



Facing the new realities for publicly traded trusts and partnerships

Expanded and updated to February 1, 2007

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Introduction

On October 31, 2006, Minister of Finance Jim Flaherty announced unexpected changes to the taxation of publicly traded trusts and partnerships (trusts). The government's subsequent news release of 15 December 2006 provided some breathing space in terms of "undue expansion" and "normal growth." However, the likelihood that many trusts will be forced to convert to a corporate structure before the end of 2011 was not eliminated. The government also communicated that it will allow trusts to convert to corporations until that time without tax consequences to investors. Draft tax legislation issued on December 21, 2006, while consistent with the October 31 announcement, did not include the December 15 guidelines.

During the same time period, a number of publications on the reporting and disclosure requirements of trusts have been made available. On November 6, 2006, the Canadian Institute of Chartered Accountants (CICA) released their draft guidance on the calculation and disclosure of distributable cash. On January 5, 2007, the Canadian Securities Administrators (CSA) published for comment their proposed amendments to National Securities Policy 41-201, some of which relate to distributable cash.

On January 30, 2007, the Finance Minister reconfirmed that the government's position on the taxation of trust was not negotiable. Accordingly, the most proactive course of action by any individual trust is to initiate the significant analysis required for a strategic response. Key areas of review should include sustainability of the business model, new reporting requirements (particularly regarding distributable cash), and governance for trustees. To help trustees, CEOs, and CFOs of trusts reassess their financial options and business strategies, Deloitte has compiled a synopsis of the most significant changes as well as our perspective on:

- Impact of changes to trust taxation
- Changes to business model and sustainability of distributions
- New draft guidance for calculation and disclosure of distributable cash
- Valuation implications of proposed tax changes
- Developing a strategic response
- Key governance areas for trustees

Growth of trusts

In recent years, traditional Canadian corporations have moved increasingly to more tax-efficient flow-through entities. As of October 31, 2006, this market comprised 256 trusts with \$207 billion in capitalization.

Initially, flow-through entities were limited to broadly-distributed retail investment arrangements such as traditional mutual funds, real estate investment trusts, and resource royalty trusts. Today, these initial arrangements make up only 32% of the trust market, while business trusts comprise 68%.

In November 2005, the government announced changes to the taxation of corporate dividends. The objective of these changes was to level the playing field for public corporations and slow the trust trend. Nevertheless, the trust trend accelerated and extended to larger traditional corporations, primarily because the changes did not address the advantages available to tax-exempt deferred income plans and non-resident investors in flow-through entities.

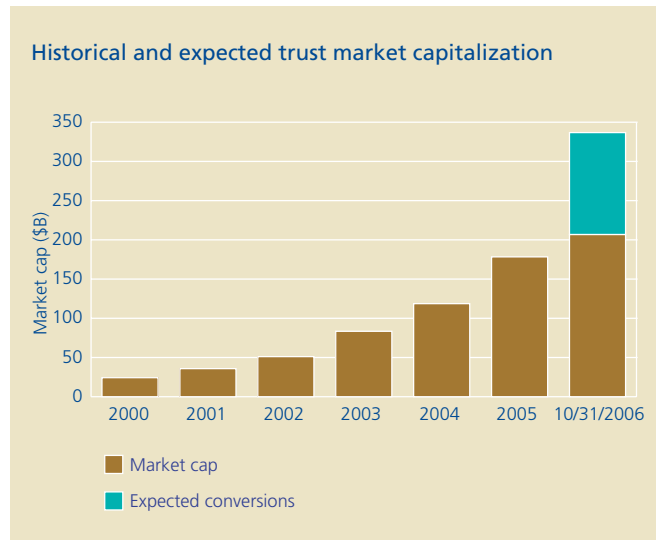


Figure 1 Source: TSX Market data and Deloitte

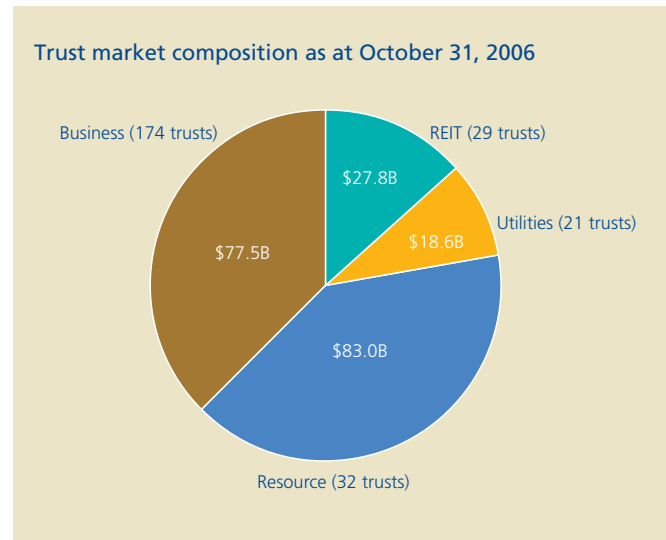


Figure 2 Source: TSX Market data

Impact of changes to trust taxation

On December 21, 2006, the government released new draft tax legislation that will apply to certain publicly traded trusts and partnerships defined as "Specified Investment Flow-Through Entities" (SIFTs).

Definition of a SIFT

SIFTs will include a trust or partnership that is resident in Canada where the units are listed on a public market and the trust or partnership holds one or more "non-portfolio properties," including certain investments in "subject entities," Canadian resource properties, timber resource properties, and real estate situated in Canada but excluding certain real estate investment trusts (REITs). "Subject entities" will include Canadian resident corporations, trusts and partnerships and non-resident corporations, and partnerships and trusts whose principal source of income is in Canada.

Definition of a REIT

A REIT will be excluded from the definition of a SIFT and from the application of the proposed rules, provided it satisfies all of the following conditions:

- It must not, at any time in the year, hold non-portfolio property other than real or immovable property situated in Canada.
- At least 95% of its income for the year must be income from properties and taxable capital gains from dispositions of real or immovable properties.
- At least 75% of its income for the year must be directly or indirectly attributable to real or immovable properties situated in Canada or to mortgages, or similar instruments, on real or immovable properties situated in Canada, or taxable capital gains from the disposition of real or immovable properties situated in Canada.

- At least 75% of the equity value of the REIT, at all times during the year, must be attributed to the fair market value of real or immovable property situated in Canada, cash and debts or other obligations of Canadian governments.

Taxation of SIFT distributions

A trust or partnership that is a SIFT will no longer be entitled to deduct distributions of "non-portfolio earnings" to unitholders. Consequently, if a SIFT distributes non-portfolio earnings to unitholders, the tax applicable to the SIFT in respect of such earnings will be the general federal corporate tax rate (21% in 2007, to be reduced to 18.5% by 2011) plus 13% for provincial tax. The amounts distributed by a SIFT to investors that are subject to the new distribution tax will be treated as taxable dividends from a taxable Canadian corporation to the recipient.

Key areas of uncertainty

The concepts underlying the legislation of 21 December 2006 are relatively clear; however, there are several areas of significant uncertainty. They include:

- **Undue expansion:** The news release of 15 December 2006 provided little guidance on what constitutes "normal growth," however this guidance was not included in the draft legislation issued on December 21. Although the guidelines have generally been viewed favourably, uncertainty relating to their application remains. In addition, since the guidance essentially sets a maximum permitted dollar value of growth, even slightly exceeding the set limits may cause the SIFT to become non-compliant. This creates issues, for example, in situations where a SIFT utilizes its units to fund

Highlights of the December 15, 2006, news release

- SIFTs that are publicly traded on October 31, 2006, will not be subject to the distribution tax until 2011 unless the SIFT is seen to have had “undue expansion” in excess of “normal growth.”
- Normal growth is defined as annual growth that doesn’t exceed the greater of \$50 million and a “safe harbour.”
- The annual safe harbour will be 40% in the first year and 20% in each of the remaining three years.
- The safe harbour will be cumulative, and based on the SIFT’s market capitalization as at the end of trading on October 31, 2006. The \$50 million annual growth amount is not cumulative.
- Market capitalization will include the SIFT’s issued and outstanding publicly traded units and will not include debt (even if the debt was able to be converted into publicly traded units).
- Equity growth for these purposes will include the issuance of both units and debt that is convertible into units.
- Converting debt that was outstanding on October 31, 2006, into equity will not be considered growth.
- Issuing equity 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 will not be considered growth.
- Any merger or reorganization of two or more SIFTs that were available to be traded on October 31, 2006, will not be considered growth to the extent there is no net addition to equity.

acquisitions, given potential fluctuations. This uncertainty highlights the need for Finance to provide comfort letters to SIFTs until clear guidelines are introduced in the legislation.

- **Conversion to corporate form:** The December 15, 2006, guidelines indicated that conversions to corporate form should be allowed to take place without any tax consequences to investors on the conversion. No comment was made on whether there would be entity level tax on a conversion. The guidelines indicated the government is examining whether any impediments to conversion exist under the current income tax rules, and if so, changes will be recommended to ensure that appropriate rules are in place to facilitate conversions. The proposed legislation did not include any changes relating to these comments. There are various methods to convert under the existing rules, but these are administratively difficult and would likely result in complicated structures going forward. The preference would be for legislation which provides a specific conversion in this context.
- **Subsidiary entities:** Many SIFTs indirectly own interests in underlying entities which have issued exchangeable securities to retained interest holders. The proposals do not expressly address the tax treatment of entities below the SIFT. There is a statement in the announcement that securities of other issuers, if those securities derive substantially all of their value from securities issued by the SIFT, will be included in investments in the SIFT. It is not clear that exchangeable securities would be considered as deriving their value from securities of the SIFT, and whether the securities of the subsidiary entity would be an investment in a SIFT.

- **Provincial tax:** The legislation provides that SIFTs will be subject to tax on taxable non-portfolio earnings at a rate equal to the actual federal corporate tax rate in the year plus an amount that serves as a proxy for tax to be collected on behalf of provincial governments. This amount has been set at 13%. To the extent that the business was carried on in corporate form, there may be a difference between the actual corporate provincial rate and this notional provincial tax.
- **REITs:** The definition of a REIT, for the purpose of determining which are exempt from the proposed rules, is narrow. A REIT that earns income only from real property should qualify for the exemption while a REIT that is engaged in the provision of services would not. There is ample room for the government to clarify where it sees income from property ending and business income from services beginning in the context of a broad range of real estate based activities (apartments, office commercial, hotels, retirement residences and nursing homes offering a wide range of assistance). Earlier generations of REITs in Canada had to contend with similar conditions, but were able to deal with service activities by earning such income through a subsidiary entity. The definition of REIT in the December 21 legislation appears considerably narrower, and may not accommodate the prior planning. Under the proposals, real property situated outside Canada will also disqualify the REIT under certain ownership structures. The ultimate formulation of this definition will fundamentally affect which REITs will be exempt and which will not. There was some expectation that both technical and policy changes and clarifications would be incorporated into the draft legislation when issued. However, the December 21 legislation is similar to what was proposed in the October 31 announcements.

Highlights of the December 21, 2006, draft legislation

- A new distribution tax will apply to distributions made by SIFTs.
 - The rate of the distribution tax payable will generally be equivalent to the combined federal and provincial tax that a Canadian corporation would have paid in similar circumstances.
 - From an investor's perspective, a distribution from a SIFT will be treated in the same way as a taxable dividend from a Canadian corporation.
 - The new distribution tax will apply to existing SIFTs beginning in 2011 (provided they adhere to the guidelines on "normal growth") and to new SIFTs in 2007.
 - The general federal corporate tax rate will be reduced by a further one-half percent to 18.5% in 2011.
- **Anti-avoidance:** In addition to undue expansion, the announcement warned taxpayers and their advisors that if structures or transactions devised to frustrate the policy objectives of the original announcement were to emerge, the government may change the announced measures with immediate effect. Further, the additional guidance issued on "normal growth" also included comments that the Department of Finance will monitor developments in the market and will take action accordingly to ensure the guidance is respected. However, the proposed legislation issued on December 21 did not contain specific anti-avoidance rules aimed at alternative arrangements, suggesting the government intends to rely on the general anti-avoidance rule. In this regard it will be difficult to discern tax policy objectives of these proposals beyond what is actually provided for therein. For example, the "clipped" debt and equity

The majority of Canadian business leaders surveyed by Deloitte in December 2006 believes that the number of trusts will decline to less than 50 by 2011. Our point of view is that the only significant reason to prefer a SIFT over a public corporation is that a trust can return capital tax-free...while a public corporation cannot.

structures known as IDSs or IPSs do not appear subject to the proposed rules as the issuers are not SIFTs. Nor is it clear that these structures would be considered to frustrate the tax policy objectives set out by the government on October 31. Nevertheless, the wise approach is to wait and see the legislative form of the proposals before entering into alternative structures that achieve tax results similar to SIFTs. As such, it may be the case that the government intends to introduce specific legislation with retroactive effect to curtail perceived abuses.

- **Legislative process:** It is well known that many SIFTs and industry groups were outraged with the government's announcement and many continue to press for changes. The energy sector believes that it deserves relief due to its unique history and the role of royalty trusts in financing the sector's activities, and to guard against excessive foreign ownership. REITs will continue to seek more broad-based relief from the proposed rules. Many SIFTs still feel the four-year transitional period is too short. Given the complexity of the proposed legislation received to date, and the key areas of the proposals for which draft legislation has not yet been provided, it may take a considerable period of time before the proposals ultimately become law.

Good news for income trusts doing SR&ED?

- Currently, most income trusts can't access much in the way of SR&ED tax credits because of their limited/general partnership structure.
- Up to 99.99% of the SR&ED tax credits earned by income trusts are not utilized due to tax rules.
- Recent events indicate that these rules may change, creating some new SR&ED tax credit opportunities.
- Trusts should investigate this possibility regardless of plans to change their structure over the next four years.

Tax policy bias in favour of public corporations

Despite the government's intention to level the playing field between SIFTs and public corporations, the tax policy bias will have swung in favour of public corporations by 2011, if not before, as supported by the following realities:

- Although the combined entity and investor level tax burden for SIFT trusts and public corporations will be roughly the same, **the SIFT trust will be required to distribute its non-portfolio earnings in order to achieve that neutral result.** Even after 2010, a SIFT trust will be forced to distribute its non-portfolio earnings or instead incur trust-level tax on retained income imposed at the highest individual rate. In this situation, investors would ultimately bear an element of double taxation when such income is distributed or when the units are sold. The effect of this forced distribution feature of trust taxation (deliberately preserved in the proposals) may not be burdensome for those trusts with conservative payout ratios and whose cash distributions comfortably exceed their taxable income. However, for those trusts whose taxable income is significant in relation to cash distributions, forced distributions may impair management's ability to run the business. For example, if a SIFT trust was otherwise inclined

to reduce its cash distributions in order to maintain its payout ratio at a sustainable level, there could be circumstances in which the forced distribution feature of trust taxation would impede management's ability to do so.

- On the other hand, **a public corporation will have the freedom or flexibility to retain its income to invest in its business and grow organically.** Also, in the case of income that would have been distributed to taxable Canadian resident shareholders, an added tax deferral benefit arises because the corporate income tax rate is significantly less than the highest individual tax rate on ordinary income.

The only potentially significant reason to prefer a SIFT trust over a public corporation is that a trust can return capital tax freely in the ordinary course of business, whereas a public corporation cannot. If the legislation is enacted in its current form and subject to the final legislation relating to the undue expansion provision and normal growth, there will be few reasons to remain a SIFT trust, other than the cost of converting back.

Changes to business model and sustainability of distributions

The changes in the taxation of trusts will have significant implications on how various trusts are managed in the future. Some large cap trusts have already announced that they will be able to adapt their businesses to the new tax regime, and will continue as trusts after the four-year transition period. Alternatively, the business models of some trusts have been terminally affected by the new rules.

Consider the following hypothetical example of a liquidating trust:

Over the past five years, “Energy Trust” has produced about \$2 billion in distributable cash from producing oil and gas. It has paid roughly the same amount to unitholders, and has a payout ratio of approximately 100%. But energy reserves need to be replenished. Accordingly, \$3 billion spent on acquisitions and capital in those five years was financed by debt and selling more units. These acquisitions have been dilutive and the reserves per unit are lower now than they were five years ago.

The draft tax legislation will limit the ability of **Energy Trust to replenish its reserves**. It is now forced into a position of liquidating, and ceasing to operate as a sustainable business in the long term.

Clearly, government taxation policies are directly affecting the flexibility of the capital structures of trusts. Given that trusts are not uniformly affected, trustees, CEOs and CFOs of trusts need to understand the impact of the tax changes on their access to capital and whether the new tax rules have fundamentally affected the sustainability of their business models.

Available debt capacity will provide temporary relief to some of the larger trusts. However, some mid-sized trusts will experience tighter bank credit as their banking facilities are renewed. Many of the current banking arrangements for mid-sized trusts involve revolving, non-amortizing loans, but during the annual loan review, nervous lenders might reduce credit limits or start demanding regular repayment of their loans. This situation is exacerbated by the fact that some trusts no longer have access to the public equity markets.

Deloitte has reviewed the capital structures of the 174 business trusts and concluded that the vast majority (approximately 89%) will experience issues with access to capital from traditional lenders. (See figure 3)

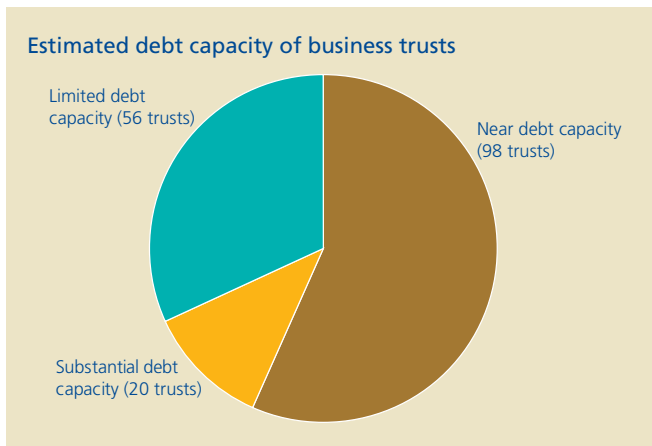


Figure 3 Source: Deloitte

It is anticipated that private equity, hedge funds and other non-traditional lenders will be actively involved in providing monies to trusts that do not meet traditional bank loan criteria. These monies will bear interest at higher rates which will reduce the amount available for distributions to unitholders.

Unlike interest payments on third-party loans which are contractual and fixed obligations of a borrower, trusts have the ability to voluntarily change their distribution levels. In fact, a trust can choose to stop paying distributions entirely for an unlimited period of time.

Over the long term, trusts will need access to additional capital to maintain their productive capacity and to continue to grow their businesses. Without access to capital, many trusts will be forced to forgo the four-year tax holiday and will convert to a corporate form sooner rather than later. Unlike trusts, a public corporation has the flexibility to retain its income to invest in its business and grow organically.

New draft guidance for calculation and disclosure of distributable cash

Until recently, a lack of comprehensive guidance regarding the calculation and disclosure of distributable cash had resulted in widely-reported inconsistencies and financial disclosure shortcomings. Currently, there are two pieces of draft guidance out for comment: a detailed document from the Canadian Institute of Chartered Accountants (CICA), and proposed amendments to National Policy 41-201 by the Canadian Securities Administrators (CSA). Although there are key differences between the two, these differences would not prevent a trust from following the CICA guidance while satisfying the CSA.

CICA draft guidance

On November 6, 2006, the CICA released its draft guidance on reporting distributable cash in Management's Discussion and Analysis (MD&A). This guidance is intended to provide more relevant and consistent information to assess the operating performance of a trust and the sustainability of its business model by addressing the following four questions:

1. How much cash was generated during the period and where did it come from?
2. Is sufficient cash being retained to provide for all long-term unfunded contractual liabilities, such as pension plans?
3. Is sufficient cash being retained within the trust to maintain productive capacity?
4. If distributable cash were to be distributed, is it likely that the entity will meet its financial commitments, such as loan covenants, for the foreseeable future?

Distributable cash calculation

Cash from operating activities,
excluding discontinued operations

Less adjustment for:

Productive capacity maintenance
Long-term unfunded contractual obligations
Financing restrictions caused by debt covenants

Distributable cash from operations

Calculation of distributable cash

Distributable cash from operations is defined as the periodic cash flow from operating activities as reported in the GAAP financial statements, including the change in non-cash working capital and excluding any cash flows from discontinued operations, less any consistently measured and documented provisions for and only for:

- **Productive capacity maintenance** expenditures consistent with the entity's strategy capitalized in accordance with GAAP.
- **Long-term unfunded contractual obligations** such as unfunded pension obligations and asset retirement obligations, to the extent not appropriately reflected in operating cash flows.
- **Financing restrictions on distributions caused by debt covenants** operational at the date of the calculation and those likely to become operational within the foreseeable future (i.e. within 12 months of that date).

Disclosure of distributable cash

Strategies for productive capacity maintenance and debt management are of critical importance in assessing the sustainability of the trust's business model and should feature prominently in the MD&A. Specifically, flow-through entities should include in the MD&A a statement of their goals for productive capacity maintenance, activities to achieve this goal, and risks related to its accomplishment. The potential impact on productive capacity from such factors as production or use, technological change, obsolescence and the effects of changes in information technology, as well as the entity's planned response to such factors should be identified. The entity's strategy for the maintenance of intangible assets that impact productive capacity should likewise be identified.

The MD&A should also contain a statement of the entity's strategy for maintaining the debt element of its financial capital structure, and the risks related to the strategy. The manner and time period over which the entity intends to repay or refinance existing obligations should be identified. The significant terms of debt and other financial obligations should be disclosed and analyzed in terms of their impact on the entity's ability to distribute cash to unitholders and other investors. Entities should explain the relationship of the productive capacity maintenance strategy to the debt management strategy, indicating the risks to distributable cash from operations and cash distributions that arise from that relationship.

Implications of the draft CICA guidance

- The new standardized method for calculating distributable cash will **influence the amount of future distributions** that certain trusts pay.
- Disclosure of sources of distributable cash will show **which trusts have sustainable cash distributions** and which ones are liquidating.
- Management will **better understand their business model** as they formulate strategies for maintenance of productive capacity and the related financing.
- Disclosure of strategies, constraints as well as mitigating initiatives will **encourage management accountability**.
- Management will need to conclude and disclose whether they are in **full compliance** with the new guidance.

Specific disclosure requirements in the CICA's draft guidance include the following:

- **Standard terminology**, with the term distributable cash from operations used to describe the cash flows from operating activities available for distribution to unitholders. Cash flows arising from investing or financing activities should be separately identified.
- **Computation and reporting of a payout ratio**, where the numerator is the cash distributions and the denominator is the distributable cash from operations.

In Deloitte's December 2006 survey of Canadian business leaders, more than half said they expect reported payout ratios to be higher as a result of new draft CICA guidance for calculation of distributable cash.

- **Disclosure of cumulative distributable cash from operations** since inception compared to cumulative cash distributions, and computation and reporting of a cumulative pay-out ratio where the numerator is the cumulative cash distributions of the entity, and the denominator is the cumulative amount of distributable cash from operations.
- **Disclosure regarding the tax attributes** of distributions.
- **Disclosure, quantification and discussion of significant differences** between the tax bases of significant classes of assets and the carrying values of those assets that may affect the taxable nature of future distributions.
- **Reconciliation** of distributable cash from operations to the GAAP financial statements.

Trusts should view these disclosure guidelines as an opportunity to explain their strategies and business model so that their investors can clearly understand the trust's business condition and assess future prospects, even if there are many uncertainties. The MD&A is probably the most appropriate document to provide these disclosures. All trusts are encouraged to carefully study the CICA's proposals and to adopt them in their 2006 MD&A so that investors and other stakeholders have relevant and consistent information with which to make their investment decisions.

Proposed amendments to National Policy 41-201 by the CSA

On January 5, 2007, the CSA published for comment proposed amendments to National Policy 41-201 – Income trusts and other indirect offerings. There is a 60-day comment period for the proposed amendments, the most significant of which relates to distributable cash. The CSA wants transparency regarding the sources of distributable cash to help investors assess the sustainability of distributions. The CSA also observed that provisions for maintenance of productive capacity is often inadequate.

Many aspects of the proposed amendments are consistent with the draft CICA guidance for calculation and disclosure of distributable cash. The primary difference is that the CSA proposed amendments are more disclosure-based and less specifically defined, especially in the area of maintenance of productive capacity. Nevertheless, both the CICA and the CSA require detailed explanations behind all adjustments in the calculation of distributable cash.

The proposed amendments provide detailed guidance on MD&A disclosure requirements for distributable cash. In addition, the proposed amendments include examples of:

- **Groupings for distributable cash reconciliations under the following headings:**
 - Cash flow from operating activities including changes in non-cash working capital balances
 - Non-recurring adjustments (not likely to recur within the next two years)

- Maintenance of productive capacity including provisions for maintaining mineral reserves or for asset retirement obligations
- Other adjustments including discretionary items
- **A table to summarize the discussion of distributed cash which clearly discloses:**
 - Excess (shortfall) of cash flows from operating activities over cash distributions paid
 - Excess (shortfall) of net income over cash distributions paid

Guidance is also provided on disclosure of risk and uncertainties, especially those which could affect:

- Predictability of distributions to unitholders.
- Potential commitment to replace and maintain capital assets including a discussion on expected maintenance expenditures in relation to current levels.
- Assumptions underlying the adjustments to distributable cash. If adjustments are not adequately supported by historical experience, CSA may take the view that a forecast is required.
- Potential inapplicability to unitholders of certain corporate law rights and remedies.
- Potential inapplicability of insolvency and restructuring legislation to trusts.

CICA Emerging Issues Committee's views on future income tax liabilities

At its December 2006 meeting, the Emerging Issues Committee (EIC) of the CICA discussed several issues involving trusts. Their tentative conclusions include:

- When the proposed tax changes are "substantively enacted," future income tax assets and liabilities should be recorded in the trust's financial statements, with a corresponding impact on future tax expense. In the meantime, trusts should ensure they are disclosing taxable temporary differences in their financial statements notes because future taxable income will affect the level of distributions. The recognition of future income tax assets and liabilities should be based on the temporary differences expected to reverse after the date the tax changes take effect (but not including existing temporary differences that will reverse before that date), and should be measured using income tax rates at the balance sheet date. The definition of "substantively enacted" is the third reading in Parliament.
- The proposed tax changes may have caused goodwill impairment at certain trusts. The EIC agreed it would be acceptable for trusts to consider the implications of the current proposed taxation changes in performing goodwill impairment testing for the current reporting period.
- The EIC agreed affected trusts should identify in their financial statements that their taxable status would change if the proposed tax changes are enacted, and that a detailed discussion of the implications for the trust should be included in the MD&A.

Valuation implications of proposed tax changes

The new tax has affected various trusts in different ways; those in the healthcare, restaurant and resource industry sectors appear to be most negatively impacted. Various factors contributed to the decline in trust unit values, precipitated by the incremental tax burden borne by tax-exempt and non-resident investors. Prior to the government's announcement, it is believed approximately 30% of the trust unitholder base was tax-exempt, and about 15% to 20% was non-resident¹.

At this point, the critical question is whether there will be a further decline in unit values. The answer depends on a range of factors, including the impact of any further legislative changes, the investor's assessment of management's strategies to respond to these changes, and the investor's assessment of the impact on the trust's business model and its ability to generate sustainable cash distributions.

Disparities in trust valuations

Factors contributing to the variance in the decline in trust unit values include, but are not limited to:

- **Return of capital:** Since the return of capital does not incur a tax, the greater the proportion of expected return of capital in distributable cash, the lower the deterioration in unit value.
- **Foreign income:** Those trusts earning a greater proportion of their income in foreign markets may suffer a lower decline in value. Such income is already taxed in foreign jurisdictions, and this may not be subjected to any incremental tax burden.
- **Type of underlying operating assets:** Many infrastructure assets are likely candidates for acquisition by tax-exempt investors because, among other reasons, cash flows can match with the investors' obligations and the tax efficiency can be preserved.
- **Type of income fund:** Some income funds, such as the clipped unit form or income deposit securities, reacted differently than traditional trusts.
- **Payout ratio:** Those trusts deemed unable to maintain their payout ratios may suffer a higher drop in trust unit value.
- **Other factors:** Other factors impacting the varying unit value declines include inorganic versus organic growth potential of the business, the liquidity of the trust unit prior to the announcement, the price of oil, and volatility of the unit.

¹ Tait G., Renkas C., and Bolton C., "Income Trusts – Complexity and Confusion," BMO Capital Markets, November 1, 2006.

The decline in unit values will require trustees and management to consider various valuation issues:

- **Goodwill impairment:** The Emerging Issues Committee of the CICA, at their December 2006 meeting, discussed the potential for goodwill impairment and tentatively agreed that it would be acceptable to consider the implications of the current proposed taxation changes in performing goodwill impairment testing for the current reporting period.
- **Revaluation of debt:** Trusts structured with foreign related-party debt instruments may be required to reconsider their valuation and commercial reasonability upon renewal.
- **Valuation of contingent consideration:** Trusts with outstanding earn-out provisions could trigger premature conversion to corporate form (i.e. if greater than 10% – 15% of capital is increased) and unintended results for both parties to the provision if not reconstituted.

- **Unit-or stock-based compensation:** There may be a need to reconsider stock- or unit-based compensation for management negatively impacted by the decline in unit values.
- **Overall value maximization:** Value will be influenced by the identification of strategic options available to mitigate the unit value decline.

Trusts evaluating the go-private option may also require fairness opinions to discharge their fiduciary duties.

As a result of the implications of the proposed tax changes, a comprehensive valuation analysis is an imperative. It is incumbent upon trustees, CEOs and CFOs of trusts to refresh their decision framework of assessing strategic options.

... a further decline in unit values depends on a range of factors, including the investor's assessment of the impact of the tax changes on the trust's business model, and its ability to generate sustainable cash distributions.

The valuation imperative

A properly designed dynamic valuation framework offers many benefits:

- **Governance due diligence:** Assurance that the four-year tax window is maximized in light of a myriad of strategic options and stakeholders.
- **Timing:** The marginal value of the transitional period tax window declines over the four-year period, increasing the chances that an alternative course of action may be value accretive. Further, this value breakeven point may not be static, and so, the timing of implementation is important.
- **Actual costs:** The potential financial burdens of exiting the trust structure are rife with tax-associated triggers. A total tax concept assures the transition occurs in the most efficient manner possible.
- **Hurdle rate:** The marginal value of the transitional period tax window net of the economic costs to exit the trust structure represents the breakeven point of options.
- **Compliance:** A foundation for asset impairment testing, fairness opinions and other governance-related valuations.

Decision-making framework parameters

Several factors taken together will suggest the best decision path for a trust:

- Transitional period growth expectations
- Long-term growth expectations
- Payout ratio
- Capital expenditures
- Cost of capital
- Effective tax rate
- Available tax pools/attributes
- Mix of foreign and domestic taxable income
- Tax and administrative costs to dismantle the trust structure
- Overhead costs of the different legal forms (i.e. trust form and corporate form) and ownership (i.e. public or private)
- Unitholder composition and corresponding tax burden
- Location of income producing property
- Net present value or accretion/dilution associated with strategic options

In Deloitte's December 2006 survey of Canadian business leaders, more than 58% said they expect the income trust index to further decline.

Although the combined entity and investor level tax burden for a trust and a public corporation will be roughly the same, the trust will be required to distribute its non-portfolio earnings in order to achieve that neutral result.

... a public corporation will have the flexibility to retain its income to invest in its business and grow organically.

Developing a strategic response

To respond appropriately to the proposed changes in trust taxation, trustees, CEOs and CFOs need to start developing plans now for the four-year transition period and beyond. In fact, year-end reporting requirements require management to discuss the implications of the draft legislation in their trust's MD&A. When formulating their plans, management should also consider:

- Significant changes to existing business strategies and the business model
- Changes to the current strategies for cash distributions to unitholders
- Changes to the financing of the business

Each trust will be under intense public scrutiny, and the markets will demand responses to the issues that will impact an entity's valuation. Specifically, trustees, CEOs and CFOs of trusts should consider the following:

- Should we convert back to a corporation?
 - What is the right time?
 - What is the cost of converting?
 - What are the tax consequences of being private or unwinding trust structures?
- When is the right time to make cash distributions?
- Should we sell assets and distribute capital?
- How do we access additional capital?

- How do we evaluate M&A opportunities and threats?
- What are the implications to our business model?
- What are the strategies to minimize tax going forward?
- How do we address corporate governance challenges?
- How do we ensure compliance with new requirements for disclosure of financing and distribution strategies?
- What are the strategic implications of compliance with disclosure standards, and what is the best way to pre-empt negative consequences?
- How do we address asset impairment and other transitional issues?

Why act now?

The need for a pro-active response:

- **Timing is everything:** Planning and understanding when to act is critical to maximizing value during the transition period.
- **A dynamic environment:** To be able to react quickly in a volatile situation, management needs to analyze the implications of changes.
- **Stakeholder expectations:** Trust management and Boards are expected to clearly understand the implications of the changes and have a concrete plan for going forward.
- **Opportunities:** Timely action will maximize opportunities.

In Deloitte's December 2006 survey of Canadian business leaders, more than 87% said they believe that trusts will need to develop a strategic response to the new tax measures within the next twelve months.

Deloitte's 5-step process

<p>1 Understand implications</p>	<ul style="list-style-type: none"> • Unfunded obligations or growth strategies may prematurely trigger new tax • Valuations and asset (goodwill) impairment issues • Access to capital and impact on covenants, especially for troubled trusts • Corporate tax planning and maintenance of payout ratios • Management compensation and retention plans • Corporate governance concerns including conflicting interests among stakeholders • Legislative uncertainty related to timing and costs associated with transition period
<p>2 Identify strategic options for long-term structure</p>	<ul style="list-style-type: none"> • Continue as a trust • Liquidate assets and return capital to unitholders • Sell entire trust to strategic or financial buyer • Convert to alternate form (e.g. public corporation listed on TSX or AIM) • Fix (e.g. carve-outs to qualify as a REIT)
<p>3 Develop 4-year comprehensive valuation model</p>	<ul style="list-style-type: none"> • Create a dynamic valuation model calibrated to identify the optimal timing to pursue value maximizing alternatives • Data required for modeling would include: cost to convert to alternate form, the cost of maintaining a trust structure versus an alternate form, and tax attributes/pools within the current structure
<p>4 Develop revised strategy with trigger points for earlier conversion from trust form</p>	<ul style="list-style-type: none"> • Link capital needs with business growth strategy • Understand possible trigger points (e.g. takeover activities, acquisition opportunities, tax plays, economy downturn, interest rates)
<p>5 Communication and reporting requirements</p>	<ul style="list-style-type: none"> • Manage differing perspectives of investors, tax authorities and securities regulators • Adopt CICA draft guidance for calculation and disclosure of distributable cash as a means to communicate go-forward strategy to investors and other stakeholders

Key governance areas for trustees

The duties and responsibilities of a corporate director are better understood from those of a trustee. The pending tax changes will require all trusts to review their strategic options and trustees have a duty to their unitholders to ensure these strategic reviews are appropriately performed on a timely basis. Some trustees will insist on independent advice and the subject of good corporate governance will be top-of-mind.

Publicly traded trusts are subject to the same provincial securities legislation, regulation and corporate governance standards as other Canadian public companies. However, trusts are established by a declaration of trust, which is similar to a contract and vary from issuer to the issuer. Although most declarations of trust are designed to approximate the corporate regime by incorporating many of the key provisions of the Canada Business Corporations Act (CBCA), trusts are not subject to statutory corporate laws. Three areas where declarations of trust often do not provide the CBCA equivalent rights and remedies are: shareholder proposals, oppression remedy and derivative actions, and dissent rights. Trusts are required to disclose these differences by comparing the rights and obligations available to corporate shareholders under corporate statutes such as the CBCA with those provided by the declaration of trust. Recommended wording is as follows:

A unitholder in the income trust has all of the material protections, rights and remedies a shareholder would have under the CBCA, except the following ...

The declaration of trust also specifies where unitholder approval is required (e.g. amalgamation, wind-up, takeover or material changes to the declaration of trust) and the level of approval required (e.g. majority or two-thirds).

It is important to realize that a trust is a relationship, not a legal entity. There is a trustee-beneficiary legal relationship between trustees and unitholders. Trustees acquire and hold legal ownership of all of the trust's assets on behalf of the unitholders.

All contracts made on behalf of a trust are made by the trustees. The trustees are personally liable for contracts made on behalf of the trust but most declarations of trust provide for full indemnity of the trustees out of property of the trust, and trustees can limit this liability through the use of limited recourse clauses. Trustees have no right of indemnity for breach of trust (e.g. fraud or gross negligence) and hence are personally liable on a joint and several basis for such acts. Trustees can delegate their responsibilities, but are unable to abdicate them.

Under common law, trustees are held to the highest fiduciary standards. They are obligated to act impartially and with good faith, and to exercise a duty of care to act reasonably and prudently.

In theory, trustees owe the above obligations and duty of care to the unitholders of the trust, whereas directors owe their duties to the corporation, which includes a broader range of stakeholders. In most situations, however, trustees will generally be held to similar standards and will need to take into account a similar range of stakeholders and considerations as corporate director.

A trustee, director of a subsidiary of the trust, member of management, and selling shareholder have different interests and responsibilities. Where the same individual holds a number of different roles at the same trust, the potential for conflicts-of-interest needs to be monitored, especially when the trust is underperforming or is in financial difficulty. For example, a conflict could occur for trustees, who are also directors of a subsidiary of the trust, if it is necessary to cease distributions due to a breach of the trust's banking covenants.

Another example of a conflict could involve selling shareholders who are also trustees if they hold certain special rights, such as board representation and vetoes over changes of management or control of the trust.

Where the operating subsidiary of a trust is a corporation, it is subject to corporate law. Where a limited partnership is used as the operating entity, the partnership is governed by a limited partnership agreement. Trusts with a limited partnership structure can lose limited partner liability protection if the trustees participate in the direct management of the operating business.

New guidance on governance for trusts

Recently, there has been a lot of activity regarding governance of trusts. The CSA's proposed amendments to National Policy 41-201 include a separate section on governance covering CEO/CFO certification, audit committees and effective corporate governance. Issuers are being asked to explain how they will satisfy their governance responsibilities. In addition, the Canadian Coalition for Good Governance has undertaken a project to consider governance issues for trusts. The Uniform Law Conference of Canada has also released a draft Uniform Income Trusts Act which provides a framework for governing trusts.

Bill 198 and civil liability

Trustees are at risk to statutory civil liability for misrepresentations and failure to make timely disclosure with respect to:

1. Misleading continuous disclosure filings and any other documents released by issuer
2. Public oral statements by a person with actual or apparent authority
3. Omitted material disclosure in core documents such as prospectuses, MD&As, Annual Information Forms, and annual and interim financial statements

To avoid liability, trustees should ensure disclosure is timely and accurate. There should be strict controls on who may speak for the trust, and the trustees should also ensure the trust has appropriate procedures for disclosure and document preparation.

Trustees should consider a number of issues in each of four key governance areas when developing a strategic response:

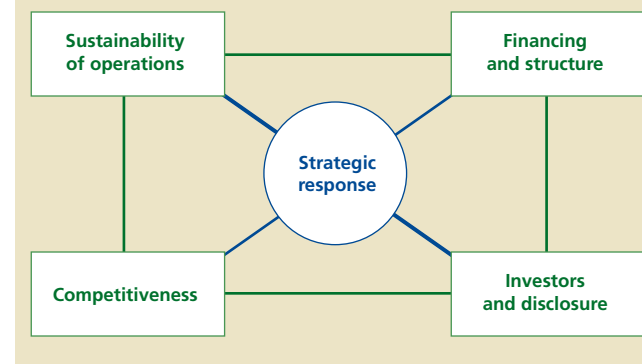
Sustainability of operations

- Is the trust sustainable or liquidating?
- How have these proposals impacted the trust's compensation policies and arrangements?
- Can the trust continue with its R&D program?
- How will they impact the trust's ability to attract and retain top talent?
- Will these tax proposals impact the behaviour or practices of suppliers?

Financing and structure

- Possibility of hostile takeover by private equity, hedge fund or strategic buyer
- Disadvantages of current trust structure
 - Attracting investors?
 - Operating the business?
 - Access to capital?
 - Growing the business?
- Whether to convert to an alternate form
 - Extent of tax policy bias in favor of corporate structure
 - Competitive advantages of being a "first mover" in converting to a new structure?

Key governance areas for trustees



Competitiveness

- Will the forced distribution feature of the tax proposals impair the trust's ability to run the business?
- Do the proposed tax changes impair the ability of the trust to retain sufficient cash to provide for all long-term unfunded liabilities such as pension plans?
- Do the proposed tax changes impair the ability of the trust to retain sufficient cash within the trust to maintain its productive capacity?
- Impact of tax proposals on the basis of competition
 - Which competitors will be affected?
 - What new competitors could emerge?
 - Have the barriers to entry changed?

Investors and disclosure

- MD&A
 - Full adoption of CICA draft guidance on distributable cash including a clear and understandable reconciliation of distributable cash in the MD&A to the financial statements? Or adoption of the CSA's proposed amendments to National Policy 41-201?
 - Impact of tax proposals on the trust
 - Principal business risks disclosed and discussed
- Quantification of temporary timing differences
- Impairment issues (including conversions in progress as of October 31)
- Going concern issues and the ability of the trust to meet its financial commitments and comply with loan covenants
- Disclosure of related party transactions
- Subsequent events

The Emerging Issues Committee of the CICA, at their December 2006 meeting, noted that a detailed discussion of the implications of the proposed tax changes for the entity would be required in this year's MD&A.

Facing the new realities for
publicly traded trusts and partnerships

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