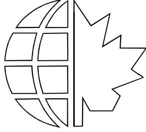
LEVEL THE FIELD FOR INVESTORS AND ENTERPRISES

SUBMISSION TO THE DEPARTMENT OF FINANCE CANADA CONSULTATION ON INCOME TRUSTS

NOVEMBER 2005



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EXECUTIVE SUMMARY

In a consultation paper published in September 2005, the Department of Finance Canada raised two key questions with respect to the proliferation of income trusts and other flow-through entities. The first is whether the growing popularity of the income trust structure is reducing federal tax revenues. The second is whether this trend is having a negative impact on economic efficiency, by shifting capital to lower-growth sectors or by encouraging a less entrepreneurial and less innovative corporate culture.

For Canadian taxpayers, the revenue issue is a red herring. Estimates of the revenue impact vary widely and are very sensitive to parameters about which too little is known. In any case, the biggest "tax leakage" is to retirement savings vehicles. Any revenue "lost" in the short term is in fact just deferred. It will be recovered at full personal income tax rates, instead of at the lower rates applied to capital gains and dividends. Finally, it will be recovered just when Canada's aging population puts maximum strain on public services such as health care.

However, the current double taxation of corporate dividends is fundamentally unfair to Canadian investors, and especially to those who invest for retirement through pension funds or Registered Retirement Savings Plans (RRSPs). There is considerable evidence that this unfair treatment is having a significant impact on economic efficiency by distorting the behaviour both of investors and of corporate boards and management.

A survey of members of the Canadian Council of Chief Executives *(CCCE) suggests that companies have converted and continue to consider conversion from a corporate to an income trust structure primarily for tax reasons. Furthermore, Canadian chief executives report that the advantages of income trusts for pension funds and RRSPs are leading to considerable pressure on corporate boards to convert to trusts for tax purposes even where management sees no other strategic advantage. This pressure is widespread, across the full range of resource, manufacturing and service industries and is being felt most heavily by Canada's largest companies.*

The only feasible solution is to level the playing field. Doing so by imposing new restrictions, levies or taxes on income trusts would undermine the value of investments made by Canadians in good faith and would be counterproductive to the government's economic goals. The only sensible path is to improve the tax treatment of corporate dividends, both by increasing the dividend tax credit and by making it refundable to pension plans and RRSPs.

The CCCE recognizes that this policy shift would have a short-term impact on government revenues, but the advantages in terms of productivity, competitiveness and future economic growth are compelling. *By a margin of more than two to one, respondents to the CCCE survey agreed with the following statement: "Improving the tax treatment of dividends should take priority over other corporate tax reductions including cuts in the statutory corporate income tax rate and improvements to capital cost allowance rates."*

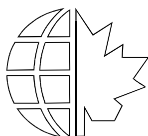
Above all, the CCCE stresses the urgency of resolving the uncertainty created by the Minister of Finance in September when he announced a moratorium on further advanced tax rulings on income trust conversions. The market needs a clear message, and it needs that message without delay.

INTRODUCTION

The income trust structure, once limited largely to the real estate and energy sectors, now has been adopted by a wide range of businesses. These trusts form a large and growing proportion of Canada's capital markets and play a key role in the retirement plans of Canadians.

The proliferation of income trusts and in particular of conversions to a trust structure by incorporated businesses has created considerable concern in the federal government. In September 2005, the Department of Finance Canada published a consultation paper, *Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships),* describing these concerns and asking for input on what, if anything, should be done in response.

The *Canadian Council of Chief Executives* (CCCE) has surveyed its members with respect to their perceptions and recommendations and has reviewed the relevant academic literature. This paper summarizes the CCCE's responses to the questions raised by the Department of Finance Canada and includes recommendations for action.



FRAMING THE ISSUES

Efficient capital markets matter to the competitiveness and growth of enterprises; they also matter to investors. The income trust issue affects both dimensions. The central policy issue is whether the current tax structure and rules affecting income trusts and corporations are distorting the behaviour of business managers or of investors and thereby undermining efficient markets and the competitiveness of the Canadian economy.

The government's discussion paper poses several specific questions about the extent and implications of the growing popularity of income trusts. In particular, the government is seeking better information about whether and to what extent the trend toward trust formation is having an impact on federal revenues, on the organization of businesses or on the overall efficiency of the economy.

The CCCE sees the key questions in the following terms:

- Does the current regulatory and tax structure pose a material risk to federal revenues?
- Is the current regulatory and tax structure distorting the behaviour of investors in the way they allocate capital among competing enterprises?
- Is the current regulatory and tax structure distorting the behaviour of managers in the way they organize their businesses and develop corporate strategies?

THE IMPACT ON FEDERAL REVENUES

Current tax rules include a provision for a tax credit to investors who receive dividends from corporations. The purpose of this credit is to establish tax neutrality between equity and debt financing of corporations. However, because the dividend tax credit is based on the small-business corporate income tax rate, investors in large corporations face a measure of double taxation on the dividends they receive.

In addition, tax-exempt investors, both large pension funds and individual Registered Retirement Savings Plans, do not receive the tax credit. In effect, these investors are paying their full share of the corporation's taxes, and while they receive these dividends on a tax-deferred basis, they ultimately face taxation at full personal rates on withdrawal. In other words, for so-called tax-exempt investors, the degree of double taxation is compounded.

The income trust structure is designed to avoid payment of corporate tax by allowing pre-tax profits to flow directly to investors. These investors then pay income tax on these distributions at full personal rates. However, when pre-tax profits flow directly into tax-exempt pension funds and RRSPs, the government in the short term collects neither corporate income tax nor personal income tax.

Estimates of how much tax revenue the government loses in the short term vary widely. The federal consultation paper puts forward an initial estimate of what it calls "tax leakage" of about $300 million a year.

Some commentators have come up with a higher figure. In their 2004 paper for the Canadian Tax Journal, Lalit Aggarwal and Jack Mintz, for instance, made a "best-guess estimate" that the combined federal and provincial tax benefits flowing to investors in income trusts is "in the order of $400 million to $600 million in 2004."

> *"The current income returns for Canadians surviving on fixed incomes are absolutely essential. We do not have other high yielding market segments such as high yield debt and the United States and other deeper capital markets do. They play a vital role for Canadians."*
>
> *CEO, Real Estate Sector*

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

When HLB Decision Economics Inc. studied the tax impacts of income trusts over a three-year period, from 2002 through 2004, its analysis took into account both the current-year revenue impact and the impact over time. It found that while conversion to trusts led to lower tax receipts in the short term, the flow of income trust distribution into pension funds and RRSPs led to much greater tax revenue over time, even when measured in terms of present value. "When the out-year impacts of income funds are combined with current year effects, the statistically best estimate indicates a net gain to governments in 2002, 2003 and 2004."

"The alleged tax leakage is a light breeze compared to the hurricane-like devastation of trust market values that took place when the Minister of Finance decided to get tough with his anti-trust talk."
CEO, Manufacturing Sector

As Cleveland S. Patterson, Emeritus Professor of Finance, Concordia University, noted in his October 2005 submission to the Department of Finance, estimated revenue loss is very sensitive to a number of parameters, including the proportion of income-trust shares held by tax-exempt rather than taxable investors, the proportion of after-tax income that is retained and reinvested by corporations rather than paid out as dividends, and the relative growth rates of the income trust and corporate capital markets. In each case, the available data is very limited. "The data presented and their analysis are subject to far too serious potential errors to provide a basis for policy change."

Even if the government's initial estimate of $300 million is correct, Simon Romano and John Lorito of Stikeman Elliott LLP have suggested first that this tax leakage is more than offset by the spin-off benefits that result from an active and dynamic capital market, including the capital gains generated by income trusts, "and even if not, is in any event a very small drop in the bucket compared to the government's other revenues…. The overall benefits of income trusts to Canadian investors, Canadian pension plans, small and mid-sized businesses and their employees, and our capital markets, seem to vastly outweigh any minimal tax leakage."

In considering whether there is a tax leakage problem large enough to warrant policy action to limit the spread of income trusts, the government also needs to consider its policy objectives with respect to

encouraging savings and investment generally and retirement savings in particular.

> *"The government has lost more in capital gains taxes by its actions than the revenue it would gain from taxing trust income for the next ten years."*
> *CEO, Resource Sector*

The purpose of tax-assisted savings instruments is to enable Canadians to ensure that they have adequate income in retirement. Policies that undermine the performance of pension plans and RRSPs will have a negative impact on seniors in both the short and long term. Trusts in general have a high level of retail ownership, and the business trusts that now account for almost half the total market have an even higher level of ownership by individual Canadians, estimated at 80 to 90 percent, compared with a typical retail share of 60 to 70 percent for the more traditional real estate and energy trusts.

As Patterson noted, income trusts have become an essential source of income for many pensioners. "They have invested in them in good faith in the absence of any prior threats to their existence or to their advantages. For them, implementation of a tax penalty which was not grandfathered would be disastrous to their income flow. It would also wipe out a significant proportion of their savings."

The CCCE acknowledges that there is legitimate concern about the current and potential tax leakage with respect to distributions from income trusts to foreign unit holders. With respect to Canadian taxpayers, however, the revenue issue is a red herring. Estimates of the revenue impact vary widely and are very sensitive to parameters about which too little is known. In any case, the biggest "tax leakage" is to pension funds and RRSPs. Any revenue "lost" in the short term is in

fact just deferred and will be recovered at full personal income tax rates, instead of at the lower rates applied to capital gains and dividends.

In any case, government policies that encourage greater savings and investment have a positive impact on competitiveness and future economic growth. Policies that encourage greater savings for retirement through tax-deferred vehicles are especially important because they also shift government revenue into years in which Canada will have a relatively smaller working-age population while facing higher demand for publicly funded services such as health care. To the extent that the relatively favourable tax treatment of income trusts is leading to lower federal revenues now, its impact on retirement savings is positive both for the economy and for the sustainability of Canada’s social programs.

THE IMPACT ON ECONOMIC EFFICIENCY

Whatever the impact of income trusts on federal revenues in the short and long term, the policy question that really matters is whether the current regulatory and tax structure is changing investor choices about where to invest within the economy, and whether any such change is having a negative impact on economic growth.

There is no question that Canada has seen a significant spread of the income trust structure into many sectors of the economy. As Aggarwal and Mintz noted, much of the expansion in the trust sector in recent years has been in business trusts rather than traditional real estate and energy vehicles. Business trusts have grown to about half the total market from just 10 percent in 1995.

They suggested two possible impacts: one positive for economic efficiency, the other negative. “On the one hand, to the extent that companies are able to obtain cheaper financing because of tax efficiency, they will face a lower cost of capital for investment, thereby improving Canada’s capital stock and productive capacity. On the other hand, if only certain types of corporations are in a position to take advantage of income trust arrangements, capital is allocated to those companies that are able to raise capital through income trusts.”

In other words, to the extent that businesses are able to convert to trusts without undermining their strategies for efficient growth, these businesses are able to get a lower cost of capital than those for whom conversion would be counterproductive.

The result, concluded Aggarwal and Mintz, is an economy in which capital flows faster into what may be slower growth sectors of the economy. "Although the income trust segment is still young in comparison with the traditional equity markets, the early indications are that the fastest-growing and highest-yielding sectors have not accessed this capital market, while the slowest-growing and lowest-yielding sectors have. From an economic efficiency standpoint, this is a significant inter-firm distortion, especially since part of its causation lies in the unintegrated part of the corporate tax."

While the government's consultation paper suggests that income trusts are primarily of benefit to stable businesses with high cash flow and low growth, there is evidence that this form of organization is spreading into a wide range of businesses without inhibiting their growth. Indeed, the experience of some members of the CCCE shows that income trusts are capable of growing dramatically despite high payout ratios.

> *"The emergence of income trusts has had a profoundly positive effect on the economy. Businesses that can fit the model of high, sustainable and stable distributions have continuous access to capital at very attractive rates. This low-cost capital is high-octane fuel for the Canadian economy."*
>
> *CEO, Manufacturing Sector*

As Vijay Jog and Liping Wang noted in their 2004 paper in the Canadian Tax Journal, "Income trusts are not only financing mature, no-growth, one-time businesses, but are also aggressively raising capital for capital expenditures and new acquisitions. Over 50 percent of new financing has gone into new acquisitions and capital expenditures. These trust vehicles may not be impediments to economic growth."

Perceptions of Canadian CEOs reflect this division of opinion within the academic community. For instance, the CCCE asked its members whether conversion from a corporate to an income trust structure changes corporate culture, leading to slower growth and less investment in new machinery and in research and development. Their responses were evenly divided between those who agreed and disagreed. Furthermore, there are strongly held views on both sides of the issue.

Similarly, roughly equal numbers of chief executives agreed and disagreed with the proposition that conversion to a trust structure leads to more efficient allocation of capital because managers must go back to market to raise capital for major expansions and acquisitions.

While CEO views on these questions did not vary much across industry sectors, there was a notable difference in views between larger and smaller companies. Responses from the CEOs of the largest companies, those represented within the S&P/TSX 60 index, were twice as likely as their smaller-cap counterparts to feel that shifting to an income trust structure has a negative impact on investment, innovation and growth and to disagree with the idea that conversion leads to more efficient allocation of capital.

In effect, the perceptions of Canadian chief executives lead to the same conclusion as that reached by Aggarwal and Mintz: “Some observers argue that income trusts are valued by investors for putting cash in their hands to make portfolio decisions rather than leaving it in the hands of corporate managers to make decisions on investors’ behalf. This may be correct, but in other instances corporations are in a better position to use cash flows in investments highly complementary to existing assets, thereby providing investors higher returns on their asset portfolios. In our view, the tax system should not distort payout decisions of business; the decisions are best left to markets to sort out.”

The members of the CCCE agree strongly that even-handed tax treatment is essential for economic efficiency and growth, and the current federal tax rules do not provide even-handed treatment of the corporate and trust forms of business organization.

“Business trusts have been and will continue to be formed purely for tax arbitrage reasons. The role of pension funds, often working in concert with hedge funds, can create great instability in capital markets. When there was speculation that firms in our industry would become trusts, our stock surged, only to lose most of these gains when the Minister indicated his concerns. This type of volatility is not good for the smooth functioning of the markets.”
CEO, Financial Services Sector

Canadian chief executives see this tax discrimination as a significant driver of corporate organization and reorganization. The vast majority of respondents to the CCCE survey agreed with the statement: “Some companies have converted or are considering conversion to trusts primarily for tax purposes.”

Canadian chief executives report that the advantages of income trusts for pension funds and RRSPs are leading to considerable pressure on corporate boards to convert to trusts for tax purposes even where management sees no other strategic advantage. This pressure is widespread, across the full range of resource, manufacturing and service industries and is being felt most heavily by Canada's largest companies.

WHAT THE GOVERNMENT SHOULD DO

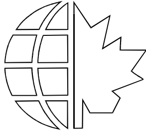
One way for the government to reduce any revenue loss flowing from the growth of the income trust sector would be limit future conversions. However, even the uncertainty created by the temporary moratorium on tax rulings announced in September 2005 appears to have had some negative impact on the value of investor holdings across the trust sector.

The CCCE's consultations show no consensus within the business community in favour either of limits on the creation of new income trusts or of restrictions on investment in trusts by tax-exempt institutions, as was proposed in Budget 2004.

> *"The government should fix what is wrong, not try to contort what is already working well. Two wrongs won't make it right. Leave the trusts alone and fix the real problem."*
>
> *CEO, Resource Sector*

Regulatory barriers to the creation of new trusts simply do not address the fundamental issue: that of the imbalance in the tax structure between the treatment of the corporate and trust forms of business organization. This imbalance, if not addressed by government policy, will continue to distort investor and management behaviour.

To correct this imbalance, the government essentially has two options: it can increase the tax burden faced by investors in income trusts, or it can reduce the tax burden faced by investors in corporations.



There would be considerable resistance in the business community to a policy of reducing the perceived tax leakage by raising the tax burden on income trusts. Among the many options that have been suggested, the revenue-enhancement measure that would face the least resistance would be a levy on income trust distributions that would be refundable to Canadian but not foreign investors. While measures to level the tax playing field between Canadian and foreign investors may make sense, any solution that would penalize Canadian holders of income trust units should be avoided.

> *"Canadian corporate tax is too high. We need to deal with the immediate problem involving trusts, but the solution must be part of a broad reform package that also addresses the corporate income tax rate, capital cost allowance rates and capital taxes."*
>
> *CEO, Transportation Sector*

The CCCE's consultation and analysis lead to the conclusion that the current regulatory and tax regime affecting income trusts is not causing material risk to federal revenues, but is leading to considerable distortion of the behaviour of both investors and managers. In particular, it is clear that the current trend in investor preferences and enterprise strategy favouring conversion to the trust form of corporate organization is being driven by an imbalance in tax policy.

Any attempt to address this imbalance by adding a new layer of taxation on investors in income trusts would inhibit investment and undermine the government's goal of fostering higher productivity growth and a more competitive economy. Any reform of tax policy should be aimed at reducing rather than increasing the tax burden on Canadian enterprises, in order to improve their ability to raise capital for investment in innovation, expansion and job creation.

There is almost unanimous support within the CCCE for action to level the playing field by improving the tax treatment of corporate dividends, whether through a higher dividend tax credit or provision for making the dividend tax credit refundable to pension funds and RRSPs.

Various ways to improve the treatment of dividends have been suggested. Aggarwal and Mintz, for instance, have suggested that to integrate fully corporate and personal taxes on dividends, the government would have to increase the gross-up of dividends from 125 percent to 150 percent and increase the combined federal-provincial tax credit to 33 percent from 20 percent.

They also have suggested making the dividend tax credit refundable to pension plans and RRSPs, provided that the refund matches exactly the amount of corporate taxes actually paid.

The CCCE recognizes that a change in policy significant enough to achieve full integration of personal and corporate taxes on dividends clearly would have a large short-term impact on federal revenues. The advantages in terms of productivity, competitiveness and future economic growth, however, are compelling.

It is clear that the current lack of integration is distorting investor and management behaviour in ways that are counterproductive to economic efficiency and therefore to the healthy and sustained growth of Canada's economy. Levelling the playing field by improving the tax treatment of dividends is the only approach that makes sense.

"I believe this is the solution. It would reinforce the needed emphasis on productivity and R&D by lowering the overall cost of capital for existing corporations, and importantly would lower the cost of equity capital for

corporations and lessen the benefit of high leverage, which permits greater deductibility for more aggressive balance sheets.”

CEO, Real Estate Sector

The support for action to improve the tax treatment of dividends is so strong that by a margin of more than two to one, members of the CCCE believe that this should take priority over other corporate tax reductions including further cuts in the statutory corporate income tax rate or improvements to capital cost allowance rates.

While the specific means and timing of tax changes may be subject to the overriding need to maintain fiscal discipline, the CCCE believes that the government should commit itself to the principle of full integration and legislate without delay a firm schedule for achieving this goal.

THE NEED FOR A QUICK DECISION

> *"It is of utmost importance that the government indicates as soon as possible the direction it wants to take with this issue, to reduce the uncertainty level even if the action plan will not be put in place now. The market needs a clear message!"*
>
> *CEO, Financial Services Sector*

The federal government initiated a consultation process because of its concern about the pace and extent of the growth of the income trust market and about the implications of this trend for its own revenues and for the future growth of the economy.

In taking action to interrupt this market trend through a moratorium on advanced tax rulings, the government created considerable uncertainty in financial markets. This uncertainty is having a serious impact both on investors and on Canadian enterprises.

> *"It is vitally important that changes be made in a rational and thoughtful way, but the government must remove the uncertainty that surrounds this issue as quickly as possible."*
>
> *CEO, Utilities Sector*

Whether or not the government chooses to address the tax issue driving the income trust trend, the strongest message that the CCCE has heard from its member chief executives is that the government must decide on its policy response and bring the current uncertainty to an end as quickly as possible.

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