TD Bank Financial Group

TD Economics

Topic Paper

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PRESSURE INCREASES ON FINANCE MINISTER GOODALE TO ACT ON INCOME TRUSTS

The Federal Department of Finance's September 8, 2005 consultation paper on FTEs hardly leaves the impression that Ottawa is keen on throwing roadblocks in the path of the burgeoning income trust sector. Consider the following evidence:

- Finance allowed 16 months to elapse from the time of suspending the measures in the 2004 Budget to limit the income trust holdings of pension funds until the release of the consultation document.
- The consultation period does not end until December 31, 2005, making it a tight squeeze to fit any action into an early 2006 Budget, if indeed there is one. Further, the timing means any deliberation on policy would be during the height of preparations for a 2006 election.
- Finance seeks to consult on such basic issues as estimates of revenue leakage, a domain where it has traditionally considered its own views as definitive.
- The consultation document puts out three considerations for possible action, but hastily notes that all are complex and some would involve further revenue losses.

We Do Not See Status Quo as a Likely Option

A conclusion that the upshot of the consultation exercise will be no policy action may be off the mark, however. Whether Ottawa's politicians and bureaucrats want to take action or not, their hand may be forced. The pressure has become even more evident since Finance sent the consultation document to the printer. Since then Precision Drilling announced its intent to convert to an income trust, CI Financial and GMP Capital Corp. opened the door for the financial services sector, CanWest Communications announced its interest the day the consultation paper came out, and Sears Canada has mused about its own plans. The final straw may be the notice from Gordon Nixon, CEO of RBC, that unless the tax disadvantage for corporations issuing dividends is corrected, institutions such as his own must consider converting parts of their organizations into the trust format. The federal government would no doubt argue that the conversion of any substantial parts of a large bank's operations would require regulatory approval and that would not likely be forthcoming. Still, that does not neatly put the genie back into the bottle. **It would be messy and unfair to have parts of the financial services sector converting while other parts are forbidden from responding.**

Finance's consultation document notes that the market capitalization of FTEs grew in Canada to $118.7 billion by the end of 2004 from $18 billion at the end of 2000. We estimate the market value at around $175 billion today. A crude tally of the plans announced just so far in September suggests we could soon be nearing the $200 billion mark. Finance could sit back and say that until it had heard the responses to the consultation document, it would not be formulating an opinion as to whether this growth is good, bad or indifferent for the economy. But this agnostic position must be surely being rocked as CEO after CEO makes it abundantly clear that the only reason they are contemplating the income trust structure is for tax purposes. All the Finance folks have taken Microeconomics 101. They know this is the classic definition of the deadweight economic efficiency loss. Further, they know that with each new conversion, the estimated revenue loss of $300 million for 2004 grows. Using Finance's sensitivity analysis, the cost has already leaped to $600 million per year. For all these reasons, Finance may have had a change of heart regarding income trusts. This might explain why advance rulings on income trusts were suspended September 19. On the surface, this is not a major event. There have been enough conversions that most organizations contemplating a trust should be able to anticipate their tax treatment. But it could be interpreted as a signal that Finance is more determined to act. In this light, would a company want to proceed with a conversion if the ground rules are going to be changed within months?

We Do Not See Any Negative Steps Happening in Advance of a 2006 Federal Election

The nature and timing of any action is even more difficult than usual to predict because we are entering a season where policy and politics mix to form a strange, but powerful brew. It seems highly unlikely that there will be action before a 2006 election that might substantially hurt the valuations of existing income trusts. It would not just be the pension funds screaming this time around. That suggests that the first two options Finance threw out in the consultation document-limiting the deduction of interest expenses and effectively putting a distributions tax on the FTEs-are unlikely to be enacted at least before spring 2006.

Even then the options are fraught with difficulties. Would new rules only apply to future conversions with a grandfathering of existing FTEs? On the one hand, it would seem unfair to change the rules for companies that have already converted. But, on the other, it would be unfair to give such a permanent advantage to existing FTEs. Further, it would be difficult to craft new interest expense deduction rules that narrowly focused on the FTE issue without broad, unintended consequences.

We believe that a Reduction in the Dividend Tax and the Corporate Tax Rate is the Most Likely Option

At least from a political perspective, it would be vastly superior to take action of a 'positive' type. That could be a combination of quickly moving on the promise to lower the general corporate income tax rate to 19% from 21% (which, as the consultation document notes, would reduce the revenue loss to $135 million from $300 million) and reducing or eliminating the double taxation of dividends. The latter could be accomplished by raising the dividend tax credit rate, say to 23% from the current 16.7%. There is much to recommend this course of action:

- The corporate tax rate reduction fulfills the promise of Minister Goodale and fits well with the Growth Agenda he is contemplating.
- The incentive to create a FTE for tax reasons would be addressed. Indeed, some of the FTEs that have been created in recent years would no doubt consider switching back.
- A reduction in the effective tax rate on dividends would address the gap that was created between the tax rate on capital gains and dividends when the capital gains inclusion rate was lowered to 50%.
- A lower tax rate on dividends would provide an incentive for Canadians to invest more in equity and that would make more capital available to the Canadian economy-another plus for a Growth Agenda.
- Politically, the moves could be billed as growth enhancing and hence overwhelmingly positive (the government might consider that it needed to balance such moves with something for lower-income Canadians and, in that regard, any tax reduction connected with the increased cost of home heating might provide the offset).

There is, however, some downside that would trouble Finance:

- On the surface, it would seem counterproductive to address a revenue leakage problem by causing a still larger revenue loss. It would likely cost the federal treasury at least $1 billion per year to meaningfully address the double taxation of dividends (if the revenue losses from FTEs are far above $300 million, then closing the incentive could in fact cost several billion dollars). A counterargument is that at least in this case something good is accomplished—a boost to growth, a better structure to the tax system, and a tax break for Canadians-as opposed to a revenue leakage from FTEs that may not be improving the economy.
- The combination of a lower corporate tax rate and a lower rate of tax on dividends would slow the creation of new FTEs, but there would still be the revenue leakage from pension funds holding units in the existing FTEs. Finance might have to conclude that this can be lived

with, as at least the leakage would not be growing over time if new FTEs are not springing up every day.

- Full integration of the personal and corporate income tax structures at the large corporation level would mean over-integration for dividends paid by small businesses. Finance would understandably be reluctant to create two separate dividend taxation regimes. Here again, it might have to live with the consequences.

This is a Tough Call, But if Pressed, We Would Place a 50% Probability on Government 'Doing the Right Thing' and Cutting the Dividend Tax

The policy and politics on this file are so complex that it seems foolhardy to make a prediction as to the outcome. Yet, for what its worth, here is our stab at it (Exhibit 1). But first, a caveat: it seems so evident that a combination of lowering the general corporate income tax rate and the tax rate on dividends is the right thing to do, that the probability assigned to this option may be biased up by an element of wishful thinking.

Exhibit 1. Probabilities Assigned to Policy Responses on FTEs by Spring 2006

Lowering corporate tax rate and dividend tax rate	50%
Restricting interest deduction	15%
Distribution tax on FTEs	15%
Do nothing	20%

Source: TD Economics

A final word. If the government does choose the right policy option, hopefully it will implement the corporate tax rate reductions faster than proposed in the 2004 Budget. If the rate does not hit 19% until 2010 (and if anything done on the dividend taxation is similarly subject to a long phase-in), then there will neither be many horses left in the barn and nor will it be possible to corral the FTEs that got out.

Don Drummond, SVP & Chief Economist
416-982-2556