Income trusts cope with upheaval

Michael Friedman and Todd Miller of McMillan Binch Mendelsohn identify the challenges and tax-planning opportunities that the new SIFT rules raise for non-resident investors

Over the past 25 years, foreign direct investment in Canada has increased dramatically. In 2005 alone, according to Foreign Affairs and International Trade Canada, foreign investment in Canadian enterprises amounted to about C$416 billion ($354 billion), representing more than a six-fold increase since 1980.

As foreign investment in Canada has accelerated, income trusts and other flow-through entities (FTEs) have become increasingly popular investment vehicles in the Canadian public markets. By October 2006, the market capitalization of income trusts trading on the Toronto Stock Exchange was about C$200 billion ($170 billion) (up from about C$18 billion [$15 billion] in 2000 and C$118.7 billion in 2004), representing about 250 separate real estate, oil and gas, telecommunications, industrial, food processing and manufacturing businesses. At that time, it was reported that Canadian pension plans, registered retirement savings plans (RRSPs) and non-resident investors collectively owned about two-thirds of the publicly traded income trust units in Canada.

It has been suggested that the proliferation of income trusts, including those resulting from the conversion of corporations to income trust form, has resulted in a substantial reduction in Canadian government tax revenues. Several independent and government-sponsored studies have attempted to quantify the amount of this tax leakage, particularly that attributable to the sizeable income trust holdings of tax-exempt and non-resident investors. For example, one recent study estimated C$700 million ($596 million) as the amount of federal and provincial tax revenues lost in 2005 on account of income trust conversions, and forecast even greater losses in future years.

On October 31 2006, the federal minister of finance unveiled a new set of tax rules to address the Canadian government's concern over the potential loss of tax revenue triggered by the increasing prevalence of income trusts and other FTEs on the Canadian public market landscape (the proposed SIFT – specified investment flow-through – rules). The announcement of the proposed SIFT rules was followed by the release of draft legislation on December 21 2006. While no specific timetable has been set for the enactment of the draft legislation, the Canadian government has indicated that, when enacted, the proposed SIFT rules will apply retroactively to the beginning of 2007.

The key element of the proposed SIFT Rules, which are ostensibly designed to level the playing field between corporations and the trusts falling within their ambit, is the imposition of a tax to be levied in respect of certain amounts earned and distributed by such trusts. The enactment of these rules could have dramatic Canadian tax consequences for non-resident investors and may alter, in many significant respects, the manner in which non-residents invest in Canada.

Structure of income trusts and other FTEs

In highly simplified terms, an income trust is a commercial trust that indirectly owns the assets of an active business. Income trusts typically raise funds by selling ownership interests (that is, units) to public investors who become the beneficiaries of the trust. Canadian income trusts have traditionally focused on the ownership of a specific, well-defined business, be it an enterprise in a specific commercial sector or a business focused on the management of a portfolio of energy-related assets or real property interests.

In the absence of the measures contained in the proposed SIFT rules, income trusts and other Canadian FTEs were generally not subject to, or were capable of eliminating (or substantially reducing) the imposition of, direct taxation on their earnings. In the case of income trusts, such results flow from the rules in the Income Tax Act (Canada) (the Tax Act) that generally permit a trust to claim a deduction in respect of the portion of its annual income that becomes payable in the year to its unitholders. Taxable Canadian unitholders receiving such distributed income are required to recognize such amounts when computing their taxable income. However, amounts payable to most other unitholders are generally not subject to any further tax (in the case of tax-exempt unitholders) or are subject only to withholding tax levied at relatively low rates (in the case of non-resident unitholders that do not carry on business in Canada).

It is the ability of an income trust to eliminate its direct tax liabilities, coupled with the lack of the full taxation of distributions made to tax-exempt or non-resident income trust investors, that heightened both the attractiveness of income trusts and the tax leakage concerns of the Canadian government.

Government response to the income trust explosion

The Canadian government's concern over the potential tax leakage associated with the rapid growth of income trusts and other FTEs first manifested itself in the March 2004 Budget with a proposal to limit the size of investments that certain tax-exempt pension funds could make in income trusts. These amendments would generally have limited the amount that pension funds would have been permitted to invest in income trusts to no more than 1% of the book value of such funds' assets and would have prohibited most pension funds from owning more than 5% of any particular income trust. Yet, in the face of strong criticism from key stakeholders, the implementation of these proposals was suspended shortly after the Budget to allow for further consultation.

A new initiative designed to assess a number of policy alternatives, including the potential taxation of income trusts, was commenced in September 2005, coupled with a moratorium on the issuance of income trust-related advance income tax rulings. This process caused much consternation in the financial markets, as evidenced by the significant decline in the market capitalization of income trusts in the two months following the announcement and came to a conclusion on November 23 2005 with the Canadian government's announcement, that it would not be implementing any changes to the taxation of income trusts and other FTEs, but would instead be reducing the rate of personal income tax payable in respect of dividends paid by most public corporations through the introduction of an enhanced gross-up and dividend tax credit mechanism. Draft legislation incorporating this mechanism was introduced on October 18 2006, but has yet to be enacted.

While the reduction in taxes payable on dividends received from Canadian public companies arguably levelled the playing field between investments in the shares of such companies and units of income trusts as far as taxable Canadian investors were concerned, it did not eliminate the income tax bias in favour of investments in income trusts by tax-exempt pension plans, RRSPs, and non-resident investors (as evidenced by the continuing large number of public corporations that converted (or announced plans to convert) to income trust form). The proposed SIFT rules are aimed at eliminating this bias – that is, to ensure that, regardless of the investor profile, the aggregate amount of tax collected on the earnings of an enterprise that conducts its business in income trust form is no less than the amount of tax collected in respect of a comparable enterprise that is constituted as a corporation.

The proposed SIFT rules

The proposed SIFT rules will apply to any trust falling within the definition of a "SIFT Trust", which will include most publicly traded income trusts, with the exception of certain real estate investment trusts that satisfy certain conditions.

More specifically, an income trust will constitute a SIFT trust throughout a taxation year if it satisfies, at any time in the year, the following conditions:

- The trust is resident in Canada for the purposes of the Tax Act;
- Units of, or other investments in, the trust are listed on a stock exchange or other "public market"; and
- The trust holds one or more "non-portfolio properties".

It is important to note that the concept of a "public market" for the purposes of the proposed SIFT rules captures markets other than public stock markets, including certain over-the-counter trading systems through which securities that are qualified for public distribution may be exchanged. (However, any facility operated solely for the issuance or redemption (or cancellation or acquisition) of a security by its issuer is excluded from the applicable definition of a "public market"). In addition, investments in a particular SIFT trust cover a wide range of rights and interests, including an income or capital interest in the trust or an independent right which may reasonably be considered to replicate a return on, or the value of, a security of the trust.

For the purposes of the proposed SIFT rules, "non-portfolio properties" will generally include certain investments in what are termed to be "subject entities", Canadian resource properties, timber resource properties and real properties situated in Canada. "Subject entities" are defined quite broadly to include corporations and trusts resident in Canada, "Canadian resident partnerships" and certain non-resident entities, the principal source of income of which is a source in Canada.

An investment in a subject entity will generally constitute a non-portfolio property if the investor holds securities (viewed broadly to include equity, debts and other liabilities, rights to revenue or income and options to acquire securities) of the entity that either:

- have a total fair market value that is greater than 10% of the entity's equity value; or
- together with all securities held in entities affiliated with the subject entity, have a total fair market value that is greater than 50% of the investor's equity value.

The "equity value" of an entity is computed based on the total fair market value of:

- if the entity is a corporation, all of the issued and outstanding shares of the capital stock of the corporation;
- if the entity is a trust, all of the income or capital interests in the trust; or
- if the entity is a partnership, all of the interests in the partnership.

While the existing provisions of the Tax Act generally allow an income trust to deduct, in computing its taxable income for a particular year, any amount of its income that it distributes to unitholders in the year, under the proposed SIFT rules, a SIFT trust will no longer be permitted to deduct certain specified amounts ("non-portfolio earnings") when computing its income, including:

- its net income from businesses it carries on in Canada;
- its net income (with the exception of certain dividends) from its non-portfolio properties; and
- its net taxable capital gains from dispositions of non-portfolio properties (and certain deemed capital gains in respect of certain non-portfolio properties).

When the non-portfolio earnings of a SIFT trust are distributed to the unitholders of the trust, the tax rate applicable to such earnings will be a rate equivalent to the general federal corporate tax rate (21% now and scheduled to be reduced to 18.5% by 2011), plus 13% on account of provincial tax, which the Canadian government intends to collect and distribute to the provinces (based on an allocation method to be developed with the provinces).

Any unitholder of a SIFT trust receiving such non-portfolio earnings amounts (a "non-deductible distribution") will be subject to tax on such distributed amounts as if the distribution constituted a taxable dividend from a taxable Canadian corporation. Accordingly, Canadian individual unitholders of a SIFT trust that receive a non-deductible distribution will generally be entitled to claim a dividend tax credit in respect of the distribution (including the enhanced dividend tax credit noted above).

Non-deductible distributions made to non-resident unitholders will generally be subject to non-resident withholding tax levied at the statutory rate of 25%. However, if the non-resident unitholder is resident in a country with which Canada has entered into a tax treaty, the applicable statutory rate of withholding tax will generally be reduced (in most cases, to a rate of 15%).

In force

The proposed SIFT rules are scheduled to take effect as early as the beginning of 2007 for any SIFT trust created or that began to be publicly traded after the release date of the proposed SIFT rules (that is, October 31 2006). For all other SIFT trusts, (that is, those which were in existence and publicly-traded as of the release date) the application of the proposed SIFT rules will, in most cases, be deferred until taxation years ending after 2010 (Grandfathering Relief). However, the Department of Finance has indicated that a particular SIFT trust's eligibility for Grandfathering Relief will be dependant, in part, on a that SIFT trust respecting the policy objectives underlying the proposed SIFT rules. In particular, the Department of Finance has stated that while existing SIFT trusts will be permitted to experience "normal growth" during the period in respect of which Grandfathering Relief is to be granted, such relief will not be made available to SIFT trusts that undertake "inappropriate...avoidance techniques", including any "undue expansion".

On December 15 2006, the Department of Finance released guidelines to illustrate what may be taken to constitute "normal growth" for the purposes of determining the availability of Grandfathering Relief (the Growth Policy). The Growth Policy states that Grandfathering Relief will not be compromised solely as a result of the growth of a SIFT trust if the equity capital of the trust increases in certain "intervening periods" as a result of new equity issuances of not more than the greater of C$50 million ($42.6 million) and an objective safe harbour amount.

This harbour amount is to be measured by reference to a particular SIFT trust's market capitalization as of October 31 2006, which is generally to be calculated with reference to the value of the issued and outstanding publicly-traded units of the particular trust as of that date (excluding, in most cases, debt, options or other interests convertible into units of the relevant trust).

For the period between November 1 2006 and the end of 2007, the safe harbour amount for a particular SIFT trust will equal 40% of its October 31 2006 market capitalization. For each of the calendar years

from 2008 through 2010, the applicable safe harbour amount will be 20% of the October 31 2006 market capitalization, thus collectively allowing for growth of a SIFT trust of up to 100% over the four-year Grandfathering Relief period. The annual safe harbour amounts will be measured cumulatively over the Grandfathering Relief period, while the C$50 million limit will not be cumulative.

Issues and opportunities

As dramatic and decisive as the Canadian government's income trust announcement may appear, the proposed SIFT rules create a host of technical and substantive issues. For instance, it appears to be the Canadian government's intent not to subject traditional mutual fund trusts, which typically invest in a broad portfolio of securities, to the application of the proposed SIFT rules. However, continuing compliance with the proposed SIFT rules may prove to be difficult in all cases, since the status of an entity as a SIFT trust depends upon measures of the fair market value of the assets of the entity from time to time, which can be inherently volatile. Thus, mutual fund managers may have to exercise greater conservatism in managing a fund's investments.

In addition, the status of an entity as a SIFT trust will generally be dependant on whether its units or other securities are traded on a stock exchange or "other public market". For the purposes of the new rules, the Canadian government has suggested that the concept of a "public market" may be extremely broad and include organized quotation systems supporting over-the-counter trading. Practitioners and investors will need to be cautious in assessing whether bulletin board or electronic services traditionally not associated with a public trading forum fall within the scope of the new rules.

Many investors have taken comfort that the application of the proposed SIFT rules will be subject to Grandfathering Relief. Nevertheless, practitioners and investors will need to remain conscious of the guidelines released by the minister to ensure that any new equity issuances of a SIFT trust fall within the parameters of the Growth Policy.

At the time the proposed SIFT rules were announced, the Canadian government indicated its intention to discourage the use of "SIFT-equivalent" structures falling within the object and spirit of the proposed SIFT rules, but outside of their technical application. Somewhat surprisingly, the draft legislation to implement the proposed SIFT rules does not contain a specific anti-avoidance provision to achieve this objective, thus seemingly leaving the Canadian government to rely on the general anti-avoidance rule contained in the Tax Act. It remains to be seen how aggressively the Canada Revenue Agency will challenge any new planning techniques that may emerge, including, in particular, any variants of the stapled securities structures (in some cases referred to as income deposit securities) that gained popularity a few years back as a viable income trust substitute in the cross-border (Canada-US) context.

Corporate re-conversions and planning opportunities

Special attention will soon be focused on the manner in which businesses that previously converted into an income trust will be able to convert back to corporate form. While the Canadian government has indicated that the conversion of an existing SIFT trust to a corporation will be permitted without any tax consequences to investors, the existing rules in the Tax Act may not permit a seamless, tax-deferred transition. The minister is investigating whether any obstacles exist under the current income tax rules to permit such transactions on a tax-deferred basis and has recently indicated that "reconversion" provisions may soon be added to the Tax Act. Assuming the Canadian government is committed to creating a truly level playing field between publicly-traded corporations and SIFT trusts, it would appear reasonable to suggest that additional rules providing for, among other things, the tax-deferred rollover of assets into a trust and the step-up or "bump" in the tax cost of certain capital assets owned by a trust (in circumstances where all (or substantially all) of the trust's units are acquired) should also be introduced.

In addition to the potential concerns noted above, the proposed SIFT rules offer some planning opportunities. In an effort to eliminate the distortive advantages that might arise from a SIFT trust not being subject to full provincial income taxation, the proposed SIFT rules impose a 13% tax as a compensatory proxy for the provincial income tax that would apply if the SIFT trust were constituted as a corporation rather than a trust. However, provincial corporate tax rates in many provinces, including the province of Ontario, are more than 13% and, therefore, provincial income tax considerations may continue to favour the maintenance of an existing income trust structure under certain circumstances. Conversely, business enterprises with ties to the province of Alberta, where the corporate income tax rate is 10%, may have an incentive, all other things being equal, to use a corporate model.

Moreover, unlike conventional publicly-held corporations, income trusts will continue to be able to, in most circumstances, return capital to unitholders free of any income tax, even following the enactment of the proposed SIFT rules (though non-resident distributions of capital by certain income trusts may continue to be subject to withholding tax in certain circumstances). By contrast, returns of capital by public corporations that are not made outside of the ordinary course of the business of the corporation are generally deemed to be dividends received by shareholders for income tax purposes. As a consequence, tax deferral opportunities may remain available to certain income trusts following the enactment of the proposed SIFT rules that will not generally be available to enterprises that are constituted in corporate form.

Finally, significant opportunities may quickly emerge for non-resident investors and enterprises to take advantage of the new market realities stemming from the enactment of the proposed SIFT rules. For instance, since the proposed SIFT rules will not apply to investments in income trusts that are not listed on a public market, non-resident investors may, in certain circumstances, be able to replicate the historical income tax treatment of income trusts by privatising publicly-traded trusts. (Such privatisation structures would have to be arranged so as to avoid the application of Part XII.2 of the Tax Act. Part XII.2 of the Tax Act imposes a special tax on trust income, which can apply if a particular trust ceases to qualify as a "mutual fund trust".) The proposed SIFT rules may also not generally apply to certain income trusts with underlying businesses that are solely situated outside of Canada. Accordingly, foreign enterprises may still be able to raise capital in the Canadian marketplace at heightened valuations using cross-border income trust or stapled share structures.

Future developments

The introduction of the proposed SIFT rules represents a major step in the Canadian government's ongoing initiative to restore neutrality to business taxation in Canada. The proposed SIFT rules have a host of negative implications for private equity and non-resident investors that viewed income trusts as a source of heightened investment returns and as a natural means of facilitating the divestiture of an existing Canadian investment. Moreover, aside from the potential political fallout and financial discomfort resulting from the announcement of the proposed SIFT rules, the introduction of the new regime raises a number of technical and interpretive issues that will, no doubt, give rise to further challenges and opportunities over the years to come.

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