Tax Leakage From Pension Fund Investment in Canadian Income Trusts

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As the fall colors begin their glorious dance across the Canadian hinterland, the corridors of Parliament Hill in Ottawa, or at least the Department of Finance, seem to be gripped by yet another controversy. This controversy revolves around the appropriate tax policy that should be put in place for business income trusts in Canada. While it may not have the histrionics of a full-fledged political scandal, its impact on the Canadian investment landscape as well as the future fortunes of millions of Canadians will be at once decisive and far-reaching.

Income trusts in one form or another have existed in Canada for at least two decades now. Nonetheless, the extraordinary interest in income trusts and their explosive growth during the past five years has been unprecedented. (For prior coverage, see Tax Notes Int'l, Aug. 8, 2005, p. 497.) The precise nature of that growth is put into perspective by statistics, such as the increase in total market capitalization of Canadian income trusts from C $45 billion at the end of 2002 to C $140 billion by the middle of 2005, more than a three-fold increase in less than three years. During the week of August 22, there were 222 income trusts of various kinds listed on the Toronto Stock Exchange (TSX) with a combined value of C $170.6 billion constituting over 10 percent of total Canadian market capitalization.\(^1\) Given those impressive growth statistics, coupled with the fact that income trusts by their very nature are flow-through entities not subject to the same tax regime as corporations, it is reasonable to assume that federal policymakers in Ottawa have been watching this issue with some trepidation.

Although Ottawa’s concerns encompass the entire range of issues on taxation of income trusts, the concerns have found expression in a select few areas that Ottawa has chosen to deliberately target, ostensibly as part of some larger vision to revamp tax policy on income trust taxation in Canada. One of those specific areas that the federal government has chosen to target is the participation of pension funds in the business income trust marketplace. Obviously, a primary concern that underlies such a specific choice is the tax-exempt nature of pension funds, by far the largest and the most influential group of tax-exempt investors in the Canadian investment arena,\(^3\) and their increased participation in the burgeoning business income trust marketplace.

In an attempt to address that issue, the 2004 federal budget proposed changes to the investment rules for income trusts that included proposals to limit the degree of pension fund participation in the business income trusts. Under the proposed measures, beginning January 1, 2005, pension fund holdings in business income trusts would have been


\(^{3}\)In the most recent consultation paper released by the Department of Finance, as a group, pension funds are recognized as the largest class of investors in Canada, with the market value of assets approximating C $626 billion at the end of 2003, equal to around half of the TSX’s market capitalization of C $1.3 trillion in 2003. Registered retirement savings plans and registered retirement income funds accounted for another C $445 billion. Canadian Department of Finance (2005), “Tax and Other Issues Related to Publicly Listed Flow-Through Entities” (Ottawa: Sept 8, 2005), p. 34 (available online at http://www.fin.gc.ca/activity/pubs/flwthruent_e.pdf). HLB Decision Economics Inc. estimates the total assets in the pension fund market in 2004 to be C $739 billion.
limited to no more than 1 percent of the book value of fund assets. In addition, the budget also proposed that investments by pension funds should be limited to no more than 5 percent of the units of any business income trust. Those proposed limitations to pension fund involvement were clearly motivated by Ottawa's concerns that increased pension fund participation in the business income trust market could contribute to loss of federal tax revenues. That loss could occur in two primary ways. First, increased pension fund participation could replace investments by other taxable investor types. Second, increased pension fund participation would defer personal income tax revenues to the future and the net present value of those future taxes may not be sufficient to offset current tax revenue loss. Following a general outcry from the Canadian investment and tax community, implementation of the 2004 federal budget proposals on limiting pension fund participation in the business income trust market was suspended until further consultations with the public. Those consultations were since initiated by the Department of Finance on September 8, with the release of a consultation paper. (For prior coverage, see Tax Notes Int'l, Sept. 19, 2005, p. 1059.) Ten days later, on September 19, the minister of national revenue announced that all advanced rulings on flow-through entities structures, a necessary prerequisite for corporations to convert to income flow-through entities structures, as well as the participants in the business income trust marketplace. Those consultations were since initiated by the Department of Finance on September 8, with the release of a consultation paper. (For prior coverage, see Tax Notes Int'l, Sept. 26, 2005, p. 1148.) Given those recent developments, there is little doubt that tax policy on income trusts is very much at the top of the policymaking agenda in Ottawa this fall.

In the context of that policy debate on income trust taxation, the purpose of this paper is to illustrate fundamental policy motivations that led the federal government to issue the 2004 federal budget proposals limiting pension fund investment in the business income trust market. The paper examines the advantages and disadvantages of imposing those limitations and whether they contribute to achieving the government's policy objectives, both in qualitative and quantitative terms. This paper also examines other policy alternatives that could achieve the government's ultimate goal of stemming tax leakage due to pension fund involvement in the business income trust marketplace. The pros and cons of those policy alternatives are also examined.

in turn, to recommend a policy alternative that might balance the interests of the federal government, as well as the participants in the business income trust market.

### Income Trust Types and Taxation: A Brief Overview

The 2004 federal budget proposals on income trusts were the first time the federal government has attempted to tackle the issue of tax leakage due to the income trust tax regime in Canada. The concern about tax leakage arises because income trusts, as flow-through entities, avoid the incidence of corporate tax in a manner similar to corporations. Instead, in most cases, the income earned within an income trust is distributed to unit holders on an annual basis and therefore is taxed at the unit-holder level at the applicable federal-provincial personal income tax rate.

**The extraordinary interest in income trusts and their explosive growth during the past five years has been unprecedented.**

It may be worthwhile to examine how income trusts generally operate in Canada and why they are such attractive investment vehicles. In Canada, the variety of businesses on which income trusts have been created is rather broad, both in the underlying industry and assets as well as in geographic location. The income trust universe, in general, comprises the following four categories:

- **Business Trusts:** A business trust is an income trust in which the principal business of the underlying corporation or other entity is in the manufacturing, service, or general industrial sectors. Conversion to the income trust structure is attractive to many existing mature businesses with relatively high, stable cash flows and low capital expenditure requirements, due to tax efficiency and investor demand for high-yielding equity securities. One of the primary attractions of business trusts, in addition to their relatively high yield, is their ability to enhance diversification in the portfolio as they cover a broad range of industries and geographies, including public refrigerated warehousing, mining, coal distribution, sugar distribution, forest products, retail sales, food sales and processing, chemical recovery and processing, data processing, gas marketing, and check printing.

- **REITs:** A real estate investment trust pools the capital of investors to invest in various forms of real estate, usually income-producing assets...
structured to generate regular distributions of cash. REITs seek out investment opportunities and actively manage real estate assets. REIT investors do not directly invest in real estate, but instead own REIT units that are publicly traded. As such, REITs are attractive to those investors who wish to participate in the real estate sector without the illiquidity of direct ownership. Canadian REITs are generally investment trusts designed to acquire real estate assets for the benefit of their unit holders.

- **Resource Trusts:** A resource trust is an income trust in which the principal business of the underlying corporation or other entity is the exploitation, production, and/or sale of commodities, such as fossil fuels, metals, minerals, timber, and their by-products. The amount of distributions paid on a resource trust’s units will vary from time to time based on production levels, commodity prices, royalty rates, costs and expenses, and deductions. Not surprisingly, most resource trusts in Canada focus on the oil and gas sector, although other resource industries like mining, forestry, and so on are also favored for those trusts.

- **Utility Trusts:** A utility trust is an income trust in which the principal business of the underlying corporation or entity derives its income from operating public utilities that provide regulated services like pipelines, telecommunications, light, power, and water.

In all cases, however, income trusts are generally structured to own debt and equity of an underlying entity that carries on an active business or owns a royalty in the revenues generated by income-producing assets. On a fundamental level, resident Canadian income trusts use the proceeds from a public offering of trust units to purchase either a business or income-producing assets of a viable, mature company with stable cash flow, that is, the operating company. The trust may then act as a lender to the operating company and capitalize the firm with a serviceable debt load that either reduces or eliminates the amount of equity capital required. Given that the interest on the debt is deductible for the operating company that has been acquired by the trust, interest payments are deducted from before-tax income, thereby reducing the corporate tax paid. To the extent that interest is earned by the operating company, that income may also be distributed to the trust as dividends. Capital taxes can also be avoided by having the trust own the assets and leasing them back to the company. As flow-through entities, then, income trusts can distribute any interest income, dividends, lease payments, capital gains, and any return on capital earned by the trust to the trust unit holders without corporate-level tax. Therefore, as long as all the earnings within an income trust are distributed to unit holders, no taxes need be paid at the corporate level by the income trust. The tax treatment of any distributions depends on their type and the tax status of the resident unit holder who may be individuals, corporations, and/or institutional investors. If a unit holder is a nonresident, withholding taxes would apply on distributions of income.

Although the income trust structure results in some tax loss at the corporate level, as long as unit holders have taxable status in Canada, the increase in personal income taxes at the unit-holder level could help mitigate some of the tax loss at the corporate level. However, when those unit holders have tax-exempt status, to the extent that they are large institutional tax-exempt investors such as pension funds, the situation changes dramatically. Because pension funds are tax-exempt investment vehicles, any investment by pension funds in the income trust market will immediately result in loss of current tax revenues, although taxes are merely deferred to the future rather than lost altogether. In the past, pension fund participation in the income trust market has not been a major issue because the unlimited liability nature of income trusts has been seen as a deterrent to participation by the major Canadian pension funds. However, by the beginning of 2004, the problem of unlimited liability of income trusts was effectively addressed by provincial limited liability legislation enacted in Ontario (2004), Quebec (1994), and Alberta (2004), the three major provinces where a majority of income trusts are formed in Canada. Although the main objective of that provincial legislation was to create the legal security necessary for inclusion of income trusts in the S&P/TSX Composite Index, that legislation also renewed Ottawa’s concerns of increased pension fund participation, which, in turn, led to the 2004 federal budget proposals that imposed limits on pension fund participation.

**Tax Leakage Effects**

From the viewpoint of the federal government, there are at least three possible tax leakage scenarios due to increased participation of tax-exempt entities in the income trust marketplace. First, increased participation by tax-exempt entities like pension funds in income trusts will reduce tax revenues at both the corporate and unit-holder levels. Second, any taxable capital gains flowed out to nonresident unit holders due to disposition of taxable Canadian property would not be subject to Canadian tax. Third, trusts with significant investments in Canadian real estate or resource property may be making some tax-exempt distributions to nonresident unit holders that should be subject to some level of tax in Canada. The first scenario concerns primarily resident Canadian tax-exempt
entities, while the other two proposals are meant to address taxation issues for nonresident unit holders in Canadian business income trusts. In the 2004 federal budget proposal, resolutions 12, 13, and 14 were proposed to address the tax leakage effects due to participation of tax-exempt entities in income trusts. Resolutions 15 and 16 were proposed to address the tax issues concerning nonresidents. Given that our main focus is the resolutions on participation of tax-exempt entities in the Canadian income trust market, we shall examine resolutions 12 to 14 in greater depth.

**As long as all the earnings within an income trust are distributed to unit holders, no taxes need be paid at the corporate level by the income trust.**

Resolutions 12 and 13 of the 2004 federal budget proposed limiting tax-exempt entities like pension funds in “business income trusts” or “restricted investment property.” For the purpose of those resolutions, “pension funds” include registered pension plan trusts and corporations as described in paragraphs 149(1)(o) to (o.2) of the Income Tax Act as well as the Canada Pension Plan Investment Board, which administers the Canada Pension Plan on behalf of all Canadians. The provisions specifically exclude registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs), and other deferred income plans.

In a similar vein, a business income trust is defined as a unit trust, any unit of which is listed on a stock exchange, when 50 percent or more of the fair market value of all the property of the trust attributable to the property is:

- a debt issued by an entity in which the trust has a significant interest;
- a share in a corporation (with some exceptions), or an interest in a trust or partnership, in which the trust has a significant interest;
- property for which the fair market value is primarily derived from the above-noted property; or
- property for which the fair market value is primarily determined by reference to the fair market value of any of the above-noted property.

A trust has a “significant interest” in the entity (trust, partnership, or corporation) if 10 percent or more of the fair market value of all of the interests in the entity are owned by the trust and entities not dealing at arm’s length with the trust. Finally, a “restricted investment property” is defined as:

- a unit of or a debt issued by a business income trust;
- an interest in, a share of, or a debt issued by an entity that is a trust, partnership, mutual fund corporation, investment corporation, or mortgage investment corporation, when the total cost amounts of the restricted investment property held by the entity exceeds 1 percent of the total cost amounts of all of the property held by the entity;
- a debt issued by a corporation controlled by one or more pension funds, when the total cost amounts of the restricted investment property held by the corporation exceed 1 percent of the total cost amounts of all the property held by the corporation; and
- a property for which the fair market value is primarily determined by reference to any of the above-noted restricted investment property.

Again, the provisions specifically exclude holdings in REITs or royalty income trusts (that is, resource and utility trusts). In essence, therefore, resolutions 12 and 13 apply rather narrowly only to pension funds, excluding RRSPs, RRIFs, or other deferred income plans, which invest specifically in business income trusts alone.

The first limitation under resolution 12 proposed that holdings of pension funds in restricted investment property be restricted to 1 percent of the total cost amounts of the property owned by the pension funds at the end of every month. Excess restricted investment property of a pension fund will be subject to a 1 percent per month penalty tax applicable beginning in 2005 with some transitional provisions between 2005 and 2013. Similarly, the second limitation in resolution 13 proposed that holdings in any particular business income trust by a pension fund will be limited to 5 percent of all of the units of the

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6Revised Statutes of Canada (R.S.C.), 1985, c.1, (5th Supplement) as amended.
7Canadian Department of Finance (2004), The Budget Plan, Ottawa: Department of Finance, resolution 14 (b).
8Id., resolution 14 (a).
9Id., resolution 14 (i).
10Id., resolution 14 (f).
11Id., resolution 12.
trust at the end of every month. Any excess holdings will also be subject to a 1 percent penalty tax based on the fair market value of the excess of the units held. That penalty tax will be applied after 2004, again with transitional provisions between 2005 and 2013.

Ostensibly, the policy objective of the 2004 federal budget proposals is to stem tax leakage due to increased pension fund participation in business income trusts. However, there are two crucial assumptions that need to be made to evaluate whether or not the proposals will in fact meet the government’s policy objectives and have the intended policy consequences. The first assumption is that pension fund participation will necessarily increase as a result of provincial limited liability legislation. That, however, is dependent on a variety of factors, not least the attractiveness of other investment choices available to pension fund managers, the mandate of the pension funds, and their diversification objectives. The second assumption is that the business income trust market will grow indefinitely and remain as attractive an investment vehicle as in the past, fueling the need for that legislation. However, both assumptions may not hold in the long term and, indeed, in the near term as well for a variety of reasons.

The explosive growth of business income trusts has been attributed to: the inadequate integration of corporate and personal income taxes for large corporations; the loss of investor confidence in the equity markets after the collapse of the stock markets during 2000; and large corporate scandals, such as Enron and Worldcom. That, coupled with the low interest rate environment of the past few years, which reduced the attractiveness of fixed income investments, has fueled the spectacular growth of income trusts, especially because they offer stable cash flow and relatively high yields. Nonetheless, in a rising interest rate environment like the one that Canada is facing and with improving investor confidence in the wake of the Sarbanes-Oxley Act in the United States and Bill 198 in Ontario, it is by no means definite that business income trusts will retain their unfettered attractiveness to all manner of Canadian investors, including tax-exempt ones like pension funds. It is in this context of uncertainty, therefore, that the 2004 budget proposals should be evaluated. That inherent uncertainty makes any measurement of the potential tax revenue loss to the government due to pension fund participation in the business income trust market a complex exercise fraught with frail assumptions and inevitable guesswork.

Empirical Evidence

Any estimate of the actual quantitative impact on tax revenues due to increased pension fund participation in the business income trust market is inextricably linked to the proportion of business income trusts held by tax-exempt investors and the average effective federal corporate income tax rate under the corporate structure. There have been a number of studies that have tried to estimate the overall tax revenue loss due to the tax policy concerning income trusts. Notably, Paul Hayward estimates that the loss of corporate tax revenues due to the current tax regime of income trusts could be as high as C $1 billion. Aggarwal and Mintz estimate that the tax revenues loss would be more in the range of C $400 million to C $600 million during 2004. Finally, HLB Decision Economics estimates that the tax revenue loss is rather minimal given some assumptions on future tax gains realized due to deferred taxes. The Department of Finance’s estimates in the most recently released consultation paper point to a federal tax revenue loss of about C $300 million in 2004, with business income trusts accounting for C $120 million of that loss.

All of those studies, however, point to total tax revenue loss rather than specific tax leakage from pension fund investments in business income trusts, which is the primary concern of this paper. The only empirical study that specifically measures the impact of pension fund participation in the business income trust market was prepared by HLB Decision Economics for the Pension Investment Association of Canada (CIPREC) and the Canadian Institute of Private and Public.

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Canada (PIAC).\textsuperscript{19} That study limits pension fund participation in the business income trust market to 25 percent or the current level of pension fund participation in the Canadian equity and bond market. Most importantly, it takes into account not only current tax revenue loss, but also the net present value of future tax gains when pensions are cashed out by investors.\textsuperscript{20} The results of that study are revealing. The annual tax leakage in one of the scenarios, when pension fund investment increases the size of the business trust market, would result in a net tax leakage of only C $39 million or about 0.10 percent of the corporate income tax base.\textsuperscript{21} If a cap is imposed on pension fund participation as proposed in the 2004 federal budget, the net tax savings to the government would be only C $17 million.\textsuperscript{22} In the second scenario, when increased investment by pension funds merely replaces holdings by other investors, the net tax leakage would be even less, at C $31 million.\textsuperscript{23} The estimates provided in the Department of Finance’s consultation paper also offer some insight into the tax leakage due to participation of all types of flow-through entities in the general income trust marketplace; however, those estimates neither focus specifically on pension fund participation nor estimate the net tax loss after taking into account the net present value of future taxes.\textsuperscript{24} As mentioned previously, the consultation paper estimates an overall tax revenue loss of C $300 million assuming a 39 percent level of participation by flow-through entities in the general income trust marketplace and an effective federal corporate tax rate of 6.3 percent.

**Limiting Pension Fund Investments**

From the limited empirical evidence on potential tax revenue loss due to increased pension fund participation, it appears that the federal budget proposals may address only a very small part of the income trust tax dilemma. In quantitative terms, it is clear that current tax losses due to increased pension fund participation will not be offset by future tax collections and therefore result in a net tax leakage. Patently unclear is the level of actual pension fund participation in the business income trust marketplace and whether the net tax savings that may be realized by the 2004 federal budget proposals is worth the legislative effort. Indeed, although the federal budget proposals may have a tangible impact on potential current tax revenue loss by limiting deferral of taxes to the future, the net savings might only be C $17 million or less, depending on the level of involvement of pension funds in the business income trust market.

\textbf{It is by no means definite that business income trusts will retain their unfettered attractiveness to Canadian investors, including tax-exempt ones like pension funds.}

Some disadvantages could accrue due to the imposition of limitations on pension fund investment in business income trusts. One key issue that needs to be addressed from a policy perspective is whether the federal government should be imposing what are arguably arbitrary limits on investments by Canadian pension funds, in essence, creating artificial barriers to investments for a select group of participants. Imposing those arbitrary limits may potentially disadvantage pension funds as a group vis-à-vis other investor types in their search for the most attractive investment opportunities. Consequently, those limitations will have adverse long-term consequences on the rates of return earned by Canadian pension funds and inevitably the fortunes of millions of Canadian retirees. As more and more Canadians reach retirement age in the coming years with fewer and fewer replacement workers taking their place, underfunding of the major pension funds, including the Canada Pension Plan, will become a significant concern. Pension funds may have to increasingly rely on their ability to earn superior returns to close the gap between contributions and payouts. In that scenario, any kind of artificial barrier that limits investment choices can only be counterproductive.

If tax-exempt flow-through entities are the real culprits contributing to tax revenue loss, imposing limits on pension funds alone and excluding other tax-exempt plans like RRSPs and RRIFs may not solve the problem. In addition, although business income trusts have seen the most explosive growth in recent years, excluding the REIT and resource


\textsuperscript{20}The discount rate used in this case to compute the net present value is a reasonable 7 percent. \textit{Id.}, p. 2.

\textsuperscript{21}If pension funds’ participation increases to twice the equity and bond market participation rate, the tax leakage rises to C $139 million.


\textsuperscript{23}If pension funds participation increases to twice the equity and bond market participation rate, the tax leakage rises to C $89 million. \textit{Id.}, pp. 13-14.

\textsuperscript{24}Canadian Department of Finance (2005), “Tax and Other Issues Related to Publicly Listed Flow-Through Entities” (Ottawa: Sept. 8, 2005), p. 29.
trust markets distorts the economics of investment in the entire income trust marketplace. In sum, some of the primary weaknesses of the federal budget proposals stem from their specific focus and discriminatory provisions that address only a very small part of the income trust universe in a manner that will introduce more distortions and possibly create counterproductive investment incentives.

**Will Limiting Pension Fund Participation Work in Practice?**

A key characteristic of any good tax policy is its ease of administration. Unfortunately, the 2004 federal budget proposals do not fulfill expectations on that front. The proposals’ call for limitations on pension fund investments in business income trusts creates a need for pension funds not only to track their own investments in business income trusts, but also to monitor the investments in their underlying investment counselors’ portfolios and hedge funds to comply with the investment limits set by the budget proposals. Even if all of those investments can be tracked in a timely and efficient manner, a challenge even when funds do not engage in heavy trading activity, the need to “look through” and specifically monitor investments in some asset classes not only stifles the investment decisionmaking process, but also imposes considerable additional costs of compliance. In addition, the penalty for the lack of compliance is rather onerous and may in some cases exceed the magnitude of the investment that was initially made in a business income trust.25

In sum, the administration of the federal budget proposals will be a logistical dilemma and require costly systems and procedures to ensure that limitations imposed by the federal budget are met at the end of each month. Given the logistics and the costs associated with that administration, perhaps it is not a surprise that a huge outcry and a call for further consultations followed the release of the proposals. It is also not surprising that the Department of Finance has initiated further consultation on the issue to specifically evaluate policy alternatives.

**Policy Alternatives and Their Feasibility**

Given the various problems associated with the 2004 federal budget proposals, the obvious next step is an examination of the policy alternatives that might better address the government’s concerns on tax leakage. Before one can examine the policy alternatives, however, it is important to realize that the tax advantage created by income trusts within the Canadian tax system is by itself a product of the discrepancy in how corporations and trusts are taxed in Canada. Trusts typically act as flow-through entities and pay corporate tax only on income that is retained by the trust. Therefore, by distributing all earnings to the unit holders, a trust can be exempt from taxation at the corporate level. On the other hand, corporations are taxed on income at the corporate level at the applicable tax rate and shareholders are taxed again on the dividend distributions they receive from the corporations’ after-tax income. Although corporations are given a dividend tax credit, for corporations incurring the highest corporate tax rates, the dividend tax credit does not entirely offset all of the taxes paid at the corporate level. Therefore, dividends paid out to shareholders are taxed twice: once at the corporate level and once more in the hands of the shareholders. On the other hand, trust earnings are flowed through to unit holders and are taxed only once in the hands of the unit holders. The fundamental problem, therefore, is the tax advantage created by earnings of an income trust versus those of a corporation and the associated tax consequences for individual investors.

The best tax policy, therefore, would be one that incorporates a mechanism that helps mitigate that tax advantage created by dissimilar tax regimes for income trusts and corporations. An associated problem is, of course, the limitation of tax leakage when income trusts are more favorably taxed vis-à-vis corporations. There have been a plethora of policy alternatives that have been proposed by various prominent tax professionals to mitigate potential tax leakage due to the income trust tax regime. However, none of those alternatives specifically address the pension fund investment problem in isolation. Instead, they look at the more fundamental issue of equalizing the playing field between income trusts and corporations. Insofar as limiting investments by tax-exempt investors is concerned, as contemplated in the 2004 budget proposals, the repeal of the foreign property rule (FPR) is a clear indication that those limitations do not always achieve the desired policy objectives.26

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26The FPR limited investment in foreign property (which included limited partnership entities) by some tax-exempt (Footnote continued on next page.)
In this paper, the most promising policy alternatives are evaluated to recommend a policy alternative that might best address the policy objectives of the government as well as the interests of the stakeholders. To that end, the three main policy alternatives that will be examined are as follows:

- taxing flow-through entities in a manner similar to corporations;
- limiting the deduction of interest expenses by operating entities of income trusts; and
- better integrating the personal and corporate income tax system by increasing the dividend tax credit.

**Limiting Deduction of Interest Expenses by Operating Entities of Income Trusts**

A majority of income trust distributions are in the form of interest income, basically the interest paid by an operating entity to an income trust that has loaned the proceeds of its public trust offering to the operating entity as a replacement of equity capital. The interest payments made by the operating entity on its debt is then deducted against the taxable income of the operating entity, effectively reducing or eliminating any corporate income tax paid by the operating entity at the corporate level.

Although imposing a limitation on the deduction of interest expenses by operating entities of income trusts is an attractive alternative, this policy alternative suffers from some of the same flaws as the 2004 federal government's policy proposals. That type of limitation would necessarily be arbitrary unless a formula can be found to effectively match the limitation of interest expenses with the actual tax revenue loss. In addition, it is not beyond the realm of imagination that an operating entity could be organized so that the optimal amount of debt-equity ratio is maintained to take advantage of the interest deduction to the extent that it is available. However, those reorganizations may potentially have the unintended consequence of limiting the amount of leverage used by an operating entity. However, the question remains as to whether that consequence is necessarily positive for investors.

Finally, limiting interest deductions only addresses one part of the problem because income trust distributions can be interest income, lease income, dividends, royalties, and the like. Therefore, limiting interest deductions by operating entities alone will not be sufficient to stem the tax leakage due to the inherent tax advantage of income trusts.

**Better Integrating the Personal and Corporate Tax System**

The idea of better integrating the personal and corporate tax system in Canada has been around since the days of the Carter Report, released in 1966. The Carter Commission concluded that the only practical way of eliminating corporate-source income was by the integration of personal and corporate income taxes. The philosophy behind integration was simple: Impose taxes at both the corporate and shareholder level, but “integrate” the two taxes so that the total of the two taxes is no greater than the single tax paid by an individual.

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who receives income directly and not through a corporation. Under a fully integrated tax system, the corporation would pay taxes on its income and then distribute that income to its shareholders. The shareholders would then report on their personal income tax returns not only the income received by them as a dividend, but also the amount of corporate income paid as tax by the corporation, in essence “grossing up” their taxable income. Subsequent to that grossing up, taxpayers would pay taxes at their applicable tax rate on the taxable income and receive a dividend tax credit for the tax paid by the corporation, leaving behind only the personal income taxes paid on the dividend distribution. Further, any tax advantage to retaining earnings within a corporation can be eliminated by equalizing the top corporate tax rate with the top personal tax rate.

In a partially integrated system like the one in Canada, the dividend tax credit is rarely, if ever, enough to offset the corporate tax.

In an ideal world of a completely integrated tax system, the credit received would fully offset the tax paid by the corporation. In a partially integrated system like the one in Canada, the dividend tax credit is rarely, if ever, enough to offset the corporate tax. Therefore, there is a tax advantage that would accrue to investors in flow-through entities vis-à-vis shareholders in corporations. Aggarwal and Mintz have suggested that increasing the level of the dividend tax credit might be the best policy alternative to level the tax advantage of income trusts over corporations and achieve neutrality between different types of investments. Given a top corporate tax rate of 33 percent, their solution is to increase the gross-up to 150 percent instead of the current 125 percent for personal income tax purposes and increase the dividend tax credit to 33 percent instead of the currently applicable 20 percent so that personal and corporate taxes on dividends will be fully integrated.

Increasing the dividend tax credit also suffers from its own problems, most notably the possibility of overintegration of the personal and corporate income taxes due to the lack of a direct link between the dividend tax credit and the actual taxes paid by a corporation. That problem, however, can be addressed by better matching the corporate tax paid and dividend tax credit. However, there is also the additional concern that tax-exempt investors would still find income trusts attractive because they do not have to pay any taxes in the first place. To address that issue, Aggarwal and Mintz propose a refundable dividend tax credit so that tax-exempt investors can get a refund on the corporate taxes paid.

Conclusion

Of the policy alternatives examined in this paper, the first alternative — taxing flow-through entities in a manner similar to corporations — has the most intuitive appeal and achieves the federal government’s policy objective of stemming tax leakage. It also addresses concerns on neutrality and ease of administration, among others. However, implementing that policy alternative would call for revamping the tax treatment of flow-through entities as a group. That, by its very nature, is a far-reaching policy initiative. Although the initiative will certainly be quite an undertaking from a tax policy perspective, it is by no means beyond the realm of possibility as evinced by the experience of countries like Australia and the United States. On the other hand, the third policy alternative suggesting increasing the dividend tax rate also achieves neutrality and is merely a question of tweaking a tax policy that is already in place. However, it does not entirely address the tax leakage because tax-exempt investors may still find income trusts more attractive than corporations unless a specific refundable dividend tax credit is put in place to offset the tax advantages that may accrue to pension funds investing in income trusts versus corporations.

Given those policy alternatives, the most comprehensive and effective way to address the question of tax leakage would be to implement the first and the third alternative together to achieve full integration and neutrality between investments in income trusts and corporations. Perhaps the first step could be to implement a “substance over form” test to tax business income trusts as corporations based on the nature of the underlying assets or business operation rather than based on the entity. That will effectively nullify any significant tax advantage that might be created by conversion to income trusts. Most importantly, it would also mitigate at least some of the concerns of increased pension fund participation in the business income trust market. In the same vein, as proposed by Aggarwal and Mintz, the dividend tax credit could be increased to better integrate personal and corporate income taxes. Any overintegration can be controlled most

31Id.

32Id., p. 816.
effectively by imposing a corporate distribution tax that is creditable against corporate income taxes, with the distribution tax rate set to equalize the dividend tax credit.\textsuperscript{33}

In sum, the implementation of the two policy alternatives in tandem would not only level the playing field between the taxation of income trusts and corporations, but also ensure that tax-exempt investors like pension funds are not motivated to choose one type of investment over another merely by virtue of their tax advantages. Most importantly, implementation of a tax policy that eliminates tax advantages and better integrates personal and corporate taxes will effectively annul the need for federal government intervention in the capital markets, especially by imposing arbitrary legislative limits on investments by a specific group of investors (that is, pension funds) in a specific type of investment vehicle (that is, business income trusts) as was proposed in the 2004 federal budget proposals. ◆

References

\textsuperscript{33}Id., p. 815.