SIFT PROPOSALS

Reverse Conversions of Mutual Fund Trusts to Corporations: Treatment of Outstanding Trust Unit Options

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Introduction

In perhaps the most fundamental change to the Canadian income tax system in recent memory, on October 31, 2006,[1] the federal Minister of Finance (together with the Department of Finance – referred to as "Finance") announced a new taxing regime for certain public mutual fund trusts and limited partnerships referred to in the announcement as "specified investment flow-throughs" or "SIFTs" (the "SIFT Proposals"). In general terms, once enacted, the SIFT Proposals will tax an entity that constitutes a SIFT[2] like a corporation by disallowing previously deductible income distributions and imposing a tax on the entity at the rate similar to the combined rate of federal and provincial tax that would otherwise be payable if the trust or limited partnership was a corporation. The net after-tax amount available for distribution (other than returns of capital) will be treated as dividends in the hands of the recipient investors.

One of the goals of the SIFT Proposals, which have since been followed up by further announcements[3] and by draft legislation,[4] was to provide a limited shelf life, through a deferral period lasting until 2011, for the tax benefits available to existing mutual fund trusts.[5] While it is to be expected that, in the short term, many mutual fund trusts will simply maintain a status quo position until the uncertainty regarding the introduction of the proposals has been resolved and the legislation has been enacted, in the longer run, many trusts may prefer to convert back to corporate form, particularly where all or substantially all of the distributions from the trust are taxable or where the underlying corporation has significant tax shelter in the form of resource pools.[6] While these sort of "reverse conversion" transactions raise numerous issues, each of which could be discussed in its own article, the purpose of this article is to describe some of the issues that may arise, under the provisions of the Income Tax Act,[7] in a reverse conversion in respect of trust unit options which have previously been issued to

employees.[8]

Typical Reverse Conversion

As time passes, various avenues will present themselves to permit a mutual fund trust to convert into corporate form. One potential way to effect this type of reverse conversion would be for a new or existing taxable Canadian corporation ("AcquireCo") to acquire all of the trust units of a mutual fund trust ("TargetMFT") from the public unitholders in exchange for the issuance of shares of AcquireCo. Under the current provisions of the Act, there is no automatic "unit for share" rollover, but it should be possible for taxable unitholders to file a joint tax election with AcquireCo, pursuant to subsection 85(1), to provide for a tax-deferred rollover on the exchange. It is not clear whether Finance intends to recommend a new automatic rollover for trust-to-corporation conversions, but its announcements suggest that it intends to accommodate such conversions on a tax-free basis.[9] Following such a reverse conversion, AcquireCo could exist with TargetMFT intact or alternatives could be considered to dissolve the trust. If one assumes, for the moment, that it should then be possible to convert a typical mutual fund structure into a corporate structure by interposing a corporation between the public investors and the trust, the question with which this article is concerned is what consequences will flow from such a reverse conversion in respect of employee trust unit options.

Effect on Trust Unit Options

Importance of Mutual Fund Trust Status

As a preliminary point, it is to be noted that the preferential treatment afforded by the provisions of section 7 and paragraph 110(1)(*d*) to employee options is granted only when the options are to acquire securities of a "qualifying person" – being a corporation or a mutual fund trust. In particular, the employee's deferral of taxation until the option is exercised pursuant to paragraphs 7(1)(*a*) and 7(3)(*a*) is dependent upon the option having been granted by a mutual fund trust to acquire trust units of such mutual fund trust. Additionally, if a mutual fund trust has agreed to issue or sell securities and paragraph 7(1)(*a*) applies, a deferral is available to the employee under subsection 7(8) if the acquisition is a qualifying acquisition. Similarly, the 1/2 deduction granted under paragraph 110(1)(*d*) from the benefit realized upon the exercise of an option is dependent upon the underlying security being "a unit of a mutual fund trust." It goes without saying that the capital gains-like treatment afforded by paragraph 110 (1)(*d*) is extremely important in making options an attractive compensation tool and therefore, it is important that it not be lost. Thus, in order to ensure optimal tax treatment to the holder of an employee trust unit option, it is critical that, at both the time the option is granted and the time the option is exercised (or surrendered), the grantor constitute a mutual fund trust and the security underlying the option constitute a unit of a mutual fund trust.

Yet, in the typical reverse conversion transaction described above, as soon as AcquireCo acquires all of the units of TargetMFT, the trust will cease to qualify as a mutual fund trust, within the meaning of subsection 132(6), because it will then have ceased to comply with the condition in paragraph 132(6)(*c*) and Regulation 4801(*b*) that there be at least 150 unitholders, each of whom owns not less than one "block of units" having an aggregate fair market value of at least $500. That failure notwithstanding, the relieving rule in subsection 132(6.2) permits a trust that qualified as a mutual fund trust at the beginning of a year to retain that status throughout that year where the loss of status would otherwise have resulted solely from having less than 150 unitholders.[10] Consequently, so long as the reverse conversion is structured properly, it should be possible for TargetMFT to maintain mutual fund trust status until December 31st of the year in which such transaction occurs. Thus, employee options granted in that year should be governed by section 7 and any exercises (or surrenders) of the same should be eligible for the

paragraph 110(1)(*d*) deduction provided that the other conditions for that deduction are satisfied.[11] For clarity, however, it may be desirable for Finance to consider an amendment to section 7 to explicitly deem the continuation of mutual fund trust status for the purpose of the stock option rules even where such status is lost after the grant of an option but before its exercise.[12]

That being said, the commercial constraints of permitting an employee to acquire trust units of TargetMFT after the time it is wholly owned by AcquireCo may make this sort of post-conversion exercise impractical, to say the least.

Change-of-Control Provisions

Depending on the terms of a particular trust unit option plan, it is possible that the acquisition of a threshold number of trust units of TargetMFT by AcquireCo may constitute a "change of control" pursuant to the particular plan, resulting in accelerated vesting of the options, notwithstanding that the actual business and ultimate owners of such business will not be changed as a result of the reverse conversion. Where vesting conditions were originally imposed in order to act as an employee retention tool, such accelerated vesting may well compromise that goal.

Exchange of Trust Unit Options for Share Options

Due to the commercial impracticalities involved with keeping options of TargetMFT outstanding following a reverse conversion, it would generally be expected that most transactions would include a step under which trust unit options would be exchanged for options to acquire shares of AcquireCo. Whether or not such an exchange can be structured without giving rise to adverse tax consequences to the employee optionholders under the current provisions of the Act is, however, far from clear.

An exchange of options for new options is generally permitted, on a tax-deferred basis, pursuant to subsection 7(1.4). Under this provision, an employee will be deemed not to have disposed of the old option and not to have acquired a new option for the old option if the exchange is properly structured. Further, the new option will be deemed to be the same option or a continuation of the exchanged option for most purposes, including for the purposes of paragraph 110(1)(*d*).[13] In the context of a reverse conversion transaction, in order to achieve this result, the following requirements would need to be satisfied:

- the employee owning the TargetMFT options must dispose of such options and receive no other consideration for the disposition other than options to acquire shares of AcquireCo;

- the AcquireCo options must be options to acquire securities of a corporation or other qualifying person that does not deal at arm's length with the original issuer (i.e., with TargetMFT) immediately after the disposition of the TargetMFT options; and

- the amount by which the total value of the securities offered under the AcquireCo options exceeds the exercise price of the AcquireCo options immediately after the exchange must not exceed the amount by which the total value of the securities offered under the TargetMFT options exceeded the exercise price of the TargetMFT options immediately before the exchange.

In the instant circumstances, the difficulty is with respect to the second requirement – since the AcquireCo options will be issued in exchange for the TargetMFT options, AcquireCo must be a person that does not deal at arm's length with TargetMFT immediately after the option exchange. While, on first blush, this requirement would not seem to be difficult to meet, given that AcquireCo should be

considered to "control" TargetMFT following the reverse conversion, subsection 7(1.11) provides a more restrictive rule for this element:

> Non-arm's length relationship with trusts – For the purposes of this section [section 7], a mutual fund trust is deemed not to deal at arm's length with a corporation only if the trust controls the corporation.

The policy reasons behind the restrictive definition of non-arm's length in this context have not been, to the writer at least, entirely clear, although it is assumed that the purpose was to ensure that there was a suitable connection between a corporate employer and the mutual fund trust in respect of which options are being issued. In addition, at the time the provision was introduced, the Act did not contain any clear rules for delineating non-arm's length relationships for trusts. In any event, the provision is clearly premised on a "traditional" mutual fund trust structure, where the trust controls, directly or indirectly, an operating corporation which employs all of the employees. Nevertheless, the effect of subsection 7(1.11) is that, in any other situation in which a corporation and a mutual fund trust would otherwise be considered to deal at non-arm's length, the provisions of subsection 7(1.4) will not apply.

Applying the foregoing to a reverse conversion undertaken along the lines described above, TargetMFT will not, at any time, control AcquireCo (in fact, the reverse will be true) and, as a consequence, the condition of subsection 7(1.11) will not be satisfied. Thus, as currently worded, it would appear that the tax-deferred rollover of TargetMFT options for AcquireCo options would not be available pursuant to subsection 7(1.4). Clearly, this result is not justifiable from a policy perspective, and can, and should, be expected to change, given Finance's announcement of its intent to ensure reverse conversions can occur on a tax-neutral basis.

In other contexts, this issue has been brought to Finance's attention and, in a Comfort Letter issued December 4, 2006,[14] Brian Ernewein agreed to recommend that the scope of subsection 7(1.11) be expanded to include a corporation and a mutual fund trust where the corporation owns securities that would give it more than 50% of the votes that could be cast under all circumstances at a meeting of unitholders of the trust.[15] The wording of the Comfort Letter indicates that it was not directed at reverse conversion transactions, but rather, was perhaps designed to permit employees of a mutual fund trust (or a subsidiary corporation or limited partnership) to acquire stock options for shares of a corporation in a situation where the corporation spins-off part of its business into a trust and "sponsors" the trust by retaining voting control of the trust, either in the form of trust units or exchangeable partnership units).[16] That notwithstanding, however, such an amendment would, if implemented, also correct the problem which arises in the context of a reverse conversion transaction, since AcquireCo would clearly have voting control of TargetMFT and thus, pursuant to the proposed amendment, should be deemed to deal at non-arm's length with TargetMFT.

However, until such time as the legislative amendments described in the Comfort Letter are enacted, care will need to be taken in structuring any option exchange in the context of a reverse conversion transaction. In particular, but for the potential applicability of the relieving rule in subsection 7(1.4), an exchange of options might be expected to be treated as a "disposition" by the employee of the TargetMFT option, triggering an employment income inclusion pursuant to paragraph 7(1)(*b*) equal to the "value" of the consideration (i.e., the AcquireCo options) received by the employee. In a case such as this where the "proceeds" received are non-monetary, it is possible that the employees could be considered to have received the fair market value of the AcquireCo options issued to them in consideration for the TargetMFT options. It might, however, be possible to argue that some protection is afforded by the provisions of paragraph 7(3)(*a*). That provision provides, in essence, that, where an employee receives a right governed by section 7 (i.e., the AcquireCo option), the employee is not to be taxed under any other provision of the Act. In the circumstances of a reverse conversion, the argument would be that, because the AcquireCo options represent an agreement by AcquireCo to issue shares

from treasury to the former TargetMFT options, paragraph 7(3)(*a*) should govern the timing of the receipt and the income inclusion to the holders. The argument that paragraph 7(3)(*a*) takes precedence over other provisions of the Act has also been confirmed in *MNR v. Chrysler Canada Ltd.*[17] This argument has not, however, been considered by the Canada Revenue Agency ("CRA") or in the case law in circumstances similar to those we are dealing with and might be said to be incorrect, on the basis that there would then be no need for a provision such as subsection 7(1.4).

Given the level of risk involved, and the potentially adverse tax consequences to employees who hold TargetMFT options, it is to be hoped that the availability of an option rollover of TargetMFT options into AcquireCo options will be clarified by the Department of Finance through legislative amendments.

Exchange of Trust Units Acquired Under Option for Shares

It is also to be expected that many mutual fund trusts considering a reverse conversion transaction may have unitholders who are employees who acquired trust units pursuant to the exercise of a TargetMFT option and that were subject to the elective tax deferral pursuant to subsection 7(8). In such circumstances, it will be desirable to structure the reverse conversion so that, when the employee exchanges such trust units for AcquireCo shares, the deferral is preserved.

This type of deferral is generally provided for in subsection 7(1.5), which is intended to provide for the continuation of a deferral under subsection 7(8) where an employee exchanges securities that are subject to such a deferral for new securities. In order to access this deferral, the following requirements would need to be met in the context of a reverse conversion transaction:

- the TargetMFT trust units were acquired by the employee in circumstances where subsection 7(8) applied;

- the employee receives no consideration for the disposition or exchange of the TargetMFT trust units other than securities of a qualifying person which does not deal at arm's length with TargetMFT immediately after the exchange; and

- the total value of the new securities must not exceed the total value of the old securities.

There are a couple of noteworthy elements in the context of applying subsection 7(1.5) to a reverse conversion transaction. First, the only consideration receivable by the employee for the TargetMFT trust units can be AcquireCo shares. Thus, where the reverse conversion contemplates both cash and share consideration being offered by AcquireCo, in order to qualify under subsection 7(1.5) in respect of the portion of trust units being exchanged for AcquireCo shares, the relevant documentation will need to split the exchange into two separate exchanges – that is, one exchange of TargetMFT trust units for AcquireCo shares and one exchange of TargetMFT trust units for cash – using what is often referred to as an "allocation of consideration" provision.

The second, perhaps more concerning issue, is with respect to the second requirement of subsection 7 (1.5). In particular, where the consideration the employee receives in respect of the disposition of TargetMFT trust units consists of AcquireCo shares, AcquireCo must deal at non-arm's length with TargetMFT. As described above with respect to subsection 7(1.4), under the current wording of subsection 7(1.1), this requirement will not be satisfied in the context of a reverse conversion since, at no time, will TargetMFT "control" AcquireCo. Thus, unless the amendments proposed by the Comfort Letter described above are enacted, it would not appear that the deferral under subsection 7(8) will be preserved in a reverse conversion.

Conclusion

The ultimate result of the SIFT Proposals announced by Finance October 31, 2006, and the types of transactions that will be generated therefrom, remain to be seen. That being said, it would appear that at least some mutual fund trusts will, over the next few years, choose to convert back to corporate form. As described above, in addition to the numerous corporate law and other tax implications of this type of "reverse conversion," several adverse tax issues can arise with respect to the employee holders of trust unit options, including the potential inability to provide a tax-deferred rollover to employee holders of trust unit options. It is hoped that Finance will address some of these concerns through enabling legislation but, until such time, these issues should be carefully examined prior to implementing any such transaction.

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[1] Press Release 2006-061, "Canada's New Government Announces Tax Fairness Plan" (October 31, 2006).

[2] As a practical matter, it is expected that most publicly-listed mutual fund trusts that hold "non-portfolio" properties will constitute SIFTs and hence be caught by the proposals. Trusts that are commonly known as real estate investment trusts or REITs are excepted from the new rules, but only if they meet a series of conditions relating to the nature of their income and investments.

[3] Press Release 2006-082, "Guidance Provided on `Normal Growth' for Income Trusts and Other Flow-Through Entities" (December 15, 2006).

[4] Press Release 2006-086, "Legislative Proposals Concerning Specified Investment Flow-Through Trusts and Partnerships" (December 21, 2006).

[5] Mutual fund trusts that were publicly traded on October 31, 2006 will be grandfathered from the new rules for four years until 2011, subject to any "undue expansion." Nevertheless, it is anticipated that many existing trusts will be immediately impacted in a number of significant ways and may need to take action well before this four-year period has expired.

[6] For example, on January 15, 2006, True Energy Trust announced its intention to revert to a "growth-oriented, dividend paying intermediate exploration and production company," citing the SIFT Proposals.

[7] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[8] In addition to the impact on trust unit options as a result of reverse conversion transactions, many employee trust unit options may no longer be "in-the-money" as a result of reductions in unit prices following the announcement of the SIFT Proposals. Thus, even where a reverse conversion is not imminent, it may be necessary to consider re-pricing such options or creating other employee incentive plans. At the time of writing, it was understood by the writer that many of these issues, including those discussed in this article, will be addressed in submissions being made to the Department of Finance by the CICA/CBA Joint Committee.

[9] Finance indicated in Press Release 2006-086, supra note 4, that it intends to allow conversions of a SIFT to a corporation to take place without any tax consequences to investors on the conversion and that it will recommend any changes that are necessary to ensure the appropriate rules are in place to facilitate such conversions.

[10] While subsection 132(6.2) was originally enacted to provide relief to mutual fund trusts that were in the process of winding-up, the wording of the provision makes it applicable in a situation where the loss of status results from a trust falling below the 150 unitholder threshold.

[11] The other key conditions for the availability of the paragraph 110(1)(*d*) deduction are that the employee deal at arm's length with the mutual fund trust and that the exercise price under the option be at least equal to the fair market value of the underlying securities at the time the option was granted.

[12] Such an amendment could be similar to subsection 7(4), which generally applies to "continue" an individual's employment relationship for the purposes of the stock option rules, notwithstanding that the individual may no longer be employed by the entity that granted the option at the time of the exercise of the option.

[13] See subparagraph 110(1)(*d*)(ii).

[14] Comfort Letter – Non-Arm's Length Relationships Between a Mutual Fund Trust and a Corporation – CL 2006/12/04.

[15] The recommendation is that the proposed amendment apply to all rights exercised or disposed of after 2004 under agreements to sell or issue securities made after 2002, indicating that the purpose of the Comfort Letter is unrelated to the SIFT Proposals.

[16] Notably, the Comfort Letter is not restricted to voting units of the trust but was broadened to include securities (such as limited partnership units) which are exchangeable into units of the trust.

[17] (92 DTC 6346 (F.C.T.D.).) This argument is also supported by a series of CRA publications dealing with the replacement of a stock appreciation right ("SAR") with a section 7 right. For example, in CRA Ruling 2004-0056921R3, the CRA provided a positive ruling that the replacement of SARs with preferred shares would not result in the employees having an immediate income inclusion, other than any income inclusion occurring under section 7. The ruling was premised on two important points: (i) the SARs had not yet vested and accordingly, the holders did not have any right to receive any amount immediately prior to the replacement transaction; and (ii) the holders of the SARs did not receive any other amount as a result of waiving their SAR rights (see, also, CRA Ruling 2003-0043361R3). Similar comments were provided in CRA Document 2001-0067027, with the proviso that the opinion might not be valid if the arrangement provided for accelerated vesting, since that might be a benefit to the employee.

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