Department of Finance Canada   Ministère des Finances Canada

Tax and Other Issues Related to Publicly Listed Flow-Through Entities

(Income Trusts and Limited Partnerships)

Consultation Paper

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Canada

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1. Executive Summary

In Budget 2005, the Government of Canada announced it would conduct open and transparent consultations with stakeholders on tax issues related to business income trusts and other flow-through entities (FTEs).

The release of this paper by the Department of Finance Canada launches these consultations. The purpose of this paper is to promote discussion and third party input on a number of key questions by providing background information on FTEs and related economic efficiency issues, an international comparison, as well as the estimated impact of FTEs on federal tax revenues.

FTEs: The Policy Challenge

Trusts and limited partnerships have been used by investors for several decades. In the last 10 years, publicly listed income trusts, and the trust sector more generally, have gained popularity as investment vehicles. Since 2000, this growth has accelerated sharply and appears poised to continue doing so.

The issues for consideration and consultation with respect to FTEs include:

- The impact of their tax treatment on how businesses are organized in Canada.
- Their impact on federal tax revenues.
- The potential role tax-exempt investors (e.g. pension funds) may have in this market.
- The impact of FTE tax treatment on the Canadian economy.

What Are FTEs?

FTEs include **income trusts** and **limited partnerships**. The use of the term “FTE” in this paper refers to FTEs that are publicly listed on a stock exchange in Canada.[1]

Income trusts, which are governed by provincial laws, are an ownership vehicle for certain assets or businesses and typically raise funds by selling units in the trust to public investors (i.e. unitholders). The unitholders are the beneficiaries of the trust, and their units represent their right to participate in the income and capital of the trust. Income trusts generally invest funds in assets that provide a return to the trust and its beneficiaries based on the cash flow of an underlying business. This return is often achieved through the acquisition by the trust of equity and debt instruments, royalty interests or real properties. There are three primary types of income

[1] FTEs have traditionally sought to raise capital through the public markets.

trusts: business income trusts, energy trusts and real estate investment trusts (REITs). Business income trusts are a more recent development in Canada than energy trusts and REITs, which have existed since the 1980s.

Limited partnerships are formed under provincial laws. These laws require limited partnerships to have one or more general partners, who have unlimited liability for the debts of the partnership. By contrast, the liability of limited partners is generally restricted to the extent of their investment in the limited partnership.

Section 2 provides further details on these types of FTEs.

Growth of FTEs

The market capitalization of FTEs in Canada has grown significantly over the past several years. Total market capitalization was $118.7 billion at the end of 2004, up from $18 billion at the end of 2000. The growth of FTEs has been linked to the low interest rate environment, the attractiveness of the tax treatment of FTEs, investors' desire for cash distributions, and high commodity (oil and gas) prices.

This growth is likely to continue due to a number of factors. For example:

- Alberta, Manitoba and Ontario have recently implemented limited liability legislation, which addresses the concerns of some investors over their potential personal liability resulting from their investments in trusts. Quebec has had such legislation in place since 1994.
- Standard & Poor's has announced that certain income trusts and limited partnerships would be included in the S&P/TSX Composite Index by March 2006.

Section 2 provides further background on factors driving the growth in demand for FTEs.

Tax Policy Implications of FTEs

One of the factors contributing to the growth in the use of FTEs has been the ability of such vehicles to "flow through" income to investors so that income tax is not paid at the entity level. This differs from the tax treatment of corporations and their shareholders, where tax is paid by both the corporation (at the entity level) on its income and by its shareholders when the income is distributed—with some recognition at the shareholder level of the taxes paid at the corporate level. It is important to note that FTEs can also distribute amounts (i.e. return of capital) that are generally taxable upon disposition of the units rather than upon receipt of distributions, which would normally be the case for a dividend paid by a public corporation.

Under Canada's income tax system, some types of businesses are better suited than others to the FTE structure. For example:

- The corporate structure may be more suited for growing businesses (businesses that are not distributing a large proportion of their cash flow as dividends). This is because income retained in the corporation generally bears less tax than if the income is earned at the personal level.

- The FTE structure may be more suited for mature businesses. This is because FTEs can distribute cash flows in a manner that achieves full integration of the personal and corporate income tax systems, removing an impediment to distributions.

Section 3 provides more details on the tax policy implications of FTEs.

International Experience With FTEs

This section provides a comparison of the tax treatment of publicly listed investment vehicles in Australia, the United Kingdom and the United States that may be similar to FTEs in Canada. While flow-through tax treatment of certain vehicles exists in these jurisdictions, they are usually more restricted to specific sectors (e.g. real estate and resource properties) than Canada. Canada appears to be in the unique position of having experienced such rapid growth with some of these structures in recent years. The comparison with these countries highlights the fact that the tax system and tax treatment of FTEs varies by jurisdiction; therefore, direct comparisons with Canada are difficult to make.

Section 4 provides further background on the international experience with FTEs.

Tax Revenue Impact

One of the policy considerations with respect to the greater use of FTEs is the impact on tax revenues. It is estimated that federal tax revenues in 2004 were $300 million lower than they would have been if FTEs were structured as corporations. Business income trusts accounted for $120 million of this total, while energy trusts, REITs and limited partnerships accounted for $55 million, $80 million, and $45 million, respectively. These estimates are very sensitive to certain parameters—in particular, the proportion of FTEs held by tax-exempt investors and the average effective corporate income tax rate under the corporate structure.

The estimates in this paper relate only to federal income tax revenues. Provincial tax impacts will depend on where corporations carried on a business prior to converting to an FTE as well as the residence of investors.

Section 5 outlines the estimated impact of FTEs on federal tax revenues.

Economic Efficiency Issues

Given that the tax system may be a factor in the decision as to whether an FTE will be used to structure a particular business, it is important to determine what effect this has on the Canadian economy. Arguments have been made on both sides of this issue: some have argued that the tax treatment of FTEs leads to greater economic efficiency—at least for certain types of businesses—while others have argued that this tax treatment distorts investment decisions and leads to reduced economic efficiency. Economic efficiency issues such as these are an important element of ensuring that Canada maintains a prosperous and secure nation that can offer an unparalleled quality of life.

Section 6 provides further information on the economic efficiency issues related to FTEs.

Potential Policy Approaches

The focus of this paper is to assess the tax and economic efficiency implications of FTEs to determine if the current tax system is appropriate or should be modified. If it is determined that the tax system needs to be modified, the question arises as to the potential policy approaches. Although not an exhaustive list, policy approaches that derive from the discussion of issues in this paper include: limiting the deduction of interest expenses by operating entities, taxing FTEs in a manner similar to corporations, or better integrating the personal and corporate income tax systems.

Section 7 lists some policy approaches that are relevant to the issues identified in this paper.

Budget 2004 Proposals and Stakeholder Reaction

Measures announced in Budget 2004 proposed to limit pension fund investments in business income trusts to 1 per cent of the book value of the fund's assets. Under the proposed measures, pension funds would also have been limited to holding no more than 5 per cent of any one business income trust. However, on May 18, 2004, in response to stakeholder concerns about the impact of these proposals on pension fund investment, the Minister of Finance suspended the proposals to allow for further consultation.

Budget 2005: Foreign Property Rule Elimination and Commitment to FTE Consultations

Budget 2005 announced the repeal of the foreign property rule (FPR) which, in addition to limiting investment in foreign property by certain tax-exempt entities such as pension funds, registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs), restricted the ownership of limited partnerships by such entities. From a tax policy perspective, limited partnerships have many of the same characteristics as income trusts and raise many of the same policy issues. Therefore, these consultations also include limited partnerships.

Scope of FTE Consultations

Budget 2005 announced that the Government would undertake a consultation process on tax issues related to business income trusts and other FTEs. This paper is being issued by the Department of Finance as background for those consultations. The consultation process will seek input on a number of key questions, including:

- Does the tax advantage of FTEs relative to public corporations have a significant impact on how businesses are organized in Canada?
- Have FTEs had a significant impact on tax revenues? Is there potential for revenue losses to grow in the years to come?
- What impacts are FTEs having on investment decisions and the allocation of capital in Canada? Is the overall impact on the economy positive or negative?
- Given the important role that tax-exempt investors play in Canadian capital markets, and could play in the FTE market, what impact could this have on government revenues and economic efficiency?
- Overall, are there public policy concerns about FTEs and how the tax system influences their existence, and if so, what actions should be considered to address these concerns?

This process does not include the separate consultations announced on December 6, 2004, regarding the Budget 2004 proposal on mutual funds maintained primarily for the benefit of non-residents.

Consultation Process/Next Steps

The Department of Finance invites submissions until December 31, 2005. An additional vehicle for public input will be symposiums to be organized and hosted by the Canadian Tax Foundation. The Canadian Tax Foundation is an independent non-profit organization devoted to education and research in the fields of taxation and public finance in Canada. The Foundation provides a forum for expert analysis and discussion of issues in these fields, but does not itself advise on or advocate specific policy recommendations to governments. The symposiums are intended to help foster a better understanding and public discussion of the tax and economic policy issues relating to FTEs. The Foundation will provide further information on these symposiums as soon as detailed arrangements have been finalized.

During the consultation process, the Department will continue to monitor developments in the FTE market. Future initiatives, if any, will be taken following these consultations and in full consideration of the costs and benefits related to FTEs.

Section 8 provides further details about the consultation process.

2. Background on FTEs

a) Income Trusts

Income trusts, which are a type of FTE governed by provincial laws, are an ownership vehicle for certain assets or businesses. In very general terms, a trust is an arrangement under which a trustee holds property for the benefit of other persons (i.e. beneficiaries). The exercise by the trustee of its duties and powers under the trust is subject to fiduciary and statutory obligations.

Income trusts typically raise funds by selling units in the trust to public investors (i.e. unitholders). The unitholders are the beneficiaries of the trust, and their units represent their right to participate in the income and capital of the trust. Income trusts generally invest funds in assets that provide a return to the trust and its beneficiaries based on the cash flows of an underlying business. This return is often achieved through the acquisition by the trust of equity and debt instruments, royalty interests or real properties. The trust can receive interest, royalty or lease payments from an operating entity carrying on a business, as well as dividends and a return of capital. (See figure 1 for a simplified example of an income trust structure.)

While the example in figure 1 uses a corporation as the operating entity, the income trust may also use an operating trust or a limited partnership as the operating entity.

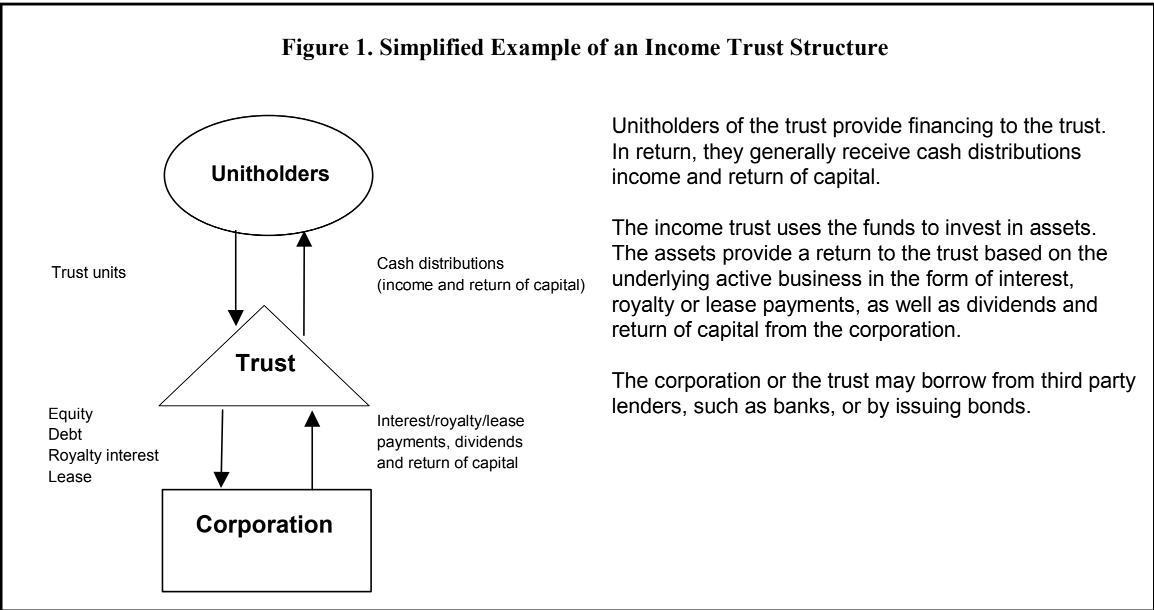

Figure 1. Simplified Example of an Income Trust Structure

There are three primary types of income trusts:

- *Business income trusts* typically acquire all or substantially all of the issued equity and debt of an operating entity. Under a common business income trust structure, the trust earns income primarily from interest payments received on the debt of the operating entity. Business income trusts are used in many sectors, such as manufacturing, food distribution, and power generation and distribution.[2]

- *Energy trusts* earn royalty income from resource properties through a royalty interest, or earn primarily interest income through the holding of equity and debt of an operating entity.

- *REITs* generally acquire income-producing real property and earn income leasing the property to an operating entity, or earn primarily interest income through the holding of equity and debt of an operating entity.

Business income trusts are a more recent development in Canada than energy trusts and REITs, which have existed since the 1980s. Although the first energy trust in Canada was established in 1986, the growth of the sector did not take place until the mid-1990s when the market cap of this sector increased significantly. In the late 1990s, the popularity of energy trusts began to decline, partially as a result of lower commodity prices and higher interest rates; however, in recent years their popularity has rebounded due, in part, to a reversal in these two factors. Although REITs existed prior to 1994, changes to the *Income Tax Act* (*ITA*) in 1994 facilitated their growth by expanding the circumstances in which REITs could qualify as mutual fund trusts under the *ITA*.

b) Limited Partnerships

Limited partnerships are formed under provincial laws. These laws require limited partnerships to have one or more general partners, who have unlimited liability for the debts of the partnership. By contrast, the liability of limited partners is generally restricted to the extent of their investment in the limited partnership.

Like income trusts, limited partnerships are another type of FTE (i.e. an entity that flows the income and therefore the tax liability to investors). As is the case with all partnerships, limited partnerships are not subject to tax on their income—instead, each partner's share of the limited partnership's income is directly taxed in the partner's hands. Consequently, limited partnerships can be used like income trusts as an ownership vehicle for certain assets or businesses.

Budget 2005 announced the repeal of the FPR which, in addition to limiting investment in foreign property by certain tax-exempt entities such as pension funds, RRSPs and RRIFs, also restricted the ownership of limited partnerships by such entities. While limited partnerships have not been as widely used as income trusts, the elimination of the FPR could increase the

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[2] Business income trust structures are also used in the resource and real estate sectors but are classified as energy trusts and REITs because of their sector-specific activities.

investment in limited partnerships by tax-exempt investors. From a tax policy perspective, limited partnerships have many of the same characteristics as income trusts and raise many of the same policy issues. These issues are discussed in more detail in Section 3.

c) Growth of FTEs

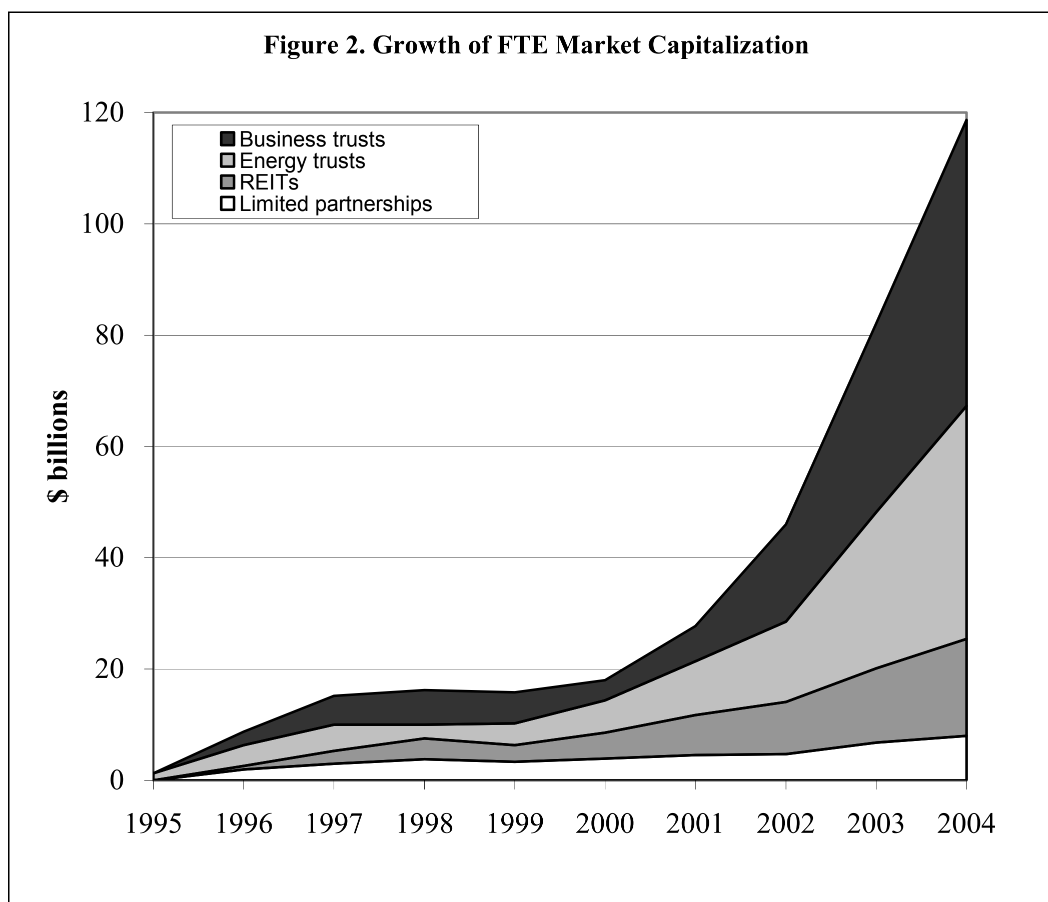
The market capitalization of FTEs in Canada has grown significantly over the past several years. Total market capitalization was $118.7 billion at the end of 2004, up from $18 billion at the end of 2000. Business and energy trusts have grown the most rapidly over that period (see Table 1 and Figure 2). The growth of FTEs has been linked to the low interest rate environment, the attractiveness of the tax treatment of FTEs, investors' desire for cash distributions, and high commodity (oil and gas) prices.

Table 1. FTE Market Capitalization
($ billions)

	Income Trusts			Limited	
	Business	Energy	REITs	Partnerships	Total
Dec. 2004	51.4	41.9	17.4	8.0	118.7
Dec. 2000	3.7	5.8	4.6	3.9	18.0
Dec. 1995	-	1.3	-	-	1.3

While there has been rapid growth in the income trust market since 2000, some stakeholders may have been concerned that the income trust structure does not offer investors the same protection against liability that the corporate structure offers shareholders. Some have suggested that income trust unitholders could potentially be held liable for amounts greater than their investment where there is an adverse event.

The implementation of limited liability legislation by some provinces may alleviate some of these concerns. In May 2004, Alberta passed legislation (the *Alberta Income Trust Liability Act)* designed to limit the liability of income trust investors. Ontario passed similar legislation in December 2004 (the *Trust Beneficiaries' Liability Act*) and Manitoba in June 2005 (*The Investment Trust Unitholders' Protection Act*). Quebec has had legislation in place since 1994.



Source: CIBC World Markets.

Standard & Poor's has announced that certain income trusts and limited partnerships would be included in the S&P/TSX Composite Index by March 2006. The limited liability issue was one of the issues considered by Standard & Poor's in determining whether income trusts should be included in the index. Other factors included differences in legal structures and whether the returns of income trusts were more similar to equities or bonds.[3] The inclusion of FTEs in the index will likely cause investment managers, particularly those managing against the S&P/TSX Composite Index, to include FTEs in their portfolio of assets.

The recent passage of limited liability legislation in Alberta, Manitoba and Ontario, the announcement of Standard & Poor's to include certain income trusts and limited partnerships in the S&P/TSX Composite Index, and the repeal of the FPR announced in Budget 2005 point to the continued growth of FTEs.

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[3] S&P Canadian Index Services, "Do Income Trusts Belong in the S&P/TSX Composite Index?" October 26, 2004; available on the Canadian Association of Income Funds' website (http://www.caif.ca/index.htm).

3. Public Corporations and FTEs: Tax Issues

One of the factors contributing to the growth in the use of FTEs has been the ability of such vehicles to “flow through” income to investors so that income tax is not paid at the entity level. This differs from the tax treatment of corporations and their shareholders, where tax is paid by both the corporation (at the entity level) on its income and by its shareholders when the income is distributed—with some recognition at the shareholder level of the taxes paid at the corporate level. This section outlines relevant aspects of the tax treatment of public corporations and FTEs and highlights the tax advantages that FTEs may provide compared to public corporations.

a) Tax Treatment of Public Corporations and Their Shareholders

Corporations generally pay income tax at a federal statutory tax rate of 22.12 per cent (including the 4 per cent federal surtax).[4] The current average federal-provincial income tax rate is just under 35 per cent for general income.[5] In computing income for tax purposes, corporations can generally deduct business-related expenses including interest, royalty and lease payments.

Public corporations generally distribute income and capital to shareholders in the form of dividends, which are taxed in the hands of recipient shareholders. To reduce double taxation, recognition of the corporate income tax on distributed dividends is provided at the personal level. First, the amount of dividends included in income by Canadian resident individual shareholders is grossed up by 25 per cent to represent the dividend amount that would have been available for distribution before federal and provincial corporate income tax was paid. Next, in recognition of corporate income taxes paid, the individual’s tax liability is reduced by the dividend tax credit (DTC). In general, these mechanisms provide shareholders with partial recognition of corporate income taxes paid on dividends received from public corporations. On the other hand, these mechanisms provide, on average, full recognition of corporate income taxes paid for dividend income received from small Canadian-controlled private corporations (CCPCs), which are subject to the small business tax rate.

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[4] Resource companies are currently subject to a 25 per cent federal tax rate that will be reduced to 23 per cent in 2006 and to 21 per cent in 2007. Budget 2005 announced the proposed elimination of the 4 per cent federal corporate surtax in 2008 and the reduction of the general corporate income tax rate to 19 per cent by 2010 (i.e. reduced by 0.5 percentage points in 2008, 0.5 percentage points in 2009, and 1 percentage point in 2010).

[5] This effective rate does not take into account provincial and federal capital taxes, which are sometimes expressed as an effective income tax rate for purposes of showing the total tax burden.

Taking into account these mechanisms, the effective federal personal income tax rate on dividends is 14.6 per cent assuming a federal personal income tax rate of 25 per cent and the federal DTC of 13.33 per cent.[6] The effective federal-provincial personal income tax rate on dividends is 22.5 per cent assuming a federal-provincial personal income tax rate of 38 per cent and an average federal-provincial DTC of 20 per cent.[7]

Table 2 compares the integration of the corporate and personal income tax systems in the case of business income earned through an unincorporated business, income earned and distributed by a public corporation and a small CCPC that is subject to the small business rate. The example of the unincorporated business illustrates full integration of the tax system (with an effective federal-provincial personal income tax rate on business income of 38 per cent).[8] The effective combined federal-provincial corporate and personal income tax rate on income earned and distributed by a small CCPC is comparable to the unincorporated business (with an effective combined federal-provincial corporate and personal income tax rate of 37 per cent). Dividends received from shareholders of public corporations are subject to an effective combined federal-provincial corporate and personal income tax rate of 49.6 per cent.

When shareholders dispose of their shares in a corporation, they are taxed on any gains realized on the disposition. Where the shareholders' gains are capital gains, only 50 per cent of the gains are included in income, such that the effective federal personal income tax rate on the capital gains is 12.5 per cent, assuming the individual is subject to a 25 per cent federal personal income tax rate. The federal-provincial personal income tax rate is 19 per cent on capital gains, assuming an average federal-provincial personal income tax rate of 38 per cent.

[6] On average, individuals receiving dividend income face a federal personal income tax rate of 25 per cent on an additional dollar of taxable income. The 14.6 per cent effective federal personal income tax rate on dividends is calculated using this federal personal income tax rate of 25 per cent and a federal DTC of 13.33 per cent. That is, a $100 dividend, grossed up to $125, would have a tax value of $31.25 (i.e. 25 per cent of $125). The DTC on the $125 dividend would have a value of $16.66 (i.e. 13.33 per cent of $125). The net tax would be $14.59 (= $31.25 – $16.66).

[7] The same calculation would apply as in the previous footnote, except that the federal-provincial income tax rate is 38 per cent and the average federal-provincial DTC is 20 per cent.

[8] This comparison could also be made using higher income tax rates, such as the top federal-provincial personal income tax rate. The example outlined in Table 2 uses the effective federal-provincial personal income tax rate of 38 per cent.

Table 2. Integration of Personal and Corporate Income Taxes Under Various Business Structures

		Unincorporated Business	Public Corporation	CCPC (Small)
1.	Business income	$100	$100	$100
2.	Effective corporate income tax rates			
	Federal		22.0%	13.1%
	Provincial		13.0%	5.7%
	Total		35.0%	18.8%
3.	Amount distributed to individual		$65	$81.20
4.	Effective personal income tax rates			
	Federal	25%	14.6%	14.6%
	Provincial	13%	7.9%	7.9%
	Total	38%	22.5%	22.5%
5.	Personal income tax	$38.00	$14.63	$18.27
6.	After-tax amount available to the individual	$62.00	$50.37	$62.93
7.	Combined corporate-personal income tax rate	38.00%	49.63%	37.07%

The corporate tax system favours the use of the corporate structure for growing businesses. This is because income retained in the corporation generally bears less income tax than if the income is earned at the personal level. On the other hand, when the income is not retained in the corporation and is distributed as dividends, the tax system may provide only partial recognition of the corporate income taxes paid (as shown in table 2).[9]

Figure 3 outlines a simplified example of the taxes paid under the corporate structure. In this example, the corporation has $100 of business income on which it pays $35 of corporate income tax. The corporation pays out its after-tax income to shareholders as a $65 dividend. Taxable Canadian shareholders pay $5.70 of tax and $2.15 is withheld in the case of non-resident investors (i.e. a 15 per cent withholding tax rate under the Canada–US treaty is applied).[10]

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[9] Mature corporations have used other distribution techniques such as open market share buy-backs. A publicly listed corporation can distribute excess cash flows to existing shareholders by purchasing, for cancellation, a portion of its outstanding shares. If done through a normal course issuer bid process, the amount thereby distributed would generally not be treated as a deemed dividend. Shareholders that sell their shares back to the corporation would treat the transaction as a regular disposition of shares.

[10] Non-resident investors would pay income tax in their country of residence and, in general, could credit Canadian taxes paid in computing their tax payable. The after-tax return earned by non-resident investors may be a key factor affecting market prices where they are the dominant investors.

Tax-exempt investors do not pay any income tax. Total taxes paid in this simplified example are $42.85.

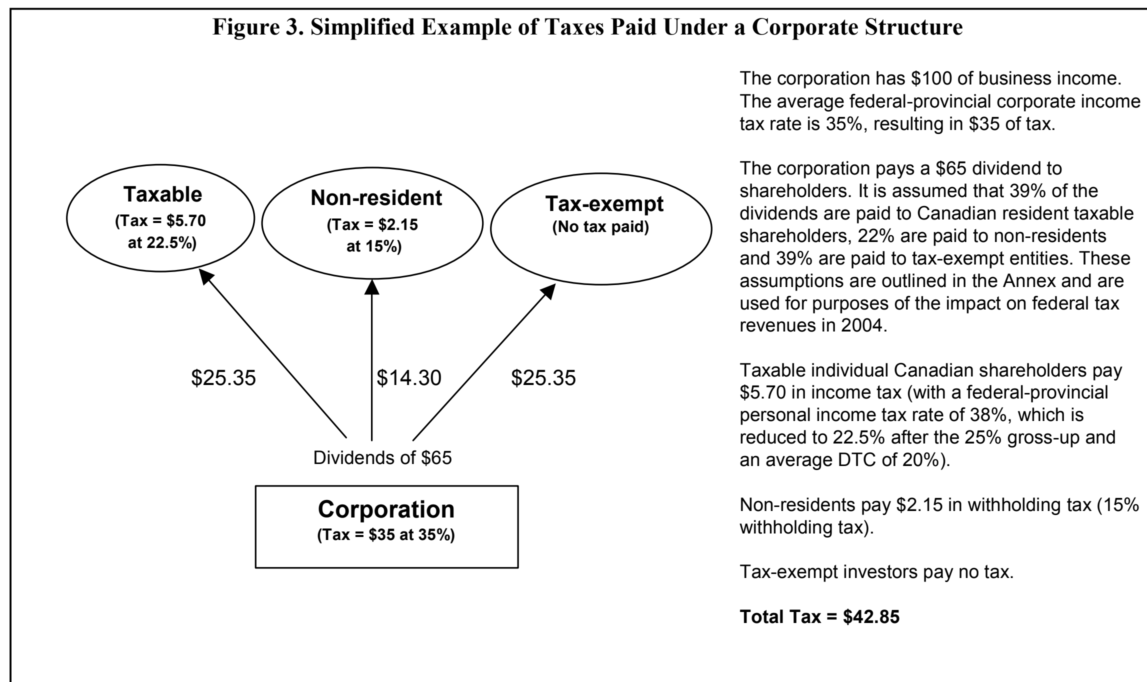

Figure 3. Simplified Example of Taxes Paid Under a Corporate Structure

b) Tax Treatment of FTEs and Their Investors

i) Income Trusts

Income trusts are structured so as to qualify as mutual fund trusts under the *ITA*. Income of mutual fund trusts that is not distributed is generally taxed at a federal tax rate of 29 per cent, representing the top personal income tax rate. The average federal-provincial income tax rate on mutual fund trusts is about 45 per cent.

In computing income for tax purposes, income trusts may deduct income distributions paid or payable to unitholders. As a result, a trust that "flows" all of its income out to unitholders would not pay any income tax. Instead, the income would generally be taxed in the hands of the unitholders as trust distributions, dividends or capital gains.

Trusts may distribute amounts to unitholders in excess of their income for tax purposes. These distributions may be a reimbursement of capital or cash flows associated with non-cash tax deductions (such as capital cost allowance) that have been claimed by the trust.

These additional distributions generally are not taxable in the hands of the unitholders at the time of the distribution. However, the *ITA* requires that the unitholder's cost be reduced by the amount of such an additional distribution, which will increase the amount of any gains (or reduce any losses) for tax purposes, realized by the unitholder on a future disposition of the unit.

In the case of a typical income trust structure, the income paid to an income trust by the operating entity may take the form of interest, royalty or lease payments, which are normally deductible in computing the operating entity's income for tax purposes. These deductions can reduce the operating entity's tax to nil. As described above, the trust does not pay tax if the income it receives from the operating entity is distributed to unitholders. The net effect is that the interest, royalty or lease payments are taxed at the unitholder level.

In the case of non-resident unitholders, income distributions from income trusts are subject to a 25 per cent withholding tax under the *ITA*.[11] This withholding tax is generally reduced under Canada's bilateral tax treaties. For example, the withholding tax rate on trust distributions under the Canada–US tax treaty is reduced to 15 per cent. The withholding tax ensures that some tax is paid on income earned in Canada by non-residents through an income trust.

Figure 4 outlines a simplified example of the taxes paid under a traditional income trust structure. In this example, the operating entity has $100 of business income but does not pay corporate income tax because the interest, royalty or lease payments it makes to the trust are deductible in computing its income for tax purposes. The trust does not pay income tax on the $100 of income received from the operating entity since it distributes all of its income to unitholders. Taxable Canadian investors pay $14.82 in tax and $3.30 is withheld at a rate of 15 per cent on distributions to non-residents. Tax-exempt investors do not pay any income tax. Total taxes paid in this simplified example are $18.12.

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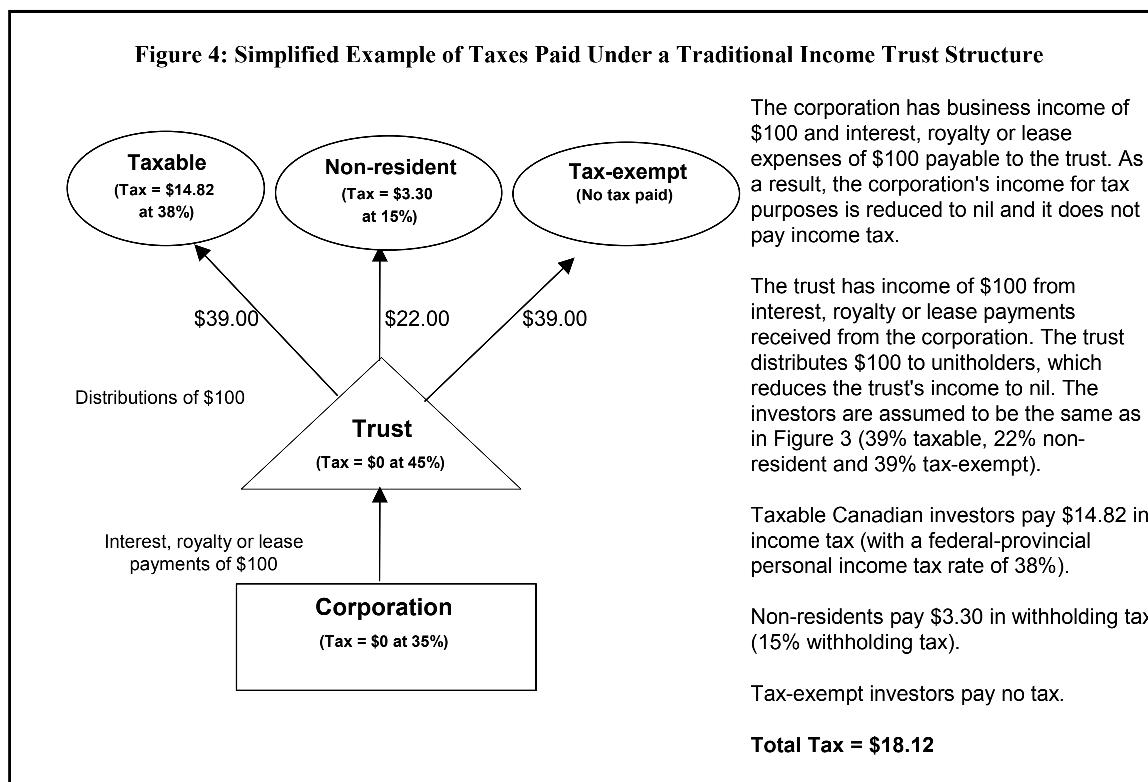
[11] With respect to certain distributions paid by a trust to non-residents, a withholding tax applies on distributions of capital gains realized by the trust on taxable Canadian property. In addition, otherwise non-taxable distributions paid by some Canadian mutual fund trusts where their value is principally attributable to resource or real properties in Canada are subject to a withholding tax. These measures reduce the disparity between the tax treatment of non-residents who invest directly in Canadian real estate or resource property and those who invest in such property through a Canadian mutual fund trust.



ii) Limited Partnerships

Unlike income trusts that are subject to tax on income not paid or payable to unitholders, limited partnerships are not taxable entities and therefore are not subject to tax. The income of a limited partnership is calculated, according to the general rules under the *ITA*, as if the limited partnership were a person distinct from its partners. However, each partner's share of the limited partnership's income is then directly taxed in the partner's hands.[12] With some limitations applicable to losses attributed to limited partners, losses realized by the partnership are also directly flowed out to partners.[13]

Like income trusts, limited partnerships can distribute amounts that are not currently taxable, such as amounts representing a reimbursement of capital (including allocations of the partners' share of the limited partnership income) or amounts in excess of the limited partnership's income for tax purposes.

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[12] Income and losses allocated to partners retain their original character (e.g. business income, dividends and capital gains).

[13] Losses flowed out to limited partners are subject to "at-risk" rules under the *ITA*. These rules permit the deduction of losses by limited partners up to a maximum amount equal to the amount "at-risk" in the limited partnership.

Non-resident partners are subject to Canadian income tax on their share of business income of a limited partnership earned through a permanent establishment in Canada.[14] Withholding tax applies at a rate of 25 per cent on distributions to non-residents unless this amount is taxable under Part I of the *ITA*. This withholding tax is generally reduced under Canada's bilateral treaties.

Because of the tax treatment of limited partnerships and their partners, these arrangements can be used in a similar way to income trusts. However, unlike income trusts, limited partnerships can be used to allocate losses to investors.

Figure 5 outlines a simplified example of the taxes paid under a limited partnership structure. In this example, the limited partnership allocates $100 of business income to the limited partners. Taxable Canadian partners pay $14.82 of income tax. Non-resident partners pay $8.36 of Canadian income tax while tax-exempt partners do not pay any income tax. Total taxes paid in this simplified example are $23.18.

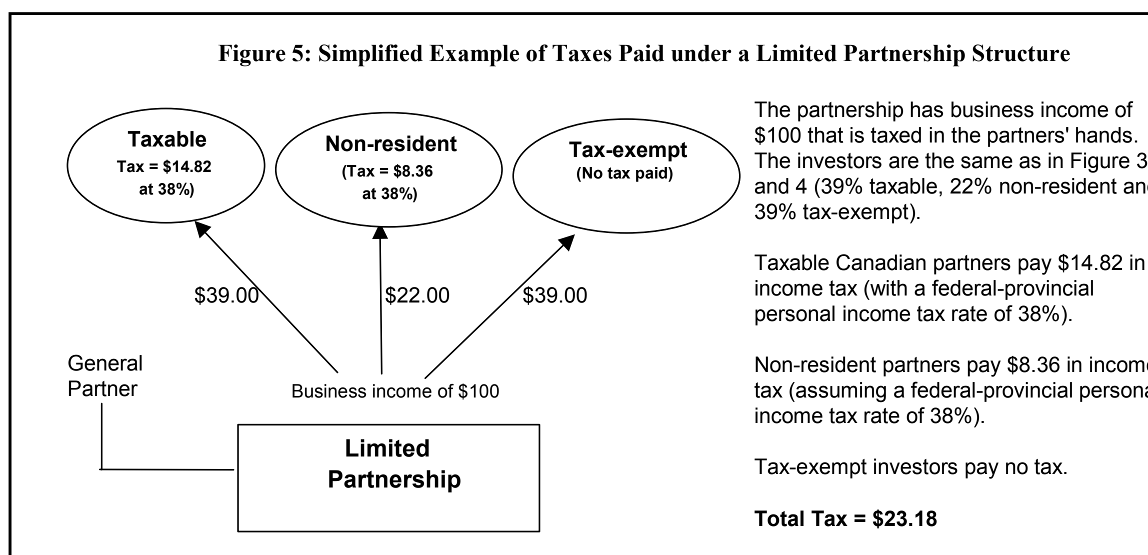

Figure 5: Simplified Example of Taxes Paid under a Limited Partnership Structure

iii) Summary of Tax Implications

The simplified examples outlined above in Figures 3 to 5 indicate that the total taxes paid under the corporate structure are higher than the total taxes paid under the FTE structures. The total tax under the corporate structure is $42.85 (Figure 3) compared to $18.12 under an income trust structure (Figure 4) and $23.18 under a limited partnership structure (Figure 5). The taxes paid under each structure are itemized in Table 3.

[14] A permanent establishment generally means a fixed place of business (including an office, branch, mine, etc.) or an agent with the general authority to contract on behalf of the business.

Table 3. Comparison of the Taxes Paid Under Different Structures

	Corporate Structure	Income Trust	Limited Partnership
Entity level	$35.00	NIL	N/A
Investor level			
Taxable Canadian	$5.70	$14.82	$14.82
Non-resident	$2.15	$3.30	$8.36
Tax-exempt	N/A	N/A	N/A
Total tax	$42.85	$18.12	$23.18

These differences in the tax treatment of FTEs and public corporations may influence the choice of business structure since:

- FTEs shift the point of taxation from the operating entity to the investors, effectively achieving "full integration" (i.e. no element of double taxation) of the corporate and personal income tax system.

- FTEs can distribute amounts that are generally taxable upon disposition of the units (or an interest in the case of limited partnerships) rather than upon receipt of distributions, which would normally be the case for a dividend paid by a public corporation.

Question for Consideration:

1. ***Does the tax advantage of FTEs relative to public corporations have a significant impact on how businesses are organized in Canada?***

4. International Comparison

This section provides a comparison of the tax treatment of publicly listed investment vehicles in Australia, the United Kingdom (UK) and the United States (US) that may be similar to FTEs in Canada. While flow-through tax treatment of certain vehicles exists in these jurisdictions, they are usually more restricted to specific sectors (e.g. real estate and resource properties) than Canada. Canada appears to be in the unique position of having experienced such rapid growth with some of these structures in recent years. The comparison with these countries highlights the fact that the tax system and tax treatment of FTEs varies by jurisdiction; therefore, direct comparisons with Canada are difficult to make.

a) Australia

Publicly listed vehicles similar to FTEs in Canada are generally treated as corporations in Australia for tax purposes. However, limited partnerships investing in venture capital, which are described below, are treated as FTEs. Prior to 1981, Australia experienced growth in the use of trusts by corporations attempting to avoid or reduce their corporate income tax payments. In response, in 1981, Australia introduced a regime that taxed certain public trusts as corporations. Additional provisions were implemented in 1985 to extend corporate tax treatment to public unit trusts that carry on a trading business.[15] The combination of corporate tax treatment of publicly listed investment vehicles and the full integration of the corporate and personal income tax systems, which was implemented in 1987, may reduce the tax incentive for corporations to convert to a trust structure. As described below, REITs do exist in Australia (and are known as listed property trusts), although the tax system does not provide them with special flow-through tax treatment.

Listed Property Trusts

Listed property trusts (LPTs) are public trading trusts that allow investors to purchase an interest in a diversified and professionally managed portfolio of real estate. There are currently over 50 LPTs listed on the Australian Stock Exchange (ASX) with a market capitalization of over A$80 billion.[16] LPTs are one of the largest sectors on ASX.[17]

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[15] Exceptions exist for eligible businesses, such as those investing in land for rental purposes, equities and securities.

[16] Australian Stock Exchange's *Listed Property Trusts* facts sheet (www.asx.com.au/investor/lmi/how/property_trusts.htm).

[17] Ibid.

Limited Partnerships

Limited partnerships investing in venture capital are generally treated as FTEs with flow-through tax treatment. This tax concession was introduced in 2002 to encourage new foreign investment into the Australian venture capital market and to further develop Australia's venture capital market.

b) United Kingdom

It appears that the UK does not have publicly listed investment vehicles similar to FTEs in Canada. In fact, regulatory limitations require that non-corporate vehicles (i.e. collective investment vehicles) be authorized by the Financial Services Authority (FSA) in order for their units to be marketed to the general public. Authorized entities have, among other things, restrictions on their investments. In general, an authorized entity has to be a passive investor and must not control any companies or businesses in which it invests. These regulatory requirements may effectively preclude Canadian-type FTEs from being listed in the UK since Canadian FTEs typically invest in one business that they control. These authorized entities are treated as corporations for tax purposes.

It is worth noting that the UK corporate tax system is partially integrated, providing a 10 per cent tax credit on dividends paid to investors, as partial recognition of taxes paid at the corporate level.[18] The REIT structure does not currently exist in the UK, although efforts are being made to develop a publicly listed REIT structure similar to that in the US that will be revenue-neutral.

REITs

The UK government (HM Treasury and HM Revenue & Customs) released a discussion paper with its March 16, 2005, budget, which follows a consultation process on promoting more flexible investment in property, including how a publicly listed REIT structure might be developed in the UK. The discussion paper suggests that the UK government is committed to introducing a REIT structure that would remove certain constraints within the UK property market and provide closer alignment between the taxation of direct and indirect property investment, providing it be revenue-neutral.

Limited Partnerships

UK limited liability partnerships, which are corporate bodies established under the *Limited Liability Partnership Act 2000*, are eligible for flow-through tax treatment.

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[18] Before 1999 (and applicable to dividends paid up to April 2004), the UK corporate tax system was fully integrated for tax-exempt investors through a refundable tax credit attached to dividends. See "Trends in Company/Shareholder Taxation: Single or Double Taxation?" Cahiers de droit fiscal international, International Fiscal Association, Volume LXXXVIIIa, 2003 Sydney Congress.

c) United States

With some exceptions for REITs and publicly traded partnerships, which are described below, publicly listed vehicles similar to FTEs in Canada are usually treated as corporations for US tax purposes, thus reducing the attractiveness of these investment vehicles. It is important to note that the US tax system does not provide direct recognition for taxes paid at the corporate level. However, dividends received by US taxpayers from US corporations (and certain foreign corporations) are taxed at a lower rate than ordinary income. Notwithstanding, income distributed as dividends can be subject to some double taxation.

Tax planning designed to eliminate double taxation of corporate distributions can result in innovative instruments being developed. A recent development in US financial markets has been the introduction of a new security, known as an income deposit security, which is described below.

Income Deposit Securities (IDSs)

The concept of the IDS is similar to that of the business income trust in Canada—the use of a debt instrument allows the operating corporation to reduce its taxable income by the amount of the interest deduction. One of the key differences between the IDS and the business income trust structure is that the IDS does not involve the creation of a trust—the investor holds the underlying securities directly—and so the US tax issues are simplified.

IDSs are essentially securities issued by a US corporation that consist of both dividend-paying common shares and high-yield subordinated notes, which are "clipped" (paper-clipped) together. The IDS can be separated by the holder and is generally automatically separated under certain events. This feature is used to provide comfort that US tax rules that cause certain debt to be treated as equity would not apply to US corporations issuing IDSs. There are currently 10 corporations issuing IDSs in the US, which are listed on either the American Stock Exchange, the Toronto Stock Exchange, or both, having an estimated market capitalization of C$3.5 billion.[19] One reason that has been put forward for the relatively small number of IDSs to date is the uncertainty over whether the subordinated notes would be treated as equity for tax purposes, which would nullify the desired tax effect.

REITs

REITs were created by the US Congress in 1960 in order to allow smaller investors to participate in large-scale, income-producing real estate investments. US REITs may be legally organized as corporations, trusts or associations. The chief tax advantage of a REIT is that it obtains a deduction for amounts distributed to its interest holders, which are then taxed at the interest holder's marginal tax rate. US tax law requires REITs to distribute at least 90 per cent of their taxable income annually in the form of shareholder dividends; most REITs distribute all their

[19] CIBC World Markets, *Income Trust Weekly*, June 30, 2005.

taxable income to shareholders and therefore pay no income tax. It is estimated that there are now nearly 180 publicly traded REITs in the US with a market capitalization in excess of US$400 billion.[20]

Publicly Traded Partnerships (PTPs)[21]

PTPs (i.e. master limited partnerships [MLPs]) have been generally taxed as corporations in the US since 1987. The rules taxing PTPs as corporations were enacted in response to concerns that PTPs would erode the corporate tax base. PTPs grew rapidly from the first PTPs in 1982 to well over 100 by 1987, when the rules were enacted to treat them as corporations.[22]

However, special rules still apply to PTPs where more than 90 per cent of their revenue is passive (e.g. resource[23] or real estate income). These special rules provide them with the favourable (i.e. flow-through) tax treatment of a partnership and the liquidity of a publicly traded company. Most PTPs are in the oil and gas and resource sector, although PTPs in other sectors also exist. There are currently 49 MLPs trading in the US with a market capitalization of approximately US$68.5 billion.[24]

d) Summary and Comparison

This section has provided a comparison of the tax treatment of publicly traded investment vehicles and business structures in Australia, the UK and the US that may be similar to FTEs in Canada. Publicly listed investment vehicles appear to be generally taxed as corporations in Australia, the UK and the US. However, listing requirements in the UK by the FSA may limit the development of the type of FTEs publicly traded in Canada. This may explain, in part, why Canada seems to be in the unique position of having experienced such rapid growth with some of these structures in recent years. The fact that the corporate and personal income tax systems are fully integrated in Australia may be another key factor in explaining this difference.

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[20] National Association of Real Estate Investment Trusts (http://www.investinreits.com/learn/faq.cfm#4).

[21] PTP rules apply to all types of partnerships, limited liability companies (LLCs) that have not elected corporate tax treatment, and business trusts. The LLC is a popular US business structure that has characteristics of both partnerships and corporations: their members are shielded from personal liability, but can enjoy the same tax treatment as partners of a partnership. When not publicly listed, LLCs are by default considered as partnerships under the check-the-box regulations. LLC legislation was originally adopted by Wyoming in 1977 and now exists in all 50 states.

[22] US Treasury Department, OTA Paper 59, “Noncorporate Business Taxation: Before and After the Tax Reform Act of 1986.”

[23] Resource income includes income and gains arising from the exploration, development, mining or production, processing, refining and transportation of any mineral or natural resource.

[24] *The Wall Street Journal*, “Energy Boom Fuels a Rise in Partnerships”, March 17, 2005.

Australia, the UK and the US currently do, however, have special tax treatment for some forms of publicly listed investment vehicles. Limited partnerships investing in venture capital in Australia as well as REITs and PTPs in the US receive flow-through tax treatment. Australia and the US provide flow-through tax treatment only to certain publicly listed vehicles in specific sectors.

Table 4. Comparison of Publicly Listed FTE Tax Treatment in Selected Countries

	Canada	Australia	UK	US
Integration	Partial	Full	Partial	Partial
General tax treatment of publicly traded FTEs	Flow-through tax treatment	Taxed as corporations	Publicly traded FTEs are generally taxed as corporations	Generally taxed as corporations
Exceptions (to the general tax treatment)				
-REITs	None	None	Consultations ongoing on possible REIT structure	REITs permitted flow-through tax treatment
-Limited partnerships (LPs)	None	LPs investing in venture capital permitted flow-through tax treatment		PTPs permitted flow-through tax treatment for passive income

5. Tax Revenue Implications of FTEs

One of the policy considerations with respect to the greater use of FTEs is the impact on tax revenues. This section outlines the estimated impact of FTEs on federal tax revenues.

The impact on federal tax revenues is measured as the difference between federal income tax revenues under the corporate structure and the FTE structure.

Under the corporate structure, tax revenues include:

- Corporate income tax paid by the corporation.
- Income tax (or withholding tax) paid by shareholders on corporate dividends and on capital gains upon the disposition of shares.
- Income tax paid by third party lenders on interest income received from the corporation.

Under the FTE structure, tax revenues include:

- Income tax paid (if any) by the operating entity and the income trust.
- Income tax (or withholding tax) paid by investors on distributions (or allocations in the case of limited partnerships) and on capital gains on the disposition of the trust units (or interest in the case of limited partnerships).
- Income tax paid by third party lenders on interest income received from the operating entity or FTE.

a) Data and Methodology

The data for the estimates in this paper are similar but not identical to those used by Mintz and Aggarwal[25] and by HLB Decision Economics.[26] The key differences with these earlier studies are that the estimates in this paper are based on 2004 data and they provide an estimated impact on federal tax revenues only (see the Annex for assumptions and estimates).

The estimated impacts on federal tax revenues are based on income trusts and limited partnerships listed on the Toronto Stock Exchange.[27] In 2004, these FTEs reported earnings

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[25] Aggarwal, Lalit and Jack Mintz, "Income Trusts and Shareholder Taxation: Getting It Right," *Canadian Tax Journal*, 2004, Volume 52, Issue Number 3; available on the Canadian Tax Foundation website (www.ctf.ca).

[26] HLB Decision Economics Inc., "Risk Analysis of Tax Revenue Implications of Income Trusts," March 11, 2004; available on the Canadian Association of Income Funds website (www.caif.ca).

[27] A small number of FTEs are listed on the TSX Venture Exchange.

before interest, taxes, depreciation and amortization (EBITDA) of $14.0 billion, of which $2.3 billion was paid to third party lenders and $8.9 billion was distributed to unitholders (in the case of income trusts) or allocated to partners (in the case of limited partnerships).[28] Distributions can take various forms. On average, 66 per cent of the $8.9 billion of distributions in 2004 were ordinary income, 4 per cent were dividends and 30 per cent were return of capital.

One of the key parameters is the distribution of investors, which vary across the different types of FTEs. These parameters are outlined in Table 7 in the Annex. On average, 39 per cent of FTEs are held by taxable Canadian investors, 22 per cent are held by non-residents and 39 per cent are held by tax-exempt investors. Of the tax-exempt investors, most are RRSPs, with some limited investments by pension funds. The same distributions were assumed for shareholders under the corporate structure.

In the case of Canadian taxable investors, the average federal personal income tax rate is 25 per cent, which is based on Canada Revenue Agency data on individual taxpayers that reported dividend income (it is assumed that Canadian taxable investors are holding FTEs in place of dividend-paying equities).[29] Using this 25 per cent federal personal income tax rate, the effective federal personal income tax rate is 14.6 per cent on dividends and 12.5 per cent on capital gains.

Statistics Canada data for 2000–2003 were used to estimate income tax that would have been payable under a corporate structure in 2004. The average effective federal corporate income tax rate (as a percentage of EBITDA) was 6.3 per cent.[30] Dividends, interest payments to third party lenders and capital gains under the corporate structure are also calculated using these data and are expressed as a percentage of EBITDA.

The effective federal corporate income tax rate may understate federal corporate income tax revenues that would have been paid under the corporate structure. This is because the effective federal corporate income tax rate includes, among other things, corporations with little or no taxable income (such as growing businesses or start-ups), as well as businesses paying the small business income tax rate. However, those businesses are not likely to use the FTE structure. Moreover, an average effective corporate income tax rate would understate taxes paid under the corporate structure if corporations put their mature business assets (i.e. income-producing assets)

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[28] The remaining $2.8 billion of EBITDA not distributed or paid as interest to third party lenders was generally attributable to depreciation, depletion and amortization. EBITDA is calculated as profit before income tax adjusted to add back interest expenses as well as depreciation, depletion and amortization deductions.

[29] The federal personal income tax rate would be 21 per cent if Canadian taxable investors were assumed to be substituting interest-bearing assets (e.g. guaranteed investment certificates, bonds and deposits) for FTEs.

[30] This effective rate is much lower than the general tax rate of 22.12 per cent in 2004 because the effective rate is expressed as a percentage of EBITDA rather than as a percentage of income for tax purposes. EBITDA is used because FTE and corporate structures are more comparable using EBITDA. Because federal corporate income tax rates were being reduced over the 2000-2004 period, the effective federal corporate income tax rate calculated for the 2000-2003 period was reduced to reflect the general and resource income tax rates that applied in 2004.

into an FTE and other assets in a corporation—for example, where a resource corporation divides its resource business into an income-producing FTE and an exploration company.[31] This would result in little income tax being paid by the exploration company due to exploration, development and other deductions.

b) Estimates for 2004

It is estimated that federal tax revenues in 2004 were $300 million lower than they would have been if FTEs were structured as corporations (see Table 5).[32] This estimate is broken down as follows:

- Business income trusts accounted for $120 million.
- Energy trusts accounted for $55 million.
- REITs accounted for $80 million.
- Limited partnerships accounted for $45 million.

Part of the taxes paid in 2004 relate to a one-time $40 million of tax payable by shareholders when they dispose of shares of corporations that have converted to an FTE structure. This revenue impact was estimated on the assumption that there was a 13 per cent premium on the disposition of shares on conversions and initial public offerings (IPOs) in 2004.[33] The total value of conversions and IPOs in 2004 was $6.6 billion.

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[31] Corporate income taxes that would have been paid on income from mature business assets are understated using an average effective federal corporate income tax rate on all the assets of the corporation due to the higher expenses related to the growing part of the business.

[32] This estimate excludes the federal capital tax, which is being phased out. This estimate also excludes income tax that may have been paid in 2004 under the FTE structure. A review of FTEs in 2004 suggested that small amounts of federal and provincial income tax were paid. Large portions of these taxes were attributable to a small number of FTEs. Financial statements suggest that these taxes may be recovered in future years (as shown by the FTEs reporting future tax assets).

[33] This estimate assumes that all gains are taxed at the shareholder level as a disposition of shares eventhough where a corporation transfers a portion of its assets to an FTE, the corporation would be taxed on the gains resulting from the transfer of assets. The assumption above does not have a material impact on the estimate. The 13 per cent premium is an estimate of the average change in share prices following the announcement of conversions to FTEs. This increase in price is, in part, a result of the increased demand for FTEs because of the tax savings under the FTE structure. This premium was applied to conversions and IPOs in 2004. The 13 per cent premium is based in part on a study by Paul Halpern, *Is the Trust in Trusts Misplaced*, Rotman School of Business, University of Toronto, pages 28-31.

Table 5. Estimated Impact on Federal Tax Revenues
($ millions, 2004)

	Income Trusts			Limited	
	Business	Energy	REITs	Partnerships	Total
1. Taxes under the FTE structure	420	505	200	80	1,205
2. Taxes under the corporate structure	565	570	285	125	1,545
3. Tax on conversions and IPOs	25	10	5	0	40
Federal revenue impact (1 – 2 + 3)	-120	-55	-80	-45	-300

c) Sensitivity of Estimates to Key Parameters

These estimates are very sensitive to certain parameters—in particular, the proportion of FTEs held by tax-exempt investors and the average effective federal corporate income tax rate under the corporate structure.

The above estimates assume that tax-exempt investors held, on average, 39 per cent of FTEs. However, there is very little data on the proportion of tax-exempt investors holding FTEs. If the estimate of the proportion of FTEs held by tax-exempt investors were 49 per cent (10 percentage points higher than the previously assumed base case), federal revenue loss would increase by $105 million.[34]

Another key assumption is the average effective federal corporate income tax rate of corporations under the corporate structure. A 1 percentage point increase in the assumed average effective federal corporate income tax rate would increase the amount of the federal revenue loss by $135 million.

Table 6 below shows the sensitivity of the estimated impact on federal tax revenues to these key assumptions.[35] For example, the federal government would have higher tax revenues under the FTE structure than under the corporate structure if: 1) no FTEs were held by tax-exempt investors and 2) the effective federal corporate income tax rate were 6.3 per cent or less. The estimated impact could, however, be over $1 billion if all FTEs were held by tax-exempt investors and the effective federal corporate income tax rate were 7.3 per cent or higher.

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[34] The sensitivity of the estimated impact does not include changes to the proportion of third party lenders that are tax-exempt investors.

[35] The sensitivities in Table 6 assume that tax-exempt investors are holding FTEs in place of equities. If tax-exempt investors sell debt instruments and acquire FTEs, then the estimated impacts on federal tax revenues would be lower than shown. However, it is important to note that a similar effect occurs when tax-exempt investors sell debt instruments to acquire shares of corporations.

Table 6. Sensitivity of Estimated Impact on Federal Tax Revenues to Key Assumptions ($ millions, 2004)

Corporate Tax Rate	Proportion of FTEs Held by Tax-Exempt Investors					
	0%	**20%**	**39%**	**60%**	**80%**	**100%**
5.3%	230	25	-165	-390	-590	-800
6.3%	100	-105	**-300**	-525	-730	-940
7.3%	-30	-235	-435	-660	-870	-1,080
8.3%	-160	-370	-570	-795	-1,010	-1,220

d) Projecting Possible Future Impacts

The preceding sections estimated the federal tax impact for 2004 and sensitivities to this estimate. It is also useful to consider how we could expect these revenue impacts to change in the future. Future tax revenue impacts, which are very difficult to predict, will depend on a number of factors, including:

- The proposed reductions in corporate income tax rates in Budget 2005.
- The growth of the FTE market.
- The proportion of FTEs owned by tax-exempt investors.
- The potential for increased use of FTEs for mature business assets.
- Future tax effects related to tax-exempt investors.

The amount of corporate income tax that would be paid under the corporate structure in the future would be affected by the proposed corporate income tax rate reductions in Budget 2005 and the completion of the rate reductions announced in Budget 2003 for resource corporations. These combined rate reductions would reduce the general federal corporate income tax rate to 19 per cent by 2010, which could decrease the impact on federal tax revenues by $165 million per year.[36]

[36] The average effective federal corporate income tax rate of 6.3 per cent (as a percentage of EBITDA) was reduced to 4.9 per cent to take into account the proposed corporate tax rate reductions to 19 per cent and the reduction in the corporate income tax rate for resource corporations from 25 per cent in 2004 to 19 per cent by 2010.

Future growth of the FTE market will reduce future tax revenues. In general, a 10 per cent increase in the FTE market capitalization would reduce federal tax revenues by about $35 million per year.[37]

As indicated above, increased holdings of FTEs by tax-exempt investors could have a significant impact on federal tax revenues in the future. For example, a 10 percentage point increase in the proportion of FTEs held by tax-exempt investors would decrease federal tax revenues by $105 million per year.

The estimated revenue losses would also increase if corporations increasingly put their mature business assets in FTEs and keep the growing part of the business in a corporation. Corporations may, for example, put a portion of their mature business assets in FTEs and retain sufficient assets in the corporation to shelter capital cost allowance, exploration, development or other deductions of the corporation. This approach would allow the corporation to generate tax savings on most of its mature business assets through the FTE. This could result in little income tax being paid by the corporation.

There may also be future tax effects related to certain tax-exempt entities, such as pension funds and RRSPs. Contributions to these plans are deductible by the contributor for income tax purposes, and distributions are taxable for the recipient. In the case of pension funds, the future impact on tax revenues would depend on the type of plan—whether a defined benefit plan or a defined contribution plan. In the case of defined benefit plans, which promise a specific benefit on retirement, higher returns on investments in FTEs may result in lower contributions. In the case of defined contribution plans (and RRSPs), higher returns on assets could result in increased payouts. Both lower contributions and higher payouts would increase federal tax revenues to the extent that contributors and beneficiaries are taxable. The amount of the increase will also depend on the magnitude of the returns on FTEs (relative to other investments) and the length of time the assets are held in the plan. The annual impact of these future tax effects is expected to be small.

e) Provincial Tax Implications

Historically, FTEs have affected provincial tax revenues and, as with federal tax revenues, the potential for future growth could affect provincial tax revenues further. Provincial tax impacts will depend on where corporations carried on a business prior to converting to an FTE as well as the residence of investors. Tax revenues are reduced in provinces in which corporations carried on a business and paid provincial corporate income tax prior to converting to an FTE. Whether there is a net revenue loss would depend on the offsetting income tax paid at the investor level. Since investors in FTEs may reside in other provinces, the potential impact on a province's tax revenues will vary depending on these parameters.

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[37] This assumes that EBITDA would also increase by 10 per cent and that there are no changes to other parameters. It assumes that the increase in EBITDA is not the result of new FTEs.

The Saskatchewan government announced in its 2005 budget that it would introduce amendments to the Saskatchewan Corporation Capital Tax (CCT) legislation, effective April 1, 2005, to include resource trusts for the purposes of levying the CCT Surcharge. This initiative is the result of a review that was announced in the 2004 Saskatchewan budget on the taxation status of resource trusts that own oil- and natural-gas-producing properties in the province.

Question for Consideration:

2. ***Have FTEs had a significant impact on tax revenues? Is there potential for revenue losses to grow in the years to come?***

6. Economic Efficiency Issues Related to FTEs

Given that the tax system may be a factor in the decision as to whether an FTE will be used to structure a particular business, it is important to determine what effect this has on the Canadian economy. Arguments have been made on both sides of this issue. That is, some have argued that the tax treatment of FTEs leads to greater economic efficiency—at least for certain types of businesses—while others have argued that this tax treatment distorts investment decisions and leads to reduced economic efficiency. This section discusses the possible factors that underlie the use of FTEs and the impact of their use on economic efficiency. In this context, it also discusses the important role that tax-exempt investors play in Canadian capital markets and how this may affect developments respecting FTEs. Economic efficiency issues such as these are an important element of ensuring that Canada maintains a prosperous and secure nation that can offer an unparalleled quality of life.

a) Economic Efficiency

Economic efficiency is achieved when scarce economic resources are allocated to their most productive uses, in a cost-effective way. For example, removing barriers to the movement of capital across industries would increase economic efficiency. In considering the economic efficiency issues related to the use of FTEs, it is helpful to draw an illustrative distinction between growing businesses and mature businesses.

As discussed in Section 3, the tax system favours the use of a corporate structure for growing businesses with high investment requirements. This is because income retained in the corporation generally bears less tax than if the income is earned at the personal level. This would suggest that the corporate structure is suited to growing businesses.

The FTE structure may be more suited for mature businesses. This is because FTEs can distribute cash flows in a manner that achieves full integration of the personal and corporate income tax systems, removing an impediment to distributions. Since business managers may face more limited reinvestment options than shareholders, it may be preferable that returns be distributed to investors, especially when the cash flows are generated by highly mature businesses with little potential for growth. The high distribution rates typically associated with FTEs may therefore favour a more productive allocation of capital in the economy.

FTEs may also promote efficiency by providing a larger pool of potential investors for mature business assets. FTEs provide:

- A financing option for corporations to reduce debt and restructure balance sheets by transferring income-generating assets into an FTE, particularly in periods of economic slowdown when capital markets are less receptive to common share issues. In addition, a spinoff of part of a business into an FTE may provide a productive allocation of capital

because it may act like an asset securitization[38] by providing funds to businesses to fund innovation and growth in other parts of the business.

- An additional option for private investment firms, or privately held businesses, to sell a closely held mature business, which may improve economic efficiency by providing private firms with an additional vehicle to become public.

On the other hand, the tax system could be driving decisions on how businesses structure themselves that could lead to inefficient economic outcomes. This could occur, for example, if businesses convert to an FTE structure before they have reached a mature state (i.e. during the business' innovation and growth stage). In addition, distribution of cash flows to investors may not result in efficiency gains if shareholders do not have perfect information on which to make investment decisions. The cost of returning to the capital market with secondary offerings could also be more costly than funding growth through retained earnings.

Furthermore, mature businesses using the corporate structure may be at a disadvantage compared to those opting for an FTE structure. To the extent that certain mature corporations may face barriers that prevent them from effectively using FTEs, concerns about unfair competition may be raised. Finally, it has been argued that economic inefficiencies may also occur if the FTE structure favours investment in low-growth industries. As a result, capital may not be allocated to its most efficient use.

Question for Consideration:

3. ***What impacts are FTEs having on investment decisions and the allocation of capital in Canada? Is the overall impact on the economy positive or negative?***

b) The Role of Tax-Exempt Investors

The key role tax-exempt investors, particularly pension funds, play in capital markets is also important in considering these economic efficiency issues.

With the low interest rate environment and reduced interest in the Canadian equity market since 2001, many pension funds, especially the large public sector funds, have begun to play a more active role in capital markets to seek out higher returns for their plan members. This has

[38] Asset securitization involves pooling groups of assets, such as mortgages, and financing them with securities that are sold to investors.

manifested itself most notably in the private equity (i.e. buyout) market, where large pension funds have become important players in taking companies public, including through income trusts. For the same reasons, pension funds have also begun to increase their investments in other alternative assets, such as infrastructure, real estate and hedge funds.

As a group, pension funds are now the largest class of investors in Canada, with the market value of assets approximating $626 billion at the end of 2003.[39] This was equal to around half of the Toronto Stock Exchange's market capitalization of $1.3 trillion in 2003. At the end of 2001, assets of other deferred income plans accounted for an additional $445 billion. As pension funds have grown, both individually and as a group of investors, so has their ownership of the shares of Canadian companies and overall influence in capital markets.

Through their investments, tax-exempt investors could influence decisions on how businesses are structured with a view to increasing returns. A 1998 report of the Standing Senate Committee on Banking, Trade and Commerce discussed the various methods pension funds and other institutional investors employ to influence corporate behaviour.[40] The *Report of the Technical Committee on Business Taxation*[41] noted that there could also be issues of fairness and efficiency at hand since it may be possible for businesses that are financed by tax-exempt investors to lower their cost of capital relative to similar businesses financed by persons subject to income tax. This could result in an unlevel playing field among businesses as some businesses would be able to price their products and services below those of their competitors.

Question for Consideration:

4. ***Given the important role that tax-exempt investors play in Canadian capital markets, and could play in the FTE market, what impact could this have on government revenues and economic efficiency?***

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[39] Statistics Canada. This total does not include registered pension plan assets held in government consolidated revenue funds, insurance companies, or Government of Canada annuities.

[40] *The Governance Practices of Institutional Investors* (http://www.parl.gc.ca/36/1/parlbus/commbus/senate/com-e/bank-e/rep-e/rep16nov98-e.htm). In 2001, the Securities Industry Committee on Analyst Standards, led by Purdy Crawford, released the report *Setting Analyst Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts*. Among other things, the report called on institutional investors to use their market power to positively influence the practice of analysts and, ultimately, improve the integrity of the market.

[41] *Report of the Technical Committee on Business Taxation* (1998), Department of Finance, Ottawa.

7. Potential Policy Approaches

The focus of this paper is to assess the tax and economic efficiency implications of FTEs to determine if the current tax system is appropriate or should be modified. If it is determined that the tax system needs to be modified, the question arises as to the potential policy approaches. This section lists some policy approaches that are relevant to the issues identified in this paper.

Measures announced in Budget 2004 proposed to limit pension fund investments in business income trusts. These proposals were made based on concerns that unlimited participation of pension funds in the business income trust market could have a significant impact on the market and government revenues because of their tax-exempt status and their influence in Canadian capital markets. Those measures were proposed not to apply to energy trusts and REITs given that pension funds can invest directly in the types of property held by energy trusts and REITs. The measures were also designed to minimize their impact on both the capital market as a whole and on individual market participants. In response to representations, it was announced on May 18, 2004, that the proposals would be suspended to allow for further consultations.

Although not an exhaustive list, policy approaches that derive from the discussion of issues in this paper include: limiting the deduction of interest expenses by operating entities, taxing FTEs in a manner similar to corporations, or better integrating the personal and corporate income tax system. Improving the integration of the personal and corporate income tax systems would make the tax system more neutral between all forms of business organizations. These approaches may be complex as they would have to take into account a variety of factors, such as the different types of FTEs and the tax status of investors in these entities. They may also be costly in terms of foregone federal tax revenues or have a significant impact on the FTE market.

Question for Consideration:

5. ***Overall, are there public policy concerns about FTEs and how the tax system influences their existence, and if so, what actions should be considered to address these concerns?***

8. Consultation Framework

This paper raises a series of questions that are intended to assist stakeholders in making submissions.

Written submissions should be e-mailed to trusts-fiducies@fin.gc.ca, or mailed to the address below by December 31, 2005. Please note that in this consultation initiative, we offer to post your submission on the Department of Finance website. Please clearly indicate in your communication whether or not you grant us permission to post your comments on our website. If you do not give explicit permission, we will not post.

If you do give permission, we need the following information:

- Your full name.
- The name of the organization for which you speak, if applicable.
- Your full mailing address, including postal code.
- Your telephone number, including area code.
- Your e-mail address and fax number, if applicable.

You should indicate by which method you would prefer to be contacted and also state whether any communication with you should be in French or English.

An additional vehicle for public input will be symposiums to be organized and hosted by the Canadian Tax Foundation. The Canadian Tax Foundation is an independent non-profit organization devoted to education and research in the fields of taxation and public finance in Canada. The Foundation provides a forum for expert analysis and discussion of issues in these fields, but does not itself advise on or advocate specific policy recommendations to governments. The symposiums are intended to help foster a better understanding and public discussion of the tax and economic policy issues relating to FTEs. The Foundation will provide further information on these symposiums as soon as detailed arrangements have been finalized.

Technical questions on the consultation process may be addressed to:

Denis Normand
Business Income Tax Division
Department of Finance
17th floor, East Tower
140 O'Connor St.
Ottawa ON
K1A 0G5
(613) 992-5887

Annex: Estimated Annual Impact of FTEs on Federal Tax Revenues

Table 7. Summary of Parameters (2004)

	Income Trusts			Limited	
	Business	Energy	REITs	Partnerships	Total
Total number of FTEs	110	31	25	6	172
Number of FTEs in sample	91	29	25	6	151
Sample as percentage of market capitalization	96%	99%	100%	100%	98%
Financial statements data [1]					
EBITDA ($ millions)	4,751	5,638	2,529	1,068	13,986
Interest expenses – third party ($ millions)	626	360	1,031	238	2,254
Interest expenses (% EBITDA)	13.2%	6.4%	40.7%	22.3%	16.1%
Distributions ($ millions)	3,339	3,844	1,201	541	8,925
Distributions (% EBITDA)	70.3%	68.2%	47.5%	50.7%	63.8%
Distributions – taxable	73.7%	70.8%	32.2%	59.2%	66.0%
Distributions – dividends	8.4%	0.3%	1.0%	4.1%	3.7%
Distributions – tax-deferred distributions	17.9%	28.9%	66.7%	36.7%	30.4%
Investors [2]					
Taxable Canadian – retail	40.0%	27.6%	41.0%	40.0%	34.8%
Taxable Canadian – mutual funds	5.0%	3.9%	6.0%	5.0%	4.7%
Non-residents	10.0%	37.5%	7.0%	10.0%	21.4%
Tax-exempt	45.0%	31.0%	46.0%	45.0%	39.1%
Third party lenders [3]					
Taxable Canadian – retail	12.0%	12.0%	12.0%	12.0%	12.0%
Taxable Canadian – institutional	13.0%	13.0%	13.0%	13.0%	13.0%
Non-residents	29.0%	29.0%	29.0%	29.0%	29.0%
Tax-exempt	46.0%	46.0%	46.0%	46.0%	46.0%
Federal personal tax rates [4]					
Interest	25.0%	25.0%	25.0%	25.0%	25.0%
Dividends	14.6%	14.6%	14.6%	14.6%	14.6%
Capital gains	12.5%	12.5%	12.5%	12.5%	12.5%
Non-resident tax rates					
Trust – taxable distributions	15.0%	15.0%	15.0%	25.0%	15.0%
Dividends	15.0%	15.0%	15.0%	15.0%	15.0%
Trust – tax-deferred distributions	0.0%	15.0%	15.0%	0.0%	15.0%
Interest	10.0%	10.0%	10.0%	10.0%	10.0%
Corporate structure (% EBITDA) [5]					
Federal corporate income tax	6.8%	6.3%	5.0%	6.8%	6.3%
Federal and provincial corporate tax	11.1%	8.8%	7.7%	11.1%	9.6%
Interest expenses – third party	21.7%	12.5%	37.7%	21.7%	20.9%
Dividends	17.6%	9.0%	19.0%	17.6%	14.4%
Capital gains [6]	33.0%	44.3%	23.8%	22.6%	35.1%

Notes to Table:

1. Financial data on income trusts and limited partnerships can be found on the SEDAR website (www.sedar.com). Funds of funds and income deposit securities were not included in these estimates. Virtually all of the FTEs are listed on the Toronto Stock Exchange (except for several listed on the TSX Venture Exchange). Financial statement data are adjusted to an annualized basis for 2004 to take into account that some FTEs do not have a December 31st year-end. Financial statement data was also annualized for FTEs that were created and listed part way through 2004.

2. The distributions of investors in income trusts and limited partnerships were based on discussions with HLB Decision Economics and industry participants.

3. The distribution of third party lenders is the same as in the HLB Decision Economics studies.

4. In the case of retail and institutional investors, the average federal personal income tax rate is 25 per cent, which is based on Canada Revenue Agency data on individual taxpayers that reported dividend income (it is assumed that Canadian taxable investors hold FTEs in place of dividend-paying equities). The effective federal personal income tax rate is 14.6 per cent on dividends and 12.5 per cent on capital gains. The effective personal income tax rate on capital gains assumes that net cash flows are reinvested at the federal government long-term bond rate, which is the same rate used to discount future taxes paid on disposition of shares, units in income trusts or interests in limited partnerships.

5. Interest expenses and corporate taxes (as percentage of EBITDA) is an average for the 2000 to 2003 period using Statistics Canada data, Catalogue no. 61-219-XIE, *Financial and Taxation Statistics for Enterprises*, 2003. The corporate income tax rates were adjusted to take into account 2004 corporate income tax rates. In the case of energy trusts, data from the Canada Revenue Agency was used. Dividend distributions (as percentage of EBITDA) are for 2003, from Statistics Canada, Catalogue no. 61-008-XIE, *Quarterly Financial Statistics for Enterprises*.

6. The estimate for gains accruing annually to shareholders is based on an estimated increase in the net value of the corporation. To arrive at this net value, the distributions and third party interest expenses of FTEs were used as an estimate of pre-interest cash flows of FTEs. These cash flows were used as a starting point for the corporate structure and were reduced by interest payments to third party lenders under the corporate structure, federal and provincial corporate income taxes, and dividends paid to shareholders. The residual is the increase in the net value under the corporate structure in 2004.

Federal Estimates for 2004

	Income Trusts			Limited	
	Business	Energy	REITs	Partnerships	Total
1. Taxes under the FTE structure					
Taxes paid by unitholders/partners	365	475	105	55	1,000
Taxes paid by third party lenders	55	30	95	25	205
Total	420	505	200	80	1,205
2. Taxes under the corporate structure					
Corporate income tax	320	355	125	75	875
Taxes paid by shareholders	155	150	70	30	405
Taxes paid by third party lenders	90	65	90	20	265
Total	565	570	285	125	1545
3. Tax on conversions and IPOs	25	10	5	0	40
Federal revenue impact (1 – 2 + 3)	-120	-55	-80	-45	-300