

# Tax Memo

## Tax Planning for Income Trust Conversions and Acquisitions

The recent PricewaterhouseCoopers publication *Income Trusts: Planning for 2011 and Beyond* summarized the key business, strategic and tax issues facing income trusts (available at [www.pwc.com/ca/incometrusts](http://www.pwc.com/ca/incometrusts)). The purpose of this *Tax Memo* is to provide more detailed comments about certain Canadian income tax issues that are relevant for planning income trust “conversions” and acquisitions, taking into account draft tax legislation that was released on July 14, 2008 (the Conversion Proposals).

The Conversion Proposals are meant to facilitate the conversion of specified investment flow-through (SIFT) trusts into corporations. However, they should also be considered in connection with any acquisition or reorganization of an income trust, including an income trust that is, or intends to qualify as, a real estate investment trust (REIT) or that does not otherwise expect to be subject to tax under the SIFT rules.

Some of the Conversion Proposals apply automatically while others are elective. Therefore, depending on the circumstances, it may be desirable to either fail to qualify for, or not elect into, certain provisions. This could be an important consideration when the transactions are not part of what might be colloquially considered a trust conversion, such as a taxable acquisition and privatization of an income trust, or when trust unitholders wish to realize accrued losses on their trust units.

### Summary of the Conversion Proposals

To provide some initial context for our more detailed comments, the following is a brief summary of the Conversion Proposals.

The Conversion Proposals largely fulfill the federal government’s commitment to introduce legislation to ensure that SIFTs can convert to taxable Canadian corporations without any undue tax consequences to either SIFT unitholders or the SIFTs themselves.

The Conversion Proposals are temporary; they apply to transactions that occur on or after July 14, 2008, and before 2013, and that are undertaken by a trust that at any time before July 15, 2008, was:

- a SIFT trust (ignoring the transitional relief provided until 2011);
- a REIT; or
- a trust of which the only beneficiary at all times since July 14, 2008, is a SIFT trust or REIT (such as a SIFT subsidiary trust).

Presumably recognizing that certain income trusts have already completed conversion transactions, some of the Conversion Proposals are also available in respect of transactions that occurred after December 19, 2007.

The Conversion Proposals contain three key tax-deferred rollover provisions:

- Subsection 85.1(8) is an automatic provision under which trust unitholders can exchange their trust units for shares of a taxable Canadian corporation on a tax-deferred basis without having to file an election. This provision could be used to effect a trust conversion through a unit-for-share exchange (the Exchange Method).
- Section 88.1 is an elective provision (in certain cases) under which a taxable Canadian corporation can wind up a wholly owned trust and its subsidiary trust on a tax-deferred basis. This provision could be used by a corporation to eliminate an income trust that it has acquired on either a taxable or tax-deferred basis.
- 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 trust can be the income trust or a subsidiary trust. If shares are distributed by a subsidiary trust, any subsequent distribution by the income trust must occur no more than 60 days thereafter. This provision could be used to effect a trust conversion through the redemption of unitholders' trust units (the Redemption Method).

The Conversion Proposals also include:

- an automatic provision to permit the tax-deferred exchange of a SIFT option for an option issued by a public corporation that participated in the conversion;
- an elective provision to prevent the application of the debt forgiveness rules when debt of a subsidiary trust is settled as part of the wind-up of the trust;
- a provision to prevent control of a corporation from being acquired where the corporation's shares are distributed by a subsidiary trust to a "parent" trust. This provision has limited application and as a general matter there is still uncertainty about whether a corporation that is a subsidiary of a trust is controlled by the trust, its trustees or its unitholders; and
- provisions that will also be relevant for the conversion of a SIFT partnership.

Not dealt with in the Conversion Proposals are exchangeable units or shares of a subsidiary partnership or corporation of an income trust. Existing provisions of

the *Income Tax Act*, such as section 85, could apply to provide for a tax-deferred transfer of exchangeable securities to a corporation, if necessary.

The Department of Finance will accept comments regarding the July 14, 2008 legislation until September 15, 2008, and it is possible that the legislation when enacted may be somewhat different from the draft legislation.

## Tax-Planning Considerations

How best to structure an income trust conversion depends on many factors other than tax considerations. From a tax perspective, however, at least seven important considerations can be identified:

- 1) **Would the unitholders prefer a taxable or tax-deferred transaction?** Some income trusts may have a significant number of unitholders who 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 are not significant.

In this situation, 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 Proposals.

- 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. This would be an important consideration for royalty funds that have large resource pools, for example. In addition, the existence of losses and undeducted expenses is relevant for comparing a section 88.1 transaction to a subsection 107(3.1) transaction, because only section 88.1 provides for a continuation of losses and undeducted expenses.
- 3) **Does the income trust have a significant number of non-resident unitholders?** It appears that the 15% Part XIII.2 tax (which applies to certain otherwise non-taxable trust distributions) can apply when the Redemption Method is selected by an income trust that derives its value primarily from Canadian real or resource property.

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, for U.S. federal income tax purposes, treated as a trust, a partnership or a corporation? 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 upon 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.

- 4) **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 Proposals.

- 5) **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 such 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.
- 6) **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. Recently, some attention has been given to U.S. master limited partnerships, but this is just one alternative along these lines that might be considered.
- 7) **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 Proposals need to be carefully considered in this case too, because, as noted above, the Conversion Proposals can affect any transaction involving income trusts, including a taxable acquisition.

## How the Conversion Proposals Could Apply – Examples

The simplified examples that follow are intended to provide a general understanding of how the Conversion Proposals could apply in different scenarios. These examples do not address all of the relevant tax considerations, nor do they exhaust all scenarios under which the Conversion Proposals could apply.

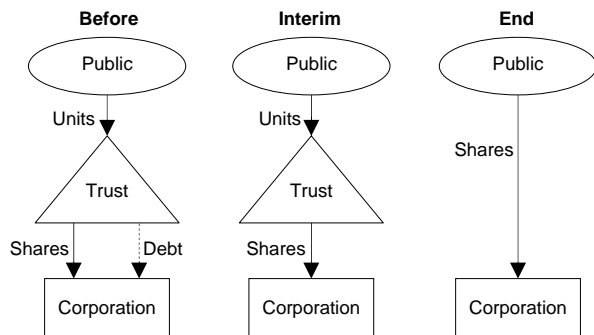
### Example 1 – Conversion of first-generation income trust

In this example, an income trust that owns shares and debt of a corporation converts to a corporation through a redemption of its units.

### Key steps:

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

#### Example 1



### General comments:

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 adjusted cost base (ACB).

Unitholders would be deemed to have disposed of trust units for proceeds of disposition equal to the cost amount of their trust units. For these purposes, the cost amount should be the ACB of their units.

It appears that, under this approach, non-resident unitholders could be subject to 15% Part XIII.2 tax if more than 50% of the fair market value of the units are attributable to a real property in Canada, a Canadian resource property or a timber resource property. In these circumstances, a unit-for-share conversion structure may be the preferable structure for these kinds of trusts.

Employee options issued by the trust could be exchanged for corporate options on a tax-deferred basis.

Any loss carryforwards or undeducted expenses of the trust would be lost when it ceases to exist.

Steps may be needed to address any debt forgiveness issues in respect of the corporate debt. The Conversion Proposals do not address this situation.

In addition to debt, an energy trust would often also own a 99% royalty interest in the resource properties of the corporation. In this case, the trust may want to transfer the 99% royalty interest to the corporation on a tax-deferred basis under section 85, in return for shares of the corporation, thereby effectively transferring a portion or all of its remaining resource tax pools to the corporation.

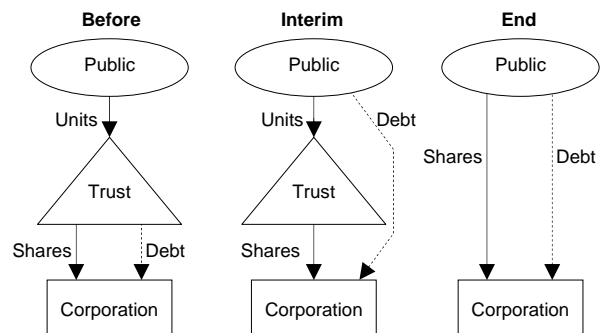
### Example 2 – Distribution of corporate debt and equity

This example shows how trust unitholders, particularly those that are tax-exempt or non-resident, might continue to receive a tax-efficient return.

### Key steps:

- Same key steps as in Example 1, except that the corporation does not settle the debt it owes to the trust. Instead, sometime before the conversion transactions, the trust distributes the corporate debt to its unitholders as a return of capital. Later, it distributes the corporation's shares to its unitholders.

#### Example 2



### General comments:

Same comments as in Example 1, except that the ACB of a unitholder's trust units would be reduced by the fair market value of the distributed debt, which could result in a capital gain for the unitholder if the ACB of its trust units became negative.

The remaining debt could provide the corporation with ongoing tax shelter through interest deductions, and non-residents may receive a return in the form of interest without the imposition of withholding tax.

An important consideration related to this example is the Department of Finance's earlier warning that it will

consider additional legislative changes to address alternative structures that are designed to avoid the application of the SIFT rules. Finance may be less concerned if the corporate debt is widely held and not stapled to the corporation's shares.

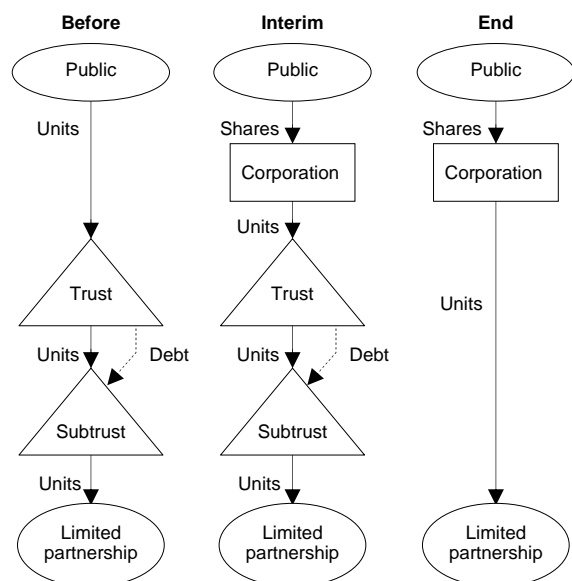
### Example 3 – Unit-for-share conversion of a second-generation income trust

In this example, an income trust holding the debt and units of a subsidiary trust (Subtrust) that holds limited partnership units of a partnership converts to a corporation through the Exchange Method.

#### Key steps:

- 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 to the corporation and ceases to exist.

Example 3



#### General comments:

Trust unitholders would be deemed to dispose of their trust units on a tax-deferred basis under subsection 85.1(8), provided they dispose of their income trust 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 within an exchange period of no more than 60 days. The cost to the corporation of the income trust units will be the lesser of the units' fair market value and the cost of the units to the trust unitholders.

Subsection 107(3.1) does not apply to the wind-up of the income trust or Subtrust because the property distributed on the wind-up of the trusts is not 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.

In addition, for the purposes of section 88.1, a synthetic paid-up capital will be calculated and used for the trust. This paid-up capital will be equal to the excess, if any, of amounts received in exchange for the issuance of trust units over the total of all distributions other than amounts payable out of the trust's income or capital gains. Because this paid-up capital is not "real" stated capital that can be reduced, a capital gain can result on the wind-up of a trust under paragraph 88(1)(b) if the lesser of the trust's synthetic paid-up capital and net asset exceeds the cost the trust's beneficiary (the new corporation) has in its units of the trust.

Employee options issued by the trust could be exchanged for corporate options on a tax-deferred basis.

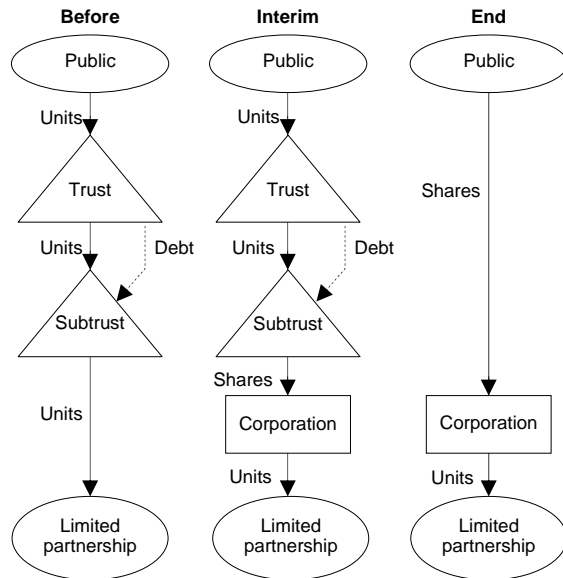
### Example 4 – Share distribution for a second-generation income trust

In this example, an income trust holding the debt and units of a subsidiary trust (Subtrust) that holds limited partnership units of a partnership converts to a corporation using the Redemption Method.

## Key steps:

- A taxable Canadian corporation is formed.
- Subtrust transfers its limited partnership units to the corporation in consideration for shares.
- Subtrust distributes its shares of the corporation to trust and ceases to exist.
- The income trust distributes its shares of the corporation to the public and ceases to exist.

### Example 4



## General comments:

Subtrust will dispose of its limited partnership units (and any other property it holds) on a tax-deferred basis under subsection 85(1).

Subsection 107(3.1) applies on the wind-up of both Subtrust and the SIFT trust. With respect to Subtrust, the result is that:

- Subtrust is deemed to have disposed of the corporation's shares for proceeds of disposition equal to their ACB and the SIFT trust is deemed to acquire the corporation's shares for that same amount;
- the SIFT trust is deemed to have disposed of its Subtrust units for proceeds of disposition equal to the cost amount of the units, which for these purposes is effectively the ACB of the units; and
- if the required election is made, there is no debt forgiveness on settlement of Subtrust's debt.

With respect to the SIFT trust, the result is that:

- the SIFT trust is deemed to have disposed of the corporation's shares for proceeds of disposition equal to their ACB; and
- the SIFT trust unitholders are deemed to have disposed of trust units for proceeds of disposition equal to the cost amount of their units and to have acquired the corporation's shares for that same amount, which for these purposes is effectively the ACB of the units.

Shares of the corporation distributed by the SIFT trust to non-residents may give rise to a 15% tax under Part XIII.2 of the *Income Tax Act*.

Employee options issued by the income trust could be exchanged for corporate options on a tax-deferred basis.

## How We Can Help

For more information about the Conversion Proposals, or any other tax matter affecting income trusts, please contact one of the PricewaterhouseCoopers or Wilson & Partners LLP individuals listed on the next page.

Together, PwC and Wilson & Partners LLP can provide all of the tax accounting and tax law services you may require in connection with any income trust conversion, or any other transaction.

## For More Information

For help understanding the implications this topic, please contact your PricewaterhouseCoopers adviser or any of the individuals listed below.

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2. Wilson & Partners LLP is a law firm affiliated with PricewaterhouseCoopers whose partners advise on a broad range of corporate tax matters including domestic and cross-border mergers and acquisitions, capital markets transactions, corporate reorganizations, financial products and structures as well as the acquisition and restructuring of income funds and REITs.

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