

Budget 2010: finance tinkers with trust conversion rules to prevent loss trading, but preserve access to existing losses

Faced with the imposition of new taxes to be imposed on public trusts and partnerships starting in 2011, most of these entities have started to consider converting to a corporation. In an effort to make the best of a bad situation, some enterprising income trusts have taken the view that if they had to convert to a corporation, why not convert to a corporation with pre-existing losses available to be carried forward against future income (a "Lossco").

The existing rules in section 111 of the *Income Tax Act* (the "Act") severely limit the use of existing losses by a corporation after an acquisition of control of the corporation by "a person or group of persons" (effectively the losses can only be used if the same business is carried on after the acquisition of control with a reasonable expectation of profit and then only to shelter income from that business or a similar business). However, if the income trust were able to convert to a Lossco without triggering an acquisition of control, the converted trust would be able to use the losses without restriction.

A number of income trusts avoided the acquisition of control rules by structuring their conversion so that an existing Lossco would acquire all the units of the income trust in exchange for shares issued by the Lossco. The exchange of trust units for shares could be completed as a tax-free rollover under subsection 85.1(8). No acquisition of control of the Lossco occurred after the exchange because its shares would be widely held by the former public unit holders of the income trust with no single person or identifiable group holding more than 50% of the shares of the Lossco. After the share for trust unit exchange, the income trust, now wholly-owned by the Lossco, would be wound-up.

These types of transactions (reverse takeovers) were previously utilized by public corporations to obtain access to loss carry forwards available in other corporations until 1997, when paragraph 256(7)(c) was added to the Act to deem such transactions to be an "acquisition of control" of the Lossco. However, paragraph 256(7)(c) only applies to transactions involving an exchange of shares and thus a transaction involving an exchange of trust units for shares was not covered.

In the March 2010 budget, the government announced its proposal to block these income trust conversions to Lossco's by adding a provision similar to paragraph 256(7)(c) that would apply to an exchange of income trust units for capital stock in a corporation.

Income trusts that converted to corporations prior to the budget will be unaffected by the rule change. Although it is always possible that the Canada Revenue Agency (“CRA”) might challenge transactions completed before the budget under the general anti-avoidance rule, considering that these transactions had an overall commercial purpose and were completed in accordance with a statutory scheme designed to encourage the conversion to a corporation, the CRA would likely be faced with an up hill battle. The amendment will also not apply to transactions agreed to in writing before the release of the budget at 4:00 p.m. on March 4, 2010. Unfortunately, the grandfathering provision for existing agreements is quite weak, as it does not apply if either party may be excused from completing the transaction as a result of a change in the tax law. As most agreements would have a clause of this nature, likely few pending transactions would be excluded from the application of the new rules.

At the same time as Finance moved to prevent an income trust from acquiring third party losses, it also took steps to ensure that an income trust was able to preserve existing losses that had accumulated in its own subsidiaries.

One of the statutory steps for an income trust conversion involved winding up the income trust into a corporation after that corporation acquired all the units of the income trust. Where the existing income trust structure included a wholly-owned subsidiary, there was a concern that the wind-up of the income trust would result in an “acquisition of control” of the subsidiary by the new corporation into which the income trust was converted.

The budget proposes an amendment to subsection 256(7) of the Act so that the wind-up of an income trust as part of a conversion to a corporation will be deemed not to result in an acquisition of control of any of the wholly-owned subsidiaries of the income trust. Consequently, the ability of the income trust’s subsidiaries to use their pre-existing losses will not be affected by the conversion of the income trust to a corporation.

Surprisingly, this amendment, which is clearly intended to correct an adverse unintended consequence of the income trust conversion process, is only effective for transactions completed after the budget date. This is contrary to Finance’s usual practice of making corrective amendments to new tax rules that provide relief to taxpayers effective retroactively to the effective date of the new tax rules.

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a cautionary note

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