The Trouble with Income Trusts

Tim Edgar*

ABSTRACT

This paper sketches broadly the efficiency and equity effects of income trusts that make their use as a substitute for the direct holding of shares of a corporation problematic for tax policy purposes. The paper also considers the potential effectiveness of an equity recharacterization rule applicable to the high-yield junk debt that is the common feature of the basic income trust structure. The author suggests that this type of narrowly focused rule would be more target-efficient than other possible responses to income trusts, such as fundamental reform of the corporate income tax or the restrictions on the holding of trust units proposed in the 2004 budget. However, a principal difficulty in designing an equity recharacterization rule is ensuring that it applies equally to structures that realize the same effect as the basic income trust structure but do not use high-yield junk debt.

The author argues that income trusts are examples of tax-driven financial innovation in the sense that they replicate an existing set of securities and therefore have no non-tax rationale. These securities are essentially redundant, and the innovative process of which they are a product does not constitute “genuine” financial innovation. This essential characteristic of income trusts distinguishes them from real estate investment trusts, which arguably do not present a tax policy problem (or at least not the same one). More particularly, income trust transactions are redundant in the sense that they do not complete capital markets by providing investors with a risk and return payoff profile that is otherwise unavailable. In the absence of any efficiency gains or desirable distributional effects associated with income trusts, the available tax benefit is the subject of a defensible government response intended to eliminate it. But without any clear evidence that income trusts are substituted generally for the corporate form, any response can defensibly be limited to a narrowly targeted one that introduces a “tax-law friction” by shifting the debt-equity boundary that is the focus of the basic income trust structure. Because the precise dividing points along this boundary lack any obvious normative content, the suggested policy focus should be the development of a legislative response that redraws the debt-equity boundary in a manner that minimizes perceived efficiency losses otherwise associated with the use of income trusts.

KEYWORDS: TRUSTS ■ DEBT-EQUITY ■ BUYOUTS ■ DEBT ■ EQUITY

* Of the Faculty of Law, The University of Western Ontario and a senior research fellow, Taxation Law and Policy Research Institute, Deakin University, Melbourne. This paper is a revised and condensed version of a background paper prepared for the Department of Finance. The views expressed in the paper are solely those of the author and should in no way be attributed to the department. The author would like to thank Ken Snider, Daniel Sandler, Paul Hayward, and Kim Brooks for their helpful comments on an earlier draft.
INCOME TRUSTS: THE CANADIAN VERSION OF LEVERAGED BUYOUTS

Income trusts are largely tax-driven structures that offer very little in the way of desirable efficiency or equity effects. In other words, they lack any significant consequential attributes that would otherwise justify their tolerance by tax policy makers. Although this characterization of income trusts seems obvious, it has been disputed aggressively by capital market participants as well as by a vast army of investment bankers, lawyers, and accountants, who make a healthy living off the paper shuffling that is necessary to access the tax saving that results from these structures.

In this paper I will attempt to support my intentionally provocative statements with some analysis presented in suitably neutral language. I will also sketch out the broad design features of a defensible response to income trusts that falls short of

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1 In this paper, I use the term “income trusts” to describe those structures in which a business previously carried on in corporate form is converted to a trust structure. The Department of Finance uses the term “business income trusts” to describe the same category of structures as distinct from real estate investment trusts (REITs) and royalty trusts. However, I argue below that royalty trusts have many of the same consequential attributes of income trusts, and any suggested response to income trusts should be extended to royalty trusts: see infra note 55 and the accompanying text. The same conclusion should not necessarily be drawn with respect to REITs: see infra notes 44-45 and the accompanying text.

2 For a similar characterization of income trusts, see Jim Stanford, Paper Boom: Why Real Prosperity Requires a New Approach to Canada’s Economy (Toronto: Canadian Centre for Policy Alternatives and Lorimer, 1999), 48-49 (“But the conversion of an existing productive asset into an income trust does not represent any new real investment in the Canadian economy, since the productive asset itself is unchanged by the transaction”); and Jim Stanford, “Some Money-Wasting Scandals Are More Equal Than Others,” Globe and Mail, May 24, 2004 (“The trusts serve no useful economic function whatsoever: in fact, they damage growth by diverting scarce capital into mundane low-tech industries, like phone directories and water heaters”).
fundamental reform of the corporate income tax, yet—unlike the 2004 budget proposals—addresses income trusts in a comprehensive manner while avoiding problems of over- and under-inclusiveness. There is no question that the design of such a legislative response is a difficult exercise. The policy case for a response is, however, easy to make.

My argument is based on three premises. First, I accept that the revenue loss from income trusts justifies the allocation of scarce government resources to the design of a legislative response. I recognize that there is some disagreement about the extent of any revenue loss attributable to these structures, but this first premise seems defensible for an obvious, albeit intuitive, reason. That is, in the absence of any compelling non-tax rationale for the use of income trusts, the tax saving must be sufficient to justify the substantial transaction costs and the sacrifice of desirable non-tax attributes associated with simpler corporate structures. I nonetheless take the opportunity to speculate on the dimensions of potential revenue loss, since this potential appears to be the reason for the 2004 budget proposal to limit the income trust holdings of registered pension funds. Second, I assume the reader’s familiarity with the technical details of both the basic income trust structure and its close substitutes, many of which have been developed over the past few years. Space limitations necessitate this assumption, which I feel comfortable making, given the available literature describing the various income trust structures. Third, I conveniently ignore any transitional issues associated with the losses that could occur for investors because of the adoption of a legislative response that eliminates the tax benefit attributable to income trust structures. I recognize that the issue of transitional relief presents a significant practical obstacle to such a response. It is at least arguable that transitional relief is unnecessary on the basis that returns should have already adjusted to account for the legal risk attributable to the tax-law uncertainty surrounding the income trust sector.4

3 Canada, Department of Finance, 2003 Budget, Notice of Ways and Means Motion To Amend the Income Tax Act, March 23, 2004, resolutions (12)-(14) (proposing that registered pension funds be limited to holding no more than 1 percent of their assets in “business income trusts” and no more than 5 percent of the units of any single “business income trust”); and Tax Measures: Supplementary Information, March 23, 2004, at 337-40. The adoption of this particular budget proposal, which was scheduled to take effect on January 1, 2005, has been deferred pending further consultation. See Canada, Department of Finance, “Minister of Finance Announces Consultations on Pension Fund Investment in Business Income Trusts,” News Release 2004-036, May 18, 2004 (herein referred to as “the May news release”).

4 There is a substantial academic literature on the case for and against the use of transitional relief when tax rules are changed. See, for example, Daniel Shaviro, When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity (Chicago: University of Chicago Press, 2000). In fact, one of the positive features of a targeted response to income trusts is that it avoids the wider transitional issues that otherwise arise with fundamental reform of the corporate income tax as a response. An inability to solve some of these transitional issues was the apparent reason that the Department of Finance ultimately rejected the adoption of some system of full integration of the corporate and shareholder income taxes when this reform option was last seriously considered in Canada as part of tax reform in the late 1980s.
Although the details of particular income trust structures differ, their one common feature is that they eliminate or substantially reduce the unintegrated portion of the corporate income tax by substituting high-yield, subordinated “junk” debt for a direct share investment in an operating corporation. In addition, the standard income trust structure includes a pooled investment trust to hold the debt and any remaining equity. A lower-taxed transaction is substituted for a higher-taxed transaction along two different boundaries, on either side of which is a different tax treatment under the Income Tax Act.

The substitution of high-yield acquisition indebtedness for shares of an operating corporation focuses on a discontinuity along the debt-equity boundary. In particular, the pattern of cash flows associated with the relevant shares is altered by the substitution of a fixed payment in the form of interest on the acquisition indebtedness. On the assumption that the business requires little or no retention of earnings for capital expenditures, the sacrifice in the desired pattern of cash flows is small; yet the debt-for-equity substitution results in a significant and disproportionate change in tax treatment (deductible interest expense at the corporate level versus non-deductible dividend payments).

5 Certain recent transactions realize the same tax benefit associated with the basic income trust structure by substituting for the pooled trust a direct holding by investors of a combination of the high-yield debt and the shares of the operating corporation that would otherwise be held proportionally by the trust. This transactional form has become increasingly popular, particularly as a substitute for cross-border income trusts into the United States, where the combined security (referred to as an “income deposit security” or “IDS”) is less likely to be regarded as equity for US income tax purposes because the component parts can be traded separately. See Jack Bernstein and Barbara J. Worndl, “Cross-Border Acquisitions: The Evolution from Canadian Income Trusts to Income Deposit Securities” (2003) vol. 31, no. 2 Tax Notes International 143-45; Christopher J. Steeves, “Income Deposit Securities—A New Hybrid” (2003), vol. 8, no. 4 Corporate Structures and Groups 450-53; and Ian Karleff, “Canadian-Style Trusts Head South,” National Post, July 23, 2003. Much the same type of security (referred to as an “income participating security” or “IPS”) is now being used as a substitute for the IDS structure. See Jack Bernstein and Barbara Worndl, “Canadian-U.S. Cross-Border Income Trusts: New Variations” (2004), vol. 34, no. 3 Tax Notes International 281-84; and Sandra Rubin, “Income Trusts’ Next Big Thing,” National Post, May 5, 2004. See also Thomas E. McDonnell, Tax-Exempt Organizations and the Financing of Taxable Businesses: An Examination of Canadian Tax Policy Issues, Working Paper 97-9 prepared for the Technical Committee on Business Taxation (Ottawa: Department of Finance, 1997), 16 (noting anecdotal evidence of the direct holding of high-yield acquisition indebtedness and shares of closely held corporations by registered pension funds and certain other tax-exempt entities other than registered retirement savings plans [RRSPs] and registered retirement income funds [RRIFs], which cannot generally hold shares of non-public corporations).

6 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

7 This point is emphasized in Lee A. Sheppard, “Blame Canada: U.S. Tax Shelters Go North” (2003) vol. 30, no. 1 Tax Notes International 8-15, at 11 (“In the Canadian income trust, however, we have a debt/equity argument that a second-year law student could make.”).
The substitution of a trust for a holding corporation as a vehicle to pool the capital of investors who acquire the shares of the operating corporation focuses on an inconsistency in the tax treatment of the cash flows distributed from these two organizational forms. Without any sacrifice in the desired pattern of cash flows, distributions from the trust form are deductible and are not subject to any entity-level tax, while distributions from a corporation are non-deductible and subject to the corporate-level income tax. However, as described in the immediately following section, the substitution of the income trust structure for a direct share investment may involve a sacrifice of certain desirable private-law attributes.

Income trusts are used overwhelmingly in debt-for-equity recapitalizations. These transactions mimic in many respects the leveraged buyout transactions (LBOs) and leveraged recapitalizations that were the subject of much contention in the United States in the 1980s. In effect, income trusts are the Canadian version of these US transactions, with similar tax-driven substitutions and policy implications. Most importantly for tax policy purposes, both types of transactions are accurately characterized as “tax-driven” in the sense that they do not represent “genuine financial innovation” as that term is used in the finance literature. A new financial instrument or finance structure is characterized as “genuinely innovative” only if it allows investors and issuers to accomplish something that they could not accomplish by using existing instruments. For investors, innovation may enhance the return associated with a given level of risk, provide greater liquidity, or create a more desirable pattern of cash flows. For issuers, innovation may lower the cost of capital and thus facilitate the undertaking of new investment. Genuine financial innovation “completes” capital markets by providing investors with a risk and return payoff profile that is unavailable with existing instruments. The efficiency of capital markets is enhanced, and value is added for both investors and issuers. In contrast to genuine financial innovation, tax-driven financial innovation takes advantage of inconsistencies and discontinuities in the tax law to increase the after-tax return for investors and/or lower the after-tax cost of capital for issuers. The relevant securities are redundant in the sense that the risk and return payoff profile (ignoring tax effects) is otherwise available with existing securities.

Like the use of high-yield junk debt in LBOs and debt-for-equity recapitalizations, the use of income trusts is sometimes justified on the basis that they reduce agency costs by imposing on corporate management the discipline of required cash flow distributions. In short, management is prevented from wasting or “burning” excess cash flows, which must instead be distributed to investors. This same argument appears to underlie the assertion in some of the literature that income trusts are

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not primarily tax-driven, but instead have proved attractive because they provide high current distributions in a low-interest, non-inflationary environment. However, existing securities, such as fixed-dividend preferred shares or income bonds, which pay fixed interest to the extent of earnings, can be used to effect the same distribution policy and consequent reduction in agency costs and/or increase in yield. In fact, the high-yield acquisition indebtedness used in income trust structures largely mimics the cash flow pattern associated with preferred shares and income bonds.

Income trusts are properly characterized, therefore, as involving redundant securities that are used strictly for the tax saving that they access. In this respect, such transactions are again similar to LBOs and debt-for-equity recapitalizations. Indeed, income trusts follow a very common pattern of tax-driven financial innovation, whereby a latent inconsistency or discontinuity in the tax law becomes the focus of structured finance transactions designed to capitalize on the inconsistency or discontinuity. The impetus is often found in a particular market development or environment, such as the low-yield or low-interest environment that is said to have encouraged the growth in income trusts (and their older royalty trust cousins). But the focus of these redundant securities is still the tax saving that they are designed to access.

In the next two sections I review the possible efficiency and equity effects of the substitution of income trusts for the direct holding of shares of a corporation. I suggest that these structures can be characterized as close (but not quite perfect) substitutes for direct share investments. In effect, they are tantamount to an election to avoid payment of the unintegrated portion of the corporate income tax. Because the election is limited to this form of transaction, there are associated transaction costs; but there may be very little in the way of direct efficiency losses.

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9 See, for example, John A. Brussa, “Royalty Trusts, Income Trusts, and the Search for Yield: A Phenomenon of a Low-Interest-Rate Environment?” in Report of Proceedings of the Forty-Eighth Tax Conference, 1996 Conference Report, vol. 1 (Toronto: Canadian Tax Foundation, 1997), 19:1-27, at 19:2-4. One way to conceptualize redundant securities is to engage in a simple thought experiment in which the following question is posed: But for the particular tax benefit, would the relevant security have been developed?


11 See Stanford, Paper Boom, supra note 2, at 48-49 (“The rise of income trusts, far from representing a new way to match ‘savers’ with ‘investors,’ actually represented a process of pure financial entrepreneurship.”).

12 For an excellent account of this development process in the United States, see Mark P. Gergen and Paula Schmitz, “The Influence of Tax Law on Securities Innovation in the United States: 1981-1997” (1997) vol. 52, no. 2 Tax Law Review 119-97. Other past examples of this pattern of development of tax-driven financial innovation in Canada are the use of preferred shares as a substitute for loan transactions and the use of finance leases as a substitute for leveraged asset acquisitions.
other than some possible allocative effects. In addition to those effects, the pre-
dominant policy consequences of the use of income trusts are the associated revenue
loss and any indirect efficiency and equity effects that follow from the need to make
up the loss. In the last section of this paper, I suggest that these consequences can
be addressed, in principle, with a targeted legislative response. In the absence of
such a response, it is not clear that there are sufficient market or any other non-tax
frictions to constrain the substitution of income trusts for direct share investments.
Indeed, in the extreme, the substitutability of these structures could be refined to the
point that the unintegrated portion of the corporate income tax will be substantially
eliminated for all but the riskiest of businesses. In this respect, public corporations
could use the income trust to realize much the same effect as Canadian-controlled
private corporations (CCPCs) already can with an appropriate mix of equity, debt,
and owner-manager salary.13

EFFICIENCY EFFECTS

The efficiency effects associated with income trusts may be both direct and indi-
direct. Direct efficiency effects include changes in the pattern of investment that
occur because of the substitution of a lower-taxed income trust and differences in
the private-law attributes of an income trust structure and a direct share investment.
These latter efficiency effects arise whether or not the tax-driven substitution
induces a change in the pattern of investment; they arise to the extent that the
substitution of an income trust structure is imperfect, in the sense that there is a
sacrifice of desired private-law attributes associated with a direct holding of shares.
Indirect efficiency effects consist of welfare losses associated with the need to use
other taxes to make up the revenue loss attributable to the use of income trusts.

I suggest here that the precise dimension of any efficiency effects in the form of
changes in the pattern of investment attributable to the use of income trusts is
unclear. The lack of clarity is attributable primarily to difficulty in determining the
completeness of the tax capitalization process in the context of income trust struc-
tures. Moreover, despite considerable emphasis in some of the literature, any
efficiency effects associated with the non-tax attributes of income trust structures
are similarly unclear—or, at the least, are difficult to quantify. In fact, the income
trust structure has been developed and refined to the point that it may now be a
nearly perfect substitute for a direct share investment in terms of the associated
private-law attributes.

Given the lack of clarity surrounding the efficiency effects that follow directly
from the use of income trusts, the indirect efficiency effects (and the equity effects,

13 See Canada, Report of the Technical Committee on Business Taxation (“the Mintz committee”) (Ottawa: Department of Finance, 1998), 7.14 (noting the similarity in tax effects of the use of an income trust or royalty trust structure and the payment of salary or other deductible payments by CCPCs with income in excess of the small business limit, as well as the use of business trusts and partnerships generally as a substitute for the corporate form).
for that matter) are a significant consideration. These indirect effects assume even greater significance as the income trust structure is refined further to provide a tax-effective, nearly perfect substitute for a direct share investment that minimizes, to a large extent, any sacrifice in private-law attributes. Indeed, I suggest in the next section that the revenue loss from the use of income trusts is not obviously limited by any non-tax constraints, other than a perceived market constraint regarding the suitability of a business for such a structure.

**Tax Capitalization and the Allocative Effects of Income Trusts**

The level of any distortion in the pattern of investment induced by income trusts depends on the completeness of the process of “tax capitalization.” This term refers to the process by which the value of a tax benefit is capitalized in the price of a particular tax-preferred asset. The process is commonly associated with explicit subsidies delivered through the tax system (“tax expenditures”) and the tax-shelter structures (for example, limited partnerships) that are used to transfer the benefit of the relevant tax expenditure to investors.

The same process of tax capitalization should apply to determine the division of the tax saving associated with income trusts. With such transactions, the benefit of the elimination of the unintegrated portion of the corporate income tax reduces the tax payable for investors, thereby increasing the after-tax return in comparison with the return on a higher-taxed share investment with comparable risk characteristics. In theory, this additional return should increase demand for the lower-taxed income trust, which should drive up the price of trust units until after-tax returns are equated with those on higher-taxed share investments. The increase in price is tantamount to an implicit tax on the returns on income trusts, which are subject to lower explicit taxes. This implicit tax lowers the after-tax cost of capital for investment in the businesses that are seen to be able to support the income trust structure.

The amount of the implicit tax associated with income trusts thus depends on the extent to which any tax saving associated with the use of these transactions is capitalized in the price of trust units, with the proceeds of such units used to purchase shares in an operating corporation with the requisite cash flows. Because

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15 This point is made, in a somewhat different manner, in James Pesando, Michael Smart, and Thomas A. Wilson, *Tax-Exempts and Corporate Capital Structure: An Analysis of Efficiency and Revenue Implications*, Working Paper 97-10 prepared for the Technical Committee on Business Taxation (Ottawa: Department of Finance, 1997), 4-7 (discussing the significance of the tax clientele hypothesis for income trust and royalty trust structures).
income trusts are predominantly debt-for-equity recapitalizations, any allocative effects attributable to the tax saving derived from these transactions are limited to the premium that is paid for shares of the operating corporation. In effect, the only new capital attributable to the transaction is the amount of this premium, which represents the amount of additional capital flowing to businesses with the requisite cash flows to support such transactions and the associated tax saving. The amount of the premium is a function of the tax capitalization process and, in particular, the identity of the marginal investor who is indifferent to holding an income trust unit and holding shares of a corporation with the same risk profile.

The “tax clientele” for the all-debt income trust structure consists of tax-exempt entities, since they face the greatest spread in explicit taxes paid on this structure and the higher-taxed all-equity structure. The premium for the lower-taxed income trust structure is maximized, therefore, when there are sufficient tax-exempt investors to purchase the supply of trust units. In that case, tax-exempt entities are the marginal investors, and the process of tax capitalization is complete in the sense that the implicit tax on the lower-taxed transaction is equal to the difference in the explicit taxes for the alternative transactions. When there is insufficient demand from tax-exempt entities to purchase all of the lower-taxed income trust units, these entities are the infra-marginal investors. Depending on the identity of the marginal investors, the process of tax capitalization is incomplete in the sense that the implicit tax on this lower-taxed transaction is something less than the maximum difference in the explicit taxes for the alternative transactions. As infra-marginal investors, tax-exempt entities will realize a greater after-tax return from income trusts, and will not be indifferent as between these transactions and higher-taxed equity investments with equivalent risk.

In principle, at least, it should be possible to measure the implicit tax associated with income trusts, since these structures use high-yield, subordinated junk debt with a cash flow pattern and a risk profile comparable to those of the outstanding shares that are refinanced by using these structures. The implicit tax should be equal to...
the difference between the purchase price of trust units and the value of refinanced shares of an operating corporation in the absence of an income trust refinancing. This determination should be relatively straightforward for those income trust transactions in which a publicly traded corporation converts to a trust structure to refinance some or all of its outstanding equity. Where the income trust structure has been used primarily as a means of effecting an initial public offering of private corporations, the share value is difficult to determine in the absence of the purchase of the shares through the use of the structure. Indeed, there seems to still be some “noise” in the valuation process associated with trust units and the underlying assets that are the subject of a refinancing using an income trust. Anecdotal evidence suggests that the valuation process continues to work “backwards” in the sense that a price for trust units is posited on perceptions of what the market can bear, and that posited price is imputed as the value of the underlying assets.17

With such a pricing process, there is no obvious way to accurately determine the implicit tax that is the result of the tax capitalization process. There is thus no way to determine precisely the extent of any allocative effects associated with income trusts. In effect, it is difficult to determine the additional flow of capital to particular businesses induced by the tax-driven adoption of this structure. All that can be said with any confidence is that such structures are marketed predominantly to retail investors, which is indirect evidence of the role of tax-exempts as infra-marginal investors.18 On the basis of this observation, the tax capitalization process seems incomplete, perhaps because some pension funds are unwilling to purchase trust units if they are uncertain about the liability of unitholders for trust liabilities. The incompleteness means that one portion of the available tax saving from the elimination of the unintegrated portion of the corporate income tax is captured by vendors of refinanced shares, and another portion is captured by infra-marginal tax-exempt investors. As a purely empirical issue, the measurement of the relative portions remains problematic.

However, even when the implicit tax associated with income trusts and the related tax capitalization process can be determined, the allocative effects of these transactions are complicated further. Because the transactions are debt-for-equity refinancings, the allocative effects are not limited to the premium paid for the tax saving attributable to the use of the income trust. Any additional flow of capital into the sector with cash flows that are considered best able to accommodate the income trust structure may be offset by the recycling of the proceeds of the share disposition into other sectors, both corporate and non-corporate. It is simply not clear to what extent this offset arises, since the information required to determine

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18 See, for example, King, ibid., at 4, citing a report from Scotia Capital (“The major investors in this asset class are retail investors, who represent on average, two-thirds of the purchases of income trust IPOs in 2002.”). However, some portion of this class of investors holds trust units through tax-exempt RRSPs. To that extent, retail investors are infra-marginal investors.
the extent of such an offset is unavailable. All that can be said with any certainty is that the proceeds of disposition are sometimes used to acquire trust units in a particular income trust structure. It is also plausible that some of the proceeds are not recycled as capital but are used by vendors for consumption purposes. Any offset of the possible allocative effects associated with income trusts is thus highly speculative.

**Efficiency Effects Associated with the Private-Law Attributes of Income Trusts**

As I have emphasized, income trusts involve the substitution of unsecured, high-yield, subordinated junk debt for shares. The substitution attempts to massage the tax-law boundary between debt and equity and the different tax treatment of these two categories of securities; it is perfect, or nearly perfect, to the extent that the private-law attributes associated with the income trust structure and a direct share investment are comparable. In effect, the junk debt attempts to approximate the cash flow pattern associated with the refinanced share investment and therefore can be characterized as “equity in drag.”

The acquisition indebtedness used in income trust structures is generally ignored by third-party lenders as debt for the purposes of required debt-equity ratios in loan covenants, and ratings agencies consider income trust units comparable to high-yield bonds that should be treated as “quasi-equity.” To the extent that the cash flow patterns are close substitutes, the only attribute that matters is the different tax treatment of the alternative investments. Standard finance theory—in particular, models of the optimal mix of debt and equity for issuers and for investors such as tax-exempt entities—are largely irrelevant as explanatory tools, since these models operate on the premise that the cash flow patterns associated with debt and equity differ significantly, and non-tax attributes either constrain tax-driven substitution or represent a cost attributable to such substitution.

19 See Bulow, Summers, and Summers, supra note 10, for this characterization of the high-yield junk debt used in LBOs.


21 The fixed-interest requirement deviates from the cash flow pattern associated with common equity. However, a long maturity and interest deferral provisions deviate from standard debt in approximating the cash flow patterns associated with common equity. See Dan Fournier, “Income Fund Financing Considerations,” in *The Canadian Institute’s National Summit on Income Trusts* (Toronto: Canadian Institute, November 2002), section VII, at 5-7 (noting the differences between the terms of an arm’s-length subordination agreement and the terms of the standard subordination agreement in an income trust transaction, which support a characterization of the acquisition indebtedness in such transactions as “quasi-equity”).

22 See, for example, Pesando, Smart, and Wilson, supra note 15, at 7-8 (reviewing risk and the treatment of capital losses as explanations for the holding of equity by tax-exempt investors.
It is arguable, however, that income trusts are not perfect substitutes for equity in terms of the private-law attributes of the alternative investment structures. Much of the non-tax legal literature highlights these differences generally under the label “corporate governance.” To the extent that differences in private-law attributes are significant in that they induce investors to prefer a simpler corporate structure over an income trust, the tax-driven substitution of the latter for the former entails direct efficiency costs.

Although it is fairly simple to highlight the differences in private-law attributes of income trusts that may be the source of inefficiencies, it is difficult to quantify any reduction in welfare that the tax-driven substitution of such structures may entail. It is also reasonably clear that the differences in private-law attributes and the associated efficiency costs differ significantly from those commonly attributed to the tax-driven substitution of arm’s-length debt for equity. In particular, the use of high-yield, subordinated junk debt in income trust structures does not significantly strengthen the payment rights of investors and therefore does not entail increased bankruptcy costs. This is especially the case for those income trusts in which the high-yield debt and any shares of the operating corporation are held proportionally by the particular trust. In these circumstances, any formal creditor rights associated with the indebtedness are unlikely to be enforced, and the holders are essentially the equivalent of equity investors. In this respect, the high-yield junk debt is tantamount to tax-deductible preferred shares or income bonds.

Pesando, Smart, and Wilson emphasize at some length certain possible efficiency effects that they see as attributable to the undesirable private-law characteristics of both income trust and royalty trust structures. In particular, they highlight two sources of potential welfare loss attributable to the agency costs that follow from the tax-driven substitution of these transactions for share investments in operating corporations.

The first source of loss is a perceived conflict between managerial incentives and the interests of unitholders, which arises primarily in the context of royalty trusts. Corporate management has an incentive to overstate expenses attributable to the royalty trust, which depresses the value of trust units and accrues to the benefit of shareholders when the recapitalization through the trust structure is partial in the sense that existing shareholders of the operating corporation are not bought out. In those instances of full recapitalization in which existing shareholders are bought out, the same incentive exists, with the benefit of overstated expenses accruing to management itself.

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when the tax clientele hypothesis posits that such entities should hold only debt. Their review follows a simple example illustrating the standard finance theory, which proceeds on the assumption that the tax treatment of interest and dividend distributions at the corporate level is the only significant variable for investment decisions. Given the fact that income trust transactions “nearly replicate that of an equity claim,” they conclude that these transactions can permit tax-exempt entities to realize the tax attributes of debt with the risk and return profile of equity.)

23 Ibid., at 8-13.
The second source of welfare loss is another set of agency costs associated with the market for corporate control. In particular, Pesando, Smart, and Wilson observe that the conversion of voting common equity into trust units reduces the cash flow accruing to the voting shares, which means that corporate management is better able to fend off value-enhancing takeover attempts. In effect, the lower value attributable to the remaining voting equity of the operating corporation permits corporate management to “entrench itself” at a lower cost of resisting takeover attempts.

Much of the non-tax legal literature emphasizes the first source of welfare loss. In the specific context of income trusts, the problem is seen to be a lack of disclosure requirements and an associated lack of transparency, at least in comparison with corporations, where the relevant private law is relatively well established in its emphasis on disclosure requirements as a means of reducing agency costs by supporting the active monitoring of management by shareholders. Trust law emphasizes instead the fiduciary responsibilities of trustees who act on behalf of passive trust beneficiaries. In this legal environment, agency costs can arise because of the lack of any requirement of independence of the board of trustees from the management of the operating corporation. The lack of independence is compounded by the fact that the administrative functions of the income trust are conventionally delegated to the same management group, along with the powers to acquire additional trust assets.

In addition to the possible efficiency losses associated with the private-law attributes of income trust structures, the tax-driven use of these structures entails transaction costs. These costs, which include investment banking and legal fees, are significant, but again are not nearly enough to constrain the use of income trusts, since they are substantially less than the associated tax saving. Indeed, these costs are a readily quantifiable efficiency cost of the tax-driven substitution of income trust structures for direct share investments in operating corporations. They are also significant because they create a vested interest in the maintenance of the tax advantage associated with such structures.

As I have already noted, the amount of any welfare loss from the private-law attributes of income trusts is difficult to quantify. What is critical from a tax policy

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24 Some of this literature is canvassed in King, supra note 17. See also Alberta, Income Trusts: Governance and Legal Status (Edmonton: Alberta Revenue, Discussion Paper, July 2004).

25 See also Paul D. Hayward, “Income Trusts: A ‘Tax-Efficient’ Product or the Product of Tax Inefficiency?” (2002) vol. 50, no. 5 Canadian Tax Journal 1529-69, at 1538 (citing as additional transaction costs (1) the costs of administering the mutual fund trust as a pooling mechanism; (2) the costs associated with the need to maintain two sets of audited financial statements and two boards; and (3) the costs of monitoring the level of non-resident ownership of trust units to ensure the conduit status of the trust).

26 See, for example, King, supra note 17, at 7 (noting that underwriting fees from initial public offerings of income trusts totalled $300 million as of the third quarter of 2002, while fees from secondary offerings totalled $150 million for the same period. He also notes that legal fees for issuer’s counsel on a trust range from $500,000 to $1 million, with legal fees for underwriter’s counsel amounting to two-thirds of that).
perspective is that these attributes have no power to constrain the tax-driven substitution of income trust structures for direct share investments. In effect, any cost associated with the undesirability of the private-law attributes of an income trust is clearly less than the available tax saving. In the absence of any non-tax factors, either in the form of transaction costs or in the form of undesirable private-law attributes, sufficient to constrain the tax-driven use of income trusts, an important tax policy issue is the potential for revenue loss from these transactions. This issue is discussed in the next section, along with the possible equity effects of income trusts.

EQUITY EFFECTS AND POTENTIAL REVENUE LOSS

The efficiency effects and the revenue loss associated with income trusts have received the majority of the attention in the literature. The equity effects have been largely ignored, perhaps because the distributional implications of income trust structures are difficult to identify. In this section I will sketch roughly the possible equity effects and consider possible limits on the revenue loss attributable to the use of income trusts.

The equity effects of income trusts are especially difficult to identify with any confidence, and they may be largely indirect in the sense that they arise as a consequence of an imperative to make up revenue loss. Potential revenue loss depends on the identification of non-tax factors that may constrain the substitution of income trust structures for simpler and more direct corporate structures. The dimensions of perceived market constraints on the use of income trusts have been relatively clear, and in fact these particular non-tax constraints have been the only significant constraints on such use. The effectiveness of these constraints is beginning to be eroded, however, by market developments that suggest a potential for revenue loss beyond existing levels.

Tax Capitalization and the Equity Effects of Income Trusts

To the extent that the possible equity effects of income trusts are even mentioned in the literature, the discussion tends to frame the issue in terms of the “fairness” of a perceived competitive advantage that the substitution of these lower-taxed structures creates for certain businesses, as well as the “fairness” of a perceived competitive advantage for tax-exempt entities that invest in trust units. The content of the term “fairness,” as used in these two different contexts, is unclear. As distinguished

27 For a discussion of the significance of non-tax constraints or “frictions” generally for tax-planning purposes, see Scholes et al., supra note 14, at chapter 6. For a discussion of the significance of such constraints from a policy perspective, see David M. Schizer, “Frictions as a Constraint on Tax Planning” (2001) vol. 101, no. 6 Columbia Law Review 1312-1409.

28 See, for example, McDonnell, supra note 5; and the Mintz committee, supra note 13, at 7.15-16.
from the possible efficiency effects canvassed in the preceding section, the equity effects associated with the use of income trusts are equated here with the income effects (that is, the income-distribution consequences) that follow from the substitution of these lower-taxed transactions. In effect, the equity effects are equated here with the distribution among taxpayers of any increase in after-tax income (and, by derivation, an increase in wealth or current consumption) that follows from the use of income trusts. These effects arise for one or both of two groups of taxpayers: (1) individuals who own shares of corporations that are refinanced by means of an income trust transaction, and (2) individuals who acquire trust units either directly or through a tax-exempt entity. Any “fairness” argument framed in terms of a perceived competitive advantage for businesses that are able to support an income trust structure is tantamount to an argument regarding the possible allocative effects of such transactions.

Like the possible allocative effects of income trusts, the equity effects depend on the completeness of the process of tax capitalization and, in particular, on the extent of the implicit tax that is the result of this process. As described above, the price of trust units should be bid up to the point that the risk-adjusted after-tax return is equated with the after-tax return on fully taxed shares held by tax-exempt entities, provided that there are enough tax-exempt entities to purchase the supply of tax-preferred trust units. More particularly, the price of units should be bid up to include the discounted present value of the unintegrated portion of the corporate income tax on the expected dividend stream associated with the shares that are refinanced with an income trust structure. In these circumstances, the full value of the tax saving attributable to the elimination of the tax will be captured in the sale price by those individuals who dispose of their shares in a trust refinancing. In effect, the implicit tax associated with the tax capitalization process will be equal to the present value of the expected explicit tax imposed by the unintegrated portion of the corporate income tax and will be borne in full by tax-exempt entities.

If there are not enough tax-exempt entities to purchase the supply of tax-preferred income trust units, the price of such units will be bid up only to the point that the risk-adjusted return for such units is equated with fully taxed shares for taxable investors, who become the marginal investors. Because the elimination of the unintegrated portion of the corporate income tax is offset by investor-level tax for this class of investor, the implicit tax associated with the tax capitalization process will be something less than the explicit corporate income tax. The precise amount depends on the marginal tax rate on dividend distributions for the class of marginal investor. In these circumstances, something less than the full value of the tax saving attributable to the elimination of the unintegrated portion of the corporate income tax will be captured in the sale price by individuals who dispose of their shares in a trust refinancing. The difference between the full value of this tax saving and the implicit tax imposed by the tax capitalization process will be captured by lower-rate infra-marginal investors in the form of an enhanced after-tax return on income trust units. A large slice of this infra-marginal gain will probably accrue to tax-exempt entities.
As noted already, there is no systematic evidence of the level of the implicit tax imposed by the tax capitalization process in the context of income trusts. All that can be said with any confidence is that the tax saving from the elimination of the unintegrated portion of the corporate income tax is probably split between vendors of refinanced shares and tax-exempt entities as infra-marginal purchasers of income trust units. The informational barriers with respect to equity effects are even more severe, making definitive conclusions problematic. If no such barriers existed, one could measure the distributional consequences of income trusts by first determining the amount of the implicit tax associated with the trusts and, by derivation, determining the windfall gain accruing to vendors of refinanced shares and infra-marginal purchasers of trust units. For the former, the windfall gain should equal the amount of the implicit tax reflected in the increase in the purchase price of the shares. For the latter, the windfall gain should equal (in present-value terms) the difference between the unintegrated portion of the corporate income tax on distributed share earnings and the amount of the implicit tax reflected in the increased purchase price for refinanced shares. Once this determination was made, the income and wealth profiles of vendors of refinanced shares and infra-marginal purchasers of trust units would have to be determined. This determination would identify the class of taxpayers who capture (in the form of an increment in wealth) the benefits of the tax saving associated with income trusts.

Even if the implicit tax in the context of income trusts could be measured with some certainty, the data required to determine the identity of vendors of refinanced shares and purchasers of trust units, either directly or through tax-exempt entities, are not readily available from tax and/or information returns. Furthermore, even if such data were available, informational constraints make measurement of the requisite implicit tax problematic. It is likely that most vendors of refinanced shares are wealthy individuals who are able to capture a portion of the tax saving from the use of income trusts. However, that may not be true of purchasers of trust units. In particular, it is not entirely clear that the distributional consequences of any windfall gain captured by tax-exempt entities are quite as problematic, since interests in such entities tend to be held by a broader range of investors than interests in, for example, tax-shelter investments.29 The precise dimensions of the equity effects of income trusts are therefore somewhat speculative. Indeed, it may be that the most significant equity effect arises from a budget constraint and the related need to reduce spending or use alternative taxes to replace lost corporate income tax revenue. This indirect effect requires knowledge of the magnitude of the budget constraint and the economic incidence of the related spending reductions or alternative taxes used to make up the lost revenue.

29 Even so, by almost any measure, holdings in tax-exempt savings plans are concentrated in the upper-income bands: see, for example, Stanford, Paper Boom, supra note 2, at 265–68 (surveying RRSP investments by level of total income). Any windfall gain associated with holdings of trust units in such plans is likely to be captured disproportionately by higher-income individuals.
Tax Capitalization and Revenue Loss: Determining the Outer Bounds of Substitutability as the Limiting Factor on Potential Loss

Not surprisingly, perhaps, the revenue effects of income trusts also depend in large part on the completeness of the tax capitalization process. If the process is complete, the present value of the revenue lost through the elimination of the unintegrated portion of the corporate income tax will be offset by tax payable by vendors of refinanced shares on the price increase attributable to tax capitalization. Such an offset will be incomplete, however, if the tax capitalization process is incomplete and the increase in share price is less than the present value of the expected corporate income tax eliminated by an income trust structure. Moreover, even when tax capitalization is complete, the tax rate applicable to vendors is generally the lower capital gains rate. The lost revenue from income trusts roughly equals, therefore, the difference between (1) the unintegrated portion of the corporate tax on expected earnings and (2) the capital gains tax on any increase in share price attributable to the tax saving associated with an income trust transaction.30

The dimension of this revenue loss is effectively set by the tax-law and non-tax factors that constrain a substitution of the lower-taxed income trust for a higher-taxed direct share investment. In short, these factors effectively determine the extent of such a substitution and the extent of any associated revenue loss. In this respect, the relevant tax factors are those that create uncertainty about the desired tax treatment and thereby impose “legal risk” in the sense that such treatment will be successfully challenged by tax administrators. The costs of such a challenge, if sufficiently high, can constrain the adoption of a lower-taxed structure or arrangement. A large element of tax-law uncertainty, which would otherwise surround the characterization of the return on the high-yield acquisition indebtedness used in income trust structures, has been eliminated by the general reliance of Canadian courts on the legal form of securities as debt or equity and the legal definition of interest as determinative of the treatment of the associated cash flow stream for income tax purposes.31 The other principal source of tax-law uncertainty is the characterization of income trusts as mutual fund trusts, the interests in which are

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30 The revenue loss should, in principle, also be reduced by the present value of the accelerated capital gains tax on the portion of realized gain that is not attributable to the tax capitalization process. It should also be reduced by the present value of personal taxes on withdrawals from tax-exempt savings accounts in excess of the amount of withdrawals that would have been available where holdings in such accounts would have been lower because of the unintegrated corporate income tax. See Shenfeld, supra note 8. Values for these amounts depend on problematic assumptions about the expected timing of the relevant taxes.

eligible investments for tax-exempt entities. In this respect, the Canada Revenue Agency (CRA) has largely eliminated any uncertainty by way of its administrative position regarding the satisfaction of the redemption requirement for open-ended funds imposed by the Act. The result is a decided lack of any tax-law uncertainty as a constraint on the tax-driven substitution of an income trust structure for a direct share investment.

The elimination of legal risk attributable to tax-law uncertainty has arguably created the equivalent of an informal check-the-box mechanism that, up to this point, is more limited in its scope than the formal check-the-box mechanism used in the United States in the application of different entity-tax regimes. The equivalent of conduit taxation of business income can be realized by effectively electing this treatment through the adoption of an income trust structure. Given this tax environment, a pertinent policy question is: To what extent is the election available? The answer to this question lies in the presence of non-tax constraints or costs associated with the adoption of the income trust structure. There are two principal categories of such costs. One category consists of the private-law attributes associated with the income trust and its higher-taxed corporate alternative. The other category consists of market factors that limit tax-driven substitution.

The private-law attributes of income trusts were discussed briefly in the preceding section of this paper. Although some costs may be associated with the undesirability of such attributes, it is clear that they have not operated as an especially robust constraint on the tax-driven adoption of the income trust structure. In this respect, the most significant development in the short term is probably Alberta’s and Ontario’s proposed adoption of legislation that would ensure the limited liability protection of income trust unitholders. The liability issue has apparently served as a barrier to the acquisition of trust units by certain registered pension funds and has prevented the listing of trust units in stock indexes. This latter barrier may have exacerbated the liquidity risk associated with thin secondary markets for trust units, which may have served to constrain, to some extent, the use of income trusts. By clarifying the liability issue and opening the way to stock index listing, this type of private-law legislation should deepen the tax clientele for income trust structures and

33 Income Trusts Liability Act, 2004, tabled in the Alberta legislature on May 6, 2004; and Trust Beneficiaries’ Liability Act, 2003, tabled by the Ontario government with the March 27, 2003 budget. The proposed legislation in Ontario was not enacted before the dissolution of the legislature for the 2003 election. In June 2004, the new government reintroduced the proposal as the Trust Beneficiaries’ Liability Act, 2004, which received first reading on June 30, 2004. The Ontario legislative proposal and the lobbying efforts for similar legislation in Alberta are described in King, supra note 17.
34 The Ontario Teachers’ Pension Board has finessed the liability issue by holding trust units through a subsidiary corporation called “Golden Apple.” See King, supra note 17, at 20.
thereby increase demand, with a likely increase in supply and the associated revenue loss. The 2004 budget proposals obviously attempt to limit this potential revenue loss by introducing a tax-law constraint on the acquisition of income trust units by registered pension funds.

In fact, however, the most significant non-tax constraint on the adoption of the income trust structure appears to be a market perception that the cash distribution requirements of the income trust will limit its use to those businesses that have relatively stable cash flows, face limited competition, and have few capital expenditures that require the retention of cash. In the absence of any appreciable tax-law uncertainty and any significant costs associated with the private-law attributes of the income trust structure, it is to be expected that all such businesses will effectively “check the box” to eliminate the unintegrated portion of the corporate income tax. A business would make this election by adopting the income trust structure; the cost of the election would be the associated transaction costs and any efficiency costs associated with the structure’s private-law attributes.

Provided that this particular market constraint on the use of income trusts is robust, any potential revenue loss should be limited to businesses with stable cash flows and low capital expenditure requirements that, for whatever reason, have yet to adopt an income trust structure. In this respect, Scholes and Wolfson have argued that the revenue loss from the elimination of the corporate income tax through the use of high-yield junk debt in the LBO market in the United States was effectively limited to the expected or “competitive” return from the assets of a particular business.35 In effect, the fixed interest element on junk debt could not be set at an amount that exceeded this return without endangering its characterization as indebtedness that pays deductible interest expense. Economic rents that are in excess of this return (and that give a project a positive net present value) would remain subject to the corporate income tax, since they would accrue to holders of common shares in the corporate capital structure. Scholes and Wolfson argue, therefore, that high-yield junk debt could be used to effectively convert a corporation into a partnership only to the extent of the competitive return on assets. The same conclusion appears to apply to the use of high-yield acquisition indebtedness with income trusts. In short, the perception that the income trust structure is suitable only for businesses with stable cash flows is based on the premise that the high-yield acquisition indebtedness can be used to strip out the competitive or normal return on the underlying assets—that is, the stable cash flow. Any loss of revenue from the unintegrated portion of the corporate income tax is thereby seen to be limited to the competitive return on assets of mature businesses.

Recent market developments have rendered even this perceived limitation of the revenue loss from the income trust structure somewhat unstable, however. In particular, changes to the basic income trust structure have been developed in an

effort to combine the tax-deductible preferred share feature of the structure with a similarly tax-efficient structuring of the distribution of that portion of a business’s earnings that represents the riskier growth element and the associated retention of earnings for capital expenditures. In short, through the combination of an income trust and a limited partnership structure, the market has developed a means to strip out from the corporate income tax base both the competitive return and the economic rents of a business in much the same way that this result is accomplished by the use of a royalty in a royalty trust structure.36 Many of these structures continue to use acquisition indebtedness to strip out the competitive return on the assets of a business with only one level of tax. Economic rents are returned to investors with one level of tax through the limited partnership. Functionally, this structure converts a business operated in corporate form into a partnership in terms of both the competitive and non-competitive return on assets. The whole of the unintegrated portion of the corporate income tax on either of these returns is eliminated.

The development of these partnership structures may underlie the spread of the income trust structure to businesses with “growth potential.” In other words, a new equilibrium may be developing, whereby the revenue loss from these structures extends to the unintegrated portion of the corporate income tax otherwise applicable to businesses that have cash flows stable enough to support the presence of preferred shares, but that also have some growth potential. The precise parameters of this market constraint on income trust structures are unclear. The incremental development of tax-driven financial innovation generally suggests that in the absence of the adoption of any tax-law constraint, markets will continue to massage the accepted tax-preferred structure in an effort to extend its application. Because there are no obvious non-tax limits to the spread of income trusts that use a partnership structure, much of the non-CCPC corporate income tax base may be at risk in the absence of any tax-law constraint intended to preserve that base.

It is thus difficult to conclude with confidence that the exposure to revenue loss is limited in any robust sense by market constraints. It is not an overstatement to suggest that much of the revenue base attributable to the unintegrated portion of the corporate income tax for non-CCPCs may be at risk. In the extreme, the corporate form could be limited to high-growth startup businesses for which an income trust structure or the partnership form may be unsuitable for non-tax reasons. Revenue from these businesses is inherently unstable. For mature businesses with relatively stable cash flows and some growth potential, the tax-preferred choice is a partnership structure that mimics a combination of preferred and common shares but eliminates the unintegrated portion of the corporate income tax. For these businesses, there appears to be no effective private-law or market constraint on the choice of this tax-preferred form.

36 As with royalty trusts, the partnership structure has been limited to date to those income trust conversions involving a sale of the assets of the relevant business.
LEGISLATIVE RESPONSE IN THE ABSENCE OF SIGNIFICANT NON-TAX CONSTRAINTS

Given the difficulties in determining the precise dimensions of the efficiency and equity effects of income trusts, it is somewhat surprising that the policy case supporting a legislative response is relatively straightforward and compelling. In fact, the much more difficult issue is the design of a legislative response that is target-efficient in the sense that its effect is limited to the offending structures and is neither over- nor under-inclusive. In this section, I argue that the extent of the potential range of substitutability of lower-taxed income trusts for higher-taxed direct share investments suggests the broad parameters of a legislative response that is defensible from a tax policy perspective. More particularly, a defensible policy case can be made for a targeted legislative response that attempts to maintain the tax-law boundary between debt and equity securities implicated by income trusts. As a means of realizing consistency of treatment across business entities, fundamental reform of the partially integrated corporate income tax is arguably required only to the extent that there is some evidence that trusts can be substituted for the corporate form generally. Income trusts have yet to provide any such evidence of this broad type of entity-driven substitution.

The Policy Case for a Legislative Response

The policy case in support of a legislative response to income trusts requires an assessment of the possible efficiency and equity effects discussed in the two sections above. Those effects can perhaps best be marshalled in support of a legislative response if they are considered in the context of the arguments that are commonly made in some of the literature in favour of income trusts and, in particular, the maintenance of the status quo on which they depend. The weakness of these arguments means that it is largely unnecessary to know the precise dimensions of the efficiency and equity effects. In particular, one can conclude with some certainty that the general direction of these effects does not support in any way an acceptance of income trusts as a means to avoid the unintegrated portion of the corporate income tax.

At a general level, some of the literature suggests that income trusts can be characterized as efficiency-enhancing because they eliminate the unintegrated portion of the corporate income tax. In effect, they are seen as a form of “self-help” or “homemade” integration of the corporate-level and investor-level taxes. As such, they are characterized as efficiency-enhancing because they eliminate the welfare losses conventionally attributed to three standard tax biases associated with an unintegrated corporate income tax: (1) a bias in favour of the unincorporated sector; (2) a bias in favour of debt over equity investment; and (3) a bias in favour of the retention of earnings rather than their current distribution to shareholders. Welfare losses arise to the extent that investors would prefer the corporate form, equity investment, or the current distribution of earnings, but the tax system alters that choice because of a preference for the unincorporated sector, debt investment, and the retention of earnings.
It is difficult, however, to characterize income trusts as efficiency-enhancing, since these structures have tended to be limited to a particular slice of the corporate sector: that is, mature businesses with stable cash flows that can support the level of distributions on the high-yield acquisition indebtedness. Income trusts may thus distort the allocation of capital in favour of such businesses. Any argument that income trusts are efficiency-enhancing presents a classic problem of “the second-best,” in which any incremental move toward the “first-best” approach of full integration is not necessarily desirable because of offsetting efficiency losses attributable to the incremental measure. In other words, the kind of homemade integration realized with income trust structures may result in efficiency losses that offset any efficiency gains from the muting of the tax biases commonly associated with an unintegrated corporate income tax. Indeed, these efficiency losses may swamp any efficiency gains, given the limited range of businesses for which an income trust is considered to be suitable and the fact that income trusts represent equity refinancings rather than new investment.\footnote{See Bulow, Summers, and Summers, supra note 10 (emphasizing the lack of new investment with the homemade leverage realized through LBOs in the United States).}

At a more specific level, Shenfeld has articulated familiar arguments in favour of income trusts and the maintenance of the status quo:\footnote{Shenfeld, supra note 8.}

1. Income trusts encourage a flow of investment capital to projects with solid rates of return.
2. Income trusts tie the ability of managers to retain earnings and thereby prevent the “burning” or waste of excess cash flow.
3. Income trusts lower the effective corporate income tax rate in Canada, which enhances Canada’s competitive position as compared with the United States.
4. Income trusts do not represent “special treatment” in their ability to shelter income from corporate-level tax by means of the deduction of corporate interest expense, which is available on corporate indebtedness generally.
5. Income trusts do not result in an absolute revenue loss, since lost corporate revenue is offset, in part, by increased and accelerated personal tax collections.

The first three arguments appear to accept that income trusts result in a revenue loss, but they hold that the loss is justified because of the specified efficiency-enhancing properties of these structures. The fourth argument denies that income trusts present a unique policy problem, irrespective of their associated efficiency effects. The fifth argument contests the amount of revenue loss on the apparently unstated premise that the efficiency-enhancing effects of income trusts are especially defensible, given the more muted revenue effect.
I will address the fourth argument first (because it denies the very existence of any uniquely problematic aspects of income trusts). I argued above that income trusts do, in fact, present a tax-driven substitution of a debt investment that differs significantly from the substitution of an arm’s-length debt instrument. The difference is the high-yield, subordinated nature of the acquisition indebtedness used in income trust structures, which, when this indebtedness is held by the trust in proportion to any remaining shares of the operating entity, mimics closely the cash flow pattern otherwise associated with a preferred share or income bond. The replication is simply much closer than that associated with an arm’s-length debt obligation, where the tax benefit otherwise associated with a corporate interest expense deduction is accessed only at the cost of some sacrifice in the cash flow pattern associated with an equity instrument. Although the difference is one of degree and not one of kind, the difference in cash flow patterns of arm’s-length debt and the high-yield, subordinated junk debt used in income trust structures means that the latter can defensibly be characterized as “equity in drag,” which is consistent with market perceptions. No such characterization extends to arm’s-length indebtedness generally. The debt-equity substitution associated with income trusts is therefore quite different from that associated with the choice between debt and equity generally.

With respect to the fifth argument, I recognize that any revenue loss from the elimination of the unintegrated portion of the corporate income tax is offset, at least in part, by investor-level taxes. It is relatively clear, however, that, for the kinds of reasons discussed above, this offset is far from complete, and that a net revenue loss is the result of income trusts. Given a budget constraint, this loss must be made up through increases in other tax bases or reductions in spending. Depending on the choices that are made, the alternatives may involve efficiency and equity effects. The important policy question is whether the revenue loss attributable to income trusts is justified.

The answer to this question implicates the first three arguments set out above in favour of the status quo. In this respect, it seems clear that the tax saving associated with income trusts has caused an additional amount of capital to be allocated to businesses with the kind of stable cash flows seen to be necessary to support the distribution requirements on the high-yield acquisition indebtedness. It is also possible that income trust structures have the positive effect of disciplining the use of excess cash by management. However, in neither case is it obvious that there is a market failure that requires government intervention; nor is it obvious that the appropriate policy instrument is a tax subsidy, even if such a market failure could

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39 Bulow, Summers, and Summers, supra note 10, emphasize the lack of any positive externalities associated with LBOs that would justify government intervention in the form of a tax subsidy for such transactions.
be identified. Indeed, it is arguable that any allocative effect from income trust transactions is inefficient in the sense that it benefits mature, stable businesses over immature, risky businesses, where there may, in fact, be a market failure that causes capital markets to clear at a price that leaves unsatisfied a range of users of capital who are otherwise willing to pay that price. It is not obvious why businesses with stable cash flows should be singled out as the beneficiaries of any competitive advantage that might follow from the effective reduction in the corporate income tax rate attributable to the use of income trusts. With respect to a perceived need to discipline the use of excess cash by management, I argued above that income trust structures are redundant in the sense that there are existing securities, such as preferred shares and income bonds, that can serve the desired disciplinary function. There is no obvious reason to provide a tax subsidy for the use of any particular type of security in an effort to induce performance of that function.

In sum, it is arguable that the debt-equity substitution effected by income trusts is uniquely problematic and is not just another example of such substitution generally. Furthermore, any revenue loss resulting from the use of income trusts is difficult to defend as efficiency-enhancing. In fact, even though the precise dimensions of the efficiency effects are difficult to determine, income trusts probably result in a net efficiency loss equal to the total of (1) the losses associated with the allocative effects of these structures, (2) the losses in desirable private-law attributes, and (3) the deadweight loss in the form of the transaction costs incurred in implementing the structures.

40 The apparent need to control the agency costs attributable to corporate management’s control of excess cash flow is nothing more than a specific application of the generalized argument for elimination of a perceived tax bias in favour of retention of earnings under a classical corporate income tax. In particular, the non-tax significance of the “signalling function” served by dividend payments is the focus of a substantial literature on the desirability of consistency in the tax treatment of distributed and retained earnings. The “new view” of dividend taxation challenges the significance of this signalling function as well as the existence of a tax bias in favour of retention even in the presence of a classical corporate income tax. See Kim Brooks, “Learning To Live with an Imperfect Tax: A Defence of the Corporate Tax” (2003) vol. 36, no. 3 UBC Law Review 621-72, at 659-63, for a recent review of some of this literature.

41 See, generally, Michael S. Knoll, “Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk-Taking” (1993) vol. 38, no. 5 Villanova Law Review 1461-1516 (emphasizing the distortion induced by the deductibility of corporate interest expense generally in the context of the unintegrated corporate income tax in the United States). In the specific context of income trusts, see Lalit Aggarwal and Jack Mintz, “Income Trusts and Shareholder Taxation: Getting It Right,” paper prepared for the Capital Markets Institute, University of Toronto, September 2003, 24-26 (describing the limited presence of the “four fastest growing and highest yielding sectors [that is, (1) professional, scientific, and technical services; (2) wholesale trade; (3) manufacturing; and (4) administration, waste management, and remediation services] in the income trusts universe”). The authors also note that 43 percent of the income trust sector grew more slowly and returned less than the economy; only 8.5 percent of the sector grew faster and returned more than the economy.
An Equity Recharacterization Rule as a Target-Efficient Response to Income Trusts

Over- and Under-Inclusiveness of the Alternatives to an Equity Recharacterization Rule

As alternatives to an equity recharacterization rule, some of the literature describes the broad design features of a range of possible legislative responses to income trust transactions.42 Those responses include

1. the replacement of the partially integrated corporate income tax with a system of full integration in order to realize greater consistency in the treatment of interest, dividends, and capital gains;
2. the characterization of a broad range of trusts as corporations in order to realize consistency of treatment of corporations and trusts;
3. the extension of the thin capitalization regime to a range of indebtedness held by tax-exempt entities; and
4. the application of some form of investor-level tax to the income of tax-exempt entities from trust units.

With the exception of point 1, the precise details of any of these possible responses have not been explored at length in the literature. Nonetheless, certain fundamental problems are acknowledged. At a general level, the most significant shortcoming of each of the four possible responses is their target inefficiency. That is, the design features of the possible responses all fail, in one or more respects, to accurately reflect the features of income trust transactions that are perceived to present a policy problem that justifies a response. The inaccuracy results in problems of both over- and under-inclusiveness.

For example, the replacement of the partially integrated corporate income tax with some form of full integration addresses the three standard perceived biases associated with partial integration. As noted already, those biases include, but are not restricted to, those that induce the debt-equity substitution that is the focus of income trust transactions. The adoption of a system of full integration is thus an over-inclusive response to income trust transactions in that it addresses these transactions along with a broad range of other transactions and decisions outside the income trust context. In other words, the policy arguments that support fundamental reform are, in fact, entirely independent of the narrower issues presented by income trusts. Therefore, the efficiency, equity, and revenue effects of broader reform measures, which are intended to eliminate the relevant tax-law boundaries and realize consistency of tax treatment, should be assessed independently of the

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42 A comprehensive canvassing of possible responses is provided, for example, in Hayward, supra note 25, at 1555-60, and McDonnell, supra note 5, at 20-25.
narrower effects associated with the narrower substitution problem presented by income trusts.  

Similarly, consistency in the treatment of trusts and corporations generally implies a range of transactions in which the former is substituted for the latter outside an income trust context. As a result, such a response would again be over-inclusive. Perhaps most obviously, real estate investment trusts (REITs) can arguably be distinguished from income trust transactions, at least as the policy problem presented by the latter is framed in this paper. Although the matter is not free from ambiguity, the policy that underlies the conduit treatment of REITs, and mutual fund investments generally, for both individual investors and tax-exempt entities appears to be a desire to avoid the tax wedge and associated distortions otherwise imposed by a corporate income tax that is only partially integrated. Conduit treatment essentially permits the realization of certain efficiencies associated with the pooling of portfolio investment while maintaining consistency of tax treatment with a direct holding of the underlying assets in unincorporated form. In this respect, mutual fund status (and the conduit treatment following from such status) is limited, for tax-exempt entities in particular, by a set of defined conditions that can be seen as an attempt to ensure that the cash flows for the holder of a trust unit largely mimic those that would be associated with a direct portfolio holding of an interest in the underlying assets. In effect, the boundary between conduit treatment and separate-entity treatment is defined for tax-exempt entities by these conditions. For REITs, the relevant conditions are generally those for closed-end mutual fund trusts—in particular, the definition of eligible fund assets, which includes real estate; the requirement that trust units be listed on a prescribed stock exchange in Canada (for REITs only); and the limitation on the holding of securities of a single issuer (not more than 10 percent of fund property).

Moreover, the extension of corporate status to a range of trusts would be under-inclusive, since the same result associated with the basic income trust structure is realized with “direct holdings structures,” in which the use of a trust as a pooling mechanism is eliminated and investors hold directly a combination of high-yield junk debt and a specified number of shares of the issuer (referred to as “income

43 For a comprehensive and critical review of the case for reform of the unintegrated corporate income tax, see Brooks, supra note 40.

44 See McDonnell, supra note 5, at 14-15 (distinguishing income trusts and royalty trusts from REITs on the basis that real estate is an eligible investment for tax-exempt entities, but the underlying businesses that are the subject of income and royalty trusts would otherwise be ineligible investments in the absence of the interposition of the corporate form).

45 This reasoning apparently underlies the exclusion of REITs from the 2004 budget proposals. There has been some debate in the United States regarding the robustness of the comparable conditions limiting conduit status for REITs. See Martin A. Sullivan, “Passive Activity or Active Passivity? Rising REITs Rock the Corporate Tax” (2003) vol. 99, no. 9 Tax Notes 1298-1301; and Tony M. Edwards, “REIT Analysis Was Wrong on Many Counts,” letter to the editor (2003) vol. 99, no. 12 Tax Notes 1851-52.
deposit securities” or “IDSs” and “income participating securities” or “IPSs”). These structures realize the same avoidance of the unintegrated portion of the corporate income tax without any significant loss of non-tax attributes. They have the additional benefit of avoiding the unlimited liability issue connected with the basic income trust structure, while reducing some of the complexity associated with that structure.46

The extension of the thin capitalization regime also suffers from the over- and under-inclusiveness attributable to the standard features of such regimes. Perhaps most importantly, over-inclusiveness arises to the extent that all indebtedness of an issuer corporation, not just high-yield junk debt used in income trust transactions, is accounted for in a denial of the corporate interest deduction. Under-inclusiveness arises to the extent that the rule applies only to debt held by tax-exempt entities, debt held by significant shareholders, and debt that exceeds a specified debt-equity ratio.

The same problem of under-inclusiveness plagues any possible response, such as the 2004 budget proposal, that takes the form of an investor-level restriction on the holding of trust units by tax-exempt entities or, alternatively, an investor-level tax applicable to the income stream on such units held by these entities. In particular, this type of response affects only the tax clientele for an income trust issue; it leaves in place the tax-induced substitution for investors who are taxable individuals. The result would be a dampening of the income trust market, not its elimination. The problem is compounded by a failure to extend the relevant restriction or tax to all substitutable forms of trust units and the full range of tax-exempt entities.47 Moreover, a holding restriction permits continued access to tax-favoured securities, while much the same type of limited access is available if an investor-level tax is not set at an amount that approximates the highest marginal rate on dividend income for taxable individuals on direct share holdings.

With respect to the broad design features of a legislative response that is target-efficient, income trusts present a classic example of the need to draw a boundary between two different tax treatments where the precise details of the boundary at any given point lack obvious normative content. Given the lack of such content, the precise dimensions of the boundary will inevitably have an element of arbitrariness. On the assumption that these kinds of boundaries are not to be eliminated in the short to medium term, certain recent literature draws on the insights of optimal

46 See supra note 5. IDS and IPS structures would also avoid the application of the 2004 budget proposal limiting the holding of trust units by registered pension funds. Other than the characterization of these securities as foreign property in a cross-border context using the IDS structure, there is no obvious regulatory constraint for tax-exempt entities on the acquisition of such securities as eligible investments. Direct holdings structures also avoid the potential tainting of the flowthrough status of a mutual fund trust that occurs where the trust can be considered to be maintained primarily for the benefit of non-residents.

47 For example, the 2004 budget proposals do not extend the restriction on holdings of trust units to RRSPs. The tax policy rationale for this failure is unclear. See Jeff Rubin, “Why Feds Clamped Down on Income Trusts,” Globe and Mail, March 29, 2004.
tax theory as the basis for an approach to line drawing that enhances efficiency.\(^{48}\) Very generally, this literature suggests that deadweight losses associated with the maintenance of boundaries in the tax law can be minimized by taxing close substitutes consistently in an effort to realize a level of “transactional neutrality.” This general approach addresses the revenue loss attributable to the substitution of lower-taxed for higher-taxed forms of transactions, while eliminating the transaction costs of such substitutions. Moreover, to the extent that the substitution involves sacrifices in non-tax factors, increasing the tax on the lower-taxed substitute eliminates the welfare losses associated with these sacrifices. The difficulty for tax policy makers is the identification of close substitutes along those boundaries with little normative content. These identification problems are especially problematic if there is a range of alternative transactions that are imperfect substitutes. If such transactions exist, increasing the tax on a lower-taxed substitute to equal that on a higher-taxed form may only lead to the substitution of alternative transactions that are lightly taxed but have associated implicit taxes attributable to their imperfect substitutability from a non-tax perspective. Tax policy makers must identify, therefore, both the range of close substitutes that can defensibly be taxed similarly and the range of alternative transactions that provide imperfect substitutes. These latter transactions should be taxed differently only if the sacrifice in non-tax factors is significant enough to constrain their substitutability for higher-taxed transactions. In effect, tax-law boundaries should be drawn where tax policy makers can have some confidence that identified non-tax factors serve as a robust constraint on instances of imperfect substitutability.\(^{49}\)

**Broad Design Features of an Equity Recharacterization Rule**

Arguably, there is only one possible response to income trusts that is target-efficient in the sense that its focus would be limited to the common feature of these structures that is the source of the policy problem they present. All income trust structures implicate the tax-law boundary between debt and equity. A target-efficient legislative response would recharacterize as equity\(^{50}\) the high-yield, subordinated


\(^{49}\) Schizer, supra note 27.

\(^{50}\) But see McDonnell, supra note 5, at 24 (describing an equity recharacterization rule as “a fairly radical approach” that “would seem best suited to direct investments by [tax-exempts],” even though “the advantages of this approach for Canada are not immediately apparent”). It is not entirely clear what reasoning, if any, supports any of these assessments of an equity recharacterization rule. I suggest here that such an approach is not radical, at least in the sense of a reform measure that implicates broad structural features of a tax system. Moreover, the approach would address both direct and indirect holdings of high-yield junk debt and, as I argue here, could be targeted to affect only those instances in which it is used in the context of income trust structures or substitute structures such as IDSs and IPSs. Conceptually, at least,
junk debt used in these structures, with the debt being treated as equity for resident issuers and all holders.\footnote{51} Equity recharacterization could be applied to the whole of the income stream associated with an affected instrument, or it could be limited to the return in excess of some specified threshold. If the latter result is chosen, the impact of the application of an equity recharacterization rule would, of course, be lessened because it would allow the deduction of some of the interest expense on high-yield junk debt.

The core feature of an equity recharacterization approach would be a legislative description of the attributes of a debt instrument that, as part of an income trust structure, serves as an equity substitute. Taken cumulatively, the following attributes tend to provide a cash flow pattern that is a close substitute for the cash flow pattern associated with a share investment and, in particular, the expected return in the form of dividend payments:

- the indebtedness provides a fixed yield in excess of some benchmark rate for a riskless instrument;
- the indebtedness is unsecured;
- the indebtedness is subordinated to third-party debt;
- the indebtedness provides for the deferred payment of accrued interest when there is insufficient current cash flow; and
- the indebtedness and any shares of the issuer corporation are held proportionally.

A focus on these enumerated attributes of a debt instrument raises problems of potential over-inclusiveness only to the extent that such attributes are found in debt instruments outside of income trusts. Although one or more of these attributes may, in fact, be found in debt instruments generally, there seems to be no systematic evidence that all of them are found together in the same instrument in a context outside of income trust structures.

This proposition, if correct empirically, suggests that an equity recharacterization rule would be potentially over-inclusive only if the conditions of such a rule were expressed disjunctively. In that case, the presence of one or more of the

\footnote{51} The same kind of targeted response suggested here was adopted in the United States in 1989 as a solution to the similar problem presented by LBO transactions. See the US Internal Revenue Code of 1986, as amended, section 163(i) (recharacterizing as a non-deductible dividend a specified portion of the discount on applicable high-yield discount obligations [AHYDOs]).

I assume that any response, including an equity recharacterization rule, would be limited to resident issuers (or non-resident issuers who carry on business in Canada). If the issuer is a non-resident and has no other connection with Canada that would attract source-basis taxation, the loss of revenue is that of another government and, if it is considered problematic, should be addressed by that other government. The equity recharacterization rule should arguably not apply to resident holders of high-yield debt of non-resident issuers. Otherwise, such debt would potentially be classified inconsistently by two countries and give rise to the possibility of double non-taxation, depending on the treatment of interest expense in the issuer’s country of residence and the treatment of dividend distributions by Canada for particular resident holders.
attributes could result in an equity recharacterization, and it might be necessary to add a mandatory condition in the definition requiring that an affected instrument be issued as part of an equity recapitalization. In effect, the presence of one or more of the specified attributes would be sufficient to result in an equity recharacterization if the affected debt instrument was issued as part of an equity recapitalization. However, the addition of this kind of condition creates an obvious focus for tax-planning strategies, whereby some temporal distance could be introduced between a refinancing and the issue of a debt instrument with one or more of the defined attributes. The substitution of a transaction with this temporal distance would involve the incurring of transaction costs and would be induced entirely by the expression of the targeting of the tax definition of affected debt instruments. Furthermore, it could result in the failure to apply an equity recharacterization rule to a range of income trust transactions, resulting in a problem of under-inclusiveness.

In the absence of evidence that debt instruments with all of the above-described attributes are used in transactions outside of income trust structures, the preferable definitional approach would focus on these attributes as the defining conditions for the application of an equity recharacterization rule and reject the adoption of an explicit requirement that an affected instrument be issued as part of a debt-for-equity recapitalization. In short, the requirement that the attributes exist together in an instrument does not appear to result in problems of over-inclusiveness. Indeed, it is not at all clear that instruments with these attributes bundled together should be treated as debt solely because of their legal form, whether or not they are issued as part of an income trust transaction involving an explicit debt-for-equity refinancing.

A focus on the above attributes of equity-like debt may, in fact, be more susceptible to problems of under-inclusiveness. Under-inclusiveness will occur when debt instruments are used in transactions that yield the same result as that associated with a basic income trust structure but are not affected by an equity recharacterization rule. Problems of under-inclusiveness seem to arise from three possible sources. The first source is the specification of the attributes that must exist for the application of the rule. In particular, the requirement that all of the above-described attributes be present in an instrument before the application of an equity recharacterization rule is triggered raises the same problem as an additional condition requiring that an instrument be issued as part of a debt-for-equity recapitalization. Here again, the focus would shift to the massaging of transactions to eliminate one of the required attributes in an effort to avoid the application of the equity recharacterization rule. To prevent this response, the definition of the affected instruments should be drafted with a focus on those attributes that are indispensable to the use of equity-like debt in income trust transactions. In effect, such attributes represent a non-tax friction or constraint on the substitution of alternative transactions using high-yield debt. In this respect, the one attribute that appears to have this necessary characteristic is a fixed yield in excess of some specified benchmark interest rate. In combination with the yield, the presence of one or more of the other attributes tends to support a presumption that the indebtedness serves as an equity substitute. For example, the definition of affected indebtedness could be extended
to any debt instrument with the specified yield characteristic and one of the other features—the lack of any security, subordination to third-party debt, or an interest-deferral feature. To avoid problems of over-inclusiveness, the rule may specify that affected indebtedness in all cases should also be held proportionally with shares of the issuer. This condition supports further the presumption that the affected indebtedness serves as equity.

A second source of potential under-inclusiveness in an equity recharacterization rule is the precise articulation of the attributes of an affected instrument, particularly where those attributes are considered necessary for the application of such a rule. The two attributes that most obviously present this potential under-inclusiveness are (1) the requirement of a fixed yield in excess of a specified benchmark interest rate, and (2) the requirement that the affected debt be held proportionally with shares of the issuer. With respect to the first attribute, two legislative pressure points are readily apparent (and there are no obvious non-tax factors that would constrain planning focused on these pressure points). One is the legislative definition of a fixed yield that falls within the legal definition of interest and is otherwise deductible for an issuer as interest expense. The concept of a fixed yield could be used as a proxy for the identification of an income stream that would otherwise fall within the legal definition of interest for income tax purposes. A difficulty with using the concept of a fixed yield in this way is that, depending on the precise legislative articulation, an element of contingency might be introduced in a return to avoid the legislative condition but maintain treatment as interest for income tax purposes. It may be possible, however, to avoid the under-inclusiveness that would result from the use of a fixed-yield condition by tracking the relatively broad definition of a fixed dividend yield in the definition of a “taxable preferred share.”

An alternative definitional approach would simply express the yield requirement as any yield on a debt instrument that is treated as interest for income tax purposes.

The other legislative pressure point is the definition of the threshold yield that determines the application of an equity recharacterization rule. This definition invariably involves the specification of a quantitative bright line, where small changes in the expected yield can result in disproportionately different tax results. This “cliff effect” could be avoided by scaling the application of an equity recharacterization rule on the basis of the amount by which the expected yield on an instrument exceeds a specified benchmark rate. For example, the effect of the rule could be limited to a portion of the yield relative to the amount in excess of a benchmark. However, problems of under- or over-inclusiveness arise when the bright line is relatively higher than or relatively close to the specified benchmark rate. Still, this problem may not be serious, at least to the extent that other specified attributes must be present in support of a presumption that an affected debt instrument serves as equity.

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52 For a discussion of the legal definition of interest and its application to high-yield junk debt in the context of income trusts, see Cannon, supra note 31, at 4:8-13.

53 See subparagraph (b)(i) of the definition of a “taxable preferred share” in subsection 248(1).
Similar targeting problems arise with a requirement that affected indebtedness be held in proportion to shares of the issuer. To avoid problems of under-inclusiveness, the requirement should probably not be expressed in terms of a quantitative bright line. Indeed, such a bright line does not suggest itself as obviously with this requirement as it does with a requirement that the yield on a debt instrument exceed a specified benchmark rate. To constrain planning focused on a proportionality requirement, the legislative expression could be cast in general terms—for example, a requirement that the affected debt be issued or acquired in circumstances that make it reasonable to expect that it will be held in rough proportion to shares of the issuer.54

A third, and arguably the most important, source of potential under-inclusiveness of an equity recharacterization rule is the exclusive focus on high-yield junk debt as the application mechanism. As indicated earlier, the rule can be designed so that it accurately targets the features of a basic income trust structure that are perceived to create a policy problem; it would also ensure the consistent treatment of stapled securities structures that are used as close substitutes for income trust structures. However, a focus on high-yield junk debt invites the use of substitute transactions that realize the same result as a basic structure without the need for such debt to strip out corporate earnings free of the unintegrated portion of the corporate-level tax.

In this respect, royalty trusts and income trusts with a partnership structure are two well-known substitute transactions. The royalty trust structure realizes the same result as an income trust, but with the use of a deductible royalty payment rather than a deductible interest payment on high-yield junk debt. Because income trusts and royalty trust transactions have the same revenue and efficiency effects, consistent treatment of the tax-driven equity substitution should be a minimum requirement of any legislative response.55 With a legislative response targeted to

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54 Where the high-yield junk debt is stapled together with a specified number of shares of the issuer and cannot be separately traded, a requirement of proportional holding is not especially problematic. However, the IDS and IPS structures (described in notes 5 and 46, supra) were specifically developed to avoid the application of this same factor of proportional holding articulated in the US debt-equity case law. In particular, the component parts of IDSs and IPSs can be separately traded. In theory, at least, this means that the high-yield junk debt component may not necessarily be considered held proportionately with the shares of the issuer.

55 The 2004 budget proposals would not apply to royalty trusts, however. The May news release, supra note 3, indicates that the Department of Finance remains convinced that there is an important policy distinction between royalty trusts and income trusts. But the same arguments regarding the policy case for a legislative response to income trusts seem to apply equally to royalty trusts. The fact that a royalty trust involves the spinoff of a particular property rather than an ongoing business does not seem to suggest any significant differences in efficiency effects. In both instances, the relevant assets have tended to be mature assets with relatively stable cash flows. The one possibly significant difference, from a policy perspective, is that royalty trusts also permit the effective transfer to investors of deductions that are provided as tax expenditures to the oil and gas and mining sectors. It is not clear, however, that royalty trust transactions are a cost-effective and desirable means to permit such a transfer, particularly since
high-yield junk debt used in income trust structures, consistency of treatment between such structures and royalty trust transactions requires the extension of an equity recharacterization rule to royalty payments made in the context of the latter. To avoid problems of over-inclusiveness, the extension of an equity recharacterization rule could be expressed narrowly in terms of the asset sale and creation of a royalty interest in favour of a mutual fund trust that is the hallmark of the standard royalty trust transaction. The risk of such an expression is, again, the problem of under-inclusiveness that arises when the standard transaction can be massaged to avoid the application of an equity recharacterization rule. An alternative means of achieving the same effect as an equity recharacterization rule, while avoiding some targeting difficulties, is the limited use of a rule whereby a trust that holds a royalty interest is deemed to be a corporation. The integrity of this approach would depend to a considerable extent on the robustness of the existing tax-law constraint that requires certain tax-exempt investors to effectively acquire business assets through royalty interests held in an interposed trust. In effect, this constraint may be sufficient to ensure that direct holdings of royalty interests cannot be substituted for holdings through a royalty trust. The effectiveness of this constraint is potentially undermined, however, by its limitation to certain tax-exempt investors.

At noted above, many of the income trusts with a partnership structure continue to issue acquisition debt to strip out the expected return on assets held indirectly in a partnership through an operating trust and an upper-tier mutual fund trust. In the standard partnership structure, the debt is simply issued at the level of the operating trust, while the unexpected return is passed on by distributing the return on the partnership interest held by the operating trust to the upper-tier mutual fund trust and then to the holders of interests in that trust. As a result, an equity recharacterization rule that is focused on high-yield junk debt issued by a corporation in an income trust structure would have to target this variation of the basic transaction, presumably by extending the rule to such debt issued by resident trusts.

An obvious alternative to the standard partnership structure would replace high-yield debt at the operating trust level with some form of fixed income interest in the trust. This structure could realize the same effect, provided that income from the partnership was distributed currently by the operating trust to holders of the trust interests. If the form of the interest was respected as an interest in the trust and not indebtedness of the trust, an equity recharacterization rule would be under-inclusive. Another alternative structure would eliminate the interposed operating trust, and limited partnership units would be held directly by the otherwise upper-tier trust.

the benefit of the subsidy is limited to mature properties. Moreover, even if flowthrough of the relevant tax expenditures was considered desirable, royalty trusts simply replicate the effect of existing flowthrough shares. The redundant nature of these transactions is perhaps evident in the fact that any tax expenditure defence of them in no way supports their use to strip out the competitive return on a property, as well as any economic rent, from the unintegrated portion of the corporate income tax.
It is unclear whether there are any non-tax factors, either market-based or private-law-based, that would sufficiently constrain the substitution of these alternative structures. It may be the case that a need to maintain mutual fund status for the pooling entity and the tax-law restrictions on that status, as well as restrictions on the ability of tax-exempt investors to hold limited partnership interests, sufficiently constrain the use of these substitute structures. Nonetheless, as with royalty trust structures used as a substitute for the basic income trust transaction, it may be necessary to draft a specific rule for variations of the latter using a partnership structure and no high-yield debt. Consistent with the suggestion above regarding royalty trust transactions, one possibility is to deem the operating trust to be a corporation and rely on the tax-law constraints requiring the use of tiers of trusts to maintain mutual fund status for certain tax-exempt investors. Provided that these constraints remain robust, an equity recharacterization rule would not suffer from problems of under-inclusiveness as long as it was suitably supported with deemed corporate status for a limited range of trusts or partnerships. This proviso is a significant one, however, and any weakening of the relevant tax-law constraints or a lack of suitable supporting rules could readily lead to the direct substitution of the limited partnership form for the corporate form, exposing yet another boundary in the tax law.

56 See Ewald R. Kacnik, “Purchases by Income Trusts” (2003) vol. 11, no. 1 Canadian Tax Highlights 7; and Lewin, supra note 32.