



THE CANADIAN CHAMBER OF COMMERCE
LA CHAMBRE DE COMMERCE DU CANADA

Submission to the Department of Finance Canada

**Re: Tax and Other Issues Related to Publicly Listed
Flow-Through Entities (Income Trusts and Limited
Partnerships)**

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Background

In its March 2004 budget, the federal government acknowledged that the income trust model has provided additional choice and flexibility for businesses to access capital markets as they determine the most advantageous structure for their particular circumstances. A concern for the Government at that time was that pension funds may consider becoming more active in this market once the liability issue¹ is clarified in provincial legislation and, as a result, unlimited participation of pension funds in the business income trust market could have a significant impact on government revenues because of their tax-exempt status and their influence in Canadian capital markets.

In response to this concern, Budget 2004 proposed to limit the size of investment and degree of participation of pension funds to no more than 1 per cent of fund assets in business income trusts and no more than 5 per cent of the units of any business income trust. These restrictions did not extend to pension funds' investments in resource royalty trusts and real estate investment trusts (REITs) or to deferred income plans that are not registered pension plans, such as Registered Retirement Savings Plans (RRSPs) and registered retirement income funds.

Due to a number of concerns raised by several groups, on May 18, 2004 the federal government suspended these proposals pending further consultation. A report² commissioned by the Pension Investment Association of Canada estimated that if pension funds increased their investments in income trusts consistent with their level of participation in the Canadian equity and bond markets (i.e., approximately 25 percent), the net annual tax loss to the federal government would be approximately \$39 million, or only a small fraction of the almost \$30 billion the federal government collected in corporate income tax in the 2004-2005 fiscal year. Pension industry representatives also suggest that the federal government's concerns about tax leakage are misplaced, because pension fund earnings are not in fact tax-exempt. All distributions from a pension fund are taxable, and like all other investment earnings of a pension fund, income from a business trust will eventually be fully taxed at ordinary rates in the hands of pensioners, their spouses or their beneficiaries.

¹ While there has been rapid growth in the income trust market since 2000, some stakeholders may have been concerned that the income trust structure does not offer investors the same protection against liability that the corporate structure offers shareholders. Some have suggested that income trust unitholders could potentially be held liable for amounts greater than their investment where there is an adverse event. The implementation of limited liability legislation by some provinces may alleviate some of these concerns. In May 2004, Alberta passed legislation (the Alberta Income Trust Liability Act) designed to limit the liability of income trust investors. Ontario passed similar legislation in December 2004 (the Trust Beneficiaries' Liability Act) and Manitoba in June 2005 (The Investment Trust Unitholders' Protection Act). Quebec has had legislation in place since 1994.

² HLB Decision Economics Inc. "Risk Analysis of Tax Revenue Implications of Income Trusts." Final Report. March 11, 2004.



In Budget 2005, the federal government announced that it would conduct open and transparent consultations with stakeholders on tax issues related to business income trusts and other flow-through entities (FTEs). The release of the September 8, 2005 paper titled *Tax and Other Issues Related to Publicly Listed Flow-Through Entities* by the federal Department of Finance ("Finance Canada") launched these consultations.

On September 19, 2005, Finance Canada announced that it has asked the Canada Revenue Agency (CRA) to postpone providing advance tax rulings to companies considering converting to income trusts. Companies considering converting to income trusts usually seek advance tax rulings from the government, though a tax ruling is not absolutely required. Such rulings are binding on the CRA and give companies certainty regarding the tax implications of a transaction. The announcement created a great deal of investor uncertainty. Several businesses that had contemplated shifting to an income trust model have put their plans on hold as they wait for further clarification on the federal government's position.

Introduction

Income trusts invest in operating companies or income-producing assets. Net cash flows generated by the operating entity's business are distributed to the income trust. The income trust then distributes these receipts to its investors (i.e. unitholders) who pay applicable taxes. Such vehicles "flow through" income to investors so that corporate income taxes or capital taxes are not paid at the entity level. This differs from the tax treatment of companies operating as taxable corporations under the *Income Tax Act* (Canada) which are subject to corporate tax on all profits, regardless of whether those profits are distributed to shareholders in the form of a dividend or retained by the corporation to re-invest in the business.

Income trusts include business income trusts, resource royalty trusts and REITs. In the last ten years, income trusts have gained popularity in Canada as investment vehicles, and since 2000 their growth has increased dramatically. At the end of 2004, income trusts had a total market capitalization of \$110.7 billion, up from \$14.1 billion in 2000 and \$1.3 billion in 1995. Mid-year 2005, total market capitalization had increased to almost \$150 billion. Since 2000, business income trusts have boasted the most rapid growth in both numbers and dollar value with conversions evident across an expanding range of industries.

Investor interest and growth in income trusts can be attributed to a number of factors. In a low interest rate environment, income trusts' dependable cash distributions have become more attractive to investors. Income trusts are also perceived by many investors as being low risk investments. More recently, further encouraging the expansion of income trusts is Standard & Poor's decision to include income trusts and limited partnerships in the S&P/TSX Composite Index.³ This has stimulated further institutional interest, particularly for portfolios managed against the Index.

³ Income trusts and limited partnerships will be included in S&P/TSX Composite Index at the end of trading on December 16, 2005 at 50 per cent of their full float adjusted weight. A new index, the S&P/TSX equity index, will begin, which will exclude income trusts. After markets close on March 17, 2006, the two provisional indices will be terminated, replaced by the S&P/TSX composite index and the S&P/TSX income trust index, which will include income trusts at their full float adjusted weight. The S&P/TSX 60 index, which includes only Canada's biggest companies, will continue to exclude income trusts.



Income trusts are overwhelmingly driven by retail investors. Retail holdings (including those held through an RRSP) account for between 60 per cent and 65 per cent of the trust market. Institutional holders make up the rest and the bulk of that is held in mutual funds. Individual investors – either through direct ownership or by mutual funds – hold up to 80 per cent of the trust market. Pension funds remain relatively small players, accounting for roughly 8 per cent of the institutional holdings. Even so, institutional interest is on the rise, particularly as the provinces enact legislation to clarify the liability issue. Index fund managers are buying trusts ahead of their inclusion in the S&P/TSX Composite Index. Hedge funds are believed to rival pension funds in terms of their holdings. More than one fifth of trust investors live outside Canada.

While any company can organize itself as a business trust, those that do have a number of common characteristics:

- The underlying cash flow at the operating level is relatively stable;
- The company faces little existing or potential competition;
- Both the product and the market are mature;
- They require new investment either to grow the company or fund investments;
- They have little expenditures beyond maintenance capital expenditures (i.e. purchases made to maintain the current level of business).

Government Concern Over Tax Leakage

Actual cash flow distribution to the trust, and ultimately to the unitholder, is a combination of interest, dividends, capital gains and a return of capital. Distributed cash flow is taxable in the hands of the unitholder. The unitholders must also pay capital gains taxes on changes to gains realized from the sale of the units. If the beneficiary of the distributions is a non-resident, withholding taxes may apply. When the income trust distributes these receipts, unitholders pay no personal tax immediately if they hold these investments in a tax-deferred account such as a RRSP. However, it is important to remember that while in present value terms it may feel like the RRSP recipient is 'tax free', the income does get taxed at a later date.

Based on Finance Canada estimates, the difference in total taxes paid under different business structures is significant. For example, total tax paid under the corporate structure is \$42.85 on a \$100 distribution of corporate income to shareholders versus \$18.12 under an income trust structure and \$23.18 under a limited partnership structure.

Income trusts are, in part, a manifestation of a tax system that discriminates against dividends compared to other sources of income. For public and large private corporations, the dividend tax credit fails to fully integrate corporate and personal income taxes – dividends are paid out of after-tax corporate profits and then they are taxed again when received by shareholders. Thus, the credit fails to fully offset corporate income taxes paid by public and large private corporations. The resulting high effective tax rate on dividends compared to capital gains discourages the distribution of profits and encourages many companies with stable cash flow to convert to income trusts. Therefore, the real issue is not the current tax treatment of FTEs but rather the



discriminatory tax treatment of income earned by public corporations and distributed in the form of dividends.

The proliferation of the income trust structure raises a number of questions from a tax policy perspective. In its September 8, 2005 paper, Finance Canada estimates that federal corporate tax revenues for 2004 were \$300 million lower than they would have been if flow-through entities (income trusts and limited partnerships) had maintained their corporate structure. In 2004, this represented approximately 1 per cent of federal corporate tax revenue. Business income trusts accounted for \$120 million of the federal tax leakage, energy trusts for \$55 million, REITs for \$80 million and limited partnerships for \$45 million. This estimate, however, does not take into account the expansion of income trusts since December 2004. Based on the size of the income trust segment at present, it is estimated that the impact on federal tax revenues has surpassed \$600 million per year.⁴

In its consultation paper, Finance Canada offers several possible policy options for discussion to help stem tax leakage, including:

- Limiting the deduction of interest expenses by operating entities;
- Taxing FTEs in a manner similar to corporations; or
- Better integration of Canada's corporate and personal income tax systems.

The Canadian Chamber's preferred option is to remove distortions in the tax system that have promoted tax-driven investment vehicles, like income trusts, and create a level playing field among different forms of business financing and organization. The Canadian Chamber's proposal is to remove the distortion by eliminating the double taxation of corporate income. As such, the dividend gross-up rate and the dividend tax credit rate should be increased for dividends paid by public corporations and by Canadian-controlled private corporations from business income not eligible for the small business deduction to reach a level which will result in dividends and capital gains being effectively subject to the same rate of tax.

While there are fiscal costs (i.e. in terms of foregone tax revenue) associated with implementing this tax-reduction measure⁵, doing nothing has far greater consequences for productivity, economic growth and our nation's competitiveness.

Other proposed solutions, including taxing FTEs in a manner similar to corporations or limiting the deduction of interest expenses by operating entities, are, from the Canadian Chamber's perspective, less appropriate.

With respect to limiting the deduction of interest expenses by operating entities, Jack Mintz and Lalit Aggarwal stated in the *Canadian Tax Journal*: "As is done in the United States, debt, if in substance it is the same, could be characterized as equity, thereby disallowing the interest expense as a deduction. In Canada, under the existing thin

⁴ According to Finance Canada, every 10 per cent increase in market capitalization of trusts costs the federal government \$35 million in tax revenue.

⁵ It is estimated that it would cost the federal government \$1 billion in annual, foregone revenue to substantially reduce the tax advantage of income trusts by lowering the effective tax rate on corporate dividends.



capitalization rule, interest deductions are disallowed on indebtedness in excess of twice the level of equity held by non-resident related taxpayers in Canadian corporations. A general thin capitalization rule could be introduced that would apply to indebtedness to resident or non-resident related parties. While this approach may be appealing as a way to limit tax arbitrage, it can create economic hardship in cases where high leverage is a necessity to conduct business (for example, for financial institutions, new companies, and failing companies with low equity values).”⁶

With respect to taxing income trusts and limited partnerships in a manner similar to corporations, RBC Dominion Securities, in a report released on October 12, 2005, stated that “should be non-starter”. It would result in a loss in market value of Canadian business trusts by as much as 30 per cent. As a result, unitholders would be faced with significant capital losses for which they would likely have difficulties claiming for income tax purposes. RBC estimates that \$3.3 billion is collected in tax on yearly trust cash distributions of \$16 billion, not including potential capital gains taxes on trust conversions. “The amount of taxes collected from the business trust sector is likely greater today than it could be if the business trusts were converted back into corporate form.” The RBC report concludes that if the federal government decides to tax income trusts in the same way as other companies “with the corresponding increase in the cost of capital for the businesses, many trusts would likely fall victim to corporate takeovers, with the cash flows from operations retained by the acquiring corporation. Trust operations would then likely be initially shielded from corporate income taxes.”

It is important to remember, however, that when RBC Dominion Securities criticizes treating trusts similar to corporations from a tax perspective, it is on the premise that there is not at the same time a change to corporate taxation that eliminates the double taxation of corporate income inherent in the tax system. In fact, eliminating double taxation of corporate income is not inconsistent with taxing income trusts as corporations. Indeed, if there is a proper method to eliminate double taxation, it might be perfectly appropriate to treat trusts as corporations. In that way, any lesser distortions (for example, the effects of provincial taxation) would be eliminated.

Conclusion

The Canadian Chamber and its members believe that income trusts (including business income trusts) are appropriate to companies that have specific operating characteristics. Moreover, for some small- and mid-cap companies that would otherwise face higher financing costs, the ability to go public as a trust opens a new avenue for growth. Thus, income trusts have provided corporate Canada with an additional financing route. As such, the FTE structure is a viable choice for many businesses. It is imperative that the federal government end the uncertainty in capital markets by reaffirming its support for the FTE structure.

Any company considering converting to an income trust structure should have the freedom to do so if it is the most appropriate structure for their particular circumstance.

Results of a poll (September 26, 2005) conducted by COMPAS for the *Financial Post* under sponsorship of BDO Dunwoody LLP and the Canadian Chamber of Commerce

⁶ Aggarwal, Lalit and Jack Mintz. “Income Trusts and Shareholder Taxation: Getting It Right.” *Canadian Tax Journal*. Volume 52, Issue Number 3. Canadian Tax Foundation. 2004.



showed that the vast majority of business leaders – 75 per cent – believe the government should equalize tax policy for corporations and income trusts to remove the tax incentive for companies to become income trusts. Only 3 per cent of respondents believe Ottawa should impede the formation of income trusts.

To improve tax neutrality among different forms of business financing and organization, the Canadian Chamber of Commerce recommends that the dividend gross-up rate and the dividend tax credit rate be increased for dividends paid by public corporations and by Canadian-controlled private corporations from business income not eligible for the small business deduction. The goal of this measure is to lower the net tax treatment of dividends and bring it in line with the tax treatment of capital gains.

The federal government must also lower corporate income taxes. In its pre-budget submission, the Canadian Chamber of Commerce recommended that the federal government reduce the general corporate income tax rate to 20 per cent for 2006 and reduce it by one percentage point in each of the following three years.

The combination of these corporate tax rate reductions and bringing taxes on dividends to the level of capital gains will, for the most part, eliminate the return discrepancies for taxable shareholders and unitholders and achieve neutrality between these corporate structures. It will also cause companies considering converting to an income trust structure to focus on the strategic rationale for such conversions rather than taking advantage of distortions in the tax system.

The Canadian Chamber of Commerce strongly believes that the removal of the double taxation of corporate income is appropriate to achieve economic efficiency and equity objectives for all taxpayers. Moreover, in combination with a reduction in the general corporate income tax rate, it is a necessary component of fundamental tax reform and crucial to achieving an internationally competitive tax system. Simply put, it is smart public policy.

