CARTER LEDYARD

our resources

U.S. Tax and Securities Law Considerations in Canadian Income Trust Conversions

November 24, 2008

Client Advisory

November 24, 2008 by Howard J. Barnet, Jr., Guy P. Lander, Dan Pittman, John Whelan and Christopher Young

On October 31, 2006 the Minister of Finance (Canada) announced that the Department would introduce legislation to subject publicly traded income trusts (known as "Specified Investment Flow-Through" entities, or SIFTs) to corporate taxation. For existing income trusts, the rules will become effective in 2011, as long as such trusts do not engage in "undue expansion." Since 2006, most SIFTs have determined that in order to avoid the effect of the new tax regime they ought to be acquired (which many have done) or convert to corporate status before 2011. However, until recently, there was no guidance on how a conversion could be effectuated on a tax efficient basis.

On July 14, 2008, the Department of Finance released draft legislation that will facilitate the conversion of SIFTs into corporations on a basis that will be tax-free for Canadian tax purposes. We have begun to see such conversions. The draft legislation contemplates two alternative mechanisms for achieving conversion. Greatly simplifying, under the first alternative conversion method, SIFT unitholders would transfer their SIFT units to a taxable Canadian corporation in exchange for shares of the corporation. Under the second alternative, the SIFT would restructure so that its only asset is a taxable corporate subsidiary (to which the SIFT has transferred any assets previously owned directly by the SIFT), and the SIFT would then liquidate and distribute to the SIFT's shareholders the shares of the taxable corporation. Most of the handful of conversions so far announced have opted for the first alternative. It is to be noted that the Department has invited comments on the draft legislation and changes are quite possible.

This Client Advisory discusses the U.S. legal aspects of SIFT conversions, specifically the U.S. income tax and securities law considerations for income trusts having unitholders resident in the United States.

U.S. Income Tax Considerations

The U.S. income tax consequences of a conversion for U.S. unitholders depend in the first instance on the entity classification of the SIFT. Although it is possible for a SIFT to elect to be treated as a partnership for U.S. tax purposes , most income trusts are treated as corporations, and that will be the assumption here. If a SIFT is treated as a corporation for U.S. tax purposes, it may be a "passive foreign investment company," which would be highly undesirable for U.S. unitholders. Most energy-related income trusts are able to avoid PFIC classification, and again we assume here that the SIFT is not a PFIC.

In general, a SIFT conversion, structured as an exchange of trust units for shares of a new corporation, should qualify as a tax free transaction for U.S. tax purposes, often without any need for tinkering by U.S. tax advisers. A conversion by means of a distribution of shares may run a risk of being considered a taxable liquidation, particularly if done without U.S. tax advice. Of course, if a unitholder has a tax loss (i.e., the value of the units is below his or her adjusted tax basis), then it might be the IRS arguing that the conversion qualifies as a tax free exchange, in order to deny the unitholder a tax deduction. Alternatively, the IRS may be able to argue, even if the transaction does not qualify as a tax-free reorganization, that a tax loss should not be allowed, under the U.S. "wash sale" rules (Code Section 1091).

U.S. Securities Law Considerations

If the SIFT has any U.S. unitholders, the issuance of new shares to them under either alternative, like all securities issuances, must be either registered or exempt under the U.S. Securities Act of 1933, as amended (the "Securities Act") and applicable state securities ("blue sky") laws. For most issuers (particularly those who are not registered under the U.S. Securities Exchange Act), registration under the Securities Act will be an unattractive alternative. Depending on the facts and circumstances of each case, structuring the transaction as a court-approved plan of arrangement exempt from registration under Section 3(a)(10) of the Securities Act and under provisions of most state blue sky laws will, in our view, usually be the most desirable way to go. However, the determination of the preferable alternative, be it registration, reliance on Section 3(a)(10) or another exemption from registration or some other technique, should be made only after an analysis of the specific facts in each conversion transaction.

related professionals

Guy P. Lander / Partner
D 212-238-8619
lander@clm.com