Canadian Income Trusts — Has the Cash Engine Been Derailed?

By Martin Przysuski

For quite some time now, the Canadian capital markets have seen exceptional growth in a class of investments that have offered investors the promise of steady income at relatively minimal risk — income trusts. Although income trusts in one form or another have existed in Canada for at least two decades now, the extraordinary interest in Canadian business income trusts and their explosive growth during the past five years has certainly been unprecedented. That growth has been largely attributed to the inadequate integration of corporate and personal income taxes for large corporations in Canada, as well as the loss of investor confidence in the equity markets after the collapse of the technology bust and large corporate scandals such as Enron and WorldCom. Indeed, income trusts by their very nature are flow-through entities and therefore not subject to the same tax regime as corporations in Canada. That, coupled with the low interest rate environment during the past few years, which has 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. The precise nature of that growth is put in perspective by statistics such as the increase in total market capitalization of Canadian income trusts from $45 billion at the end of 2002 to $140 billion by the middle of 2005, more than a threefold increase in less than three years. During the week of August 22, 2005, there were 222 income trusts of various kinds listed on the Toronto Stock Exchange (TSX) with a combined value of $170.6 billion, constituting more than 10 percent of total Canadian market capitalization.

Income trusts are generally structured to own debt and equity of an underlying entity that carries on an active business or to own 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 acquired by the trust, the interest payments are deducted from before-tax income, thereby reducing the corporate tax paid. To the extent income is earned by the operating company, that income may also be distributed to the trust as dividends. Also, capital taxes can 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 return on capital earned by the trust to the trust unit holders without being taxed at the corporate level. 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 and the tax treatment of any distributions depend on their type and on the tax status of the resident unit holder who may be an individual, corporation, or an institutional investor. Given that favorable tax treatment, it is not very hard to imagine the tax advantages of

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2It should be noted that income trusts do differ from fixed income investments markedly since distributions are dependent (Footnote continued in next column.)
in the income tax treatment of income trust distributions.

In the recent past, however, the continually rising interest rate environment in Canada and tax policy proposals contemplated by the Canadian government seem to be casting a long shadow on the continued growth and attractiveness of the income trust sector. In tandem, recent IRS audits of U.S. subsidiaries of Canadian income trusts have also put a damper on the cash-generating ability of some cross-border income trusts.

The Canadian government’s first foray into closing the income trust tax loophole came in the 2004 federal budget, when it proposed that holdings of pension funds in restricted investment property — business income trusts — be limited to 1 percent of the total cost amounts of the property owned by the pension funds at the end of every month.6 The budget also proposed that holdings in any particular business income trust by a pension fund be limited to 5 percent of all of the units of the trust at the end of every month.7 Significantly, the provisions excluded holdings in real estate investment trusts or royalty income trusts (resource and utility trusts) and applied narrowly only to pension funds, excluding registered retirement plans or other deferred income plans.

Following a general outcry from the Canadian investment and tax community, the implementation of the 2004 federal budget proposals on limiting pension fund participation in the business income trust market were suspended until further consultations with the public. Those consultations were initiated by the Department of Finance on September 8, 2005, with the release of a consultation paper.8 On September 19, 2005, the Minister of National Revenue announced that all advanced rulings on flow-through entity structures, a necessary prerequisite for corporations to convert to income trusts, would be postponed until the end of the consultation process on December 31, 2005.9 As part of the consultation process, the federal government is considering several policy approaches to close the tax loophole. Some of those approaches include limiting the deduction of interest expenses by operating entities, taxing flow-through entities in a manner similar to corporations, or better integrating the personal and corporate income tax systems in a manner similar to corporations, or better

10This was first proposed by Lalit Aggarwal, policy analyst at the C.D. Howe Institute, Toronto, and Jack Mintz, the Deloitte & Touche LLP Professor of Taxation, J.L. Rotman School of Management, University of Toronto, and president and CEO, C.D. Howe Institute, Toronto. For a detailed discussion, see Aggarwal and Mintz, supra note 1, at 792-818.
12If Sun Gro is unable to defend its position, the income taxes it will pay on the non-deductible interest will put a serious dent in its cash distribution ability.
13Cheveldayoff, supra note 11.
14U.S. Treas. reg. sections 1.482-1 to 1.482-8.
15As Cheveldayoff points out in his article, supra note 11, newer trusts using the income participating securities approach could be unaffected because the high-interest debt is held directly by the unit holder.

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