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FEBRUARY 1, 2007

Management Liability

Canadian tax change sparks D&O concerns

Publication Date: **01/31/2007**
Source: **Business Insurance**

OTTAWA-A proposal to revamp tax rules for Canadian income trusts could the directors and officers liability exposure of companies that have adopted trust structures to reduce their tax burden.

The federal government's proposed tax rules likely will initiate a trend of conversions of income trusts to corporate structures and increase merger and acquisition activity in the sector, thus creating new D&O exposures.

Minister of Finance Jim Flaherty proposed a comprehensive tax rule overhaul for income trusts in an effort to curb what administration officials view as tax avoidance by Canadian corporations converting to income trusts (see box).

An income trust holds income-producing assets and passes the income on to its investors. Under Canada's current system, income trusts pay little or no corporate taxes because most income is distributed to investors. In contrast, Canadian companies pay corporate taxes at very high rates.

The favorable tax treatment has led to significant growth in income trusts, 253 of which are traded on the Toronto Stock Exchange.

Announcements of planned conversions to income trusts by several corporations-including two of Canada's largest telecommunications companies, Vancouver, British Columbia-based TELUS Corp. and Montreal-based BCE Inc.-provided the impetus for the government's proposal.

``I think the federal government got more and more concerned that there was going to be tax leakage and other problems in the economy,'' said Garth Pepper, a senior associate and the national management risk practice leader for Integro (Canada) Ltd. in Toronto.

In response to the proposal, TELUS and BCE said they will not move forward with their planned conversions, a decision other companies likely will follow, observers say. ``Many trust conversions are probably not going to happen anymore because of this,'' said Raymond Hupfer, an Edmonton, Alberta-based partner with McLennan Ross L.L.P. with expertise on taxation and trust issues.

The tax rules are in a consultation scheduled to end Jan. 31. The House of Commons Finance Committee this week will begin reviewing the federal government's proposal amid lobbying efforts by the income trust sector that includes allegations that the government overstated the lost tax revenue created by income trust conversions.

Although the market value of these income trusts declined about $20 billion Canadian ($17.8 billion) in the days following the government's announcement last October, insurance market sources doubt there will be a spate of securities lawsuits because the decline was not based on any actions taken by the income trusts themselves.

While a tax structure change was a widely acknowledged risk factor for income trust conversions, how well companies prepared for and respond to such a change could be the basis for D&O suits, insurers and brokers say.

The loss of tax-favored status diminishes the value of income trusts and will likely initiate a trend of income trusts converting to corporations, which creates potential liability in terms of how efficiently directors and officers manage the transition, Mr. Pepper said.

At least one income trust-Calgary, Alberta-based True Energy Trust-has announced plans to convert back to a corporate structure in light of the government's tax proposal.

M&A activity-a key risk factor for increased D&O liability-may also rise as undervalued trusts become takeover targets, brokers and insurers say.

Disclosure becomes very important and can be closely scrutinized when a company is in the process of or considering a sale, said Jordan Solway, regional vp, claims and legal, for Arch Insurance Canada in Toronto. The quality of disclosure has become particularly important in light of amendments to securities legislation in Alberta, Manitoba and Ontario that establish liability for incomplete or inaccurate disclosure in the secondary markets, he said (BI, Jan. 8). ``It makes risk management a very challenging issue,'' Mr. Solway said.

Despite the tax proposal, the markets are unlikely to have a knee-jerk reaction to these potential exposures and focus instead on discussing with policyholders and brokers how their policies will respond to specific situations, brokers and insurers say.

"It’s not a doomsday scenario at all," said Adam Briklyn, senior vp, financial lines, for Toronto-based Executive Risk Services Ltd. “It’s more a reflection of having to adjust.”

The pricing for D&O coverage for income trusts became very competitive as more insurers grew comfortable with the risk, a trend that is unlikely to change despite the government's proposal, Mr. Pepper said. ``I don't think there will be any great change in the pricing,'' he said. ``I think we'll see an aggressive marketplace and competitive pricing.''