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Canadian Business Trusts: A New Organizational Structure

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Abstract

The focus of this paper is a subset of income trusts called business trusts, a Canadian financial innovation that has experienced remarkable success in the Canadian market, but not in the U.S. At theendof2005, there were more than 170 business trusts (most of them in Canada, but a handful in the U.S.) with an aggregate market value of over $90 billion.

Like income trusts generally, which include REITs and oil & gas trusts, business trusts are designed in large part to avoid taxation at the corporate level by distributing a substantial proportion of a business's operating cash flow. The business trust structure provides investors (called "unit holders") with what amounts to a combination of subordinated, high-yield debt and high-yielding equity. But unlike the subordinated debt in most highly leveraged transactions (HLTs), the "internal" debt in a business trust unit is effectively "stapled" to the equity part of the security. And this kind of "strip financing" (which was a common practice in U.S. LBOs during the'80s) means that, besides providing stable cash-generating companies with a tax-minimizing way of paying out excess cash, the business unit structure also limits the "financial distress costs" associated with HLTs. In the event of financial trouble, the unit holders are likely to be much more cooperative than ordinary subordinated debt holders in restructuring interest payments since the benefits of so doing accrue to the equity portion of their units.

The original income trust structure has also been used by a number of U.S.-based companies that listed their shares on the TSX. But, in the attempt to make the securities suitable for listing on the AM EX, and in response to auditor demands intended to address potential IRS concerns, the instruments were modified in ways that sacrificed one of the important benefits of the original structure. The changes were designed to make the subordinated debt issued as part of a package with equity look more like external, *third-party* debt. And in so doing, the low-cost restructuring feature built into the Canadian version was lost, and the U.S. trusts failed to gain acceptance.