Tax Bulletin

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Proposed Legislation Shifts Focus Away From Income Trusts

Over the past several years, the Canadian public market landscape has been strongly influenced by an ever-increasing number of corporate enterprises converting themselves into "income trusts". Yesterday, the Department of Finance announced measures in an effort to address the Canadian government's growing concern with the potential loss of tax revenue arising from the use of these trust structures and other types of flow-through entities. The proposed measures involve a reduction in personal income taxes on dividends in order to "level the playing field" between corporations and income trusts.

Background

The Tax Drain

In highly simplified terms, income trusts are commercial trusts that indirectly own the assets of an active business. Of special interest to investors (and of special concern to taxation authorities), income trusts (and their subsidiaries) are generally capitalised in a manner that avoids (or substantially eliminates) the imposition of the entity-level taxation that normally applies to the business profits of a corporation.

The tax-efficient character of income trusts is well documented and has led to their proliferation in Canada's public markets. From 2000 through 2004, the total market capitalisation of income trusts in Canada increased from CDN$14.1 billion to CDN$110.7 billion.[1] Similarly, during the first six months of 2005, approximately CDN$11.2 billion was raised in the public markets by Canadian income trusts, including 49 initial public offerings that collectively raised CDN$5.5 billion.[2]

In recent years, several independent studies have attempted to quantify the tax revenue lost by virtue of the emergence of income trusts.[3] In 2004, it was estimated that the Canadian government loses between CDN$400 and CDN$600 million in tax revenue each year from the use of income trusts. More recently, it has again been suggested that the amount of lost tax revenue arising from the use of income trusts may be as high as CDN$600 million annually.[4]

A Solution in the Making

By the spring of 2004, the federal government determined that the potential tax leakage spawned by the expanding use of income trusts needed to be addressed. As a result, the government tabled a number of significant amendments to the *Income Tax Act* (Canada) in an effort to limit the future loss of tax revenue. In its 2004 budget, the federal

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[1] Canada, Department of Finance, Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships) (Ottawa: Department of Finance, 2005) at 10.

[2] Andrew Willis, Eric Reguly, Sinclair Stewart and Grant Robertson, "Income Trust Sector in Disarray", The Globe and Mail (27 September 2005). By contrast, between January and June of 2005, only CDN$1.5 billion was raised in the Canadian marketplace through the initial public offering of corporate shares.

[3] Lalit Aggarwal and Jack Mintz, "Income Trusts and Shareholder Taxation: Getting it Right" (2004) 52(3) Canadian Tax Journal 792.

[4] Stephen Chase "Trust tax loss $600-mln, economist says", The Globe and Mail (22 September 2005).

government proposed to limit the investments that certain tax-exempt pension funds could make in income trusts. The proposed amendments would generally have limited the amount that pension funds could have invested in income trusts to 1 percent of the book value of such funds' assets. In addition, most pension funds would have been prohibited from owning more than 5 percent of any particular income trust. However, in response to strong criticism from the financial sector, the Canadian government later suspended the implementation of its 2004 budget proposals, pending the completion of further consultations.

In the 16 months following the suspension of its income trusts proposals, the federal government undertook a lengthy review of the Canadian tax treatment of both income trusts and other types of flow-through entities, including limited partnerships. On September 8, 2005, the government released a consultation paper entitled "Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trust and Limited Partnerships)" (the "Consultation Paper"). The Consultation Paper identified a number of issues in respect of which the Canadian Department of Finance wished to solicit the views of market stakeholders and tax professionals. The Canadian government stated that it would accept submissions in response to issues raised in the Consultation Paper until the end of 2005 and that any future initiatives would thereafter be undertaken with a full appreciation of the costs and benefits of treating flow-through entities in a particular manner. Despite these assurances (perhaps because of the imminent election campaign), yesterday's announcement brought an early end to the consultation period.

The Fix

In its news release yesterday, the Minister of Finance stated that the overwhelming consensus among the submissions received during the consultation process was to reduce personal income taxes on dividends.

The mechanism for the tax reduction will take the form of an enhanced dividend "gross-up" and tax credit such that the total tax on dividends received from large Canadian corporations will be comparable to the tax paid on distributions from income trusts.

The enhanced dividend gross-up and tax credit will apply to "eligible dividends". Eligible dividends will generally include dividends paid after 2005 by public corporations (and other corporations that are not Canadian-controlled private corporations ("CCPCs")) that are resident in Canada and subject to the general corporate income tax rate. CCPCs will be able to pay eligible dividends to the extent that their income (other than investment income) is subject to tax at the general corporate income tax rate. The table set out in Appendix A illustrates how the proposal will level the playing field between corporations and income trusts.

End to Moratorium on Advance Tax Rulings By CRA

Yesterday's announcement confirmed that the Canada Revenue Agency (the "CRA") will resume providing advance tax rulings on flow-through entity structures. In September, as an indication of the government's desire to seriously consider significant changes to the manner in which income trusts and other flow-through entities are taxed, the Minister of Finance requested that the CRA immediately suspend the issuance of advance income tax rulings relating to the tax treatment of income trusts and other flow-through entities. The moratorium on the issuance of income tax rulings has had a significant chilling effect on the Canadian income trust market as well as the cross-border "income deposit securities" market. While a corporation is not required to obtain an advance income tax ruling prior to undertaking an income trust conversion, market imperatives often make the receipt of a positive tax ruling a commercial necessity.

Going Forward

Commentators have consistently advocated the reduction of tax imposed on dividends on the basis that corporate earnings should not effectively be taxed twice. It is interesting that concerns over the taxation of trusts have prompted this long-standing issue to finally be addressed.

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The pending election raises some uncertainty as to when the proposed amendments will be enacted into law. If not passed by the government prior to the election, the changes would have to be tabled again following the election.

Of greatest importance, yesterday's announcement does not foreclose the possibility of further legislative changes. The government will certainly keep an eye on the income trust market, especially considering the fact that the proposed changes do not have any meaningful impact on pension funds and other tax-exempt investors. If still unsatisfied with any perceived tax losses, the government could very well consider additional tax changes, such as an independent tax levied on income trust earnings or placing a limitation on the amount of interest that may be deducted by corporate entities that are owned by an income trust (thereby effectively establishing a degree of entity-level taxation).

Appendix A

Comparative Tax Treatment under the New Proposals

	Large Corporations		Income Trusts
	Current	Proposed	
A. Income	100	100	100
B. Corporate Tax	(32)[1]	(32)[1]	0
C. Amount distributed to an investor	68	68	100
Canadian Taxable Individual Investor			
D. Amount Included in Income (1.25 x C)	85	99	100
E. Personal Income Tax (46%[2] of D)	39	46	46
F. Dividend Tax Credit	(17)[3]	(32)[4]	—
G. Net Personal Income Tax (E – F)	22	14	46
H. Total Tax Paid (B + G)	**54**[5]	**46**	**46**

[1] The combined average federal-provincial corporate income tax rate in 2010 including the Budget 2005 proposed corporate tax rate reductions and proposed provincial tax changes.

[2] The average top federal-provincial personal income tax rate.

[3] The assumed 20 per cent dividend tax credit rate approximates the combined average federal-provincial small-business rate.

[4] Assumes that provinces will also provide an enhanced dividend tax credit for eligible dividends.

[5] Because the combined average federal-provincial corporate income tax rate for large corporations is proposed to be 32 per cent in 2010, the dividend gross-up/credit mechanism, which is based on an assumed 20 per cent corporate income tax rate, does not fully compensate individuals for taxes paid at the corporate level.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

For further information, please contact your McMillan Binch Mendelsohn lawyer, or one of the following members of our Tax Group:

Michael Friedman	416.865.7914	michael.friedman@mcmbm.com
Todd Miller	416.865.7058	todd.miller@mcmbm.com
Ryan Morris	416.865.7180	ryan.morris@mcmbm.com
Laura Stoddard	416.865.7277	laura.stoddard@mcmbm.com

McMillan Binch Mendelsohn

TORONTO | TEL: 416.865.7000 | FAX: 416.865.7048

MONTRÉAL | TEL: 514.987.5000 | FAX: 514.987.1213

www.mcmbm.com