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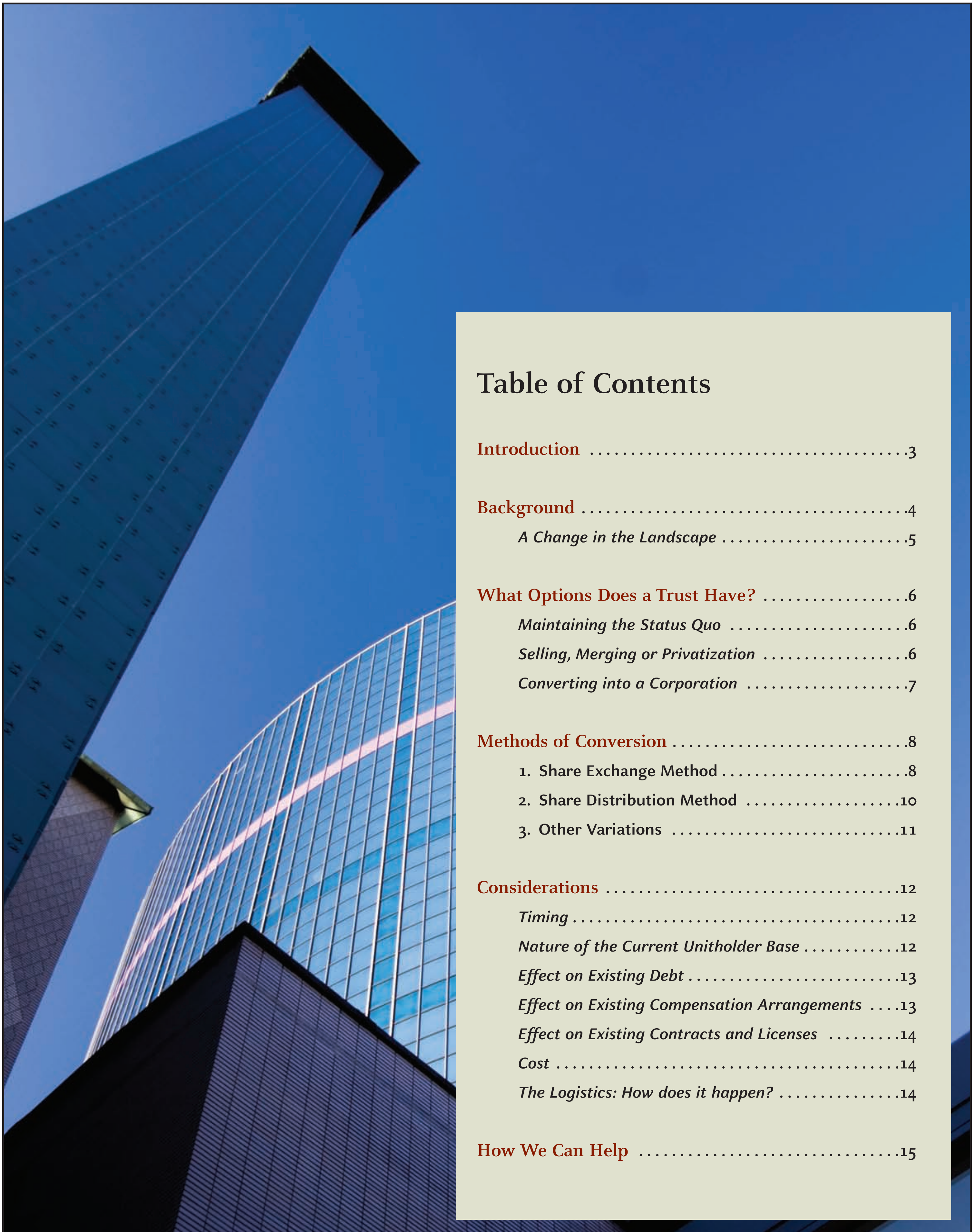
Osler Guide

Income Trust Conversions

Osler, Hoskin & Harcourt LLP



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Introduction

The purpose of this Osler Guide is to review the available alternatives and to help set a framework for the discussion that needs to happen among all stakeholders when making these decisions.

The Canadian income trust market has always been defined by continual changes in Canadian tax rules. Beginning on January 1, 2011, the application of the Specified Investment Flow Through (SIFT) tax will effectively level the playing field between trusts and corporations, leaving the income trust structure with little, if any, tax advantage. Since being announced on October 31, 2006, the SIFT rules have forced trustees of income trusts to consider their strategic alternatives, considerations made all the more difficult by the recent unprecedented turmoil in the global banking system and a meltdown in the global capital markets.

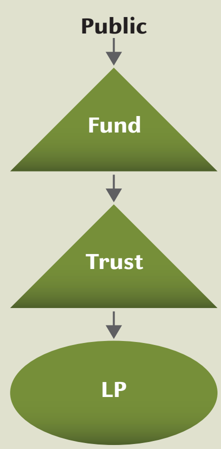
Against this uncertainty, the SIFT rules have forced trustees to consider:

- whether (or when) to convert into a corporation;
- whether to pursue growth opportunities (within or outside the "normal" growth limitations under the SIFT rules as described below); and
- whether to find a buyer and sell.

Background

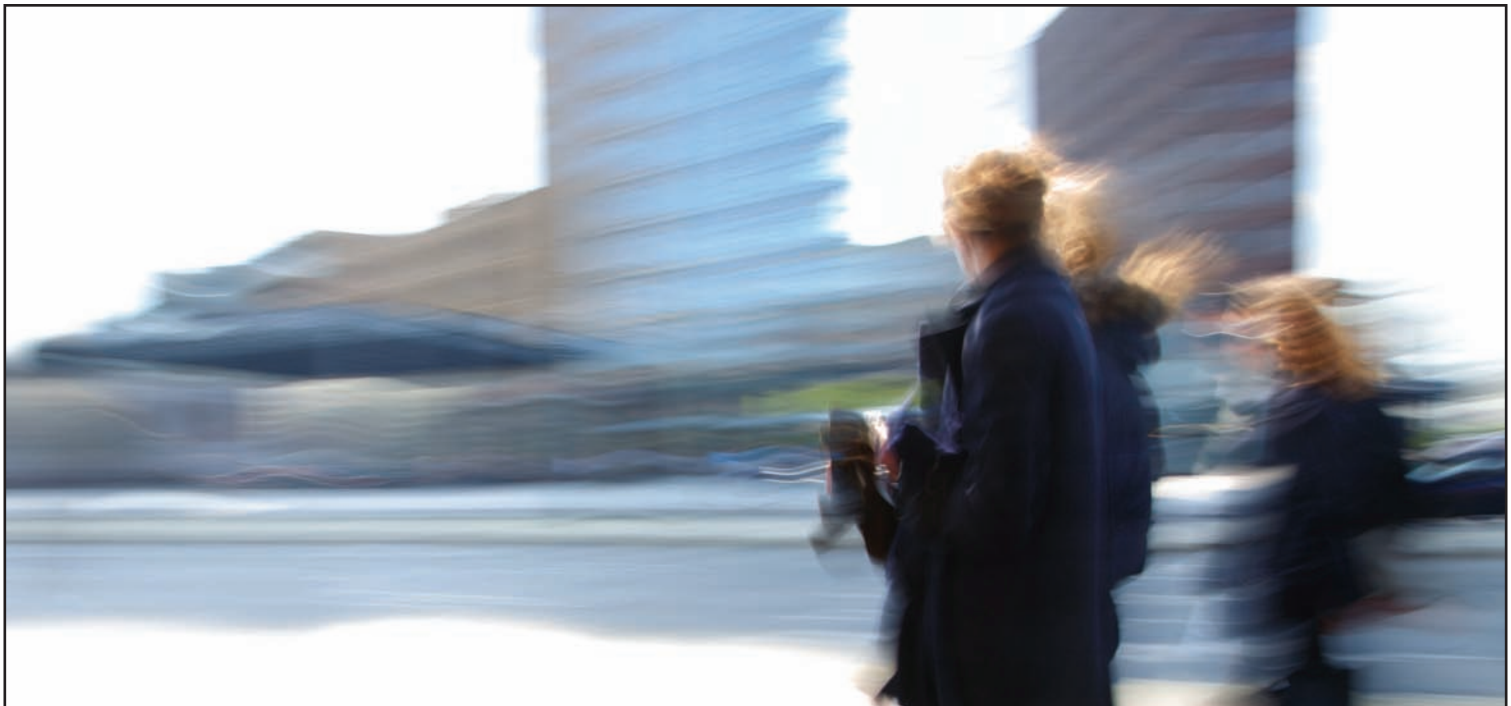
Income trusts enjoyed booming popularity in Canada before the announcement of the SIFT tax. This popularity arose from the tax advantage that they gained from being a mutual fund trust, which effectively permitted them to distribute their available cash flow to unitholders with no (or a significantly reduced) entity-level tax.

The cash flow-through was accomplished through a number of variations on a basic structure by using vehicles that were (or could be made to be) flow-through for entity-level tax purposes. The following illustrates a simplified second generation income trust structure:



The cash distribution provided an attractive income stream to retail investors, particularly those who were past their prime capital formation years, that was not otherwise available from investments in traditional equities issued by corporations. Trusts subsequently attracted an institutional following as mutual funds began including them in their portfolios.

Income trusts were originally used in the energy and real estate industries. Starting in 2000, more and more enterprises converted from a corporation into a trust to shelter themselves from corporate tax rates. At their peak in mid-2006, there were 245 income trusts in Canada with a total market value of over $200 billion.



A Change in the Landscape

In 2006, the prospect of several large companies (including BCE) converting into income trusts set off alarm bells in Ottawa, and on October 31, 2006, federal Finance Minister Jim Flaherty announced that he was implementing the SIFT tax to level the playing field for trusts and corporations. The SIFT tax applied immediately to new trusts, and this effectively ended overnight any new trust conversion activity. Existing trusts received the benefit of a deferral through the end of 2010, but effective January 1, 2011, the SIFT tax will apply to all distributions of income from income trusts to unitholders.

This unexpected change set off a wave of activity in the trust sector as trustees weighed their strategic alternatives and began to implement strategies to maximize unitholder value prior to the implementation of the SIFT tax. By the autumn of 2008, many trusts had been sold and a handful of larger trusts (such as TransForce Income Fund, CI Financial Income Fund and Aeroplan Income Fund) had converted back into corporations, in large part to gain greater financial flexibility and access to capital or, in some cases, to eliminate limits on foreign ownership or to get out from under the growth limits imposed under the SIFT rules. Those trusts not sold or not re-converted in the short term chose instead to continue receiving the tax benefit of the income trust structure as long as possible.

However, the time to act is quickly approaching. The SIFT tax will apply to all distributions of income beginning in January 2011, and trusts will only be allowed to convert into corporations on a tax-deferred basis until December 31, 2012.

Effective January 1, 2011, the Specified Investment Flow Through tax will apply to all distributions of income from income trusts to unitholders.

What Options Does A Trust Have?

There are three principal options available to existing trusts:

- maintain the status quo;
- sell, merge or privatize; or
- convert into a corporation.

Maintaining the Status Quo

A trust can choose to maintain its trust status. In doing so, it will become subject to the SIFT tax and effectively be subject to corporate tax rates on the taxable income that it distributes to unitholders and to personal tax rates (which are generally higher) on taxable income that it does not distribute. Trusts that are able to shelter taxable income (through the application of tax pools) may choose to maintain the status quo, at least until the end of the tax-free conversion period in 2012. Others may find that the advantages of conversion do not warrant the cost and so will simply proceed after 2012 as a fully taxable income trust.

Selling, Merging or Privatizing

While a sale or merger may initially have been a very feasible option in the days following the announcement of the SIFT tax, current market prices and the ongoing difficulty in obtaining acquisition financing make a sale or merger a difficult prospect for many trusts. In some cases, privatizing a trust by selling to institutional investors open to maintaining the trust structure may be a viable alternative because private trusts are not subject to the SIFT tax on distributions. However, in most cases, opportunities to privatize remain very limited, except to the most successful of income trusts.

Trusts that are able to shelter taxable income (through the application of tax pools) may choose to maintain the status quo, at least until the end of the tax-free conversion period in 2012.

Converting into a Corporation

Converting into a corporation is an option open to all trusts. The number of announced conversions is increasing, and a torrent of conversions is expected in 2010. The most significant business trust conversions that have occurred to date provided the following reasons for choosing to convert back to a corporation in advance of the application of the SIFT tax:

- a corporate structure was better suited to their growth strategy;
- a corporate structure allowed for greater access to financing; and
- the trust's valuation was at a discount to growth-oriented corporate peers.

The most often cited potential benefits of converting into a corporation include the following:

- a corporation is likely to have easier access to capital, given the certainty of its structure and governance requirements;
- a corporation may have access to a broader universe of investors and analyst coverage (as trusts have been considered as a separate class of specialty investments); and
- a corporation is not subject to tax at higher personal tax rates on taxable income that is not distributed.

Key reasons for choosing to revert to being a corporation.

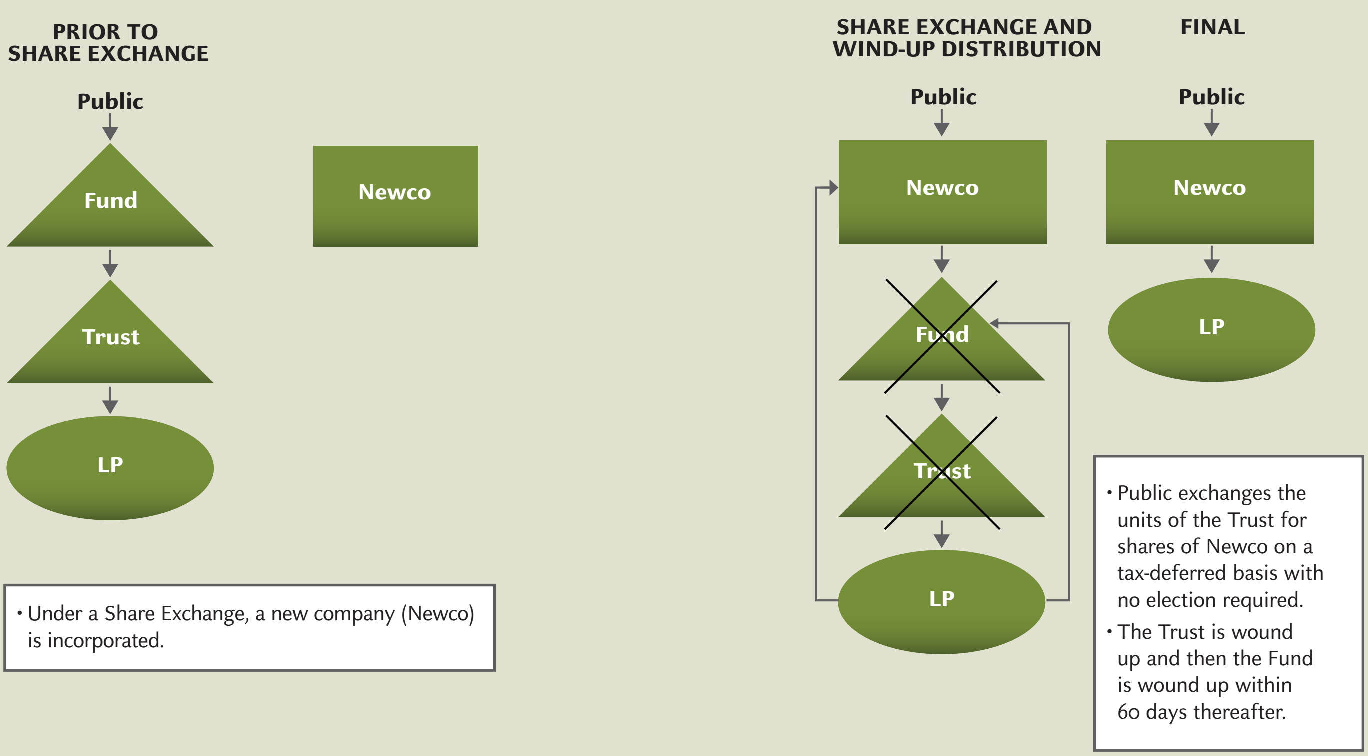
Methods of Conversion

Two basic methods are available to convert a trust into a corporation on a tax-deferred basis under the SIFT conversion rules: the Share Exchange Method and the Share Distribution Method

1. SHARE EXCHANGE METHOD

Under this scenario, the units of the trust are exchanged for shares of a new corporation. The trust itself is wound up (together with any subsidiary trusts).

The following simplified charts illustrate the steps involved in a Share Exchange:



One advantage of using a Share Exchange over a Share Distribution transaction is that the new corporation can access certain tax attributes of the Trust.

Conditions

Certain conditions must be met for the automatic rollover to apply (and to eliminate the need for the parties to file tax elections):

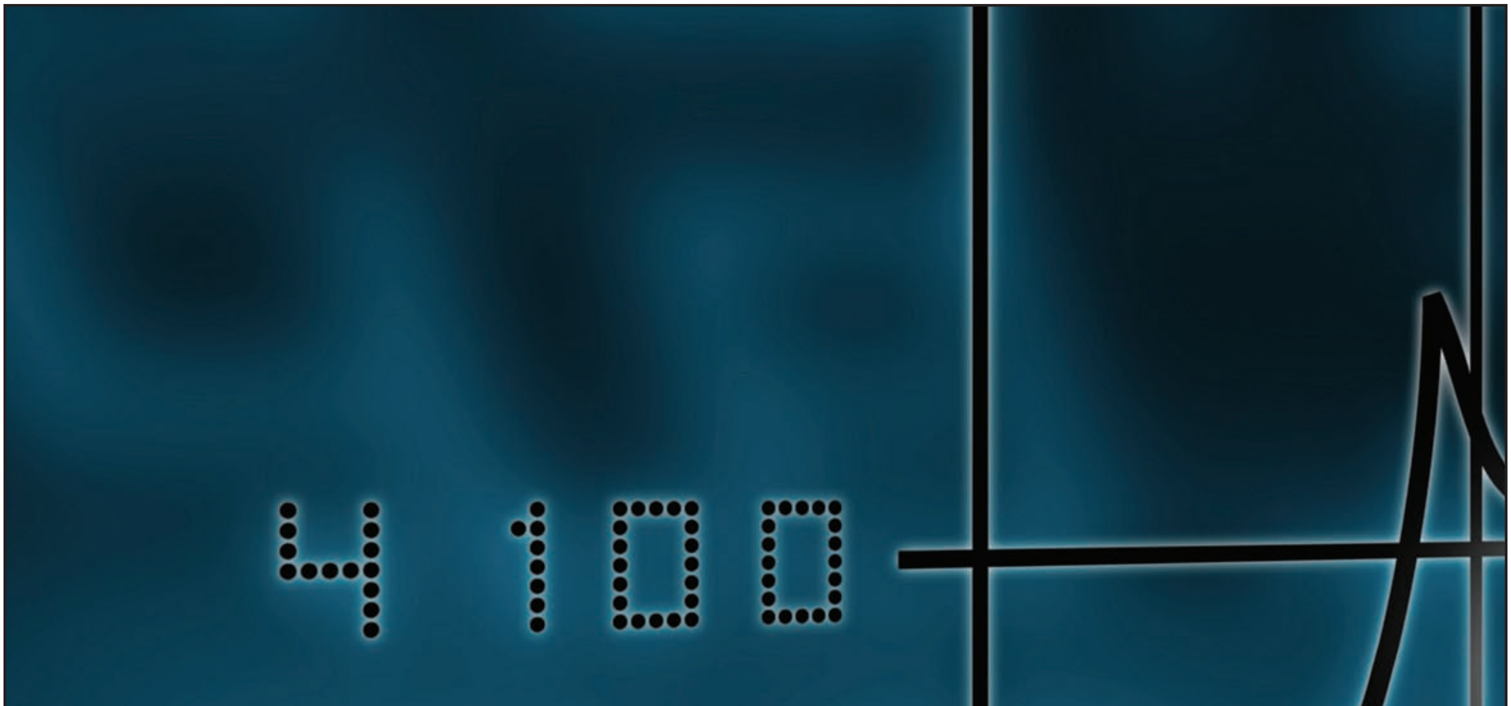
- the exchange must occur during a specified 60-day exchange period, at the end of which the new corporation owns 100% of the units of the trust;
- unitholders must dispose of all of their trust units during this exchange period;
- unitholders must only receive shares of Newco in return for their trust units;
- all unitholders must be issued the same class of Newco shares; and
- the transaction must occur no later than December 31, 2012.

Unitholders are then deemed to have transferred their units at a price equal to the tax cost of the units. To the extent that the fair market value of the Newco shares received by a unitholder exceeds the fair market value of the units exchanged for such shares, there will be an income inclusion to the unitholder (in the case of a non-resident, such excess will be subject to withholding tax).

To the extent that the fair market value of the units exchanged by a unitholder exceeds the fair market value of the shares received by the unitholder and any part of the excess can be viewed as a benefit incurred by a person with whom the unitholder does not deal at arm's length, the excess will be an income inclusion to the unitholder. (In the case of a non-resident, such excess will be subject to withholding tax.)

Note that these fair market value issues referred to above may, in turn, cause valuation issues that require a valuation opinion, particularly where the new corporation holds assets other than the newly acquired units of the trust.

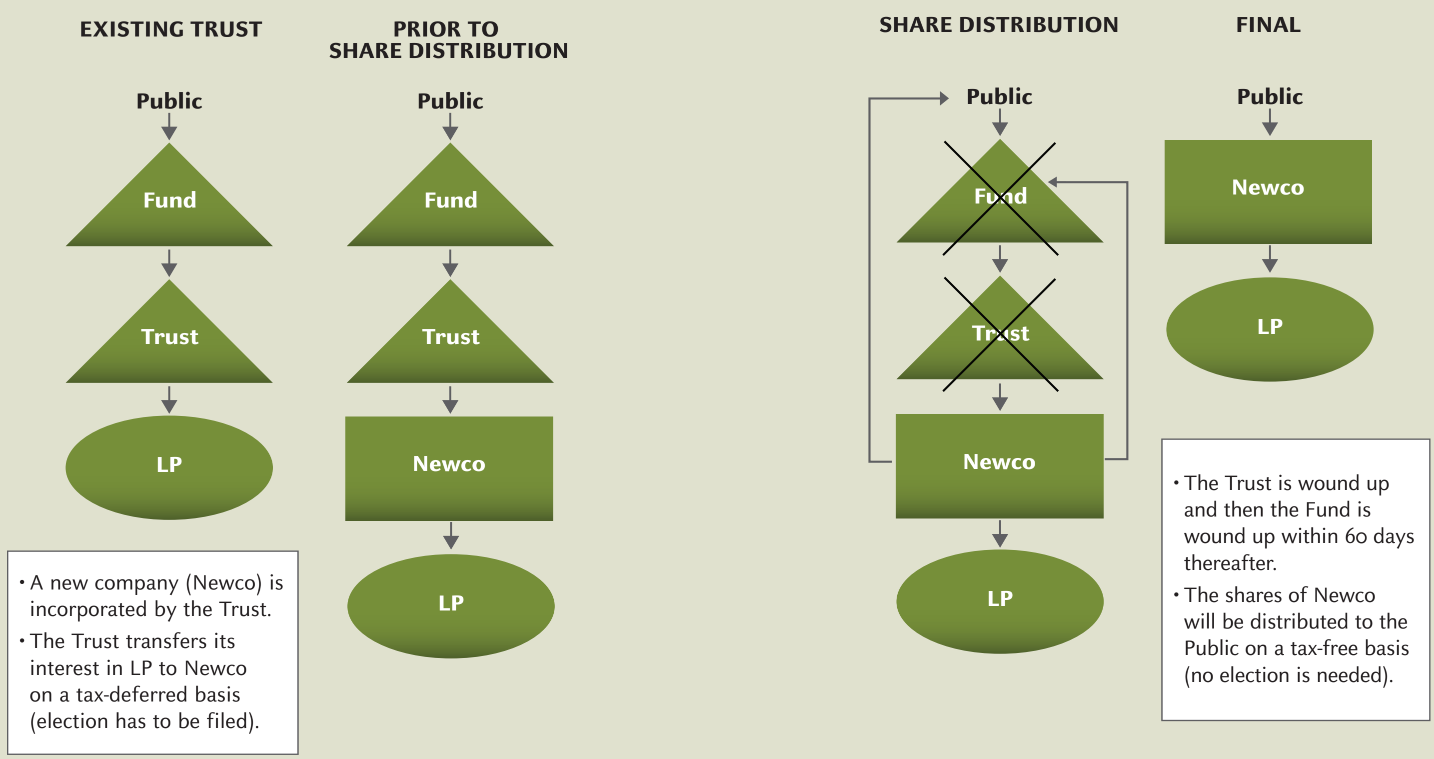
One advantage of using a Share Exchange over a Share Distribution transaction is that the new corporation becomes a unitholder of the former trust. As a result, the corporation can access certain tax attributes of the trust.

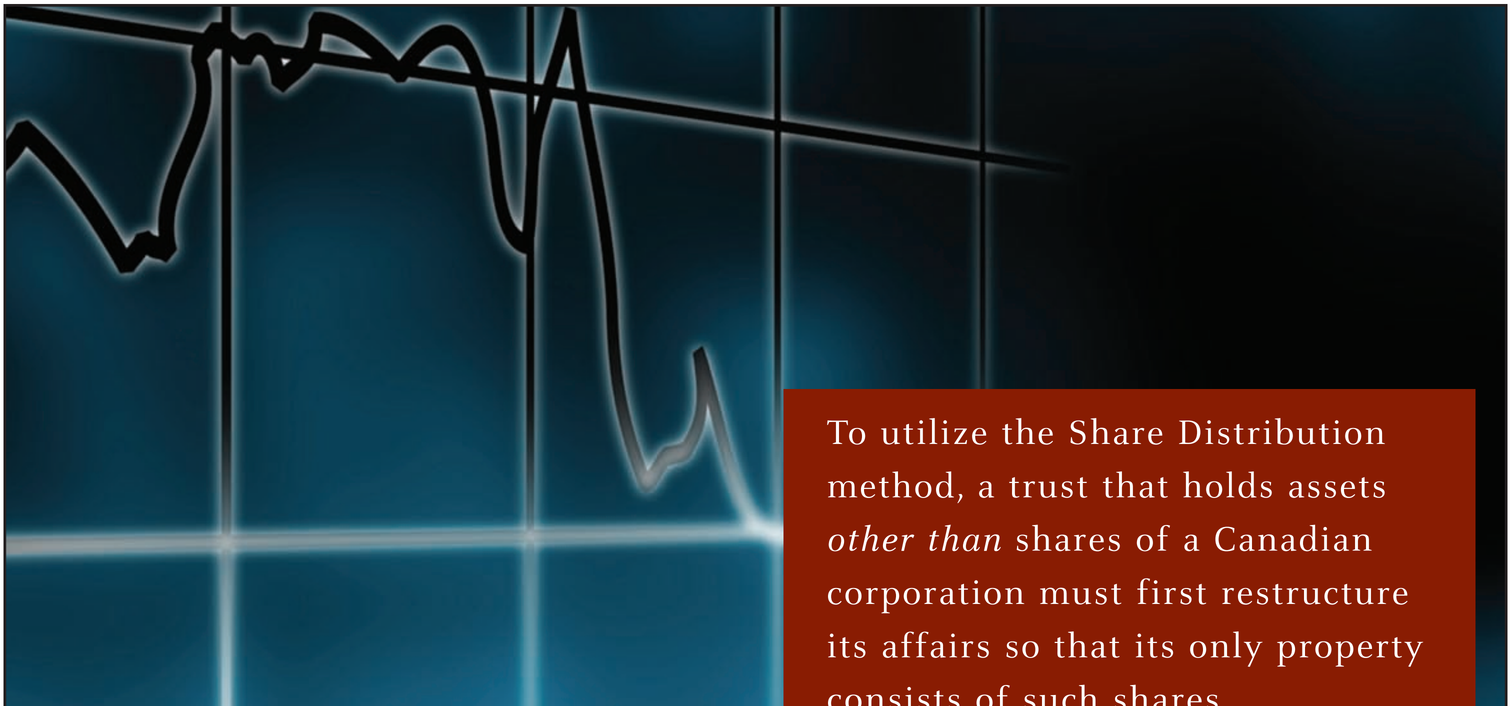


2. SHARE DISTRIBUTION METHOD

Like the Share Exchange Method, the Share Distribution Method allows a trust to distribute to its unitholders on a tax-deferred basis the shares of a corporation owned by the trust. The trust (whose only asset can be shares of a taxable Canadian corporation) winds up and distributes the shares of that corporation to its unitholders.

The following simplified charts illustrate the steps involved in a Share Distribution:





> To utilize the Share Distribution method, a trust that holds assets *other than* shares of a Canadian corporation must first restructure its affairs so that its only property consists of such shares.

Conditions

Certain conditions must be met for the automatic rollover to apply (and to eliminate the need for the parties to file tax elections):

- the only property of the trust is shares of a single class of a taxable Canadian corporation;
- the distribution occurs no later than December 31, 2012;
- the distribution occurs within a 60-day period;
- all of the unitholders' units of the trust are disposed of; and
- there is a distribution of all of the trust's property.

To take advantage of the Share Distribution Method, a trust that holds assets *other than* shares of a Canadian corporation must first restructure its affairs so that its only property consists of such shares.

Unlike a Share Exchange, a Share Distribution transaction does not result in the new corporation becoming a unitholder of the former trust. As a result, the corporation may not access the tax attributes of the trust.

3. OTHER VARIATIONS

In addition to a Share Exchange and a Share Distribution, there are other methods by which a trust may convert into a corporation on a tax-deferred basis that may be considered in specific circumstances. However, the critical factor in considering any structure is that the conversion can be implemented on a tax-deferred basis.

Considerations

Deciding whether, when and by which method to convert a trust into a corporation involves a number of (often inter-connected) factors that should be reviewed within the context of a trust's structure, business, tax position and distribution policy.

Timing

The new SIFT tax does not come into play for existing trusts until January 2011. As such, any trust considering a conversion before then needs to determine whether the benefits of becoming a corporation outweigh the tax benefits available to a trust pre-2011. Such a determination involves a consideration of the following questions:

- What are the actual tax savings that will be available to the trust and its unitholders by postponing the conversion?
- Does the market price of the trust's units reflect the value of the tax savings versus those of its non-trust peer group, and what is the market "punishment" likely to be for converting before the trust is subject to the SIFT tax?
- Can the trust sustain its distributions through 2011?
- What is the strategic vision for the entity and what distribution policy aligns with that vision?
- Are there benefits to implementing a new corporate strategy earlier?

Nature of the Current Unitholder Base

The nature of the trust's unitholder base needs to be examined. Initial investors in trusts typically sought a regular return on their investment. "Income" unitholders may choose to sell if there will be a fundamental change in strategy and corporate dividend policy post-conversion.

Consideration must also be given to the tax ramifications to both Canadian and non-resident investors on conversion of a new business structure. For example, in many cases it may be possible to structure a trust conversion under either the Share Exchange or Share Distribution method as a tax-free rollover for U.S. unitholders. In each case, however, all of the particular circumstances of the conversion will need to be examined, including the tax classification of the trust as a corporation, partnership or grantor trust for U.S. tax purposes as well as the possible application of the U.S. passive foreign investment company rules, before determining the actual consequences of a conversion to U.S. unitholders.

Income trusts are bound by certain foreign ownership restrictions and many have already run up against their limit. However, no such restrictions apply to corporations (subject to any industry-specific ownership restrictions). As a result, the corporation should receive the benefit of increased liquidity.

Effect on Existing Debt

The specific terms of a trust's debt will need to be examined as part of any decision to convert. Generally speaking, bank and public debt contain restrictions on change of control transactions. A number of questions are relevant when examining the issue of existing debt:

- Will the transaction trigger a repayment of the debt under any change of control provisions?
- Is any lender consent required for the transaction? Will the lender(s) require any amendments as a result of the new structure?
- What will happen to the public debt? Will it be exchanged? Can the public debtholders force a "put" right?
- Does the new tax position of the corporation have an impact on the corporation's cash position and does it affect either its financial covenants or its ability to service the debt?

Effect on Existing Compensation Arrangements

Employment contracts signed by the trust may also have similar change of control provisions that would trigger severance or change of control payments to employees on conversion into a corporation. Careful consideration should be given to how to deal with these provisions.

In addition, the trust should examine its other compensation arrangements (e.g., unit purchase plans) and determine how they should be revised to reflect the new corporate structure. The trust should also reflect on the type of securityholder approval required to implement such a new plan.

Bank and public debt must be reviewed for restrictions on change of control transactions.

Effect on Existing Contracts and Licenses

What will the impact of conversion be on the existing contracts and licenses to which the trust is a party? Are there any change of control or assignment provisions in business-critical arrangements that will potentially have a negative impact on the conversion itself or on the operation of the business going forward?

Cost

Finally, the trust will have to assess whether the costs (financial advisors, lawyers, meeting costs, management time, etc.) warrant the incremental benefits to be obtained by converting.

The Logistics: How Does it Happen?

Most conversions to date have occurred by way of a plan of arrangement. The creation of Newco under each of the methods described above allows the trust to access the applicable corporate statutes' plan of arrangement procedures. This process requires unitholder approval, which requires a special meeting.

Most arrangements provide for dissent rights (and, to date, many conversions have provided such rights although, in practice, they have seldom been exercised). Yet, in an arrangement where the ultimate economic ownership does not change, it is unclear whether dissent rights should automatically be granted in a conversion.

Most conversions to date have occurred by way of a plan of arrangement.

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How Can We Help?

Osler has extensive experience in providing advice on the strategic alternatives available to trusts. We draw upon the proficiency of legal practitioners in our Mergers and Acquisitions, Tax, Financial Services and Corporate Finance groups to ensure that the required expertise is brought to bear in executing strategic decisions. Our multi-jurisdictional capabilities in our offices in Toronto, Calgary, Montréal and New York allow our specialty groups to consistently provide outstanding client service.

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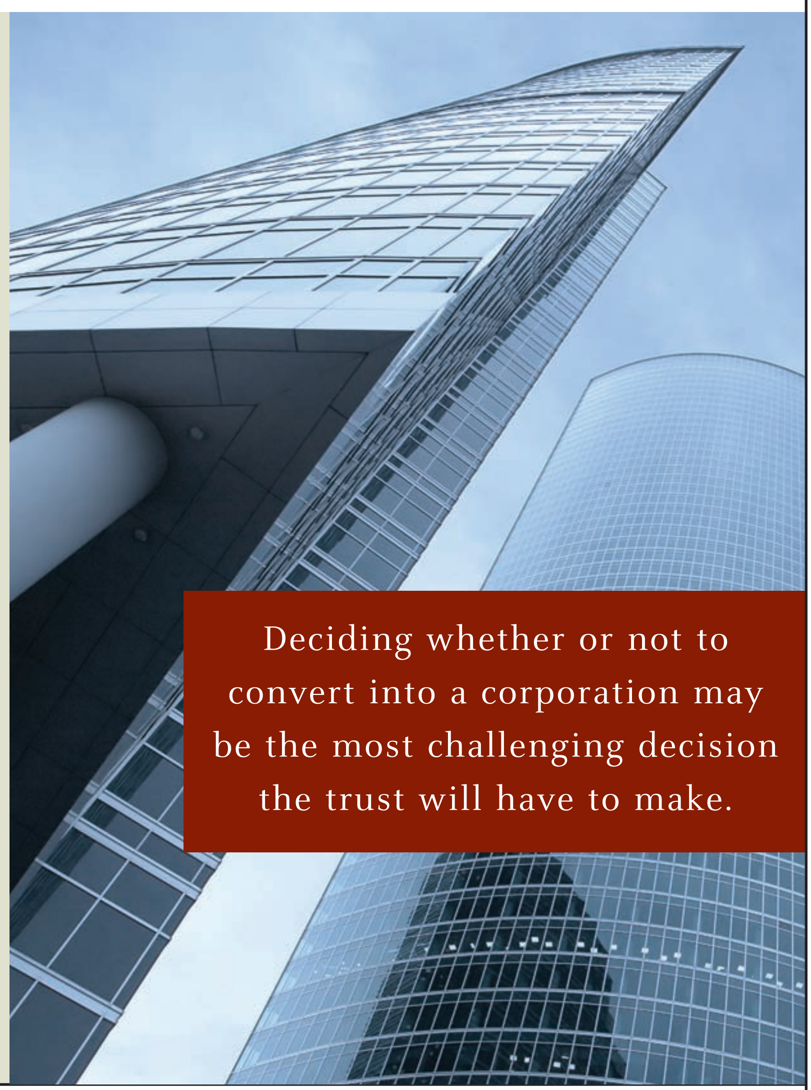

Deciding whether or not to convert into a corporation may be the most challenging decision the trust will have to make.

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