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1 hot issues

INCOME TRUST CONVERSION UPDATE

Background

Income trusts have had an interesting role in the Canadian capital markets, for more than a decade. The Federal Finance Minister Jim Flaherty announced on October 31, 2006 that there would be a new tax on income trust distributions in a bid to stem the growing number of companies that were converting to trusts. Mr. Flaherty was quoted at the time as saying that \$70 billion of new trust conversions had been announced so far in 2006 and it was hurting the Canadian economy. He called trust conversion “a growing trend to corporate tax avoidance.” Flaherty’s announcement came three weeks after BCE proposed the biggest trust conversion in Canadian history. It proposed to convert its Bell Canada subsidiary to a trust – a move that would have saved it \$800 million in tax by 2008. As of 2006 there were more than 250 income trusts in Canada. Trust conversions were increasing in popularity because trusts did not pay corporate tax. Instead, they paid out most of their income in distributions to unitholders, who would then pay tax on those distributions. In June 2007, the Government of Canada enacted legislation that would apply a tax at the income trust level on unitholder distributions commencing January 1, 2011. The tax changes, once effective, would effectively eliminate the comparative advantage of the previous income trust structure.

Fast forward to today:

With just **over a year remaining** until the new legislation takes effect, it is becoming increasingly important for income trusts to have a clear, direct communication plan in place to inform the investment community of their respective strategies for the new tax regime.

While many income trusts continue to evaluate their options for the post-2010 tax regime, a number of trusts have already taken action, using the pending taxation as a catalyst to **convert to a corporate structure** early and make any necessary adjustments to distribution levels. The rationale for early conversion and adjusting distribution/dividend levels has often centered on a shift in focus towards a more growth-oriented strategy, and the need to invest more cash into the operating business or to pursue acquisition opportunities. For “early converters” that also cut distributions, effective redeployment of capital in growth opportunities is vital. If it appears that unsustainable, trailing distribution levels were perhaps the defacto “raison d’être” for early conversion and an accompanying distribution cut, the issuer risks a prolonged market discount and a loss of credibility.

Some income trusts have insulated investors from the impact of early conversion by acquiring tax losses that can be applied as credits against corporate taxes. This strategy can enable the converted entity to maintain pre-conversion distribution/dividend levels for a period, and thereby create a longer “runway” for income-oriented investors to make any necessary portfolio adjustments, creating a more orderly market transition to investors that are more growth-oriented.

For income trusts that have **not yet disclosed** definitive structural or distribution policy plans for 2011, and are currently allowing their unitholders to benefit from a prolonged tax holiday, this issue should be addressed as soon as possible to remove market uncertainty. Concerns in the investment community regarding the sustainability of an income trust’s distributions once they become taxable could result in unit price volatility. To support fair market valuation, income trusts should disclose their contemplated structural and distribution/dividend policy plans, as well as any re-calibration of their future strategy, as soon as they are determined.

Pending taxation for income trusts in 2011 is a transformational event for Canadian capital markets, and as with any significant change comes opportunity. Trusts that effectively communicate their plans, strategic rationale and then successfully execute, can enhance their capital market profiles and build credibility.

For more information, see IR Matters – Equicom’s Blog. To view the latest updates go to:

<<http://www.irmatters.com/wp-content/themes/irmatters/images/mail-header.gif>>

IRmatters.com has posted a new item, ‘Income Trusts Need to Communicate in Advance of 2011

<<http://www.irmatters.com/uncategorized/brucealice/income-trusts-need-to-communicate-in-advance-of-2011/>> ‘

Implementation Considerations:

Some of the items to consider are when an income trust converts to a corporation:

- Accounting implications, including the implication complexity resulting from the January, 1 2011 replacement of **Canadian GAAP by International Financial Reporting Standards (IFRS)**
- Stock Exchange and securities regulatory approvals
- Contracts of the trust and its subsidiaries will need to be reviewed to determine if the conversion would raise consent / amendment requirements
- Transaction costs could be hefty which would include legal, accounting and financial advisory fees, as well as unitholder meeting costs.

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What is a unitholder?

Answer is in this bulletin.

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