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Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships): 1

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1. Executive Summary

In Budget 2005, the Government of Canada announced it would conduct open consultations with stakeholders on tax issues related to business [income trusts](#) and 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 issues, providing background information on FTEs and related economic efficiency issues, a 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. [Publicly listed income trusts](#), and the trust sector more generally, have gained popularity. Since 2000, this [growth](#) has accelerated sharply and appears poised to continue.

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 the future.
- 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" 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 businesses and typically raise funds by selling units in the trust to public investors. Unit holders are the beneficiaries of the trust, and their units represent their right to share in the income and capital of the trust. Income trusts generally invest funds in assets that generate income for the trust and its beneficiaries based on the cash flow of an underlying business. This income is distributed to the trust and its beneficiaries through the acquisition by the trust of equity and debt [instruments](#), royalty interest trusts, energy trusts, and [investment trusts](#) (REITs). Business income trusts are a more recent development. [Energy trusts](#) and REITs, which have existed since the 1980s.

Limited partnerships are formed under provincial laws. These laws require limited partners, one or more general partners, who have unlimited liability for the debts of the partnership. The liability of limited partners is generally restricted to the extent of their investment in the 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 market capitalization was \$118.7 billion at the end of 2004, up from \$18 billion at the beginning of 2000. The growth of FTEs has been linked to the low [interest rate](#) environment, the attractive 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 that addresses the concerns of some investors over their potential personal liability for [investments](#) in trusts. Quebec has had such legislation in place since 1994.
- Standard & Poor's has announced that certain income trusts and limited partnerships will 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 to pass through "flow through" income to investors so that income tax is not paid at the entity level (but is paid at the shareholder level) on its income and by its shareholders when the income is distributed. This is in contrast to the tax treatment of corporations and their shareholders, where tax is paid by both the corporation (at the entity level) and by its shareholders when the income is distributed. It is important to note that the tax treatment of FTEs is generally more favorable than that of corporations. For example, FTEs are not subject to the corporate tax on distributions (i.e. return of capital) that are generally taxable upon distribution, which would normally be the case for a dividend-paying corporation.

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

- The corporate structure may be more suited for growing businesses (businesses that are distributing a large proportion of their cash flow as dividends). This is because the corporation generally bears less tax than if the income is earned at the shareholder 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 trusts in the United Kingdom and the United States that may be similar to FTEs in Canada. In the United Kingdom and the United States, where a similar tax treatment of certain vehicles exists in these jurisdictions, they are usually more restricted (e.g. real estate and resource properties) than Canada. Canada appears to be in a position of having experienced such rapid growth with some of these structures in comparison with these countries highlights the fact that the tax system and tax treatment vary 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. It is estimated that federal tax revenues in 2004 were \$300 million lower than they would have been if they were structured as corporations. Business income trusts accounted for \$120 million, energy trusts, REITs and limited partnerships accounted for \$55 million, \$80 million respectively. These estimates are very sensitive to certain parameters—in particular, the number of FTEs held by tax-exempt investors and the average effective [corporate income tax rate](#) in the corporate structure.

The estimates in this paper relate only to federal income tax revenues. Provincial taxes on where corporations carried on a business prior to converting to an FTE as well as taxes on 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 is the best structure for 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 FTEs lead to greater economic efficiency—at least for certain types of businesses—while others argue that this tax treatment distorts investment decisions and leads to reduced economic efficiency issues such as these are an important element of ensuring that Canada remains 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 the current tax system is appropriate or should be modified. If it is determined that the current tax system should be modified, the question arises as to the potential policy approaches. Although many policy approaches that derive from the discussion of issues in this paper include: limiting interest expenses by operating entities, taxing FTEs in a manner similar to corporations, and 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 public companies 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. However, on May 18, 2004, in response to stakeholder concerns about the impact of the 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, [savings plans \(RRSPs\)](#) and [registered retirement income funds \(RRIFs\)](#), restricted investment in limited partnerships by such entities. From a tax policy perspective, limited partnerships have the same characteristics as income trusts and raise many of the same policy issues. The consultations also include limited partnerships.

Scope of FTE Consultations

Budget 2005 announced that the Government would undertake a consultation process 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 key questions, including:

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

This process does not include the separate consultations announced on December 1, 2004. The Budget 2004 proposal on mutual funds maintained primarily for the benefit of investors.

Consultation Process/Next Steps

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

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 taking into account the costs and benefits related to FTEs.

Section 8 provides further details about the consultation process.

2. Background on FTEs

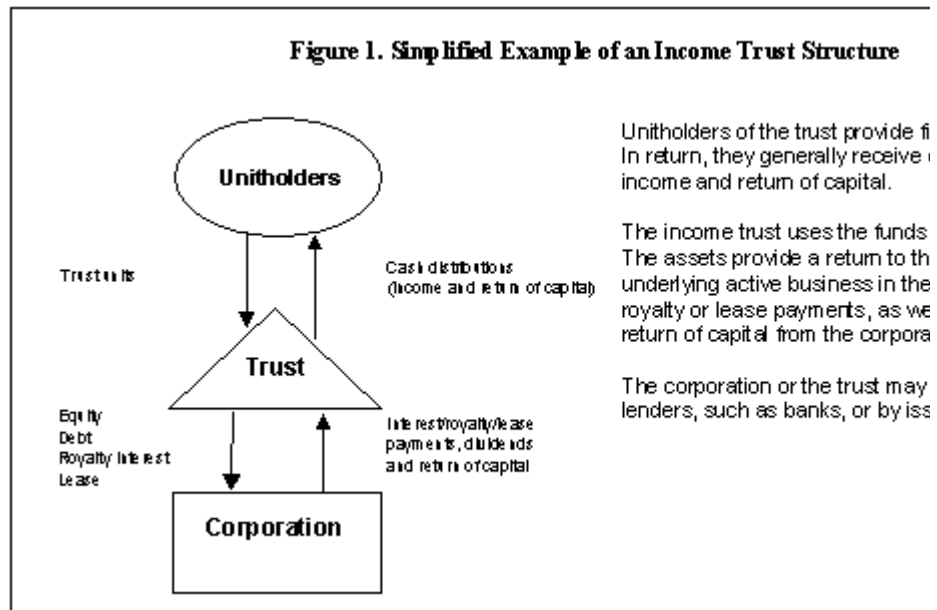
a) Income Trusts

Income trusts, which are a type of FTE governed by provincial laws, are an owner of assets or businesses. In very general terms, a trust is an arrangement under which property is held for the benefit of other persons (i.e. beneficiaries). The exercise by the trustee of 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. unit holders). Unit holders are the beneficiaries of the trust, and their units represent their right to share in the income and capital of the trust. Income trusts generally invest funds in assets that generate income for the trust and its beneficiaries based on the cash flows of an underlying business. This is typically achieved through the acquisition by the trust of equity and debt [instruments](#), royalties, and other properties. The trust can receive interest, royalty or lease payments from an operating business, as well as dividends and a return of capital. (See figure 1 for a simplified diagram of an income trust structure.)

trust structure.)

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



There are three primary types of income trusts:

- *Business income trusts* typically acquire all or substantially all of the issued equity of the 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 distribution.^[2]
- *Energy trusts* earn royalty income from resource properties through a royalty trust structure.
- *REITs* generally acquire income-producing real property and earn income primarily from rental income from an operating entity, or earn primarily interest income through the holding of debt of an operating entity.

Business income trusts are a more recent development in Canada than energy trusts. Energy trusts have existed since the 1980s. Although the first energy trust in Canada was established in 1980, the growth of the sector did not take place until the mid-1990s when the market capitalization of the sector grew significantly. In the late 1990s, the popularity of energy trusts began to decline, partly due to 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 in Canada prior to the *Income Tax Act (ITA)* in 1994, the 1994 amendments facilitated their growth by expanding the circumstances under 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, and one or more limited partners, the liability of whom is generally restricted to the extent of their investment in the partnership.

Like income trusts, limited partnerships are another type of FTE (i.e. an entity that

therefore the tax liability to investors). As is the case with all partnerships, limited partners are subject to tax on their income—instead, each partner's share of the limited partnership is directly taxed in the partner's hands. Consequently, limited partnerships can be used as an ownership vehicle for certain assets or businesses.

Budget 2005 announced the repeal of the FPR which, in addition to limiting investment by certain tax-exempt entities such as pension funds, RRSPs and RRIFs, also restricted limited partnerships by such entities. While limited partnerships have not been as popular as trusts, the elimination of the FPR could increase the investment in limited partnership investors. From a tax policy perspective, limited partnerships have many of the same issues as income trusts and raise many of the same policy issues. These issues are discussed in Section 3.

c) Growth of FTEs

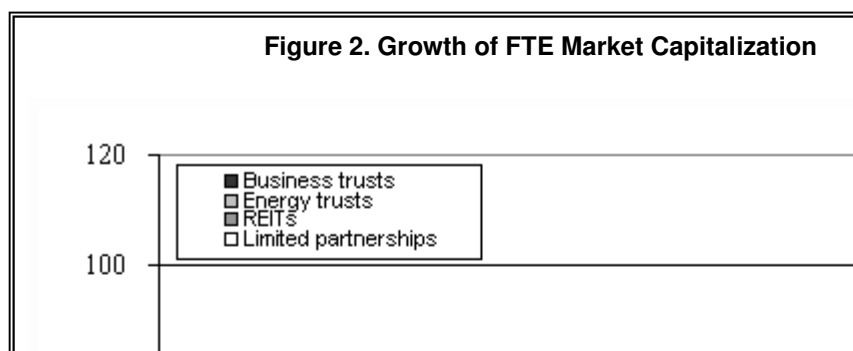
The market capitalization of FTEs in Canada has grown significantly over the past decade. Total market capitalization was \$118.7 billion at the end of 2004, up from \$18 billion at the end of 1995. Business and energy trusts have grown the most rapidly over that period (see Table 1). The growth of FTEs has been linked to the low interest rate environment, the attractive treatment of FTEs, investors' desire for cash distributions, and high commodity prices.

Table 1. FTE Market Capitalization (\$ billions)

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

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

The implementation of limited liability legislation by some provinces may alleviate these concerns. In May 2004, Alberta passed legislation (the *Alberta Income Trust Limited Liability Act*) to limit the liability of income trust investors. Ontario passed similar legislation in December 2004 (*Beneficiaries' Liability Act*) and Manitoba in June 2005 (*The Investment Trust Unit 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 in the S&P/TSX Composite Index by March 2006. The limited liability issue was or considered by Standard & Poor's in determining whether income trusts should be. Other factors included differences in legal structures and whether the returns of in similar to equities or bonds.^[3] The inclusion of FTEs in the index will likely cause i particularly those managing against the S&P/TSX Composite Index, to include FT assets.

The recent passage of limited liability legislation in Alberta, Manitoba and Ontario, Standard & Poor's to include certain income trusts and limited partnerships in the Index, and the repeal of the FPR announced in Budget 2005 point to the continue

3. Public Corporations and FTEs: Tax Issues

One of the factors contributing to the growth in the use of FTEs has been the ability "flow through" income to investors so that income tax is not paid at the entity level tax treatment of corporations and their shareholders, where tax is paid by both the entity level) on its income and by its shareholders when the income is distributed—at the shareholder level of the taxes paid at the corporate level. This section outlines the tax treatment of public corporations and FTEs and highlights the tax advantages provide compared to public corporations.

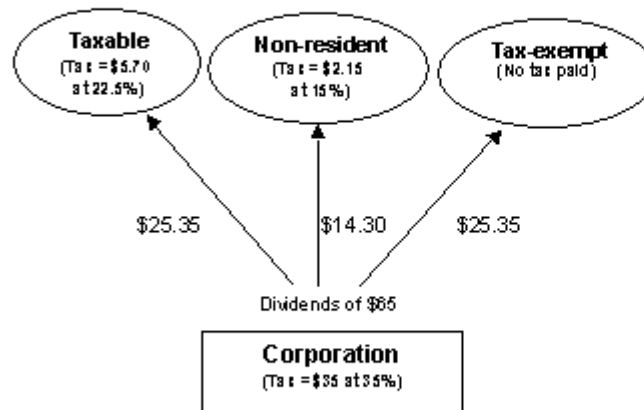
a) Tax Treatment of Public Corporations and Their Shareholders

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

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

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

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

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

The corporation has \$11
The average federal-prov
tax rate is 35%, resultin

The corporation pays a
shareholders. It is assu
dividends are paid to C
shareholders, 22% are
and 39% are paid to tax
assumptions are outline
used for purposes of the
revenues in 2004.

Taxable individual Can
\$5.70 in income tax (wit
personal income tax rat
reduced to 22.5% after
an average DTC of 20%)

Non-residents pay \$2.15
withholding tax).

Tax-exempt investors p

Total Tax = \$42.85

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 that is not distributed is generally taxed at a federal tax rate of 29 per cent, plus a provincial personal income tax rate. The average federal-provincial income tax rate on mutual fund income is 45 per cent.

In computing income for tax purposes, income trusts may deduct income distributed to unitholders. As a result, a trust that "flows" all of its income out to unitholders would not pay tax. Instead, the income would generally be taxed in the hands of the unitholders on 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 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 unitholder. However, the *ITA* requires that the unitholder's cost be reduced by the amount of the additional distribution, which will increase the amount of any gains (or reduce any losses) realized by the unitholder on a future disposition of the unit.

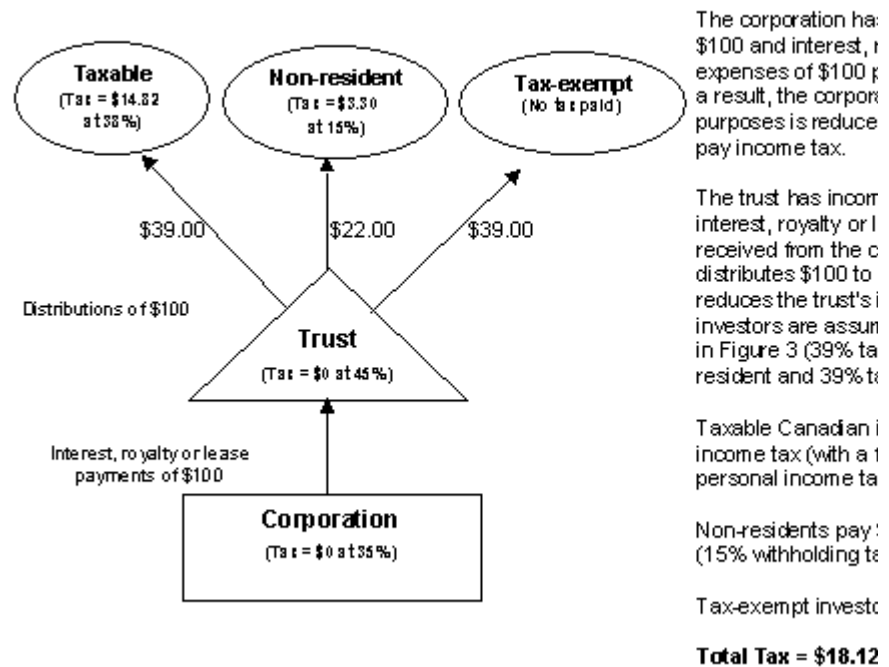
In the case of a typical income trust structure, the income paid to an income trust may take the form of interest, royalty or lease payments, which are normally deducted from the operating entity's income for tax purposes. These deductions can reduce the operating entity's taxable income. As described 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 15 per cent withholding tax under the *ITA*.^[11] This withholding tax is generally reduced under tax treaties. For example, the withholding tax rate on trust distributions under the *ITA* is reduced to 15 per cent. The withholding tax ensures that some tax is paid on income distributed to unitholders.

by non-residents through an income trust.

Figure 4 outlines a simplified example of the taxes paid under a traditional income trust. In this example, the operating entity has \$100 of business income but does not pay corp tax because the interest, royalty or lease payments it makes to the trust are deductible 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 income tax and \$3.30 is withheld at a rate of 15 per cent on distributions to non-resident investors. Total taxes paid in this simplified example are \$18.12.

Figure 4: Simplified Example of Taxes Paid Under a Traditional Income Trust



ii) Limited Partnerships

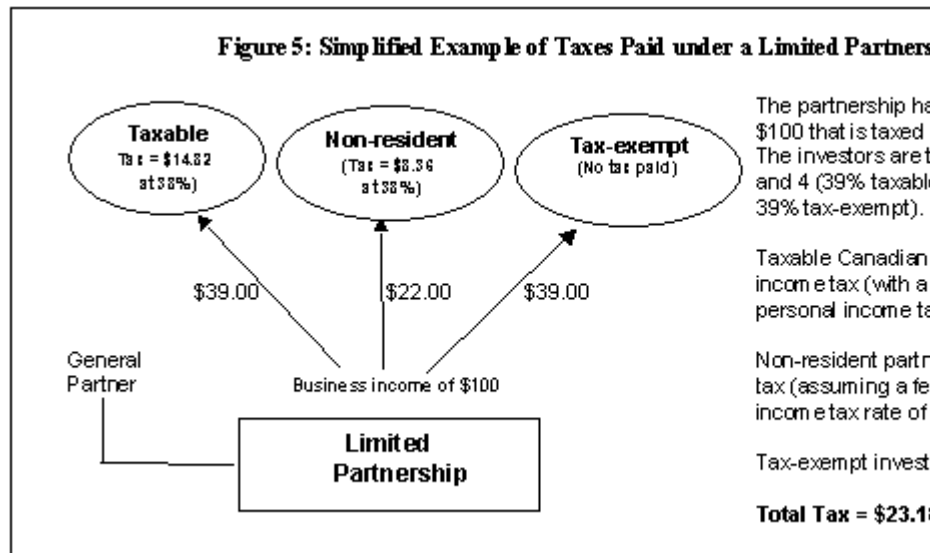
Unlike income trusts that are subject to tax on income not paid or payable to unitholders, limited partnerships are not taxable entities and therefore are not subject to tax. The income of a limited partnership is calculated, according to the general rules under the *ITA*, as if the partnership were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

Like income trusts, limited partnerships can distribute amounts that are not current income, such as amounts representing a reimbursement of capital (including allocations of the partnership's income) or amounts in excess of the limited partnership's income.

Non-resident partners are subject to Canadian income tax on their share of business income earned through a permanent establishment in Canada.^[14] Withholding tax of 25 per cent on distributions to non-residents unless this amount is taxable under a tax treaty. Withholding tax is generally reduced under Canada's bilateral treaties.

Because of the tax treatment of limited partnerships and their partners, these arrangements are structured in a similar way to income trusts. However, unlike income trusts, limited partnerships do not allocate losses to investors.

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



iii) Summary of Tax Implications

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

Table 3. Comparison of the Taxes Paid Under Different Structures

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

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

- FTEs shift the point of taxation from the operating entity to the investors, eliminating the "double taxation" (i.e. no element of double taxation) of the corporate and personal level.
- FTEs can distribute amounts that are generally taxable upon disposition of the asset (in the case of limited partnerships) rather than upon receipt of distributions.

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 the United Kingdom (UK) and the United States (US) that may be similar to FTEs. Although a similar tax treatment of certain vehicles exists in these jurisdictions, they are usually specific to certain sectors (e.g. real estate and resource properties) than Canada. Canada has a unique position of having experienced such rapid growth with some of these structures.^[15] The comparison with these countries highlights the fact that the tax system varies by jurisdiction; therefore, direct comparisons with Canada are difficult to make.

a) Australia

Publicly listed investment vehicles similar to FTEs in Canada are generally treated as corporations for tax purposes. However, limited partnerships investing in venture capital, which are often treated as FTEs. Prior to 1981, Australia experienced growth in the use of trusts by investors attempting to avoid or reduce their corporate income tax payments. In response, it introduced a regime that taxed certain public trusts as corporations. Additionally, it implemented in 1985 to extend [corporate tax](#) treatment to public unit trusts that carry on business. The combination of corporate tax treatment of publicly listed investment vehicles and the integration of the corporate and personal income tax systems, which was implemented to reduce the tax incentive for corporations to convert to a trust structure. As described, these structures exist in Australia (and are known as listed property trusts), although the tax system provides special flow-through tax treatment.

Listed Property Trusts

Listed property trusts (LPTs) are public trading trusts that allow investors to purchase a diversified and professionally managed portfolio of real estate. There are currently 10 listed on the Australian Stock Exchange (ASX) with a market capitalization of over A\$80 billion. They are among the largest sectors on ASX.^[17]

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

It is worth noting that the UK corporate tax system is partially integrated, providing on dividends paid to investors, as partial recognition of taxes paid at the corporate structure does not currently exist in the UK, although efforts are being made to de 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 disc March 16, 2005, budget, which follows a consultation process on promoting more property, including how a publicly listed REIT structure might be developed in the paper suggests that the UK government is committed to introducing a REIT struct certain constraints within the UK property market and provide closer alignment be direct and indirect property investment, providing it be revenue-neutral.

Limited Partnerships

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

c) United States

With some exceptions for REITs and publicly traded partnerships, which are desc listed vehicles similar to FTEs in Canada are usually treated as corporations for U reducing the attractiveness of these investment vehicles. It is important to note th does not provide direct recognition for taxes paid at the corporate level. However, US taxpayers from US corporations (and certain foreign corporations) are taxed a ordinary income. Notwithstanding, income distributed as dividends can be subject taxation.

Tax planning designed to eliminate double taxation of corporate distributions can | instruments being developed. A recent development in US financial markets has t 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— [instrument](#) allows the operating corporation to reduce its [taxable income](#) by the ar deduction. One of the key differences between the IDS and the business income | IDS does not involve the creation of a trust—the investor holds the underlying sec the US tax issues are simplified.

IDSs are essentially securities issued by a US corporation that consist of both divi shares and high-yield subordinated notes, which are "clipped" (paper-clipped) tog separated by the holder and is generally automatically separated under certain ev used to provide comfort that US tax rules that cause certain debt to be treated as to US corporations issuing IDSs. There are currently 10 corporations issuing IDSs listed on either the American Stock Exchange, the Toronto Stock Exchange, or bc market capitalization of C\$3.5 billion.^[19] One reason that has been put forward fo number of IDSs to date is the uncertainty over whether the subordinated notes wc 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 investo scale, income-producing real estate investments. US REITs may be legally organi trusts or associations. The chief tax advantage of a REIT is that it obtains a deduc distributed to its interest holders, which are then taxed at the interest holder's [mar](#) law requires REITs to distribute at least 90 per cent of their [taxable income](#) annua

shareholder dividends; most REITs distribute all their taxable income to shareholders on income tax. It is estimated that there are now nearly 180 publicly traded REITs 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 since 1987. The rules taxing PTPs as corporations were enacted in response to concerns that would erode the corporate [tax base](#). PTPs grew rapidly from the first PTPs in 1982 to 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 the (i.e. flow-through) tax treatment of a partnership and the liquidity of a publicly traded corporation. PTPs are in the oil and gas and resource sector, although PTPs in other sectors are currently 49 MLPs trading in the US with a market capitalization of approximately

d) Summary and Comparison

This section has provided a comparison of the tax treatment of publicly traded investment vehicles in Australia, the UK and the US that may be similar to FTEs in 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 publicly traded investment vehicles in Canada. This may explain, in part, why Canada seems to be in a position not having experienced such rapid growth with some of these structures in recent years. The corporate and personal income tax systems in Australia and the US are fully integrated in Australia may be explaining this difference.

Australia, the UK and the US currently do, however, have special tax treatment for publicly listed investment vehicles. Limited partnerships investing in venture capital in Australia and PTPs in the US receive flow-through tax treatment. Australia and the US provide special 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
Integration	Partial	Full	Partial
General tax treatment of publicly traded FTEs	Flow-through tax treatment	Taxed as corporations	Publicly traded FTEs are generally taxed as corporations
Exceptions (to the general tax treatment)			
-REITs	None	None	Consultations ongoing on possible REIT structure
-Limited partnerships (LPs)	None	LPs investing in venture capital permitted flow-through tax treatment	

5. Tax Revenue Implications of FTEs

One of the policy considerations with respect to the greater use of FTEs is the impact on federal 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 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 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) from limited partnerships and on capital gains on the disposition of the trust units in the case of limited partnerships).
- Income tax paid by third party lenders on interest income received from the FTE.

a) Data and Methodology

The data for the estimates in this paper are similar but not identical to those used by HLB Decision Economics.^[25] and by HLB Decision Economics.^[26] The key differences with these earlier studies 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 companies listed on the Toronto Stock Exchange.^[27] In 2004, these FTEs reported earnings before depreciation and amortization (EBITDA) of \$14.0 billion, of which \$2.3 billion was distributed to unitholders and \$8.9 billion was distributed to unitholders (in the case of income trusts) and partners (in the case of limited partnerships).^[28] Distributions can take various forms: 66 per cent of the \$8.9 billion of distributions in 2004 were ordinary income, 4 per cent were interest income and 30 per cent were return of capital.

One of the key parameters is the distribution of investors, which vary across the different FTEs. These parameters are outlined in Table 7 in the Annex. On average, 39 per cent of the investors are 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 by registered 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 report income from FTEs (it is assumed that Canadian taxable investors are holding FTEs in place of dividends). 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 paid under a corporate structure in 2004. The average effective federal corporate income tax rate (percentage of EBITDA) was 6.3 per cent.^[30] Dividends, interest payments to third parties, and capital gains under the corporate structure are also calculated using these data as a percentage of EBITDA.

The effective federal corporate income tax rate may understate federal corporate income tax 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 (e.g., growing businesses or start-ups), as well as businesses paying the small business tax rate. However, those businesses are not likely to use the FTE structure. Moreover, an effective federal corporate income tax rate would understate taxes paid under the corporate structure on their mature business assets (i.e. income-producing assets) into an FTE and other assets held in a corporation—for example, where a resource corporation divides its resource business into a 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 on the disposal of shares of corporations that have converted to an FTE structure. This revenue is estimated on the assumption that there was a 13 per cent premium on the disposals of shares in conversions and initial public offerings (IPOs) in 2004.^[33] The total value of conversions and IPOs in 2004 was \$6.6 billion.

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

	Income Trusts		
	Business	Energy	REITs
1. Taxes under the FTE structure	420	505	200
2. Taxes under the corporate structure	565	570	285
3. Tax on conversions and IPOs	25	10	5
Federal revenue impact (1 – 2 + 3)	-120	-55	-80

c) Sensitivity of Estimates to Key Parameters

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

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

Another key assumption is the average effective federal corporate income tax rate 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 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 the effective federal corporate income tax rate were 6.3 per cent or less. The estimated impact would, 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.

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%
5.3%	230	25	-165	-390
6.3%	100	-105	-300	-525
7.3%	-30	-235	-435	-660
8.3%	-160	-370	-570	-795

d) Projecting Possible Future Impacts

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

- 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 would be affected by the proposed corporate income tax rate reductions in Budget 2005. These rate reductions would reduce the general federal corporate income tax rate to 19 per cent from 28 per cent. These rate reductions could decrease the impact on federal tax revenues by \$165 million per year.^[36]

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.

As indicated above, increased holdings of FTEs by tax-exempt investors could have a significant impact on federal tax revenues.

on federal tax revenues in the future. For example, a 10 percentage point increase in FTEs held by tax-exempt investors would decrease federal tax revenues by \$105

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

There may also be future tax effects related to certain tax-exempt entities, such as RRSPs. Contributions to these plans are deductible by the contributor for income tax purposes, but distributions are taxable for the recipient. In the case of pension funds, the future impact 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, high returns on investments in FTEs may result in lower contributions. In the case of defined contribution plans (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 pay taxes on the amounts. The amount of the increase will also depend on the magnitude of the returns on FTE investments and the length of time the assets are held in the plan. The annual impact is expected to be small.

e) Provincial Tax Implications

Historically, FTEs have affected provincial tax revenues and, as with federal tax revenues, future growth could affect provincial tax revenues further. Provincial tax impacts on corporations carried on a business prior to converting to an FTE as well as the resulting impact on provincial tax revenues are reduced in provinces in which corporations carried on a business prior to converting to an FTE. Whether there is a net revenue impact depends on the offsetting income tax paid at the investor level. Since investors in FTEs may pay taxes on their share of the potential impact on a province's tax revenues will vary depending on these parameters.

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

Question for Consideration:

2. Have FTEs had a significant impact on tax revenues? Is there potential for growth 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 is used for 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 use of FTEs leads to greater economic efficiency—at least for certain types of businesses. 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 on economic efficiency. In this context, it also discusses the important role that tax-exempt entities play in Canadian capital markets and how this may affect developments respecting FTEs. These issues such as these are an important element of ensuring that Canada maintains a secure nation that can offer an unparalleled quality of life.

a) Economic Efficiency

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

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

The FTE structure may be more suited for mature businesses. This is because FTEs allow 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 options than shareholders, it may be preferable that returns be distributed to investors. If the cash flows are generated by highly mature businesses with little potential for growth, distribution rates typically associated with FTEs may therefore favour a more productive use of capital in the economy.

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

- A financing option for corporations to reduce debt and restructure balance sheet items by converting income-generating assets into an FTE, particularly in periods of economic downturn when markets are less receptive to common share issues. In addition, a spinoff or a sale of an FTE may provide a productive allocation of capital because it may act like a [securitization](#)^[38] by providing funds to businesses to fund innovation and growth of the business.
- An additional option for private investment firms, or privately held business owners, to convert a mature business, which may improve economic efficiency by providing private equity an additional vehicle to become public.

On the other hand, the tax system could be driving decisions on how businesses are structured that could lead to inefficient economic outcomes. This could occur, for example, if a business converts to an FTE structure before they have reached a mature state (i.e. during the business growth stage). In addition, distribution of cash flows to investors may not result in the most efficient use of capital if shareholders do not have perfect information on which to make investment decisions. If cash flows returning to the capital market with secondary offerings could also be more costly than 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 are prevented from effectively using FTEs, concerns about unfair competition may be argued that economic inefficiencies may also occur if the FTE structure favours 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 of tax-exempt investors, particularly pension funds, in capital markets is significant when considering these economic efficiency issues.

With the low interest rate environment and reduced interest in the Canadian equity market, many pension funds, especially the large public sector funds, have begun to play capital markets to seek out higher returns for their plan members. This has manifested in the private equity (i.e. buyout) market, where large pension funds have become taking companies public, including through income trusts. For the same reasons, pension funds have begun to increase their investments in other alternative assets, such as infrastructure and hedge funds.

As a group, pension funds are now the largest class of investors in Canada, with total assets approximating \$626 billion at the end of 2003.^[39] This was equal to around 20% of the Stock Exchange's market capitalization of \$1.3 trillion in 2003. At the end of 2001, deferred income plans accounted for an additional \$445 billion. As pension funds have grown individually and as a group of investors, so has their ownership of the shares of CSE-listed companies, and their overall influence in capital markets.

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

Question for Consideration:

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

7. Potential Policy Approaches

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

Measures announced in Budget 2004 proposed to limit pension fund investments in energy trusts. These proposals were made based on concerns that unlimited participation in the energy trust market could have a significant impact on the market and on the economy because of their tax-exempt status and their influence in Canadian capital markets. The measures were proposed not to apply to energy trusts and REITs given that pension funds do not hold these types of property held by energy trusts and REITs. The measures were also designed to have a minimal impact on both the capital market as a whole and on individual market participants. In the Budgetary Control Report, it was announced on May 18, 2004, that the proposals would be subject to further consultations.

Although not an exhaustive list, policy approaches that derive from the discussion include: limiting the deduction of interest expenses by operating entities, taxing FTEs to corporations, or better integrating the personal and corporate income tax systems. The integration of the personal and corporate income tax systems would make the tax system more uniform between all forms of business organizations. These approaches may be complex and would need to take into account a variety of factors, such as the different types of FTEs and the characteristics of these entities. They may also be costly in terms of foregone federal tax revenues and could 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 exists, 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

Written submissions should be e-mailed to trusts-fiducies@fin.gc.ca, or mailed to the Department of Finance website. Please clearly indicate in your communication 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 specify the language of 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 that provides education and research in the fields of taxation and public finance in Canada. The forum for expert analysis and discussion of issues in these fields, but does not itself advocate specific policy recommendations to governments. The symposiums are a better understanding and public discussion of the tax and economic policy issues. The Canadian Tax Foundation will provide further information on these symposiums as soon as details 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 Revenues

Table 7. Summary of Parameters (2004)

	Income Trusts		
	Business	Energy	REITs F
Total number of FTEs	110	31	25
Number of FTEs in sample	91	29	25
Sample as percentage of market capitalization	96%	99%	100%
Financial statements data ¹			
EBITDA (\$ millions)	4,751	5,638	2,529
Interest expenses – third party (\$ millions)	626	360	1,031
Interest expenses (% EBITDA)	13.2%	6.4%	40.7%
Distributions (\$ millions)	3,339	3,844	1,201
Distributions (% EBITDA)	70.3%	68.2%	47.5%
Distributions – taxable	73.7%	70.8%	32.2%
Distributions – dividends	8.4%	0.3%	1.0%
Distributions – tax-deferred distributions	17.9%	28.9%	66.7%
Investors ²			
Taxable Canadian – retail	40.0%	27.6%	41.0%
Taxable Canadian – mutual funds	5.0%	3.9%	6.0%
Non-residents	10.0%	37.5%	7.0%
Tax-exempt	45.0%	31.0%	46.0%
Third party lenders ³			
Taxable Canadian – retail	12.0%	12.0%	12.0%
Taxable Canadian – institutional	13.0%	13.0%	13.0%
Non-residents	29.0%	29.0%	29.0%
Tax-exempt	46.0%	46.0%	46.0%
Federal personal tax rates ⁴			
Interest	25.0%	25.0%	25.0%
Dividends	14.6%	14.6%	14.6%
Capital gains	12.5%	12.5%	12.5%
Non-resident tax rates			
Trust – taxable distributions	15.0%	15.0%	15.0%
Dividends	15.0%	15.0%	15.0%
Trust – tax-deferred distributions	0.0%	15.0%	15.0%
Interest	10.0%	10.0%	10.0%
Corporate structure (% EBITDA) ⁵			
Federal corporate income tax	6.8%	6.3%	5.0%
Federal and provincial corporate tax	11.1%	8.8%	7.7%
Interest expenses – third party	21.7%	12.5%	37.7%
Dividends	17.6%	9.0%	19.0%
Capital gains ⁶	33.0%	44.3%	23.8%

Notes to Table:

1. Financial data on income trusts and limited partnerships can be found on the S (www.sedar.com). Funds of funds and income deposit securities were not include. Virtually all of the FTEs are listed on the Toronto Stock Exchange (except for seven on the TSX Venture Exchange). Financial statement data are adjusted to an annualized basis to take into account that some FTEs do not have a December 31st year-end. Financial statement data are 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 HLB Decision Economics and industry participants.

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

4. In the case of retail and institutional investors, the average federal personal income tax rate, which is based on Canada Revenue Agency data on individual taxpayers that

income (it is assumed that Canadian taxable investors hold FTEs in place of dividend-paying corporations). The effective federal personal income tax rate is 14.6 per cent on dividends and 14.6 per cent on capital gains. The effective personal income tax rate on capital gains assumes that net capital gains are taxed at the federal government long-term bond rate, which is the same rate used to discount the present value of cash flows 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 of 14.6 per cent over a 10-year period using Statistics Canada data, Catalogue no. 61-219-XIE, *Financial and Tax Statistics for Enterprises*, 2003. The corporate income tax rates were adjusted to take into account changes in the corporate income tax rates. In the case of energy trusts, data from the Canada Revenue Agency, *Dividend distributions (as percentage of EBITDA) are for 2003, from Statistics Canada, Catalogue no. 008-XIE, Quarterly Financial Statistics for Enterprises.*

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

Federal Estimates for 2004

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

ENDNOTES

[1] FTEs have traditionally sought to raise capital through the public markets. [\[Return\]](#)

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

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

[4] Resource companies are currently subject to a 25 per cent federal tax rate that was 23 per cent in 2006 and to 21 per cent in 2007. Budget 2005 announced the proposed 4 per cent federal corporate [surtax](#) in 2008 and the reduction of the general corporate 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 0.5 percentage point in 2010). [\[Return\]](#)

[5] This effective rate does not take into account provincial and federal [capital tax](#) sometimes expressed as an effective income tax rate for purposes of showing the effective rate. [\[Return\]](#)

[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 rate on dividends is calculated using this federal personal income tax rate of 25 per cent and a DTC of 13.33 per cent. That is, a \$100 dividend, grossed up to \$125, would have a value of \$125 (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). [\[Return\]](#)

[7] The same calculation would apply as in the previous footnote, except that the federal 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 45 per cent personal income tax rate. The example outlined in Table 2 uses the effective federal income tax rate of 38 per cent. [\[Return\]](#)

[9] Mature corporations have used other distribution techniques such as open market repurchases. A publicly listed corporation can distribute excess cash flows to existing shareholders by cancelling a portion of its outstanding shares. If done through a normal course of business, the amount thereby distributed would generally not be treated as a deemed dividend. If the corporation repurchases their shares back to the corporation would treat the transaction as a regular disposition. [\[Return\]](#)

[10] Non-resident investors would pay income tax in their country of residence and can 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.

[11] With respect to certain distributions paid by a trust to non-residents, a withholding tax is applied to distributions of capital gains realized by the trust on taxable Canadian property. In contrast, non-taxable distributions paid by some Canadian mutual fund trusts where their value is attributable to resource or real properties in Canada are subject to a withholding tax. This tax treatment reduces the disparity between the tax treatment of non-residents who invest directly in Canadian estate or resource property and those who invest in such property through a Canadian trust. [\[Return\]](#)

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

[13] Losses flowed out to limited partners are subject to "at-risk" rules under the Income Tax Act. The deduction of losses by limited partners is up to a maximum amount equal to the partner's at-risk amount in the limited partnership. [\[Return\]](#)

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

[15] Exceptions exist for eligible businesses, such as those investing in land for resource purposes and securities. [\[Return\]](#)

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

[17] Ibid. [\[Return\]](#)

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

[19] CIBC World Markets, *Income Trust Weekly*, June 30, 2005. [\[Return\]](#)

[20] National Association of Real Estate Investment Trusts (<http://www.investinreit>) [\[Return\]](#)

[21] PTP rules apply to all types of partnerships, limited liability companies (LLCs) corporate tax treatment, and business trusts. The LLC is a popular US business s characteristics of both partnerships and corporations: their members are shielded but can enjoy the same tax treatment as partners of a partnership. When not publ default considered as partnerships under the check-the-box regulations. LLC legis adopted by Wyoming in 1977 and now exists in all 50 states. [\[Return\]](#)

[22] US Treasury Department, OTA Paper 59, "Noncorporate Business Taxation: Tax Reform Act of 1986." [\[Return\]](#)

[23] Resource income includes income and gains arising from the exploration, dev production, processing, refining and transportation of any mineral or natural resou

[24] *The Wall Street Journal*, "Energy Boom Fuels a Rise in Partnerships", March

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

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

[27] A small number of FTEs are listed on the TSX Venture Exchange. [\[Return\]](#)

[28] The remaining \$2.8 billion of EBITDA not distributed or paid as interest to thir generally attributable to depreciation, depletion and amortization. EBITDA is calcu income tax adjusted to add back interest expenses as well as depreciation, deplei deductions. [\[Return\]](#)

[29] The federal personal income tax rate would be 21 per cent if Canadian taxabl assumed to be substituting interest-bearing assets (e.g. guaranteed investment c deposits) for FTEs. [\[Return\]](#)

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

[31] Corporate income taxes that would have been paid on income from mature b understated using an average effective federal corporate income tax rate on all th 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. Thi

excludes income tax that may have been paid in 2004 under the FTE structure. A suggested that small amounts of federal and provincial income tax were paid. Lan taxes were attributable to a small number of FTEs. Financial statements suggest i recovered in future years (as shown by the FTEs reporting future tax assets). [Ret

[33] This estimate assumes that all gains are taxed at the shareholder level as a c eventhough where a corporation [transfers](#) a portion of its assets to an FTE, the cc taxed on the gains resulting from the transfer of assets. The assumption above dc impact on the estimate. The 13 per cent premium is an estimate of the average cf following the announcement of conversions to FTEs. This increase in price is, in p increased demand for FTEs because of the tax savings under the FTE structure. applied to conversions and IPOs in 2004. The 13 per cent premium is based in pa Halpern, *Is the Trust in Trusts Misplaced*, Rotman School of Business, University 31. [Return]

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

[35] The sensitivities in Table 6 assume that tax-exempt investors are holding FTE tax-exempt investors sell debt instruments and acquire FTEs, then the estimated i revenues would be lower than shown. However, it is important to note that a simil: tax-exempt investors sell debt instruments to acquire shares of corporations. [Ret

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

[37] This assumes that EBITDA would also increase by 10 per cent and that there other parameters. It assumes that the increase in EBITDA is not the result of new

[38] Asset [securitization](#) involves pooling groups of assets, such as mortgages, ar securities that are sold to investors.[Return]

[39] Statistics Canada. This total does not include [registered pension plan](#) assets consolidated revenue funds, [insurance companies](#), or Government of Canada [anr](#)

[40] *The Governance Practices of Institutional Investors* (<http://www.parl.gc.ca/36/1/parlbus/commbus/senate/com-e/bank-e/rep-e/rep16nc> the Securities Industry Committee on Analyst Standards, led by Purdy Crawford, r *Setting Analyst Standards: Recommendations for the Supervision and Practice of Industry Analysts*. Among other things, the report called on institutional investors t power to positively influence the practice of analysts and, ultimately, improve the i [Return]

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

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[Important Notices](#)