ROYALTY TRUSTS

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This article outlines several key economic and income tax aspects of the royalty trust financing form. The author describes various ways to structure a royalty trust, to ensure that it will function as a successful financing vehicle with the ability to take maximum advantage of certain tax consequences which are enumerated by the author. Three variations of the royalty trust structure are identified by the author: (a) the classic royalty trust, (b) the income trust, and (c) the acquisition royalty trust. Each of the three variations are distinguished on the basis of their economic utility, and in particular their structure and their resulting tax implications — the greatest attention being given to the classic royalty trust variant. The author concludes that notwithstanding the complexity of these structures, royalty trusts can provide a flexible financing vehicle, having the ability to achieve desirable economic results.

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I. INTRODUCTION

The following discussion is intended to outline the key income tax aspects of the "royalty trust," a financing form which, as will be pointed out, invariably includes a trust, but does not always (or possibly ever) include a "royalty."

The royalty trust financing form has a number of key economic and income tax characteristics including:

(1) a high level of distributions as a function of financing entity revenue;

(2) a significant portion of revenue distributions that are not taxable to recipients; and

(3) an interest in the financing entity as an eligible investment for tax-deferred or tax-exempt persons.

The economic underpinning of a royalty trust is identifying an asset or business with a relatively stable cashflow of long duration with capital requirements, which permit

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a distribution of a large proportion of the operating cashflow. Assets such as mature oil and natural gas properties, producing oil sands or heavy oil facilities, pipelines and gas processing facilities appear to be ideal candidates. The tax planning challenge is packaging such assets in a manner which makes the cashflow stream available on a tax advantageous basis. In this outline, the first issue to be addressed is the qualification under the *Income Tax Act*[1] of the royalty trust financing vehicle as both a "unit trust" and a "mutual fund trust." The second portion of this discussion will focus on the various types of assets that are acquired by such trusts and the income tax consequences of the various acquisition transactions.

II. THE CONCEPT OF A "UNIT TRUST" AND A "MUTUAL FUND TRUST"

Essential to the structuring of a royalty trust is ensuring that it complies with the *Act*'s definition of a "unit trust" and a "mutual fund trust." The importance of so qualifying the financing vehicle cannot be overstated. The characterization of the trust being the financing vehicle as a unit trust and a mutual fund trust ensures that:

(1) units in the trust will qualify for registered retirement savings plans ("RRSPs"), registered retirement income funds ("RRIFs") and deferred profit sharing plans ("DPSPs"), such that an investment therein will not trigger the penalty taxes under Part X and Part X.1 of the *Act*;

(2) provided that the trust does not invest more than 20 percent of its assets in property which is considered "foreign property," units in the trust will not be considered "foreign property" to tax exempt purchasers, including RRSPs, RRIFs and DPSPs;

(3) the trust will not be subject to the twenty-one year deemed realization provisions of s. 104(4) of the *Act* — this provision requires that other trusts must realize any inherent gain in their assets every twenty-one years; and

(4) the trust is not taxable under Part XII.2 in respect of the share of its income from real property (including resource properties) and most capital gains which are attributable to non-resident beneficiaries.

Each of these enumerated advantages is important in a successful financing. A trust is a flow-through vehicle for income under the *Act* (insofar as it may eliminate its income subject to taxation by distributing such amount to its beneficiaries). Hence, it is attractive to tax-exempt persons such as RRSPs, RRIFs and DPSPs, allowing these plans to fully take advantage of their tax-exempt status by eliminating an intervening level of taxation. The exception from the definition of "foreign property" allows these deferred plans to invest in such trusts without regard to the 20 percent limitation on foreign property and without regard to the penalty tax on investments in excess of this limit. The exemption from the deemed realization provisions permits the acquisition of long life assets without regard to the need to liquidate the trust prior to the expiration

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1 R.S.C. 1985 (5th Supp.), c. 1 [hereinafter the *Act*].

of the twenty-one years. Finally, the exemption from the special tax imposed on a trust under Part XII.2 in respect of their non-resident beneficiaries allows, within certain limitations, significant participation by non-resident beneficiaries on an advantageous basis.

Insofar as most trust financings are intended to qualify as unit trusts and mutual fund trusts, one need make only passing references to the consequences of non-compliance. One of the most important consequences arises under the provisions of Part XI.1 of the *Act* governing acquisitions by RRSPs and RRIFs of non-qualified investments. With certain very limited exceptions, if a trust does not qualify (or ceases to qualify) as a mutual fund trust, units are non-qualified investments for an RRSP and an RRIF. Part XI.1 of the *Act* imposes a penalty tax at the rate of 1 percent per month of the fair market value of the interest in the trust at the time that it was acquired until it has been disposed of. Part X of the *Act* imposes a similar 1 percent tax on DPSPs acquiring non-qualifying investments. These taxes are borne by the RRSP, RRIF and DPSP investors. Loss of qualification as a mutual fund trust also affects the trust, if it owns certain types of property and has non-resident beneficiaries. In such circumstances, the trust is liable to tax at the rate of 36 percent in respect of its "designated income." Basically, designated income includes non-resident beneficiaries' share of all income from real property, resource properties (including petroleum and natural gas and mineral royalties), the carrying on of any business in Canada and capital gains, which would have been taxable had the non-resident realized such gains directly. Insofar as distributions from a trust are taxed to non-residents on a withholding tax basis (with the maximum rate of 25 percent), there exists certain tax planning advantages to non-residents of holding assets through a trust, rather than through directly holding them. Such advantages arise where the non-resident would be taxed at a rate which exceeds 25 percent, if he directly held the assets. The tax under Part XII.2 is intended to remove such advantage to trusts which do not qualify as mutual fund trusts by imposing the equivalent rate of taxation on the trust. Tax under Part XII.2 is borne by the trust and adversely effects, in particular, any units held by RRSPs, RRIFs and DPSPs, since the tax paid at the trust level prevents a full flow-through of income to the beneficiaries.

The starting point for the qualification of a trust as a mutual fund is that it must first be a unit trust. A unit trust is defined in s. 108(2) of the *Act* as an *inter vivos* trust which has certain defined attributes, and where the interest of each beneficiary therein is subdivided into units. The concept of a "unit" is not defined under the *Act*, but is generally interpreted as an undivided interest in a certain entitlement *vis-à-vis* the trust. For example, a unit could represent a percentage interest in the income of the trust, the income of the trust from a particular source, or the capital of the trust. In addition to qualifying as an *inter vivos* trust, entitlements under which are divided into units, a trust must meet one of three tests to qualify as a unit trust, as set out below:

(1) at least 95 percent of the fair market value of all issued units of the trust (with value determined without reference to voting rights) must have conditions attached thereto which permit the holder to demand that the trust re-purchase

his units at prices determined and payable in accordance with the terms of the trust;

(2) it must meet each of the following conditions:

a. residence in Canada;

b. its undertakings must be restricted to the investing of its funds in property (other than real property), the acquiring, holding, maintaining, improving, leasing or managing of any real property that is capital property, or any combination of the foregoing;

c. at least 80 percent of its assets must consist of any combination of shares, bonds, mortgages, marketable securities, cash, real property situated in Canada, rights to or interests in any rental or royalty computed by reference to the value or amount of production from an accumulation of petroleum and natural gas or minerals located in Canada;

d. not less than 95 percent of its income computed prior to any distributions was derived from property described in (iii); and

e. not more than 10 percent of its assets may consist of bonds, shares or other securities of any one corporation or debtor other than the Crown;

(3) The trust qualified under certain conditions as a real estate investment trust.

In practice, royalty trusts comply with either (1) or (2). Insofar as royalty trusts tend to hold non-liquid assets, there is generally a preference of complying under category (2) rather than providing for a redemption right. Compliance with category (2) is impossible where the trust has in excess of 10 percent of its assets in securities of a single issuer. In those circumstances, creative methods must be employed to arrive at a reasonable redemption procedure, notwithstanding a lack of liquidity in the trust's assets.

Once a trust qualifies as a unit trust, it must meet other requirements to be considered a mutual fund trust. Such requirements are set out in s. 132(6) of the *Act* and include:

(1) residence in Canada;

(2) that its only undertaking must be the investing of its funds in property other than real property, which is not capital property; and

(3) that it must comply with certain requirements as to the distribution of units established by regulation.

The conditions as to distribution are set out in the *Income Tax Regulations*[2] and include:

(1) that a class of units of the trust must be qualified for distribution to the public; and

(2) that there be no fewer than 150 unit-holders of the trust, each of which holds one "block" of units having a value of not less than $500.

The first requirement can only be met if units have been offered by prospectus. In respect of the second requirement, a "block of units" is defined in s. 4803 of the *Income Tax Regulations*[3] as one hundred units if the fair market value of one unit is less than $25; twenty-five units if the fair market value of one unit is $25 or more but less than $100; and ten units if the fair market value of one unit is $100 or more. In most offerings, units are issued at or around $10 per unit such that the minimum unit holding would be one-hundred units unless the price per unit fell below $5. A limited grouping of unit-holders is permitted to meet these tests.

A further requirement for a trust to qualify as a mutual fund trust is set out in s. 132(7) of the *Act*. That provision specifies that unless all or substantially all of a trust's assets consist of property other than real property or property that would be taxable if held by a non-resident, the circumstances surrounding the trust, including the terms and conditions of units of the trust, must be examined to determine that the trust was neither established nor maintained primarily for the benefit of non-resident persons. This is the corollary of the exemption of mutual fund trusts from taxation under Part XII.2. In the context of determining whether "all or substantially all" of the trust's assets consisted of property other than real property or property that would not have been exempted from taxation in the hands of a non-resident, Revenue Canada's administrative practice is that 90 percent of the trust's assets must so qualify. In the context of whether a trust is established or maintained "primarily" for the benefit of non-residents, Revenue Canada's administrative practice is that "primarily" connotes in excess of 50 percent. In practice, the test that the trust not be established or maintained primarily for the benefit of non-resident persons is by far the easier to meet. Consequently, most trusts contain restrictions on non-resident ownership, the nature of which will be discussed in a subsequent portion of this review.

III. THE STRUCTURE OF ROYALTY TRUSTS: COMPLYING WITH THE REQUIREMENTS IMPOSED ON "MUTUAL FUND TRUSTS" AND "UNIT TRUSTS"

Although the structure of royalty trusts is circumscribed by restrictions placed on unit trusts and mutual fund trusts, the nature of the property owned by such trusts and the structure of the transactions whereby such trusts acquire their assets are driven by financial and commercial exigency.

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2 C.R.C., c. 945, s. 4801.

3 *Ibid.*, s. 4803.

By distilling the requirements and restrictions inherent in the definition of a unit trust and a mutual fund trust, a number of broad generalizations may be made:

(1) a mutual fund trust may acquire and hold virtually any type of asset, provided that the holding is essentially passive (the requirement in s. 132(6) that a mutual fund trust restrict its activities to investing its funds has been interpreted administratively as prohibiting a mutual fund trust from carrying on business);

(2) a mutual fund trust must have units which are qualified for distribution to the public under applicable securities law and must have reasonable dispersal of ownership (*i.e.* at least 150 unit-holders);

(3) if a mutual fund trust is to invest more than ten persons of its funds in securities of one issuer (other than the Crown), units must have a defined and reasonable retraction feature — conversely, if the trust restricts its investments to certain types of property, including royalties on petroleum, natural gas or mineral production, it will qualify without a retraction feature; and

(4) the trust must maintain restrictions on ownership by non-residents to ensure that less than half of its units are owned thereby.

A critical consideration in structuring a successful financing is that the nature of the trust's assets be such that income therefrom is taxed on an efficient basis. This consideration mandates that every attempt be made to eliminate any intervening level of taxation between the ultimate source of the income which is the basis of the financing, and the trust. In practice, this necessitates that as high a proportion as possible of the payments received by the trust be on account of income and, not represent distributions of amounts which have been previously subject to taxation in the hands of the payor. Hence, one of the principal income tax issues in ensuring tax efficiency is that the trust receive payments which are either deductible to the payor or are excluded from the payor's income which is subject to taxation.

A further significant issue which must be considered in the context of structuring a royalty trust financing is the income tax consequences to the vendor of property to the trust, or to the organizer of the trust. A number of variations from the classic royalty trust have evolved with the purpose of minimizing the adverse income tax consequences to a vendor of property into a trust arrangement. The most important distinction to a vendor is that between selling the assets of a business and selling the shares of a corporation by which the business is carried out. When making this distinction, the vendor does not typically take into consideration only the rate differential inherent in selling shares (generally capital gains treatment, taxed at 75 percent of prevailing rates) as against selling assets (although some business assets sold into royalty trusts could give rise to capital gains treatment, generally speaking, any amount received in excess of cost is generally on account of income). Rather, consideration is usually also given to the fact that the vendor's adjusted cost base in his shares may differ from the cost for tax purposes of the underlying assets of the business carried on by the corporation to be sold. This most typically occurs when the vendor of property itself purchases its shares in the corporation carrying on the business after substantial depletion of the corporation's tax attributes has occurred. In considering the various structures used in royalty trusts, it is noteworthy that certain of the variations are not driven by the needs of the investors but rather, by the desire on the part of the vendors of property to achieve a tax efficient result.

In discussing what is commonly known as a "royalty trust," a distinction should be drawn between three basic types of transactions:

(1) the "classic royalty trust" such as the Enerplus, Pengrowth, Athabasca Oilsands Trust, Westrock or more recently the NAL, Starcor, ARC Financial or Maximum Energy, where a mutual fund trust essentially acquires a net profit's interest on the proceeds of hydrocarbon production from a special purpose corporation;

(2) the "income trust," where a mutual fund trust receives a distribution of substantially all of the income from a corporation holding a limited pool of assets, or carrying on a business, through a combination of debt and equity payments, examples of this include the Labrador Mining Trust and the Luscar Coal Income Fund; and

(3) the "acquisition royalty trust," whereupon a royalty trust is used to re-structure an existing corporation — the sole example being to this point, the EnerMark transaction.

Each variant on the royalty trust structure will be discussed below.

A. THE CLASSIC ROYALTY TRUST

The basis of this financing structure is the creation of a mutual fund trust (the "Royalty Trust") which purchases a "royalty" from a newly incorporated corporate vehicle ("Opco"). A schematic diagram of the classic royalty trust is set out in Appendix 1.

The economic basis of the classic royalty trust structure is to create a resource based revenue stream which is passive (because a mutual fund trust may not carry on business), but gives the Royalty Trust all of the benefits (and requires the Royalty Trust bear virtually all of the risks) of carrying on an oil and gas business. This is done by causing Opco to acquire "working interests" or leasehold interests in petroleum or natural gas or bituminous sands production and to then carve out 99 percent of the "net revenue" thereof to the Royalty Trust as a "royalty." The method whereby the Royalty Trust, as a "mutual fund trust" (which is essentially prohibited from carrying on business) is able to capture the tax and economic benefits of carrying on an active oil and gas business owes much to the ingenuity of the structure used, and to the administrative tolerance of Revenue Canada in having granted favourable rulings on various contentious issues. The following will describe the rudiments of the structure and certain of the income tax issues arising therefrom.

(1) The first step is the organization of Opco, the entity which will carry on the oil and gas business. Insofar as Opco is intended to be essentially a flow-through vehicle to the Royalty Trust, ownership of its shares is not economically significant. However, in order to create some demarcation between the business being carried on, and the essentially passive investment required of the Royalty Trust by the definition of a mutual fund trust, the shares of Opco are typically owned by the manager of the offering ("Manageco"). Typically, Manageco's renumeration does not come from ownership of the shares of Opco, but rather from management and other fees paid by Opco.

(2) Opco will be the purchaser of the petroleum and natural gas or bituminous sands working interests (be they leasehold interests in production or freehold title to mines and minerals) from the vendor.

(3) Insofar as Opco has no financial resources of its own, it seeks essentially two sources of financing for the acquisition of these working interests. The first source of financing is the Royalty Trust, which raises funds by the issuance of units to the public. Insofar as the Royalty Trust typically does not wish to provide redemption of such units, it is required to limit its investments, with one such permitted investment being "royalties" based on the value of production from an accumulation of petroleum or natural gas. The Royalty Trust purchases "royalties" from Opco, which are based on production from the working interests to be acquired by Opco for cash. It is noteworthy that administratively, Revenue Canada does not consider the grant by Opco of a royalty to the Royalty Trust to be the acquisition by the Royalty Trust of a security of the single issuer. Consequently, they have ruled favourably in these circumstances, finding that the Royalty Trust qualifies as a unit trust notwithstanding the lack of a redemption feature.

(4) Although the issue is not altogether clear, better practice suggests that the proceeds from the sale of a royalty to a Royalty Trust should not be used to finance that portion of the working interests relating to tangible property such as wellhead equipment, facilities or gathering systems. The portion of the purchase price of the working interest allocable to tangible depreciable property (generally between 10 to 25 percent of the aggregate purchase) must generally be financed through borrowings by Opco from a bank or other financial institution (the "Lender"). It should be noted that the Lender is not restricted to financing the tangible portion of the working interest. If the Royalty Trust has insufficient funds, the Lender may finance the remaining purchase price.

In assessing the relative claims against Opco, it should be noted that as a practical matter, any borrowing effected by Opco generally requires that the Lender be given a first charge against the working interest acquired by Opco, without reference to the Royalty Trust's entitlement to the royalty. This results in a measure of circularity since, as we shall see, the royalty granted to the Royalty Trust is an interest in the net revenue, after the making of all other required payments (including the principal and interest payments to the Lender).

To understand the nature of the royalty granted by Opco to the Royalty Trust, consideration should first be given to what the royalty is seeking to achieve. From an economic perspective, the royalty is intended to vest in the Royalty Trust the net profit from the petroleum and natural gas production business carried on by Opco. From a tax perspective, the royalty is intended to create a deduction in Opco of its net income, being its gross revenue less any available deductions that it may have (for example, costs of operation, fees paid to Manageco, tax depreciation against any tangible depreciable property and interest expense in respect of outstanding borrowings). This is to be contrasted with the income tax consequences of a distribution by Opco of its profits to a shareholder, which would not be deductible to Opco, thereby imposing an intervening level of taxation between the source of the income and the ultimate recipient. In effect, the nature of the royalty granted by Opco to the Royalty Trust is structured to achieve a flow-through of Opco's income to the trust, itself a flow-through vehicle for unit-holders. Basically, "royalty" income consists of the excess of gross revenue from production, including the share reserved to the Crown less the aggregate of:

(1) all costs of production;

(2) all costs of transportation and marketing of production;

(3) any capital expenditures financed other than through borrowing;

(4) any interest or principal due to the Lender;

(5) any corporate tax of Opco in respect of its production; and

(6) any corporate overhead, including the fee payable to Manageco.

As can be discerned, Opco is left without resources to remit the Crown's share of production from the working interest. To deal with this liability, the Royalty Trust agrees to reimburse Opco for its Crown royalty obligations and agrees to permit Opco to offset the amount owed under the reimbursement obligation against Opco's liability to pay the royalty. The reimbursement mechanism was originally introduced to achieve two specific tax results:

(1) insofar as Crown royalties are not deductible to Opco (subject to the resource allowance), the reimbursement operates under s. 80.2 of the *Act* to shift the burden of non-deductibility and the partial offset created under the resource allowance to the Royalty Trust, where the excess of the non-deductible Crown royalties over resource allowance can be allocated to unit-holders under s.

104(29) of the *Act* — to the extent that unit-holders are exempt from taxation, this represents a significant tax savings; and

(2) it permitted the Royalty Trust to claim Alberta Royalty Tax Credit.

The reimbursement mechanism also increases the overall permitted claim for resource allowance. Ordinarily, Opco would claim the resource allowance on the basis of its net production income after deduction of capital cost allowance for tangible depreciable property. Insofar as the reimbursement mechanism shifted virtually the entire ability to claim resource allowance to the Royalty Trust (where no capital cost allowance was claimed since the tangibles are owned by Opco), the result was an overall increase in resource allowance. This is especially the case in Royalty Trusts such as the Athabasca Oil Sands Trust, where the component of tangible depreciable property, and hence the ability to claim capital cost allowance, is relatively more significant. The Department of Finance has expressed concerns with this aspect of royalty trusts and it would not be unexpected to see this anomaly corrected.

One must now examine the tax effects of the structure. Essentially, Opco acts as a flow-through vehicle, with all of the taxable profit from its operations being vested in the Royalty Trust. The Royalty Trust, as the recipient of the income is also the repository of the cost for tax purposes of the bulk of the business expenditures, being the purchase price of the working interest. That is because the cost of the royalty (in respect of conventional production) constitutes a Canadian oil and gas property expense ("COGPE") to the Royalty Trust, and is a deduction from the cumulative COGPE of Opco (which was created on Opco's purchase of the working interest). It should be noted that if the royalty relates to bituminous sands production, the cost of the royalty to the Royalty Trust (like the cost of the intangible component of the working interest to Opco) is a Canadian development expense ("CDE"). The Royalty Trust is entitled to deduct 10 percent of the balance of its cumulative COGPE in any particular year to offset its income from the royalty. It is permitted to claim 30 percent of the balance of its cumulative CDE in any particular year to offset royalty income. Furthermore, a trust, unlike a corporation, is entitled to deduct that portion of its income computed under the *Act* which was paid or payable to its beneficiaries, and, designate to unit-holders increases to its income created by the non-deductibility of Crown charges. Such amount is taxed in the hands of the beneficiaries. To the extent that beneficiaries are themselves generally exempt from taxation under the *Act* (as is the case with RRSPs, RRIFs and DPSPs), the trust permits such entities to take full advantage of their tax-exempt status by receiving income which is not being subject to an intervening level of taxation.

A brief summary of certain of the income tax issues and their resolution in the context of a classic royalty trust are set out below.

(1) The characterization of the interest carved out by Opco to the Royalty Trust as both a "royalty" and a "Canadian resource property" are integral to the functioning of this type of royalty trust. Although considerable dispute exists as to when a periodic payment not grounded in ownership of, or interest in, property is in fact a "royalty," Revenue Canada has long established a policy

that payments which are based entirely on petroleum and natural gas production will be considered "royalties" under the *Act*. If they are considered "royalties," then they are included in the definition of a "Canadian resource property." The former characterization is necessary for the Royalty Trust to continue to qualify as a mutual fund trust absent a retraction feature. The latter characterization is integral to establishing that the interest granted to the Royalty Trust is a separate source of income, and hence any entitlements thereunder are excluded from the computation of Opco's income. The characterization of the periodic payment as a royalty which constitutes a "Canadian resource property" is also integral to the Royalty Trust's characterization of the cost thereof as COGPE or CDE, as the case may be, so as to permit the deduction over time of the unamortized cost thereof. In this respect, it is important to note that Revenue Canada's policy is that the revenue stream which forms the basis for payments must be restricted exclusively to income from production in order to so qualify. Consequently, Opco must not pay to the Royalty Trust any income derived from, for example, natural gas processing revenue so as to not taint the nature of the Royalty Trust's interest as a "royalty" which is based on production. Revenue Canada has permitted that revenues of Opco which are not production-related be used to offset costs of Opco (for example, fees which are paid to Manageco). The same approach has been used in respect of the 1 percent of residual revenue which is retained by Opco after payment of the 99 percent royalty.

(2) In order to comply with the restrictions on a mutual fund trust of owning real property which is not capital property, the royalty granted by Opco to the Royalty Trust must not be an interest in land. Insofar as the royalty is purely contractual, this is typically not a problem. However, it is permissible to secure payments under the royalty by having Opco grant a fixed or floating charge against its working interest to the Royalty Trust.

(3) Insofar as Opco will often rationalize its business, the structure must accommodate such changes to Opco's property mix. In the context of any future disposition of a working interest by Opco, provision must be made to release the royalty therefrom. This is usually effected by way of a pre-arranged agreement whereby Opco may, by paying a pre-determined portion of the proceeds of disposition, re-acquire the royalty from the Royalty Trust on the properties to be sold. Generally, the pre-determined percentage of proceeds is 99 percent of the proceeds less any amount which must be paid to the Lender in respect of the borrowing which applies to the disposed-of properties. It is important to ensure that Opco in fact acquires the royalty (rather than simply has it disappear) insofar as Opco will require the attendant COGPE or CDE in order to offset the proceeds it receives from the disposition of the working interest.

(4) Revenue Canada has ruled favourable that the Royalty Trust may compute its income from the royalty granted by Opco on a cash, rather than on an accrual

basis. This facilitates the trust's ability to pay its income out to beneficiaries (and thereby avoid being subject to taxation).

(5) Insofar as the Royalty Trust has a cumulative COGPE or cumulative CDE from the acquisition of the royalty, as well as undeducted unit issue costs (deductible over five years under s. 20(1)(e) of the *Act*), its income will almost invariably be less than its cashflow. The Royalty Trust will typically distribute all of its cashflow. The portion which is distributed over and above its income will reduce the adjusted cost base of a holder's units. A capital gain is realized by a holder when its units have an adjusted cost base which is less than zero. This, of course, is not a concern if the holder of the units is exempt from taxation.

(6) In the context of the classic royalty trust, it should be noted that the payment of large corporations tax is avoided. Insofar as Opco has insignificant assets, and as a mutual fund trust is exempt from taxation under Part I.3 of the *Act*, the tax, at 0.2 percent of taxable capital, is effectively avoided. It should be noted that the Department of Finance is aware of this anomaly and there is significant likelihood that Part I.3 of the *Act* will be amended to include "mutual fund trusts."

In summary, the classic Royalty Trust creates a vehicle whereby an investor receives revenue without an intervening level of taxation (by virtue of the flow-through nature of both Opco and the Royalty Trust). The classic Royalty Trust also creates an investment which is eligible for RRSPs and other tax-exempt persons (through the qualification of the Royalty Trust as a mutual fund trust) and which holds certain other tax advantages (cash based accounting, the effective deductibility of the cost of one's investment as COGPE or CDE).

B. INCOME TRUSTS

An alternative to the classic royalty trust arises where the vendor of property to the trust is the owner of shares of a corporation, rather than of assets, and the sale of shares represents sufficient advantage to the vendor to overcome any inherent tax which is inherited by the trust in the underlying assets of the particular corporation being acquired. The structure of a typical income trust is set out in Appendix 2.

Although income trusts share many of the characteristics of classic royalty trusts (most notably that they both operate as unit trusts and mutual fund trusts), the fact that income trusts are essentially purchasers of shares presents certain challenges. Keeping in mind that income trusts appeal to the same market of purchasers as to classic royalty trusts, and that corporations represent an intervening level of taxation, the biggest challenge is that steps must be taken to reduce the inherent intervening level of taxation of a purchase of shares. The easiest device to achieve a flow-through of income is by creating a deductible interest expense payable by the corporation to the trust, to shelter the corporation's revenues. In addition, it may be possible to create a deductible royalty on the corporation's assets.

A typical structure is as follows.

(1) A trust (the "Income Trust") is established. In light of the proposed investments of the Income Trust, qualification as a unit trust will require that its units be retractable. This will be discussed in somewhat greater detail below.

(2) The Income Trust organizes a whollyowned or partially owned subsidiary ("Subco"). It capitalizes Subco with the proceeds of the issuance of units in a manner where a substantial portion of its capitalization is by way of interest-bearing debt (the "Note"). Generally the portion attributable to debt will be between 75 and 95 percent.

(3) The vendor is the owner of the shares of a corporation ("Opco") which has an operating business or a stable asset base (referred to hereinafter as the "Assets"). Typically, the Assets do not have a significant tax cost or amount of accumulated deductions such that, as a stand alone vehicle, Opco is in a tax-paying situation. The vendor of the Opco shares either has an adjusted cost base in those shares which exceeds the tax cost of the Assets, or the vendor wishes to take advantage of the preferential tax treatment accorded to capital gains. He sells all, or a substantial portion, of the shares of Opco to Subco.

(4) Insofar as Subco has borrowed funds from the Income Trust to acquire the income producing assets (the shares of Opco), such interest is deductible to it. Subco then merges with Opco to form Amalco. Amalco inherits Subco's debt to the Income Trust in the form of the Notes and since the interest on the Notes was originally deductible, Amalco may deduct such interest from the revenue produced from the Assets.

The result is that the Income Trust has a substantial debt owing from Amalco and also has a substantial (if not entire) equity interest in Amalco. The interest payable by Amalco to the Income Trust is deductible in computing Amalco's income and is included in the income of the Income Trust. The Income Trust avoids taxation on such income by distributing such amount to unit-holders, a large portion of which would be tax-exempt persons such as RRSPs and RRIFs. A residual revenue to Amalco is paid out to the Income Trust as either a return of capital, a repayment of the Notes or a dividend.

As can be discerned, provided that the interest due to the Income Trust is deductible by Amalco, a partial flow-through of income from the Assets to the Income Trust has been achieved. Although not as advantageous as the classic royalty trust (where a full flow-through is achieved through the deductibility of royalty payments), this disadvantage is often more than compensated for by the fact that the vendor has not had to suffer the income tax consequences of an outright sale of the Assets to the Income Trust. Secondly, it should be noted that certain types of Assets could not be acquired directly by the Income Trust because they constitute the business assets of an operating business (the principal example of which would be the assets of an ongoing non-oil and natural gas production business). However, it should be noted that in the Income Trust structure, tax at the Amalco level has not been eliminated but merely deferred. As the principal amount of the Notes is repaid, the interest expense available to Amalco will decrease, ultimately giving rise to taxation of Amalco. Especially for unit-holders in the Income Trust who are themselves tax exempt, any tax paid by Amalco represents a detriment over the classic royalty trust.

In considering the income tax issues of an income fund, two issues are paramount, as set out below:

(1) The first consideration is the issue of interest deductibility to Amalco in order to offset its revenue from the Assets. Under s. 20(1)(c) of the *Act*, "reasonable" amounts of interest are deductible to the extent that the amount was incurred to gain or produce income from a business or from property. First, the amount owing to the Income Trust by Amalco under the Notes must meet the classical definition of interest, in that it must accrue as a percentage of a fixed amount on a periodic basis. Consequently, payments that are based entirely on profit will not be considered interest and would likely not be deductible to Amalco. Secondly, the rate of interest on the Notes must be reasonable in quantum, having regard to the inherent credit risk. This is a question of fact to be determined by prevailing interest rates at the time the Notes are issued. Thirdly, the debt upon which the interest is paid must not be considered equity. This entails ensuring that the debt-to-equity ratio of Amalco is not excessive and that payment terms under the Notes are reasonable. In order to comply with this requirement, it is suggested that detailed projections be undertaken to ensure that, on a pro forma basis, the future income producing potential of the Assets permits the full repayment of the Notes within a reasonable period of time, or that the Assets are such that the Notes may be refinanced at the end of their term. This operates as somewhat of a limitation on the amount of interest expense which may be used to shelter Amalco's income from the Assets.

(2) The second critical issue is ensuring that the Income Trust qualifies as a unit trust so that it may qualify as a mutual fund. Insofar as more than 10 percent of its assets are in the securities of one issuer (Amalco), this requires that units have a retraction feature. Since the Income Trust's assets are largely non-liquid, some creativity is required in arriving at a methodology to effect redemptions. A solution must be found within the context of Revenue Canada's stated administrative requirement that the redemption terms must not unduly discourage redemptions or, to put the matter conversely, that there should be scenarios whereby redemption is desirable. The typical method used in an Income Trust is to provide redemptions based on a formula (usually a 5 to 15 percent discount to the trading price of units) with a limitation on the amount of cash which may be distributed in redemptions during a defined period (usually a year, quarter or month). Any redemptions in excess of the cash threshold are paid *in specie*. In the case of an Income Trust, this can be effected through a distribution of Amalco shares or Notes. It is submitted that

in respect of *in specie* distributions, a distribution of debt instruments alone will likely more readily satisfy Revenue Canada's criteria that there be certain circumstances whereby a redemption is desirable (principally where a unit-holder anticipates that Amalco will face financial difficulty and wishes to become a direct creditor of Amalco rather than owning debt and equity securities through the Income Trust).

In addition to these two principal issues, certain mechanical issues arise in the organization of Income Trusts. Firstly, unlike royalty income, interest income to the Income Trust is taxed on an accrual basis, rather than on a cash basis. This can be ameliorated somewhat by ensuring that interest is paid to the end of the fiscal period of the Income Trust (which under the *Act* must be December 31), although this may not be possible if Amalco also faces delays in receipt of its revenues with which to pay the interest. In such circumstances, it may be advisable to establish a cash reserve at either the Amalco level or at the Income Trust level to permit the distribution (and hence the deduction under the *Act*) of interest which has accrued but has not been paid. A related issue arises to the extent that an Income Trust uses cash-flow from interest payments to fund redemptions of units. In such circumstances, it may not have sufficient cash to effect a distribution of all of its income (and hence a deduction thereof to avoid taxation). It is generally advisable to have the Income Trust issue additional units to existing unit-holders and to deduct the amount "paid" in units. Although this results in income to unit-holders without a corresponding receipt of cash, the significant percentage of units held by RRSPs and other tax-deferred persons will generally ameliorate this disadvantage.

In conclusion, income trusts are somewhat less efficient than classic royalty trusts in that they retain an intervening level of taxation. However, to the extent that taxation can be deferred over a significant period of time, this disadvantage can be more than offset by the advantage to vendors of structuring dispositions in an advantageous manner.

C. ACQUISITION ROYALTY TRUSTS

The acquisition trust is a hybrid of the classic royalty trust and the income trust. It represents a structure using features of both to effect the restructuring of a corporation into a mutual fund trust. The structure of the EnerMark transaction is set out in Appendix 3.

The essential feature of an acquisition trust is that it involves a public corporation ("Pubco") wishing to restructure itself to increase shareholder value. This usually occurs in the face of an unsolicited acquisition proposal from a third party.

(1) Pubco brings in a professional manager who organizes Manageco and establishes a mutual fund trust (the "Acquisition Trust"). The Acquisition Trust and Manageco jointly organize Subco, with Manageco holding a majority of Subco's voting securities.

(2) Using the arrangement provision of corporate legislation,[4] Subco makes an offer for the shares of Pubco by offering a combination of debt securities ("Notes") and non-voting shares, with the result that the former Pubco shareholders become shareholders of Subco (holding non-voting shares) and creditors of Subco by way of the Notes, and Pubco becomes a whollyowned subsidiary of Subco.

(3) The Pubco shareholders exchange their Notes and Subco Shares for units of the Acquisition Trust.

(4) Subco and Pubco amalgamate to form Amalco. Amalco is whollyowned by the Acquisition Trust except for the voting securities held by Manageco. The Acquisition Trust is also a creditor of Amalco through the Notes.

(5) The Acquisition Trust stipulates that Amalco distribute to it all of its net income (after any required capital expenditures or payments to any third party creditors of Amalco) in the form of interest on the Notes, principal repayments, and distributions on the shares of Amalco owned by the Acquisition Trust. The Acquisition Trust therefore receives 100 percent of the distributable cashflow from Pubco's former business.

(6) As an optional feature, to the extent that Amalco has a cumulative COPGE account, it may dispose of a royalty on it assets to the Acquisition Trust, using the proceeds to reduce the amount of the Notes. The advantage of creating the royalty is that it permanently removes the income which forms the basis of the royalty from any intervening level of taxation. Furthermore, insofar as the proceeds of the royalty are sufficient to deplete the cumulative COGPE of Amalco (inherited from Pubco) while creating a corresponding cumulative COGPE account at the level of the Acquisition Trust, no overall loss of "tax pools" occurs.

As one can discern, the income tax aspects of this hybrid are a combination of those accruing to a classic Royalty Trust and those accruing to an income fund, including:

(1) Pubco's shareholders are considered to have disposed of their Pubco shares for proceeds equal to the fair market value of the units received, and thereby will realize a capital gain or capital loss under the *Act*;

(2) the Acquisition Trust must have a redemption feature insofar as more than 10 percent of its Assets are in the securities of one issuer;

(3) the Acquisition Trust must report its income on a combined cash basis in respect of its royalty payments and on an accrual basis in respect of its interest payments on the Notes;

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[4] See *e.g. Alberta Business Corporations Act*, S.A. 1981, c. B-15, Part 15.

(4) to the extent that the tax attributes of Pubco are such that there is a deficiency between the level of its accumulated tax deductions and its implicit asset value, the Acquisition Trust merely defers tax and corporate tax must eventually be paid;

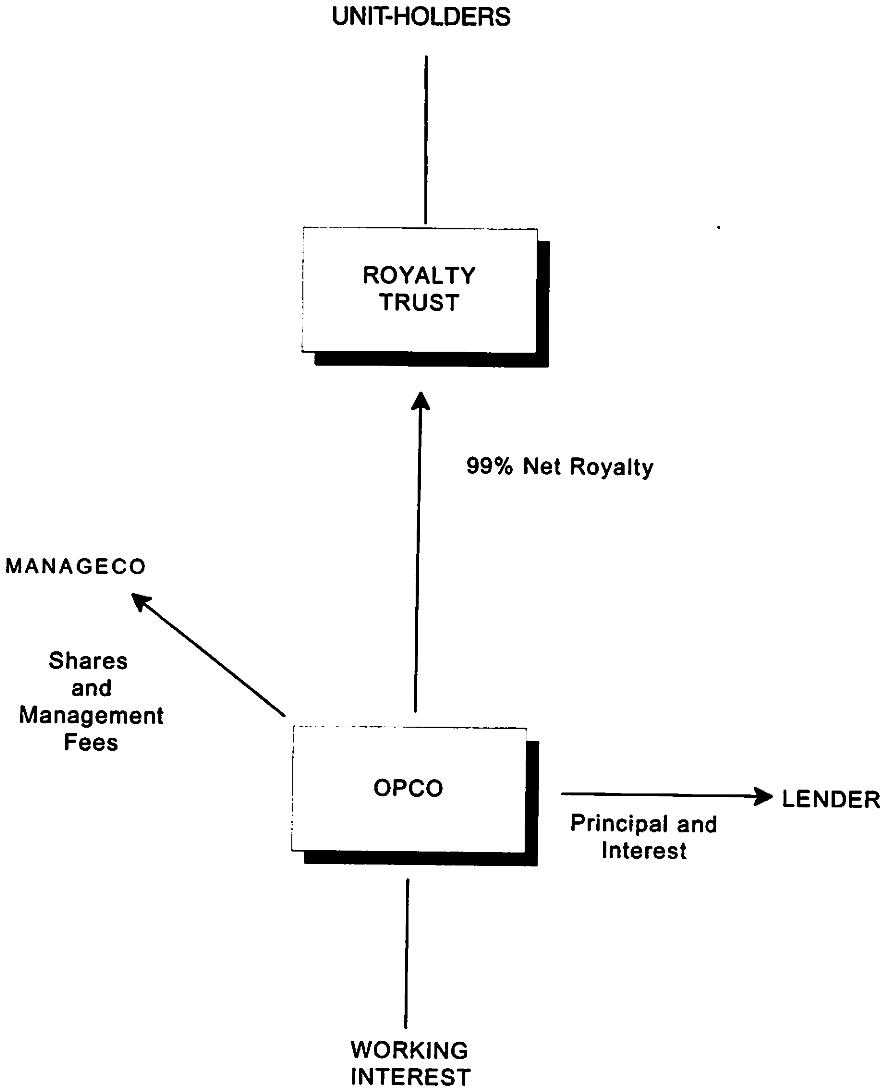
(5) the issues of the deductibility of interest on the Notes and on the royalty payments remain essentially the same; and

(6) unlike classic royalty trusts, Amalco remains liable for large corporation tax.

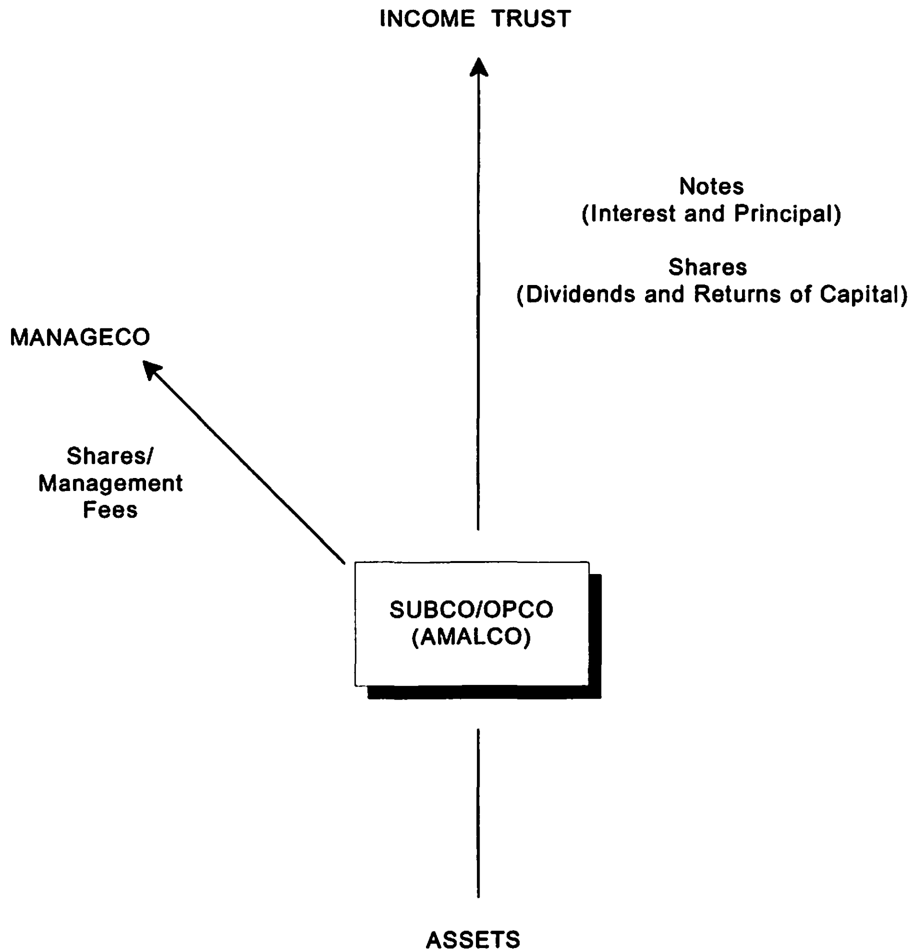
IV. CONCLUSION

Although the royalty trust phenomena appears to give rise to extraordinarily complex structures, by keeping in mind the restrictions in the *Act* on unit trusts and mutual fund trusts in the context of producing a vehicle with high levels of distributable cashflow and reductions in intervening levels of taxation, one can use the flexibility in such financing vehicles to achieve desirable economic results.

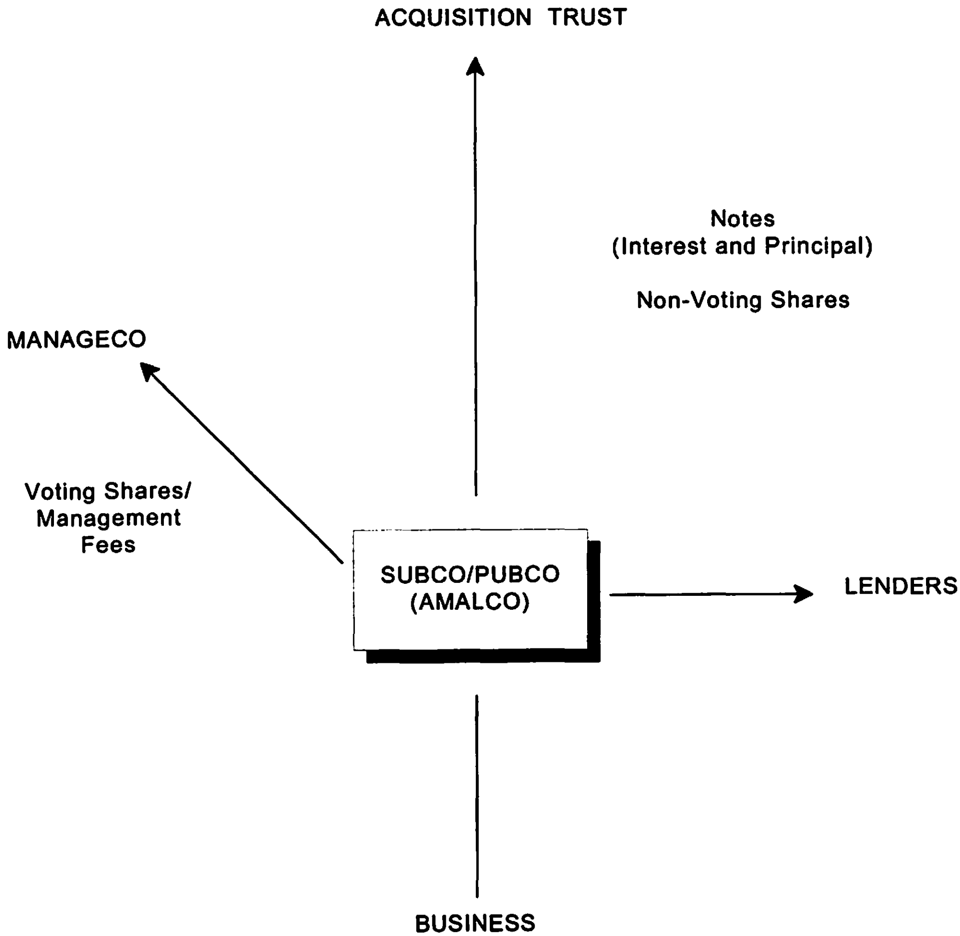
APPENDIX 1


UNIT-HOLDERS
ROYALTY TRUST
99% Net Royalty
MANAGECO
Shares and Management Fees
OPCO
LENDER
Principal and Interest
WORKING INTEREST

APPENDIX 2


INCOME TRUST
Notes
(Interest and Principal)
Shares
(Dividends and Returns of Capital)
MANAGECO
Shares/
Management
Fees
SUBCO/OPCO
(AMALCO)
ASSETS

APPENDIX 3


ACQUISITION TRUST
Notes
(Interest and Principal)
Non-Voting Shares
MANAGECO
Voting Shares/
Management
Fees
SUBCO/PUBCO
(AMALCO)
LENDERS
BUSINESS