# The Joint Committee on Taxation of
# The Canadian Bar Association
# and
# The Canadian Institute of Chartered Accountants


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February 21, 2007

Mr. Gerard Lalonde
Acting Director
Tax Legislation Division
Tax Policy Branch
Department of Finance
17th Floor, East Tower
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Dear Mr. Lalonde:

**December 15, 2006 Release**
**Guidance on "Normal Growth" for**
**Income Trusts and Other Flow-Through Entities**

The enclosed submission provides the Joint Committee's comments with respect to the guidance on "normal growth" for flow-through entities contained in Department of Finance News Release 2006-082, issued on December 15, 2006. In addition, the submission proposes measures that would facilitate the conversion of flow-through entities to corporate form.

We have previously commented on the technical aspects of the draft legislation released by the Department of Finance on December 21, 2006 in a submission dated January 31, 2007.

We trust that you will find our comments and suggestions helpful. If you and your colleagues think it would be of assistance, the Joint Committee would be pleased to meet with you to discuss this submission as well as our previous submission on the draft legislation. As always, we very much appreciate the opportunity to provide input while legislative proposals are under development.

Yours truly,

Bruce Harris, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

William R. Holmes
Chair, Taxation Section
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Cc: Brian Ernewein – Department of Finance
Lawrence Purdy – Department of Finance

**Submission of the**
**CICA-CBA Joint Committee on Taxation**

# December 15, 2006 Guidance on "Normal Growth" for Income Trusts and Other Flow-Through Entities

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**Submission of the**
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**December 15, 2006 Guidance on "Normal Growth" for Income Trusts and Other Flow-Through Entities**

## A. INTRODUCTION

This submission comments on the two matters that are the subject of Department of Finance News Release 2006-082 of December 15, 2006 (the **"December 15 Release"**).

The first matter is the meaning of "normal growth" for specified investment flow-through (SIFT) trusts and partnerships. The Department of Finance Backgrounder issued on October 31, 2006, which contained details of the proposed distributions tax on SIFTs, stated that there would be a transitional delay for SIFTs that were publicly traded before November 2006. It noted, however, that the transitional delay could be revisited if there were to be undue expansions of existing SIFTs, but qualified this by saying that there was no intention to prevent existing SIFTs from undergoing "normal growth" during the transitional period. The December 15 Release provides guidance on what is regarded as "normal growth" for this purpose (the **"Guidelines"**).

The second matter is the conversion of SIFTs to corporations. The December 15 Release states that the Department of Finance is considering what, if any, legislative changes are required to facilitate such conversions.

This is our second submission on the SIFT distributions tax. Our submission of January 31, 2007 (the **"January 31 Submission"**) commented on the technical aspects of the draft legislation released by the Department of Finance on December 21, 2006 (the **"Draft Legislation"**).

## B. GENERAL COMMENTS ON GUIDELINES

We understand that the Department of Finance (**"Finance"**) currently has no intention to incorporate the Guidelines into the legislation implementing the SIFT distributions tax. Consequently, existing partnerships and trusts will be left having to interpret the imprecise and incomplete language contained in the Guidelines with no legal recourse if Finance should disagree with their interpretation and obtain the enactment of amendments that would, on a retroactive basis, eliminate the benefit of the transitional delay in certain circumstances. We submit that it is inappropriate to leave taxpayers with such uncertainty regarding the application of the transitional delay. Under the Canadian provincial securities laws, SIFTs are required to consider how the proposed tax changes will impact them and clearly communicate the expected impact to their unitholders. SIFTs must describe and disclose material risks relating to an investment in their units in prospectus and other public disclosure documents. Where the application of the Guidelines is uncertain, such uncertainty would have to be disclosed. Uncertainty about a SIFT's status could be a material risk factor which affects the ability of a SIFT to raise funds in the capital market or to complete a merger or acquisition transaction. We recommend that the legislation specifically set out the circumstances under which the benefit of the transitional delay will be lost.

If the Guidelines are not legislated, we would urge Finance to be prepared to review specific proposed transactions on a timely basis and to provide written comfort that the transactions will not result in disqualification for the transitional delay. In this case, "comfort letters" should be published so that all taxpayers are informed of Finance's application of the Guidelines and of any modifications to them.

## C. GUIDANCE ON NORMAL GROWTH

Set out below are a number of ambiguities that have been identified in the Guidelines. We recommend that these be clarified. We have also noted situations that are not covered by the Guidelines, as well as aspects of the Guidelines that we think need to be reconsidered.

### (a) Safe Harbour Amount

The safe harbour amount is measured by reference to a SIFT's market capitalization as of October 31, 2006. For these purposes, market capitalization is equal to the value of the SIFT's issued and outstanding publicly-traded units. Market capitalization does not include debt, options or other interests that are convertible into units of the SIFT. On the other hand, the listing condition in the definitions of a "SIFT trust" and a "SIFT partnership" in the Draft Legislation refers to any "investments" in the entity that are listed on a stock exchange or public market. As discussed in our January 31 Submission, the term "investments" is very broad. As a result, a trust or partnership could be a SIFT even if its units are not publicly traded. In that case, it would seem that the market capitalization of the trust or partnership would be zero, and hence its safe harbour amount would also be zero.

In our January 31 Submission, we recommended that the definition of "investments" be restricted so that a trust or partnership would be a SIFT only if units in the trust or partnership are listed, subject to an anti-avoidance rule. If this recommendation is not accepted, we submit that market capitalization should include all listed and unlisted units of the trust or partnership on October 31, 2006. We submit that it would also be reasonable to include all other outstanding publicly-listed investments in the trust or partnership on that date, so as to include the same investments that result in the trust or partnership being within the SIFT regime.

### (b) Grandfathered Trusts and Partnerships Other Than SIFTs

The restriction on undue expansion in the Backgrounder and the Guidelines is applicable to "existing SIFTs", which we understand to mean trusts and partnerships that would have been SIFTs on October 31, 2006 if the definitions of "SIFT trust" and "SIFT partnership" in the Draft Legislation had been applicable at that time. This is not the same class of entities as the class of entities to which the transitional relief provided by the Draft Legislation applies. The transitional relief applies to a trust or partnership if units in the trust (interests in the partnership) or other securities of the trust or partnership were, before November 1, 2006, listed on a stock exchange or other public market. On the other hand, for a trust to be a "SIFT" trust, three conditions must be met: (1) the trust must be resident in Canada, (2) investments in the trust must be listed on a stock exchange or other public market, and (3) the trust must hold one or more non-portfolio properties. The definition of "SIFT partnership" has similar conditions.

There may be trusts and partnerships that satisfy the grandfathering condition but that do not satisfy the definition of a SIFT trust or partnership until after October 31, 2006. Such entities were not "existing SIFTs" on October 31, 2006 and would not appear to be covered by the restriction on undue expansion. If it is intended that the restriction apply to them, this should be stated. In this case, the appropriate time to measure market capitalization may be the date on which such an entity first meets the conditions in the definition of SIFT trust or partnership.

(c) Issuer Bids/Redemptions

A SIFT that re-acquires its units for cancellation pursuant to an issuer bid or a redemption after October 31, 2006 will reduce the amount of its issued and outstanding equity capital. Although the safe harbour amount will not be reduced by such a transaction, it is unclear whether the subsequent issuance of new equity to the extent of the value of the re-acquired units will be considered "growth". For example, assume that a SIFT with a market capitalization of $500 million on October 31, 2006 buys back $20 million of its units on January 15, 2007. In its 2007 taxation year, can the SIFT issue $200 million of new equity (i.e., 40% of $500 million) or $220 million of new equity (i.e., adjusted for the issuer bid)?

If the rationale underlying the Guidelines is to measure true equity growth after October 31, 2006, we recommend that a SIFT be entitled to issue new equity in an amount up to the value of the equity which is repurchased or redeemed subsequent to October 31, 2006, without that new equity counting towards its growth limits.

(d) Distribution Reinvestment Plans

Many SIFTs have established distribution reinvestment plans whereby unitholders are given an opportunity to have their cash distributions automatically reinvested in additional units of the SIFT. Does the Department of Finance consider such units to be new equity under the Guidelines?

(e) Unit Distributions

Where a SIFT trust has income for a year in excess of its cash available for distribution in the year, it will commonly declare that the excess amount of income is payable to unitholders in the year (so as to reduce its income to nil) and satisfy such amount payable by issuing additional units to its unitholders on a pro-rata basis. The SIFT might then consolidate its units so that the number of units outstanding immediately after such consolidation is the same as the number of units outstanding immediately before the issuance, subject to withholding tax adjustments for non-residents. We submit that the value of the units issued in these circumstances should not be considered to be new equity for the purposes of the Guidelines as no new equity would be contributed to the SIFT.

(f) Replacing Outstanding Debt

Issuing equity to replace debt (whether convertible or not) that was outstanding as of October 31, 2006 will not be considered growth for the purposes of the Guidelines. There are a number of issues with respect to the application of this exclusion:

- Is equity issued to replace outstanding lower-tier debt excluded from growth in equity capital? In many cases, SIFTs have chosen to make third party borrowings in lower-tier entities (corporations, partnerships or trusts in which the SIFT has a direct or indirect interest) for valid commercial reasons. We submit that the replacement of debt of this nature should be regarded the same as the replacement of debt of the SIFT.

- Is equity issued to replace refinanced debt excluded from growth in equity capital? For example, if a SIFT had $20 million of debt outstanding as of October 31, 2006 that it refinances with new debt, we submit that the replacement of all or part of the new debt should not be included as growth in equity.

- If the outstanding amount of a debt has fluctuated over time since October 31, 2006, is equity issued to replace the debt excluded from growth in equity to the extent of the amount of the debt outstanding on October 31, 2006, notwithstanding that a lower amount has been outstanding after that date?

(g) Exchangeable Securities

The Guidelines indicate that an issuance by a SIFT of new equity will not be considered growth to the extent that the issuance is made "in satisfaction of the exercise by another person or partnership of a right in place on October 31, 2006 to exchange an interest in a partnership, or a share of a corporation, into that new equity." Under some circumstances, the *issuer* of an exchangeable security may be entitled to require the exchange to occur, or the exchange may be deemed to automatically occur, in either case without any exercise of a right by the holder. We submit that it should not matter how the exchange is triggered, i.e., the exclusion should not be limited to situations where the holder exercises an exchange right.

Another issue with the above-noted Guideline regarding exchangeable securities and growth is that it does not extend to certain transactions that are similar in effect to an exchange. In the type of situation we are referring to, one or more persons hold interests in a lower-tier entity that are exchangeable for units of an income trust. The exchangeable interests give the holders a right to cause the trust to issue its units to the public for cash and to receive the net cash proceeds of such offering instead of receiving units of the trust on an exchange. We submit that new units issued to the public to raise cash to redeem exchangeable interests should not be considered growth under these circumstances. The overall result of the issuance of the new units and the redemption of the units is the same as if the exchangeable interests had been exchanged for trust units which were then sold to the public for cash.

A further issue with respect to exchangeable securities is that it is unclear whether the issuance after October 31, 2006 of such securities in an entity below a SIFT would ever be considered by Finance to be new equity of the SIFT. The Guidelines state that "new equity" may be broader than only SIFT units and convertible debt if attempts are made to "develop other substitutes for equity." It might be inferred from the fact that convertible debt is specifically mentioned whereas exchangeable securities are not that exchangeable securities are not intended to be regarded as "other substitutes for equity". We submit that it would be inappropriate to treat exchangeable securities of a lower-tier entity as new equity of the top tier SIFT before the exchange right is exercised. Until that time, the assets held by the top-tier SIFT have not increased. For example, if a SIFT has an underlying partnership that acquires an asset in consideration for a partnership interest, and the partnership interest is exchangeable for units of the SIFT, we submit that the SIFT should not be considered to have expanded before the partnership interest is exchanged for SIFT units.

(h) Options

The Guidelines do not specifically address whether SIFT units issued pursuant to the exercise of options outstanding as of October 31, 2006 are to be counted as new equity. The Guidelines confirm that SIFT units issued in connection with existing convertible debt and exchangeable securities do not count as new equity and we submit that the same should apply to units issued in exercise of existing options. In both cases, the SIFT is committed to issue the equity pursuant to a pre-November 1, 2006 agreement.

We also recommend that it be clarified whether options issued after October 31, 2006 are to be treated as new equity and, if so, how the amount of the new equity is to be determined, both at the time an option is issued and at the time the option is exercised or expires.

(i) Mergers and Reorganizations

The Guidelines state: "The merger of two or more SIFTs each of which was publicly-traded on October 31, 2006, or a reorganization of such a SIFT, will not be considered growth to the extent that there is no net addition to equity as a result of the merger or reorganization." The words "merger" and "reorganization" are not technical terms and we assume that Finance intends them to be interpreted broadly.

There is some uncertainty regarding the application of the "no net addition to equity" condition when the merger steps include the issuance of SIFT units for cash. The following is an example. The acquiring SIFT is to acquire units of the target SIFT in consideration for cash or a combination of cash and units of the acquiring SIFT. The cash consideration is to be financed by the acquiring SIFT through the issuance of units to third parties for cash either before, during or after the merger. We submit that a "net addition to equity" should be considered to occur only to the extent that the cash raised by the acquiring SIFT exceeds the cash paid for the units of the target SIFT. We request confirmation that the Department of Finance agrees with this.

Following a merger of SIFTs, it is unclear how the Guidelines will apply to the merged SIFT. We request clarification that each of the relevant items in the Guidelines (market capitalization, existing debt, existing exchangeable securities, etc.) is to be determined in respect of the merged SIFT on an aggregated basis.

We recognize that it is not possible to contemplate all of the ways in which a merger or reorganization could be carried out and to develop rules for every issue that may arise. On the other hand, if a merger of SIFTs is proposed, it will be important for the SIFTs and their investors to understand the tax consequences of the proposed merger. This will also be so in the case of a proposed reorganization of a SIFT. In order to provide the certainty that will be required, the Department of Finance should be prepared to review specific transactions and issue and publish "comfort letters".

## D. CONVERSION OF SIFTS TO CORPORATIONS

### (a) Taxation of Investors

The December 15 Release states that the Department of Finance is examining whether there are any impediments to converting a SIFT to a corporation without any tax consequences to investors.

One way to carry out a conversion would be for each investor to transfer their interest in the SIFT to a taxable Canadian corporation in exchange for shares of the corporation, and to elect under subsection 85(1) of the Act to have the transfer occur on a rollover basis. However, there are practical concerns with such a transaction.

One concern is that subsection 85(1) requires the corporation and each investor to complete an election form. Most of the information to complete the election form is not available to the corporation and accordingly it would be the responsibility of each investor to complete the form with the required taxpayer information, including the desired elected amount. Many investors are not familiar with this form, and could have difficulty completing it. Dealing with investor inquiries and with errors and omissions in completing the form could impose a substantial administrative burden on the converting SIFT.

Another concern arises from the fact that, in order for a conversion to be effective, all of the interests held by all investors must be transferred to the corporation. While it may be possible to ensure this through the use of a plan of arrangement or other means, this could be a complex multi-staged transaction. In some cases, it may be easier to implement the conversion in an alternative way. As a first step, the SIFT would transfer its assets to a corporation on a rollover basis or, if the SIFT already owns a corporation that carries on the business, it would convert debt of the corporation to shares. The second step would be for the SIFT to redeem the investors' interests in the SIFT and to pay the redemption proceeds by transferring shares to each investor.

We recommend that these concerns be addressed by the introduction of two new rollover provisions. One provision would apply where investors in a SIFT trust or partnership transfer their interests to a corporation. It would provide an automatic rollover, without any need for election forms to be filed, and would parallel subsection 85.1(1) of the Act. The second rollover provision would apply where a SIFT trust transfers shares of a corporation to investors in the SIFT on the redemption of their interests in the SIFT. This provision would be analogous in some respects to subsection 85(3), which applies with respect to partnerships. However, the rollover would have to apply not only where the distribution of shares follows a transfer of property to a corporation, but also where the SIFT already owns a corporation.

(b) Simplification of SIFT Structures

We submit that, in addition to measures to facilitate the conversion of a SIFT to a corporation, measures should be introduced to enable the resulting structure to be simplified on a tax-free basis. For example, if a conversion is structured so that a corporation acquires the investors' interests in a SIFT trust, it would be desirable to be able to wind the SIFT trust up into the corporation on a tax-deferred basis. Furthermore, many SIFT trusts are structured with lower-tier subsidiary trusts. It would be desirable to be able to wind up the lower-tier trusts on a tax-deferred basis as well. In addition to the resulting administrative benefits, the elimination of unnecessary entities would enable governance and liability issues affecting trusts to be avoided following the conversion into corporate form. We believe that a fairly simple rollover rule could be introduced for this purpose. The rule would apply only when a trust has a single beneficiary and all the assets of the trust are distributed on its winding-up.

(c) Acquisition of Control

The steps taken to convert a SIFT trust to a corporation and to simplify the resulting structure could result in an acquisition of control of a corporation owned by the SIFT trust. For example, assume that a SIFT trust that is to be converted to a corporation has a wholly-owned subsidiary corporation (Subco"). To implement the conversion, the unitholders of the trust transfer their units to a newly formed corporation ("Newco"), in return for shares of Newco. There are no other shareholders of Newco. Subsequent to this transfer, the trust distributes the shares of Subco to Newco. As a result of these transactions, Newco will be considered to acquire control of Subco, and none of the relieving rules in subsection 256(7) will apply to prevent this result. We submit that it is inappropriate for an acquisition of control to be considered to occur in this circumstance. Accordingly, we recommend that the Act be amended to provide that no acquisition of control occurs in situations such as that in the example.

(d) Employee Options.

We expect that, in the case of some conversions, there will be a desire to replace employee options to acquire SIFT trust units with options to acquire shares of a corporation. Subsection 7(1.4) provides for such an exchange to occur on a tax-deferred basis only if the SIFT trust does not deal at arm’s length with the corporation immediately after the exchange. Subsection 7(1.11) deems a mutual fund trust to deal at arm’s length with a corporation unless it controls the corporation, which would not be the case following a conversion. A similar issue also arises with the application of subsection 7(1.5), which is intended to preserve the paragraph 110(1)(d) deduction following an exchange of options. We recommend that section 7 be amended to permit the tax-deferred exchange of employee options issued by a SIFT trust for stock options of a corporation that replaces the trust on a conversion, and to preserve the paragraph 110(1)(d) deduction following the exchange.