

Planning for 2011 and beyond

(updated to include SIFT conversion rules)



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Introduction

Income trusts' wave of expansion and ready access to capital came to an abrupt end on October 31, 2006, when Finance Minister Jim Flaherty announced tax and growth restrictions on publicly listed income trusts and limited partnerships, to be known as specified investment flow-through (SIFT) entities. The impact of this announcement on the income trust market was swift and dramatic, as illustrated in the chart to the right. Since then, many income trust investors and managers have been trying to evaluate their options and determine their best course of action.

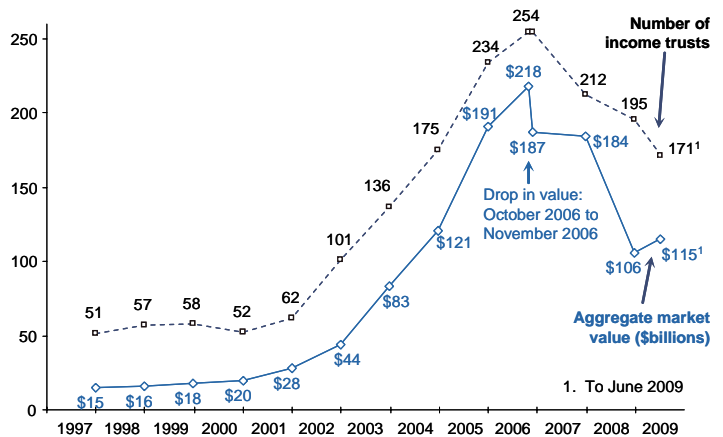
In the three years that have passed, we have already seen a significant change in the income trust market. Some income trusts have converted into corporations (or plan to in late 2010), while others have been privatized. Still other income trusts have stayed the course and are waiting until 2011 to assess their options.

This publication is designed to help trustees and managers with this decision making process by summarizing the key business, strategic and tax issues facing income trusts and the advantages and disadvantages of various options.

Trustees and management should be aware that any transaction will require substantial planning, organization and thought. In light of the required resources, it is important that decisions are not made hastily, without full consideration of all of the issues.

To help trustees and management consider the issues raised in this publication, they should seek the advice of a professional services adviser with strong experience in income trust formation, privatizations, insolvency and financing. PricewaterhouseCoopers has a number of professionals with experience in these areas. For further information on the services we provide, please refer to the **How PwC Can Help** section at the end of this publication.

Number and aggregate market value of existing income trusts
(at end of year, except 2006 and 2009)



The Trust Market Today

As of June 2009, the trust sector had a market capitalization of approximately \$115 billion, accounting for approximately 7.5% of the TSX. The aggregate number of trusts at that date was 171. Before the October 31, 2006 announcement, the number stood at 254.

Market capitalization by sector	June 2009		October 2006		% Change	
	Count	Market cap. (\$ mm)	Count	Market cap. (\$ mm)	Count	Market cap.
Business	110	32,174	173	95,493	-36%	-66%
Pipeline & power	14	12,509	23	20,156	-39%	-38%
Oil & gas royalty	22	52,295	31	76,216	-29%	-31%
REITS	25	17,960	27	26,440	-7%	-32%
Total	171	114,938	254	218,305	-33%	-47%

Source: TD Newcrest – *Income Trust Score Sheet*, June 2009

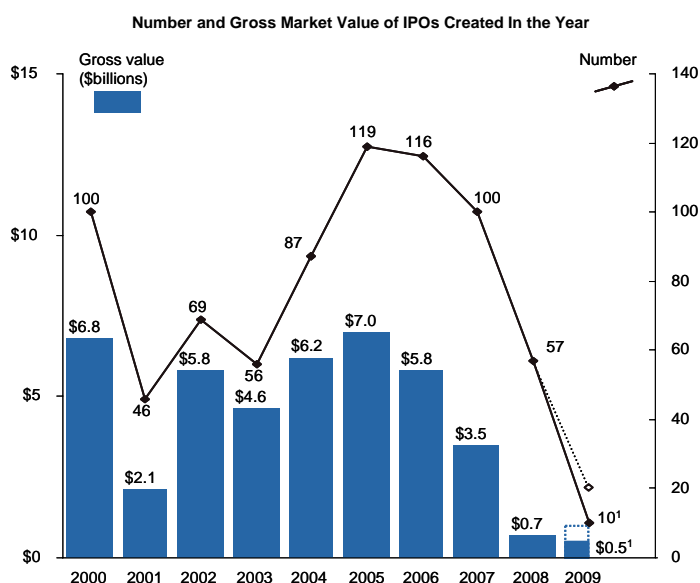
This drop in the number of trusts is largely the result of the conversion of trusts into public companies (approximately 28 to October 2009) and a high number of trust M&A transactions that occurred since the announced changes in trust taxation (as shown in the table on page 3). Interestingly, half of these M&A transactions involved foreign buyers, reinforcing concerns surrounding the “hollowing out” of the Canadian corporate sector.

Looking for background information on the income trust tax policy issues? Visit www.pwc.com/ca/incometrusts for a comprehensive report, dated December 11, 2006, which analyzes a number of economic and tax policy issues related to income trusts. You will also find two detailed *Tax Memos*, “Income Trust Conversion Rules Enacted” and “Tax Planning for Income Trust Conversions and Acquisitions” that outline how the SIFT tax is to be applied, on www.pwc.com/ca/taxmemo.

M&A activity Nov. '06 to Jun. '09	Strategic buyer		Private equity		Total
	Domestic	Foreign	Domestic	Foreign	
Business	14	11	9	9	43
Pipeline & power	3	2	–	1	6
Oil & gas royalty	9	1	1	–	11
REITS	5	3	1	–	9
Total	31	17	11	10	69

Source: RBC Capital Markets – *RBC Trust Weekly*, July 3, 2009

Introduction of the SIFT tax appears to have had a significant effect on the IPO market. During the period from 2000 to 2006, IPO activity was fuelled by the creation of new income funds to satisfy the demand of the market for high-yield securities. Following the SIFT tax announcement, gross proceeds from IPOs between 2007 and June 2009 declined to their lowest level since 2001. More recently (2008/2009) the decline in IPO activity reflects the overall economic climate.



1. To June 2009. Broken lines show annualized figures for comparison to other years.

Despite the predictions of several industry analysts, the SIFT tax has not resulted in a significant increase in the number of Canadian high-yield debt offerings. However, many SIFTs did issue convertible debentures post-2006.

Key Business Issues to Consider

Not all trusts are the same. They come in a variety of sizes and industries. Their balance sheets vary from no debt to relatively high levels of debt. Some are purely domestic; others operate internationally. Even though most trusts still make large cash distributions, payout ratios vary. As a result, the SIFT tax will affect some more than others.

Snapshot of Trust Sector (June 2009)

Business trusts	Count	Market cap. (\$mm)	EV + EBITDA	Net debt + EBITDA	Payout ratio	Run rate yield
Energy equipment & services	15	2,981	4.7x	1.8x	70%	16.9%
Materials	13	3,471	13.9x	9.0x	120%	29.1%
Industrials	28	4,737	5.4x	1.7x	86%	17.2%
Consumer discretionary	24	6,506	6.4x	2.1x	85%	21.9%
Consumer staples	12	1,425	7.5x	3.0x	n/a	10.0%
Healthcare	3	1,484	8.3x	3.2x	112%	11.7%
Financials	11	2,379	15.5x	10.2x	85%	11.0%
Information technology	1	111	4.0x	1.7x	77%	0.0%
Telecommunication services	1	6,043	6.0x	1.9x	92%	10.9%
Utilities	2	3,037	8.0x	2.3x	126%	9.5%
Total	110	32,174				

Power & pipeline	Count	Market cap. (\$mm)	EV + EBITDA	Net debt + EBITDA	Payout ratio	Run rate yield
Pipeline	6	8,568	9.5x	4.1x	n/a	10.8%
Power	8	3,941	8.6x	3.7x	n/a	12.3%
Total	14	12,509				

Oil & gas trusts	Count	Market cap. (\$mm)	EV + DACF	Net debt + cash flow	Payout ratio	Cash yield
Oil & gas trusts	22	52,295	7.7x	1.8x	60%	13.0%

REITS	Count	Market cap. (\$mm)	P + FFO	P + AFFO	AFFO payout ratio	Run rate yield
Commercial	15	11,783	6.8x	9.0x	97%	10.8%
Hotel	3	2,031	4.3x	6.6x	132%	21.8%
Multi-residential	5	3,130	11.2x	10.6x	99%	13.4%
Senior housing	2	1,016	6.5x	7.1x	96%	13.5%
Total	25	17,960				

Grand Total	171	114,938
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Source: TD Newcrest – *Income Trust Score Sheet*, June 2009

Despite their differences, all trusts must now address these key business issues:

- sustainability of distributions;
- optimal capital structure;
- access to capital;
- equity valuation;
- equity-based compensation; and
- governance and financial reporting.

Sustainability of Distributions

At least at inception, a key benefit of the trust structure was the ability to make cash distributions of income in the most tax-effective manner. Some people have said that the trusts were tax-exempt. This is inaccurate, because trusts are subject to a top marginal personal tax rate

(ranging from 39% to 48%, depending on the province or territory of residence). This tax was avoided only by distributing income to the trust's unitholders, who were subject to tax on that income, depending upon their nature (e.g., Canadian individual, corporation, pension fund, non-resident, etc.).

The only feature that made a trust more tax-efficient was that it eliminated the double taxation of income that had been inherent in Canada's corporate income tax system. By double taxation, we mean that corporate income was taxed both as it was earned and when it was distributed as dividends. The effect of this double taxation has been reduced somewhat with increases in the personal dividend tax credit.

Aside from the tax efficiency of a trust structure, many investors were particularly attracted to the promise of a high-yield cash-paying investment. Stung by large corporate scandals or unsuccessful attempts at diversification, many investors wanted simple cash-generating businesses in which to invest. Many trusts met that objective and continue to do so. Others, however, were subject to business cyclicity and the same management issues faced by corporations. Some may have been caught by overly-aggressive estimates of distributable cash.

Over the past year, payout ratios have increased to between 77% and 126% across the trust universe (see chart on page 3). At these levels the trust units appear particularly vulnerable to a broad-based economic slowdown. In fact, many have had to reduce or suspend cash distributions.

A trust today still faces the same basic questions that it dealt with on formation: What level of cash distribution should be made to the equity holder and how much should be reinvested in the business? These are simple questions with complex answers that look to the need for capital for expansion and the optimal capital structure for the business.

As a first step, we recommend that at a minimum every trust understand how the SIFT tax will affect its operating cash flow and whether the current level of distributions can be sustained after 2010.

Example: Three Distinct Trusts

Consider the example of three distinct trusts (**A**, **B** and **C**) with different types of income distributions. The example is based on the following assumptions:

- Before implementation of the SIFT tax, the trust distributes \$950 or 95% of its \$1,000 distributable cash. Distributions after implementation of the SIFT tax are assumed to be reduced by the amount of the SIFT tax.
- Assume the 25% SIFT tax rate reflects a 15% (based on the 2012 federal rate) federal component and a 10% provincial component. In fact, the provincial component will vary depending on the actual provincial corporate tax rates in provinces in which the SIFT maintains a permanent establishment.
- Personal tax rates of 46% and 29% are assumed to apply to trust income and eligible dividends, respectively. These personal tax rates vary by province of residence.

The calculations on pages 5 and 6 demonstrate several points regarding the potential effect of the SIFT tax on cash distributions.

1) Trusts that operate in Canada will face distribution reductions.

A trust that currently distributes most of its income and operates mainly in Canada will likely face distribution reductions (i.e., cash that would have gone to investors will now have to be held back to pay the SIFT tax). However, an individual taxable investor should be no worse off on an after-tax basis, because the Canadian source portion of his or her distribution will be taxed as a dividend eligible for the dividend tax credit.

Given the reaction to the SIFT tax by the markets to date, it appears that the markets do not fully consider tax issues. Or, at least, it appears that exempt or non-resident investors have more influence on the market price than taxable individual investors. If the level of the distribution is the only driver of market valuation, then unit values will drop, which has occurred over the past three years. However, the valuation model has been slowly evolving to a corporate earnings model instead of a capitalized distributions model.

2) Tax-exempt investors will be most seriously affected by the SIFT tax.

The SIFT tax will affect tax-exempt investors (e.g., pension funds and RRSPs) because they are not eligible for a dividend tax credit. In fact, income allocated to exempt investors will still be double-taxed, once as earned by the SIFT and again as distributed to the beneficiaries (e.g., as personal pension income). Many commentators, including PwC, have suggested that the government consider a form of refundable dividend tax credit for pension funds.

3) Large tax-exempt investors can avoid the SIFT tax by creating private trust or partnership structures.

A privatization of an existing SIFT by a pension fund investor offers considerable tax advantages. While the loss of corporate tax revenues resulting from the conversion of some corporations into trusts is often mentioned as a key reason for the introduction of the SIFT tax, a privatization by a pension fund will also significantly reduce corporate tax revenues. It appears that pension funds have been able to successfully maintain a tax advantage over taxable and retail investors.

4) Non-resident investors also appear to be worse off.

The analysis above does not consider tax payable in the investor's country of residence. The effect of the SIFT tax is to increase Canada's share of the overall tax, which may be viewed as reasonable when the income is from a Canadian source.

5) Trusts with mostly foreign source income are not subject to the SIFT tax.

Distributions of foreign source income are not subject to the SIFT tax, so the trust structure may continue to be most optimal for these trusts. Trusts that operate both in Canada and abroad should ensure that any foreign source income retains its character as it flows to the trust. For example, some restructuring may be necessary to ensure that foreign-source income earned by a subsidiary corporation does not become re-characterized as Canadian interest paid on debt between the trust and the Canadian parent corporation.

		Trust			
		A	B	C	
Source of income	Canadian	100%	80%	20%	
	Foreign	-	-	80%	
	Return of capital	-	20%	-	
Distributions	Distributable cash	1,000	1,000	1,000	
	Payout ratio	95%	95%	95%	
	Subtotal	950	950	950	
	Distributed as:				
	Return of capital	-	190	-	
	Non-portfolio earnings	950	760	190	
	Foreign source income	-	-	760	
	Cash available for distribution (before SIFT tax)	950	950	950	
SIFT Tax calculation	Non-deductible distributions	713	570	143	
	Gross-up factor ¹	133.3%	133.3%	133.3%	
	Taxable SIFT distributions	950	760	190	
	SIFT tax rate	25.0%	25.0%	25.0%	
	SIFT tax payable	238	190	48	
Individual investor	No SIFT Tax	Canadian source income	950	760	190
		Foreign source income	-	-	760
		Taxable trust distribution	950	760	950
		46% personal tax	(437)	(350)	(437)
			513	410	513
		Return of capital	-	190	-
		After tax cash to investor	513	600	513
	With SIFT Tax	Taxable dividends	713	570	143
		29% personal tax	(207)	(165)	(41)
			506	405	102
Foreign source income		-	-	760	
46% personal tax		-	-	(350)	
	-	-	410		
	Return of capital	-	190	-	
	After tax cash to investor	506	595	512	
Loss/(gain) of cashflow from SIFT tax regime		7	5	1	

1. Equals 100%/(100%-25%).

6) Trusts that distribute cash mainly as a return of capital may not be immediately affected by the SIFT tax.

Typically, these are trusts with high levels of tax shelter (e.g., resource deductions) in capital intensive industries. The tax shelter offsets income, and cash flow can be distributed as a return of capital. Presumably, over time the level of income distributions would increase.

7) The SIFT tax is not 25% of income distributions.

In fact, the calculation is as follows:

Non-deductible distribution amount	\$1,000
	$\div (100\% - 25\%)$
Taxable SIFT trust distributions	1,333
	$\times 25\%$
Tax payable	\$333

The 25% applies to a grossed-up amount, so that the actual distribution is akin to an after-tax corporate dividend. SIFTs will have to ensure that, as a consequence of the circularity of the calculation, they retain adequate cash to fund the SIFT tax.

These seven points demonstrate that before considering alternatives, trusts must assess how they will be affected by the SIFT tax. Many have already announced whether the level of distributions will be affected.

Optimal Capital Structure

From a leverage perspective, the trust universe has become increasingly leveraged over the past year with Net Debt / EBITDA levels ranging widely between 1.7x to 10.2x. Historically 1.0 – 2.0x had been the norm. The increase appears to reflect both reduced EBITDA and the need to use debt (e.g., convertible debentures) to finance growth. It has either been not possible or too expensive to issue trust units.

There is no doubt that leverage in combination with a high payout ratio adds considerable risk to the sustainability of distributions. Examples abound of lenders forcing a suspension of distributions following debt covenant violations. Because market valuation is so closely tied to the level of distributions, unit valuations typically drop dramatically.

It is worth stating again that cyclical businesses are not well suited to either a trust model or a corporate model with high levels of distributions or dividends relative to cash flow. Investors must understand that trust distributions, just like corporate dividends, are returns on equity investments that carry risk. Investors would be mistaken to treat such investments as “debt-like.”

		Trust			
		A	B	C	
Source of income	Canadian	100%	80%	20%	
	Foreign	-	-	80%	
Return of capital		-	20%	-	
Tax-exempt investor	No SIFT Tax	Net taxable trust distribution	950	760	190
		Return of capital	-	190	-
		After tax cash to investor	950	950	950
	With SIFT Tax	Taxable dividend	713	570	143
		Foreign source income	-	-	760
		Return of capital	-	190	-
After tax cash to investor		713	760	903	
Loss/(gain) of cashflow from SIFT tax regime		238	190	48	
Non-resident investor	No SIFT Tax	Trust distribution	950	950	190
		15% withholding tax	(143)	(143)	(143)
		Net distribution to investor	807	807	807
	With SIFT Tax	Trust distribution	713	760	143
		15% tax	(107)	(114)	(21)
		Net distribution to investor	606	646	767
Loss/(gain) of cashflow from SIFT tax regime		201	161	40	

Access to Capital

A key business issue for investors and income trust managers is access to capital. Businesses require capital to expand, and the trust market was a good source of capital for mid-market Canadian companies. Many trusts have used that capital to expand domestically and internationally. In that respect, the income trust market was a huge success by anyone's standards. By effectively destroying the trust market without any immediate form of replacement, the federal government created a significant problem for trusts requiring capital to expand. The cost of capital has increased even for those able to access capital.

Since October 2006, secondary issuances of trust units have declined dramatically and there have been limited circumstances where trust units have been issued as partial consideration on the acquisition of a business. Some trusts have issued high-yield, subordinated debt, but that market is still limited in size.

Trusts that need capital (to either expand or refinance) may have to look to foreign sources or private domestic sources. Concerns include not exceeding the SIFT growth limitations and maintaining majority Canadian ownership, as required under the mutual fund trust tax rules.

Faced with these issues, some trusts have decided to convert back into a corporate form. Others have decided to privatize by initiating a sale process.

Equity Valuation

At one time, trusts were afforded a valuation premium over corporations. This resulted from the fact that trusts tended to be valued based on a capitalization of distributions as opposed to an earnings model. Some might argue that the yields applied to trust distributions were too low and not fully reflective of risk. As a consequence, trust unit valuations were highly susceptible to changes in the level of distributions.

The introduction of the SIFT tax reduced market valuations reflecting the possible impact on distributions starting in 2011. The size of that “tax-driven” discount may increase as 2011 draws nearer. On the other hand, the valuation model may move more in line with a corporate valuation model.

In our view, the valuation premium given to trusts over comparable public companies structured as corporations has eroded since the SIFT tax announcement. In fact, many smaller individual trusts now carry valuations that reflect a decline in research coverage and institutional investor following. These trusts could struggle to raise capital in the near-term and may well initiate a sale process before 2011, likely once the M&A markets show signs of a sustained improvement.

Equity-Based Compensation

The changing economic, tax and accounting environment in which income trusts operate demands a thorough review of existing equity-based compensation plans. Institutional investors are particularly sensitive to the appropriateness of income trust equity-based compensation plans in the context of conversions to public corporations and privatizations.

Larger institutional investors and their advisers have indicated that they will vote against, or recommend voting against, conversions into which resolutions for ineffective or otherwise unacceptable equity-based compensation plans are bundled.

The review of existing equity-based compensation plans should address the following questions:

- Will changes in the sustainability of distributions require increased focus on equity compensation structures that reward capital appreciation?
- Will changes in tax structure result in more emphasis on the tax deductibility of equity compensation awards?
- What are the design considerations to ensure that existing “in-the-money” value in equity compensation plans can be transferred on a tax-deferred basis to new plans?
- Will the market's lack of full consideration of tax issues and the tax insensitivity of exempt investors cause a significant change in equity-holder profile? If so, how should equity compensation plans reflect this change and align the interests of executives with those equity-holders?
- Would a conversion trigger change-of-control provisions inadvertently?
- Will changes in structure and accounting, such as those relating to International Financial Reporting Standards (IFRS), affect market sensitivity to the financial statement volatility caused by certain plan designs?

These and other significant questions relating to optimal equity compensation plan design should be considered early in the planning process, given the complex interrelation of plan design and enterprise-wide changes.

Governance and Reporting

Many boards of directors, audit committee members and senior management teams of income trusts will recall the often complex structures, significant tax implications and unique accounting and financial reporting issues associated with their original IPO, conversion or carve-out transactions. These transactions required substantial planning, organization, thought and the assistance of various professionals to clarify the objectives of the plan to become a trust.

Similar processes will have to be given consideration again in respect of the various alternatives raised in this discussion paper. Costs are likely to be comparable to the completion of another IPO, conversion or carve-out transaction. Planning the course for conversion back to a corporation (if that is the right route) may trigger numerous new and complex tax, financial reporting and accounting issues, reinforcing the importance of a plan that contemplates the alternatives and their consequences.

Clearly, it is important that trust management review and evaluate all of the matters raised in this discussion paper. It is also important to plan for the timely involvement of the board of directors and audit committee members in the issues, risks, alternatives costs and timetable for the conversion plan. These issues can have significant and varying effects on the various unitholders of the trust. As a result, the board of directors should evaluate those implications to determine the right course of action for each trust.

International Financial Reporting Standards (IFRS) are affecting all public reporting entities on January 1, 2011—the same date the SIFT tax takes hold for income trusts. Income trust management and their boards may have dual challenges to face in dealing with the development and management of their IFRS conversion plan in conjunction with the significant challenge of managing the alternatives as a result of the implementation of the SIFT tax.

Many income trust managers have already experienced the challenges and constraints associated with having to account for future income taxes with the legislation being substantively enacted for their quarters ending on or after June 30, 2007. As well as the significant and complex issues that will arise through conversions using many of the alternatives suggested in this publication, managers will face further financial reporting and accounting challenges after December 31, 2010, with the introduction of the SIFT tax.

New and unforeseen accounting and financial reporting issues that may arise as a result of conversion plans likely will have no immediate solutions. Therefore, it is imperative that income trusts consider and evaluate the available alternatives, with a view to having solutions in hand before the deadlines for completion.

While the dual tasks of evaluating each of the options available to the trusts, in conjunction with implementing International Financial Reporting Standards may seem daunting, trust managers can reduce the stress and cost of these activities by developing plans that are efficient and give due consideration to the implications and significance of each of these enterprise-wide changes. Now is the time to start the planning process on both fronts to ensure that adequate consideration, time and resources are available to meet these deadlines.

Evaluating the Options

Income trust investors and managers have a variety of options. The level of M&A activity and conversions into corporations suggests that many businesses, perhaps driven by the need to access capital, have decided to move away from the public trust structure. However, many income trusts are trading in the market today that have not announced their path.

All remaining trusts need to evaluate their options and consider the advantages and disadvantages of each opportunity depending on their financial situation and strategic business objectives.

1. Status Quo

Why not just stay as a trust? That could be the best choice for some.

Trusts with high levels of foreign income or those able to shelter their income from the SIFT tax may feel no pressure to change. Smaller trusts may also not wish to bear the costs associated with converting to a public corporation. But we predict few trusts will choose the status quo for the following reasons:

- Most businesses will require access to capital and only the most mature business can ignore this reality. Because of the Department of Finance's "Normal Growth Guidelines" an income trust can issue units to bring cumulative equity up to twice the trust's market capitalization on October 31, 2006. Equity includes securities convertible into trust units. Corporations do not have these restrictions.
- Market valuations for a high dividend-paying public company may exceed those for trusts. The universe of corporate investors and level of analyst coverage is simply much wider for corporations.
- The world, especially the tax world, is simply a better place for a corporation. Tax rules (e.g., reorganization rules) are more established and understood. The same could be said of issues relating to debt financing, governance, legal and accounting matters. Trusts can operate in a corporate world, but those that have done it understand the ongoing challenges related to the complex structure.

Resource and real estate trusts face a few other considerations.

Oil and Gas

Similar to income trusts operating in other industry sectors, many oil and gas income trusts likely will determine that conversion to a corporate structure is the most attractive option for carrying on operations after 2010. Many have been, and will continue to be, hurt by the “normal growth” provisions that restrict new capital issuances by all trusts. These provisions will severely restrict the ability of oil and gas trusts to raise new capital to finance the acquisition or development of their underlying oil and gas reserves, which are subject to continuous depletion.

A few oil and gas trusts may conclude that retaining the trust structure after 2010, at least for a period, will be more beneficial than converting to a corporation. One or more of the following factors could lead to this decision:

- the existence of significant tax shelter in the form of “resource tax pools” and other tax deductions that would allow the trust to treat its cash distributions as a return of capital, and therefore tax-deferred, as opposed to income distributions, which would attract the SIFT tax;
- situations in which the trust owns mature oil and gas properties with a long-term reserve life, which would require a relatively small amount of additional capital; and/or
- significant ownership of foreign oil and gas properties, income from which would not be subject to the SIFT tax.

Real Estate

Real estate investment trusts (REITs) will be excluded from the SIFT tax if all of the asset and revenue conditions in the definition of “real estate investment trust” (the “REIT test”) are satisfied.

The REIT test restricts the types of assets that may be held and the types of revenue that may be earned by a REIT. To comply, many REITS will have to restructure their operations and activities in certain ways. Most REITs are expected to undertake any necessary reorganization to be able to maintain their trust status and continue to be treated as flow-through entities. REITs with sufficient shelter from capital cost allowance and interest expense may be able to delay reorganizing until after 2010.

REITs that operate hotels, retirement homes and nursing homes will not be able to satisfy the REIT test, because payments for the occupation of, use of, or right to use a room in a hotel or other similar lodging facility will not be characterized as “good” income for purposes of the REIT

test. If it is not possible to restructure these REITs by separating the real estate from the operating activity, it is expected that they will convert to public companies, sell their assets and operations or be taken over. It is also possible that a REIT with these “off-side” activities could maintain its status as a trust for some time after 2010 if it has sufficient deductions to shelter its income.

2. Convert to a Public Company

A number of trusts have already taken steps to become public companies. Generally, this decision has been made to respond to a specific problem, such as the need to cut distributions, the need to access capital, or a high level of non-resident ownership. In other cases, the conversion has been structured using a company with significant tax attributes (e.g., tax losses or credits). Before recommending a conversion transaction, trustees have to consider:

- fiduciary duties to unitholders who were promised cash distributions;
- the dividend-paying capacity of the corporation;
- the effect on the investor base and likely “churn”;
- tax ramifications to both resident and non-resident investors;
- effect on existing debt;
- effect on and need to restructure management compensation plans;
- viability as a public company (share float, analyst coverage); and
- cost of converting.

Conversion of a trust into a public company may be a viable option for the larger trusts. As a high dividend yielding public company, valuations and access to capital may be enhanced. Some simplification may also result from operating in corporate form.

Smaller trusts may not be viable as public companies. In fact, many were once public companies that were effectively “orphaned” in the market. They became trusts to enhance value and access capital.

New tax rules were introduced specifically to facilitate the conversion of income trusts into corporations. The ‘Conversion Rules’ are only available up to 2013. Before considering the mechanics of the Conversion Rules, a broader tax planning analysis should be completed.

Tax-Planning Considerations

From a tax perspective, how best to convert an income trust into a corporation requires the assessment of at least these six important considerations:

1) Would the unitholders prefer a taxable or tax-deferred transaction?

Some income trusts may have a significant number of unitholders that would prefer to realize accrued losses on their units and/or are tax-exempt, or non-resident unitholders for whom the Canadian tax implications of a conversion, such as a gain, are not significant.

When a gain is desired, consideration could be given to effecting a conversion transaction that is fully or partially taxable. Various approaches could be taken that could involve existing provisions of the *Income Tax Act* as well as aspects of the Conversion Rules. Care must be taken if the intent is to allow unitholders to access losses on a conversion because of superficial and suspended loss rules that have been introduced to defer loss recognition until unitholders have fully exited their investment.

2) Does the income trust have significant losses or undeducted expenses?

In some cases, pre-conversion steps should be undertaken to use or preserve losses and undeducted expenses. For example, this would be an important consideration for royalty funds that have large resource pools. In addition, the existence of losses and undeducted expenses is relevant for comparing alternatives under the Conversion Rules because not all alternatives will permit a continuation of losses and undeducted expenses.

In some cases, the U.S. tax implications may be a key consideration. The implications to U.S. unitholders and their preference for one form of conversion over another will vary considerably depending on the answers to at least two trust-specific questions.

First, is the trust treated as a trust, a partnership or a corporation for U.S. federal income tax purposes? The answer is trust-specific and can depend on various factors including the specific provisions of the trust indenture itself. Historically, many trusts have assumed that, for U.S. federal tax purposes, they will be treated as a corporation. However, given the potential wide variance in the tax results arising from how the trust is classified, trusts may want to review

their historical assumptions and understand the consequences to the U.S. unitholders.

Second, what are the specific assets held by the trust? Again, the answer to this question is trust-specific, with significant differences in the U.S. tax treatment depending on the answer. The U.S. tax consequences to the U.S. unitholders will vary considerably from trust to trust and will depend on the specific facts.

3) Should some of the income trust's assets remain in trust or other flow-through form?

Depending on the composition of an income trust's assets and its business objectives, it might make sense to consider a divisive reorganization of the trust rather than a standard conversion. For example, it might be possible to:

- leave a trust's non-portfolio property and/or property in respect of which there are considerable remaining tax deductions (such as interest and capital cost allowance deductions) in a flow-through entity, notwithstanding the SIFT rules; and
- transfer the balance of its assets to a corporation.

Similarly, some of the trust's assets and operations may be suitable for a REIT, while others may not. These types of transactions might involve a combination of existing provisions of the *Income Tax Act* as well as the Conversion Rules.

4) Should a subsidiary partnership be retained?

Many income trust structures include a subsidiary partnership that has issued units exchangeable for trust units. Depending on the characteristics of the holders of these partnership units, there may be a desire to retain or a need to eliminate the partnership, and this will affect how to structure any conversion or other reorganization of the trust.

5) Is a migration preferable to a conversion transaction?

Depending on the composition of an income trust's assets and the manner and location in which it conducts its activities, consideration might be given to transactions that would involve transferring all or some of the trust's assets to a foreign entity, perhaps a flow-through entity that would not be subject to the SIFT rules.

6) Is a privatization transaction that preserves flow through treatment preferable?

A privatization transaction that is structured to maintain flow-through treatment of an income trust's assets may be more tax-efficient and perhaps a better way to maximize shareholder value than a standard conversion. The Conversion Rules need to be carefully considered in this case too because they can affect any transaction involving income trusts, including a taxable acquisition.

For an overview of the mechanics of the Conversion Rules see **Appendix A**.

3. Sell/Privatize

Smaller or mid-size trusts may not believe that either the status quo or conversion to a public company is optimal. Reasons include:

- the trust's small size may hurt valuation/analyst coverage;
- the trust faces an urgent need for capital to grow or refinance;
- the trust may be concerned by the complexity and costs related to public company status; and
- the trust may be concerned that the business cannot sustain high levels of distributions.

These trusts should consider a sale or privatization transaction. Rather than waiting for it to happen, management and trustees should take an active role in the process and selection of a future owner/business partner. This process often starts with a strategic business assessment.

Mergers between smaller trusts are also likely to be a viable way to reach a size sufficient to make conversion to a public company optimal. Probable candidates are resource trusts, smaller REITs and business trusts in similar businesses. Particular caution is advised when trusts hope to solve business problems through a merger. Synergies, integration costs and cash flow/distribution effects must be considered.

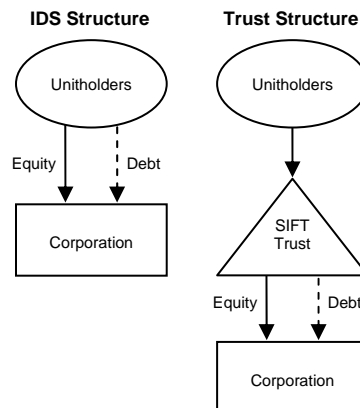
An income trust can be privatized in two main ways – by acquiring trust units or acquiring trust assets (discussed in more detail in **Appendix B**). Each alternative has its specific tax considerations. Trust mergers are more complex and require an analysis of other specific tax rules.

Some trusts are considering a privatization using a private mutual fund trust because the SIFT tax will apply only to publicly-listed trusts. This alternative can be used to retain the tax benefits associated with the flow-through trust structure. Additionally, private mutual fund trust units are eligible investments for RRSPs and tax-free savings accounts. To qualify as a private mutual fund trust, the units must be qualified for distribution to the public (although there will be no public offering) and there must be at least 150 beneficiaries, each of which holds at least \$500 worth of trust units.

4. IDS/Stapled Structure

Income deposit securities (IDS) were developed as an alternative structure to an income trust. In simplest form, an IDS unit is simply a share of a corporation and an interest-paying note of that corporation. Rather than trading as separate equity and debt securities, the two pieces are “clipped” together and traded as a unit.

The IDS structure simply eliminates the “trust” in a “trust over corporate” structure. For U.S. tax reasons, this direct holding of separate equity and debt securities was felt to be advantageous, so IDS structures have been used in cross-border structures. They also allow for a majority of non-resident unitholders, something not permitted for an income trust.



As 2011 draws nearer, many trusts that hold debt of corporate subsidiaries may consider distributing that debt to the unitholders as a distribution of capital. The corporate debt would then be held directly by the public and interest payments would not be subject to SIFT tax. The debt could trade separately or could possibly be “clipped” to a trust unit. Another possibility would be for the trust to distribute the corporate debt and equity to the unitholders as a clipped unit.

The effect of any restructuring on the unitholders must also be considered. For example, if the amount of debt distributed exceeds the adjusted cost base of the unitholder's unit, a capital gain will result.

The SIFT tax rules contain a warning that the Department of Finance might make further changes to address alternative structures designed to avoid corporate tax in the future. Whether an IDS structure, which is akin to a highly levered public company, would attract the attention of the Department of Finance is difficult to predict. Presumably the Department of Finance could place limits on the level of shareholder-held debt – a domestic thin capitalization rule. New Zealand has enacted rules that will deem the debt portion of a clipped or stapled unit to be equity for tax purposes. This would result in the loss of the corporate interest deduction and the interest itself would be treated as a dividend.

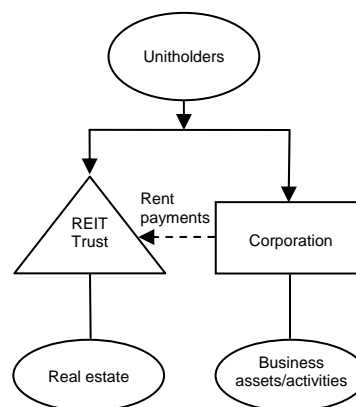
Widely held public debt is less likely to be considered offensive by the Department of Finance. However, corporate issuers must recognize the commercial differences between public debt and IDS debt. A debtholder that has no equity stake is going to be more problematic to deal with if the company ever faces cash flow or restructuring issues.

Interestingly, several of the companies that issued IDSs in the past have recently made offers to eliminate the note portion of the IDS in exchange for a share. The offer to exchange is made by way of an issuance of rights providing for the exchange upon exercise. The exchange is conditional upon a minimum percentage (perhaps 66 2/3%) of the rights being exercised. The exchange is completed on a tax-deferred basis by filing a joint subsection 85(1) election. Aside from this type of offer, there may be no way to force a conversion of the IDS notes into equity or otherwise eliminate them before their maturity date.

Presumably, the rationale for eliminating the IDS notes in most cases is to conserve cash flow within the corporation for expansion purposes. Once again, the fundamental question for income trust investors and managers is: What is the most appropriate capital structure and distribution policy in light of the strategic objectives of the business?

5. Stapled REIT Structures

Certain REITs (e.g., those in the hotel or retirement home business) that will be unable to satisfy the REIT test for exemption from the SIFT tax can restructure by separating their real estate from their operating activity. For example, a stapled structure often used in Australia is set out below. The REIT trust would qualify for exemption from the SIFT tax and would receive rent from the taxable corporation operating the business.



The challenges of moving to this type of structure are:

- managing the Canadian tax costs arising from a transfer of either the business operations or the real estate into a separate corporation or trust; and
- uncertainty as to the acceptability of this structure to the Department of Finance.

A Canada Revenue Agency (CRA) ruling should be obtained before implementing this type of structure.

6. Master Limited Partnerships (MLPs)

Some trusts should consider the possibility of converting into a U.S. publicly traded partnership, more commonly referred to as Master Limited Partnerships or MLPs. MLPs have become increasingly attractive investment structures in the U.S. MLPs are similar to trusts in that the MLP earnings are not subject to tax at the entity level, but rather, the income is taxed only once, at the unitholder level.

A Canadian trust that converts to a U.S. MLP must be sure to move its "mind and management" outside of Canada to avoid being subject to the SIFT regime. If the MLP is organized in the U.S., it must also meet certain gross income requirements. Otherwise, the U.S. will tax the partnership as a corporation and the tax advantages

of the MLP will be lost. For the gross income requirements to be met, at least 90% of the gross income must be from qualifying sources. Qualifying sources include interest, dividends, real property rents and certain active businesses in the mineral, natural resource or energy sectors. Given that qualifying income includes dividends and interest, MLPs do not have to be restricted to companies in the resource or energy sectors. Rather, an MLP could include all businesses and be structured similar to current income trusts with operating subsidiaries.

Some of the possible advantages of an MLP are:

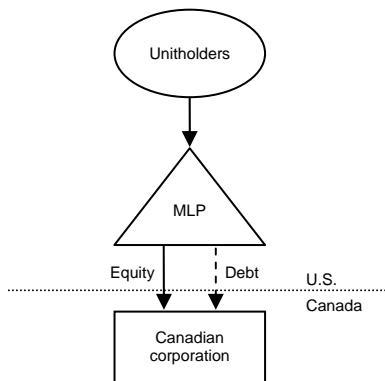
- lower cost of capital;
- access to a larger capital market (generally, MLPs would be traded on a U.S. exchange);
- lower effective tax rates; and
- ability to grow without being subject to the SIFT growth limitations.

A major disadvantage of the structure is the cost of conversion. From a Canadian tax perspective, conversion into an MLP generally would be a taxable event only for Canadian unitholders. The tax impact to other unitholders in their own jurisdiction should also be considered.

In the context of Canadian income trusts, an MLP could be a viable alternative structure, especially for trusts that:

- currently have a significant number of U.S. unitholders; or
- are trading at the low end of their historical range.

It could also be an attractive vehicle for trusts that operate in the energy or natural resource sector because the MLP would allow them to expand their business into the U.S. The following diagram shows a simplified structure of an MLP with investments in Canada.



How PwC Can Help

All trusts have some decisions to make between now and 2011. Each of the issues described in this publication will affect income trusts differently depending on their unique situation. At the risk of oversimplification, we can categorize trusts into three different groups, depending on whether their primary business objective is to achieve:

- rapid growth;
- organic growth; or
- stability.

Those facing rapid growth may feel especially constrained by the limits imposed by the Department of Finance and may have to take immediate action to access the required capital. That could include a conversion to a public company or even a sale or privatization transaction.

Trusts in more mature businesses may be able to grow organically and may not be especially constrained by the SIFT rules. For these businesses, waiting until 2010 to convert into a public company may be the best option. It maximizes the tax-efficiency of the trust structure for the longest period possible.


However, a large number of trusts can be grouped into the stabilizing category. These trusts face challenges in maintaining distributions and perhaps are simply too small to operate as public entities. Because of their size, these trusts may have to address immediate financing and capital structure issues and a sale/privatization transaction may be their best or only option.

Because of these differences, it is important that income trust investors and managers carefully consider their strategic options before making final decisions.

PwC has worked closely with many trusts in structuring their formation, raising additional capital, privatizations, insolvency and financing.

The chart on page 14 outlines a number of our advisory services for trusts organized using the three broad categories of trusts outlined above.

Issues and implications by type of business objective

	Issues/ options	Implications	PwC advisory services for trusts	Timing
Business objective 	<ul style="list-style-type: none"> Identify/prioritize opportunities Obtain financing Implement efficiently Overcome structural impediments 	<ul style="list-style-type: none"> SIFT growth guidelines Must resolve structural uncertainties immediately Must respond rapidly to avoid missing opportunities 	<ul style="list-style-type: none"> Environmental assessment, including transaction activity and valuations Identifying acquisition categories and related targets Identifying capital requirements and optimizing capital structure Advising on legal/tax restructuring Transaction advisory services (diligence, valuation, structuring) 	Before 2010
	<ul style="list-style-type: none"> Identify growth opportunities Obtain financing Assess impact of SIFT tax Determine post-2010 structure (status quo, public company, sale?) 	<ul style="list-style-type: none"> Growth may offset SIFT tax cost Levels of past distributions Impact of alternative structures on equity value 	<ul style="list-style-type: none"> High-level assessment of business plan Reviewing options for organic growth Quantifying impact of SIFT tax Identifying range of potential performance and implied effect on value Reviewing and advising on sale versus structure alternatives post-2010 Fairness opinions Tax restructuring and tax election preparation 	Before 2011
	<ul style="list-style-type: none"> Reverse negative cashflow Remedy negative covenants Reduce distributions Refinance/sell/other 	<ul style="list-style-type: none"> Possible insolvency Reduced unitholder value Possible need for structural changes Flow/allocation of taxable income 	<p>Financing issues:</p> <ul style="list-style-type: none"> Assessing capital structure Identify potential financiers Recovery services if immediate action required <p>Sale alternatives:</p> <ul style="list-style-type: none"> Environmental assessment, including comparable transactions Identifying potential buyers Valuation analysis Impediment analysis and recommendations Tax restructuring 	Immediate

Appendix A

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.

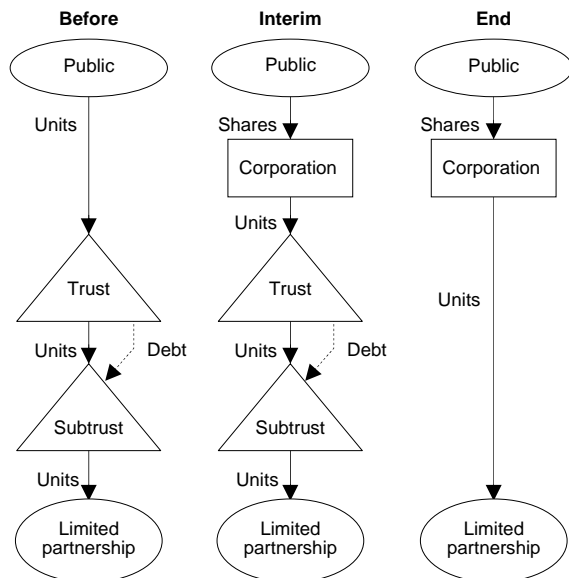
1) Exchange Method: Subsections 85.1(7) and (8)

To demonstrate the Exchange Method, consider an income trust that holds the debt and units of a subsidiary trust (Subtrust). Subtrust holds limited partnership units of a partnership. The income trust will convert to a public corporation.

The key steps that would occur are:

- A taxable Canadian corporation is formed.
- The income trust unitholders transfer their trust units to the corporation in consideration for a single class of shares.
- Subtrust distributes its limited partnership units (and any other property it holds) to the income trust and ceases to exist.
- The income trust distributes the property it acquires from Subtrust (limited partnership units) to the corporation and ceases to exist.

The Exchange Method rules deal with the unit for share exchange. The Trust-Wind Up rules are discussed next.



In this example, the Exchange Method permits a trust unitholder to automatically exchange its income trust units for shares of the taxable Canadian corporation. Trust unitholders are deemed to dispose of their trust units on a tax-deferred basis under subsection 85.1(8), provided they dispose of these units solely for shares of a single class of the corporation with a fair market value equal to the fair market value of the income trust units disposed of. The exchange of all units must occur within 60 days of the transaction to qualify. The cost to the corporation of the income trust units acquired will be the lesser of the units' fair market value and the capital of the trust (original invested capital less capital returned to unitholders since the trusts' inception).

The exchange does not require the filing of a tax election. Other key aspects of the Exchange Method include:

- No non-share consideration can be issued as consideration for trust units.
- Unitholders' cost amount of their shares should equal the cost amount of their units.
- Employee options issued by the trust could be exchanged for corporate options on a tax-deferred basis.
- Other elective tax-deferred rollover provisions in the *Income Tax Act* will override the Exchange Method. This will give income trusts added flexibility in planning their conversion to a corporation.
- Only one class of shares can be issued by the taxable Canadian corporation to all unitholders as part of an Exchange Method transaction. Taxable Canadian corporations requiring more than one class of shares to be held by shareholders that 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 Rules include a new stop-loss rule to prevent unitholders from realizing a loss on the unit-for-share exchange.

2) Trust Wind-up: Section 88.1

Following an exchange of units for shares (discussed previously), it will be necessary to eliminate the trust. These steps are the last two points in our example. The Trust Wind-Up rules permit a taxable Canadian

corporation 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.

Section 88.1 will apply on the wind-up of the trusts (Subtrust and income trust), so that the rules in subsections 88(1) to (1.7) will apply, subject to certain modifications. The modifications treat the trust as a taxable Canadian corporation that is not a private corporation, the distribution by the trust as the winding up of the corporation, and the beneficiary's interest in the trust as shares of the corporation. This will allow for the continuation of the tax attributes of the trusts to the corporation. The debt forgiveness rules should not apply to the settlement of Subtrust's debt if the required election is made.

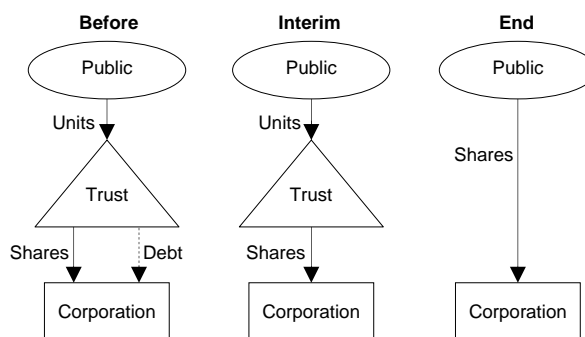
Other key aspects of the Trust Wind-up include:

- The taxable Canadian corporation will not realize a gain on the disposition of its trust units on a wind-up of the trust.
- 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.
- The Trust Wind-up rules apply only to first and second-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.
- Tax loss carryforward balances and other tax attributes of the trust will transfer to the taxable Canadian corporation.

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. Under this approach, the trust would transfer all of its assets to a corporation before a distribution of the shares. The key steps under this method are:

- the corporation issues additional shares to the income trust in satisfaction of its outstanding indebtedness; and
- the income trust redeems all of its units, distributes its shares of the corporation to its unitholders as redemption proceeds and ceases to exist.



This conversion would occur on a tax-deferred basis by virtue of subsection 107(3.1). More specifically, the income trust would be deemed to have disposed of the corporation's shares for proceeds of disposition equal to their cost.

Unitholders would be deemed to have disposed of trust units for proceeds of disposition equal to the cost amount of their trust units. Any loss carryforwards or undeducted expenses of the trust would be lost when the trust ceases to exist.

Other key aspects under the Redemption Method rules:

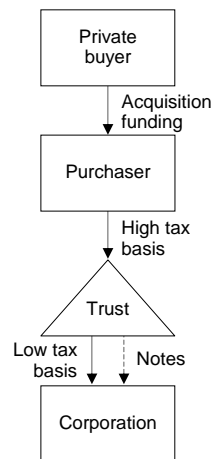
- Unitholders' cost amount of their shares should equal the cost amount of their units.
- Non-resident unitholders will not be subject to withholding tax on a Redemption Method distribution.
- Debt obligations of a trust assumed by a taxable Canadian corporation as part of a Redemption Method transaction are deemed to be a debt of the taxable Canadian corporation.
- Unlike a Trust Wind-up under section 88.1, the Redemption Method can be used to dissolve third- and lower-tier trusts tax-free.
- Consistent with the Exchange Method, only one class of shares of the corporation can be distributed by the trust.

Appendix B

Trust Privatization

1) 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.

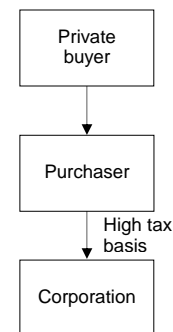


The Conversion Rules could be used to do so, as follows:

- The purchaser can use the Trust Wind-up Rules 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 the Trust Wind-up Rules, tax attributes of the trust (e.g., losses, depreciable tax basis) are transferred to the purchaser.
- The purchaser could also use the Redemption Method 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 the Redemption Method, 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 these rules.

- Under both the Trust Wind-up and Redemption Method it should be possible to settle intercompany debts within the structure. Planning may be required depending on the circumstances.
- Both methods will 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.



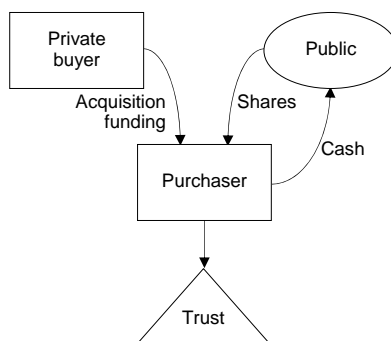
2) Acquiring income trust units – Cash and share consideration

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.
- 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, and will not be available on a unit sale when share consideration is received.
- The purchaser can still use the Conversion Rules 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. However, other tax rules should still permit the trustees to dissolve the trust structure.



PricewaterhouseCoopers Contacts

Tax

Toronto (GTA)	Doug Frost	416 365 8852	doug.l.frost@ca.pwc.com
	Janice Russell ¹	416 365 8810	janice.russell@ca.pwc.com
	Eoin Brady	416 869 2354	eoin.brady@ca.pwc.com
	(Equity compensation) Richard Schubert	416 947 8984	richard.c.schubert@ca.pwc.com
Montreal	Denis Langelier	514 205 5270	denis.langelier@ca.pwc.com
Calgary	Ron Gratton	403 509 7492	ronald.p.gratton@ca.pwc.com
	Angelo Toselli	403 509 7581	angelo.f.toselli@ca.pwc.com
	Johnson Tai	403 509 7544	johnson.tai@ca.pwc.com
Vancouver	John Robinson	604 806 7099	john.robinson@ca.pwc.com
	Ronnie De Zen	604 806 7065	ronnie.de.zen@ca.pwc.com

Wilson & Partners LLP

A law firm associated with PricewaterhouseCoopers

David Glicksman ¹	416 947 8988	david.glicksman@ca.pwc.com
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Audit and Assurance Group

Toronto GTA	Ross Sinclair	416 228 4000	ross.sinclair@ca.pwc.com
--------------------	---------------	--------------	--------------------------

Advisory

Toronto	Keith Mosley	416 941 8307	keith.mosley@ca.pwc.com
Calgary	Brooke Valentine	403 509 7471	brooke.valentine@ca.pwc.com
Vancouver	Jim McGuigan	604 806 7594	jim.j.mcguigan@ca.pwc.com

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