THE DRAFT LEGISLATIVE PROPOSAL
A RECIPE FOR TAX REVENUE LOSS

In his October 31, 2006 policy statement concerning the changes to the tax treatment of Flow-Through Entities (FTEs), Minister Flaherty put very strong emphasis on the allegation that the conversion of corporations into trusts was resulting in heavy tax revenue loss for the government. He stated: " *If left unchecked, these corporate decisions would result in billions of dollars in less tax revenue for the federal government to invest in the priorities of Canadians, including more personal income tax relief."* Minister Flaherty did not however care to document his allegation and no serious or credible study in support of his policy decision and draft legislation has been released.

Minister Flaherty's undocumented allegation of heavy tax revenue loss has been questioned in a number of well-developed analyses. He has remained deaf to calls for an in-depth and credible study of the alleged tax revenue loss on which he based his policy decision. In spite of this, draft legislation aimed at implementing his decision was issued on December 21, 2006. The draft legislation is based on incorrect premises. It should be withdrawn until a credible study of its implications for tax revenue is performed.

Our comments will show, by types of investors, that the changes in the taxation of FTEs proposed in the Minister's draft legislation will lead to a <u>major tax revenue loss</u>.

I. <u>TAXABLE ACCOUNTS</u>

Fact#1: Trust distributions received by investors in their taxable accounts are presently taxed at a federal/provincial personal tax rate averaging about 38%. This is a significantly higher tax rate than the 27% effective corporate tax rate applicable to their earnings.

<u>Fact #2:</u> Trust distributions are based on distributable cash flow and not on earnings. Distributable cash flow is about 1.5 times earnings. Dividends paid by corporations are based on their after-tax earnings. On average, only 28% of corporation earnings are paid out to shareholders in the form of dividends.

<u>Fact #3</u>: Shareholders of public corporations pay very little tax on dividends they receive given the enhanced dividend tax credit and the fact that dividend yield rarely exceed 3%.

Fact #4: If a trust reconverts to the corporate structure the government will only collect about 27% -- the effective tax rate according to Statistics Canada -- of its earnings and the shareholders would pay very little tax on their dividend income.

Fact #5: As things are now the government collects more taxes from trust investors than it would collect if the trusts reconverted to the corporate structure.

These facts are illustrated in the following tables:

TABLE 1-A

PRESENT TAXATION OF TRUST DISTRIBUTIONS (1) (2)

DISTRIBUTION PAID BY TRUST BASED ON CASH FLOW	TRUST'S EARNINGS	TAX PAID AT TRUST LEVEL	PERSONAL TAX PAID ON DISTRIBUTIONS	TOTAL TAX PAID
$150.00	$100.00	0	$57.00/$69.00	$57.00/$69.00

(1) Personal Tax Paid and Total Tax Paid are shown for the federal/provincial average personal tax rate of 38% and the top rate of 46%.
(2) The actual amount of personal tax paid on distributions may be slightly lower than $60.80/$73.60 since distributions may include small amounts of dividends and a certain amount of return of capital giving rise to capital gain tax when the units are eventually sold.

TABLE 1-B

TAXATION OF TRUST DISTRIBUTIONS STARTING IN 2011 (1) (2)

DISTRIBUTION PAID BY TRUST BASEDON CASH FLOW	TRUST'S EARNINGS	TAX PAID AT TRUST LEVEL	TAX PAID BY INVESTOR ON DIVIDENDS	TOTAL TAX PAID
$150.00	$100.00	$47.25	$20.86	$68.11

(1) Assumes that the proposed general federal/provincial corporate tax rate of 31.5% applies to trust distributions.
(2) Tax Paid by Investor on Dividends shows the anticipated top dividend tax rate of about 20.3% applicable to "eligible" dividends.

TABLE 1-C

TAXATION OF RE-CONVERTED TRUST STARTING IN 2011 (1) (2)

EARNINGS	CORPORATE TAX PAID	DIVIDENDS PAID OUT	TAX ON DIVIDENDS	TOTAL TAX PAID
$100.00	$25.00	$28.00	$5.68	$30.68

(1) Assumes an effective federal/provincial corporate tax rate of roughly 25% as a result of the proposed reduction of the federal general corporate tax to 18.5% by 2011.
(2) Assumes the highest federal/provincial tax rate of about 20.3% on "eligible" dividends once the proposed enhanced dividend tax credit becomes effective.

All this means that the combined federal/provincial government tax revenue presently collected from income trusts and their taxable investors could drop by as much as 50% if all trusts were to reconvert by 2011. This sharp drop in tax revenue might be lessened modestly if, as is expected, some of the trusts manage to survive after 2011. Table 2-C shows that tax revenue collected from trusts and their unit holders might be slightly higher on average than it is presently if the proposed legislation is adopted. There is a broad consensus however that the vast majority of trusts will reconvert to the corporate structure or, in certain cases, be acquired by private equity investors. It could be argued that this very large drop in tax revenue resulting from re-conversion might also be offset in part by capital gain taxes paid sometime in the future as a result of corporate share appreciation. Realization of capital gains is however a very "iffy" question and capital gains and losses can be highly volatile from year to year. Moreover, trust unit holding can also result in capital gains and losses. Whichever way one looks at it the net impact of the draft legislation would clearly be a major drop in tax revenue.

FIRST CONCLUSION: IF IMPLEMENTED THE PROPOSED LEGISLATION WILL RESULT IN A MAJOR NET LOSS OF TAX REVENUE ANNUALLY IN THE CASE OF TAXABLE ACCOUNTS

III. TAX-DEFERRED ACCOUNTS (RRSP/RRIF and Pension Plans)

These accounts are thought by the Department of Finance to be by far the worst cause of tax revenue leakage. Their reasoning is as follows: a major tax leakage occurs since trust distributions are not taxed at the source and the "tax-exempt" (sic) RRSP/RRIF holders and pension funds don't pay tax when they receive trust distributions. The tax law clearly specifies that the latter are tax-deferred (not tax-exempt) entities and must ultimately pay taxes at personal tax rate on all fund withdrawals. The truth is that tax leakage would only occur if the present value of such future tax revenue were lower than the taxes foregone when the distributions are received. The Department of Finance has however not responded for calls for the conduct of a scientific study of the issue based on the present value method prior to the release of the draft legislation.

Table 2-A below illustrates the case of a RRSP holding income trust units with an annual yield of 8% and distributions paid monthly. These monthly distributions are judiciously re-invested for a period of say 8 years before the monies are withdrawn resulting in a compound rate of growth. The total tax paid by the investor upon withdrawal is $72.41 while the cost to the government is simply the cost of tax collection deferral.

TABLE 2-A

TAXATION OF INVESTMENT IN INCOME TRUSTS PAYING 8% IN DISTRIBUTIONS DEPOSITED IN A RRSP OVER A PERIOD OF 8 YEARS UNDER PRESENT TAX RULES (1)

INITIAL CONTRIBUTION TO RRSP	RRSP TAX REFUND	AMOUNT INVESTED INCLUDING TAX REFUND	VALUE OF RRSP AFTER 8 YEARS	TAX PAID UPON WITHDRAWAL
$72.50	$27.50	$100.00	$190.56	$72.41

(1) Assumes that the average personal federal/provincial tax rate of 38% applies.

The only way to determine if the government is losing tax revenues would be to apply the present value method. If that method were applied using a 2% annual discount rate (about the rate of inflation in recent years) or, alternatively, a 4% annual discount rate (about the yield on long-term federal bonds) it would become evident that the government is a net beneficiary in terms of tax revenue.[1] In other words, for the government to lose tax revenue the discount rate would have to be in excess of 8% a year.

[1] The longer the value of the portfolio increases as a result of compound growth the more the government will gain in tax revenue when the monies are eventually withdrawn.

The tax revenue would have been much lower however if the RRSP holder had invested his money in low-yield instrument such as GICs, bonds, equities, or various types of mutual funds with a compound rate of return lower than the 8% paid by trusts as per our example. The draft legislation proposed by the minister will unfortunately force tax-deferred investors to invest their savings in lower yield instruments as we will now show.

Assuming that there will still be income trusts around after 2011, adoption of the proposed legislation will have a heavily punitive tax impact on the holding of trust units in RSP/RRIFs and pension funds. This can be summarized in the following table:

TABLE 2-B
IMPACT OF DRAFT LEGISLATION ON TAX-DEFERRED INVESTORS RECEIVING TRUST DISTRIBUTIONS STARTING IN 2011 (1) (2)

DISTRIBUTION PAID BY TRUST	TAX PAID BY TRUST	PAID TO INVESTOR	TAX PAID UPON WITHDRAWAL	TOTAL TAX PAID
$100.00	$31.50	$68.50	$26.03/$31.51	$57.53/$63.01

(1) Assumes that the reduced general federal/provincial corporate tax rate of 31.5% will apply in 2011 as proposed by the Minister of Finance.
(2) Tax Paid upon Withdrawal and Total Tax Paid are shown for both the average federal/provincial personal tax rate of 38% and the top marginal rate of 46%.

Faced by such a drastic tax burden due to unfair double taxation these tax-deferred investors will have no alternative but to either hold trust units, if any, in their taxable accounts to benefit from the better tax treatment shown in Table 1B or, what is more likely as trusts reconvert, to shift to other investment instruments such as shares of public corporations and lower-yield instruments within or outside their tax-deferred accounts.

SECOND CONCLUSION: IF ADOPTED THE PROPOSED LEGISLATION WILL DEPRIVE TAX-DEFERRED INVESTORS OF THE OPTION TO INVEST IN HIGH YIELD INCOME TRUST UNITS AND LEAD TO LOWER TAX REVENUE OVER TIME FOR THE GOVERNMENT. THE EXTENT TO WHICH THIS LOSS OF TAX REVENUE CAN BE OFFSET BY A SHIFT TO OTHER INVESTMENT INSTRUMENTS IS MOST UNCERTAIN.

III. NON-RESIDENT INVESTORS

Investment in income trust units by non-residents has been identified as a problem because trust distributions are not taxed at the source and non-residents pay only the 15% withholding tax. Nevertheless, in addition to the very positive economic benefit and the indirect tax revenue arising from such non-resident investment the federal government also collected over $200 million from non-residents in 2005 in the form of withholding tax on trust distributions. When all factors are considered it is very doubtful that the government loses any significant amount of tax revenue. It should also be noted that non-residents do not consume any services provided by the Canadian government.

The tax treatment of trusts proposed the draft legislation would deal with the perceived problem but at the same time it would deprive the government of a very large proportion of the revenue collected through the withholding tax. Non-residents investing in trusts are obviously income-oriented investors seeking high yield on their money. Taxation of trust distributions at the source in addition to the withholding tax will make investment in Canadian trusts totally unappealing to non-residents. Re-conversion of trusts into public corporations will reinforce this disincentive. It should be remembered that non-residents' income is also subject to taxation in their country of residence although they can usually claim a tax credit for the withholding tax paid in Canada. These factors will lead to divestment by non-residents and a sharp decline in withholding tax payments.

The impact of the proposed legislation on non-resident investment in trust units may be summarized as follows:

TABLE 3-A

TAXATION OF NON-RESIDENTS BEFORE 2011

DISTRIBUTION BY TRUST	TAX PAID BY TRUST	NON-RESIDENT WITHHOLDING TAX	AFTER-TAX DISTIBUTION	TOTAL TAX PAID
$100.00	0	$15.00	$85.00	$15.00

TABLE 3-B

TAXATION OF NON-RESIDENTS STARTING IN 2011 (1)

DISTRIBUTION BY TRUST	TAX PAID BY TRUST	NON-RESIDENT WITHHOLDING TAX	AFTER TAX DISTRIBUTION	TOTAL TAX PAID
$100.00	$31.50	$10.28	$58.22	$41.78

(1) Assumes that the general federal/provincial corporate tax rate of 31.5% applies.

Given their investment objectives, it is most unlikely that these investors will plough back their money into other Canadian investment instruments, although it is conceivable that non-residents may be involved in the private take-over of a number of trusts.

<u>THIRD CONCLUSION: THE PROPOSED LEGISLATION WILL LEAD TO COMPLETE DIVESTMENT FROM INCOME TRUSTS BY NON-RESIDENTS AND RESULT IN THE LOSS OF MOST, IF NOT ALL, OF THE TAX REVENUE COLLECTED ANNUALLY IN THE FORM OF WITHHOLDING TAX.</u>

IV. CONCLUSION

In his October 31, 2006 policy statement the Minister made it very clear that his objective was to stop the loss of "billions of dollars" in tax revenue. No study has been released in support of this allegation. Ironically, it is the draft legislation proposed by the Minister, not the existence of the income trusts, that will lead to a significant loss of tax revenue. This draft legislation should be withdrawn and an in-depth study of its implications for tax revenue should be performed before a policy course is set. Canadians and their Parliament deserve no less than the utmost clarity and transparency in this matter.