Income trust report

PricewaterhouseCoopers LLP

December 11, 2006

Table of Contents

Executive Summary....1

1.0 Introduction....3

2.0 Background on Income Trusts....4
- 2.1 Comparison of Tax Treatment....4
- 2.2 The Tax Fairness Plan and its Implications for Income Trusts....6
- 2.3 Income Trust Structures in other Countries....7
- 2.4 Trust Structures in the United States....7

3.0 Literature Review....9
- 3.1 Survey of the Estimated Revenue Impact of Income Trusts....9
  - 3.1.1 Aggarwal and Mintz, 2004....10
  - 3.1.2 HDR│HLB Decision Economics, 2004....10
  - 3.1.3 Department of Finance, 2005....11
  - 3.1.4 HDR│HLB Decision Economics, 2005....12
  - 3.1.5 The Last Word on Tax Leakage – Mintz 2006....13
  - 3.1.6 Summary....13
- 3.2 Income Trusts and Economic Growth....14
  - 3.2.1 Aggarwal and Mintz, 2004....15
  - 3.2.2 Department of Finance, 2005....16
  - 3.2.3 HDR│HLB Decision Economics, 2006....16
  - 3.2.4 Jog and Wang, 2004....18
  - 3.2.5 Canaccord Adams, 2006....18
  - 3.2.6 BMO Nesbitt Burns Economics, 2005....19
  - 3.2.7 Summary....21

4.0 The Canadian Macroeconomic Picture....22
- 4.1 Government Fiscal Position....22
- 4.2 Canadian Investment and Productivity Trends....24
- 4.3 The Secular Downtrend in Canadian and US Bond Yields....26
- 4.4 Canadian Real GDP Growth....27
- 4.3 Summary....28

5.0 Economic Benefits of Income Trusts....30
- 5.1 Access to Capital Markets....30
- 5.2 Cost of Capital Advantage....32
- 5.3 Principal-Agent/Disciplined Capital Re-investment....33
- 5.4 Elimination of Double Taxation....34
- 5.5 Summary....34

6.0 Policy Alternatives for Income Trust Taxation....35
- 6.1 Analysis of Tax Treatment by Investor Classification....35
  - 6.1.1 Taxable Investors....36
  - 6.1.2 Tax-Exempt Investors....36
  - 6.1.3 Non-Residents....38
- 6.2 PwC Suggestions....38
- 6.3 Anticipated Concerns....40
  - 6.3.1 Impact on Provincial Revenues....40
  - 6.3.2 Restrictions for Non-resident Investors....40
  - 6.3.3 The Success of the Income Trust Market....40
  - 6.3.4 Equal Treatment....41
  - 6.3.5 Sector Specific Exemptions....41
  - 6.3.6 Transition Period....41
- 6.4 Summary....41

Appendix....43

Executive Summary

PricewaterhouseCoopers LLP ("PwC") research and an in-depth analysis of the current income trust market in Canada sheds new light on the real performance of income trusts, their role in the Canadian economy and the tax implications of trusts in the period prior to the recent federal *Tax Fairness Plan*. This new information has the potential to markedly affect our understanding of the income trust sector.

This report includes:

- **A comprehensive look at estimates of federal tax leakage from income trusts**
  - there is little consensus on estimates of the total lost corporate tax revenue due to income trusts.

- **A review of the economic implications of income trusts**
  - There is little evidence supporting the hypothesis that income trusts hinder capital expenditure, productivity or economic growth.

- **A review of macroeconomic considerations**
  - With the challenges in improving productivity and the role of income trusts in creating a new avenue in capital markets perhaps there is the latitude and the incentive to consider alternatives to the tax system that recognizes the role of income trusts.

- **New information on the economic performance of income trusts**
  - The economic contribution of income trusts and other benefits, and a new threat to growing companies posed by the *Tax Fairness Policy*, requires further consideration.

- **PwC's proposal for policy alternatives**
  - Among the many alternatives proposed, two additional positive steps should be considered: make the proposed tax on trusts refundable to all Canadian investors (including pension funds and RRSP-holders), and eliminate double taxation of income earned and distributed as dividends by corporations by making the dividend tax credit fully refundable to all Canadian investors (including pension funds and RRSP-holders).

  - Consider sector specific exemptions, such as those proposed for certain Real Estate Investment Trusts ("REITs"), for certain sectors where warranted by economic policy. These sectors may include the energy and infrastructure sectors.

Our Position

We believe a confluence of events has delivered a rare opportunity for our capital markets. Not only could we improve the fairness of the Canadian tax system, but also streamline the performance of our capital markets, give our businesses an opportunity for more disciplined capital reinvestment and help them be more competitive, and enhance returns for tax-exempt investors like pension funds and RRSP-holders. These changes could be achieved at the same

time as the government considers other alternatives including applying these changes to future conversions and limiting the negatives consequences associated with the inevitable alternative investment strategies for those investor groups most impacted by these changes. It is the ideal time to make the changes that will benefit current and future generations.

1.0 Introduction

On October 31, 2006 the federal Minister of Finance announced a Tax Fairness Plan for Canadians. A principal component of the government's Tax Fairness Plan involves changing taxation rules governing income trusts. In his announcement, the Minister of Finance stated that a tax on income trusts was necessary to "restore balance and fairness to Canada's tax system, to ensure our economy continues to grow and prosper and to bring Canada in line with other jurisdictions."[1]

The Minister of Finance emphasized the need for income trust tax reform due to the "growing trend towards corporate tax avoidance,"[2] and further suggested income trusts could cost Canadians billions of dollars in foregone tax revenues.[3] The Minister of Finance also expressed concern that income trusts create economic distortions that threaten Canada's economic growth.

It is true that the rate of growth in Canada's income trust sector has been explosive, particularly over the past five years, and that income trusts are tax advantaged compared to corporations. However, the evidence regarding income trusts' effect on tax revenues and economic growth does not fully support the government's conclusions.

Our report is structured as follows. Section Two provides a brief background on income trusts, including a comparison of tax treatments across investor types, a summary of the new income trust tax policy, and a survey of the history of income trusts in the United States. Section Three presents a literature review of the existing research on the tax consequences of income trusts and their effects on economic growth. Section Four frames the government's concerns regarding income trusts in the context of the current macroeconomic environment. Section Five outlines the economic benefits of income trusts and Section Six presents policy alternatives we believe provide a more effective and equitable solution to the government's income trust concerns.

[1] Department of Finance, "Canada's New government Announces Tax Fairness Plan", October 31, 2006 (available online at: http://www.fin.gc.ca/news06/06-061e.html).
[2] Statement by the Honourable Jim Flaherty, Minister of Finance, October 31, 2006.
[3] Ibid.

2.0 Background on Income Trusts

Income trusts are investment vehicles designed to maximize cash distributions from a set of revenue-generating assets.[4] Much like corporate dividends from owning common stock, distributions are paid out periodically to the trust's investors (called "unitholders").

Income trust are often referred to as flow-through entities ("FTEs") because under current tax legislation, trusts can flow all underlying operating income through the trust structure directly to investors, thereby bypassing corporate taxes. Distributions are usually set so as to offset any taxable income within the trust, meaning income trusts pay little or no corporate tax. However, this result should not be viewed as a corporate tax loophole, as taxable income is simply shifted to the unitholder level.

Since income trusts investors expect regular cash distributions, the trust structure has generally been popular with firms that can generate reliable cash flows from mature assets. As a result, the trust sector was originally populated with resource sector firms (mining, oil and gas) often referred to as royalty trusts, and REITs. These classes of trusts often generate passive income from holding resource rights or property that flows through the income trust directly to investors.

Although income trusts have been in existence in Canada since the mid-1980s, their popularity both as an investment and as a business structure is a more recent phenomenon. Since 2000, and coinciding with the dot-com bust and a historically low interest rate environment, the number of income trusts has grown from just 52 to more than 250. Furthermore, as the trust sector has grown, it has also diversified. Businesses as diverse as pizza chains, investment managers and the Yellow Pages have converted to income trusts. As of 2006, income trusts listed on the Toronto Stock Exchange worth over $200 billion[5] in market capitalization.

2.1 Comparison of Tax Treatment [6]

Income trust unitholders are typically classified as either taxable Canadians (39% of unitholders), tax-exempts (39% of unitholders), or non-residents (22% of unitholders).[7] Each of these classes is treated differently for tax purposes and each has a different tax consequence.

In general, income trust distributions received by individual taxable Canadians are taxed at their personal income tax rate. For tax-exempt investors such as pension funds or individuals holding income trusts in an RRSP, taxes are deferred until withdrawal and then taxed at the individual's

---

[4] Michael R. King, "Income Trusts – Understanding the Issues," Bank of Canada Working Paper 2003-25, September 2003.
[5] From data provided by the Toronto Stock Exchange and available at: http://www.tsx.com/en/listings/sector_profiles/income_trusts/index.html.
[6] A detailed analysis of tax implications is provide in Section Six and in the Appendix.
[7] These are the percentages used in Department of Finance, "Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)", Consultation Paper, September 2005.

personal tax rate. For non-residents, a Canadian withholding tax of 15% is applied to the distribution. The non-resident may also pay additional tax in their country of residence.

The following example illustrates how each class of unitholder is taxed on income earned through a trust versus income earned through a corporation under the current tax system. To facilitate comparison with income trusts, the example makes the simplifying assumption that corporations pay out all after-tax earnings as dividends. The example further assumes $100 of pre-tax business income is allocated to each investor and that the personal income tax rate is the top marginal rate of 46%.

Table 1: Comparative Tax Burden Under Different Business Structures

	Earned Through a Trust			Earned Through a Public Corporation		
	Individual	**Tax-Exempt**	**Non-Resident**	**Individual**	**Tax-Exempt**	**Non-Resident**
Business Income	100	100	100	100	100	100
Less: Corporate Tax (federal & provincial tax, 35%)	-	-	-	(35)	(35)	(35)
Amount Available for Distribution to Investor	100	100	100	65	65	65
Grossed up Dividend (45%)	-	-	-	94	-	-
Less: Personal Tax (46%)	(46)	-	-	(43)	-	-
Less: Withholding Tax (15%)	-	-	(15)	-	-	(10)
Add: Dividend Tax Credit (federal & provinical, 32%)	-	-	-	30		
Amount Retained After-tax	54	100	85	51	65	55
Less: Personal Tax on Pension Distribution (46%)	-	(46)	-	-	(30)	-
Amount Retained After-tax	54	54	85	51	35	45
Overall Effective Tax Rate	**46%**	**46%**	**15%**	**49%**	**65%**	**45%**

Incorporating the adjustments announced in November 2005 to the dividend tax credit[8], the overall effective tax rate on distributions from income trusts and dividends from corporations are nearly equal for taxable investors. By 2010, when federal corporate tax rates are slated to be reduced to 19%[9], personal and corporate income taxes will be fully integrated, meaning that corporate income will effectively be taxed once only. This should mean that, on a tax basis, individual taxable Canadians will be indifferent between receiving income trust distributions and corporate dividends because the overall taxes paid will be the same.

However, even with full integration of personal and corporate taxes, significant advantages still exist for tax-exempt investors and non-residents to invest in income trusts.

As Table 1 shows, for $100 of business income, the overall effective tax rate for tax-exempt investors is 46% on income trust distributions and 65% on corporate income. Similarly, the effective tax rate for non-residents on trust income is simply the withholding tax of 15%, whereas income from corporations is taxed at 45%.

[8] Department of Finance, “Minister of Finance Acts on Income Trust Issue”, November 23, 2005 (available online at: http://www.fin.gc.ca/news05/05-082e.html).
[9] Department of Finance, “The Budget in Brief 2006”, May 2, 2006 (available online at: http://www.fin.gc.ca/access/budinfoe.html).

The disparity between overall effective tax rates on income trust and corporate income for tax-exempts arises because pension funds and RRSP-holders do not receive the benefits of the dividend tax credit. Therefore, the favourable tax treatment of income trusts produces an incentive for tax-exempt investors to hold income trusts units over dividend paying common stock.

Although pension funds and RRSPs are referred to as “tax-exempt,” the more accurate term is tax-*deferred,* because taxes are eventually paid when money is withdrawn. Therefore, tax revenue from tax-exempts is not lost, but is realized in the future.

Unlike the income trust holdings of tax-exempt, non-resident holdings of income trusts do not provide any tax deferral. The tax consequences of non-resident investors is further complicated by the flow-through structure of income trusts as non-residents pay only the statutory withholding tax of 15% on trust distributions.

2.2 The Tax Fairness Plan and its Implications for Income Trusts

Controversy over the tax advantage of income trusts arose in 2005 when the government of the day announced it would be launching consultations on the economic and fiscal implications of FTEs. After some deliberation, the government opted to leave income trusts untaxed, and instead, reduce personal income taxes on dividends as a way of achieving tax neutrality between corporations and income trusts.

As discussed in Section 2.1, despite the adjustments to dividend taxes, the income trust structure still provides an advantage to tax-exempt and non-resident investors. Therefore, on October 31, 2006, under the Tax Fairness Plan, the government announced a Distribution Tax on distributions from publicly traded income trusts and limited partnerships. According to the Minister of Finance, the new measures “are necessary to restore balance and fairness to the tax system, to ensure our economy continues to grow and prosper and to bring Canada in line with other jurisdictions.”[10]

Despite its name, the Distribution Tax is not a direct tax on distributions. Instead, certain distributions will not be deductible to publicly traded income trusts and partnerships. These entities will be taxed on their non-deductible distributions; in effect, they will be taxed as corporations (at a rate comparable to the general combined federal/provincial corporate income tax rate). These distributions will be taxed as taxable dividends to investors. Distributions to Canadian resident individuals will be deemed to be “eligible dividends,” qualifying for the enhanced dividend tax credit.

[10] Statement by the Honourable Jim Flaherty, Minister of Finance, October 31, 2006.

For trusts and partnerships that become publicly traded after October 31, 2006, the new tax regime will apply starting in the 2007 taxation year. Other publicly traded trusts and partnerships will have four years to adjust to the changes, becoming subject to the new rules starting in the 2011 taxation year. In order to address potential avoidance techniques, the proposed four year transition period will be accelerated for firms experiencing higher than normal rates of growth or "undue expansion."[11]

2.3 Income Trust Structures in other Countries

In his October 31 announcement, the Minister of Finance cited the necessity to "bring Canada in line with other jurisdictions."[12] Indeed, income trusts are not unique to Canada. In the early 1980s, the United States and Australia experienced similar income trust issues to those currently faced in Canada. Much like Canada, both countries ultimately passed legislation to tax income trusts and corporations equally. The following section describes the experience of trust-like structures in the United States in more detail.

2.4 Trust Structures in the United States

During the early to mid 1980s, the United States experienced rapid growth in a type of business structure known as a Master Limited Partnership ("MLP") or Publicly Traded Partnership ("PTP"). Like income trusts in Canada, MLPs are FTEs, enabling distributions to be paid out to partners without income first being taxed at the firm level.

MLPs multiplied in the early 1980s, numbering over 100 in 1986 when the United States government, citing concerns about erosion of the tax base, legislated that MLPs would be taxed as corporations.[13] Existing MLPs were provided a ten-year period to restructure before the new tax legislation was applied, with the majority of MLPs opting to become public corporations.[14] Newly created MLPs, however, were immediately taxed as corporations.

Similar to the Canadian government's income trust proposal, REITs were exempted from the 1986 legislation. However, unlike the proposed Canadian policy, American MLPs operating in the natural resource sector were also exempted from the 1986 tax legislation.

Today, REITs thrive in the United States, with total assets worth over $400 billion.[15] However, the 1986 legislation imposed limitations on institutional ownerships of MLPs based on restrictive "qualifying" income tests, therefore limiting their appeal to investors.

---

[11] Department of Finance, Backgrounder to Statement by the Honourable Jim Flaherty, Minister of Finance, October 31, 2006.
[12] Statement by the Honourable Jim Flaherty, Minister of Finance, October 31, 2006.
[13] Susan Nelson, "Noncorporate Business Taxation: Before and After The Tax Reform Act of 1986", US Treasury Department OTA Paper 59, May 1988.
[14] Grant Robertson, "What we can learn from other markets," *The Globe and Mail*, October 13, 2005
[15] http://www.investinreits.com/learn/faq.cfm.

A 2004 change to the United States tax code opened up MLPs to institutional investors and enhanced MLPs access to capital, particularly in the natural resource sector. The new United States legislation amended Section 7704 (a) of the Internal Revenue Code of 1986, to provide an exception to the general rule that 90% or more of the MLP's gross income in each taxable year must consist of "qualifying income" before a mutual fund is allowed to invest in an MLP. Qualifying income, as amended in Section 7704 (c), now includes income and gains derived from exploration, mining, oil and gas transportation, including pipelines and the marketing of any mineral or natural resource.[16]

We caution against making strict comparisons between the United States and Canadian experiences. The United States tax system has never provided an integrated corporate/personal tax system (perhaps because of lower US personal tax rates), so it is more understandable that action was taken to preserve the United States corporate tax base. In Canada, with a partially integrated system and relatively high personal tax rates, the case for taxing FTEs is much less compelling.

[16] Gregory M. Bopp and Rhett E. Jackson, "New Law Allows Mutual Funds Greater Flexibility to Directly Invest in Publicly Traded Partnerships," Bracewell and Patterson, LLP, 2004.

3.0 Literature Review

The Minister of Finance emphasized two main concerns introducing the Tax Fairness Plan. The first was that, if left unchecked, income trusts would result in billions of dollars of lost revenue for the federal government.[17] The Minister of Finance further implied that taxing income trusts was necessary for the sake of future economic growth and prosperity by stating, “This trend towards income trusts is also creating an economic distortion that is threatening Canada’s long-term economic growth. It is limiting the ability of Canadian capital-intensive corporations to invest, to grow and compete in this highly competitive global economy.”[18]

In the following section we present a literature review of studies examining the evidence regarding these two concerns.

3.1 Survey of the Estimated Revenue Impact of Income Trusts

Because income trusts are a relatively young segment of the Canadian economy, there are few formal studies examining their fiscal and economic implications. The papers we reviewed are presented in the order in which they were published:

1) Lalit Aggarwal and Jack Mintz, “Income Trusts and Shareholder Taxation: Getting it Right,” *Canadian Tax Journal,* Vol. 52, No.3, 2004

2) HDR│HLB Decision Economics, “Risk Analysis of Tax Revenue Implications of Income Trusts,” Report commissioned by the Canadian Association of Income Funds, March 2004 (available online at: http://www.caif.ca/content/TaxRevImplicationsNov2005.pdf)

3) Department of Finance, “Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)”, Consultation Paper, September 2005.(available online at: http://www.fin.gc.ca/news05/05-055e.html)

4) HDR│HLB Decision Economics, “Tax Revenue Implications of Income Trusts,” Report commissioned by the Canadian Association of Income Funds, November 2005(available online at: http://www.caif.ca/content/TaxRevImplicationsNov2005.pdf)

In addition to the above papers, there are two earlier but less detailed explorations into income trusts. The first, a 2002 essay by Paul Hayward, a corporate finance lawyer, estimated the negative effects of income trusts to be $1.1 billion[19]. The second, by CIBC World Markets economist Avery Shenfield, argued that there was effectively no tax leakage[20].

[17] Department of Finance, “Canada’s New government Announces Tax Fairness Plan,” October 31, 2006.
[18] Statement by the Honourable Jim Flaherty, Minister of Finance, October 31, 2006.
[19] Paul D. Hayward, “Income Trusts: A ‘Tax Efficient’ Product or the Product of Tax Inefficiency,” *Canadian Tax Journal,* Vol. 50, No.5. 2002.
[20] Avery Shenfield, “The Economic Benefits of Income Trusts,” *Economic Perspectives*, CIBC World Markets, March 7, 2003.

3.1.1 Aggarwal and Mintz, 2004

An often cited and influential paper on the topic of income trusts tax policy is a 2004 Canadian Tax Journal study by Lalit Aggarwal and Jack Mintz. This paper was originally presented in 2003 at a University of Toronto Capital Markets Institute conference and so pre-dates a similar Department of Finance Consultation Paper on income trusts by two years.

The primary focus of the Aggarwal and Mintz study was to estimate corporate tax revenue lost due to Canadian corporations converting to income trust structures. This loss is generally referred to as "tax leakage."

Aggarwal and Mintz identified the four primary drivers of the aggregate tax revenue impact of income trusts as:

1) erosion of the corporate tax base;
2) increase in receipts relating to the rise in interest income for unitholders;
3) reduced dividends paid; and
4) reduced capital gains realized.

The aggregate tax revenue impact is the difference between the negative effects of the erosion of the corporate tax base, the reduction in dividends paid, and the reduction in capital gains realized and the positive effect of an increase in tax receipts on income trust distributions.

Using the above framework, and after a range of sensitivity testing, Aggarwal and Mintz estimated the total provincial and federal tax leakage to be between $400 million and $600 million for 2004[21].

3.1.2 HDR│HLB Decision Economics, 2004

Following the Aggarwal and Mintz study, the Canadian Association of Income Funds ("CAIF") commissioned the economic consulting firm HDR│HLB Decision Economics ("HDR│HLB") to study the question of tax leakage. The resulting paper, titled "Risk Analysis of Tax Revenue Implications of Income Trusts", was released in 2004.

The paper used essentially the same conceptual framework as the Aggarwal and Mintz study to examine the tax impact of income trusts based on the effects of taxes lost offset by taxes gained.

[21] Lalit Aggarwal and Jack Mintz, "Income Trusts and Shareholder Taxation: Getting it Right," *Canadian Tax Journal,* Vol. 52, No.3, 2004.

Unlike the deterministic estimate provided by Aggarwal and Mintz, HDR│HLB used Monte Carlo simulation to produce probabilistic estimates that a specified tax consequence would occur. In contrast to the $400 to $600 million estimated aggregate tax revenue impact provided by Aggarwal and Mintz, HDR│HLB's model placed a less than 10% probability of realizing a tax loss of $560 million.

HDR│HLB's own best (mean) estimate of the effect of income trusts in 2004 was a tax loss of $217 million.

In addition to a "static" or current year estimate of the tax leakage, HDR│HLB also provided a dynamic estimate of the potential tax impact by including what they referred to as "out-year" impacts. These out-year impacts account for the present value of future government tax receipts realized by investments held in tax-exempt accounts assuming an average holding period of between 15 and 25 years.

Including out-year impacts, HDR│HLB's mean estimate indicated a small net gain to the federal government of $51 million.

3.1.3 Department of Finance, 2005

In 2005, the government of the day announced that it would conduct "open and transparent consultations with stakeholders on tax issues related to business income trusts and other FTEs."[22] Part of the process initiated by the government was a consultation paper on income trusts published by the Department of Finance ("Finance") in September of 2005.

In its study, Finance examined the potential tax leakage and associated effects on federal tax revenues. Finance estimated the effect of income trusts and other FTEs on federal tax revenues to be $300 million, $255 million of which was due to income trusts. Of this $255 million, 47% was due to business trusts, 22% was due to energy trusts, and 31% was due to REITs. However, it is important to note that the Finance study did not consider the implications for provincial revenue.

Along with its estimate of tax leakage, Finance also provided the following sensitivity analysis:

- A 1% increase in the assumed average effective federal corporate income tax would increase the federal revenue loss by $135 million.

- If the proportion of FTEs held by tax exempt investors were to increase by ten percentage points (from 39% to 49%), the federal revenue loss would increase by $105 million.

[22] Department of Finance, "Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)", Consultation Paper, September 2005.

The Finance study further expanded on the possible tax consequences of income trusts in future years, noting:

- The planned reduction of the federal corporate tax rate to 19% (from 22.12%) by 2010[23] would reduce the tax impact of income trusts by $165 million.

- A 10% increase in the market capitalization of FTEs would reduce federal tax revenues by $35 million.

- The estimated revenue losses would also increase if corporations increasingly shifted their mature assets into trust structures while maintaining their high growth segments in a corporation.

In November of 2005, before the December 31 conclusion of the consultation period, the government decided to not levy a tax on income trusts, but instead, decided to better integrate personal and corporate taxes by increasing the federal dividend tax credit.[24]

3.1.4 HDR│HLB Decision Economics, 2005

After the release of the Department of Finance Consultation Paper, HDR│HLB was again commissioned by the CAIF to provide an update of its 2004 report.

The updated report was released in April 2005 and provided an updated estimate of tax leakage from income trusts under both HDR│HLB's original framework, as well as from a budgetary perspective. To better align with the Department of Finance Paper, HDR│HLB considered only federal tax impacts, and presented findings broken down by income trust sector.

According to HDR│HLB, the only material difference between its methodology and that of Finance was that Finance's approach was designed to assess the annual fiscal effects of income trusts from a budget planning perspective. In contrast, HDR│HLB examined the aggregate tax revenue impact using a net present value approach, which incorporated current year and deferred (out-year) tax effects.

---

[23] A component of the Conservatives budget announcement on October 31, 2006 was a reduction of the federal corporate tax rate to 18.5% by 2011. See Department of Finance, "Canada's New government Announces Tax Fairness Plan", October 31, 2006
(available online at: http://www.fin.gc.ca/news06/06-061e.html).
[25] Department of Finance, "Minister of Finance Acts on Income Trust Issue", November 23, 2005, (http://www.fin.gc.ca/news05/05-082e.html).

Using updated parameter estimates and data, HDR│HLB estimated the tax leakage from income trusts to be $178 million in 2004. Excluding the effects of deferred taxes, business trusts accounted for 46% of the income trust tax leakage, 14% of the leakage was due to energy trusts, and 40% was due to REITs.

The inclusion of deferred taxes from tax-exempt investments reduced this amount to a net loss of $71 million in federal tax revenue. An increase in federal tax revenue from deferred taxes generated by the energy sector partially offset the negative tax consequences from business trusts and REITs.

HDR│HLB also estimated tax leakage based on the assumption that planned federal rate reductions outlined in the 2005 federal budget were fully implemented in 2004. Under this assumption, the tax leakage, excluding deferred taxes, was $43 million. Including deferred taxes created a net gain of $56 million in federal tax revenues.

Under a budget based approach, HDR│HLB estimated that continued and sustained growth in the income trust sector would produce no significant escalation in tax leakage over the following five years. HDR│HLB reported that this outcome was largely due to planned federal corporate tax rate reductions through 2010.

Given concerns about the growth of the income trust sector, HDR│HLB estimated that a doubling in size of the income trust market would result in only $30 million in additional annual tax leakage by 2009.

3.1.5 The Last Word on Tax Leakage – Mintz 2006

In 2006, Canadian telecom giants Telus and BCE announced they were planning to move ahead with income trust conversions. In a brief article published in *The Globe and Mail*[25] on October 17, Jack Mintz updated his 2004 tax leakage estimate of between $400 million and $600 million to include the announced intentions of Telus and BCE, as well as recent growth in the income trust market.

Excluding the effects of Telus and BCE, Mintz estimates the total tax leakage for 2006 to be $700 million. According to Mintz's calculations, the conversion to trusts by BCE and Telus would expand the federal revenue loss significantly to an estimated $1.1 billion.

3.1.6 Summary

The preceding survey of aggregated tax revenue leakage reveals differing estimates of the impacts of income trusts on government revenues. The estimates, based on varying approaches, range from a net loss of $1.1 billion to a gain of $56 million in corporate tax revenues.

---

[25] Jack Mintz, "Income Trust Conversions: Estimated Federal and Provincial Revenue Effects," *The Globe and Mail,* October 17, 2006.

Our review of the literature, revealed a consensus that non-resident income trust unitholders are a source of tax leakage. The tax consequences of tax-exempt holdings of income trusts in RRSPs and pension funds are dependent on whether the present value of tax receipts from tax-exempt holdings are included in the estimate. HDR│HLB contend that by incorporating these deferred taxes much of the estimated "current year" tax loss is offset.

The personal tax rate paid by individual taxable Canadians on income trust distributions is similar to, or higher than, the combined federal and provincial corporate tax rate.[26] Therefore, the tax consequences from this class of investors, which comprises 39% of all income trust investors, may not have negative consequences for overall tax revenues.

Tax leakage is certainly occurring due to income trust holdings by non-resident investors (22% of all income trust investors), who pay only the 15% withholding tax on trust income. However, the available literature shows that the magnitude of tax leakage, from all classes of investors, is contingent on uncertain parameters and is highly sensitive to modeling assumptions.

3.2 Income Trusts and Economic Growth

In addition to concerns over the corporate tax base, the Minister of Finance also implied that taxing income trusts was necessary for the sake of future economic growth and prosperity.[27] A common theme repeated in the media is that income trusts create economic inefficiencies in capital markets.

The rationale for the argument that income trusts create inefficiencies stems from the hypothesis that income trusts invest less in capital expenditures than do corporations. Capital investment is regarded as a key component of productivity growth because it allows firms to extract additional output from its workers, thereby boosting productivity. Productivity growth, in turn, is the key driver of long-run economic growth.

On the surface, the concept that income trusts spend less on capital expenditure seems intuitive, given that the structure lends itself particularly well to mature, low-growth companies. Conventional wisdom is that the income trust market is primarily for firms with limited growth opportunities and little need for capital expenditure. However, current research, reviewed below, suggests the income trust market has grown and diversified into high-growth businesses as well.

[26] Aggarwal and Mintz assume a personal tax rate of between 25% and 34% while HDR│HLB assume a distribution of personal tax rates ranging from 29% to 40%. The Department of Finance confined its estimate to federal taxes only and used a federal personal tax rate of 25%. According to the Department of Finance, the average combined federal and provincial corporate tax rate is 31.5%.
[27] Statement by the Honourable Jim Flaherty, Minister of Finance, October 31, 2006.

As with estimates of tax leakage, there are varying opinions regarding the effect of income trusts on economic growth. Moreover, the relationship of income trusts to economic growth is less well defined, and therefore, more difficult to quantify than tax leakage. Unfortunately, this difficulty means that much of the current literature contains speculative hypotheses but relatively little evidence to support or refute these hypotheses. This is perhaps largely a function of the relative infancy of the sector, which also might explain the small pool of formal studies upon which to draw.

The following section presents arguments that have been put forward, both in support and in criticism of income trusts. The studies reviewed are:

1) Lalit Aggarwal and Jack Mintz, “Income Trusts and Shareholder Taxation: Getting it Right,” *Canadian Tax Journal,* Vol. 52, No.3, 2004.

2) Department of Finance, “Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)”, Consultation Paper, September 2005.

3) HDR│HLB Decision Economics, “Income Trusts and the National Economy” Report commissioned by the Canadian Association of Income Funds, April 2006.

4) Vijay Jog and Liping Wang, “The Growth of Income Trusts in Canada and the Economic Consequences,” *Canadian Tax Journal,* Vol. 52, No.3, 2004.

5) Canaccord Adams, “Income Trust Tax Reform: Unintended Consequences – a new National Energy Policy?,” November 2006.

6) BMO Nesbitt Burns, “Income Trusts and the Economy: Net Gain or Loss?” October 2005.

3.2.1 Aggarwal and Mintz, 2004

In 2004, as well as in prior research, Mintz discussed the possibility that income trusts create economic distortions or economic inefficiencies. Economic efficiency is generally achieved when scarce resources, including capital, are allocated to their most productive uses. Inefficiency can arise when capital is not allocated to its most productive use. For instance, if an incentive exists that directs capital to less productive firms, and this incentive cannot be accessed by all firms, then markets will be distorted. Aggarwal and Mintz’s argument was that the tax advantage of income trusts creates such a distortion.

The authors suggested that because only certain firms are in a position to convert to an income trust structure and benefit from the tax advantages, markets will allocate capital to those firms. Aggarwal and Mintz’s argument was based on the assumption that only low productivity, low growth firms have accessed the income trust market. Under this assumption, and because of the appeal of income trusts to investors, markets have directed capital to less productive means than they would have if the tax advantage of income trusts was not present.

According to research by Aggarwal and Mintz, the fastest growing and highest yielding sectors of the economy have not yet accessed the income trust market. The authors claim that this has created significant inter-firm distortion. As an example, if two firms, A and B, are competing in the same market and firm A is a corporation while firm B is an income trust, firm B may be better positioned to raise capital because of its tax advantaged structure. If this competitive edge is due only to the tax advantage, then capital allocation decisions may be distorted.

The effectiveness of this argument hinges on the investment characteristics of income trusts remaining as they were from 1993 to 2002, the sample period drawn on for Aggarwal and Mintz's analysis. If the income trust sector continues to be characterized by a low return on capital and shallow rates of reinvestment, then capital market distortion may indeed have consequences for future economic growth.

3.2.2 Department of Finance, 2005

In its 2005 Consultation Paper, the Department of Finance echoed Aggarwal and Mintz's argument along with the concern that firms may be motivated to convert to an income trust structure before they have matured. Due to the pay-out obligations of income trusts, this could limit the investment that would normally be taking place during a firm's growth phase.

Finance also noted ways in which income trusts may promote economic efficiency, such as:

- Income trusts provide an added financing option for firms in times when capital markets are less receptive to common equity issues.

- Income trusts provide a viable strategy for private firms looking to become public.

Finance introduced the additional concern that due to the immense size of the tax-exempt investment class in Canada, these investors could have undue influence on how businesses are structured. According to Finance, businesses financed by tax-exempt investors may have a lower cost of capital than their corporate counterparts, which could introduce significant fairness and efficiency issues in Canadian markets.

3.2.3 HDR│HLB Decision Economics, 2006

In April of 2006, the CAIF once again commissioned HDR│HLB, this time to study the issue of income trusts and economic growth.

The study revolved around addressing the concern that "the trust structure, by virtue of the need to make regular distributions to unitholders, might attract companies with little need to invest in productivity enhancing projects."[28]

---

[28] HDR│HLB Decision Economics, "Income Trusts and the National Economy," Report commissioned by the Canadian Association of Income Funds, April 2006.

HDR│HLB broke down the economic growth issue into four essential questions, as follows:

1) Does the trust structure itself create barriers to capital investment in plant, equipment and business systems?

2) Is the trust sector attracting low growth firms, indicating that the trust structure diverts capital resources from high growth to low growth sectors?

3) Do firms that adopt the trust structure reduce their rate of capital investment?

4) Are income trusts making the kind of investments that promote productivity growth?

Using a database of income trust financial information assembled by HDR│HLB, as well as survey data collected from a sample of twenty-four income trusts, HDR│HLB concluded that concerns over income trusts hurting productivity growth were unwarranted. HDR│HLB further stated that "suppressing growth in the trust sector – by means of law, regulation or taxation policies – could be tantamount to suppressing growth in the Canadian economy."

This conclusion was based on the following report findings:

- firms in the business and energy trust sector are disproportionately more capital intensive than firms in the economy at large;

- the annual rate at which firms continue to invest in productivity-enhancing plant, equipment and high technology business processes is unaffected by conversion to the trust structure;

- almost 40% of all business and energy trusts in 2004 resided in industry sectors exhibiting above-average productivity growth over the period 1997 to 2003; and

- firms are taking capital needs into account as a precondition for adopting the trust structure.

It is difficult to place a large degree of confidence in the survey data collected by HDR│HLB, given that the response rate to the survey was only 17%.[29] However, the data collected did reveal some interesting characteristics of the income trust sector.

For example, according to the HDR│HLB income trust database, the majority of income trusts reside in sectors with above average growth in capital intensity rates. Furthermore, the manufacturing sector, which accounts for 21% of income trusts by number and 8% by market capitalization, realized labour productivity growth 38% higher than the national average from 1997 to 2003.

[29] Of 141 firms queried, 24 firms completed the HDR│HLB survey. The authors stated that though not sufficient to yield results at the highest benchmark of statistical reliability, the sample was statistically representative of the business and energy trust sector.

Additionally, from 1997 to 2003, capital intensity in the mining, oil and gas extraction sector grew at over eight times the average rate for all businesses. This sector represented 29% of income trusts by number and over 50% by market capitalization.

These findings would suggest that, contrary to the concerns expressed by Aggarwal and Mintz, income trusts are continuing to reinvest in productivity enhancing projects and technologies.

3.2.4 Jog and Wang, 2004

The focus of Vijay Jog and Liping Wang's 2004 paper, "The Growth of Income Trusts in Canada and the Economic Consequences" was IPO pricing and subsequent performance in the income trust market from 2000 to 2003. As part of their analysis, the authors also examined the potential economic consequences of income trusts and revealed some interesting financing characteristics of income trusts.

Among Jog and Wang's findings were:

- the nature of the income trust market had changed with business trusts being as prevalent as resource and utility trusts;
- after the initial public offering, income trusts continued to access the capital markets in subsequent offerings;
- income trusts were not only financing no-growth, one-time business but were also aggressively raising capital for capital expenditures and new acquisitions; and
- over 50% of new financing had gone into new acquisitions and capital expenditures.

Moreover, and consistent with the findings of HDR│HLB, Jog and Wang concluded that "if there are attractive opportunities in the underlying operating companies, they [income trusts] will (and have accessed) capital markets for additional financing."

3.2.5 Canaccord Adams, 2006

According to research conducted by Canaccord Adams ("Canaccord"), the average business increased its capital expenditures by 28% after converting to a trust. Furthermore, trusts reinvested approximately 20% of their revenues as capital expenditures. This compared to only 10% reinvestment by members of the TSX 60.

Much of the research in the Canaccord report emphasizes the important role of income trusts in Canada's energy sector. In particular, the energy dominated royalty trust sector has shown significant growth:

“On a relative basis, royalty trusts are now spending twice that of what they were two years ago on development activity [...] Over the last three years, reinvestment on a per unit of production basis has grown by 137%.” – Canaccord Adams, “Income Trust Tax Reform”, November 2006

Although expenditure in the energy sector often occurs via the acquisition of mature assets, Canaccord found that royalty trusts directed almost half of their spending ($5.3 billion) towards capital expenditure in 2006.

In addition, Canaccord reported that many firms choosing to convert to a trust structure retained anywhere from 10% to 50% of their cash flow in order to fund growth. Canaccord further pointed to the emergence of “payout ratio investing”, or investing in income trusts that retain cash flow to fund growth, as signalling an evolution in the characteristics of the income trust segment.

3.2.6 BMO Nesbitt Burns Economics, 2005

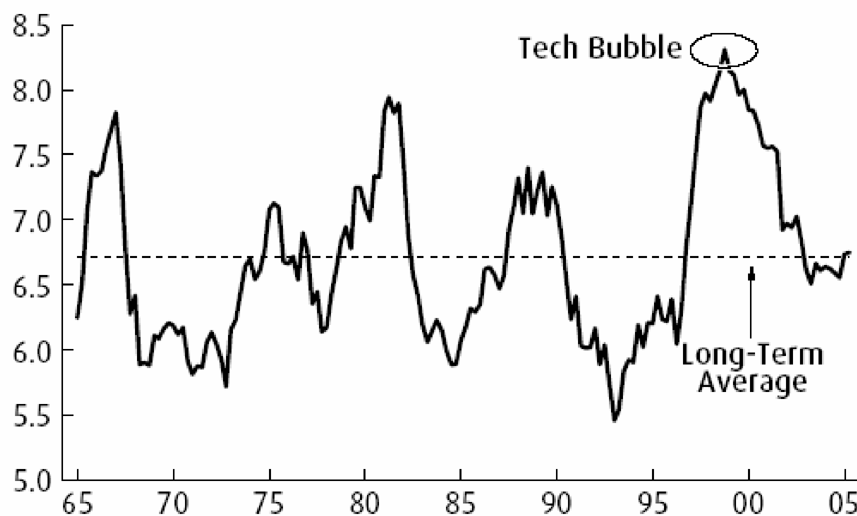
Similar to the findings of Canaccord, economists Douglas Porter and David Watt of BMO Nesbitt Burns[30] found that the capital spending of the top 50 income trusts by market capitalization was at least as high now, per employee, as it was pre-conversion.

Examining business spending on machinery and equipment as a percent of GDP, the authors showed that aggregate business investment in Canada was close to its long-run average of 7% of GDP. Figure 1 displays the rate of investment in machinery and equipment since 1965.

Figure 1

Canadian Capital Spending on M&E

(% of nominal GDP)



Source: BMO Nesbitt Burns

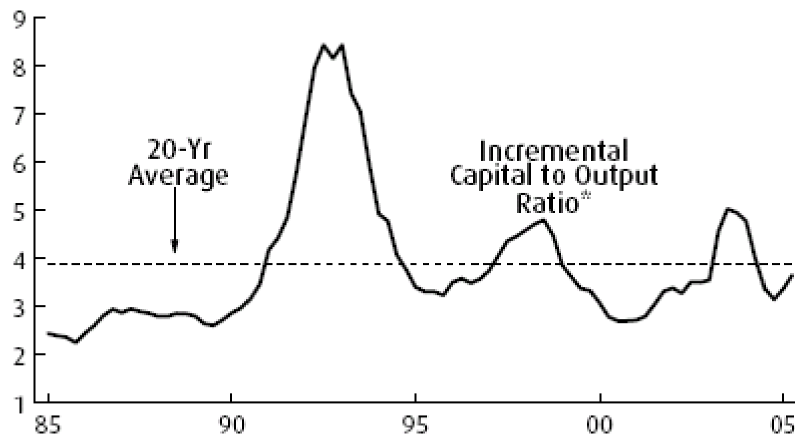
[30] BMO Nesbitt Burns, “Income Trusts and the Economy: Net Gain or Loss?” October 2005.

Investment in machinery and equipment has been shown to be highly correlated with productivity, and therefore, is important as an indicator of economic growth.[31] The authors suggested that given the current rate of investment compared to the historical average from 1965 to 2005, it was difficult to discern any material harm from the growth of income trusts.

Porter and Watt also observed that because income trusts must pay out relatively high distributions, management is forced to focus capital spending only on the most productive projects. If correct, this suggests that managers in income trusts are able to use capital more efficiently than their corporate counterparts.

The authors also examined Canada's incremental capital to output ratio ("ICOR"), which is a measure of capital efficiency. ICOR measures the investment needed to generate an additional unit of output, defined as the ratio of annual investment to the annual growth rate of GDP. Canadian ICOR since 1985 is illustrated in Figure 2 below.

Figure 2
Canadian Capital Spending: More Efficient



* The ratio of business investment to GDP growth (smoothed)
Source: BMO Nesbitt Burns

Efficiency is greater when the value of ICOR is low, which signals that firms require less capital expenditure to generate additional output. The data displayed in Figure 2 implies that Canadian businesses are wresting more growth out of each dollar of capital invested. While it is not possible to attribute the improvements in ICOR to income trusts, the data suggests that income trusts have not acted as a significant drag on capital efficiency.

---

[31] See J. Bradford DeLong and Lawrence H. Summers, "Equipment Investment and Economic Growth", *The Quarterly Journal of Economics,* Vol. 106, No.2, May 1991.

3.2.7 Summary

After citing concerns about economic growth in his announcement, no supporting argument regarding the detrimental effect of income trusts on economic growth is made in the backgrounder document accompanying the Minister of Finance's announcement.

Despite the sometimes definitive tones of both policy makers and the media, little evidence has been brought forward supporting the hypothesis that income trusts hinder capital expenditure, productivity or economic growth.

In fact, much of the available research would point to the opposite conclusion. Based on the empirical findings of several authors, capital expenditure in the income trusts sector is at least as strong as the corporate sector and has shown no tendency to decrease upon conversion.

4.0 The Canadian Macroeconomic Picture

As discussed earlier, the Minister of Finance has expressed concern that income trusts undermine the economic health of Canadians by shifting the tax burden from corporations to individuals and by threatening economic growth.

To consider the economic implications of income trusts, we have examined the current state of the Canadian economy, future challenges to economic growth, and what challenges, if any, income trusts present for economic growth.

Because the Minister of Finance emphasized tax revenues and economic growth in his statement accompanying the income trust policy announcement, we have confined our analyses to these areas. Section 4.1 discusses the potential tax leakage within the context of the current government fiscal position. Section 4.2 concentrates on the productivity consequences of the income trust market and the related effects on potential economic growth.

4.1 Government Fiscal Position

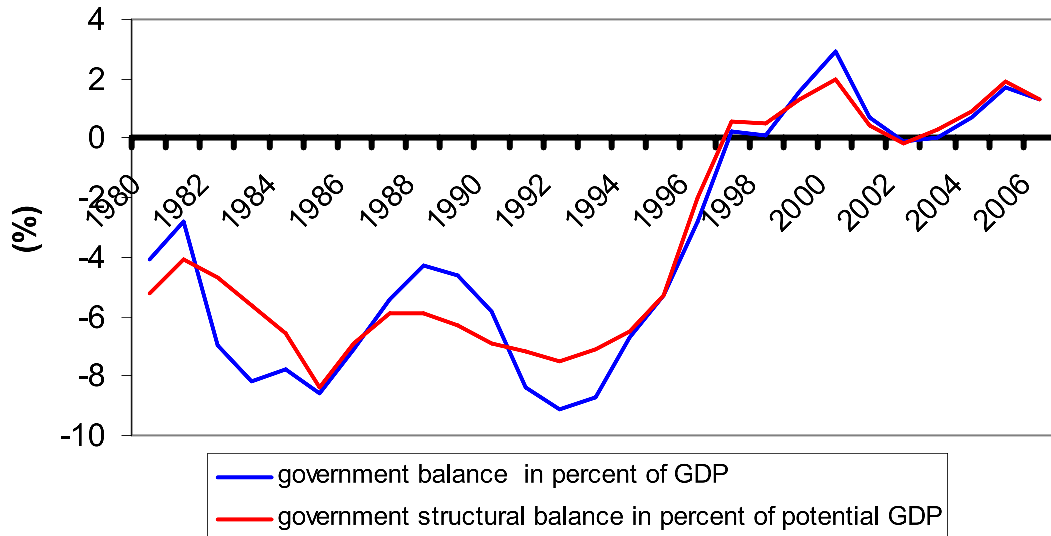
Much of the recent discussion of changes to income trust tax policy centers around tax leakage, or loss of government tax revenues, associated with income trusts. The largest estimate of tax leakage from the literature we have reviewed suggests that the tax advantages of income trusts reduce corporate tax revenues by $1.1 billion each year. While $1.1 billion is not an insignificant amount of money, it represents only about 2% of the $50 billion Canadian corporate tax base or less than 1% of the $224 billion in total income tax revenues collected in 2006.[32]

The government balance, or fiscal position, is the difference between government revenues and expenditures. Figure 3 below illustrates the government balance from 1980 to 2006.

---

[32]Statistics Canada, CANSIM, table 385-0001 (Consolidated federal, provincial, territorial, and local government revenue and expenditures).

Figure 3
Canadian Government Balance and Structural Balance as a % of GDP



Source: IMF World Economic Outlook Database, April 2006

Economic growth can be a contributing factor to an increase in government revenues. For example, all else being equal, if GDP growth is strong, increased taxable economic activity occurs and government collects greater revenues, which may produce a surplus. On the other hand, when the economy slows down, all else equal, economic activity decreases and government revenues may fall, potentially resulting in a deficit.

These types of surpluses and deficits are sometimes called "cyclical", because they vary with the business cycle. If an economy is growing at its potential or "full-employment" level[33] and government runs a surplus or deficit, it is referred to as a structural surplus or deficit.

The federal surplus is currently estimated at $8 billion[34] and because the economy is operating at or very near its full-employment level[35], one can say that Canada has a "structural" surplus. The implications of a structural surplus are that when the economy is growing faster than its full-employment growth rate, the budget surplus will increase. Similarly, if the economy slows slightly, there is capacity in the budget to absorb a decline in tax revenues. This implies a significant degree of flexibility in Canada's budget position.

[33] In its October 2006 Monetary Policy Report, the Bank of Canada estimates that full-employment or potential GDP growth in Canada is approximately 2.8%.
[34] http://www.fin.gc.ca/news06/06-013e.html.
[35] Bank of Canada Monetary Policy Report, October 2006.

4.2 Canadian Investment and Productivity Trends

The Minister of Finance implied that, in addition to tax leakage, income trusts may have negative implications for Canadian investment, productivity, and economic growth.[36]

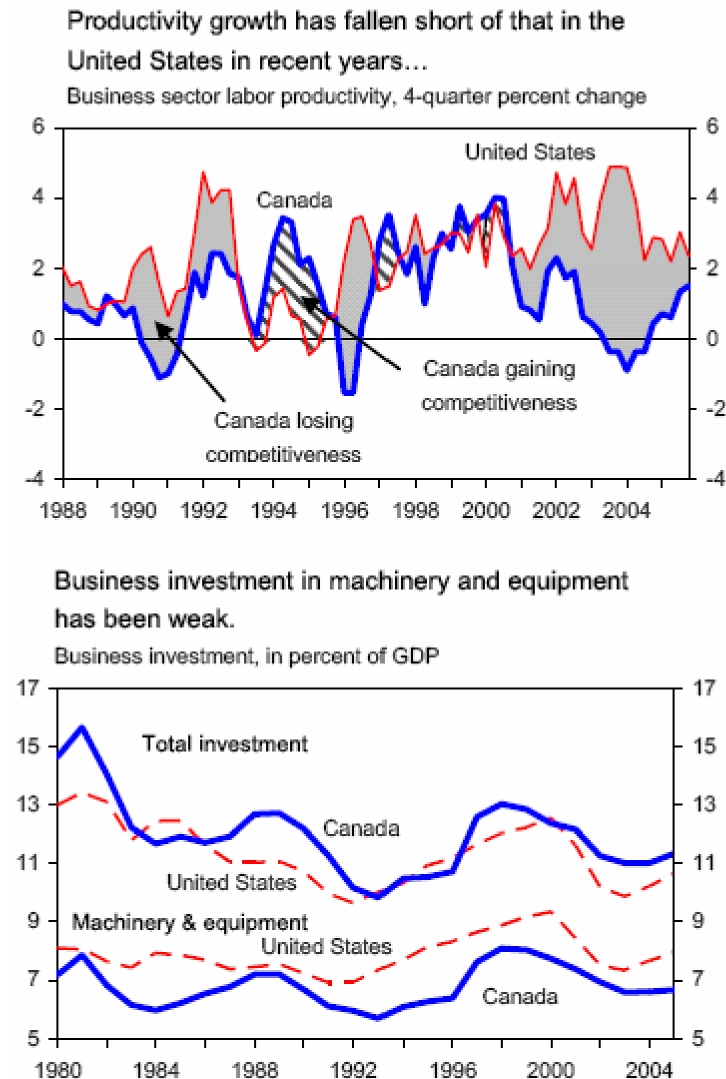
However, below average productivity growth in Canada has been a puzzle for economists long before emergence of income trusts. Adjusting for business cycles, annual labour productivity growth in Canada has averaged just 1.05% from 1980 to 2000 while the United States realized average annual labour productivity growth of 1.24% over the same time period.[37]

In its 2006 Country Report, the IMF singled out Canada's productivity as a lingering problem despite Canada's otherwise robust economy.[38] The IMF cites lacklustre investment by Canadian firms and Canada's relatively high corporate tax rates as likely causes of low productivity.

The United States is Canada's closest neighbour and largest trading partner, and the productivities of the two nations are often benchmarked against each other. Figure 4 shows the relative labour productivity growth and investment rates of Canadian and American firms as presented in the IMF Country Report.

[36] Department of Finance, "Canada's New government Announces Tax Fairness Plan", October 31, 2006 (available online at: http://www.fin.gc.ca/news06/06-061e.html).
[37] Serge Coulombe, "The Canada-U.S. Growth Paradox", Industry Canada Working Paper No.32, March 2000. These productivity estimates represent the averages for data smoothed of business cycle effects using a Hodrick-Prescott filter.
[38] Country Report No. 06/230, June 2006
(available online at http://www.imf.org/external/pubs/ft/scr/2006/cr06230.pdf).

Figure 4
Canadian versus United States Productivity and Investment

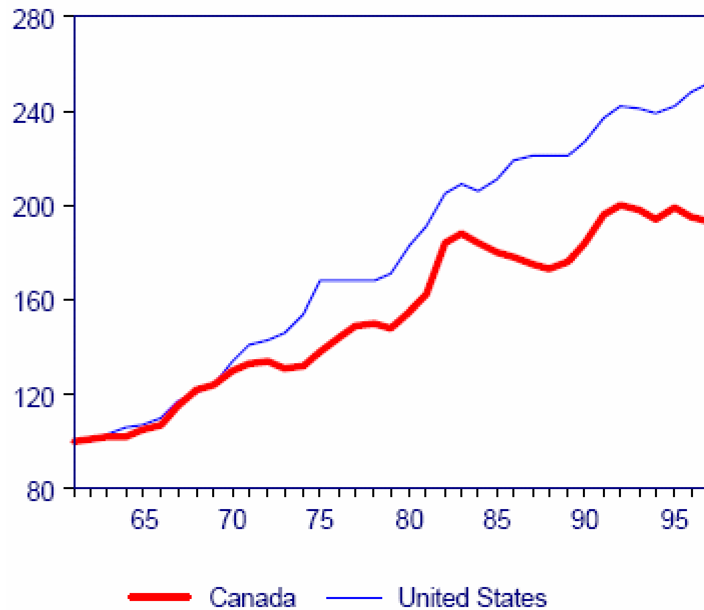


Source: IMF World Economic Outlook, Country Report No. 06/230, June 2006

Figure 4 compares the productivity struggles of Canadian firms as compared to their American counterparts. While there are periods where Canada has converged in competitiveness to the United States, these seem to be a function of exogenous technology shocks such as the technology boom of the 1990s, and show very little persistence. As previously discussed in Section 3.2.6, investment in machinery and equipment has been shown to correlate with productivity growth. As shown in the bottom panel of Figure 4, machinery and equipment investment in Canada has historically trended below similar investment in the United States.

In addition to analysing trends in aggregate investment, economists are also often interested in the degree of capital inputs used in the production process relative to labour inputs. From Figure 5 below we can see the divergence in capital intensity, measured as the ratio of capital to labour, between the United States and Canada.

Figure 5
Evolution of the Capital/Labour Ratio, Canada and the United States



Source: Industry Canada Working Paper No. 32, March 2000

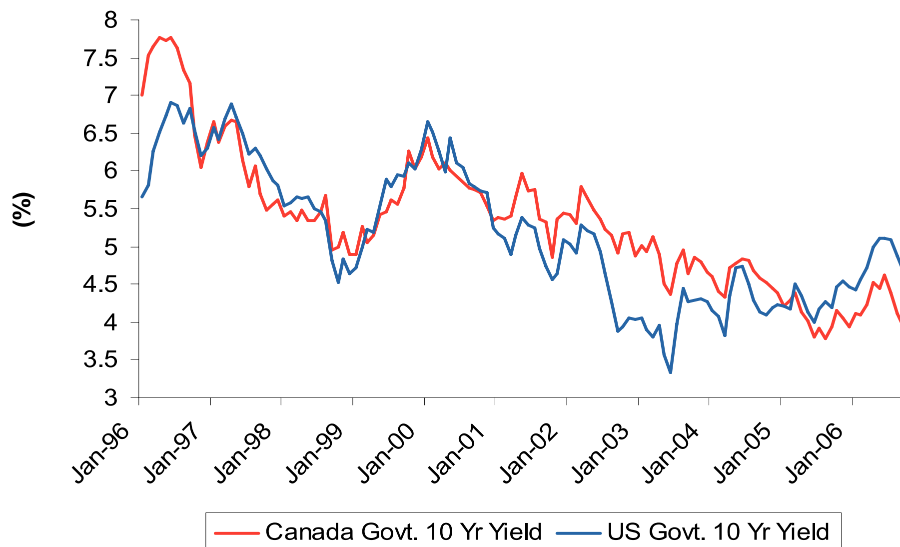
This divergence of capital intensity implies that Canadian firms have been investing less in capital equipment relative to the United States, and instead substituting labour in production. The trend in capital intensity illustrated in Figure 5 has been positive for both countries, but has increased at greater rate for the United States. While the substitution of labour for capital may have positive implications for Canada's employment rate, a lack of capital intensity can lead to lagging productivity growth.

Given the historical productivity struggles of Canadian firms, the natural question to ask is if the new income trust policy addresses Canada's productivity problem. The unfortunate answer is that taxing income trusts appears to do little or nothing to promote investment. The additional 0.5% reduction in the federal corporate tax rate is certainly welcome, but will likely not be enough to motivate firms to invest further in machinery and equipment. In fact, it could be argued that by eliminating a popular avenue for firms to raise capital, the new policy presents a stumbling block for future investment.

4.3 The Secular Downtrend in Canadian and US Bond Yields

It is not a coincidence that the observed boom in income trusts has occurred while interest rates, measured as government bond yields, in both Canada and the United States have been at historical lows, as depicted in Figure 6. Moreover, this downtrend in interest rates is often referred to as being "secular," as opposed to cyclical, because of perceived long-run stability of low rates of inflation. A permanently low inflation environment would translate to permanently lower interest rates because central banks would not have to drastically increase interest rates to tame inflation.

Figure 6
Downtrend in Canadian and US Interest Rates



Source: Bank of Canada, St. Louis Federal Reserve Database

The low-yield environment and tech-bubble overhang in the equity markets has made the cash distributions of income trusts attractive to retail investors, pension funds, and non-residents. The Bank of Canada has suggested that income trusts, by filling a void between low-risk bond investments and higher risk common equity, reflects an evolution of Canada's capital markets.[39] Other commentators have compared the risk characteristics of income trusts to the high-yield bond market in the United States.[40] It can then be inferred that these instruments act to complete Canadian capital markets and may be an important tool for portfolio diversification.

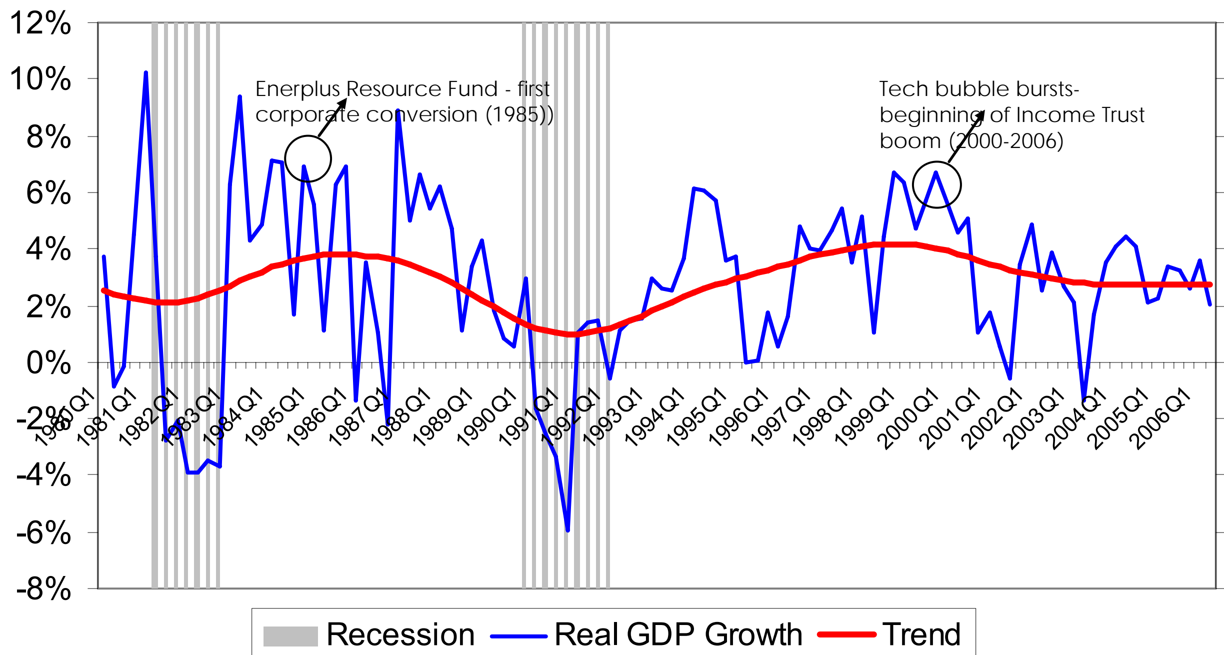
4.4 Canadian Real GDP Growth

If income trusts have been harmful to economic growth, it is very difficult to find support from the economic data. Perhaps growth would have been even stronger absent the existence of income trusts, but such an argument is difficult to substantiate. Figure 7 shows the annual rate of Canadian Real GDP growth since 1980. The shaded regions represent recessions as defined by the Economic Cycle Research Institute.[41]

---

[39] Michael R. King, "Income Trusts – Understanding the Issues," Bank of Canada Working Paper 2003-25, September 2003.
[40] BMO Nesbitt Burns, "Income Trusts and the Economy: Net Gain or Loss?" October 2005.
[41] Recession estimates are provided in Philip Bodman and Mark Crosby, "Phases of the Canadian Business Cycle," *The Canadian Journal of Economics*, Vol. 33, No.3, August 2000.

Figure 7
Canadian Real GDP Growth vs. Trend, 1980Q1 to 2006Q2



Source: Statistics Canada; Economic Cycle Research Institute

Proving that unabated growth in the income trust sector will harm future or potential economic growth is also a difficult proposition. In the context of the wider Canadian macroeconomic perspective, income trusts are likely faced with the same investment and productivity challenges as traditional corporations. The empirical evidence reviewed suggests that income trusts are aggressively reinvesting in capital expenditures and acquisitions, a positive indication for future economic growth.

4.3 Summary

Key drivers of economic growth are labour supply and productivity growth. The growth of the labour supply has various components, such as the labour force participation rate and labour demographics. The latter is likely to present a challenge for future economic growth as the Canadian population ages and more people retire. This means that productivity growth will be even more important to economic growth in the coming years, and the development of real productivity enhancing policy should be a main focus for policymakers.

From the macroeconomic data we have reviewed, the following conclusions can be drawn:

1) The strength of the federal budget position provides flexibility to consider alternatives to the decision on income trusts.

2) Investment and productivity growth in Canada are concerns requiring legitimate attention. Taxing income trusts as corporations will likely have no positive effect on either the rate of investment or productivity growth.

3) The growth of the income trust market has been partly driven by the low interest rate environment. Furthermore, the popularity of income trust among investors indicates that income trusts serve a segment of the market not met by traditional financial instruments.

4) GDP growth has been strong and shows no evidence of drag due to income trusts.

Based on the evidence we have reviewed, it would appear that the income trust market does not present a threat to economic growth.

While it is too late to correct the immediate consequences of the income trust policy announcement there is still ample time, and fiscal flexibility, to review viable alternatives. The concluding sections outline why we feel income trusts are beneficial to the Canadian economy and how alternative polices may be structured to achieve tax fairness while maintaining the benefits of the income trust market.

5.0 Economic Benefits of Income Trusts

PwC believes that the income trust market provides a range of benefits to Canadian firms and investors that may have been overlooked by the government. Before the new income trust taxation policy is passed into law, we suggest that government fully investigate the full spectrum of economic benefits generated by the income trust market.

Of the numerous benefits of the income trust market, one of the most important is that it has allowed a diverse array of firms, who may otherwise have no access to financial markets, to raise capital and finance their growth. Additionally, the flow-through structure of income trusts creates needed transparency for effective and disciplined capital re-investment. Finally, income trusts have highlighted the unfairness of, and provided a simple and efficient solution to, double taxation. These benefits are discussed further below.

5.1 Access to Capital Markets

Some analysts have suggested that the growth of income trusts has created inefficiencies in Canadian capital markets.[42] We believe this view ignores the value of enhanced access to capital for Canada's growth engines – small and medium sized enterprises ("SMEs") – that the income trust market provides.

Close to 80% of income trusts are small to mid-sized businesses with capitalizations of under $1 billion.[43] Prior to the modern income trust market, many SMEs lacked the access to capital the income trust market affords them. We argue that income trusts have made market allocations of capital more efficient by unleashing the growth potential of Canada's small and medium sized firms.

Research by PwC, presented in Table 2 below, bears this out:

Table 2: Income Trusts – Growth and Capital Spending

	2004	2005
Sales Growth	39%	54%
Sales Growth 2000-2005	577%	605%
Total Sales ($ billions)	51.7	74.3
Net Income Growth	22%	62%
Total Net Income ($ billions)	6.3	10.6
Capital Spending as a % of Net Income	376%	230%
Total Capital Spending ($ billions)	21.8	26.5

[42] See Aggarwal and Mintz (2004) and Department of Finance (2005).
[43] Acuity Investment Management, "Income Trust Benefits to the Canadian Economy," November 2005.

The data in Table 2 was compiled by PwC from financial statements filed by income trusts. The growth rates reported above contradicts concerns that the income trust market inefficiently allocates capital to low growth firms. The growth and capital spending data contained in Table 2 shows Canadian income trusts generated significant, double digit revenue and income growth and reinvested tens of billions of dollars in capital expenditures. Moreover, as illustrated in the following table, research by Jog and Wang (2004) shows income trusts aggressive in raising capital from both Initial Public Offerings (“IPOs”) and subsequent offerings.

Table 3: Initial Public Offerings: Uses of Proceeds by Operating Companies 2001-2003

	Business		Resource		Utility		Total	
Use	$ mil.	%	$ mil.	%	$ mil.	%	$ mil.	%
Acquisition	886.18	20.7	1,332.70	82.2	462.05	20.5	2,680.93	32.8
Repayment of debt	1,569.73	36.6	–	–	635.22	28.2	2,204.95	27.0
Other uses	42.20	1.0	–	–	–	–	42.20	0.5
Unspecified	1,788.36	41.7	288.00	17.8	1,158.42	51.4	3,234.78	39.6
Total	4,286.47	100	1,620.70	100	2,255.69	100	8,162.86	100

Source: Jog and Wang (2004)

Table 4: Subsequent Issuances: Uses of Proceeds 2001-2003

	Business		Resource		Utility		Total	
Use	$ mil.	%	$ mil.	%	$ mil.	%	$ mil.	%
Secondary offering	459.17	30.0	303.19	9.5	400.79	22.6	1,163.16	17.9
Capital expenditures and new acquisitions	967.95	63.3	1,793.85	56.4	1,010.58	57.0	3,772.37	58.2
Repayment of indebtedness	103.18	6.7	1,075.66	33.8	362.90	20.5	1,541.74	23.8
Other	–	–	5.10	0.2	–	–	5.10	0.1
Total	1,530.30	100	3,177.80	100	1,774.27	100	6,482.37	100

Source: Jog and Wang (2004)

The over $8 billion in IPO activity from 2001-2003 Table 3 shows the importance of the income trust market as a source of financing for Canadian firms. Clearly, given the amount of financing raised, the income trust market provides an avenue for raising capital that was not previously available to Canadian firms. Furthermore, the increasing diversification of the income trust market is illustrated by the distribution of IPO financing across business trusts (53%), resource trusts (20%), and utility trusts (27%).

Moreover, the data on uses of proceeds from subsequent issues presented in Table 4 supports the previously reviewed research showing that income trusts reinvest in growth enhancing capital expenditures. Contrary to the belief that the trust structure prohibits investment, Jog and Wang’s research shows that income trusts used almost 60% of the proceeds raised in the income trust market to fund growth through capital expenditure and new acquisitions.

Given the level of economic activity illustrated by Jog and Wang's data, the value of the income trust market is apparent. Access to capital facilitated by the income trust market has provided Canadian firms growth opportunities previously unavailable. Furthermore, empirical evidence not only shows income trusts reinvesting in their businesses but also achieving impressive growth in revenues and earnings from this reinvestment. This evidence suggests that rather than hindering the growth potential of the Canadian economy, income trusts are contributing to Canada's prosperity.

5.2 Cost of Capital Advantage

The capital structure of most income trusts affords them a lower cost of capital than could be achieved under a corporate structure. Due to their tax advantage, income trusts can provide cash distributions that are often much higher than corporate dividends. Therefore, units in income trusts are valued at a premium which translates to a lower cost of capital for firms organized as income trusts. A firm's cost of capital is of primary importance for firms evaluating potential projects, investments, or acquisitions. If a firm's cost of capital decreases, it will undertake more investments or projects that were not previously feasible. Therefore, all else being equal, a lower cost of capital will translate into higher levels of investment.[44]

A lower cost of capital can also elevate the competitive position of Canadian firms. Traditionally, because of Canada's higher corporate taxes and relatively shallow capital markets, Canadian companies were at a competitive disadvantage to their counterparts in the United States. Because of the income trust structure, Canadian businesses can compete on a level playing field for assets and market share with foreign firms.

Consequently, the federal government's decision to tax income trusts removes this cost of capital advantage and has therefore coincided with double digit percentage losses in the income trust market.[45] Because most income trusts are now trading at much lower valuations, and have proven cash generating assets, many have become acquisition targets for foreign private equity firms.[46] The absence of financing previously available from the income trust market may leave small and medium sized firms with fewer options and the threat from private equity and pension funds.

Private equity firms tend to favour the use of leveraged buyouts which allow interest deductions to offset income, virtually the same model currently used by income trusts. Furthermore, the proposed changes may induce large pension funds to take existing trusts private, achieving an equivalent tax-exempt source of income from interest paid by the operating entity. Incidentally, the ability of private equity firms, large pension funds, or large foreign corporations to engineer structures that replicate the tax benefits of income trusts presents a challenge to the fairness of

---

[44] In Jason G. Cummins, Kevin A. Hassett and R. Glenn Hubbard, "Tax Reforms and Investment: A Cross-Country Comparison," Journal of Public Economic No. 62, 1996, the authors estimate that in Canada a 1% change in the cost of capital will lead to a 0.81% change in investment.

[45] Tavia Grant and David Parkinson, "TSX Income Trust Sector sheds $20-billion", *The Globe and Mail*, November 1, 2006 (available online at http://www.theglobeandmail.com/servlet/story/RTGAM.20061101.wstocks1101/BNStory).

[46] Sinclair Stewart, Boyd Erman, and Andrew Willis, "Private equity casts its eyes on bruised trust firms", *The Globe and Mail*, November 4, 2006.

Canadian capital markets. Of the major Canadian tax-exempt investors, only large pension funds have the capacity, financial and otherwise, to realize gains from privatizations of income trusts.

Therefore, the ultimate effect of the government's policy on tax revenues could be minimized by a wave of private equity acquisitions and privatizations by pension funds. Essentially, should this prospective private equity buying occur, the only lasting effect of the government's policy may be the elimination of a key source of capital for Canadian firms.[47]

Therefore, the loss of a cost of capital advantage presents doubly negative effects for the economy. Not only may firms suffer from decreased competitiveness in global markets, but economic gains from Canadian businesses may be realized by foreign firms rather than Canadian investors. Furthermore, because of a potential slough of private equity acquisitions there may be only marginal recouping of the tax revenues the government was originally concerned about losing.

Other, perhaps unintended, consequences of the government's decision may include the loss of valuable head office jobs and an increased level of business uncertainty that could slow near-term growth in income trust dominated segments of the economy.

5.3 Principal-Agent/Disciplined Capital Re-investment

The principal-agent problem defines the misalignment of shareholder (principals) and manager (agents) objectives.[48] This occurs due to asymmetric information, that is, one side being privy to better or more complete information than the other.

Managers are contracted agents that act on behalf of a firm's shareholders. In reality, due to the high cost of monitoring and asymmetric information, managers sometimes place their own interests ahead of shareholders. Prominent examples of the principal-agent problem include Enron and WorldCom. These failures were abetted by the complexities of the accounting system and the inability of regular investors to effectively monitor management.

A key benefit of the income trust structure is that managers and unitholders are more efficiently aligned due to an effective and transparent monitoring system – cash.

If ineffective management of the income trust leads to a reduction in distributions, the ramifications are felt immediately via the market and income trust unit prices will fall. Furthermore, the transparency of cash distributions might make it more difficult for firms to hide their mistakes.

This transparency benefits not just shareholders, but firms as well. The scarcity of available capital forces managers to focus on strategic, value-added projects. This cuts down on corporate waste and leaves less cash flow idle on company balance sheets.

---

[47] Ibid.

[48] The Principal Agent Problem (Agency Theory) was introduced and developed in Alchian and Demsetz (1972), Eisenhardt (1985, 1989), and Jensen and Mekling (1976).

5.4 Elimination of Double Taxation

Income trusts have proven to be an effective tool for circumventing double taxation. The government has recognized the essential unfairness of taxing income twice and has already taken important steps to rectify this unfairness by reforming dividend taxation. However, because Canada's tax-exempt investors cannot take advantage of dividend tax credits, a significant portion of investors still remain financially better off investing in income trusts. Under the government's proposed changes to income trust taxation, these investors will be faced with a disproportionate tax burden.

We believe that there exist more equitable avenues for addressing the remaining imbalances between classes of income trust investors. Specifically, a fair solution, and one that will preserve the income trust structure, should target equating the tax treatments of taxable and tax-exempt investors. A detailed exposition of our recommendation is contained in Section 6.2.

5.5 Summary

PwC believes that the various sources of economic activity stemming from the income trust market, and the effective disciplined capital re-investment structure encourages outweigh the potential tax consequences of income trusts. Moreover, the government's proposal could have substantial unintended consequences. The most prominent of these is a potential wave of acquisitions of former income trusts by foreign private equity firms, leading to the economic benefits of Canada's small and medium size firms flowing into private equity coffers rather than to Canadian retirees and investors.

The following section will discuss policy alternatives to the income trust component of the government's Tax Fairness Plan that we believe offers a better solution for Canadian firms and investors.

6.0 Policy Alternatives for Income Trust Taxation

We have reviewed the income tax implications of the income trust proposals contained in the government's Tax Fairness Plan. To assist the reader understand what changes are being proposed by the government, we have quantified the levels of taxation and the deferral available to the three classes of investor. This section of the report also provides several specific suggestions for tax amendments and discusses some related concerns.

6.1 Analysis of Tax Treatment by Investor Classification

The current tax regime treats classes of investors unevenly and presents substantial fairness issues in the income trust market. The proposals in the Tax Fairness Plan address some of these issues but are not complete, especially as they relate to tax-exempt investors. We have defined the different classes of investors as follows:

1) Taxable investors: Canadian individual investors holding units of income trusts outside of tax-exempt accounts such as pension funds and RRSPs.

2) Tax-exempt investors: Individual investors holding units of income trusts inside RRSPs or pension funds holding units of income trusts.

3) Non-residents: Non-residents of Canada with holdings in Canadian income trusts.

The Appendix attached to this report provides a detailed analysis of the taxes incurred on $100 of pre-tax income earned and distributed to each class of investor based on the following simplifying assumptions:

1) A taxable investor is a Canadian individual resident in British Columbia, Alberta or Ontario and taxable at the top personal marginal rates.

2) Top personal marginal rates are equal to the rates for the latest year for which they have been announced by the respective jurisdictions.

3) The level of corporate tax paid by the entity is 31.5% in 2011, consisting of an 18.5% federal corporate tax rate as announced in the Tax Fairness Plan and an average 13% provincial corporate tax rate.

4) Federal and provincial changes proposed for the taxation of eligible dividends have been implemented and fully phased-in.

5) Non-resident investors are residents of the United States eligible for the benefits of the Canada-U.S. Tax Treaty.

6.1.1 Taxable Investors

As noted in the Appendix, the tax paid on income earned and distributed to a taxable individual from an income trust is not substantially different from income distributed as a dividend from a publicly traded corporation. Prior to November 2005, an additional tax cost associated with the corporate dividend reflected a degree of double taxation of corporate income earned and distributed to shareholders. This tax cost was largely eliminated with the enhanced dividend tax credits announced by the previous government and the provinces. The 2005 changes were designed to eliminate the taxation differences between income trusts and publicly traded corporations for taxable investors, and in our view, the government was successful in this regard.

The tax changes announced in the current government's proposal will only marginally affect taxable investors. The results vary slightly by province of residence, reflecting differences between provincial tax rates and dividend tax credits.

6.1.2 Tax-Exempt Investors

Tax-exempt investors, such as pension plans and RRSPs, have been attracted to the income trust market by the ability to generate pre-tax investment returns. Essentially, income trusts are structured to earn business income without incurring any initial corporate tax. To the extent that this business income is then distributed to exempt investors, tax is deferred until the tax-exempt itself distributes the income to a taxable beneficiary (e.g. a pensioner). This tax deferral is not available to a corporation, which must pay a "first level" corporate tax on income before paying dividends. This deferral advantage is currently equal to 34% (declining to 31.5% in 2011) on all business income distributed to a tax-exempt investor. The tax deferral is only a permanent tax saving in the case of a tax-exempt entity such as a charity that uses its investment income in the pursuit of its charitable works. We do not expect any tax leakage associated with income trust holdings by charities to be material.

An income trust investment is also ultimately more tax-efficient than an investment in a dividend paying public company. For example, it is not possible for a pension plan or the beneficiary of a pension plan to obtain the benefit of the dividend tax credit. As a consequence, pension income funded by corporate dividends is subject to double taxation (once within the corporation and again in the hands of the pensioner). As the analysis presented in the Appendix shows, the total tax borne by tax-exempt investors is approximately 60%, due to the inability to benefit from the dividend tax credit.

The policy decision of the previous government to adjust the dividend tax credit, announced in November, 2005, did not address the deferral advantage or the double taxation of dividends earned by pension funds. As a result, exempt investors continued to favour investments in income trusts over publicly traded corporations.

The changes proposed in the Tax Fairness Plan eliminate the tax deferral advantage, but do not address the resultant double taxation of dividend income earned by a pension plan. We submit that this tax burden exceeds the tax paid by other classes of investors and is inconsistent with a tax policy designed to level the playing field between the classes of investors. While, in the past, a possible rationale for this rate discrepancy may have been that the higher tax rate offsets the deferral advantage afforded tax-exempt investors, that is no longer valid given the proposals in the Tax Fairness Plan to tax income trusts. [49]

As noted in the Appendix, by eliminating the deferral benefit, the overall tax collected from this group will increase by approximately 20% once all income has been flowed through to the beneficiaries of tax-exempt investors. We do not believe this treatment is unintended because it mirrors the tax treatment afforded to tax-exempt investors owning publicly traded corporations. However, we suggest that the new income trust tax policy unfairly penalizes tax-exempt investors by not balancing their tax burdens with those of the other investor classes on a flow-through basis.

The inherent double taxation of income earned and distributed by tax-exempt investors is already a problem within the corporate tax system. The extension of this inequity to public income trust investments is one of the most significant concerns we have with the government's proposals. These tax policies make it more difficult for pension plans to earn the returns required to fund future pension payments. Pension plans are struggling to improve yields because of the pressures of declining interest rates and long-term pension cost/solvency issues. The tax proposals also motivate pension fund investors to structure "around the rules" by means of debt arrangements or privatizations. One need only look at the privatization of Canada's public real estate companies by the pension funds as an example.

Given that the deferral advantage has been eliminated by the government's proposal to tax income trusts up front, it is not surprising that valuations in the income trust market have adjusted to reflect the differing tax treatment across investor classes. One may speculate that the market reaction was largely driven by tax-exempt investors acting in response to the lost tax-deferral advantage. Under the income trust policy change, a rational action by these investors is to adjust their portfolios to reflect the punitive tax burden imposed by the new policy. As noted, taxable investors were largely unaffected on a tax basis (although they suffered alongside the tax-exempt and non-resident investors in the market decline).

[49] In addition, one could argue that when outflows (withdrawals) from tax-exempt vehicles exceed the inflows from investments, then there is in fact an increase in tax collections by the government. This proposition is examined by Gordon Tait, in his BMO Capital Markets discussion paper released on December 4, 2006.

6.1.3 Non-Residents

Prior to the government's proposed changes to income trust taxation, non-resident investors benefited substantially from owning income trusts. By investing in income trusts instead of publicly traded corporations, non-resident investors eligible for treaty benefits could lower their respective Canadian tax rates from approximately 44% to 15%. This gap was an unambiguous loss of Canadian tax revenues. Furthermore, international tax treaties substantially limit flexibility on this matter. Accordingly, this class of income trust investor was a main focus of the government's proposed income trust tax policy.

As noted in the Appendix, the new income trust tax policy under the Tax Fairness Plan will close the gap between tax rates levied on non-resident investors in corporations versus income trusts. In fact, as our analysis shows, the new tax policy will narrow the gap to within 90% of the effective tax rate of publicly traded corporations, thus removing much of the incentive for non-residents to invest in income trusts. However, rather than narrowly targeting non-resident investors, the broad scope of the proposals affects tax-exempt investors, which largely consist of Canadians saving for retirement. One only need ask whether the price of fixing the tax leakage from non-resident investors is worth the cost of diminishing the wealth of retired Canadians.

6.2 PwC Suggestions

We submit that the proposed changes to income trust taxation contained in the Tax Fairness Plan should be reconsidered. Rather than proceeding in a piecemeal manner, the government should address the overall question of integration in the corporate tax system. The last government's proposal to increase the dividend tax credit affected only taxable Canadian individuals and did not address issues related to non-resident and tax-exempt investors. The current government's Tax Fairness Plan addresses the tax revenue loss resulting from non-resident investors to the detriment of tax-exempt (deferred) investors and retired Canadians.

However, rather than introducing a new set of tax rules, we believe that the government's tax and economic policies could be best achieved by making a few refined adjustments to the *Canadian Income Tax Act*:

1) The *Income Tax Act* already contains rules that tax trusts that have non-resident beneficiaries. More specifically, Part XII.2 of the current *Income Tax Act* applies a 36% tax on the designated income (which includes capital gains and income from businesses carried on in Canada) of trusts with designated beneficiaries (non-residents and tax-exempts). This Part XII.2 is refundable to Canadian taxable beneficiaries. Currently, publicly traded mutual fund trusts are exempt from this tax. Income trusts structure themselves as mutual fund trusts in order to avoid this tax. We believe that in place of the government's proposal to tax income trusts as corporations and tax their distributions as dividends, this provision could be amended to tax income trusts at the desired level (31% percent instead of the 36% rate currently in effect in the provision) on any income distributions, regardless of the class of investor (i.e., resident, non-resident and tax-exempt investors).

2) Publicly-traded limited partnerships will also be subject to the government's proposed tax in 2011. Tax revenue loss is associated with non-resident investors in a partnership, because the non-resident partners must report their share of partnership income by filing Canadian tax returns. For this reason, we expect that non-resident investment in publicly-traded partnerships is negligible. If investment in partnerships by tax-exempts is a concern, one solution would be to eliminate such investments as qualifying investments for RRSP purposes. The few existing PTPs could either be grandfathered or encouraged to convert into public company form.

3) If the Part XII.2 tax discussed above is applied to all income distributed by an income trust, then we suggest that the Part XII.2 tax and the dividend tax credit (on Canadian corporate dividends) be made refundable to tax-exempt investors (possibly excluding charities). The timing of the refunds should notionally coincide with the timing of distributions from tax-exempt pension funds and RRSPs to their beneficiaries. Rather than an overly complicated tracking system, we advocate a proxy (e.g., refund on a straight-line basis over a reasonable number of years).

4) The *Income Tax Act* contains a myriad of reorganization rules that are available to corporations. Rather than trying to extend these rules to trusts, we suggest that income trusts be given a tax-deferred means of converting to corporate status. A straightforward conversion before 2011 may also be the best way to achieve the government's tax policy goals. This suggestion would require an amendment to allow a trust to distribute shares of an underlying corporation to its beneficiaries on a tax-deferred basis – somewhat similar to the rules currently available to personal trusts.

As noted in the Appendix, taxable investors would be unaffected by our proposals because the immediate tax would mirror the tax collected from publicly traded corporations and would be creditable to the investor. There is no deferral advantage for taxable investors. The extent of any tax leakage attributable to tax-exempt investors, as noted above, relates solely to the deferral benefit, not any permanent benefit. The Part XII.2 tax would apply immediately (eliminating the deferral) but would be creditable as required to ensure that the level of tax paid on the ultimate flow-through of income equates to the tax paid by the taxable investor. Full refundability of Part XII.2 tax by way of the credit mechanism will equalize the tax treatment of tax-exempt and taxable investors. In other words, the current inequity suffered by tax-exempt investors through the loss of integration would be eliminated.

Lastly, in respect of non-resident investors, this tax would have no effect on income tax treaties in place between various countries because it is levied domestically. Moreover, the tax would substantially eliminate the permanent tax benefit available to non-residents, and would restore equity between the three classes of investors.

6.3 Anticipated Concerns

A number of concerns have been expressed in public about the government's proposed changes to income trust taxation. Our comments, including the impact of our suggestions, are captured in the following brief analysis.

6.3.1 Impact on Provincial Revenues

The government proposal refers to a proxy tax level of 13%, which will be shared equitably with the provinces. This division is to be subject to negotiation between the provinces. A portion of the Part XII.2 tax under our suggestion could be shared in the same manner. Rather than entering into protracted negotiations, we suggest that the allocation be based on established tax principles, imperfect though they may be. Business income earned by a corporation is allocated to the provinces in which that corporation maintains permanent establishments. The allocation formula is based on revenues earned and payroll in those provinces. An income trust could allocate its Part XII.2 tax cost to the particular provinces based on this same approach, taking into account consolidated revenue and payroll. A consolidated approach would be required, because trusts carry on business through subsidiary corporations and partnerships. These requirements should be no more onerous or complex than what is required of corporations today.

A second tax principle is that the tax on distributions to equityholders (e.g., dividends) is collected by the province in which the equityholder resides. This principle is reflected in both the government's proposal and our suggestions.

6.3.2 Restrictions for Non-resident Investors

If our suggestions were adopted, we believe that the current restriction on investment in income trusts by non-residents would not be required. Currently, Canadian mutual funds cannot be held by non-resident investors if their numbers exceed the number of Canadian investors. Eliminating this restriction would address some concerns expressed about the need to attract foreign capital to Canada.

6.3.3 The Success of the Income Trust Market

The economic benefits resulting from increased capitalization of smaller entities, enhanced access to financing, and the creation of head offices in locations across the country mean that tax policy should be designed to help income trusts grow and expand, within and outside of Canada. Our suggestions are successful in this regard because they are not designed to penalize existing income trusts, nor are they designed to stop the growth of conversions. Our suggestions are designed to provide a level playing field and remove imbalances in the tax treatment among investor classes. In addition, the deferral advantage enjoyed by tax-exempt investors is eliminated, although in a way in that the tax-exempts are not penalized as they are in the existing system and would be in the proposed system.

6.3.4 Equal Treatment

True equality between publicly traded corporations and income trusts will only occur when government policy changes eliminate the current level of double taxation implicit in our system. Previous changes announced by government are moving in the right direction, but have not fully eliminated this concern. The time is right to address this issue and we have done so with our recommendation to make the Part XII.2 tax and the dividend tax credit fully refundable.

6.3.5 Sector Specific Exemptions

The government's Tax Fairness Plan provides an exemption for certain REITs to ensure that the Canadian REIT structure is comparable to the United States REIT structure. We believe that a similar exemption should be considered for energy and infrastructure income trusts as well. Income trusts have historically proven to be a very effective vehicle for investing in these sectors. These industries are capital intensive and require efficient access to capital markets, both national and international, in order to fund their growth. In particular, given the increasing scarcity of easily accessible oil and gas reserves, the energy industry plays a key strategic role in the Canadian economy. Accordingly, the Canadian oil and gas industry should not be put at a competitive disadvantage relative to the other jurisdictions, especially the US. As noted in Section 2.4, energy flow-through entities are allowed under the US fiscal regime and continue to be an effective investment structure for the energy industry. It is important that changes made to the Canadian taxation of income trusts maintain a level playing field for Canadian energy income trusts vis-à-vis their American counterparts. Energy income trusts could be considered for either a full exemption from the proposed new tax rules or, if subject to a proposed tax, the Canadian withholding tax on distributions to non-residents be reduced or eliminated. This second approach would benefit trusts which require access to foreign capital while preserving the ability of the new system to better distribute provincial tax revenues (see Section 6.3.1).

6.3.6 Transition Period

Our proposal is designed to avoid the need for extended transitional rules. Similar to the government's proposals, a period of adaptation would be required from a business and financing perspective.

6.4 Summary

PwC believes that income trusts have a place in Canada and have been an economic success. The income trust structure has enhanced Canadian capital markets by offering small and medium sized firms opportunities to expand their businesses and invest in innovation.

The proposed solution to what the government views as inequities in the comparative tax treatment of corporations and income trusts, as proposed in the Tax Fairness Plan, fails to address the unfair treatment of tax-exempt investors. Under the government's proposed policy, this class of investor faces an excessive tax rate on investment income.

Non-resident investors have benefited in the past from uneven tax treatment on investments in income trusts, and correcting this imbalance is favourable for all Canadians. However, it is important to achieve this without sacrificing the benefits of the entire income trust market in the process.

We believe that without appropriate adjustments, the government's proposed solution may fail, resulting in the loss of a potentially important engine of growth, and may limit the wealth accumulation of Canadian investors and retirees.

We believe alternative policies are available to government and ask government to consider these alternatives.

Appendix

Comparative Tax Burden: Publicly Traded Corporations and Income Trusts

Analysis of the PwC Proposal vs. Proposed government Policy

This appendix compares total tax paid by a corporation or entity and a recipient for British Columbia, Alberta or Ontario, under the following assumptions:

1. A taxable investor is a Canadian individual resident in British Columbia, Alberta or Ontario and taxable at the top personal marginal rates.
2. Top personal marginal rates are equal to the rates for the latest year for which they have been announced by the respective jurisdictions.
3. The level of corporate tax paid by the entity is 31.5% in 2011, consisting of an 18.5% federal corporate tax rate as announced in the Tax Fairness Plan and an average 13% provincial corporate tax rate.
4. Federal and provincial changes proposed for the taxation of eligible dividends have been implemented and fully phased-in.
5. Non-resident investors are residents of the U.S.A. eligible for the benefits of the Canada-U.S. Tax Treaty.

British Columbia 2011 taxation year			**Publicly traded corporation**	**Income trust**		
				Before October 31 announcement	**Tax Fairness Plan**	**PwC proposal**
Corporation or entity		Income	$100.00	$100.00	$100.00	$100.00
	A	Tax paid	$31.50	-	$31.50	$31.50
		Available for distribution	$68.50	$100.00	$68.50	$68.50
Taxable Canadian individuals		Income	$68.50	$100.00	$68.50	$68.50
		Income tax rate	18.47% (on dividends)	43.7% (on ordinary income)	18.47% (on dividends)	17.81%* (on trust income)
	B	Income tax	$12.65	$43.70	$12.65	$12.20*
		Net after-tax income	$55.85	$56.30	$55.85	$56.30
	A+B	**Total tax**	**$44.15**	**$43.70**	**$44.15**	**$43.70**
Tax-exempt recipients		Income	$68.50	$100.00	$68.50	$68.50
		Income tax on receipt	-	-	-	-
	C	Tax refunded	-	-	-	$31.50
		On flow out to beneficiaries:				
		Income	$68.50	$100.00	$68.50	$100.00
		Income tax rate	43.7%	43.7%	43.7%	43.7%
	D	Tax	$29.93	$43.70	$29.93	$43.70
		Net after-tax income	$38.57	$56.30	$38.57	$56.30
	A-C+D	**Total tax**	**$61.43**	**$43.70**	**$61.43**	**$43.70**
Non-residents		Income	$68.50	$100	$68.50	$68.50
		Withholding tax rate	15%	15%	15%	15%
	E	Withholding tax	$10.28	$15.00	$10.28	$10.28
		Net after-tax income	$58.22	$85.00	$58.22	$58.22
	A+E	**Total tax**	**$41.78**	**$15.00**	**$41.78**	**$41.78**

* $12.20 income tax paid by taxable Canadian individuals under the PwC proposal assumes that the individual receives a full credit for the $31.50 tax already paid by the trust, making the effective rate on the income distribution 17.81% and the total tax equal to the amount under the system before the October 31 announcement.

Alberta 2011 taxation year			**Publicly traded corporation**	**Income trust**		
				Before October 31 announcement	**Tax Fairness Plan**	**PwC proposal**
Corporation or entity		Income	$100.00	$100.00	$100.00	$100.00
	A	Tax paid	$31.50	-	$31.50	$31.50
		Available for distribution	$68.50	$100.00	$68.50	$68.50
Taxable Canadian individuals		Income	$68.50	$100.00	$68.50	$68.50
		Income tax rate	14.55% (on dividends)	39% (on ordinary income)	14.55% (on dividends)	10.95%* (on trust income)
	B	Income tax	$9.97	$39.00	$9.97	$7.50*
		Net after-tax income	$58.53	$61.00	$58.53	$61.00
	A+B	**Total tax**	**$41.47**	**$39.00**	**$41.47**	**$39.00**
Tax-exempt recipients		Income	$68.50	$100.00	$68.50	$68.50
		Income tax on receipt	-	-	-	-
	C	Tax refunded	-	-	-	$31.50
		On flow out to beneficiaries:				
		Income	$68.50	$100.00	$68.50	$68.50
		Income tax rate	39%	39%	39%	39%
	D	Tax	$26.72	$39.00	$26.72	$39.00
		Net after-tax income	$41.78	$61.00	$41.78	$61.00
	A-C+D	**Total tax**	**$58.22**	**$39.00**	**$58.22**	**$39.00**
Non-residents		Income	$68.50	$100	$68.50	$68.50
		Withholding tax rate	15%	15%	15%	15%
	E	Withholding tax	$10.28	$15.00	$10.28	$10.28
		Net after-tax income	$58.22	$85.00	$58.22	$58.22
	A+E	**Total tax**	**$41.78**	**$15.00**	**$41.78**	**$41.78**

* $7.50 income tax paid by taxable Canadian individuals under the PwC proposal assumes that the individual receives a full credit for the $31.50 tax already paid by the trust, making the effective rate on the income distribution 10.95% and the total tax equal to the amount under the system before the October 31 announcement.

Ontario 2011 taxation year			**Publicly traded corporation**	**Income trust**		
				Before October 31 announcement	**Tax Fairness Plan**	**PwC proposal**
Corporation or entity		Income	$100.00	$100.00	$100.00	$100.00
	A	Tax paid	$31.50	-	$31.50	$31.50
		Available for distribution	$68.50	$100.00	$68.50	$68.50
Taxable Canadian individuals		Income	$68.50	$100.00	$68.50	$68.50
		Income tax rate	22.38% (on dividends)	46.41% (on ordinary income)	22.38% (on dividends)	21.77%* (on trust income)
	B	Income tax	$15.33	$46.41	$15.33	$14.91*
		Net after-tax income	$53.17	$53.59	$53.17	$53.59
	A+B	**Total tax**	**$46.83**	**$46.41**	**$46.83**	**$46.41**
Tax-exempt recipients		Income	$68.50	$100.00	$68.50	$68.50
		Income tax on receipt	-	-	-	-
	C	Tax refunded	-	-	-	$31.50
		On flow out to beneficiaries:				
		Income	$68.50	$100.00	$68.50	$68.50
		Income tax rate	46.41%	46.41%	46.41%	46.41%
	D	Tax	$31.79	$46.41	$31.79	$46.41
		Net after-tax income	$36.71	$53.59	$36.71	$53.59
	A-C+D	**Total tax**	**$63.29**	**$46.41**	**$63.29**	**$46.41**
Non-residents		Income	$68.50	$100	$68.50	$68.50
		Withholding tax rate	15%	15%	15%	15%
	E	Withholding tax	$10.28	$15.00	$10.28	$10.28
		Net after-tax income	$58.22	$85.00	$58.22	$58.22
	A+E	**Total tax**	**$41.78**	**$15.00**	**$41.78**	**$41.78**

* $14.90 income tax paid by taxable Canadian individuals under the PwC proposal assumes that the individual receives a full credit for the $31.50 tax already paid by the trust, making the effective rate on the income distribution 21.77% and the total tax equal to the amount under the system before the October 31 announcement.