wind up the trust.
- Generally the transaction is tax-free. The trust is treated as a corporation and the result of the transaction is the same as when a taxable Canadian corporation is wound-up into another taxable Canadian corporation. This includes the potential to “bump” the shares of the trust's eligible property (i.e., shares of the corporation) if there is an accrued gain in the property and other conditions are met.



- Under section 88.1, tax attributes of the trust (e.g., losses, depreciable tax basis) are transferred to the purchaser.
- The purchaser could also use subsection 107(3.1) to wind up the trust. This rule is available when the only asset of the trust being distributed on the wind-up is shares of a taxable Canadian corporation. Under subsection 107(3.1), the purchaser will generally be deemed to acquire the shares of the taxable Canadian corporation at the trust's cost amount. Tax attributes of the trust will not transfer to the purchaser under this rule.
- Most income trust wind-ups are expected to be completed under section 88.1.
- Under both section 88.1 and subsection 107(3.1) it should be possible to settle intercompany debts within the structure. Planning may be required depending on the circumstances.
- Section 88.1 and subsection 107(3.1) will both result in the purchaser acquiring control of the trust's subsidiary corporations. An acquisition of control will cause the subsidiary corporations' non-capital losses to be restricted in use.



- To take advantage of a tax rollover, the purchaser and trust unitholders must file a joint tax election under the existing tax rollover rules in section 85. This tax election allows unitholders to defer the gain on their units up to the value of the shares issued as consideration by the purchaser.
- The cash consideration received is taxable to a unitholder if the amount received exceeds the tax basis of that unitholder's units.
- Losses, if any, realized by the trust unitholders may be treated as suspended or superficial, as discussed above.
- The purchaser can still use the trust wind-up rules in section 88.1 or subsection 107(3.1) to unwind the structure.

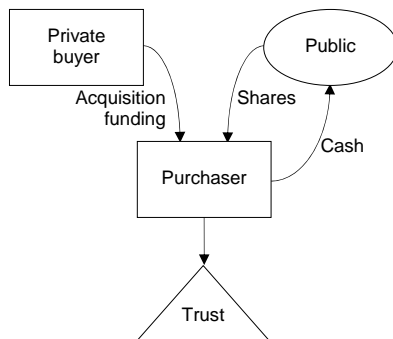
Acquiring an income trust's assets

An asset acquisition is generally preferred by a purchaser because of the ability to obtain full fair value tax basis in the acquired assets. In an income trust structure, either the business assets or an operating subsidiary entity can be acquired. Post-sale, the after-tax proceeds are distributed to the unitholders and the trust structure is dissolved. Care must be taken to ensure tax costs do not arise both on the sale of subsidiary assets and on the disposition of trust units by the unit holders. Because of restrictions in section 88.1 and subsection 107(3.1), these rules are unlikely to apply.

Acquiring income trust units – Cash and share consideration

A unit acquisition for cash and share consideration is an alternative that buyers could also use to acquire an income trust. It should be possible for this type of transaction to be completed on a full or partial tax rollover basis:

- The automatic unit-for-share Exchange Method outlined previously will not be available if the unitholders receive both shares and cash consideration.



For More Information

For more information on what the legislative changes mean, please contact your PricewaterhouseCoopers tax adviser or:

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