IAS 32: Classification of Income Trust Units

Excerpt, IFRS Discussion Group Report on Meeting – March 4, 2010

In Canada, income trusts generally issue units that are redeemable by the holder at a discount to market value. IAS 32 *Financial Instruments: Presentation* addresses the classification of these "puttable" instruments. The instruments would usually be classified as liabilities unless they met the criteria in paragraphs 16A and 16B of IAS 32 that allows them to be classified as equity. However, in Canada, these trust structures commonly contain a requirement to distribute, in cash or additional units, a value equivalent to either or both the "distributable cash" as defined in the trust indenture or the taxable income.

Distributions that May Be Settled in Units or Cash

The members were asked to consider whether the units can be classified as equity in accordance with paragraph 16A(d) of IAS 32, if they meet all of the requirements of paragraphs 16A and 16B, except that the trust is unable to avoid a distribution either in cash or additional trust units. The members discussed the following situations:

- Scenario one assumes that the distribution may be made in cash or additional trust units at the sole and absolute discretion of the trustees. View A — such a trust would violate the conditions of paragraph 16A(d) IAS 32. View B — such a trust would not violate the conditions of paragraph 16A(d) IAS 32.
- Scenario two assumes that the distribution is to be paid in cash to the extent it is on hand and allows any deficiency to be made up in units. View A — such a trust would violate the conditions of paragraph 16A(d) of IAS 32. View B — such a trust would reassess whether the puttable instruments continue to meet the conditions of paragraphs 16A and 16B of IAS 32 at each financial statement date.

The members discussed the implications of whether the distributions were pro-rata, whether the type of consideration used to settle the obligation affected the classification, or if it was the trustees' ability to avoid any outflow of resources that affected how an instrument could be classified. Those commenting on scenario one thought the trust would not violate paragraph 16A(d) of IAS 32 because of the ability to avoid the distribution of cash. Those commenting on scenario two expressed support for View A because there is a requirement to distribute any cash on hand.

The IASB's current project on Financial Instruments with Characteristics of Equity is addressing IAS 32 issues, but the IASB's annual improvements project could provide clarification of the current standard. The members recommended that the AcSB staff contact the IASB staff to determine if they would consider proposing the clarification of paragraph 16A(d) of IAS 32. A communication to that effect has subsequently been sent to the IASB staff.

Structure of Trusts Allows Income to be “Dammed” Within a Group

The members were asked to consider whether the units can be classified as equity in accordance with paragraph 16A(d) of IAS 32 if they meet all of the requirements of paragraphs 16A and 16B, except that the trust is able to avoid a distribution by “damming” the income through the structuring of trusts.

- This scenario involves a layering of income trusts. The members contemplated a trust that had issued units to investors, referred to as the “fund” trust. The fund trust owned an operating trust, which in turn owned an operating corporation. The indenture for the fund trust required distribution in cash of all taxable income of the fund. The indenture for the operating trust allowed the trustees sole and absolute discretion on whether to make distributions from the operating trust to the fund trust. The arrangement allows for the “damming” of income in the operating trust. View A – such a trust would violate the condition of paragraph 16A(d) IAS 32when looking narrowly at the fund trust itself. View B – the Fund units would not violate the IAS 32.

The members discussed the implications of whether the ability to dam income in a subsidiary trust affected the classification of the instrument. Those commenting on the issue expressed support for View A because it would be contrary to the business purpose of the fund trust to “dam” income for anything but a short period. Those members commented that any clarification resulting from the request above through the annual improvements project could help, but they did not recommend a separate request be made to the IFRIC.