Income Trusts and Integration of Business and Investor Taxes: A Policy Analysis and Proposal

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PRÉCIS

Cet article porte sur l'imposition des fiducies de revenu au Canada et sur la question plus générale de l'intégration de l'imposition du revenu au niveau de l'entreprise et au niveau de l'investisseur. Les auteurs fournissent d'abord des renseignements généraux sur l'utilisation des fiducies comme véhicules de placement et d'exploitation d'entreprise au Canada, incluant la récente popularité des fiducies de revenu publiques. Ils fournissent ensuite des informations qui permettent de comprendre de façon générale la nature et l'imposition des fiducies de revenu et autres entités intermédiaires dans le régime fiscal canadien et les questions de politique fiscale que soulève leur utilisation. Certains avantages précis et des exigences associés à l'utilisation des fiducies de revenu pour exploiter une entreprise sont décrits plus en détail, incluant notamment l'avantage très important que représente l'intégration de l'imposition au niveau de l'entreprise et au niveau de l'investisseur en vertu de l'actuel régime fiscal. À partir de ces renseignements généraux, les auteurs élaborent un cadre analytique pour déterminer les approches possibles en matière de politique fiscale pour régler les problèmes que posent ces structures d'entreprise, et ce cadre est ensuite appliqué à l'évaluation de plusieurs approches possibles. L'une d'elles, élaborée et recommandée par les auteurs, fait appel à un crédit d'impôt pour dividendes remboursable et à un régime d'imputation fiscale des distributions des sociétés pour faciliter l'intégration de l'impôt sur le revenu de la société et des actionnaires. Cette approche est décrite et analysée en détail.

ABSTRACT

This article deals with the taxation of income trusts in Canada and the more general issue of integration of business-level and investor-level income taxation. It begins with background information about the use of trusts as vehicles for investment and business in Canada, including the recent popularity of public income trusts. It goes on to present

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information relevant to a general understanding of the nature and taxation of income trusts and other flowthrough entities in the Canadian taxation system, and the tax policy issues raised by their use. Some of the specific benefits and requirements associated with the use of income trusts as vehicles for carrying on business are described in more detail, including in particular the very important benefit of integration of business-level and investor-level taxation under the current income tax regime. From this background, an analytical framework is developed for determining possible tax policy approaches to the issues raised by these business structures, and this framework is then applied to evaluate several different possible tax policy approaches. One of these approaches, developed and recommended by the authors, uses a refundable dividend tax credit and a corporate distribution tax imputation system to greatly enhance integration of corporate-level and shareholder-level income tax for corporate businesses. The recommended approach is described and analyzed in detail.

KEYWORDS: INTEGRATION ■ TRUSTS ■ CORPORATE ■ DISTRIBUTIONS ■ INCOME TAXES ■ TAX REVENUES

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AUTHORS' NOTE

This article was originally prepared for symposiums on the subject of income trusts and other flowthrough entities, sponsored by the Canadian Tax Foundation and scheduled to be held on November 30 and December 8, 2005. We completed the final draft on November 22, 2005. The next day, November 23, federal Minister of Finance Ralph Goodale announced the removal of the moratorium on advance tax rulings from the Canada Revenue Agency for transactions involving income trusts (which had been put in place earlier in the year), and proposed legislative changes to the taxation of dividends received by taxable resident individuals from Canadian corporations, which would provide an increased after-tax return similar to the treatment of distributed earnings of income trusts. As a consequence of this announcement, the symposiums were immediately cancelled. A few days later, a federal election was called, resulting in a change of government in February 2006.

The removal of the advance rulings moratorium was effective upon announcement, but the fate of the legislative proposals remained uncertain. The May 2, 2006 federal budget has now proposed making the same changes to the taxation of dividends received by taxable resident individuals from Canadian corporations as were originally proposed in November 2005. If ultimately enacted in this form, these proposals would increase the dividend tax credit for eligible dividends paid by corporations to resident individual shareholders (assuming that the provinces follow along with matching changes) from 25 percent to 45 percent, thereby cutting taxes on dividends substantially. This higher dividend tax credit would lower the top personal tax rate on eligible dividends from 32 percent to 21 percent—slightly below the top tax rate on capital gains (currently 23 percent). Combined with the current 35 percent corporate tax rate, the overall top corporate and personal tax rate on dividends would decline from 56 percent to 49 percent, moving closer to, but still above, the average top rate of 46 percent on salaries and other income. The differential will be effectively eliminated by 2010 if the corporate rate reduction and elimination of the corporate income surtax proceed as proposed in the 2006 budget.

Under these proposals, dividends paid by small businesses from income taxed at a low corporate rate (approximately 20 percent), or from their investment income, would continue to qualify for the current dividend tax credit, while dividends paid from other business income would be entitled to the new increased dividend tax credit. This situation appears to require a new and complex legislative regime for identifying and tracking dividends paid from different sources of income as these flow from one corporation to another or directly to individual shareholders.

No legislative changes have been proposed for the taxation of income trusts and their investors, or of corporate distributions to either tax-exempt resident investors (such as registered pension plans, registered retirement savings plans, and registered retirement income funds) or non-resident investors. Thus, under the proposals, while taxable resident individual investors would face similar tax rates on earnings distributed as dividends and as trust distributions (roughly 46 percent by 2010), tax-exempt resident investors and non-resident investors—which together account for almost two-thirds of Canadian equity financing—would continue to prefer to hold trust units, as compared with shares, because they provide tax savings by eliminating corporate-level income taxes. Tax-exempt savings plans pay no tax on income trust distributions, while non-resident investors generally pay only a 15 percent withholding tax on such distributions.

Accordingly, it is our view that, while the proposed changes to reduce the income tax burden on corporate earnings paid as dividends to taxable resident individuals are a move in the right direction, because they would increase integration of corporate and shareholder taxation, they are fundamentally inadequate to deal with the important tax policy issues raised by the use of income trusts and other flowthrough vehicles in Canadian capital markets. As the analysis in our article demonstrates in detail, any such proposal that fails to take cognizance of or deal with the beneficial "integration" tax treatment of business earnings of income trusts flowed through to tax-exempt Canadian investors, such as registered pension plans and registered retirement savings plans and income funds, and to non-resident investors, will not substantially change the utility of income trusts in Canada.

As the article makes clear, the absence of a comprehensive change regarding the degree of integration of business-level and investor-level taxation applicable to all three major investor groups—taxable residents, tax-exempt residents, and non-residents—will fail to substantially alter the status quo, which provides income trusts with a marketable tax advantage over public corporations. In fact, the lack of measures to deal with the current tax regime for tax-exempt residents and non-residents will preserve the preference for income trusts, in Canadian taxation terms, by a large number of important investors, and will thus continue to encourage the conversion of existing corporate businesses to income trusts and the establishment of new income trust businesses. The only caveat that we add in this regard is that some businesses may continue to shy away from an income trust approach, or may make an incorrect business decision to convert to a trust, because of the "forced" requirement to distribute all taxable earnings of income trusts.

Our conclusion is reinforced by the vibrancy of the market for new income trusts after November 2005. For example, the *Globe and Mail* reported on April 7, 2006 that the market for new equity financings in Canada in the first quarter of 2006 rose sharply over the prior year, to $2 billion, "thanks largely to the introduction of new income trusts," including the largest initial public offering by a trust, to that date, of $235 million by Jazz Air Income Fund.

From this analysis, our article proceeds to set out a comprehensive proposal for substantially increased integration that would deal with distributions of earnings to both taxable and tax-exempt resident investors in Canadian public corporations, and at the same time suggests changes to be considered to tighten the income tax regime applicable to income trust earnings distributed to non-resident investors. This would make the income taxation for all resident investors in Canadian public corporations as good as or better than the regime applicable to investors in income trusts, while reducing the inappropriate benefit currently enjoyed by non-resident investors in income trusts as compared with corporations. The proposal would also eliminate the relative tax penalty on retention of income by income trusts. We acknowledge that our proposal is costly to governments and contains a fair amount of legislative complexity. However, the 2006 budget proposals would also be costly to governments (particularly because they introduce no effective limit on the continued use of the current income trust structure), and the proposed two-tier dividend tax credit would not be at all simple.

While, in our view, our article thus demonstrates that the proposals announced on November 23, 2005, and brought forward again in the 2006 budget, would fail to deal effectively with the ostensible subject of the announcement—that is, the key tax policy issues relating to income trusts—we do not wish to leave the impression that the proposals, taken by themselves, would not provide any positive tax policy results. We suggest that the announced changes would result in three main tax policy benefits.

First, with similar taxation of dividends and capital gains, Canadian individual investors would no longer prefer tax-saving, normal course share repurchases to dividend payouts. In addition, the scope for complex financial instruments that result from differential tax rates would be reduced.

Second, the lower tax on dividends would benefit investors with taxable equity securities, making it easier to accumulate wealth for retirement and other needs. Even resident individual investors in small business earning high-taxed business income would benefit from the increased dividend tax credit, thereby making it much less important to pay out salary bonuses each year to avoid the high corporate income tax rate (assuming the 2010 corporate rate reductions are implemented and the provinces increase their dividend tax credit for eligible dividends to match the federal proposal).

Third, the competitiveness of Canadian businesses and capital markets would be enhanced because Canadian corporations would find it easier to issue equities in Canada, compared with seeking US financing (which has become more difficult to attract since the Bush dividend tax cut to 15 percent reduced the cost of equity financing for shares sold to US investors).

In conclusion, we commend our article to the reader's attention, even assuming that the 2006 budget proposals are implemented as proposed, for three reasons: (1) our analysis of the tax policy and economic considerations relating to and driving income trusts and other flowthrough vehicles remains entirely relevant; (2) the issues we discuss in this regard remain open; and (3) we can expect to return to a public discussion of these matters in the not-too-distant future.

INTRODUCTION

The use of trusts owned by public investors as a vehicle for carrying on business and investment activities in Canada has grown rapidly in recent years. As of October 2005, trusts (usually referred to as "income trusts") with interests traded in Canadian public markets had a market capitalization of about $150 billion.[1] The rapid growth of the public trust form of business organization in Canada, as a conversion from or substitute for a public corporation, has been enthusiastically supported by a large group of investors and investment dealers, but at the same time has elicited concerns from government, regulatory experts, and some in the investment community itself. Following the release of a consultation paper on income trusts and other flowthrough entities by the federal government on September 8, 2005 and the subsequent announcement by the government that it would stop providing advance income tax rulings for income trust transactions,[2] income trusts have become even more topical for the business press and the general media.

The purpose of this article is to present an analytic framework for the major tax policy issues raised by income trusts and other flowthrough business vehicles in the context of the Canadian income tax system and to make suggestions for improving the current taxation of corporations and their shareholders to deal with these issues. It is our hope that this exercise will be broadly useful within the context of the consideration of this area that has been undertaken by the federal government.

As we have noted, this article was originally prepared for presentation at symposiums on income trusts and other flowthrough entities that were to have been held in November and December 2005.[3] It does not attempt to provide information about or analysis of the full range of issues presented by such entities. Many of these issues (such as the legal and tax differences between different forms of public business

1 See the report published by Canaccord Capital Corporation, "Trust Reform Hurts Canadians," October 26, 2005 (online: http://www.canaccord.com/). According to this report, market capitalization was $66 billion for oil and gas trusts, $53 billion for business trusts, $11 billion for power and pipeline trusts, and $22 billion for real estate investment trusts. According to the Department of Finance consultation paper, infra note 2, market capitalization at the end of 2004 was $118.7 billion, including a small number of limited partnerships that have units offered to the public.

2 Canada, Department of Finance, *Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)* (Ottawa: Department of Finance, September 2005) (herein referred to as "the consultation paper"). According to the joint press release issued by Finance Minister Ralph Goodale and National Revenue Minister John McCallum on September 19, 2005, advance income tax rulings on matters involving income trusts and other flowthrough entities would be "postponed" throughout the consultation period and "until the Government announces what action it may take." See Canada, Department of Finance, "Government Postpones Advance Rulings on Income Trusts and Other Flow-Through Entities: Emphasizes Importance of Consultations," *News Release* 2005-059, September 19, 2005.

3 The Symposiums on Income Trusts and Other Flow-Through Entities (herein referred to as "the income trust symposiums") were organized by the Canadian Tax Foundation/L'Association canadienne d'études fiscales and were to have been held on November 30, 2005 in Toronto and December 8, 2005 in Calgary. They were cancelled as a result of the announcement relating to income trusts made by the federal minister of finance on November 23, 2005: Canada, Department of Finance, "Minister of Finance Acts on Income Trust Issue," *News Release* 2005-082, November 23, 2005. In May 2006, the new government introduced proposals to make changes substantially similar to those in the November announcement. See Canada, Department of Finance, 2006 Budget, Budget Plan, May 2, 2006, annex III, 231-32.

structures and the place of these vehicles in capital markets and the economy) have been dealt with elsewhere.

In the next section, we present information relevant to a general understanding of the nature and taxation of income trusts and other flowthrough entities, and the tax policy issues they raise. From this background, we develop an analytical framework and then apply that framework to evaluate several tax policy approaches for dealing with some of the more important issues. One of these approaches provides the basis for a specific proposal for a major restructuring of business income taxation in Canada, which we then describe and analyze in detail.

TAX POLICY BACKGROUND

One of the most curious things about the use of income trusts in Canada as a public investment vehicle is their absence from the markets until comparatively recently. There is, of course, a fairly lengthy history of the use of trusts as vehicles for mutual fund investment, based on a specific regime established in the Income Tax Act (Canada),[4] and for passive investment in real estate—so-called real estate investment trusts (or REITs), which are also accommodated through specific provisions of the ITA.[5] The use of trusts as investment vehicles for resource properties is a more recent development, apparently dating from the mid-1980s, but the realization of the fuller potential of trusts as a vehicle for the conduct of active operating businesses seems to be much more recent: the Technical Committee on Business Taxation, reporting to the federal minister of finance in 1997, identified the increasing use of income trusts as a new development deserving future attention.[6] The rapid growth of the sector since the late 1990s has been attributed to a number of factors. While it is not the purpose of this article to document or analyze this growth in detail, it is important to include here a few key observations on the nature and use of income trusts, and some of the related taxation issues, in order to provide a context for the policy analysis that follows.

The Essential Nature of Income Trusts

What is an income trust, as the term is used for the purposes of this article? It must first be noted that "income trust" is not a term of art for purposes of taxation in Canada. Income trusts have been developed, and more or less defined, by the use of trust vehicles in public capital markets. In that context, an income trust can be described as a legal arrangement involving a trust relationship established under

4 Sections 132 through 132.2 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "ITA"). Unless otherwise noted, statutory references in this article are to the ITA.

5 See subparagraph 108(2)(b)(ii), which allows closed-end trusts that invest in real estate to qualify as "unit trusts" under the ITA.

6 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), 7.17.

provincial law for purposes of ownership and management of a business or investments or both. Under this arrangement, a trust controlled by a group of trustees is established for the benefit of investors who are its beneficiaries, and whose interests in the trust capital and income are represented by their ownership of publicly issued units in the trust. The trust then, directly or through other vehicles, owns and operates the investments and business of the enterprise. There appear to be no particular legal limitations on the use of these trusts as public investment vehicles, other than regulatory regimes of general application such as those governing the operation of vehicles with securities issued in public markets, though there are specific requirements for qualification for certain beneficial tax treatment associated with the status of "unit trusts" and "mutual fund trusts" under the ITA.[7]

As noted above, while trusts (and other flowthrough arrangements such as limited partnerships) have long been used as vehicles for public investment in assets such as marketable securities, real estate, and (more recently) resource properties, the important new development of the past few years is the use of trusts for investment in operating businesses, including manufacturing, processing, and service businesses that previously were, or normally would be, owned and operated through the use of a corporation with shares issued to the public. Moreover, absent non-tax regulatory considerations of general application or particular business considerations, there is no reason to conclude that there are any inherent limitations on the types of investments or businesses that could be owned through the use of a trust structure in Canada. The discussion and analysis in this article is focused primarily on this category of trusts because we recognize some historical and structural basis for separating out the treatment of REITs and similar investment vehicles. Nevertheless, we emphasize that strong policy arguments can be made in favour of treating all business and investment vehicles in the same optimum fashion for income tax purposes.

Of course, a critical aspect of trusts used as vehicles for carrying on business is the regime established under the ITA for the taxation of the income of a trust in its hands and on distribution to beneficiaries. This regime is, and has been for a very long time, fundamentally different from the taxation regime applicable to corporations that carry on business and their shareholders. As described in the consultation paper, business trusts are generally treated as a flowthrough vehicle for Canadian income tax purposes. This means that, generally, income earned by a trust is taxed once under the Canadian income tax system: income that is paid or payable to a resident beneficiary in the year it is earned is taxed at the combined federal-provincial marginal tax rate applicable to the beneficiary based on the beneficiary's income and other relevant

7 A "unit trust" is, generally, a trust with interests that are determined to be units redeemable at the option of the holder—that is, an open-end fund; however, a closed-end REIT resident in Canada can also qualify. See the definition of "unit trust" in subsection 108(2). A "mutual fund trust" is, generally, a unit trust resident in Canada the only undertaking of which is the investment of its funds (other than certain permitted activities for a trust investing in real estate), and which meets certain minimum requirements with respect to dispersed public distribution of the units of the trust. See subsection 132(6) for the definition of "mutual fund trust."

circumstances; income that is not paid or payable to a beneficiary in the year it is earned is taxed in the trust at the top combined federal-provincial marginal tax rate for individuals.[8] However, distributions of income previously taxed in the trust, and of invested capital and other cash or assets not representing deductible income of the trust, are treated as a return of capital when distributed to the beneficiaries, which results in a reduction of the beneficiary's cost base in the units of the trust for income tax purposes.[9] For non-personal trusts such as income trusts, this creates the possibility of further income taxation of undistributed income from previous years for taxable unitholders, which does not appear appropriate for a "flowthrough" entity. Of course, as we will discuss below, the retention of income by income trusts is exceedingly rare under the current income tax regime.

The structural elements of an income trust need to be carefully planned in order to obtain the benefits of this income tax treatment. In particular, the trust has to be structured so that the taxable income earned by its business is recognized in the trust itself and not in a lower-tier taxable entity such as a corporation. This is often accomplished by using a lower-tier corporation heavily capitalized by interest-bearing debt or similar means.[10] Some trust structures also provide the opportunity to reduce or eliminate liability for capital taxes.

8 See subsections 104(6), (12), and (13) and related provisions of the ITA for the rules dealing with the deductibility to a trust of income paid or payable to beneficiaries by the trust and the inclusion of that income in the income of the beneficiaries. We assume here and in the analysis that follows that income trusts are not, generally, subject to the additional tax liability that could result under part XII.2 of the ITA. Part XII.2 tax is exigible where a trust with non-resident beneficiaries or certain tax-exempt beneficiaries has income from certain sources in Canada (principally real property and specified resource properties), unless the trust is exempt by virtue of being a mutual fund trust. This exemption provision is one of the key reasons why income trusts are normally structured as mutual fund trusts.

9 See paragraph 53(2)(h) for the reduction of the cost base of an income trust unit to the unitholder based on a distribution of capital to the unitholder. There is no provision of the ITA that adds an amount to the untiholder's cost base to recognize income earned and taxed in the trust but not distributed in the year, though there is an exception to the paragraph 53(2)(h) reduction for amounts of capital paid to non-residents that are taxable under part XIII.2. This reduction in cost base results in double taxation of taxable resident unitholders on their share of such undistributed income: on disposition of the unit, the value of the income either increases the value of the unit and the proceeds of its disposition (if the income has not yet been distributed), or does not increase the value of the unit (if the income has been distributed in a year subsequent to that in which it was earned), but the reduction in cost base of the unit resulting from such distribution increases the gain or reduces the loss of the unitholder. This tax consequence may be compared with the treatment that applies to a partnership: the partners incur a cost base reduction in their partnership interest for distributions to them, but also receive a cost base increase for their share of the income of the partnership; thus, the partnership mechanism of adjustments to cost base of the partnership interest provides the appropriate result for a flowthrough entity, unlike the outcome for investors in an income trust. See subsections 53(1) and (2).

10 See the consultation paper, supra note 2, at 15-19, which describes the general structuring of income trusts using a wholly owned corporation to maximize the amount of taxable income

This overall tax treatment of income trusts (subject to the issue described above with reference to undistributed income) may be referred to as "flowthrough" or "conduit" treatment or as representing the "integration" of the taxation of business income at the two potential levels of taxation—the business entity level and the investor level. However it is referred to, this taxation of business income once at the investor's personal marginal tax rate should not be regarded as an aberration of trust taxation, but rather as one example of a broader range of situations where similar integrated income tax results obtain, including taxation of partnerships, individual proprietorships, and, generally, Canadian-controlled private corporations.[11]

Thus, income trusts receive, by virtue of their form as trusts, benefits of integration of business-level and investor-level income taxation that are not available to public corporations. In fact, to the extent that income trusts pay out all of their taxable income earned in a year, they receive the benefits of a fulsome form of integration. This can be illustrated by looking at the income tax treatment of distributions of trust income that applies to three different categories of income trust investors:

1. Taxable resident investors, including individuals with low marginal tax rates, pay income tax once at their applicable marginal rate of tax on their share of the trust's business income.
2. Tax-exempt Canadian-resident investors (such as registered pension plans [RPPs], registered retirement savings plans [RRSPs], registered retirement income funds [RRIFs], and other deferred-income plans) also pay tax on their share of the trust's income at their applicable marginal rate, which (since they are not taxable on investment income) can be taken as a rate of zero.[12]

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that is recognized in the trust while minimizing the amount of income that is recognized in the corporation. In addition to the use of deductible interest, the consultation paper refers to the possibility of using deductible lease payments and deductible royalty payments for the same purpose. Note that one important reason for an income trust to use a lower-tier business vehicle such as a corporation is the requirement that the only undertaking of the trust is the investment of its funds, so that the trust will qualify as a mutual fund trust. However, an income trust could, in theory, be structured using a second-tier partnership or trust arrangement, instead of the more common second-tier corporation, thus eliminating the need for any tax-deductibility-based arrangement such as interest-bearing debt, royalties, or leases.

11 A description and comparison of the income tax results in many of these situations was prepared by Jim Wilson for the income trust symposiums, but at the time of writing, remains unpublished.

12 In principle, income earned by RPPs, RRSPs, and RRIFs, and other deferred-income plans is taxed upon withdrawal of funds from the plan. However, contributors are generally able to deduct contributions to these plans from taxable income. If the tax saving arising from contributions is determined at the same rate as the tax paid on withdrawals, these plans are effectively tax-exempt on their investment income. However, as is generally observed in the literature, contributions to such plans may result in positive or negative effective tax rates on investment income if applicable tax rates change over time or the risk-adjusted rate of return on investments in these plans is more than the investor's discount rate (opportunity cost of funds).

3. Non-resident investors usually pay only a gross withholding tax in Canada on distributions made to them, though they may be liable to further taxation in their jurisdiction of residence.[13]

By contrast, shareholders of public corporations, and of private corporations that do not have access to the integration benefits referred to above, suffer a more onerous income tax cost on the corporation's business income. For these corporations, business income is subject to income tax once at the corporate level and then again at the shareholder level when that income is distributed to shareholders as a dividend, with only partial recognition—in the form of the dividend gross-up and tax credit available to taxable Canadian residents[14]—of the corporate income tax that may already have been paid. Further, if income is retained and reinvested in the corporation, the income generated is subject to corporate tax and, at the shareholder level, tax on capital gains that is exigible when a taxable shareholder disposes of shares. While tax-exempt shareholders and non-resident shareholders do not pay this second-level shareholder tax, they still bear the cost of their proportionate share of the corporate-level tax, with zero further tax on dividend distributions for the former and, generally, 15 percent withholding tax for the latter. This is an important point to which we will return later.

The current taxation of public corporations and their shareholders and of income trusts and their unitholders is generally illustrated in table 1. In this table and in tables 2 and 2A, three investor categories are identified, as described above: "taxable" refers to taxable resident individuals; "tax-exempt" refers to RPPs, RRSPs, RRIFs, and other similar taxpayers that do not pay tax under part I of the ITA; and "non-resident" refers to persons who are not residents of Canada and usually pay only Canadian withholding tax (assumed in these tables to be imposed at the reduced treaty rate of 15 percent).

13 Under paragraph 212(1)(c) and subsection 212(11), an amount of income of a trust paid or credited to a non-resident of Canada is subject to general part XIII gross basis withholding tax of 25 percent. This rate may be reduced in any particular case by application of the provisions of a Canadian bilateral tax convention. For example, under article XXII of the Canada-US tax convention, the rate of part XIII tax would be reduced for a payment of income from a Canadian-resident trust to US-resident beneficiaries to 15 percent for Canadian-source income and to zero for other income: see the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997. Note also the addition of part XIII.2 to the ITA, which requires a type of withholding tax of 15 percent of gains to be paid in respect of distributions of capital to non-resident holders of mutual fund units in certain defined situations.

14 The current ITA provisions for dividend gross-up and tax credit apply to dividends paid by Canadian-resident corporations when received by Canadian-resident individual shareholders. The amount of the gross-up is 25 percent of the actual dividend, and the federal dividend tax credit (DTC) is two-thirds of the amount of the gross-up. Provinces generally accept the same gross-up mechanism and determine their own portion of the DTC. Table 1 illustrates the current effects of this dividend gross-up and tax credit.

TABLE 1 Existing Tax Regimes for Corporations and Income Trusts

	Corporation/shareholder			Trust/unitholder		
	Taxable	Tax-exempt	Non-resident	Taxable	Tax-exempt	Non-resident
	dollars					
Corporation/trust						
Corporate/trust income	100.00	100.00	100.00	100.00	100.00	100.00
Federal corporate/trust tax @ 22%	22.00	22.00	22.00	nil	nil	nil
Provincial corporate/trust tax @ 13%	13.00	13.00	13.00	nil	nil	nil
Retained earnings	65.00	65.00	65.00	100.00	100.00	100.00
Dividend/distribution paid	65.00	65.00	65.00	100.00	100.00	100.00
Shareholder/unitholder						
Dividend/distribution	65.00	65.00	65.00	100.00	100.00	100.00
Gross-up	16.25	nil	nil	na	na	na
Federal personal tax @ 29%	23.56	nil	nil	29.00	nil	nil
Provincial personal tax @ 17%	13.81	nil	nil	17.00	nil	nil
Non-resident withholding tax @ 15%	na	na	9.75	na	na	15.00
Federal dividend tax credit	10.83	nil	nil	na	na	na
Provincial dividend tax credit	5.42	nil	nil	na	na	na
Net federal personal tax	12.73	nil	nil	29.00	nil	nil
Net provincial personal tax	8.40	nil	nil	17.00	nil	nil
Tax summary						
Federal tax	34.73	22.00	31.75	29.00	nil	15.00
Provincial tax	21.40	13.00	13.00	17.00	nil	nil
Total tax	56.13	35.00	44.75	46.00	nil	15.00

Note: Tax rates are based on federal-provincial rates for 2005, adjusted to produce an illustrative combined corporate income tax rate of 35 percent and combined personal income tax rate of 46 percent.

Integration: The Driver Behind Income Trusts

It is quickly apparent that the fulsome integration of business-level tax and investor-level tax enjoyed by income trusts, as presently structured and offered in Canadian capital markets, is subject to an important peculiarity. As discussed above, in order for an income trust to obtain these integration effects—in particular, to avoid paying high-rate tax at the business-vehicle level, including some possible double taxation of undistributed income—the trust must pay out all of its taxable income earned in a year to its investor-beneficiaries; otherwise, it will suffer what can only be a more onerous tax result. The retention by an income trust of taxable income in a year to be taxed in the trust would not be neutral (as compared with distribution of the income) even for unitholders who would be subject to the same top rates on their receipts of taxable trust distributions, because of the potential double taxation of this income. Other trust investors would be even worse off in this situation, because they would, in addition, have paid less tax on the income if it had been distributed. These other taxpayers are, in particular,

- resident individual investors who would pay tax at less than the top marginal personal income tax rate (generally, those with taxable income less than the top rate threshold of $115,740);
- resident investors that are exempt from tax on their investment income (primarily RPPs, RRSPs, RRIFs, and other deferred-income plans); and
- non-resident investors, who are generally subject only to withholding tax on their income trust distributions, in many cases at the reduced treaty rate of 15 percent.

There are, of course, a number of other rationales for the payout of all or a substantial portion of annual earnings by a business enterprise, in addition to income tax considerations. The most important of these, in our view, relates to the issue of control over the optimal use of the investors' money. In other words, in a properly governed and free market for capital, the business enterprise should continually be making a determination (with input from investors) as to the extent to which income (or capital available as cash flow) of the trust can be reinvested optimally by retaining it in the enterprise and thereby producing a higher rate of return on investment than investors could otherwise obtain individually. The opportunity and intentions of both existing and potential new investors should figure in this analysis, since it is open to the enterprise, all other things being equal, to make distributions to existing investors and obtain the funding for further investment with optimal returns from new investors in the market who are seeking those returns.

This approach to management of the business enterprise, while simple in theory, is obviously complex and subject to great imprecision in practice, because of the elements of risk, imperfect information, differences of and changes in circumstances, and the burden of transaction costs. For example, such an analysis should include the crucial question of whether and to what extent new or further investment in assets of the business such as machinery and equipment, technology, and employment needs to be made in order to provide a certain minimum market investment return, or improved return, to investors in future. Nevertheless, in spite of these practical challenges, the application of an approach that attempts to optimize the future return on current earnings of the business enterprise (which is discussed, together with other related factors, in more detail below) should result in a variety of different outcomes for different enterprises, ranging from full payout to no payout, with differences ranging both across enterprises and at a single enterprise over time.

It is thus reasonable to conclude that the full payout of taxable income by virtually all income trusts in Canada is fundamentally a consequence of something other than the application of otherwise sound business principles—that is, the applicable income tax regime. While other factors, such as imperfections in market information about the nature of income trust investments, a low interest rate environment, and the like, have also been suggested as driving factors behind the rapid growth of income trusts in Canada, it is our view that these should not be considered important dynamics in a proper open market over time.

The payout of all income annually (so-called forced distribution) has become the hallmark of the income trust structure as a vehicle for public investment in Canada. In addition, many or most of these trusts have established a pattern of paying back capital to unitholders to increase the annual cash flow returns to investors. It is important to note that, while this repayment of capital is more tax-efficient for trusts than for public corporations in Canada as a result of specific provisions of the ITA affecting the practice for these corporations,[15] the practice of returning capital to income trust unitholders is not "forced" by the income tax system in the same way as the distribution of income. The return of capital is a predominantly business-based decision (whether arrived at on a sound or unsound basis in any given case). As with the distribution of income, the payment or repayment of capital should generally depend on whether the enterprise has optimal business use for such funds—that is, whether, as these funds become available, they can be reinvested at a better rate of return in the activities carried on by the trust—or whether it is better left to investors to make the determination to reinvest or consume these funds on an individual basis.

The Purpose of the Corporate Income Tax

The use of income trusts in Canada in the manner described above, whether as conversions from corporations or as alternatives to them, results in a shift from corporate income tax and personal income tax on corporate earnings distributed to investors to primarily personal income tax on distributed earnings of an income trust. This raises a fundamental question long discussed in the tax policy literature: Why does the corporate income tax exist, and (a related issue) what is the purpose of integrating corporate and personal income taxes?[16] Here, we briefly review this literature as it pertains to the issues under consideration.

Three roles for corporate income taxes can be articulated:

1. *Backstop to the personal income tax.* One role of the corporate income tax is that it serves as a backstop to the personal income tax by withholding income tax at the corporate level. Without the corporate income tax, investors could

15 See ITA subsection 84(4.1) and related provisions and pronouncements, which impose substantial effective tax limitations on return of corporate capital to shareholders on a basis that is neutral for tax purposes.

16 The purpose of the corporate income tax is explained in Canada, *Report of the Royal Commission on Taxation*, vol. 4 (Ottawa: Queen's Printer, 1966), and in the *Report of the Technical Committee on Business Taxation*, supra note 6, at chapter 7.

shift their income from personal to corporate entitlement and avoid paying the personal income tax. If the personal income tax were applied fully to all sources of income accruing to investors, no corporate income tax would be needed. However, accrued capital gains are never fully taxed at the personal level, since this would require market valuation of assets in each taxation year and forced liquidation of assets for some taxpayers unable to meet their tax liabilities on accrued capital gains.[17] Instead, capital gains taxes are assessed when investors dispose of their assets, providing a deferral advantage to those who hold their assets for long periods of time. Investors thus have an opportunity to earn income at the corporate level, causing the value of shares to rise, but avoid paying personal taxes on that income currently since the accrued capital gains are not taxed. A corporate income tax levied at a rate similar to the personal income tax rate ensures that such earnings do not escape income taxation.

2. *Withholding tax on income accruing to non-residents.* The corporate income tax also serves as a source-based withholding tax on income that accrues to non-resident investors. Generally, dividends and capital gains earned by non-residents on assets held in Canada are taxed by the country of residence. In addition, Canadian withholding taxes on dividends are relatively low. As a result, without the corporate tax, this corporate income would be largely untaxed in Canada. Two justifications may be given for a source-based income tax on corporate earnings accruing to non-residents. First, a country should be entitled to some tax on income earned from a source in that country by non-residents, just as a matter of tax-base sharing between capital-exporting and capital-importing countries, especially if the capital-importing country provides public services that benefit businesses owned by non-residents.[18] Second, Canadian corporate income taxes are at times credited against corporate income taxes levied by capital-exporting countries, including the United States, the United Kingdom, and Japan. The elimination of corporate income taxes in Canada would result in higher taxes paid to foreign governments through these tax-crediting arrangements. Both arguments justify some withholding of tax on foreign-source income.
3. *Payment for public services.* A third justification for the corporate income tax is that it represents payment for public services that benefit corporations in

17 We note that full taxation of accrued capital gains is achieved for major financial traders who pay taxes on all of their business income, including accrued capital gains, under mark-to-market rules. However, it would not be possible to apply mark-to-market rules to all taxpayers. Alan Auerbach has proposed an approach to the taxation of accrued capital gains at the personal level whereby the investor, on disposing of the asset, would be assessed an additional tax reflecting the number of years the investor had held the asset: see Alan J. Auerbach, "Retrospective Capital Gains Taxation" (1991) vol. 81, no. 1 *The American Economic Review* 167-78.

18 See Richard M. Bird and Jack M. Mintz, "Sharing the International Tax Base in a Changing World," in Sijbren Cnossen and Hans-Werner Sinn, eds., *Public Finance and Public Policy in the New Century* (Cambridge, MA: MIT Press, 2003), 405-46.

carrying on their operations. This justification rests on weaker grounds, since user fees or benefit taxes would be a far better mechanism for assuring payment for public services. Further, it is not clear why only corporations should bear the source-based tax, rather than other business organizations that are exempt from corporate tax but also benefit from these public services.

The above purposes for the corporate income tax raise several important points related to the integration of corporate and personal taxes.

- As a backstop to the personal income tax, the corporate income tax should be fully integrated with the personal income tax. If dividends are fully taxed at the personal level, the corporate income tax should be refunded as distributions are paid out, or a credit should be provided to investors for corporate income tax payments. With respect to capital gains that arise as businesses reinvest their profits (causing the value of shares to rise), some form of relief is given to investors (such as exclusion of a portion of the gain from income) in recognition of the corporate tax applied to earnings.[19]
- With respect to tax-exempt savings (held through RPPs, RRSPs, RRIFs, and other similar plans), the intent is to allow individuals to accumulate wealth such that the income earned in the plan is not subject to tax. A corporate tax on income paid by corporations in which these plans own shares therefore taxes the income accruing to pension plans and retirement savings accounts, contrary to the intent of policy. Thus, in principle, the corporate income tax should be refunded in these circumstances to avoid taxation of these pension and retirement savings.[20]
- A corporate income tax applied to Canadian-source income would be applied to corporate profits of non-residents without refund. If dividend distributions were deducted from corporate profits, Canada would be giving up its source-based tax to investors in (and in some cases, governments of) other countries unless withholding taxes on payments to non-residents were raised to the corporate income tax rate.
- If the role of the corporate income tax is to capture the returns to investors arising from public services that benefit business operations, then integration of corporate and personal income taxes is inappropriate. However, given that other taxes are levied on businesses, an unintegrated corporate tax would likely result in double taxation for this purpose.[21]

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19 The *Report of the Royal Commission on Taxation* recommended a credit for capital gains, similar to that for dividends: see supra note 16, at vols. 3 and 4.

20 For example, prior to 1997, the United Kingdom provided a refundable dividend tax credit that was available to domestic pension plan investors.

21 The Technical Committee on Business Taxation showed that the burden of other taxes—payroll taxes, property taxes, sales taxes on business inputs, user fees, and other similar levies—is over four times greater than the burden of profit-sensitive taxes: *Report of the Technical Committee on Business Taxation*, supra note 6, at chapter 2.

Thus, we come to the view that the primary role of the corporate income tax is to serve as a backstop to the personal income tax and as a source-based withholding tax on non-residents. The current corporate tax system is imperfect, because the current dividend gross-up and tax credit (DTC) and the capital gains exclusion provide relief based on a reduced federal-provincial corporate income tax rate of roughly 20 percent applicable to certain business income of small businesses, instead of the usual rate of about 35 percent. Thus, corporate and personal income taxes for large and medium-sized businesses are not fully integrated.

Efficiency and Equity Issues in Business Income Taxation

The development of the income trust market in Canada has had an impact on the efficiency and fairness of the tax system. A tax system is said to be efficient if it minimizes distortions by imposing similar burdens on economic decisions, so that individuals and businesses allocate resources to their best use rather than being influenced by tax policies. A fair tax system can be viewed as one in which persons in similar economic circumstances face the same tax burden (horizontal equity) while those in different economic circumstances bear appropriately different tax burdens (vertical equity). With respect to fairness, business taxes should be neutral, consistent with horizontal equity, since the incidence of business taxes falls on workers, owners, and/or consumers. To accomplish vertical equity objectives, it is better to use the personal tax system than the business tax system.[22] Thus, neutral treatment of different forms of business organization is an appropriate standard to consider for both efficiency and equity objectives. Here, we provide a brief review of the issues.[23]

As indicated above, the use of the income trust structure can be seen largely as a response to distortions in the Canadian income tax system arising from the discriminatory taxation of return on equity through payment of corporate dividends. The discrimination has two aspects. First, as illustrated in table 1, corporate and personal income taxes are higher on corporate business income paid through to Canadian-resident shareholders as dividends by public corporations and large Canadian-controlled private corporations (from roughly 56 percent for high-income individual investors to the corporate tax rate of roughly 35 percent for RPPs, RRSPs, and RRIFs) than on other income such as interest, royalties, and rents (from roughly 46 percent for high-income individual investors to zero for RPPs, RRSPs, and RRIFs). This creates incentives to reduce payments of dividends to owners in favour of other income. Second, dividends are more heavily taxed than capital gains (at a top rate of 32 percent for dividends, compared with a top rate of 23 percent on capital gains), leading corporations to retain income or repurchase shares rather than pay dividends.

22 Ibid., at chapter 1.

23 Economic efficiency issues in this area have been analyzed by Kenneth J. McKenzie in a paper prepared for the income trust symposiums, entitled “Efficiency Aspects of Income Trusts.” At the time of writing, this paper remains unpublished.

In light of this, it can be seen that while an income trust achieves substantial integration of business-level and personal-level taxes, the circumstances involved produce varying consequences for capital market efficiency.

- *Business financial policies.* As described above, in the absence of taxation, business enterprises should generally determine distribution of profits to optimize returns for investors. Reinvestment of profits should be favoured where it produces higher investment returns (taking into account savings of transaction costs) in comparison with trying to raise capital from markets to finance investments. Distribution of profits, through either the payment of dividends or the repurchase of shares, should be favoured where investors can make better financial use of the funds, whether through investment or consumption. With asymmetric information in markets, whereby market investors do not have as much knowledge about business prospects as the companies themselves, the financial policy of the enterprise can also matter in conveying information to the market; for example, enterprises with greater need to raise money from markets may signal that they have fewer internal resources for investment. Some financial theorists have suggested that it is more costly to raise equity from markets than to use retained earnings, since outside investors have less knowledge about a corporation's prospects and discount the equity.[24] On the other hand, corporations with greater dividend distributions or share repurchases signal the quality of their investments.

  Thus, businesses have various business reasons to distribute profits or not. With taxation, the distribution policy of businesses is distorted in several ways. More onerous taxation of dividends relative to capital gains encourages corporations to retain rather than distribute income. The more disadvantageous taxation of retained earnings of income trusts encourages trusts to distribute profits rather than retain income (the so-called forced distribution discussed above).[25] Neither the double taxation of dividends nor the comparatively onerous tax on retained earnings of an income trust is neutral. Both distort the optimal financial policy of businesses.
- *Investment.* The use of the income trust structure to finance capital investments results in a lower cost of capital, given the lower corporate and personal income taxes paid or borne by taxable investors, RPPs, RRSPs, and RRIFs, and non-resident investors. Assuming that the tax savings generated result in a lower cost of equity financing, Aggarwal and Mintz estimate that the cost of capital is reduced by 0.9 percentage points, corresponding to an increase in

24 See, for example, Stewart C. Myers, "Determinants of Corporate Borrowing" (1977) vol. 5, no. 2 *Journal of Financial Economics* 147-75.

25 According to the consultation paper, supra note 2, distributions as a proportion of earnings before the deduction of interest, taxes, and depreciation are 73.7 percent for business trusts, 68.2 percent for royalty trusts, 32.2 percent for REITs, and 50.7 percent for limited partnerships.

business capital investment of $9 billion.[26] On the other hand, the high tax rate on undistributed income of income trusts results in large distributions, requiring trusts to fund capital by issuing more units to investors in the market, and this could be more costly than using retained earnings. Jog and Wang provide some evidence that underpricing of income trust units was negligible in the period 1997-2003 (except in 2003) even though 36 of 61 issues during that period were underpriced.[27] Given the high level of distributions, which reduce the informational cost to investors, these pricing data suggest that a shift from the corporate form with retained earnings to income trusts with new unit issues to finance capital investments may not significantly affect financing costs in this respect. Regardless, corporations that need to rely on new equity issues face higher financing costs compared with those that use retained earnings, or with income trusts.

- *Savings.* To the extent that tax benefits accrue to investors as a higher after-tax rate of return on capital rather than to businesses as a lower cost of capital, savers will be able to accumulate capital at a faster rate for future consumption purposes. The effect of tax reductions on savings is to reduce distortions and encourage thrift rather than consumption. With total yields of income trusts for investors being higher than equities,[28] the reduction in taxes on savings provides an efficiency gain to the economy.
- *Allocation of capital among businesses.* To the extent that income trusts provide opportunities for businesses to achieve a lower cost of capital by better integrating corporate and personal taxes but at a cost of adopting a structure with high distribution policies, the effect is to cause a misallocation of capital. The income trust structure is more appropriate for businesses with stable earnings and lower growth prospects, so that distribution policy objectives can be achieved. However, the competitive positions of businesses will be distorted to the extent that some are better able to use the income trust structure with its greater tax benefits, instead of the corporate form. Aggarwal and Mintz also show that capital financing has tended to support industries with lower growth rates and lower rates of return on capital (since earnings are more stable).[29]

The net efficiency gain arising from the growth of income trusts is therefore unknown. However, the above analysis suggests that policies that reduce taxes on investments and savings and create greater neutrality of different forms of business organizations should be the overall thrust for initiatives that we turn to later.

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26 See Lalit Aggarwal and Jack Mintz, "Income Trusts and Shareholder Taxation: Getting It Right" (2004) vol. 52, no. 3 *Canadian Tax Journal* 792-818, at 812.

27 Vijay Jog and Liping Wang, "The Growth of Income Trusts in Canada and the Economic Consequences" (2004) vol. 52, no. 3 *Canadian Tax Journal* 853-80, at 877.

28 Ibid., at 878.

29 See Aggarwal and Mintz, supra note 26, at 814.

Tax Revenue Loss from Income Trusts

The Finance Canada consultation paper explains at some length the estimated magnitude of government tax revenue loss resulting from the use of income trusts.[30] This analysis appears to take into account that the gross loss of tax revenues that results where income trusts do not pay the equivalent of federal corporate income tax is reduced by gross increases in personal income tax paid directly by resident individuals on their trust income, and by one-time income tax revenue gains from taxable dispositions of property occurring in the course of some income trust conversion transactions. The computation does not, however, include any estimation of additional tax revenues that may flow from increased investment resulting from economic efficiency gains realized by the income trust structure.

On this basis, the current level of the annual tax revenue loss to the federal government is estimated to be $300 million.[31] Aggarwal and Mintz estimated the revenue loss to both levels of government in 2004 to be $540 million.[32] It is important to note in this context that, while a net annual tax revenue loss is suffered by the provinces and territories collectively, based on the same factors that cause the net annual tax revenue loss to the federal government, for any given province or territory the result could be very different, ranging from a much more significant proportionate net revenue loss to a net revenue gain. This is because the income trust structure, in moving the taxation of business income from the business vehicle level to the investor level, in effect changes a component of the taxation of this income from *source taxation* (based on the ITA and provincial rules for apportioning business income among provinces where it is considered to be earned) to *residence taxation* (based on recognition of the income in the province of residence of the investor who is the recipient of the income). Accordingly, substituting an income trust for a corporation could—depending on the business group structure—result in larger or smaller relative revenue loss implications for individual provinces than for the federal government; for example, a province with relatively more income-generating activity and relatively fewer investors could suffer, in relative terms, a greater revenue loss.

Complexity

The Canadian income tax system, like the income tax systems of other developed countries, is very complex. Nevertheless, any change in income taxation in relation to the question of income trusts and other flowthrough entities will, we are sure, make the system much more complicated than it already is. For example, there has been some public comment about the possibility of "taxing income trusts like corporations," a formula that sounds disarmingly simple (and one that we do not advocate).

30 See the consultation paper, supra note 2, at 25-31.

31 Ibid., at 27-28 (including table 5).

32 See Aggarwal and Mintz, supra note 26, at 811.

That approach would add substantial complexity to the tax system for a number of reasons, including the following:

- Definitions determining a category of trusts to be treated in this manner would have to be formulated, involving, in particular, the question of whether REITs and perhaps other passive investment trusts should be excluded.
- Definitions of trust "residence" would have to be formulated, attempting to approximate the rules applicable to the determination of corporate residence.
- Because trusts do not have share capital or pay dividends, rules would have to be formulated to determine the composition of payments by trusts as either dividends or reduction of capital, including rules that determine a computation for the equivalent of "paid-up capital."
- Rules would have to be formulated or imported from other parts of the income tax system to deal with payments to resident corporations (intercorporate dividend deduction and term preferred and taxable preferred share rules).
- Rules would have to be formulated or imported from other parts of the income tax system to determine the results of various transactions between trusts and their beneficiaries (such as loans) as if they were, respectively, corporations and shareholders.

This list of issues is far from complete, but it is sufficient to indicate the level of complexity involved in a major change in this area. While we do not in any way minimize the very significant complexity that would also be involved in some of the proposals offered for consideration below, we do not see this, in relative terms, as an impediment. In fact, the only option we can envisage that will not add incremental complexity to the current income tax system is to make no changes at all.

A FRAMEWORK FOR POLICY ANALYSIS

We can now summarize and combine the analysis and conclusions above into an analytical framework as follows.

A. *Integration*

1. Integration of business-level and investor-level income taxation is positive for increasing economic efficiency and thereby contributes to economic growth, including increased savings, investment, and employment.
2. Integration of business-level and investor-level income taxation can be, and often is, effected to varying degrees in a particular tax system as regards the treatment of the three main investor groups of taxable residents, tax-exempt residents, and non-residents.
3. The greater the integration of a business income tax system, the greater is the reduction in government income tax revenues, as compared with an otherwise equivalent but less integrated system.

B. *The current situation in Canada*

1. Integration of business-level and investor-level taxation is provided for to only a very limited extent for income earned by public corporations.
2. Integration of business-level and investor-level taxation is provided for to a substantial extent for income earned by partnerships, trusts, joint ventures, sole proprietorships, small business, and investors using debt securities.
3. There are serious flaws in the current system of integration for public trust vehicles, primarily the following:
   a. the requirement for full distribution of income to achieve full integration effects (so-called forced distribution), which could be contrary to the best economic interests of the business;
   b. the unequal access of different businesses in the economy to the integration benefits of the income trust structure, often as a result of regulatory or other non-tax considerations; and
   c. the opportunity for non-resident investors to pay only Canadian withholding tax, which in many cases is applicable at a rate of 15 percent, on their share of Canadian business earnings, compared with the corporate income and withholding taxes exigible on income distributed by corporations.
4. Notwithstanding these flaws, absent any change in the current income taxation regime applicable to income trusts, existing public corporations in Canada will continue to seek to convert fully or partially to the trust structure and new businesses will increasingly adopt this structure.[33]

C. *Tax policy goals*

1. The tax system should seek to optimize retention of the economic benefits produced by integration in the current income trust sector, but reduce or eliminate the undesirable effects of "forced distribution" of income.
2. The tax system should seek to increase the economic benefits produced by integration by expanding the extent and availability of integration beyond the current income trust sector, thereby also reducing or eliminating the undesirable effects of unequal access to the trust structure.
3. Special consideration should be given to the issue of taxation of non-resident investors, including the treatment of investors under the current income trust structure, to ensure that Canada receives its share of tax revenue on income earned from business activities in Canada.
4. Implementation of the above goals must take into account, and may need to be modified to reflect, any resulting reduction in government tax revenues.

33 It is worth noting here that the conversion of existing corporate businesses to income trusts can generate income tax revenues for governments as a result of realization of current accrued gains. While this result will vary greatly from case to case, the consultation paper, supra note 2, estimates that the total federal tax paid as a result of such effects in 2004 was $40 million.

D. *Tax policy approaches*[34]

1. Reduce the current level of integration of business and investor taxation for income trusts and other flowthrough entities by changing the existing income tax regime applicable to such entities.
2. Retain the current level of integration and the existing tax regime except in respect of the treatment of non-resident investors.
3. Retain the current level of integration and make no changes to the existing tax regime.
4. Increase the level of integration of corporate-shareholder taxation under the Canadian income tax system in such a way that problems currently associated with the taxation of income trusts (such as forced distribution and unequal access) are reduced.

CONSIDERATION OF TAX POLICY APPROACHES

Reduce the Current Level of Integration by Changing the Existing Tax Regime for Income Trusts

Approach 1 would attempt to reverse, fully or partially, the growth and use of trusts that provide a high level of integration of business and investor taxation as vehicles for public investment in Canada. In our view, this approach is not desirable, for several reasons. The primary reason is that it would represent a step in the wrong direction from a tax policy perspective: the government should, in our view, be trying to improve the economic efficiency of the business income tax system in Canada by increasing (not reducing) integration, and thereby increasing investment, employment, and economic growth. In fact, with certain reservations, it could be argued that, under the current tax system, taxable Canadian investors in income trusts—both those at higher marginal tax rates and those who may have insufficient income to fully benefit from the DTC—are receiving more appropriate tax treatment than investors who hold shares in public (and some private) corporations.

The second difficulty with approach 1 is that it would involve not just establishing a different regime for new situations after an effective date, but adversely changing the tax treatment of the existing income trust sector without providing an alternative. It would likely not be feasible, either from a policy point of view or practically, to provide indefinite transition relief, or grandfathering, for existing enterprises because of the undesirability and difficulty of "ring-fencing" existing income trust arrangements. Thus, after perhaps a reasonably lengthy period of transition during which the current rules would remain in force, the economics of existing income trust investments would be altered. This would, of course, create significant loss and disruption in public capital markets.

Finally, it is worth noting that approach 1 is not at all easy to accomplish from a technical point of view. This is because it is not only income trusts that would have

34 The four options set out here are presented in only general terms; they are described and analyzed in more detail in the discussion that follows.

to be dealt with. If changes were made to the taxation of income trusts to eliminate or reduce their integration benefits in comparison with the treatment of public corporations, it appears that changes would also have to be made to the tax regimes applicable to all of the other structures that could be utilized to achieve similar tax results. For example, if the regime for the taxation of income trusts and their beneficiaries were changed so as to "tax trusts like corporations"—say, to apply corporate tax rates and analogous tax credit treatment for distributions to investors, along with limitations on return of capital—then, in addition to dealing with the complex issues raised above in the context of income trusts, it would be necessary to make similar or equivalently effective changes to prevent the use of public limited partnerships and stapled security structures as alternatives to the current income trust structure.

In this regard, it may be helpful to draw attention to an approach that could be available to reduce the integration benefits of existing income trusts in a more straightforward fashion than full corporate treatment, though it would not avoid the problem of having to deal with other structures. This would involve altering the provisions of the ITA that provide for the deductibility of amounts that are paid or payable to beneficiaries such that these amounts *would not be deductible* in computing the taxable income of the trust and *would not be includible* in computing the taxable income of the beneficiaries who are entitled to receive the distributions.[35] The effect of this change would be to tax all trust income at full top personal marginal income tax rates, which would vary depending on the situs of the income (ranging from a combined federal-provincial rate in 2005 of 39 percent in Alberta to 48.64 percent in Newfoundland and Labrador). Realized capital gains of the trust would be taxed at the appropriately reduced rates in the trust and not flowed through for taxation in the hands of investors. In addition, changes could be made to the mechanism for adjusting the cost base of trust units so that taxable unitholders would not be double-taxed in the case of undistributed income.[36] This technique would shift the taxation of trust income back from a residence basis to a source basis, corresponding to the taxation of public corporations. This would not represent a substantial change for

35 We have chosen not to discuss several other techniques that could be, or have been, considered as a means of effecting a reduction in the tax benefits of income trusts, each of which presents serious potential difficulties. However, given that considerable attention has been directed to the question of the deductibility of interest in many income trust structures (see, for example, Tim Edgar, "The Trouble with Income Trusts" (2004) vol. 52, no. 3 *Canadian Tax Journal* 819-52), we note here that, in our view, attempting to deal with deductibility of interest as it relates to facilitating the two-tier income trust structure would not be a useful approach. First, it is not adequate to deal with the multitude of ways of structuring income trusts, either using income-transferring devices other than interest or avoiding these devices completely by the use of second-tier vehicles other than corporations, such as partnerships or trusts. Second, the existence of alternatives to income trusts, such as limited partnerships, which can carry on business directly without the need for a second-tier vehicle, will contribute to the failure of such an approach. In this regard, see supra note 10.

36 See supra note 9.

high-rate taxable resident investors; it would, however, significantly reduce integration benefits for taxable residents at lower rates, for tax-exempt investors, and for non-resident investors, all of whom would suffer the full tax costs of one level of personal income taxation on their business income regardless of their status for tax purposes. The result of this approach would be to leave two different forms of public investment vehicle in the marketplace: public corporations, with their current lower business-level tax rate but potential additional taxation on distributions to shareholders; and income trusts, which would pay a higher tax rate on business income initially but with no further tax on distributions (save, perhaps, for non-residents).[37] A further variation would involve the use of a corporate income tax rate (currently in the range of 35 percent) instead of the top personal tax rate.

Despite the drawbacks of this approach in terms of the reduced economic benefits of integration, it is important to recognize that one very important aspect of approach 1—perhaps its sole raison d'être—is the maintenance of government income tax revenues that would otherwise be reduced through the continued use of the existing income trust structure. As indicated in our analysis below of a new integration approach to corporate-shareholder taxation, these revenue costs are potentially very substantial.[38]

Retain the Current Income Trust Regime, With or Without Changes to the Treatment of Non-Residents

Approaches 2 and 3 would leave the current integration regime in place for income trusts and other flowthrough entities, and thus maintain some of the economic benefits of integration achieved by the income trust structure. However, while these benefits are not small, they are countered to some extent, perhaps significantly, by the serious distortionary effects of forced distribution and unequal access to the trust structure for various business enterprises largely owing to non-tax factors. It is our view that, in spite of these limitations, in the medium and longer term a very large proportion of public corporate businesses in Canada will be compelled by legitimate market dynamics to seek the integration tax benefits of income trusts or equivalent structures. These two tax policy approaches, by leaving the income trust structure

37 The results of this approach can be illustrated by a simple example, if we assume that appropriate adjustments are made to cost base on the distribution of retained income, as discussed above. Suppose an income trust earns \$100 in business income in a taxation year, but none of this income is paid to investors in the year. Assuming that the trust is taxable at the top marginal personal income tax rate of 46 percent, the tax payable by the trust is $\$100 \times 0.46 = \$46$. Assuming that one-third of the trust units are held by taxable residents of Canada, one-third by tax-exempt residents, and one-third by non-residents, and that the after-tax income ($\$100 - 46 = \$54$) is paid out to all of the investors in the following year, the total income tax payable on the \$100 of earned income is \$46 at the trust level, the cost of which is borne by all unitholders, plus an additional withholding tax on the distribution to the non-resident investors of $\$18 \times 0.15 = \$2.70$ (assuming that the reduced treaty withholding rate applies).

38 See the discussion under the heading "Revenue Loss Estimate."

available indefinitely, would result in a reduction in government income tax revenues, but—crucially—without having eliminated the important problems of forced distribution and unequal market access. Accordingly, even in a world where the government might consider the economic benefits of substantial integration to be worth the predicted loss of tax revenues, any option that would leave the income trust structure in place, without increasing integration for investors in corporations to a similar level, cannot be considered analytically as more than a distant second-best.

However, we emphasize that in this second-best world of income trusts, there are still very strong arguments for making changes to the taxation of non-resident investors, as contemplated by approach 2, so that they pay a more substantial Canadian income tax on their share of the earnings of the trust. We are aware that in certain specific circumstances, notably situations where trusts invest in Canadian real estate and resource properties, there have been difficulties in formulating an effective legislative regime that would accomplish this goal.[39] Nevertheless, we consider the current undertaxation in Canada of non-resident investors in income trusts to be one of the most important issues requiring close attention in the near term.

Increase Integration of Corporate-Shareholder Taxation

Approach 4 would change the taxation of income earned through a Canadian-resident public corporation to increase significantly the availability of integration of corporate-level and shareholder-level taxation; that is, this approach would generally reduce the taxation of distributed corporate income, compared with the current corporate-shareholder income tax system, and generally equate the tax results, in most but not all circumstances, with those currently available through the use of the income trust structure. At the same time, this proposed system of taxation would minimize the problems associated with forced distribution in the income trust structure and unequal market access to the integration benefits of income trusts. Non-resident investors would also be treated much differently than under the existing income trust regime. In the next section, we will describe the major elements of our proposal for a system of corporate-shareholder taxation in Canada, within the ambit of approach 4.

THE PROPOSED CORPORATE-SHAREHOLDER INTEGRATION SYSTEM

We will begin by describing the system in general terms. Next, we will explain our reasoning behind this particular system and how it can be adapted in variation. Then we will analyze the potential income tax revenue loss to government from

39 See supra note 8 regarding part XII.2 tax and the exemption for mutual fund trusts. It is our understanding that, generally, it is very difficult to apply a tax such as part XII.2 in the circumstances of a public, widely held trust vehicle because of the necessarily cumbersome mechanics of full tax liability of the trust offset by a "deemed payment" of part of the tax by certain beneficiaries, depending on their taxable status for purposes of the ITA. See the discussion of this issue below under the heading "The Alternative of a Refundable Tax on Trusts."

implementation of the system. Finally, we will discuss in more detail some important structural issues.

General Description of the System

In general terms, we propose the adoption in Canada of a "full integration" corporate imputation system, using a dividend gross-up and tax credit that would be fully refundable to resident shareholders, including both taxable and tax-exempt investors, but not refundable to non-residents. This DTC would be set at a level that fully recognizes the level of corporate tax paid by Canadian-resident corporations, but would never provide more credit than the tax *actually* paid because of the use of a corporate distribution tax (CDT) along the lines proposed in the *Report of the Technical Committee on Business Taxation*.[40] The CDT rate would be adjusted to ensure that the earnings of Canadian-controlled private corporations subject to the lower small business rate would not be taxed more onerously than under the current rules.

This system, as proposed in this article, is designed to produce the following results (which are illustrated in tables 2 and 2A):

1. Canadian-resident corporations would continue to pay corporate income tax on corporate income, as earned, at prevailing rates.
2. On distribution of these earnings (or any other source of cash) as dividends, the corporation would pay an additional CDT to the extent that it had not already paid sufficient mainstream corporate tax to cover the amount of the DTC at a reference rate of corporate tax.
3. On receipt of a dividend from the corporation, shareholders would include the dividend (grossed up to reflect the reference rate of corporate tax) in their income for Canadian tax purposes.
4. Shareholders of the corporation receiving such a dividend would then determine entitlement to a DTC to reflect the reference rate of corporate tax paid, as follows:
   a. Canadian-resident individual shareholders would receive a full DTC against income tax payable equal to the amount of corporate tax/CDT attributable to the dividend, and to the extent that the shareholder had insufficient tax payable in a year to use the full DTC, the balance would be refundable to that shareholder;
   b. tax-exempt resident shareholders (such as RPPs, RRSPs, and RRIFs) would be treated like other resident shareholders and would receive a full DTC, which in their case would always be fully refundable since they effectively pay tax at the rate of zero;

40 See the discussion of a recommended system of corporate distribution tax and non-refundable dividend tax credit in the *Report of the Technical Committee on Business Taxation*, supra note 6, at 7.11-21.

c. non-resident shareholders would receive no refund, and thus generally would suffer the cost of corporate-level tax, and would also be subject to non-resident gross withholding tax at the applicable rate on the amount of the dividend.[41]

The tables illustrate the tax results for a corporation subject to corporate tax on the full amount of its income (table 2) and a corporation with a reduced amount of corporate tax payable—through access to tax incentives, for example (table 2A). The "taxable," "tax-exempt," and "non-resident" shareholder categories are defined as in table 1.

This system would generally preserve the treatment currently available to resident investors under the income trust structure for income of the business entity that is distributed to investors; that is, they would suffer a tax burden on business income distributed to them at their own personal marginal tax rates (taking the rate for tax-exempt investors as zero). However, it is crucial to note that to obtain these results, this system does *not* require the distribution of earnings by the corporation in the year earned, as is currently the case with income trusts, so that the distortion of forced distribution by income trusts is reduced very substantially. It is equally crucial to note that this system would be available to all public corporations in their current form, thereby eliminating distortions resulting from unequal access to the income trust structure in the current situation.

As regards non-resident shareholders, however, our proposal would increase their burden of taxation as compared with the current income trust regime. That is because non-resident shareholders would not be allowed any refund of the DTC, such that (without any other taxable income in Canada) these non-residents would, in effect, bear their proportionate share of the cost of the corporate income tax on the earnings distributed to them. We will come back to this question of not having a refund for non-resident shareholders in the discussion below.

We would add one further crucial element to our proposal, which would be just as important in any variation that provided less integration than we propose. This element involves the need to use a two-pronged approach in dealing with the addition of further integration through the corporate-shareholder income tax system. The first prong is whatever set of changes to the existing system of corporate-shareholder taxation is decided upon—for us, this is the proposed system for full integration. The equally necessary second prong involves changing the current income tax regime applicable to income trusts to make it less beneficial than it now is from an income tax perspective.

41 The existing withholding taxes on corporate dividends paid to non-residents are in addition to the corporate income tax borne on investments in Canada. Reductions in withholding tax rates on dividends could also be considered if this would level the playing field between corporate and flowthrough entities. Our proposal does not include measures to reform non-resident withholding taxes on income derived from corporate securities.

TABLE 2 Existing and Proposed Corporate-Shareholder Tax Regimes: Full Corporate Taxation

	Existing corporate/ shareholder taxation			Full corporate/ shareholder integration		
	Taxable	Tax-exempt	Non-resident	Taxable	Tax-exempt	Non-resident
	dollars					
Corporation						
Corporate income	100.00	100.00	100.00	100.00	100.00	100.00
Federal corporate tax @ 22%	22.00	22.00	22.00	22.00	22.00	22.00
Provincial corporate tax @ 13%	13.00	13.00	13.00	13.00	13.00	13.00
Corporate distribution tax	na	na	na	nil	nil	nil
Retained earnings	65.00	65.00	65.00	65.00	65.00	65.00
Dividend paid	65.00	65.00	65.00	65.00	65.00	65.00
Shareholder						
Dividend received	65.00	65.00	65.00	65.00	65.00	65.00
Gross-up	16.25	nil	nil	35.00	35.00	35.00
Federal personal tax @ 29%	23.56	nil	nil	29.00	nil	nil
Provincial personal tax @ 17%	13.81	nil	nil	17.00	nil	nil
Non-resident withholding tax @ 15%	na	na	9.75	na	na	9.75
Federal dividend tax credit	10.83	nil	nil	23.33	23.33	nil
Provincial dividend tax credit	5.42	nil	nil	11.67	11.67	nil
Net federal personal tax	12.73	nil	nil	5.67	−23.33	nil
Net provincial personal tax	8.40	nil	nil	5.33	−11.67	nil
Tax summary						
Federal tax	34.73	22.00	31.75	27.67	nil	31.75
Provincial tax	21.40	13.00	13.00	18.33	nil	13.00
Total tax	56.13	35.00	44.75	46.00	nil	44.75

Note: Tax rates are based on federal-provincial rates for 2005, adjusted to produce an illustrative combined corporate income tax rate of 35 percent and combined personal income tax rate of 46 percent. Negative amounts of personal income tax indicate refund of the dividend tax credit.

We believe this second prong is necessary because, without it, the new corporate-shareholder taxation regime will remain unattractive and underutilized by comparison, with continuing pressure for conversions of corporate businesses to the income trust structure. For example, in the case of the system we propose in this article, income trusts, under their current treatment, would continue to provide lower taxation for non-resident investors and a better result for all other investors on return of capital. The new corporate approach would not make much sense, then, from the

TABLE 2A Existing and Proposed Corporate-Shareholder Tax Regimes: Reduction of Corporate Tax

	Existing corporate/ shareholder taxation			Full corporate/ shareholder integration		
	Taxable	Tax-exempt	Non-resident	Taxable	Tax-exempt	Non-resident
			dollars			
Corporation						
Corporate income	100.00	100.00	100.00	100.00	100.00	100.00
Deduction[a]	–40.00	–40.00	–40.00	–40.00	–40.00	–40.00
	60.00	60.00	60.00	60.00	60.00	60.00
Federal corporate tax @ 22%	13.20	13.20	13.20	13.20	13.20	13.20
Provincial corporate tax @ 13%	7.80	7.80	7.80	7.80	7.80	7.80
Corporate distribution tax	na	na	na	14.00	14.00	14.00
Retained earnings	79.00	79.00	79.00	65.00	65.00	65.00
Dividend paid	79.00	79.00	79.00	65.00	65.00	65.00
Shareholder						
Dividend received	79.00	79.00	79.00	65.00	65.00	65.00
Gross-up	19.75	nil	nil	35.00	35.00	35.00
Federal personal tax @ 29%	28.64	nil	nil	29.00	nil	nil
Provincial personal tax @ 17%	16.79	nil	nil	17.00	nil	nil
Non-resident withholding tax @ 15%	na	na	11.85	na	na	9.75
Federal dividend tax credit	13.17	nil	nil	23.33	23.33	nil
Provincial dividend tax credit	6.58	nil	nil	11.67	11.67	nil
Net federal personal tax	15.47	nil	nil	5.67	–23.33	nil
Net provincial personal tax	10.21	nil	nil	5.33	–11.67	nil
Tax summary						
Federal tax	28.67	13.20	25.05	32.87	nil	36.95
Provincial tax	18.01	7.80	7.80	13.13	nil	7.80
Total tax	46.68	21.00	32.85	46.00	nil	44.75

Note: Tax rates are based on federal-provincial rates for 2005, adjusted to produce an illustrative combined corporate income tax rate of 35 percent and combined personal income tax rate of 46 percent. Negative amounts of personal income tax indicate refund of the dividend tax credit.

[a] For example, the corporation qualifies for a tax incentive under the ITA.

investor's point of view, in a continued competition with income trusts under their current structure.

Another example would arise in circumstances where our proposal is adopted in a modified form that would provide less than a full refund of the DTC to tax-exempt resident shareholders. As discussed below, such a modification could result, effectively, in preserving some level of corporate income taxation on business income earned by resident corporations that is distributed to these shareholders. A corporate-shareholder tax system containing this element would not effectively compete, from the investor's point of view, with the benefit of a zero rate of income taxation on such income currently obtained by tax-exempt investors through the income trust structure.

Accordingly, any scenario involving changes to increase integration in the corporate-shareholder income tax regime must also include consideration of some negative changes to the current income taxation of the income trust structure; and this may well necessitate dealing in some similar or equivalent negative fashion with other structures, such as limited partnerships and stapled security structures, that could mimic the tax consequences of income trusts.

While it is beyond the scope of this article to deal with the question of what is the best set of changes to make to the existing taxation of income trusts for this particular purpose, we do recognize the potential technical and other difficulties in this area. The optimum solution would probably be to impose compensating taxation where necessary on distributions at the investor level. For example, if our proposed corporate-shareholder tax system were to be implemented, it would be desirable to remove the remaining income tax benefits for non-resident investors in income trusts by levying a new tax on income distributions to them at a rate considerably in excess of the 15 percent withholding tax that is often applicable under current rules. However, as explained below, Canadian bilateral tax treaty obligations, particularly the provisions of the Canada-US treaty, prevent this approach for the foreseeable future.

One other theoretical possibility is to make a comprehensive set of changes to the income trust tax regime so that it would represent a precise analogue to the new corporate-shareholder imputation system (including CDT and distribution gross-up and tax credit). This would, we feel, be extremely complicated and technically difficult, and unlikely to be worth the effort: in a world where the corporate-shareholder income tax regime and the income trust-unitholder income tax regime are effectively equivalent, there should be little use for the trust structure. For these reasons, we do not recommend this approach.

We think, therefore, that less than perfect but more practical solutions would have to be considered to effect these second-prong changes to the income trust tax regime where integration is being increased considerably in the corporate-shareholder tax regime. One approach that we note for further consideration is denial of the deduction to income trusts in computing their own income for income paid or payable to beneficiaries (where such income is to be received by the beneficiaries as after-tax capital of the trust). As discussed above in our analysis of approach 1, this would effectively subject all investors, including tax-exempt residents, non-residents, and taxable residents with marginal rates below the applicable top marginal personal income tax rate, to a tax cost equal to the applicable top personal rate of tax on income flowing through such a trust. This approach is not entirely simple, particularly as it could relate to the taxation of income of tax-exempt investors; however, it may be difficult to find better alternatives for the purpose. In this context, consideration could also be given to changing the taxation of a payment of capital to income trust investors in order to eliminate the potential double taxation of undistributed income.

We recommend that, if negative changes are to be made to trust taxation as a second prong to improving corporate-shareholder integration, these changes should not apply to existing income trusts for some reasonable period of years, to allow for transition. In addition, any such changes should be accompanied by special tax rollover provisions allowing an existing income trust to, in effect, convert back into corporate form without immediate tax consequences for the trust or its unitholders.

Rationale for the Full Integration System

We believe that this approach of providing full integration of business-level and investor-level income taxation for resident investors and not for non-resident investors is well justified on both a tax policy and an economic policy basis, even though it would result in significant reduction of government tax revenues (as discussed below). It avoids many of the problems and disadvantages associated with the other three approaches, and it recognizes the substantial benefits to be obtained from further integration in the income tax system.

We have considered other mechanisms for changing the existing corporate income tax regime to, in effect, increase integration, such as reducing corporate income tax rates or providing for the deduction of the amount of dividends paid by corporations in computing their taxable income. While reduction of corporate income tax rates would reduce the tax burden on investment and reduce inefficiencies caused by inter-asset and inter-industry distortions under the corporate income tax, anything less than complete elimination of the corporate income tax (and the DTC) would not establish parity between the income tax regime applicable to corporate businesses and the regime applicable to trust businesses. Even if the corporate tax rate were reduced to the 20 percent combined federal-provincial rate applicable to active business income of small businesses, tax-exempt and non-resident investors would continue to prefer businesses organized as income trusts. Moreover, a substantially reduced corporate income tax rate would provide further opportunities for taxable resident individuals to defer some tax on investment income.

As for dividend deductibility, many corporations would pay little or no income tax and would accumulate tax losses, thereby creating further pressures on the income tax system as they sought to obtain value for these losses through tax shelter arrangements. Further, deductibility of dividends would allow non-resident investors to avoid full Canadian taxation of profits from business activity in Canada, and in some cases it would only shift this tax revenue from Canada to other jurisdictions that would otherwise give credit for underlying Canadian corporate income tax. As discussed elsewhere in this article, we do not believe this is an appropriate policy result.

The system we propose for full integration of personal and corporate income taxes provides a number of efficiency benefits:

- It reduces the cost of equity financing to the extent that businesses finance at a lower cost of funds. Although in an open economy like Canada businesses rely on international sources to help finance their capital needs, evidence suggests that equity prices are determined in part by domestic considerations.[42]
- To the extent that integration of corporate and personal taxes improves the economics of saving, it reduces tax-induced distortions affecting the choice between current and future consumption.
- Full integration creates more neutral treatment of different business structures, as well as reducing the differential between dividend and capital gains taxation that influences the choice of financial structures.[43]

We do not provide an estimate of efficiency gains arising from our proposal. What we do know is that our proposed system would reduce not only the tax distortion arising from the discriminatory taxation of dividends but also the distortion in the choice between corporate and flowthrough structures. Full integration is a policy that increases the efficiency of capital markets by removing two distortions at the same time. Not many single policies have this feature.

It is important to emphasize that while we have set out in this section a proposal for full integration for domestic investors and not for non-resident investors in Canadian businesses, based on our view of the relevant tax policy as described above, the mechanics that we propose for implementation of such a system, which we describe in detail below—in particular, the grossed-up refundable DTC (based on a creditable CDT)—provide for a flexible approach that can effect a whole range of different policy results on a continuum of increasing integration. For example, while we have concluded that, on balance, full refund of the DTC to tax-exempt residents is desirable on a policy basis, this issue is certainly not cut and dried, taking into account

42 See Kenneth J. McKenzie and Aileen J. Thompson, *The Economic Effects of Dividend Taxation*, Working Paper 96-7 prepared for the Technical Committee on Business Taxation (Ottawa: Department of Finance, December 1996), which reviews financial studies on the taxes that influence Canadian equity values. Several financial studies have shown that the prices of Canadian stocks are influenced by personal taxes on dividends in Canada. In a small open economy, one would not expect Canadian personal taxes on dividends to influence equity prices, since only international factors would play a role in determining international equity prices.

43 At a top combined federal-provincial personal income tax rate of 46 percent, the dividend tax rate is about 17 percent while the capital gains tax on realized gains is 23 percent. Assuming that shares are held by taxable investors for 10 years and the shareholder's nominal discount rate is 10 percent inclusive of risk, the effective capital gains tax rate on accruals is about 16 percent.

some concerns that have been expressed with this approach—including its cost in terms of lost tax revenue for government. Thus, it is helpful to keep in mind that it would be possible, and fairly easy, to make mechanical adjustments in order to provide less than full integration—that is, a tax rate of zero—to tax-exempt residents by providing only a partial DTC refund to these investors, or a reduced DTC to both tax-exempt and taxable resident investors. As an example of this approach with respect to tax-exempt investors, it would only be necessary to reduce the rate of DTC refund on dividends received from Canadian corporations from 100 percent to, say, 80 percent of the DTC in order to have the effect of imposing a 20 percent gross tax on receipts of these dividends. Of course, like full corporate-shareholder integration, in order to be effective, any such approach would require some changes to the existing tax regime applicable to income trusts to prevent them from remaining a preferred structure in the marketplace.

We are not making this point about the adaptability of our proposal (including examples such as the one in the previous paragraph) for the purpose of advocating integration effects that are less than those described in the proposal; however, we do think it is very important to recognize that as a result of any number of considerations or differences in analysis or view—including, in particular, potential government revenue loss—the proposal may not meet the requirements of government decision makers at a given time. Accordingly, we want to emphasize that the really important idea in the proposal is to have *more integration* in the corporate income tax system, not *less integration*, as compared with the existing treatment of corporate business income, and that the system we propose can be adapted across a range of intermediate possibilities to accomplish that objective.

Revenue Loss Estimate

Clearly, a system of greatly enhanced integration, such as the one we propose, is highly desirable when it comes to improving capital market efficiency. However, it would impose a revenue cost for federal and provincial governments. One could view this cost in terms of the tax revenues that would be lost if all corporate businesses chose to achieve full integration by converting from their current corporate structure to an income trust or other flowthrough structure—an outcome that is inhibited under the current income trust tax regime by the forced distribution of taxable income to unitholders to avoid the extra tax on undistributed income.

To estimate the government tax revenue loss arising from the adoption of full integration,[44] we take into account three types of investors: taxable resident individuals (subject to personal income taxes on investment income and capital gains) holding about 40 percent of equity; tax-exempt residents, mainly RPPs, RRSPs, and RRIFs, holding a similar amount; and non-residents, holding the remaining 20 percent. Using an average federal-provincial income tax rate of about 40 percent and a

44 The data are taken from several sources, including the consultation paper, supra note 2, and Statistics Canada, *Quarterly Financial Statistics for Enterprises*, catalogue no. 61-008-XIE.

dividend tax rate of 25 percent on net dividends, we estimate that moving to the full integration of corporate and personal taxes on dividends would lower the effective dividend tax rate to 8.7 percent for taxable investors. For tax-exempt investors, the total DTC refund would be 53.8 percent of net dividends received. If it is assumed that the DTC increases the return earned by these tax-exempt investors (which is reinvested at the investor's discount rate) and subject to the average federal-provincial tax rate of 40 percent, the net subsidy rate is 32 percent.[45] Since full integration is not provided to non-residents, there is no change in their overall tax rate. Finally, the proposed CDT would be applied at a 53.8 percent rate on net dividends, but corporate income tax payments (estimated to be 19 percent of corporate book income, based on a 9.6 percent corporate income tax rate on earnings before the deduction of interest, taxes, and depreciation) would be credited against the CDT. For companies paying little or no corporate income tax (generally applicable at about 40 percent of total income), the CDT would generate a positive cash flow to the government. We apply these rates to dividends paid by large corporations because our proposal would not provide the benefits of integration at the 35 percent corporate income tax rate for small businesses (which benefit from a reduced rate of about 20 percent on active business income). For small businesses, an adjustment to CDT liability would ensure that corporate income taxes paid at a rate of 20 percent or less would match the DTC received by shareholders, thus leaving unaffected the current combined corporate and personal income tax rate on small business active income (as discussed further below).

Table 3 shows the estimated government tax revenue effects of full corporate-shareholder integration for taxable and tax-exempt resident investors, including the impact of a new CDT. Under our proposal, full integration for taxable resident investors would result in an estimated annual revenue loss of $1.3 billion to federal and provincial governments combined. This cost would include DTC refunds paid to investors taxed at lower rates. The revenue loss from providing the refundable DTC to tax-exempt investors is estimated to be $2.6 billion annually. It is estimated that the CDT would raise about $0.6 billion in revenue annually. Further, the dynamic effect on investment produced by lowering corporate and personal tax on business income with full integration would generate almost $1.2 billion in new income tax revenues, based on $42 billion in new investment.[46] Overall, the impact on government revenue of full integration is estimated to be a net annual loss of $2.1 billion.

These estimates are preliminary, since we are still refining the data. We also note the following issues, some of which would affect the analysis in determining revenue

45 An alternative assumption is that businesses gain from tax savings by having a lower cost of capital when borrowing from tax-exempt investors such as RPPs, RRSPs, and RRIFs. Governments would gain additional revenue in the form of corporate and personal taxes on new investment projects resulting from a lower cost of capital. This amount would be netted from the DTC refund credited to these tax-exempt investors.

46 The elasticity of investment with respect to the gross tax cost of capital is assumed to be 0.5 percent.

TABLE 3 Impact on Income Tax Revenues of Full Domestic Integration (Preliminary Estimate)

	Proportion of equity	Tax rate on dividends	Annual revenue gain/loss
	percent		*$ billion*
Taxable resident	40	8.7	−1.3
Tax-exempt (RPP/RRSP/RRIF)	40	−32.0	−2.6
Corporate distribution tax[a]		53.8	+0.6
Dynamic effects			+1.2
Net gain/loss			−2.1

[a] Assuming that this tax is reduced by corporate tax payments.

loss. First, the reduction in the effective personal tax rate will encourage more dividend payments (and lower capital gains, one-half of which are taxed when assets are disposed of). In the case of taxable investors, the revenue effect of increased dividend payouts will depend on how long the assets are held. For RPPs, RRSPs, and RRIFs, which pay no tax on dividends and capital gains, revenues are not affected. Second, no revenue impact is included for any additional withholding taxes that could be negotiated with treaty partners on income trust distributions. Third, with respect to the CDT, we do not include the revenue impact associated with improved integration of corporate and personal income taxes at the small business level.

Some Structural Issues

The CDT Imputation System

The introduction of the proposed CDT imputation system involves careful construction and coordination of both corporate and shareholder levels of taxation. As noted earlier, we have adopted most of the main structural elements of the proposed system from the *Report of the Technical Committee on Business Taxation*,[47] with, of course, the crucial addition of refundability for the dividend tax credit. Also, our proposed CDT imputation system provides a level of credit and refund generally equivalent to the full combined federal-provincial tax rate, not just a partial credit. Accordingly, we feel that the system proposed by the technical committee, having been developed in a different context and with no provision for refundability, would require careful review and consideration of its structural elements before being used for the current purpose. Still, the other general elements of that system, as described in the committee's report, appear to remain sufficiently sound for purposes of putting forward our proposal in this way.

The operation of the proposed CDT imputation system is illustrated in tables 2 and 2A above. First, income of corporations is taxed, as currently, at prevailing corporate

47 Supra note 6. Also see supra note 40 and the accompanying text.

income tax rates in the year the income is earned. No further tax, or reduction of tax, results until such time as the corporation distributes amounts to its shareholders in the form of a dividend. When a corporation does distribute a dividend to its shareholders, the corporation is subject to a special distribution tax (the CDT) at a percentage rate applied to the amount of the dividend paid, determined in a manner that gives full recognition to resident shareholders for the income taxes paid by the corporation on that income. For example, to reflect a full combined corporate income tax rate of 35 percent, the CDT rate would be set at approximately 54 percent of the dividend paid.[48] Thus, using the example in table 2, where a corporation had $100 of income, on which it paid $35 of mainstream corporate income tax, and then paid out retained earnings of $65 as a dividend to shareholders, the corporation would have a CDT liability of $35 ($65 × 0.54). If the corporation, as in this case, has paid sufficient tax on this or any other income, it can credit that tax against its CDT liability; thus, in this example, the corporation would not pay any further amount in respect of CDT. If, by contrast, the corporation has not paid sufficient mainstream corporate income tax to fully credit against the CDT liability, the difference must be paid as CDT. Thus, using the example in table 2A, where the corporation, because of the availability of corporate tax incentives, or for any other reason, paid only $21 of mainstream corporate income tax, leaving $79 of retained earnings, it would have a further net income tax liability on payment of the optimum dividend; that is, the corporation would have a CDT liability of $35 on a dividend of $65, which would be reduced by its payment of $21 of mainstream corporate tax, leaving a net CDT liability of $14, payable on payment of the dividend. As described in more detail in the *Report of the Technical Committee on Business Taxation*, a corporation could recoup any excess CDT to the extent that it had paid corporate income tax over a period in excess of credits against CDT.[49]

The key effect of, and raison d'être for, the CDT imputation system is to attempt to ensure that tax credits given to shareholders of a corporation (in particular to the extent that these would be refundable under the proposal) do not exceed the amount of tax paid by the corporation, either as mainstream corporate tax or as CDT. In this way, as a general matter, the income tax effect of a receipt of dividends will be the same for shareholders of corporations no matter how much actual mainstream corporate tax is paid by the particular corporation. When the CDT is combined with the DTC as proposed, the tax results to shareholders will differ depending on the shareholder's taxable status; however, the corporation will not need to establish the status of its shareholders. This benefit is generally much more difficult to obtain in other imputation systems that use approaches such as refundable taxes, where the tax liability

48 For purposes of illustration, combined federal-provincial corporate tax rates are used and the gross-up and credit rate is determined by the formula $R/(1 - R)$, where R is the approximated combined federal-provincial corporate tax rate (without reduction to recognize small business income). Thus, where a combined corporate tax rate of 35 percent is used, as in the text and the examples in tables 2 and 2A, the CDT rate is $0.35/(1 - 0.35) = 0.5384$.

49 See *Report of the Technical Committee on Business Taxation*, supra note 6, at 7.11, proposing a 10-year carryforward and 3-year carryback of excess CDT.

or refund to the distributing entity must be determined according to the tax status of each particular shareholder.

Thus, as can be seen from both tables 2 and 2A, the proposed system of CDT and DTC results in full integration for taxable resident individual shareholders. The example shows that a shareholder with a marginal personal income tax rate of 46 percent suffers a total tax cost of $46 on $100 of income earned through a Canadian corporation; similarly, shareholders with a lower marginal personal income tax rate will suffer a total tax cost based on that rate. Moreover, even in circumstances where a shareholder does not have sufficient personal tax liability in a year to use the full amount of the DTC, the tax burden of the shareholder will be reduced appropriately by the amount of the DTC refund.[50] In addition, these tables indicate how, through the mechanism of the refundable DTC, tax-exempt resident shareholders would also benefit from full integration, in that they would bear a total income tax cost on distributed income equal to their tax rate of zero. All of these results are the same as those currently obtainable through the income trust structure (see table 1), but without the forced distribution element of that structure and with equal access for all Canadian-resident corporations.

The Treatment of Non-Residents

By contrast, as shown in tables 1, 2, and 2A, non-resident shareholders receiving distributed earnings from Canadian corporations would bear a heavier burden of Canadian income tax under our corporate integration system than non-resident investors under the current income trust structure. In fact, we have designed the proposed system to deny any refund of the DTC to non-resident shareholders specifically in order to put these investors in the same tax position that results for their investments under the current corporate-shareholder tax regime. As discussed earlier, we do not think it appropriate for non-residents to receive business income through Canadian public investment vehicles without primary income tax liability in Canada on their proportionate share of profits. Accordingly, while a reasonable case can be made for further reduction of dividend withholding taxes, perhaps on a reciprocal basis, we see no good reason at this time for tax jurisdictions in Canada to effectively give up, or hugely reduce, source taxation of business activity. We also observe, in this regard, that it is a widely accepted principle of international taxation that profits from a business carried on through a permanent establishment in one country by residents of another country may be taxed in the country of source, subject to relief from double taxation being provided by the country of residence of the investor.[51]

50 For example, a resident individual shareholder with tax losses or deductions from other sources that reduce taxable income to zero in a year would receive a full cash refund of the amount of DTC associated with the dividends received by the shareholder in the year from Canadian-resident corporations.

51 See, for example, the principles represented in the OECD model treaty: Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, January 2003).

Under our proposal, as in the current corporate tax regime, non-resident shareholders effectively bear their proportion of the corporate income tax and then pay further Canadian tax, not generally as residents of Canada under part I of the ITA, but on a gross withholding basis under part XIII. The part XIII withholding rate of 25 percent may be reduced by an applicable treaty; for example, the Canada-US tax convention reduces the rate on dividends to 15 percent for portfolio investors.[52] Non-resident shareholders may also pay tax in their own jurisdiction, often subject to some relief for double taxation by credit or exemption. In the example in tables 2 and 2A, the non-resident investor bears tax in Canada on its share of corporate earnings at the rate of 44.75 percent.

Having made this determination regarding the taxation of non-resident investors, we do recognize both the historical and the contextual indicia of pressures that would be applied to Canada by other countries, notably the United States, to obtain some reduction in the taxation of their residents in the event that Canada implemented a full integration system that included a CDT and refundable DTC but denied the refund to non-residents.[53] Our response to concerns over such pressures is as follows. First, the question of treatment of non-resident shareholders remains a decision for Canada to make according to the context of any particular bilateral negotiation. Second, the absence of a DTC refund for non-residents could be defended, to some extent, by reference to the lack of reciprocity in most cases. Third, even if Canada decided it had to make some move in the direction of a refund of DTC for non-residents in negotiating a particular treaty, it would remain open to try to limit the amount of the refund (for example, to 50 percent) and in such circumstances to seek to obtain a higher withholding tax of, say, 25 percent on the amount of any dividend received (and the amount of the DTC refunded).

The Treatment of Small Business

Under the current income tax system, the first $300,000 of annual active business income earned by a Canadian-controlled private corporation is subject to taxation at a reduced combined federal-provincial rate—generally in the range of 20 percent. In this circumstance, as shown in table 4, the existing dividend gross-up and tax credit provides shareholders receiving dividends with somewhat better than full recognition for corporate tax paid on that income. Under the proposed system, application of the CDT would reverse this effect, since the CDT is calculated at a rate reflecting the normal high-rate corporate income tax. We propose, therefore, to reduce the

52 See supra note 13, article X.

53 When the United Kingdom had in place its former imputation system, which provided a dividend tax credit refund to domestic tax-exempt pension funds, a number of its treaty partners, including the United States and Canada, negotiated the provision of full or partial refunds of corporate tax to their resident shareholders who received dividends from UK corporations. In these circumstances, the United Kingdom levied a withholding tax on both the dividend and the refund.

rate of CDT paid by a Canadian-controlled private corporation to the extent that it has earned low-rate income, in order to achieve the same overall rate of corporate-shareholder tax as under the prevailing rules. We have made this adjustment in the example in table 4 by reducing the CDT liability by approximately 13 percent. It would be necessary for the corporation to keep track of a cumulative CDT reduction entitlement, adding some further complexity at the corporate level; however, we feel that adjustment of the CDT is probably significantly less complex than a two-tier dividend tax credit system.[54]

The Taxation of Capital Gains on Shares

There is a long history in the Canadian income tax system demonstrating the serious structural problems that arise where the personal income tax rates applicable to dividends received by resident individuals are not at least roughly in line with the personal income tax rates applicable to capital gains realized on the disposition of shares. It is far beyond the scope of this article to describe these issues and their history in detail. Suffice it to say that these difficulties result from taxpayers' understandable determination (and resourcefulness) in attempting to take advantage of tax rate differentials: where rates on dividends are higher than rates on capital gains, by converting undistributed corporate surplus into capital gains on a disposition of shares (dividend stripping); and where rates on dividends are lower than rates on capital gains, by converting capital gains on a disposition of shares into dividends (capital gains stripping).[55]

Accordingly, in designing any major changes to the taxation of Canadian-resident corporations and shareholders, it is advisable to avoid either creating or exacerbating problems in this area. Fortunately, the current income tax system has a built-in advantage in the range of 9 percentage points of tax for recognition of capital gains (at a top personal rate of about 23 percent) as compared with dividends that carry the benefit of the current DTC (taxed at a top personal rate of about 32 percent). For this reason, it appears that increasing the amount of the DTC, as indicated in the proposal, would reverse the direction of existing issues arising from the differential taxation of dividends and capital gains on shares, but with a smaller differential, because the top personal rate on dividends would be reduced to about 17 percent (which may be close to an effective top rate on capital gains, taking into account the deferral of tax resulting from taxation on a realization basis).

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54 A two-tier dividend tax credit system would require some or all Canadian-resident corporations to have two accounts to tag high- and low-taxed dividends to match the dividend tax credit. See the 2006 budget proposals, supra note 3.

55 The *Report of the Royal Commission on Taxation*, supra note 16, dealt extensively with the problem of dividend stripping under the pre-1972 Canadian income tax system, which had no tax on capital gains. Those looking for evidence of capital gains stripping concerns need look no further than subsections 55(2) and (3) of the current ITA.

TABLE 4 Existing and Proposed Integration System: Small Business Deduction

	Existing corporate/ shareholder taxation		Full corporate/ shareholder integration		
	SBD	No SBD	SBD	No SBD	SBD adjusted[a]
			dollars		
Corporation					
Corporate income	100.00	100.00	100.00	100.00	100.00
Federal corporate tax @ 12%/22%	12.00	22.00	12.00	22.00	12.00
Provincial corporate tax @ 5%/13%	5.00	13.00	5.00	13.00	5.00
Corporate distribution tax	na	na	18.00	nil	15.62[a]
Retained earnings	83.00	65.00	65.00	65.00	67.38
Dividend paid	83.00	65.00	65.00	65.00	67.38
Shareholder					
Dividend received	83.00	65.00	65.00	65.00	67.38
Gross-up	20.75	16.25	35.00	35.00	36.38
Federal personal tax @ 29%	30.09	23.56	29.00	29.00	30.09
Provincial personal tax @ 17%	17.64	13.81	17.00	17.00	17.64
Federal dividend tax credit	13.83	10.83	23.33	23.33	24.24
Provincial dividend tax credit	6.92	5.42	11.67	11.67	12.12
Net federal personal tax	16.26	12.73	5.67	5.67	5.85
Net provincial personal tax	10.72	8.40	5.33	5.33	5.51
Tax summary					
Federal tax	28.26	34.73	35.67	27.67	33.47
Provincial tax	15.72	21.40	10.33	18.33	10.51
Total tax	43.98	56.13	46.00	46.00	43.98

Note: Tax rates are based on federal-provincial rates for 2005, adjusted to produce illustrative combined corporate income tax rates of 17 percent for low-rate income and 35 percent for other income, and a combined personal income tax rate of 46 percent.

[a] The corporate distribution tax liability is adjusted downward by a factor of 13.22 percent.

Federal-Provincial Issues

As described earlier in this article, income trusts, by integrating the taxation of business income, shift some of that taxation from the business-entity level (source-based taxation) to the investor level (residence-based taxation). This can cause differential relative revenue impacts for provinces by shifting income that remains subject to tax from one provincial jurisdiction to another. The same effect generally occurs with other methods of integration, including corporate-shareholder imputation systems using a dividend gross-up and tax credit. For example, under the existing DTC regime, where a corporation that earns all of its income in province A pays a dividend to its shareholders, some of whom reside in province B, province B provides a DTC that notionally results from income taxes paid by the corporation to province A.

Similar results will occur under the corporate-shareholder system that we propose in this article; however, the potential difficulty of these effects will be magnified very considerably because of the refundability of the DTC. Under this system, the refundable DTC needs to be structured to approximate the total value of both federal and provincial corporate income taxes, including any refund. Thus, a particular province, in addition to bearing the cost of the proposed increased value of the DTC, generally could be expected to provide the required provincial component of the DTC refund to its resident shareholders, even though the mainstream provincial corporate tax that notionally supports that reduction in tax or refund could have been collected by one or more other provinces. In some circumstances, a portion of this provincial corporate income tax may not have been exigible in the first instance (just as the equivalent federal portion will not have been exigible), resulting in an imposition of CDT on payment of dividends. Though dealing with this issue may be somewhat difficult in practice, it should be possible to construct a provincial allocation system for CDT that could provide some new revenue to provinces to offset their DTC costs. However, as can be seen from the numbers in table 3 above, this would make up only a fraction of the potential revenue cost.

Accordingly, it would be necessary for the federal government and the provinces to achieve a high degree of consensus and cooperation in order to implement the type of corporate-shareholder integration system that we propose. It may be that new methods would need to be explored and developed for allocating corporate income tax revenues among provinces, or even for exchanging some elements of tax revenue bases as between provinces and the federal government, in order to ensure the implementation of an effective and fair system of corporate-shareholder taxation. Though clearly a difficult task, making these types of changes would be a positive development, since the current, somewhat uncoordinated system of federal-provincial corporate income taxation gives rise to distortions and costs in a number of areas, the reduction or elimination of which would provide further benefits to the Canadian economy. Having said that, we do not at all underestimate this issue of provincial participation in the corporate-shareholder integration system as a very serious challenge for our proposal.

The Alternative of a Refundable Tax on Trusts

In considering the income tax policy issues related to income trusts and the range of possible changes that might be contemplated to deal with them, we made some effort to find a mechanism that would provide integration effects for business income earned by and eventually flowing through income trusts similar to those that we have provided for in our proposal for income earned by and flowing through public corporations. Such an approach would, of course, need to deal with the issues of forced distribution, unequal access, and the treatment of non-residents, which are addressed by our corporate-shareholder proposal. So far we have been unable to discover any such approach that would not, in effect, involve the creation of a precise analogue to our proposed corporate-shareholder imputation system with a CDT and refundable DTC.

In coming to this result, we have considered in particular the possibility of creating a new refundable tax for income trusts, levied at corporate rates and refundable to the trust, except with respect to the portion of the tax that is attributable to the share of profits of non-resident investors. And here, exactly, lies the problem, because this would require the trust to determine the applicable tax consequences according to the tax status of each particular investor as a resident or non-resident—a very difficult and questionable task. While it is true that a similar determination is required in the case of the corporate-shareholder refundable DTC system, in that system the determination is ultimately left to the shareholder, who has to supply sufficient proof of residence to support a DTC claim. There are also serious business difficulties raised by this refundable tax approach, in that it creates an economic net cost of taxation in the trust that is related to only one group of unitholders (non-residents), while the value of the remaining refund is shared by all (unless some structure involving separately valued classes of units or other similar sophistications can be added). The difficulties of switching the compliance onus and keeping economic interests valued properly are illustrated in an ugly form by the example of the existing part XII.2 tax under the ITA, which presumably exempts mutual fund trusts from its application for these types of reasons.[56] If these problems are solved by providing the refund of this "refundable" tax to unitholders instead, according to their tax status, the whole thing reduces to an attempted equivalent of the corporate-shareholder imputation system as proposed.

One variation to this attempt to deal with the basic income tax issues of income trusts within the trust taxation regime would involve retaining the deduction in computing the taxable income of a trust for income paid or payable to beneficiaries in the year (perhaps even with some type of carryover to try to address the forced distribution problem), and adding a new tax applicable only to non-resident investors—or, should it be decided to provide for a similar or partially similar effect for tax-exempt residents, applicable to these investors as well. We believe that this approach is very unlikely to work—first, because in a number of cases Canada's income tax treaties (including the Canada-US treaty) limit the taxation of non-residents receiving distributions of trust income to a rate of 15 percent;[57] and second, because the appearance of a new and separate tax on tax-exempt pension plans and savings plans could raise a number of other practical difficulties.

CONCLUSION

We believe that an important contribution of the income trust structure has been to reduce distortions arising from the onerous taxation of corporate business income paid to investors as dividends. Any change being considered to provide more neutral

56 See supra note 8.

57 See supra note 13.

income tax treatment of business trusts and business corporations should be directed toward more integration of business-level and personal-level income tax, rather than increasing taxation of trusts and their investors to match that of corporations. Our proposal would provide for the full integration of corporate and shareholder taxation for domestic shareholders, including tax-exempt investors such RPPs, RRSPs, and RRIFs, by use of a refundable DTC. We do not provide for refundability of this credit to non-resident investors, to ensure that Canada retains an appropriate share of tax revenue from business activity carried on in Canada. In this context, we also propose that some changes be made to the taxation of income trusts, to ensure that they would not continue to provide more favourable treatment than investors could obtain under a new corporate-shareholder tax regime.

We have not had the time or resources in preparing this article to fully explore all of the difficult and complex technical aspects of alternatives that would utilize the trust arrangement instead of, or coexistent with, the public corporation as a mainstream vehicle providing increased benefits of business-level and investor-level integration in the Canadian income tax system. Nevertheless, in our view, it is far more natural over time to allow businesses to remain in and return to the corporate structure, to which many regimes and rules, including taxation, apply with a degree of precision and certainty well beyond that available in the case of trusts, than to carry out the very difficult and seemingly unnecessary opposite approach of creating improved integration benefits available only or equivalently in the trust structure. For these reasons, we commend our proposal for examination, critique, and consideration by all interested parties.

As a final, crucial point, we observe that the types of changes we propose will clearly take some considerable time to develop in detail and to implement. Moreover, we do not think that, with an issue as important as the overall income taxation of business and investment in Canada, the government should rush into a solution that, if not properly and carefully worked out, could cause more harm than good. In fact, the only simple course of action that can be implemented immediately is to do nothing at all.

COMMENTARY BY BEV DAHLBY ON THE MINTZ-RICHARDSON PROPOSAL FOR INTEGRATING CORPORATE AND PERSONAL INCOME TAXES*

Mintz and Richardson provide an excellent discussion of the issues surrounding the taxation of income trusts. Their article is a valuable contribution to tax policy in this important area. While I agree with the general thrust of their proposal—increasing the degree of integration of the personal and corporate income taxes as the best way of reducing the incentive for conversion to income trusts—I think that there are some aspects of the proposal that need more attention. First, the federal-provincial dimension is not adequately developed. Second, the implications for tax incentives, such as the research and development tax credits, need to be considered. Finally, the revenue loss from implementation of the proposal needs to be qualified, and the implications of the growth of income trusts for provincial revenues need to be examined more closely, because this may affect the provinces' willingness to participate in the expansion of the dividend tax credit (DTC).

The Federal-Provincial Dimension

The provincial governments collect roughly one-third of the corporate income tax. Although Mintz and Richardson acknowledge that the issue of provincial participation in the proposed corporate-shareholder integration system is "a very serious challenge" for their proposal, they provide only a short discussion (three paragraphs) of the federal-provincial dimension. Furthermore, most of that discussion is focused on the issue of the misalignment of provincial personal income tax (PIT) (residence-based) and provincial corporate income tax (CIT) (source-based). There are other issues that should be considered, which I will only touch on here.

Even if there were no misalignment of PIT and CIT (because all of the corporation's shareholders live in the province where the corporation operates), there would be problems because of variations in provincial PIT and CIT rates. In the table that I have attached to this comment, I have tried to develop the implications of the Mintz-Richardson proposal for Alberta, assuming the same 10 percent rate for both provincial CIT and PIT. The first column (A) shows what I take to be the taxes that would be levied by the federal and provincial governments under the existing system. The total tax rate on the investor is 48.15 percent.

The second column (B) shows what I assume would occur under the Mintz-Richardson proposal, with the CDT calculated at a nominal 35 percent CIT rate. The federal government would impose a 3 percent net CDT because the Alberta CIT rate is 10 percent and not the nominal 13 percent provincial rate. In these calculations, I assume that the DTC is split between the federal government and the province in the same proportion as in table 2 of the article ($23.33 and $11.67, respectively). The net effect of the proposal is to reduce the total effective tax rate to 39 percent—that is, integrate the total CIT and PIT—but the provincial tax rate is only

* Bev Dahlby is of the Department of Economics, University of Alberta, Edmonton.

8.33 percent while the federal rate is 30.67 percent. In other words, the provincial tax is over-integrated and the federal tax is under-integrated.

Column C repeats these calculations but with the DTC of $35 split between the province and the federal government on the basis of their PIT shares. Full integration is achieved, but now the federal tax is over-integrated (at 27.97 percent) while the provincial tax is under-integrated (at 11.03 percent).

In column D, the DTC is distributed according to the federal and provincial CIT shares. Now the federal tax is under-integrated (29.94 percent) and the provincial tax is over-integrated (9.06 percent).

These examples show that the proposal would redistribute the CIT between the federal and provincial governments. It would be very useful if the authors could expand upon this topic and discuss how the DTC and the CDT might be distributed between the two levels of government so as to achieve a "reasonable" allocation of the revenue losses to both levels of government in moving toward full integration.

However, this discussion might be moot because the proposal would create the incentive for all provinces to levy at least the nominal provincial CIT rate of 13 percent. This is illustrated in column E. If Alberta reduced its CIT rate to 9 percent, the federal CDT would increase to offset the tax. The net tax rate on the investor would not change. All that would happen would be a transfer of tax revenue from the province to the federal government. Obviously, the reverse would happen if the province raised its CIT rate to 13 percent. Thus, under the proposal, the provinces would have a strong incentive to levy the nominal provincial tax rate of 13 percent. Whether this could be "a good thing" (because it would prevent tax competition and harmonize provincial tax rates) or "a bad thing" (because it would eliminate effective provincial control over CIT rates) should be discussed.

The Clawback of Tax Incentives

Another topic that needs to be discussed is the effective clawback of tax incentives, such as the scientific research and experimental development tax credit. The numerical examples in tables 2 and 2A of the article show that a taxpayer would get the same after-tax return whether or not it chose the action that would lead to the $40.00 "deduction" from corporate income in table 2A. In other words, the CDT effectively claws back any tax incentive (federal or provincial) that would otherwise reduce the effective CIT rate below the nominal (35 percent) rate. This is a very important aspect of the Mintz-Richardson proposal that needs further consideration. One can argue that some of our current tax incentives are too generous. It is quite another matter to argue that we should adopt a system that would effectively wipe them out. In my view, some mechanism for passing tax incentives through to investors would have to be adopted for the proposal to be acceptable.

The Revenue Loss from Full Integration

A couple of points should be made regarding the expected revenue losses from full integration. First, although the revenue losses may be relatively large, it should be stressed that these are "high-cost" sources of tax revenue. That is, the economic losses that are sustained, through reduced investment and productivity and distortions in savings, are relatively large. Forgoing a high-cost source of tax revenue is not necessarily a bad policy if it will be replaced by a lower-cost source of tax revenue with similar distributional effects. This type of argument should be made to buttress the case for moving toward fuller integration.

Another aspect of the revenue losses that should be stressed is that without fuller integration, more CIT revenue will be lost through conversion of corporations to income trusts. I think this should have been given more emphasis in the article.

Finally, the provincial revenue losses need to be discussed. For example, Alberta loses a disproportionate share of the CIT base through conversions to income trusts, while Ontario may be a net gainer because of the conversion of firms in the oil and gas sector. This may affect a province's attitude toward proposed changes to the existing system. In other words, Ontario may not have much to gain from moving to a more integrated system because its loss from income trust conversions may be relatively low and its share of an expanded DTC may be very high. Further analysis of interprovincial effects on tax revenues would greatly enhance our understanding of the income trust issue and the consequences of implementing the Mintz-Richardson proposal.

TABLE A Federal and Provincial Tax Implications of the Full Integration Proposal: A Hypothetical Example

	Existing system	Full integration			
Provincial CIT rate	10%	10%	10%	10%	9%
Provincial PIT rate	10%	10%	10%	10%	10%
	A *Mintz-Richardson*	B *Mintz-Richardson*	C *PIT shares*	D *CIT shares*	E *Mintz-Richardson*
Corporation					
Corporate income	100.00	100.00	100.00	100.00	100.00
Federal CIT @ 22%	22.00	22.00	22.00	22.00	22.00
Provincial CIT	10.00	10.00	10.00	10.00	9.00
Net CDT	na	3.00	3.00	3.00	4.00
Retained earnings	68.00	65.00	65.00	65.00	65.00
Dividend paid	68.00	65.00	65.00	65.00	65.00
Shareholder					
Dividend received	68.00	65.00	65.00	65.00	65.00
Gross-up	17.00	35.00	35.00	35.00	35.00
Federal PIT @ 29%	24.65	29.00	29.00	29.00	29.00
Provincial PIT	8.50	10.00	10.00	10.00	10.00
Federal DTC	11.33	23.33	26.03	24.06	23.33
Provincial DTC	5.67	11.67	8.97	10.94	11.67
Net federal PIT	13.32	5.67	2.97	4.94	5.67
Net provincial PIT	2.83	–1.67	1.03	–0.94	–1.67
Tax summary					
Federal tax	35.32	30.67	27.97	29.94	31.67
Provincial tax	12.83	8.33	11.03	9.06	7.33
Total tax	48.15	39.00	39.00	39.00	39.00

CIT = corporate income tax PIT = personal income tax CDT = corporate distribution tax DTC = dividend tax credit