

# DECISIONS, decisions

## Business trusts must choose a new path. But which way will they go?

BY PAUL HALPERN

Income trusts might have been dealt a major blow last Halloween, but there is a chance that the continuing uncertainty about their future might actually come to an end shortly. On October 31, 2006, the Minister of Finance announced that trusts, apart from REITs, would be subject to corporate income tax within the trust (the “Halloween provisions”). However, the tax would not be effective for existing trusts until 2011, providing them with a tax holiday. Trust unit prices fell precipitously after the announcement but subsequently recovered some ground.<sup>1</sup> On December 15, 2006, the Department of Finance provided some interpretation surrounding the amount of permissible growth for existing trusts, thus clarifying some of the statements in the announcement. As of the date of publication of this article, there is still uncertainty about whether the new provisions will be introduced and passed into law. There are also questions about how the legislation and policy announcements will be interpreted by the taxation authorities.

Regardless of the merits of the argument that led to the government’s decision, trust company management will continue to operate trusts to create needed cash flow. However, even with the tax holiday, trust management must consider what corporate or financial structure their company will take in the future. There are likely to be no major moves in the near future, due to the tax holiday and the remaining uncertainty associated

with the timing and final wording of the legislation and related policies.<sup>2</sup> There is, however, some consolidation taking place in the sector and several trusts have been or are rumoured to be takeover targets. But planning is essential. Any restructuring must take into consideration the major benefit of trusts—the continuing demand in the market for yield-driven products and the positive impact of removing cash from management who may invest it in non-productive ways.

### Where to now?

This discussion, focused on business trusts exclusively, is intended to identify some of the possible responses by trust management. We recognize that there are unique elements to each trust that have to be incorporated in the final decision about which structure is ultimately chosen. Further, whether the market has over- or under-estimated the impact of the tax holiday on trust values will have some influence on the ultimate decision. We are not recommending any specific structure, but only identify some of the underlying fundamentals requiring consideration in any discussion about where to go from here. This is by no means an exhaustive list.

To remind the reader, there are currently two forms of trust structure. The original, or first generation trust, consists of a unit of internal debt and equity on which distributions are paid. The internal debt is structured so that at the time of its initial public offering (IPO) or conversion, the interest component is large enough to eliminate corporate tax. The components of the unit cannot be separated—a major benefit of the structure since it eliminates

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potential problems associated with financial distress.<sup>3</sup> In the second generation trust, the underlying structure is a partnership in which the trust holds securities. This means that all income is taxed in the hands of the partners and not at the trust level. The provisions of the October 31, 2006, announcement will apply to Special Investment Flow Through (SIFT) entities, which include both public trusts and public partnerships.

We now turn to the possible structures:

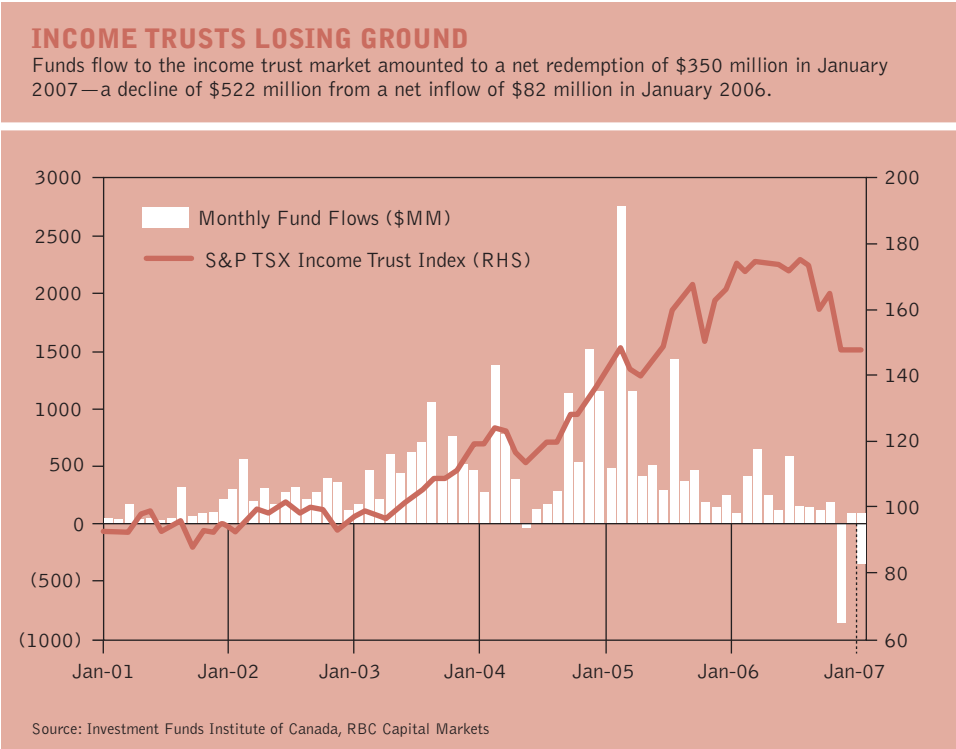
**OPTION ONE: Find a new tax-efficient structure**

During the period before the new tax treatment comes into effect, tax lawyers and accountants will be thinking about new structures to replicate the benefits of the previous SIFT structure. One approach is to eliminate the trust and replace it with a corporation that issues debt and equity, which are stapled together and trade as a unit. These units can be broken into their debt and equity components, each of which can trade in the market, although it is unlikely that this would happen. The underwriters in the IPO would state that they would make a market in these securities (or at least use their best efforts to make a market). This is, however, unlikely to occur given the small size of any such debt issues and the lack of liquidity in Canada for such issues. An example of this stapled unit structure is Timberwest Timber Trust, established in 1998. It is argued that this structure does not rely on a trust and the proposed legislation refers to trusts and not stapled units. There are also some U.S.-based trusts that use this structure.

Another approach, a variation of the stapled unit, is to use the structure that is prevalent for U.S.-based trusts, most of which trade on the Toronto Stock Exchange. These structures are called either income participating securities, or enhanced dividend securities depending on the underwriter involved. There are approximately 10 of these structures currently trading on the TSX and are considered by some to escape the Halloween provisions.<sup>4</sup> They are

structured to meet the demands of accounting firms, which stated they would not sign trust company financial statements unless the structure had characteristics that they believed would minimize potential income tax-related problems with the Internal Revenue Service (IRS). These securities do not have a trust holding the debt and equity but have paper-clipped debt and equity trading as a unit. The unit can be easily undone with the underlying securities trading separately. In addition, some of the debt is privately placed to demonstrate that the yield on the debt is market-related. Also, equity, separate from the unit, is listed for trading. This structure most closely resembles the standard corporate form.

One problem with both structures, although more serious for the IPS/EDS, is that the ability to split the unit into components eliminates or at least reduces the benefits of the lowered costs of financial distress. Once the units separate, the debt holders and equity holders can have different views on outstanding payments on the debt in the event of the company's inability to pay interest. Further, in the case of the IPS/EDS the outstanding debt brings into play a third party for which cooperation with the unit holders may not be in its best interests.<sup>5</sup> Obtaining consents from widely disbursed debt holders, whose interests are not aligned with equity holders, is problematic and often very expensive.



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Finally, and most important, the government signalled very clearly in its October 31, 2006, announcement that it would look carefully at all new structures to ensure they were not inappropriate tax-avoidance techniques. Is the fact that these structures do not involve an underlying trust sufficient to permit them to escape the tax ruling? Will trustees encounter difficulty obtaining reliable, written tax opinions on this thorny question?

#### **OPTION TWO: Traditional to corporate structure**

The Department of Finance in its December 21, 2006, announcement was clear that there would be no tax on investors in the event of a conversion from a trust to a traditional structure. However, there remains uncertainty as to how trusts technically eliminate underlying income trust entities to convert to a public corporate entity without incurring significant tax penalties.

Given our tax system where interest payments are a tax-deductible expense, companies can create value for shareholders by having a debt-intensive capital structure.<sup>6</sup> The resulting debt will be of lower quality, thus generating a higher yield. Also, the company can still pay out all (or most) of its cash flows as dividends to investors, thereby satisfying the demand for high distributions. In this corporate structure, as opposed to trusts, there is no need to pay out cash flow or face punitive tax consequences at the highest marginal personal tax rate. Also, in the trust structure, third-party lenders restrict third-party leverage to exceedingly modest levels as compared to the corporate structure. The combination of high interest payments and high dividends will provide the appropriate incentives to management in the corporate structure to invest only in projects that are profitable. Thus, in theory, the corporate governance benefits associated with the trust structure can be available in the corporate form as well. However, the benefits are not as strong as those of trusts. Unlike the trust structure, there is no necessity to pay out all cash flows as dividends. Missing or reducing a trust distribution is likely to have a stronger impact on unit price than a comparable change in dividend payments under the traditional form.

Notably, only companies whose cash flows are stable can use this approach. Fluctuating cash flows would

result in debt that is of very poor quality and the increase in value to shareholders would not be as great, given the possibility of default or bankruptcy. Since investors not only want high distributions but also stable ones, trusts with volatile cash flows will not generate high valuations by converting to a normal structure, using limited amounts of debt and paying substantially all of their cash flows as dividends. The volatile cash flows will ultimately require the company to borrow to maintain a steady dividend and this will expose the company to risk of default.

#### **Abandon public markets and go private**

A trust structure is available if a company is private, thus making a private placement to tax-deferred customers a possible approach. However, to issue securities, the company will need to take advantage of one of the exemptions permitting securities to be sold without a prospectus. Further, to qualify for a mutual fund trust and thus be eligible to tax-deferred investors, the trust must have in excess of 150 unitholders. Also, as a trust, all profits need to be paid out—there can be no retentions—or the trust pays tax on the amount at the highest marginal personal tax rate. This can be a problem for trusts for which cash flows are highly volatile or where third-party debt principal repayments and/or additional growth capital investment is required. This approach may be useful for many stable business trusts that do not expect to need the public markets or that might benefit from eliminating significant and evolving regulatory burdens and investor relations costs associated with public markets.

Associated with this approach is the acquisition of the trust by either a publicly traded company with a traditional structure or a private equity transaction. In fact, since the October 31, 2007 announcement there have been seven takeovers launched, including \$1.9 billion in deals over the period January 2007 to mid-February, 2007.<sup>7</sup> The acquirers were either traditional companies (the Labatt Breweries of Canada takeover of Lakeport Brewing Income Fund) or private equity players (British private equity fund Marwyn Investment Management in a \$120 million deal to acquire Entertainment One Income Fund).

For the traditionally structured acquirer, crucial variables will be the issue of fit, current unit price, and the potential premium that has to be paid. For private equity investors, the potential use of leverage and price paid are crucial. Depending on the stability of the

underlying firm, private equity investors can use leverage of six or more times EBITDA in their deals. In some cases, private equity players will be able to offer premiums to current prices in the 15% to 20% range. In other cases, they will be able to see through current operating difficulties, purchase at low premiums to current market and fix the companies without the glare of the public markets.

In both situations where the private equity investor feels that unit prices for trusts are too high, the premiums will have to be much lower in order to have a profitable transaction. In these acquisitions, the expectation is significant returns upon exit. However, due diligence has a high fixed cost and it is more likely that larger private equity players will focus on the larger trusts, with smaller private equity players focusing on smaller business trusts. It is also possible that a pool of institutional money could be generated to acquire a diversified portfolio of trusts. Finally, unless the acquisition is by a private trust or a current trust that doesn't grow above the limits set by the government, the tax holiday will be lost.

### OPTION THREE: Keep the trust structure

As a final option, the trust can keep its current structure. In this case its distributions will be taxed at corporate rates and the distribution will be deemed to be dividends and taxed at the appropriate rates, including the dividend tax credit available to non-tax-deferred accounts. The trust will still have to meet the payout requirements of a trust. Thus, any taxable profits not paid out will be taxed at the highest marginal personal tax rate. Unlike a normal corporation, the return of capital element will still be exempt from corporate tax and will be taxed in the hands of investors as a capital gain upon sale of the security. However, this element may be small to negligible for many business trusts, especially those that are more mature and do not have a large growth in assets. In addition, for trusts with stable cash flows, there can be a greater utilization of third-party debt providing an additional benefit through the tax deductibility of interest. To the extent a trust would like to grow organically or by way of acquisition, it would need to review the alternative of converting to a corporate form early. In the corporate form, it would have access to normal leverage levels and earnings retention policies to compete with private equity

players and other corporates for acquisitions. It is highly unlikely that many companies will choose to remain a trust.

The business trust market is an important component of the capital market and, eventually, there will be a large number of changes in business trust structures over the next couple of years. In any event, it is highly doubtful that more than a few trusts will retain their current form beyond December 2010. The ultimate choice, and the timing of any change, will be based on a number of variables including the impact on the taxable status of investors and their after-tax cash flow, the need or desire to make acquisitions, repay debt or grow with capital expenditures, the impact on the investor's investment, and the need for the company to access public markets to finance growth. Any decision will result in significant transaction costs. The final choice must be the result of in-depth analyses of the alternatives and the need of trustees to maximize unitholder values. Although the apparent and declining value of the tax holiday will continue for four more years, business trusts should begin to study their options now. ■

### Acknowledgments

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### Endnotes

1. The price of the trusts should be the present value of the untaxed cash flow until the tax is effective and the present value of the after-tax cash flows from that time forward. If you assume that corporate tax will occur at 30% in five years, time, with a 10% discount rate the initial negative impact on price upon the announcement should be about 20.5% with small reductions thereafter until the tax is implemented.
2. Of course, in a rational market, this holiday is already included in the current share price. However, the acquirer in any transaction will have to be able to take advantage of the tax holiday. This may be difficult if the acquirer is a public non-trust and even if it is a trust, there are rules that limit the growth that a trust can undertake during the tax holiday period.
3. In the event of distress where cash flows are insufficient to make the interest payment on the internal debt, there is no chance of default since the debt holders and the equity holders are the same and there is no benefit of putting the company into default.
4. There are some companies that use this structure and trade both on the TSX and AMEX. Also two companies with this structure trade only on AMEX.
5. See P. Halpern and O. Norli, "Business Trusts: A New Organizational Structure," *Journal of Applied Corporate Finance*, Summer 2006, pp. 66-75 for a discussion of the IPS/EDS structures.
6. Company management will have to decide whether the company issues straight or convertible debt or some combination.
7. *Report on Business*, February 15, 2007, p. B4