Editor's Introduction: Income Trust Conversions

The second Policy Forum contribution to this issue is by Professor Jack Mintz, and it too is important and timely. It deals with income trusts—a topic that is the subject of continuing debate, and one on which Jack Mintz has commented frequently, in formal papers and articles and in the press. In this article, he presents updated estimates of the tax revenue loss from these corporate conversions. The article was written on the eve of the government's decision to discourage conversions of incorporated businesses to income trusts, announced on October 31, 2006. Despite the government's announcement, we think there is still merit in presenting Mintz's analysis, to contribute to an understanding of the present government policy and to support further study of how business income is taxed.

The recent announcements by Telus Corp. and BCE Inc. of their proposed conversions to an income trust structure evidently stoked the debate about the future of Canada's corporate tax system. Corporations, being taxable legal persons, are of course a mainstay of Canadian taxation. Canadian tax policy has long been concerned with how the taxation of a corporation's income should be integrated with the taxation of its economic owners—the shareholders who receive distributions of that income as dividends. The government's October 31 announcement seemingly ensures the primacy of the corporate business form.

It is conceivable that the debate in this area might begin one or two steps earlier and address whether the legal form—whether a trust, a partnership, or a corporation—within which business is conducted and through which business income is earned has anything to do, in principle, with how business income should be taxed, including the application of different degrees or methods of taxation to what is essentially the same type of income. That, perhaps, is an issue lying beneath the surface of the income trust debate, and if so, it is fundamental to the continuing study of the Canadian tax system. Neil Brooks, a former editor of this journal, has spoken to me about this and agrees that it is indeed a question that deserves to be considered.

The Canadian tax system contrasts with other corporation-shareholder tax regimes in the world, which either follow a "classical" approach in providing limited or no relief in the form of integration, or adopt other ways to rationalize the taxation of corporate income and its economic ownership through "advance corporations tax" and imputation systems. However, a characteristic of all these systems is that they reflect a deliberate development of tax policy, the translation of that tax policy into legislation, and the application of that legislation to taxpayers and their income. The present debate is perhaps made more complicated by the implications of commercial and market circumstances, which influence how and to what end tax policy responses can be formulated.

The critical study of income trusts and the conversion of corporations into this mode of conducting business and earning business income—and, indeed, the study of the relevance of legal form to how business income is taxed—has lagged behind the ongoing commentary in the media and other public forums. However, the *Canadian Tax Journal* is trying to remedy this by contributing to an informed debate on the subject. Most recently, in the previous issue, Jack Mintz and Stephen Richardson offered their analysis of income trusts in the context of the integration of corporate-shareholder taxation, with commentary on their proposal for reform by Professor Bev Dahlby.[1] In this issue, Professor Kenneth McKenzie examines the government's modifications of individual shareholder taxation, which are intended to limit ultimate differences in the taxation of business income earned by income trusts as compared with the taxation of income distributed by corporations to individual shareholders. The government's proposal to modify the dividend tax credit applies to individuals who receive dividends. It was first announced by the former Liberal government and is now reflected, after some public commentary, in a notice of ways and means motion tabled in the House of Commons by the minister of finance.[2]

In the article that follows, as in his earlier studies, Jack Mintz adheres to a rigorous and well-defined examination of the subject, which we hope contributes to an understanding of current developments in this area. Indeed, though perhaps not intended this way, Mintz's comments invite reflection on whether the debate provoked by income trusts should extend to consideration of why the Act should apply differently to the taxation of the same business income according to the legal entity—corporation, trust, or partnership—through which it is earned. It is perhaps this principal question, which has yet to be considered carefully, that should be a subject for further study in the *Canadian Tax Journal* and elsewhere.

Scott Wilkie
Editor

1 Jack M. Mintz and Stephen R. Richardson, "Income Trusts and Integration of Business and Investor Taxes: A Policy Analysis and Proposal" and "Commentary by Bev Dahlby on the Mintz-Richardson Proposal for Integrating Corporate and Personal Income Taxes" (2006) vol. 54, no. 2 *Canadian Tax Journal* 359-402 and 403-6.

2 Canada, Department of Finance, Notice of Ways and Means Motion To Implement Certain Provisions of the Budget Tabled in Parliament on May 2, 2006, October 16, 2006.

Policy Forum: Income Trust Conversions—Estimated Federal and Provincial Revenue Effects

Jack M. Mintz*

ABSTRACT

This article provides a new estimate of the tax revenue costs associated with conversions of income trusts, including the recently proposed Telus and Bell Canada Enterprises conversions, using a consistent approach to convert all tax changes into annualized amounts. Trust conversions are estimated to reduce annual corporate taxes by $2.8 billion, offset by annualized increases in personal and withholding taxes equal to $1.7 billion, for a net annual loss of $1.1 billion. While the revenue loss is not large relative to total annual government revenues, the tax cut is significant, raising a deeper question as to whether it would be better to implement a more efficient growth-promoting tax policy.

KEYWORDS: TRUSTS ■ CORPORATE TAXES ■ PERSONAL INCOME TAXES ■ TAX REDUCTION

Announcements in the fall of 2006 of proposed income trust conversions by Telus Corp. and BCE Inc. have raised questions about the reduction of federal and provincial taxes through the conversion of corporations into income trusts. Since the time of my last estimate, in the fall of 2004, of a total tax reduction of approximately $500 million,[1] the income trust market has grown by about a third, from $62 billion to $83 billion[2] in issuances. With the Telus and BCE conversions, expected to be close to $48 billion, the market will have more than doubled since 2004. However, during the past two years, federal and provincial governments have reduced corporate income tax rates and increased the dividend tax credit for large companies, thereby reducing the revenue effects of corporate conversions into income trusts.

Overall, the tax savings for investors have increased substantially since 2004. As documented in more detail below, I estimate the current annual reduction in federal and provincial taxes combined to be $700 million. With the proposed Telus and BCE

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

2 Scotia Capital, *Business Trust Bulletin*, October 11, 2006.

conversions, federal and provincial tax reductions for investors are expected to total $1.1 billion annually.

Estimating the revenue impacts of income trust conversions requires data that are sometimes difficult to obtain. The basic exercise is to consider how income trust conversions affect tax revenues paid by business, investors with taxable accounts, pension plans and registered retirement savings plan (RRSP) account holders, and non-residents. By converting to a trust, a business is able to avoid payment of corporate taxes, and investors no longer pay personal taxes on corporate dividends and appreciation in share values. However, investors will pay personal or withholding tax on income trust distributions that is typically more than the personal tax that would have been owed on preferentially taxed corporate dividend and capital gain income.

The tax effects of a conversion to an income trust vary for different categories of investors:

- For taxable residents, income trust distributions are in the form of ordinary income that is fully taxed in the hands of the investor, who otherwise would have received more favourably taxed dividends and capital gains on corporate shares.
- Pension plans and RRSP account holders do not pay tax on income received from corporations or income trusts. With income trust conversions, these investors save corporate tax, although this could be offset by an annualized revenue gain arising from a higher yield on trust investments and larger pension and RRSP withdrawals.
- Non-residents pay withholding tax at a reduced treaty rate of 15 percent (or the statutory rate of 25 percent) on corporate dividend and income trust distributions.
- Investors may also pay capital gains taxes on conversions of corporate shares to units of an income trust. These are one-time revenue flows that must be annualized to be included with yearly flows of taxes paid.

The accompanying table presents estimates of the tax revenue effects of income trust conversions. The notes to the table explain how these estimates were calculated.

As of September 2006, the estimated reduction in corporate taxes was $1.8 billion and the estimated increase in net personal and withholding taxes paid on trust distributions was $1.1 billion, for a net tax reduction of $700 million annually. Taking into account the Telus and BCE trust conversions, corporate tax reductions are expected to rise to $2.8 billion, offset by a personal and withholding tax pickup of $1.7 billion, resulting in a net tax cut of $1.1 billion annually.

Looking at these estimates from the perspective of each type of investor provides some useful information.

As a result of moving to a two-tier dividend tax credit to equalize taxation of corporate and income trust distributions, it is not surprising that there is little net tax reduction for taxable resident investors when companies convert to income

TABLE 1 Annualized Federal and Provincial Tax Effects Arising from Income Trust Conversions, by Investor Category, Estimated for September 2006 and Projected To Include Telus and BCE Conversions

	September 2006	With Telus and BCE
	$ billions	
Taxable residents		
Corporate tax	−0.7	−1.1
Personal tax	+0.7	+1.1
Pension plans and RRSPs		
Corporate tax	−0.7	−1.1
Personal tax	+0.2	+0.3
Non-residents		
Corporate tax	−0.4	−0.6
Withholding tax	+0.2	+0.3
Total		
Corporate tax	−1.8	−2.8
Personal and withholding taxes	+1.1	+1.7
Net change	−0.7	−1.1

Note:

Calculations are based mainly on data provided in 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). Values have been updated to 2006, including the impact of tax changes, where possible.

All numbers have been rounded to the nearest $100 million.

Earnings before interest, taxes, depreciation, and amortization (EBITDA) of income trusts are estimated to be $18.7 billion by September 2006, based on growth in income trust issuances. Payments to third parties are estimated to be $3.1 billion, and to unitholders, $11.9 billion. With the Telus and BCE conversions, EBITDA are estimated to be $29.1 billion; third-party payments, $4.8 billion; and payments to unitholders, $18.5 billion.

Of all distributions, 66 percent are in the form of ordinary income; 4 percent, dividends; and 30 percent, return of capital.

Unit trusts are estimated to be owned according to the following distribution: taxable investors, 39 percent; pension plans and RRSP accounts, 39 percent; and non-resident investors, 22 percent.

Federal and provincial corporate taxes are estimated to be 9.7 percent of EBITDA, taking into account corporate tax changes and provincial capital taxes.

Personal tax rates for taxable investors are estimated to be 40 percent on ordinary income, 13.8 percent on dividends (reflecting the new dividend tax credit regime), and 16 percent on accrued capital gains.

It is assumed that corporate tax efficiency gains increase pension and RRSP investment income on an annualized basis. The additional retirement payments are taxed at 34 percent, with the gain reflecting the 9.7 percent corporate tax rate on earnings.

Non-resident investors are assumed to pay a 15 percent withholding tax on corporate dividends and income trust distributions to the federal government.

Transitional capital gains are assumed to be 13 percent of issuance value, subject to tax at 16 percent on an accrual basis. Amounts are converted to an annualized value at a 5 percent discount rate.

trusts. These investors are estimated to hold 39 percent of issued trust units. Their share of the reduction in corporate taxes (currently estimated at $700 million) is offset by higher federal and provincial personal taxes of almost the same amount.

For pension plans and RRSP account holders, who are also estimated to hold 39 percent of trust units, the tax cut is largest. Their share of the reduction in corporate tax revenues is currently equal to $700 million. If it is assumed that a higher yield on units of income trusts provides greater retirement income in the future for investors,[3] additional personal tax revenues, on an annualized basis, would be $200 million for current trust conversions, resulting in a net loss of $500 million annually. With the Telus and BCE conversions, the share of the corporate tax reduction grows to $1.1 billion, offset by increased personal taxes of $300 million, for an annualized net reduction of $800 million in taxes paid by pension plans and RRSP account holders.

The tax cut for non-resident investors, who hold about 22 percent of trust units, is smaller than for pension plans and RRSP account holders at this time. The non-resident share of the corporate tax reduction is $400 million, offset by additional withholding taxes of $200 million, for a net reduction of $200 million annually. With the Telus and BCE conversions, the corporate tax reduction rises to $600 million, offset by $300 million in withholding taxes, for a net reduction of $300 million annually. If non-resident ownership increases substantially in the future, the net reduction in federal and provincial tax revenues will become more significant.

The above estimates of tax changes do not take into account dynamic effects through increased investment, because it is assumed that the gains go primarily to investors through higher yields on savings.

Specific provincial effects have not been estimated. However, Alberta is especially affected by trust conversions, since it accounts for over one-fifth of the Canadian corporate tax base. Residents of Alberta currently hold less than 10 percent of issued trust units owned by Canadian-resident and non-resident investors.

Overall, the tax revenue loss to government is not large compared with current annual federal and provincial revenues of almost $500 billion. However, as the income trust sector grows, it will be important to evaluate whether this tax cut is more efficient than other growth-oriented policies.

3 This calculation assumes that firms do not benefit from a lower cost of capital arising from trust conversions. Since it is unlikely that all of the tax reduction would accrue to investors, inclusion of personal tax gains on pension income would be overstated. However, if businesses benefit from a lower cost of capital, additional corporate and personal tax revenues would be paid, reflecting increased investment.