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# Cross-Border Financing and the Use of Income Trusts

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Presented by Robert Worthington

# Income Trusts - Background

- Income trusts have no entity-level taxation if income flowed through to investors
  - High yields (typically 8% - 15%)
  - Popular investments in Canada from 2000 – 2006
  - Canadian government’s concern of tax base erosion led to legislative change in 2006 (the “SIFT” rules)
- SIFT rules effectively tax publicly-listed income trusts as corporations

# Income Trusts - Background

- Exceptions to the SIFT rules:
  - REIT
  - Private income trust
  - Foreign asset income trust (FAIT)
- Foreign Asset exception resulted in some resurgence of income trusts since 2010
- May be structured to be tax-efficient for both Canadian and non-Canadian investors

# Cross-Border Income Trusts

*“Foreign asset income trusts revive interest in income trust market”*

-Doug Richardson, *Canadian Energy Law*

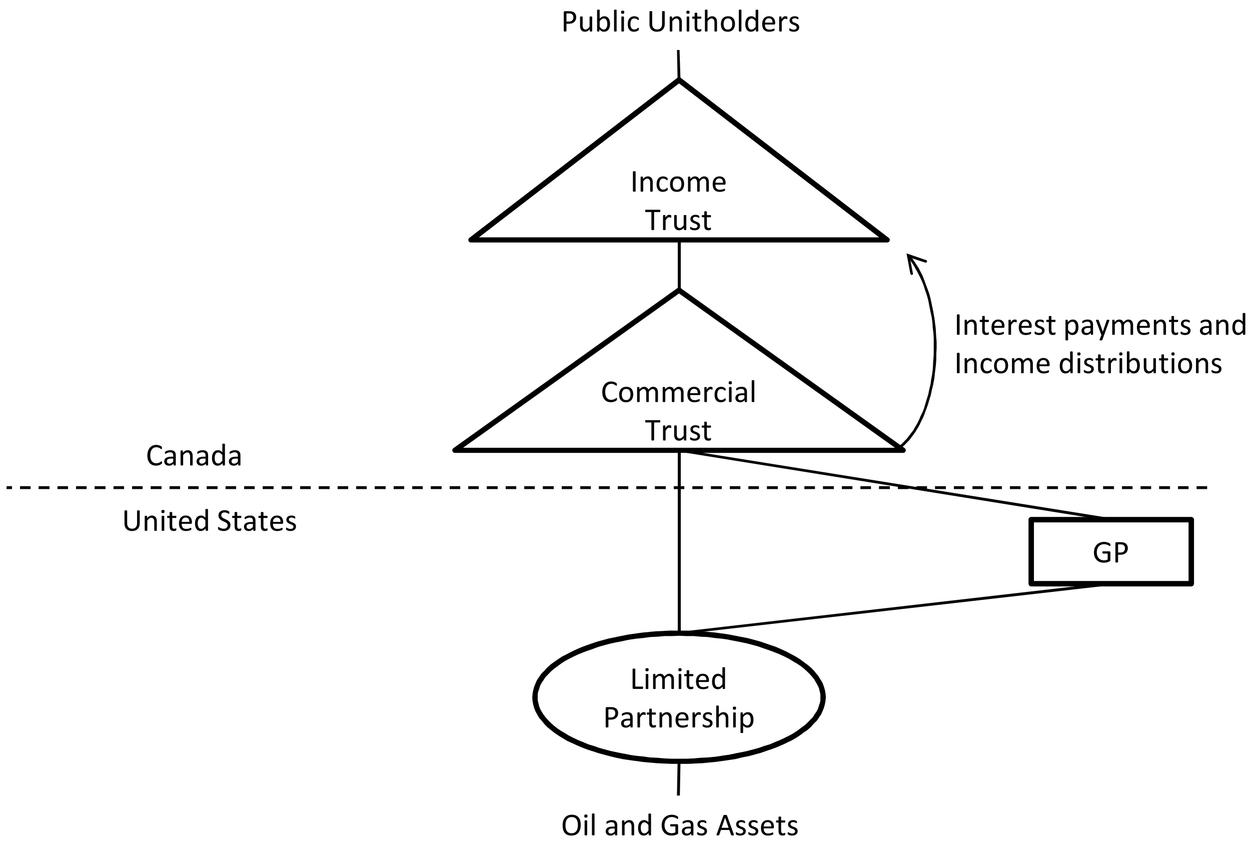
# Securities Law Issues

- Cross-border income trust IPO's may be structured to rely on exemptions from foreign securities laws
- After IPO, trust becomes subject to continuous disclosure requirements under provincial securities laws and the issuing Canadian stock exchange
- Private trusts are not subject to continuous disclosure but will be subject to laws relating to the issuance of securities
- To qualify as a registered retirement investment for Canadians, must be a "mutual fund trust"

# Mutual Fund Trust - Requirements

- Must be a unit trust resident in Canada
- Only undertaking is investing its funds in property
- At least one class of redeemable units must be qualified for distribution to the public or fall under a securities law exemption
- At least 150 unit-holders of the trust holding at least 1 block of units each with a FMV of at least $500
- Non resident ownership may be restricted if the Trust invests in taxable Canadian property

# Cross-Border Income Trust (Canada – U.S. Example)



# Cross-Border Income Trust (Canada – U.S. Example)

- Canadian and U.S. individuals invest in Trust units
- The Trust invests in the CT Trust with both equity and debt and receives in return interest on the notes and income and return of capital on the units
- The CT Trust invests in the US LP with equity and receives income and return of capital from the LP interest
- This structure is designed to be tax efficient in both the Canada and the U.S.

# Cross-Border Income Trust (Canada – U.S. Example)

- The Trust elects to be treated as a corporation for U.S. federal tax purposes
- Under U.S tax law principals, the Trust will own all the assets of the partnership and therefore it will be deemed to have U.S. effectively connected income (ECI)
  - 5% branch profits tax under the U.S. - Canada Income Tax Treaty
  - But, deduction is available on interest paid from Commercial Trust to Income Trust, reducing U.S. branch tax
- The Trust will deduct interest paid on the notes and the expenses of the partnership, subject to debt equity ratio being limited to 1.5 to 1
- Must take into consideration the conduit financing rules under the Regulations
- For U.S. citizen unit holders, the units will be classified as equity in a corporation and distributions should be "qualified dividends" for U.S. income tax purposes.

# Looking at the Numbers

**Comparison of Corporation and Foreign Asset Income Trust on $100 of Income**

| | Corporation | | FAIT | |
|---|---|---|---|---|
| | **Canadian Investor (Exempt)** | **Non-Canadian Investor** | **Canadian Investor (Exempt)** | **Non-Canadian Investor** |
| **Entity Level Tax** | 25.00 | 25.00 | - | - |
| **Personal Tax** | - | Varies | - | Varies |
| **Withholding Tax*** | N/A | 11.25 | N/A | 15.00 |
| **Canadian Tax Burden** | 25.00 | 36.25 | - | 15.00 |
| **Marginal Tax Benefit** | | | **25.00** | **21.25**** |

*Assume treaty rate of 15% available

**Will depend on tax rates in non-resident's country

# Conclusion

- Opportunity to access Canadian capital markets (public listings and private equity) in a tax-efficient manner
- Possible industries include oil and gas, real estate, trade-mark and other IP licensing, or any other business with royalties or stable cash flow

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