



TD Economics

Topic Paper

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FEDERAL FINANCE DEPARTMENT RELEASES LONG-AWAITED CONSULTATION PAPER ON INCOME TRUSTS

In reaction to concern over possible revenue losses, the 2004 federal budget proposed to limit pension fund investments in business income trusts in two ways:

- Business income trusts could be no more than 1 per cent of the book value of a pension fund's assets; and
- Pension funds could hold no more than 5 per cent of any one business income trust.

Following a storm of protest, the proposals were suspended on May 18, 2004 and a consultation process was promised before any action is taken. Almost 16 months later, a document has been released by Finance to launch that process. Submissions will be accepted until December 31, 2005.

The consultation document and the process suggest that this is not a file that is going to go very far or very fast. On key issues of the economic impact of income trusts, the revenue loss and what, if any policy changes should be made, the document is largely agnostic. Both positive and negative influences on economic efficiency are identified without a clear view offered on what Finance thinks is the net impact. Finance gives its best guess estimate of the federal revenue loss at \$300 million per year (\$120 million from business income trusts, \$55 million from energy trusts, \$80 million from REITS and \$45 million from limited partnerships). As this loss largely results from the holdings of pension funds, it should more appropriately be thought of as a revenue deferral. Finance highlights the extreme sensitivity of the estimate to certain assumptions and identifies various factors that could change the revenue loss over time. Clearly, if more businesses shift to an income trust model and pension funds

increase their holdings the losses will increase. On the other hand, under the promise Minister Goodale has made to cut the corporate income tax rate from 21 to 19 per cent, the \$300 million revenue loss would shrink to \$135 million. Given all the uncertainties surrounding the estimates, that should not be considered a significant figure.

While indicating it is not intended as an exhaustive list, Finance suggests 3 policy options be considered in the consultations:

- Limiting the deduction of interest expenses by operating entities (ie characterizing debt as equity);
- Taxing flow-through entities (FTEs) in a manner similar to corporations (one possibility would be to treat distributions as dividend payments); and
- Better integrating the personal and corporate income tax system (ie changing the dividend gross-up/dividend tax credit to reduce or potentially eliminate double taxation of dividends issued by companies subject to the general corporate income tax rate).

There isn't a hint as to which, if any, of these options Finance might favour. Indeed, Finance states that all of these approaches "may be complex" and "may also be costly in terms of foregone federal tax revenues". That does not sound very promising if the purpose of any action is to limit revenue losses.

The Finance consultation document is likely being warmly received in some quarters. Pension fund managers will be pleased that re-introducing limits on their holdings of income trusts is conspicuously absent from the list of options Finance suggests be considered. Tax policy commentators who have advocated addressing

the double taxation of dividends, and this includes TD Economics and others such as the C.D. Howe Institute, should be pleased that Finance has at least put the option on the table (although the reference to options causing a revenue loss is surely a veiled shot by Finance at idea). Businesses who have already or might be contemplating shifting to an income trust model might take some comfort that there will not be any immediate roadblocks put in their way.

However, by not offering a more definitive view on whether the proliferation of income trusts is a good, bad or indifferent development, a great deal of uncertainty is left. Therein lies the key issue with income trusts. The total market capitalization of flow-through entities (income trusts and limited partnerships) has ballooned from \$18 billion at the end of 2000 to \$118.7 billion at the end of 2004. Hardly a week goes by without an announcement of another convert. Yet to date Finance has offered no clear opinion on the appropriateness of this dramatic shift in the Canadian business landscape. To some degree this is understandable. Commentators have offered mixed views on the economic efficiency impact. There has been a wide range of estimates of any revenue loss. So it is not surprising that Finance is not taking a firm position on some of the

key questions. Yet there is surely one thing everyone would agree on. There is a loss of economic efficiency if business decisions are shaped solely in the interest of tax advantage. And this is definitely what is driving many, though not all, of the conversions to income trust status. Finance needs, at a minimum, to address this aspect.

The political cycle suggests that any clarification of Ottawa's attitude toward income trusts and any policy changes will not be forthcoming soon. It seems inconceivable that measures could be formulated between the end of the consultation period on December 31, 2005 and an early 2006 Budget if, indeed, there even is one. More likely, the results of the consultation process will be at least temporarily swept aside during an early 2006 election.

In conclusion, it will be satisfying to many that Finance's consultation paper does not offer an alarmist view on the growth of income trusts. But this does not detract from the need for Ottawa to quickly clarify its position on the phenomenal growth in this sector and act to correct the tax elements promoting this structure.

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