Income Trusts and Shareholder Taxation: Getting It Right

Lalit Aggarwal and Jack Mintz*

ABSTRACT

The income trust sector, which has grown rapidly over the past three years, offers investors opportunities to finance investments on a more tax-efficient basis than conventional equity instruments. This paper, which updates a version prepared in 2003 for the Capital Markets Institute at the University of Toronto, provides a new estimate of the tax benefits to investors resulting from the income trust financing of corporations. Although many assumptions must be made to derive the estimates, the authors' best-guess estimate is that the federal and provincial tax benefits are in the order of $400 million to $600 million for 2004. The effect of income trust arrangements is to improve Canada's capital stock by $9 billion, although the benefits tend to accrue to businesses with low growth prospects and stable income. The tax policy implications are clear: the federal and provincial governments should create a level playing field to ensure that the tax system does not influence the investor's choice of business financing. The dividend tax credit for high-taxed corporate income should be increased to eliminate the discrimination against dividend-paying stocks.

KEYWORDS: INVESTMENT TRUSTS ■ CORPORATE TAXES ■ INTEGRATION

CONTENTS

Introduction	793
Background	795
Specific Tax Considerations	797
Corporate and Capital Taxes	798
Pension Plans, RRSPs, and Foreign Property Restrictions	798
Distributions	799
Cross-Border Investments	799
The Value of Tax Benefits Associated with Income Trusts	800
Economic Efficiency and Tax Proposals To Improve It	811
An Evaluation	812
Policy Options	813
Lowering the Personal Tax Rate on Dividends	815

* Lalit Aggarwal is a graduate student at Oxford University; Jack Mintz is the Deloitte & Touche LLP Professor of Taxation, J.L. Rotman School of Management, University of Toronto, and president and CEO, C.D. Howe Institute, Toronto.

Other Solutions 817
The 2004 Budget Proposal To Limit Pension Plans' Income Trust Holdings 817
Conclusions 818

INTRODUCTION

The recent growth in income trust financing of corporate capital, which accounted for a market capitalization of close to $79 billion for the sector by April 2004, has raised old questions about the taxation of shareholder income in Canada. Income trusts are in part a manifestation of a tax system that does not fully integrate corporate and personal income taxes on shareholder income so that investors can choose to hold corporate securities independent of tax effects. Our task in this paper is to assess the impact of income trusts on economic efficiency and to suggest reforms that would create a more neutral tax system—one that would not distort the allocation of capital financing among different types of businesses.[1]

The taxation of shareholder income has undergone considerable change since capital gains taxation was introduced in the tax reform of 1972. Interest on debt securities is deductible from corporate taxable profits and fully taxed in the hands of investors. Dividends are not deductible at the corporate level and are subject to personal income tax. Since 1972, a dividend tax credit has offset corporate tax levied prior to the distribution of profits, so that the investor pays corporate and personal income tax on distributions at the same rate as personal tax on interest income. The effect of the dividend tax credit is to establish tax neutrality between equity and debt financing of corporations. Until recently, capital gains, after being partially excluded from income, were assessed at same tax rate as dividends, so that high-income investors would be less indifferent between paying out profits as dividends and reinvesting them in the corporation.

However, the dividend tax credit is based on the small business corporate income tax rate (about 20 percent),[2] which creates tax neutrality only for small Canadian-controlled private corporations (CCPCs) that are fully taxed. Therefore, for large corporations that pay tax at rates above 20 percent, the dividend tax credit fails to

1 The original version of this paper was prepared in September 2003 for a conference held by the Capital Markets Institute, University of Toronto. This revised version reflects comments given to us at the conference as well as a paper prepared by HLB Decisions Economics Inc. that provides some additional analysis extending our own earlier paper: see HLB Decisions Economics Inc., "Final Report: Risk Analysis of Tax Revenue Implications of Income Trusts," reference no. 6799, prepared for the Canadian Association of Income Funds and Canadian Institute of Public and Private Real Estate Companies, March 11, 2004 (available online at http://www.caif.ca/ and http://www.cipprec.ca/). We have also incorporated some discussion of recent federal budget changes with respect to limitations on pension plans' holdings of business trusts.

2 The small business tax rate applies to the first $300,000 of active business income earned by a Canadian-controlled private corporation. The benefits of the low rate are clawed back when the corporation has capital that is more than $10 million ("capital" is the base used for the large corporations tax). Investment income and the profits of public corporations are fully taxed.

fully integrate corporate and personal taxes. For example, a large company will find it cheaper to raise capital from debt than from conventional preferred or common equity (tax-exempt institutions such as pension plans also favour debt financing for tax reasons, since interest is deductible at the corporate level and dividends are not).

As is discussed in more detail below, the development of real estate, royalty, and business income trusts is in part a result of the inadequate integration of corporate and personal income taxes for large corporations. Although non-tax benefits accrue to businesses and investors who arrange income trusts, the tax benefit effectively eliminates the unintegrated portion of the corporate tax by the conversion of equity into debt, royalty payments, or lease financing. Because the income trust is a tax-exempt vehicle whose distributions of income are subject to tax paid by the investors,[3] companies have been able to lever ownership of assets used by operating companies with payments made to investors who hold a greater mixture of debt and equity securities through the income trust, often eliminating any corporate tax payable by the operating company.[4]

The tax policy issue is whether income trust arrangements that have exploited the non-neutral treatment of equity and other financial flows create specific economic distortions that undermine the efficiency of capital markets in Canada. On the one hand, to the extent that companies are able to obtain cheaper financing because of tax efficiency, they will face a lower cost of capital for investment, thereby improving Canada's capital stock and productive capacity. On the other hand, if only certain types of corporations are in a position to take advantage of income trust arrangements, capital is allocated to those companies that are able to raise capital through income trusts. In this paper, we empirically evaluate the tax benefits of income trust arrangements. Although any estimate is difficult to measure, some specific economic distortions are implied by the growth of income trust financing in Canada in that capital has been allocated to businesses operating in an environment of slower growth and low rates of return to investment.

Given our understanding of the economic impacts of income trust arrangements, we consider tax amendments to reduce non-neutralities in the tax treatment of different forms of corporate financing, an issue raised by the report of the Technical Committee on Business Taxation.[5] Our recommendation is to modify the dividend

---

3 Income trusts are subject to tax if taxable income is not distributed to investors. Undistributed income held by the trust is subject to tax based on the top personal tax rate.

4 Income trust arrangements have also led to the avoidance of capital tax payments in cases where the income trust owns assets that are leased to the operating company. Unlike limited liability partnership arrangements that similarly eliminate the unintegrated corporate income tax (since income is only subject to tax accruing to the partners), income trust units can be held by investors as Canadian investments in registered retirement savings and pension plans, thereby increasing their attractiveness in the retail market. Limited liability partnership units are treated as foreign property and are therefore less attractive to registered plans, which can hold only 30 percent of their assets in foreign property.

5 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998).

tax credit regime so that corporate and personal income taxes are better integrated, thereby improving the climate for conventional equity finance and creating a more tax-neutral environment.

BACKGROUND

The income trust segment has grown to a market capitalization of approximately $79 billion as of April 2004 from $15 billion in May 1999.[6] The number of issuers has more than doubled from 65 in May 1999 to 135 at December 31, 2003. As a result, income trusts represented 7 percent of the entire capitalization of the Toronto Stock Exchange in 2003. Of total Canadian equity issuance, income trusts accounted for 41 percent in 2002, 37 percent in 2001, and 12 percent in 2000.[7] The trend toward income trust arrangements is even stronger than it was in 1997, when income trusts accounted for 29 percent of equity financing.

Two predominant developments underlie the recent popularity of the asset class. The first is a change in investor sentiment toward growth equities after the decline of the NASDAQ by almost two-thirds from a peak in spring 2000. The second is the corporate-governance scandals in the headquarters of such market stalwarts as Enron, WorldCom, Tyco, and Adelphia. One might expect equity risk to drive investors into short-term fixed-income instruments; instead, income trusts became popular because of their cash distributions and the average unit yield (as much as 5 percentage points higher than government debt securities). The sector appears to be an ideal compromise for discouraged investors who are seeking lucrative cash flows.

Income trust units offer higher valuations for two reasons: increased liquidity for investors and tax efficiency. All else being equal, higher-quality businesses offer a higher valuation to investors by paying out not only a return on capital but also the return of capital as a cash distribution, leaving the reinvestment of distributed profits in the hands of the investor. The value of the units is bid up because the investors perceive a lower risk in the distribution. Prevailing low interest rates are also a key variable in determining the value of an income trust. Tax efficiency arises primarily from a reduction in income and capital taxes paid by the corporation. "[A] subordination feature attached to units retained by existing equity owners may enhance the value of the units offered to the public. Similarly, improving tax efficiency can increase a unitholder's after-tax cash flow, thus increasing value."[8] Strong investor demand, the rate environment, and structural advantages all increase the attractiveness of the income trust, which transforms assets originally valued at

---

6 Scotia Capital, "Income Trusts: Competitive Longterm Returns" (mimeograph, Toronto, 2003). The income trust market had grown to more than $70 billion by early 2004. By December 31, 2003, 135 income trusts were publicly traded.

7 Michael R. King, *Income Trusts—Understanding the Issues*, Working Paper 2003-25 (Ottawa: Bank of Canada, September 2003).

8 See "Why an Income Fund?" in *Goodmans' Guide to REITs and Income Funds*, available online at http://www.goodmansincomefunds.com/index.htm.

5 to 6 times EBITDA (earnings before interest, taxes, depreciation, and amortization) into assets worth 10 to 12 times EBITDA. It is no surprise that issuers, who are rationally trying to maximize the value of their assets, are quick to adopt such structures.

Business trusts are the fastest-growing sector in the income trust segment (see table 1) in comparison with the more traditional royalty trusts and real estate investment trusts (REITs). Royalty trusts and REITs represented 90 percent of the market in 1995, but they now account for only about 50 percent. Businesses that sell such items as telephone directories, hamburgers, and mattresses represent the popular form of income trust, although business trusts have been in place for many years. In essence, business trusts attempt to emulate characteristics shared by royalty trusts and REITs—namely, the sustainability and predictability of cash flows. These characteristics are often what private equity investors seek when they pursue leveraged buyout (LBO) opportunities. Some market participants consider a conversion to an income trust a method of achieving a public market LBO.

Canadian retail investors and mutual funds are the two main players in the market, although attractive yields continue to appeal to non-resident investors and, in the case of Provident Energy, have raised concerns about a potential violation of the mutual fund trust requirements. Pension funds participate in the segment, but to a lesser degree than they do in the equity markets, principally because of concerns about the unlimited liability framework that governs traditional trust structures. Pending legislation should alleviate these concerns; it proposes to protect unitholders of publicly traded trusts by affording them the same protection against personal liability that shareholders of a corporation have. This legislation was tabled in Ontario before the 2003 election, and ought to remain a top priority for the new government. Alberta is introducing limited liability, and other provinces are considering whether income trusts should be eligible for limited liability protection.

With respect to the composition of retail investors versus mutual fund investors in income trusts, there is a bias toward retail investors. According to sources at Merrill Lynch, this is due to questions about underlying business stability as well as the liability issue mentioned above. With respect to investors that hold income trusts, the market is fragmented. On one side there are the traditional issuers (pipelines, real estate, etc.) and on the other the riskier business trusts. The more traditional income trusts are said to be "institutionally geared" because of the perceived longer life, stability, and visibility of the underlying assets. In terms of allocations, the traditional income trust market is 30 to 40 percent institutionally held and 60 to 70 percent retail, while the business trust market is about 10 to 20 percent institutionally held.[9] This estimate is supported with data obtained from CIBC, which provide a breakdown of the offering allocations for new issues.[10] In a sample

9 Provided in conversation with professionals at Merrill Lynch.

10 Ibid.

TABLE 1 Income Trusts: New Issues

	1999	2000	2001	2002	2003*	Total
			number			
Energy	9	13	23	21	6	72
Consumer	1	0	4	17	4	26
Power	5	2	7	6	2	22
Industrials	1	0	4	15	2	22
REITs	5	7	19	18	2	51
Resource	1	0	0	5	2	8
Utilities and Infrastructure	2	2	5	6	2	17
Total	24	24	62	88	20	218
			percent			
Energy	37.5	54.2	37.1	23.9	30.0	33.0
Consumer	4.2	0.0	6.5	19.3	20.0	11.9
Power	20.8	8.3	11.3	6.8	10.0	10.1
Industrials	4.2	0.0	6.5	17.0	10.0	10.1
REITs	20.8	29.2	30.6	20.5	10.0	23.4
Resource	4.2	0.0	0.0	5.7	10.0	3.7
Utilities and Infrastructure	8.3	8.3	8.1	6.8	10.0	7.8

* Data as of April 22, 2003.

Source: Scotia Capital, "Income Trusts: Competitive Longterm Returns" (mimeograph, Toronto, 2003).

of 24 representative transactions, on average, about 63.75 percent of the initial investor base is retail. These numbers are particularly important when one tries to understand the tax implications of the income trust segment, especially since the tendency is for investors to buy and hold such issues instead of actively trading them.

SPECIFIC TAX CONSIDERATIONS

An income trust is a mutual fund trust for the purposes of the Income Tax Act. The income trust must meet four criteria: (1) it must have Canadian-resident trustees; (2) it must limit its activities to passive investing (although it can hold both Canadian and foreign property); (3) it must act in accordance with specified conditions (its units must be qualified for distribution, and it must have a minimum of 150 holders holding 100 units, each having a value of at least $500) relating to the distribution and ownership of its units; and (4) it must not be established or maintained primarily (more than 50 percent) for the benefit of non-resident persons. Once the mutual fund trust is established, the trust units are sold to investors, who are the beneficiaries.

The income trust is a flowthrough vehicle for tax purposes. Income earned by the trust flows through to investors, who will pay tax on dividends, interest, or capital gains earned by the trust. The unitholders must also pay capital gains taxes on changes to gains realized from the sale of the units.

Four specific tax issues arise with respect to the income trust arrangement: (1) payment of corporate income and capital taxes; (2) qualification as an investment for registered retirement savings plans (RRSPs) and registered education savings plans (RESPs), deferred profit-sharing plans, and registered retirement income funds (RRIFs); (3) the taxation of distributed and undistributed income held by the trust; and (4) the taxation of cross-border investments.

Corporate and Capital Taxes

The basic structure of an income trust is consistent across all industries. A Canadian-resident trust indirectly purchases either a business or income-producing assets using the proceeds garnered from the public offering of trust units. The trust, however, also acts as a lender to the operating company and capitalizes the firm with a serviceable debt load that reduces or eliminates the amount of equity capital required. This is in essence what private equity funds do when an LBO is structured, although they often rely on external lending and supply only the equity capital. Since interest payments are tax-deductible, the taxable operating company effectively reduces its tax liability by paying interest on the loan to the trust. Should there be a seasonal boom in revenue one year, it is possible that some of the operating income will not be sheltered by the interest payments to the trust. As a result, the operating company will incur a tax liability, since operating companies pay taxes according to the regular rules for corporations. The after-tax proceeds in such an instance, however, might lead to a dividend stream to the trust.

The income trust arrangement employs a similar technique to shelter income in the less common instance where the trust acquires the assets from the operating company and leases them back to it. The lease payments are deducted from operating income generated at the operating company level, thereby reducing corporate income taxes payable by the operating company. If the assets are held by the trust rather than the operating company, an additional tax advantage arises by virtue of the avoidance of capital tax payments to federal and provincial governments. Given that the trust is a non-taxable flowthrough vehicle that is not subject to either corporate income taxes or capital taxes, the resulting distributions to unitholders are often a mixture of interest income, dividend income, lease payments, capital gains, and even returns of capital packaged at the trust level.

Personal income taxes, however, are applied to income received by unitholders. If the beneficiary of the income trust distributions is a non-resident, withholding taxes apply to dividend, interest, royalty, and rental payments. Distributions are also taxable in the hands of the corporate investors, and therefore they are not eligible for the intercorporate dividend exemption.

Pension Plans, RRSPs, and Foreign Property Restrictions

If the income fund is a mutual fund trust, its units will be a qualified investment for RRSPs, registered income funds, registered pension plans (RPPs), deferred profit-sharing plans, and RESPs.

For qualifying tax-assisted savings plans, the income may be exempt from taxation. The tax treatment of pension and RRSP income operates in the following manner. Tax is applied to withdrawals of income and principal from the RRSP or the RPP. However, an investor can deduct contributions to income trust funds if they are placed in a registered asset. As long as tax rates do not vary over time and the income trust's risk-adjusted returns are no different from returns on alternative investments, the present value of taxes owing on registered savings plans is zero, implying that the income is equivalently exempt. We assume this to be the case when we empirically assess the tax implications of income trust arrangements, which implies that any gains in tax efficiency accrue to the business through a lower cost of capital. However, as discussed later, we provide an alternative analysis that allows the investors to fully capture efficiency gains.

If, on the other hand, income trusts were treated as foreign property they would be less attractive, since registered funds must hold less than 30 percent of their investments as foreign property or be subject to a penalty tax.

The income trust itself can invest in foreign property, although its investments in shares and debt of a corporation will be determined to be foreign property if their value is directly or indirectly derived by primarily (50 percent) foreign property or if the corporation has a "substantial Canadian presence." The second requirement can be satisfied by a number of tests, including Canadian incorporation, the presence of an office in Canada, and a sufficient number of employees in Canada.

Given its eligibility for tax-assisted saving plans, the income trust has been more favourably accepted by the market than limited liability partnerships, for example, which otherwise accomplish a similar objective of reducing corporate income taxes but are treated as foreign property for RRSPs and pension plans.

Distributions

If a trust distributes less than its taxable income to unitholders (which would have to be possible under its trust indenture terms), the undistributed amount is subject to tax in the trust and is possibly subject to further tax to the unitholders on subsequent distributions. The double taxation of undistributed taxable income is a significant penalty that can be avoided by fully distributing taxable income.

Further, distributions in excess of taxable income may be made on a tax-free basis as a return of capital. The excess distribution reduces the tax basis of the unitholder's investment and contributes to a capital gain or reduces a capital loss when the unitholder disposes of the investment. The deferral of capital gains taxes until units are sold provides another tax benefit to unitholders when distributions are in excess of taxable income rather than reinvested in the operations of the company to earn future distributed dividends, which are subject to a higher rate of tax as dividends.

Cross-Border Investments

A recent trend is the growth of cross-border income trust arrangements, which we will address only briefly here. As discussed above, Canadian income trusts can hold

US or other foreign property and still qualify for the tax benefits discussed above.[11] The main issue that arises for cross-border income trusts is the US tax treatment of interest expense and withholding taxes. For a cross-border income trust to be tax-efficient, the operating company in the United States must be capitalized with debt to reduce US corporate income tax (dividend distributions can be remitted tax-free to the Canadian entity). US rules based on "substance over form" can result in debt being characterized as equity for tax purposes if the debt is viewed as substitute equity held by the investor. Given that income trust units derive a combination of income from bonds and equity held in the operating company, US rules could restrict interest deductions.

Further, even if debt is not characterized as equity, the US earnings-stripping rules could apply to related non-resident investors to limit interest expense deductions. These rules apply when interest is more than 50 percent of adjusted income (adjusted income is taxable income before the deduction of interest and depreciation) and the indebtedness is more than 1.5 times equity. Currently, the earnings-stripping rules are being reviewed by the US administration and Congress; it is possible that the ratio of interest expense to adjusted income will be reduced and the threshold at which the rules apply lowered.

The US withholding tax on interest applies unless ownership is less than 10 percent of the combined voting power of the payer and the fund is structured as a fixed investment trust for US income tax purposes, and the term of the notes cannot be renegotiated.[12] Dividends paid from current or accumulated earnings and profits to non-residents are subject to a withholding tax of 5 percent when paid to the income fund.

THE VALUE OF TAX BENEFITS ASSOCIATED WITH INCOME TRUSTS

The emergence of the income trust sector has triggered an emotional debate among market participants about the value to investors of the tax benefits of income trust financing and the associated tax-revenue impact on the provincial and federal governments. Despite the lack of a formal analysis by the Department of Finance, several observers have attempted to arrive at an actual number. Paul Hayward[13] estimates the loss to governments in corporate tax revenue at $1 billion. Avery

---

11 Cross-border income trusts, like other specific tax structures, can sometimes achieve other tax efficiencies. See Jack Bernstein, "Canada-U.S. Tax Arbitrage: A Canadian Perspective" (2003) vol. 30, no. 7 *Tax Notes International* 683-84.

12 See "U.S. Income Tax Considerations," in *Goodmans' Guide to REITs and Income Funds*, supra note 8. A fixed investment trust can hold securities in only one entity; a new offering of the fund units must be used to purchase common shares and subordinated notes of subsidiaries entities in proportion to the initial distribution of shares and notes.

13 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.

Shenfeld[14] argues that personal taxes offset most of the loss. A recent study by HLB[15] estimates that governments have lost virtually no revenue because of income trusts—possibly as little as $150 million in 2003 ($217 million if deferral effects are ignored). Hayward's and HLB's estimates provide the endpoints that frame our discussion. As we will describe in our analysis, numerous complexities are inherent in estimating the integrated tax impact of income trusts; the HLB study emphasizes that estimates are highly uncertain and difficult to make.[16]

In assessments of the tax benefits associated with income trusts, one must look at corporate and personal incomes separately. When corporations employ the trust structure to reduce the amount of income tax paid, the government loses revenue equal to the product of the aggregate net income of income trust funds and the weighted average corporate tax rate across all trusts. We estimate the loss in corporate tax by applying an effective tax rate on operating cash flow, which is derived from the historical financial and taxation statistics published by Statistics Canada, to the projected aggregate operating cash flow of the income trust asset class.[17] Most of this operating cash flow will result in distributions to trust unitholders. However, this ratio differs across REITs, royalty trusts, and business trusts. Likewise, the effective tax rate on operating cash flow differs across industries; since all industries are not represented in the asset class, it would be inaccurate to aggregate statistics. We attempt to correct for this inaccuracy by looking at different industries individually when possible and by using average corporate taxes as a proportion of the cash flow by industry.

Companies that convert assets into income trusts have extra cash on hand. The cash might be used to increase capital investments or to retire debt or equity. If debt is retired, governments may obtain some additional tax as a result of lower debt-asset ratios in conventional associated companies. We have no information, however, by which to judge whether cash is actually used to reduce debt or increase investments over time. Our assumption is that debt ratios do increase for the overall operations of the business.

Our estimated average corporate tax rate is 14.7 percent of cash flow. However, as the HLB study shows, some income trusts continued to pay corporate taxes that amounted to about 1.2 percent of cash flow, suggesting that the effective rate, on

---

14 Avery Shenfeld, "The Economic Benefits of Income Trusts," *Economic Perspectives*, CIBC World Markets, March 7, 2003.

15 "Risk Analysis of Tax Revenue Implications of Income Trusts," supra note 1.

16 The HLB study, ibid., uses a methodology similar to that used in our original paper, except that HLB provides a useful analysis that incorporates the uncertainty involved in making assumptions to obtain an estimate. Some assumptions in the HLB study differ from ours, and these will be highlighted later for the reader.

17 Such data aggregate taxpaying and non-taxpaying companies and may therefore underestimate true corporate tax costs for income trusts. However, even if we could match the actual corporate tax payments of operating companies before the income trust transactions, we would not know the true savings in the anticipated corporate taxes that were avoided by the creation of the income trust.

average, should be reduced to 13.5 percent. Further, the HLB study shows that, in the period prior to converting to an income trust, companies faced an average corporate tax rate of 9.2 percent, considerably less than the average industry rate. Although it is tempting to use this latter number, it is not necessarily indicative of the true corporate tax rate that will prevail after some assets are sold off to an income trust. For example, in the oil and gas sector, companies that are involved in exploration (and therefore pay less corporate tax owing to the availability of capital cost deductions and exploration tax credits) sell off discovered assets to trusts that exploit them. One would expect a typical profit and loss company involved in development and extraction to pay taxes at a higher rate, perhaps even above the industry average. Thus, the corporate tax rate is itself uncertain, and various calculations should be undertaken to consider the sensitivity of estimates to particular assumptions.

In addition to the decline in corporate income taxes paid, the income trust structure allows firms to avoid paying capital taxes if assets are transferred to an income trust. Although federal capital taxes are in the process of being eliminated, income trust financing can still result in a reduction of provincial taxes. Our estimates do not include capital tax revenue losses, since we do not know how many leasing arrangements were undertaken; however, we will later consider the implications that would arise if capital taxes were saved owing to income trust arrangements.

An analysis of the tax revenue impact of income trusts must extend beyond the evident reduction of the corporate tax base. There is a commensurate increase in the personal income tax base because trusts distribute pre-tax cash flow as more highly taxed interest rather than as dividends or capital gains to unitholders. These distributions are taxable at personal marginal income tax rates that are substantially higher than the otherwise applicable corporate tax rates.

Personal income taxes apply not to the whole yield earned in the income trust, but only to the distributions that are a return on capital. To measure taxable distributions, the ratio of distributions to pre-tax cash flow, using market-analyst estimates, is applied to EBITDA. Firms tend to allocate some portion of their operating cash flow to maintain capital expenditures and changes in working capital, resulting in a distribution ratio that is less than 100 percent. Further, some of the distributions paid from EBITDA that are in excess of EBITDA are a return of capital.

When the distribution ratio rises above 100 percent of taxable income, such that some portion of the underlying capital is returned to the investor, then no personal tax is collected on that part of the yield. However, a return of capital will affect the underlying cost/book basis of the trust, and as a result will have an impact on future capital gains tax calculations should the trust units be sold. It is important to distinguish between a return *on* capital and a return *of* capital. We do not explicitly adjust for this distinction in our calculation (which would be the difference between the personal tax rate and the accrual-equivalent capital gains tax rate), but we note that if we did, personal tax revenues would likely be lower.

An erosion of the corporate tax base and an increase in investment income tax receipts are the two main drivers of the overall net tax revenue impact of the income

trust sector. Although the amounts are relatively small, there is also a potential loss of capital gains and ordinary dividends to investors. Capital gains and dividends are features of traditional corporate structures; historically, they have driven nominal equity returns in a 70/30 proportion, respectively.[18] We account for the increase in personal tax collections due to income trust distribution above, but we must note that this distribution already encompasses what investors might ordinarily have collected as dividends through ownership of common shares. If we did not reduce the increase in investment income tax receipts by the decrease in taxes resulting from lost dividends, we would be overstating the net increase in personal taxes paid by the investors on distributions.

In addition to making the adjustment for lost dividends, we must also consider the issue of capital gains. In the case of income trusts, investors rely disproportionately on a consistent stream of income rather than on capital appreciation. As mentioned above, traditional equity investors have historically relied on capital gains for approximately 70 percent of their returns. The dividend yield has declined in recent years, and investors are increasingly anticipating higher capital gains to compensate themselves for the lower dividend portion of their total return. Although only 50 percent of capital gains are taxable in Canada, the net effect of the emergence of the income trust sector on tax receipts from capital gains is material. Given that capital gains taxes are paid only when units are actually sold, we calculate the accrual-equivalent capital gains tax paid each year based on a 10-year holding period for shares.

As discussed above, one can argue that income trust units offer the potential for capital gains as well; but from the limited historical data we have, we find that the average capital gain was 1.0 percent (with a standard deviation of 19 percent) from 1997 to 2001. This is substantially lower than what equity investors would expect; and given that holders of income trust units are more likely to experience risk as a result of missed or lower distributions, we feel that relying on capital gains from income trust units, although entirely possible in a volatile state, goes against the rationale behind the structure of these securities.

Therefore, we conclude that the aggregate tax revenue impact of the income trust sector has four primary drivers. The first is an erosion in the corporate tax base, which is somewhat mitigated by the second, an increase in receipts relating to the rise in interest income for unitholders. The third and fourth drivers—reductions in dividends paid and in capital gains realized—result in lower tax receipts. Our calculations suggest that the erosion in the corporate tax base, along with the reduction in dividends paid and capital gains realized, is not fully covered by an increase in interest income tax receipts. The result is some overall tax leakage for the sector.

---

18 In the period 1946-2001, the average arithmetic stock return was 12.8 percent in the United States, according to Jeremy J. Siegel, *Stocks for the Long Run*, 3d ed. (New York: McGraw-Hill, 2002); 8.7 percent of the return stemmed from capital appreciation and the remainder from dividends.

In looking at the three drivers above that relate to the investing community, one must consider a number of nuances when estimating the tax impact. Different holders will be subject to different tax rates (for example, pension funds versus non-resident investors). We divide our shareholder bases into three main components—institutional, retail, and non-resident investors. The institutional category is further divided into pension funds and mutual funds. We apply personal tax rates, weighted according to income tax bracket,[19] to our aggregate cash flow estimates in order to calculate the overall tax impact. Note that such tax rates apply only to the mutual fund and retail investor categories to the degree that the pension funds are tax-exempt and the non-resident investors are subject only to the 15 percent withholding tax (although certain distributions through mutual funds were exempt from the withholding tax until the recent federal budget). Although these tax rates apply to the mutual fund and retail investor categories, they do not apply to the entire amount of the cash flow received, since some proportion of such holdings is in tax-exempt retirement accounts. We estimate this number from the average household balance sheet as derived by Statistics Canada.[20]

Further, companies could use proceeds from income trust conversions to invest in new assets, to reduce debt, or to repurchase shares in related businesses. Our estimates do not account for these secondary effects, although in a later section of this paper we consider the long-term impact of income trusts on the growth in capital stock held by businesses that face a lower cost of capital owing to income trust arrangements.

Until this point, our focus has been on the primary drivers relating to the net aggregate tax impact of the income trust sector. A number of other secondary influences might affect the value of tax benefits to investors, but estimates of the impact of these influences are difficult to derive. For example, for business owners who want to convert their holdings into an income trust vehicle, some level of transitional capital gains tax is likely to be payable if some existing units are offered in an initial public offering (IPO). This is especially important as more entrepreneurs attempt to exploit the higher valuations available to them in the income trust sector as compared with the traditional equity markets. Also, because some distributions constitute a return of capital in addition to the return on capital that investors are more accustomed to, the underlying tax basis for original unitholders is changing. Should unit prices not track the book value of capital but instead result in some sort of multiple expansion with respect to that metric, one would expect a higher capital gains tax to be paid on a sale in the future. There are a number of issues of this nature that affect the net tax revenue impact of the income trust sector; we provide some further estimates below to complete our analysis.

Tables 2 to 4 illustrate the estimated impact of income trust arrangements on tax revenues. Table 2 estimates the corporate tax revenue loss based on the income

19 Data provided to us by the Department of Finance.

20 Statistics Canada, *National Balance Sheets*, catalogue no. 13-219-XDB (2003).

TABLE 2 Estimated Corporate Tax Revenue Impact

(A) Corporate tax loss	Operating cash flow (EBITDA), $ millions	Cash distribution/ EBITDA, %	Estimated distributions, $ millions	Taxes paid/ EBITDA, %	Corporate tax loss, $ millions
Business trusts	3,419.2	66.1	2,260.4	16.8	573.3
Power trusts	577.7	82.1	474.3	14.3	82.6
Resource trusts	1,127.8	76.6	863.7	17.4	195.7
Royalty trusts	2,328.2	80.2	1,867.1	10.2	237.5
REITs	1,989.7	57.1	1,135.8	15.1	300.4
Total trust universe	9,442.6	69.9	6,601.3	14.7	1,389.5

	Reduction in dividends	
	Dividends paid/ EBITDA, %	Estimated dividends, $ millions
Business trusts	17.8	607.5
Power trusts	14.6	84.1
Resource trusts	18.0	202.4
Royalty trusts	10.5	244.5
REITs	18.7	372.1
Total trust universe	16.0	1,510.5

(B) Capital tax loss: negligible

Note: We derive our EBITDA estimate for the income trust universe using the projections of research analysts at Scotia Capital. Of the 119 income trusts comprising the Scotia Capital Markets Income Trust Index in the August 2003 *Income Fund Monitor*, Scotia Capital has projected 2004 EBITDA for 50. Although these 50 income trusts make up only 42.0 percent of the universe on an absolute basis, on a market value basis this number rises to 63.6 percent. Using this data, we extrapolate to estimate aggregate EBITDA for the universe.

We calculate the distribution percentage using Scotia Capital estimates. In order to do so, we take the product of the number of units outstanding and the 2004 projected cash distribution per unit and divide this number by the EBITDA estimate for that particular income trust.

We estimate the proportion of EBITDA paid in taxes and paid out in dividends on a sector basis using data available from Statistics Canada in table 187 of the *National Income and Expenditure Accounts*.

trust's EBITDA, assuming that the arrangements fully eliminate corporate tax payments through leverage or leasing. The total corporate tax revenue reduction is estimated at $1.4 billion, on the assumption that operating companies would have otherwise paid taxes at the average rate of EBITDA as reflected for the industry. Table 3 illustrates the net personal tax loss to investors from income trust arrangements whereby the personal tax on interest and leasing income is more highly taxed than dividends and capital gains (the latter are measured according to an accrual-equivalent tax basis). The amount of personal tax paid depends on estimating a typical tax rate applicable to unitholders, taking into account assets held in tax-exempt form. We assume that the typical owner of income trusts is an investor who receives dividend income. The personal tax loss to investors is approximately $980 million on

TABLE 3 Estimated Personal Tax Revenue Impact

(C) Interest income tax gain, %		Estimated distributions, $ millions	Proportion held tax-exempt, %	Weighted average tax rate, %	Personal tax gain, $ millions
Institutional investors	25.6				
Pension funds	6.2	407.4	100.0	0.0	—
Mutual funds	19.4	1,282.6	52.3	34.0	208.2
Canadian retail investors	45.0	2,972.1	52.3	34.0	482.4
Non-resident holders	29.4	1,939.1	0.0	15.0	290.9
Total trust universe		6,601.3		14.9	981.4
(D) Dividend income tax loss, %		**Estimated dividends, $ millions**	**Proportion held tax-exempt, %**	**Weighted average tax rate, %**	**Personal tax loss, $ millions**
Institutional investors	45.9				
Pension funds	22.1	334.3	100.0	0.0	—
Mutual funds	23.8	359.1	52.3	17.7	30.3
Canadian retail investors	24.7	373.4	52.3	17.7	31.5
Non-resident holders	29.4	443.7	0.0	15.0	66.6
Total trust universe		1,510.5		8.5	128.4
(E) Capital gains income tax loss, %*		**Estimated capital gains, $ millions**	**Proportion held tax-exempt, %**	**Weighted average tax rate, %**	**Personal tax loss, $ millions**
Institutional investors	45.9				
Pension funds	22.1	1,114.4	100.0	0.0	—
Mutual funds	23.8	1,197.0	52.3	13.7	31.4
Canadian retail investors	24.7	1,244.6	52.3	13.7	32.6
Non-resident holders	29.4	1,479.0	0.0	0.0	—
Total trust universe		5,035.0		1.3	64.0

(Table 3 is concluded on the next page.)

interest income, offsetting the personal tax avoided on dividends equal to $130 million and accrual-equivalent capital gains taxes of about $65 million. Thus, the net personal tax revenue loss to investors is approximately $785 million.

The summary in table 4 shows that the federal and provincial tax benefits from income trust arrangements for investors are estimated at $600 million. As discussed, the estimate requires a number of assumptions, and we have undertaken some sensitivity tests to obtain a range of possible values (see table 5). First, we have estimated EBITDA to be about $9 billion for the income trust sector, which is 17 percent of capitalization (similar to the typical estimates of pre-tax rates of return on investments). We provide some sensitivity analysis related to cutting the EBITDA estimate, which would therefore shrink the estimate of tax losses.[21] Second,

21 The HLB study, supra note 1, reports EBITDA of $11.5 billion, higher than our amount.

TABLE 3 Concluded

* Current market yield	1.8%
Implied market value	$83,917,100
Stock market appreciation	6.0%
Total capital gains	$5,035,000
Inclusion rate	50%
Accrual rate	80%

Note: To estimate the non-resident ownership base, we use the proportion of savings of non-residents to total savings documented in table 46 of the *National Income and Expenditure Accounts*.

Our institutional versus retail investors estimate for the income trust sector is attributable to a CIBC World Markets sample of 24 representative offerings over the last year.

Tax-exempt ratio based on data from Statistics Canada. We exclude principal residences from the calculation.

Tax rates for interest, dividends, and capital gains are from the Department of Finance.

Our estimate of the institutional versus retail mix for the equity market comes from conversations with professionals at Merrill Lynch. Initial allocations tend to be kept to 15 to 25 percent retail; but with institutions liquidating in the secondary market to take advantage of the IPO discount, a fair estimate of stable institutional ownership is 60 to 70 percent.

We back into an estimate for the proportion that pension funds make up of the institutional shareholder base using the following methodology. On July 31, 2003, the market capitalization of the Toronto Stock Exchange was $795 billion. If we reduce this amount by the amount held by non-resident investors and Canadian retail holders, we are left with approximately $365 billion held by Canadian institutions. Reducing this amount by the IFIC data for balanced, Canadian common shares and dividend and income fund types on July 31, 2003, we are left with approximately $176 billion held by Canadian pension funds (or about 48 percent) of the institutional arena. With pension funds not participating in the income trust segment as vigorously as they do the traditional equity markets, we assume that their share of the institutional investor base in the income trust segment to be half that number, but we run a sensitivity analysis on it.

the personal tax rate on distributions may be higher than 34 percent if the income trust unitholder tends to be wealthier than the assumed investor who receives dividends. On the other hand, distributions of capital rather than income are untaxed and therefore would result in a personal tax rate lower than 34 percent on distributions. The tax is applied to income rather than to the return of capital, thereby lowering the personal tax applied to interest distributions. For example, if the effective tax rate is 25 percent on interest, the tax benefit associated with income trust arrangements rises to $785 million (with 0 percent adjustment in the size of EBITDA). Third, the portion of income trust held by tax-exempt pension institutions is reduced, which implies an increase in the effective personal income tax rate assessed on income trust distributions. If only one-quarter of institutional financing is provided by tax-exempt pension plans, the revenue loss will be $600 million. As a starting point, we suggest that the tax benefits associated with income trusts are in the range of $500 million to $700 million on the basis of the methodology and assumptions set out above. However, the estimate is highly uncertain and further adjustments are warranted.

TABLE 4 Estimated Net Tax Revenue Impact

		$ millions
(A)	Corporate tax loss	1,389.5
(B)	Capital tax loss	Negligible
(C)	Interest income tax gain	981.4
(D)	Dividend income tax loss	128.4
(E)	Capital gains income tax loss	64.0
	Net Impact	(600.5)

We have already highlighted several assumptions that affect our estimates. Because it is so difficult to estimate exactly the true tax benefits, it is useful to consider here the various adjustments that affect our base estimate.

- *Corporate tax rates:* As discussed above, our estimated corporate income tax rates are based on industry averages, not on the anticipated corporate tax rate that would be paid on assets not converted into a trust. As the HLB study points out, the estimated corporate tax rate may be overstated because the income trusts did pay some tax (about 1.2 percent of cash flows), and pre-existing corporate tax rates are lower than the industry averages. Although it is to be expected that the corporate tax paid on assets converted in trusts will be higher than pre-existing tax rates and even average corporate tax rates (since they are a blend of low-tax and high-tax assets), it is appropriate to consider some alternative calculations. For example, if the two corporate tax rates from the HLB study and the industry (9.2 percent and 14.7 percent, respectively) are averaged, and the average corporate tax rate of 1 percent on income trust is subtracted, the corporate revenue loss falls from almost $1.4 billion to $1 billion. When offsetting personal income tax payments are taken into account, the tax benefits to investors drop from $600 million to $250 million.
- *Capital taxes:* As mentioned, it is possible for the trust to own tangible and intangible assets and thereby collect leasing, royalty, and other payments from the operating company. Such payments allow the corporation to save not only corporate income tax, but also capital tax that is not payable by the trust. For example, if we assume $42 billion as a proxy for the book value of income trust financing that eliminates capital taxes, the tax benefit could be increased by $150 million (based on an average provincial capital tax rate of 0.35 percent on taxable capital and ignoring the federal large corporations tax, which will be phased out by 2008). This would imply that all income trust arrangements are implemented as leasing arrangements in which the income trust owns the assets. But even if only half of the assets were held by trusts, the capital tax savings would still be substantial.
- *Transitional capital gains:* When shares are converted into income trust units, capital gains taxes are paid on a one-time basis. However, the tax gain to the government is only the present value of taxes paid on capital gains realizations. We assume that shares are held for 10 years on average based on the

TABLE 5 Sensitivity Analyses

	Weighted average tax rate applied to interest income from trust units[a]				
Downside to EBITDA estimate, %	20%	25%	30%	35%	40%
	$ millions				
0	(885.2)	(783.7)	(682.2)	(580.8)	(479.3)
5	(840.9)	(744.5)	(648.1)	(551.7)	(455.4)
10	(796.6)	(705.3)	(614.0)	(522.7)	(431.4)
15	(752.4)	(666.1)	(579.9)	(493.7)	(407.4)
20	(708.1)	(627.0)	(545.8)	(464.6)	(383.5)
25	(663.9)	(587.8)	(511.7)	(435.6)	(359.5)
	Pension funds as a percentage of institutional investor base in the income trust market[b]				
Downside to EBITDA estimate, %	0%	25%	50%	75%	100%
	$ millions				
0	(534.3)	(602.9)	(671.5)	(740.1)	(808.6)
5	(507.6)	(572.8)	(637.9)	(703.1)	(768.2)
10	(480.9)	(542.6)	(604.3)	(666.1)	(727.8)
15	(454.2)	(512.5)	(570.8)	(629.0)	(687.3)
20	(427.5)	(482.3)	(537.2)	(592.0)	(646.9)
25	(400.8)	(452.2)	(503.6)	(555.0)	(606.5)

[a] Base case assumes a tax rate of 34.0 percent on interest income implied from the effective average dividend tax rate as calculated by the Department of Finance. The actual average effective tax rate on interest is approximately 24.9 percent.

[b] Base case assumes that pension funds are 24.1 percent of the institutional investor base. This is simply half of the 48.2 percent share of the institutional investor base that pension funds occupy in the traditional equity markets.

historical average float to the volume of shares traded on the Toronto Stock Exchange.[22] However, at a point in time, the average term of shares to be sold would be 5 years, assuming that the float and the volume of shares held are constant over time.[23] Given the implied capital gain of 15 percent[24] arising from the trust structure, the total one-time capital gains tax raised is $120 million. On an annual basis, the cost is $6 million per year, taking into account the typical interest cost of government debt.

- *Foreign ownership:* Our assumption is that foreign investors pay a 15 percent withholding tax on interest and dividends derived from trusts, while capital

22 Jack Mintz and Thomas A. Wilson, "Realization and Revenue Effects of Lifetime Capital Gains Exemptions" (1995) vol. 21, supplement *Canadian Public Policy* S174-92.

23 Specifically, the one-time tax gain can be calculated simply as $Tc = c(1 - a/(a + R))$, where c is the capital gains tax on realizations, a is the equivalent declining balance rate of selling off shares ($a = 2/T$, T being the average term in which shares are held), and R is the nominal discount rate. We take $c = 17.1\%$, $a = 0.4\%$, $r = 0.05\%$, so that $Tc = 1.9\%$.

24 The HLB study, supra note 1, provides this value.

gains are exempt (except for gains on Canadian property, which are subject to Canadian capital gains tax). However, capital gains from the ownership of real property held by non-residents through mutual funds, a primary form of investment, are exempt from withholding tax. The 2004 federal budget eliminates this exemption; therefore, trust income, inclusive of capital gains from property held in royalty trusts and real estate, will be subject to withholding tax. Further, we assume that foreign investors own approximately 30 percent of trusts, which may be somewhat low in comparison with the increase in foreign ownership of income trusts that occurred in the fall of 2003.[25] If foreign ownership were, for example, 35 percent of income trust assets, the tax loss to the Canadian government would rise by $60 million.

- *Tax-exempt holdings:* Pension and RRSP investment income is not taxed, since investors who deduct contributions from taxable income and pay tax on withdrawals of interest and principal pay no tax on investment income (taking into account the time value of money and the constancy of tax rates over time). Only if the risk-adjusted return on investments is more than the investor's discount rate will the investor pay some tax on a present-value basis. Normally, one expects that investors will hold assets with the same risk-adjusted rates of return—otherwise, they would specialize in holding securities with preferential returns.[26] If investors have assets that are converted into income trusts, and assuming that the transactions take place in the plan, the only extra tax collected by the government over time will be tax on the excess returns earned by the income trust units.

  What are those excess returns? We assume that once risk and transaction costs are adjusted for, securities will offer the same rates of return. However, if the income trust units provide for greater tax efficiency, it is possible that the investments could earn a return higher than conventional securities upon conversion into an income trust. Income trust tax efficiency would result from the reduction in corporate-level taxes. While the corporate tax savings could benefit the firm through a lower cost of capital, which would increase investment rates, it is also possible that the investors would benefit from higher valuations that reflected ongoing savings in corporate taxes. Assuming that all the tax benefits accrued to investors rather than to the firm through more investment, which would drive down returns to after-tax returns, owners of pension plans would be taxed on their yields over time. A straightforward

25 The foreign ownership of some trusts, especially royalty trusts, has increased to the 50 percent level. The increased foreign ownership of royalty trusts during the fall of 2003 was noted in a session held by the C.D. Howe Institute in Calgary.

26 The literature suggests that for tax reasons, investors would prefer tax-exempts to hold bond assets to avoid payment of personal income tax. However, tax-exempt plans could hold risky securities, since losses for tax purposes are effectively shared with the investor through the personal tax applied to withdrawals. See Jack Mintz and Michael Smart, "Tax-Exempt Investors and the Asset Allocation Puzzle" (2002) vol. 83, no. 2 *Journal of Public Economics* 195-215.

way of estimating the annualized taxes paid by owners of tax-exempt plans is to multiply the corporate tax savings by the proportion of wealth held in tax-exempt savings and the effective rate of tax on pension earnings (which we assume is 34 percent). We estimate that owners of tax-exempt savings would pay at most $55 million per year on their excess returns, owing to tax efficiency.[27]

- *Growth of the income trust sector:* Our estimate of tax benefits is based on income trust issuance of $42 billion at the end of 2002. However, the sector had grown by almost 35 percent by April 2004 to $57 billion in issuance, thereby suggesting a substantially higher revenue loss. For example, a $400 million tax benefit would increase to almost $540 billion.

To sum up, our base estimate of $600 million in annual tax benefits associated with income trust financing would be adjusted as shown in the accompanying table:

	$ millions
Base estimate	600
Lower estimated corporate income tax rate	-350
Capital taxes	+150
Transitional capital gains	-6
Foreign ownership	+60
Pension plan and other tax-exempt savings	-55
Net amount	399
Adjusted for growth in income trust sector	540

The tax benefit estimates provided, however, are very tentative; it is clear that many assumptions are needed to determine parameters. The HLB study looks at a range of estimates, and we think this is appropriate. Although we have arrived at an estimate of $400 million to $600 million in tax benefits associated with income trust structures, we believe that there is a wider range of possible numbers. However, our overall conclusion is that neither an estimate of close to zero nor an estimate of close to $1 billion in tax benefits is reasonable.

Nonetheless, further growth in the income trust sector will certainly provide more tax benefits, in an aggregate sense, to investors. This is specifically a concern to the government, since greater revenue losses raise important tax policy issues, not only for fiscal reasons but also with respect to capital market efficiency.

ECONOMIC EFFICIENCY AND TAX PROPOSALS TO IMPROVE IT

The emergence of income trusts has prompted questions about the implications for economic efficiency. Economic efficiency implies that investments, no matter

27 The HLB study estimates that the deferred taxes on the increased valuation of tax-exempt savings are $572 million for 2004. On an annualized basis, the amount would be $28 million, since this is a one-time hit. Our estimate is considerably higher but still relatively small.

how they are structured, should bear the same level of tax. Some observers argue that income trusts are valued by investors for putting cash in their hands to make portfolio decisions rather than leaving it in the hands of the corporate managers to make decisions on the investors' behalf. This may be correct, but in other instances corporations are in a better position to use cash flows in investments highly complementary to existing assets, thereby providing investors higher returns on their asset portfolios. In our view, the tax system should not distort payout decisions of businesses; the decisions are best left to markets to sort out.

An Evaluation

Economic efficiency is enhanced to the degree that tax benefits associated with income trust arrangements lower the effective tax rate on capital for businesses (which at present is roughly 30 percent, including corporate income, capital, and sales taxes on capital expenditures).[28] A lower tax cost would encourage investment. For example, if we assume that the tax benefits are $500 million for about $57 billion in new issues to finance investment, the cost of capital is reduced by 0.9 percentage points. Roughly, this corresponds to an increase of investment equal to $9 billion.[29]

Although a lower cost of capital is beneficial to firms in some ways, we must ask whether such financing opportunities are available to all firms without prejudice. One view is that the firms most likely to benefit from the income trust structure are those that are able to make large distributions to investors with high degrees of leverage financing. Firms that need cash flows to invest in capital will not want to use the income trust structure, since leverage will increase their risk and a penalty tax will be applied to undistributed taxable income. These features can entice a private equity investor into reconfiguring the capital structure of a target investment with increased debt to lower the overall cost of capital in an LBO. Target investments are mature but stable cash-generating firms that are under-leveraged and present the opportunity for operational improvements and that, as a result, are undervalued because of an unnecessarily high cost of capital and suboptimal margins.

The unintegrated portion of the corporate income tax has already led to some inter-firm distortions by favouring debt over conventional financing. Income trust financing vehicles provide an opportunity for businesses to use debt financing more easily, since the unitholders are the owners of both the equity and the debt—that is, the debt is not held by a third party. To the extent that income trusts are more easily used by certain types of companies, capital will be allocated to those that are able to take advantage of this form of financing. This could impair the efficiency of capital markets by directing capital to certain types of investments more suitable for income trust arrangements.

---

28 Duanjie Chen and Jack M. Mintz, *Taxing Investments: On the Right Track, but at a Snail's Pace*, C.D. Howe Institute Backgrounder no. 72 (Toronto: C.D. Howe Institute, June 2003).

29 This assumes that the elasticity of capital demand to the cost of capital is 0.5.

For the 10-year period from 1993 to 2002, total real output growth for all non-financial industries in Canada was 3.38 percent. The average return on capital employed for the same industries over the same period was 6.22 percent. Theoretically, and on a risk-adjusted basis, capital should flow to the fastest-growing and highest-returning investment opportunities. Of the different non-financial economic sectors as defined by Statistics Canada, only four both grew faster and yielded a higher return on capital than the economy as a whole. They are (1) professional, scientific, and technical services; (2) wholesale trade; (3) manufacturing and administration; and (4) waste management and remediation services. Although the manufacturing sector does boast some income trust issuers, its cyclical nature does not suit the requirements of cash flow stability of the income trust arrangement. The consumer and industrial sectors accounted for only a 20.4 percent weighting in the Scotia Capital Income Trust Index.[30] There is limited representation from the four fastest-growing and highest-yielding sectors in the income trust universe.

On the flip side, of the two sectors that both grew more slowly and yielded a lower return on capital than the economy as a whole, we find an abundance of income trust issuers. These two sectors are mining and oil and gas extraction (energy enjoys a 31.6 percent weighting in the Scotia Capital index alone) and accommodation and food services. Of the remaining 11 sectors, 5 grew more slowly than the economy but yielded a higher return on capital, while 6 grew faster than the economy but yielded a lower return on capital. The utilities sector and the agriculture, forestry, fishing, and hunting industries represent the slower-growing but higher-yielding income trust issuers, while the real estate and rental/leasing sector is the major income-trust-issuing sector that grew faster than the economy but yielded a lower return on capital.

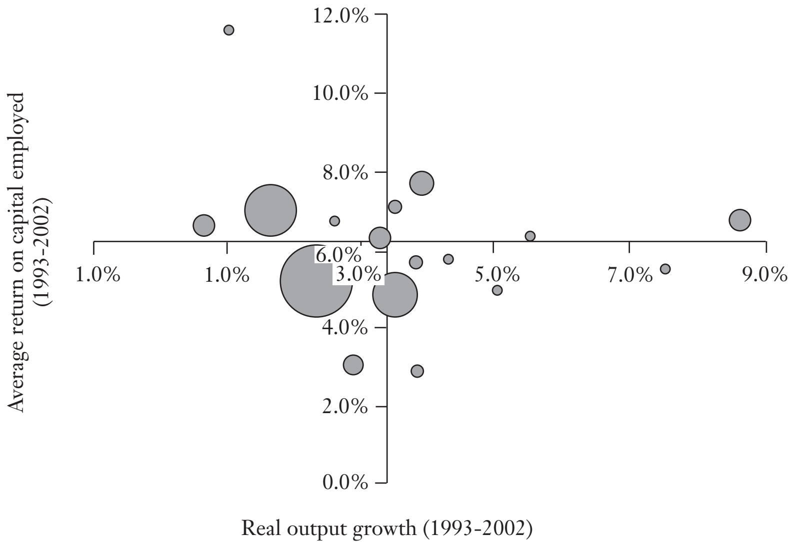
Although the income trust segment is still young in comparison with the traditional equity markets, the early indications are that the fastest-growing and highest-yielding sectors have not accessed this capital market, while the slowest-growing and lowest-yielding sectors have. From an economic efficiency viewpoint, this is a significant inter-firm distortion, especially since part of its causation lies in the unintegrated part of the corporate tax. With respect to real estate and rental/leasing, the lower return on capital could explain the price volatility in some issues such as the Legacy REIT, and it might suggest that not all types of properties are suitable for such arrangements. Figure 1 shows the relationship of the rate of return on capital, the growth of the sector, and the importance of income trust financing by industrial sector as represented by the size of the bubbles. Clearly, businesses with lower economic performance benefit more from income trust financing.

Policy Options

Given the economic efficiency issues raised above, what, if anything, should the government do about its tax policies? The issues related to income trust financing were

30 Supra note 6.

FIGURE 1 Inter-Firm Distortions in the Income Trust Sector



Note: Forty-three percent of the 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.

raised by the Technical Committee on Business Taxation in its report;[31] McDonnell,[32] Pesando et al.,[33] and Hayward[34] raise some tax policy approaches as well.

The income trust arrangement is, as discussed, a manifestation of high taxes imposed on conventional common or preferred equity financing because corporate and personal taxes on income derived from equity are higher than taxes on debt for all taxpayers, including tax-exempt institutions. Other structures could achieve the same aim of lessening the corporate tax to be paid by businesses, but income trust arrangements have been most popular because they qualify as RRSP and RPP investments.

Further, given that capital gains taxes are lower than dividend taxes, financing structures aim to replace dividends with capital gains to provide a tax-efficient source of income to investors. Companies that reinvest profits in a business obtain a tax advantage, since the reinvestment profits give rise to more lightly taxed capital gains.

31 Supra note 5.

32 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).

33 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).

34 Supra note 13.

The problem, therefore, does not rest with income trust financing but with the lack of neutral treatment of different forms of corporate financing. From a tax perspective, conventional equity financing is less favoured than reinvested profits because dividends are more highly taxed than capital gains. Leveraged income trust financing is more tax-efficient than conventional equity financing and even more tax-efficient than conventional debt financing if capital tax payments are also eliminated.

Neutrality among different forms of financing could be achieved, but it would require significant changes to the tax system.[35]

Lowering the Personal Tax Rate on Dividends

One possible approach is to increase the dividend tax credit to eliminate the unintegrated corporate income tax for corporations that pay tax at general corporate tax rate (small business income is taxed at a rate of approximately 20 percent). For example, by 2005 the top federal-provincial corporate income tax rate will be approximately 33 percent. If dividends were grossed up by a factor of 150 percent (instead of 125 percent) for personal income tax purposes and a combined federal-provincial tax credit of 33 percent (instead of approximately 20 percent) was imposed, corporate and personal taxes on dividends would be fully integrated. Income trusts would therefore provide little tax advantage over conventional common or preferred equity financing.

One difficulty is that the dividend tax credit is not tied to the amount of corporate taxes actually paid by businesses. In some cases, owing to tax incentives and other mismatching of actual and taxable income earned by corporations, the average corporate income tax rate may actually be below the statutory tax rates. A dividend tax credit provided at the top statutory corporate tax rate could over-integrate corporate and personal taxes. One might say that this over-integration is appropriate if tax incentives should flow through to investors. However, it raises some technical difficulties, since a higher dividend tax credit might lead to excess distributions of profits for tax reasons. One can avoid this result by trying to better match the corporate tax paid with the dividend tax credit, either by cutting back incentives or by imposing a corporate distribution tax that is creditable against corporate income taxes, with a distribution tax rate set to equalize the dividend tax credit.[36]

Three results would follow from this strategy:

---

35 Some radical changes, which will not be discussed here, include disallowing the deduction for interest expense and providing an interest tax credit similar to the dividend tax credit as an offset for underlying corporate income tax paid. Alternatively, dividends could be deductible from profits and fully taxed in the hands of investors. The latter approach would be contrary to income tax principles and could impair tax crediting by foreign governments for Canadian income taxes paid by their resident taxpayers.

36 See the *Report of Technical Committee on Business Taxation*, supra note 5, which recommended such a tax. The European countries used the "imputation" approach to better integrate corporate and personal taxes by assessing a corporate level tax to ensure that the dividend tax

1. The personal tax rate on dividends for upper-income investors would be close to 20 percent (net of the credit and adjusting for the dividend gross-up), somewhat less than that for capital gains, which would be taxed at close to 23 percent. The capital gains tax rate would have to be reduced further to limit the scope for taxpayers' converting capital gains into dividend income.
2. Tax-exempt assets (such as pensions) would still find income trust arrangements attractive, since these assets do not qualify for a dividend tax credit that would offset any corporate tax paid before the distribution of income. In principle, the appropriate policy response would be the provision of a refundable dividend tax credit, which would mean that pension plans and other low-taxed investors would receive a refund for corporate taxes paid (this has been done in some European countries in the past). The refund would match exactly the amount of corporate taxes paid by a company as long as distribution taxes were imposed.
3. Dividends paid by small businesses taxed at a combined federal-provincial corporate tax rate of 20 percent would be much more lightly taxed (once the new dividend tax credit was taken into account) than salary or other income. The latter issue is important: it is very difficult to increase the overall dividend tax credit to reflect higher corporate income taxes. One could address the small business integration issue by applying a corporate distribution tax on small businesses to increase the corporate tax payment on distributions to 33 percent in order to eliminate tax planning. Alternatively, a two-dividend tax credit regime could be introduced. The tax credit could be raised for dividends paid by all public and non-Canadian-controlled private corporations, which are taxed at 33 percent, and for dividends derived from "high-taxed" sources of income in CCPCs that are eligible for the small business corporate income tax rate of about 20 percent on active business income. CCPCs would therefore be required to create pools of high-taxed income (similar to another pool created for capital dividends) for the dividends to qualify for the higher dividend tax credit (the pool could apply to current and future high-taxed sources of income). Dividends paid from low-taxed profits to public or private corporations might have to be subject to a special distribution tax to bring the effective tax rate up to 33 percent.

Reducing the tax on dividends is appealing for other reasons, including the removal of tax distortions that apply to corporate payouts, equity financing, and corporate reorganizations. However, the dividend tax rate can be reduced only if adjustments are made to dividend taxes applied at the small business level where

---

credit reflected actual corporate taxes paid. However, the Europeans had to abandon the approach when rulings of the European Court of Justice suggested that the imputation systems in Europe discriminated against some EU nationals. Most European countries have some form of integration today—for example, giving dividend relief to national investors, although the relief is not tied to the actual corporate taxes payable.

corporate and personal income tax are integrated for active business income. Further, the lower dividend tax rate would not eliminate the incentive for tax-exempts to avoid corporate tax payments, since no (refundable) dividend tax credit is payable to tax-exempts.

Other Solutions

Other—and, from our perspective, less appropriate—approaches limit the scope for interest (and leasing) deductions at the corporate level but either restrict deductions for corporations or apply taxes at the investor level.

To reduce the tax arbitrage accomplished by income trust arrangements, interest deductions at the corporate level, which currently face few limitations, could be restricted. As is done in the United States, debt, if in substance it is the same, could be characterized as equity, thereby disallowing the interest expense as a deduction. In Canada, under the existing thin capitalization rule, interest deductions are disallowed on indebtedness in excess of twice the level of equity held by non-resident related taxpayers in Canadian corporations. A general thin capitalization rule could be introduced that would apply to indebtedness to resident or non-resident related parties. While this approach may be appealing as a way to limit tax arbitrage, it can create economic hardship in cases where high leverage is a necessity to conduct business (for example, for financial institutions, new companies, and failing companies with low equity values).

An alternative approach is to apply a tax at the investor level. For example, trust income derived from active business could be subject to a special tax (passive income would remain exempt). However, a credit would have to be provided when the income was paid to the investor. Otherwise, double taxation would result, and trusts would effectively be excluded from earning active business income. An alternative is to apply this special tax only on business assets held by pensions and other tax-exempt investors in order to eliminate the incentive to lease assets to corporations.

The 2004 Budget Proposal To Limit Pension Plans' Income Trust Holdings

In the 2004 federal budget, the minister of finance proposed that pension plans not be permitted to own more than 1 percent of their assets as business income trusts and no more than 5 percent of the units of any one business trust (REITs and royalty trusts would be exempt from this provision), beginning January 1, 2005. The rule would not apply to RRSPs. The minister has subsequently withdrawn the implementation of the proposal to provide an opportunity for consultation.

The rationale for the proposal is that it would reduce new demand for income trusts, since pension plans would find business trusts unattractive. However, we believe that this specific proposal is flawed for several reasons.

- Pension plans and RRSPs are already hampered by a number of policies, including foreign property rules, that compromise their financial performance. Further, since no refundable dividend tax credit is paid to pension

plans, the holding of income trust assets provides an opportunity to eliminate the corporate level of tax imposed on pension plan holdings. To eliminate corporate-level taxes, pension plans could instead own limited liability partnerships, but such investments are included in the foreign property limitation. The intent of tax-assisted savings instruments is to provide retirement income to workers, and policies that undermine the financial performance of pension plans will have a negative impact on retirees.

- Given that only the holding of business trusts by pension plans is limited, it is far from clear that markets will not simply sort themselves out so that pension plans hold REITs and royalty trusts while other investors hold business trusts. The proposed rule is less effective in its application because it focuses on only one type of investor.
- Rules that apply to pension plans but not to RRSPs have a long-run impact in distorting savings decisions. Businesses that choose to adopt money purchase pension plans could instead choose group RRSPs to provide retirement benefits for their workers. Group RRSPs are more costly to transact, but they provide greater flexibility to individuals than money purchase plans, which are commonly held by beneficiaries. If rules specifically discriminate against pension plans, then the tax system will have the unfortunate effect of distorting decisions between pension arrangements and group RRSPs.

We believe that reducing the dividend tax rate for corporations is the sensible means of improving economic inefficiency by moving to a more neutral tax system with respect to financing structures. A more fundamental reform would provide pension plans and RRSPs with a refundable dividend tax credit. However, the application of corporate-level distribution tax might be warranted to ensure that corporate taxes and personal taxes are fully integrated.

CONCLUSIONS

Income trust financing is in part a reaction to high taxes levied on equity financing due to the lack of full integration of corporate and personal taxes. Two economic-efficiency issues arise from income trust financing. First, such financing results in a lower cost of capital for businesses as a result of tax benefits received by investors. We estimate that tax benefits are in the likely range of $400 million to $600 million; this has provided a boost to investment. Second, income trust arrangements favour certain types of businesses that are best able to take advantage of the financing structure. Typically, these businesses are those with stable earnings. We find, however, that the industries that benefit the most from income trust arrangements are those that demonstrate lower economic performance, suggesting that income trust financing is distorting capital markets toward slower-growth companies.

Governments should seek to develop tax policies that are neutral among different forms of financing. We suggest that the Department of Finance consider cutting dividend taxes by enhancing the dividend tax credit for distributions from high-taxed sources of income in order to improve the efficiency of capital markets.