Limiting Pension Fund Investment in Canadian Business Income Trusts

by Martin Przysuski

In an attempt to address the issue of increased pension fund participation in the Canadian business income trust market, the 2004 federal budget issued by Canada’s federal government proposed changes to the investment rules for income trusts. They included proposals to limit the degree of pension fund participation in the business income trust marketplace. Two key limitations were proposed, one limiting the level of a pension fund’s investment in the business income trust market in general and the other limiting the level of investment holdings of a pension fund in any particular business income trust. Those two limitations, the consequences of exceeding them, and the associated transition rules are discussed below.

The 1 Percent Limit

Under the proposed measures, beginning January 1, 2005, the restricted investment property holdings of a registered pension plan (RPP) trust, an RPP corporation, and a tax-exempt pension investment corporation would have been limited to no more than 1 percent of the book value of the fund’s assets. Here, restricted investment property was defined to include direct holdings in units and debt of a business income trust, as well as holdings of the units of a mutual fund trust, which in essence gave indirect exposure to those business trust investments. It was also proposed that a penalty tax of 1 percent would apply to any restricted investment property in excess of 1 percent of the fund’s assets for each month the excess is held.

The 5 Percent Limit

The budget also proposed that a pension fund would be restricted from holding more than 5 percent of the units of any one business income trust. As above, any holdings in excess of that limit would be subject to a penalty tax of 1 percent per month.

Transition Rules

The 2004 federal budget also contained transitional provisions meant to soften the blow of the proposals. Transitional relief was made available to pension funds that held income trust units at the time the budget proposals were put forward. Existing investments in restricted investment property would not have been subject to penalty taxes, but would have been taken into account when determining the extent to which new restricted investment property could have been acquired by the pension fund. Transitional relief for direct holdings would expire after 10 years. Transitional relief for indirect holdings, that is, holdings in business income trusts through pooled investment vehicles and other mutual funds, would end after five years because they might pose a greater risk to pension funds. In an effort to provide pension funds with sufficient time to develop systems required to monitor those new investment limits and restructure their portfolios, penalty taxes would apply only after January 1, 2005.

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 initiated by the Department of Finance on September 8 with the release of a detailed consultation paper on taxation issues for publicly listed flow-through entities, both income trusts and limited partnerships.

1Canadian Department of Finance (2004), The Budget Plan, Ottawa: Department of Finance.

2Canadian Department of Finance (2005), “Tax and Other Issues Related to Publicly Listed Flow-Through Entities” (Footnote continued on next page.)
Evaluating the 2004 Budget Proposals

Notwithstanding the controversy surrounding actual net tax leakage to the federal government from increased pension fund involvement in the business income trust market, it is vitally important to address whether the 2004 budget proposals measure up to generally accepted standards that would make it a good tax policy alternative. This evaluation is important because, in the absence of any other proposals or publications on the issue except for the consultation paper, the 2004 budget proposals provide the best clue as to the Department of Finance’s revealed preference on the appropriate tax policy alternative to address tax leakage from increased pension fund involvement.

Perhaps the most objective way to evaluate the proposals is to analyze how they hold up against a set of universally accepted criteria that govern whether a proposal qualifies as good tax policy. The American Institute of Certified Public Accountants has developed a framework of 10 guiding principles of good tax policy that may be used to evaluate proposals to change a tax rule, as well as a fundamental overhaul of an entire tax system. The 10 guiding principles were inspired by the framework originally proposed by the economist Adam Smith in his 1776 book, The Wealth of Nations, which contained the first 4 of those 10 principles. The remaining six principles were developed over the years by state and federal legislators, administrators, tax advisers, and economists.

The 10 guiding principles of good tax policy are summarized below in no particular order:

- **Equity and fairness.** Similarly situated taxpayers should be taxed similarly. That includes horizontal equity (taxpayers with equal ability to pay should pay the same amount of taxes) and vertical equity (taxpayers with a greater ability to pay should pay more taxes). Equity is best measured by considering a range of taxes paid, not by looking just at a single tax.

- **Certainty.** Tax rules should clearly specify when and how a tax is to be paid and how the amount will be determined. Certainty may be viewed as the level of confidence a person has that a tax is being calculated correctly.

- **Convenience of payment.** A tax should be due at a time or in a manner most likely to be convenient to the taxpayer. Convenience helps ensure compliance. The appropriate payment mechanism depends on the amount of the liability and how easy (or difficult) it is to collect.

- **Economy in collection.** The costs to collect a tax should be kept to a minimum for both the government and the taxpayer.

- **Simplicity.** Taxpayers should be able to understand the rules and comply with them correctly and in a cost-efficient manner. A simple tax system better enables taxpayers to understand the tax consequences of their actual and planned transactions, reduces errors, and increases respect for that system.

- **Neutrality.** The effect of the tax law on a taxpayer’s decision whether or how to carry out a particular transaction should be kept to a minimum. A tax system’s primary purpose is to raise revenue, not change behavior.

- **Economic growth and efficiency.** A tax system should not impede productivity, but should be aligned with the taxing jurisdiction’s economic goals. The system should not favor one industry or type of investment at the expense of others.

- **Transparency and visibility.** Taxpayers should know that a tax exists, and how and when it is imposed on them and others. Taxpayers should be able to easily determine the true cost of transactions and when a tax is being assessed or paid, and on whom.

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(Ottawa: Sept. 8, 2005); available online at http://www.fin.gc.ca/toce/2005/toirplf_e.html.


6 AICPA, supra note 4 at 9-16.

7 Id., pp. 9-10.
Minimum tax gap. A tax should be structured to minimize noncompliance. The tax gap is the amount of tax owed less the amount collected. To gain an acceptable level of compliance, rules are needed. However, a balance must be struck between the desired level of compliance and the tax system’s costs of enforcement and level of intrusiveness.

Appropriate government revenues. A tax system should enable the government to determine how much tax revenue it likely will collect and when; that is, the system should have some level of predictability and reliability.

Therefore, to get an objective view of the merits of the 2004 budget proposals as a good tax policy initiative, this article evaluates the 2004 federal budget proposals against the criteria to determine which the proposals satisfy and which they don’t.

Equity and Fairness

Exclusion of RRSPs and RRIFs

If investments in business income trusts by tax-exempt investors are the real culprits contributing to tax revenue loss, as was claimed by the federal government, then imposing limits on pension funds alone and excluding other deferred income plans like registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs), and deferred profit sharing plans (DPSPs) certainly runs afoul of the equity and fairness criterion.

The official reason given for the exclusion at the release of the 2004 budget proposals was the Department of Finance’s view that the value of funds invested in RRSPs, RRIFs, and DPSPs is much smaller than that of pension funds. That assertion, however, was contradicted in the Department of Finance’s most recent consultation paper on the issue. The Department of Finance recognized pension funds as the largest class of investors in Canada, with a market value of assets approximating C $626 billion at the end of 2003, equal to around half of the Toronto Stock Exchange’s market capitalization of C $1.3 trillion in 2003. However, the consultation paper also estimated that RRSPs and RRIFs accounted for another C $445 billion, equal to about 34 percent of the Toronto Stock Exchange’s market capitalization. Given that RRSPs and RRIFs are the second largest class of investors in the capital markets, singling out pension funds in the 2004 federal budget proposals seems patently unfair. Indeed, there is no policy rationale to target pension funds alone if the federal government’s stated policy objective is to stem tax leakage from participation of tax-exempt investors in the business income trust market. In addition, there is no obvious technical difficulty with extending the 2004 budget proposals to RRSPs and RRIFs. Indeed, if the federal government saw fit to impose foreign property rules on RRSPs and RRIFs, there is no reason why it could not impose rules restricting investments in specific asset classes.

There is little doubt that tax policy on income trusts is very much at the top of the policymaking agenda in Ottawa this fall.

The 2005 budget also announced the repeal of the foreign property rule (FPR). In addition to limiting investment in foreign property by some tax-exempt entities, like pension funds, RRSPs, and RRIFs, this also restricted the ownership of limited partnerships by those entities. However, limited partnerships have many of the same characteristics as income trusts; therefore, excluding limited partnerships from the tax policy discussion, especially after the repeal of the FPR, would give rise to a serious tax loophole.

Last, but not least, in Canada, defined benefit pension plans (in which any shortfall in benefits is the responsibility of the plan sponsor) are being increasingly replaced by defined contribution pension plans (in which the risk of shortfall is transferred to pension beneficiaries). Given that trend, placing restrictions on pension fund investments ultimately affects pension beneficiaries more than anyone else.

One is left to wonder, therefore, if the exclusion of RRSPs and RRIFs, which are widely held by Canadian retail investors, was motivated by political reasons rather than a clear policy objective. Perhaps the reasons are administrative, especially given that pension funds are institutional investors and are relatively few in number (perhaps a few hundred at most). They are easier to monitor when compared with the literally millions of individual RRSP and RRIF plans and hundreds of group RRSP and RRIF plans.

Notwithstanding the actual reasons behind the exclusion of RRSPs and RRIFs, deliberately curtailing the investment activity of institutional tax-exempt investors alone cannot be justified from an equity and fairness perspective.

Exclusion of REITs and Resource Trusts

The 2004 federal budget runs afoul of the equity and fairness criterion in another way. By defining restricted investment property to include direct holdings in units and debt of business income trusts
alone, as well as holdings of units of a mutual fund trust, which in essence gave indirect exposure to those business trust investments, the 2004 federal budget proposals excluded real estate investment trusts and resource trusts. Although business income trusts have had the most explosive growth in recent years, excluding the REIT and resource trust markets distorts the economics of investment in the entire income trust marketplace.

There is also the problem of defining and demarcating the differences between REITs and resource trusts vis-à-vis business income trusts. For instance, some business income trusts may be invested in operating companies engaged in the resource or real estate industry. Alternatively, some resource trusts may be invested in actively managed operating companies in the natural resources sector whose main purpose is processing resources and perhaps would be more appropriately considered to be business income trusts.

Excluding limited partnerships from the tax policy discussion, especially after the repeal of the FPR, would give rise to a serious tax loophole.

Even if one were to assume that business income trusts were targeted due to their explosive future growth potential, discriminating against them specifically for that reason in no way justifies the exclusion of REITs and resource trusts, as well as other types of flow-through entities (FTEs). In its recent consultation paper, the Department of Finance pointed out that the market capitalization of FTEs in Canada had grown from C $18 billion at the end of 2000 to C $118.7 billion at the end of 2004. Although that growth is significant, on closer examination of the actual growth components, it is a mystery why the 2004 federal budget proposals addressed business income trusts alone.

As the table below on FTE market capitalization shows, although business income trusts had the biggest growth from December 2000 to December 2004, energy trusts had significant growth during the same period. REITs and limited partnerships also grew rapidly during that period. Therefore, the real problem is one of growth of all types of FTEs rather than business income trusts alone. The exclusion of other types of FTEs in the 2004 budget proposals not only runs counter to the equity and fairness criterion, but also seems rather short-sighted if the policy objective was to stem tax leakage from involvement by tax-exempt investors in the income trust marketplace. Indeed, in addition to business income trusts, pension funds do have large holdings of REITs and energy trusts as well. The tax leakage stemming from those holdings is completely ignored by the 2004 federal budget proposals.

Certainty

In terms of certainty, the federal budget proposals do outline specific limits to pension fund involvement in the business income trust market. Although that may give the illusion of certainty, the limits themselves are arbitrary and are not grounded in any economic rationale. For instance, it is not clear why a 1 percent limit on total fund assets was chosen as the preferred restriction rather than, say, 5 percent or 10 percent. Many pension funds have pointed out that their current holdings of business income trusts are much higher than the proposed limits. Immediately following the release of the 2004 budget proposals, one of the largest pension funds in Canada, Ontario Teachers’ Pension Plan, announced that its ownership in the Yellow Pages Income Fund alone was above the limits imposed by the budget proposals.

Given the way the limits are defined, that is, limiting pension fund investment in business income trusts to 1 percent of book value of fund assets each month and limiting investments in any one business income trust to no more than 5 percent of the units of a business income trust each month, there are other problems. One of the main problems with imposing limits based on book value of assets is that asset values within a pension fund portfolio are determined by the market and therefore fluctuate considerably, sometimes on a daily basis. Consequently, book value does not capture the full extent of the value of the assets held by a pension fund and, in some instances, may overstate or understate the actual market value of the assets held by the pension fund. In a world of constantly changing asset values, there would certainly be considerable discrepancy between the book value and market value of fund assets during any particular month. Given the potential for daily discrepancy, there is no guidance on what precisely a pension fund manager is expected to do, other than that he is expected to adhere to the limits imposed by the government or incur a penalty tax for failure to comply. The situation is further complicated if the pension fund is

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9Id., p. 12.

indirectly investing in business income trusts through another mutual fund.

In sum, imposing arbitrary limits based on the book value of assets held by pension funds, as in the 2004 federal budget proposals, does not increase certainty when constant fluctuations in asset values are the norm and not the exception. In fact, it contributes to the confusion of constantly assessing what constitutes an acceptable level of investment.

**Convenience of Payment**

In terms of convenience of payment, given that the only tax imposed by the federal budget proposals is the penalty tax for exceeding limits set by the proposals, at first glance it seems that the budget proposals meet that criterion. Nonetheless, the arbitrariness of the limits set in the budget proposals and the inherent difficulty in monitoring and adhering to those limits at the end of each and every month makes it a pretty daunting logistical challenge and, if anything, inconvenient for the taxpayer.

**Economy in Collection**

It can certainly be argued that the costs of collection to the government have been kept quite low because only penalty taxes come into play when pension funds exceed the threshold limits. However, it is by no means certain if the costs of enforcement are going to be particularly low as well. After all, to ensure compliance, tax auditors have to check detailed transaction records of a pension fund under a tax audit at the end of each month to ensure that they are sticking to the limits proposed in the 2004 federal budget. In some of the larger and highly diversified pension funds that have thousands of those transactions every year, that task can take on a magnitude that is rather onerous.

On the taxpayer's side, the costs of compliance can be exceptionally high. A key characteristic of any good tax policy is its ease of administration and compliance. The 2004 federal budget proposals do not measure up to that criterion. The proposals' call for limitations on pension fund investments in business income trusts creates a need for pension funds to not only track their own investments in business income trusts, but also monitor 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, which is 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 sum, compliance with the federal budget proposals will be a logistical dilemma for pension funds and require costly systems and procedures to ensure that limits imposed by the federal budget are met at the end of each month. The transitional relief provisions, although well intentioned, provide only a few months for pension funds to set up monitoring systems and other procedures to monitor investments. Still, the 10-year transitional relief provisions for direct holdings and five-year transitional relief for indirect holdings do ensure that the potential impact of the budget proposals are spread over a number of years to soften the blow of those proposals on pension funds and the Canadian capital markets.

Given the logistical challenges associated with investment tracking and monitoring, an alternative would be to expand the time horizon from the end of every month to the end of every quarter. In addition, the problem of having to monitor investments constantly and the logistical problems with the look-through rules would remain unresolved because the budget proposals are not workable without such close monitoring by pension funds on their investments.
Simplicity

Although the 2004 budget proposals appear simple, as already discussed above, the arbitrariness of the limits, the inherent lack of certainty in how they are defined, and the requirement to monitor investments at the end of each and every month make the 2004 federal budget proposals fall well short of the simplicity criterion required of any good tax policy proposal.

Neutrality

Tax neutrality essentially stipulates that the effect of the tax law on a taxpayer’s personal and business decisions should be kept to a minimum. In other words, taxpayers should not be unduly encouraged or discouraged from engaging in particular activities primarily due to the effect of the tax law on the activity. The main thrust of the 2004 federal budget proposals is to influence investment decisionmaking by pension funds in the business income trust market. They without a doubt run afoul of the tax neutrality criterion in more ways than one. The obvious policy question here is whether the federal government should be in the business of legislating arbitrary limits on pension funds and, for that matter, any investor class. The better alternative would be to address the basic problem with the tax treatment of FTEs in general, rather than to impose limits on a specific investor class that does nothing to address the fundamental flaws in the Canadian Income Tax Act (the act).

Economic Growth and Efficiency

Another key issue from a policy perspective is whether the federal government should impose what are arguably arbitrary limits on investments by Canadian pension funds, in essence creating artificial barriers to investment for a select group. Imposing those arbitrary limits may 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. Indeed, as Mintz and Aggarwal point out, rules that apply to pension plans but not to RRSPs have a long-run effect in distorting savings decisions.11

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.

Transparency and Visibility

One could argue that the 2004 federal budget proposals do indeed meet the transparency and visibility criteria given the extraordinary attention that has been paid to the specific proposals on pension fund involvement in the business income trust market. Unfortunately, meeting those criteria alone does not guarantee that the 2004 federal budget proposals can be considered good tax policy.

Minimum Tax Gap

Given that the tax imposed by the budget proposals is a penalty tax, one could assume that the proposals minimize the tax gap, that is, the difference between taxes owed and taxes paid. Nonetheless, the penalties for noncompliance are rather onerous and may in some cases exceed the magnitude of the investment that was initially made in a business income trust.12 Although the penalties might force pension funds to monitor their investments extremely closely, the cost of compliance raises the question of whether there might not be a better tax policy alternative.

Appropriate Government Revenues

Finally, there should be some level of predictability and reliability to determine how much tax revenue is likely to be collected. Given that the proposals are specifically designed to stem tax leakage, the measure of their success is a tangible decrease in the level of pension fund participation in the business income trust market. However, that decrease may also be motivated by external economic factors, such as an increasing interest rate environment or the increased attractiveness of other types of investments. Therefore, it is very hard to isolate the effect of the proposals versus other external factors. That, therefore, makes the quantification of any tax benefit due to the budget proposals rather problematic.

Given that only pension fund investments in business income trusts are targeted, it is unclear whether the markets may sort themselves in a way that pension funds invest in royalty trusts and

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REITs while other investors focus on business income trusts.\textsuperscript{13} Pension funds may also choose to invest in other types of FTEs, such as limited partnerships, rather than invest in taxable investments. In addition, the repeal of the foreign property rule has also opened the door for investment in non-Canadian assets. Therefore, the federal budget proposals may simply contribute to a reallocation of investments rather than increase the reliability that tax revenue losses from pension fund investments in business income trusts will be effectively addressed.

Policy Alternatives

To address the problem of income trust taxation, the federal government’s consultation paper identified a number of policy alternatives as listed below:\textsuperscript{14}

- taxing FTEs 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.

Nonetheless, the fundamental problem with all of the policy alternatives proposed in the federal government’s consultation paper is that they do not specifically address the problem of pension fund investment, or the investment of all other types of tax-exempt investors, in business income trusts as well as other FTEs. A critical evaluation of the 2004 budget proposals indicates that they fall short of a majority of the criteria that should be satisfied by any good tax policy alternative. Perhaps fundamental to its failure as a good tax policy is that it imposes arbitrary limits on investments by a specific investor class and deliberately targets only one type of FTE — business income trusts. Among others, not only are the criteria of equity and fairness violated, but so is tax neutrality, which stipulates that good tax policy should not encourage some taxpayers to change their investment behavior. That unfortunately seems to be the stated objective of the 2004 budget proposals, that is, limiting pension fund involve-

\textsuperscript{13}Aggarwal and Mintz, supra note 11, p. 818.
\textsuperscript{14}Canadian Department of Finance, supra note 2 at 35.

Alternative 1

In their constant search for better investment returns, pension funds invest in a variety of asset classes to derive their investment income: shares of corporations; income trust units; corporate bonds; Treasury bonds; and so on. In an ideal world, there is no reason for them to discriminate between two asset classes, like corporations and income trusts, unless that gives an obvious advantage. In Canada, that advantage occurs because income trusts are FTEs, whose income is not taxed at the income trust level if distributed to unitholders. A pension fund that invests in an income trust is assured of receiving 100 percent of the investment income and defers tax until that income is distributed as retirement benefits. On the other hand, a corporation pays tax at the corporate level on the income it earns and then distributes income net of tax income as dividends. Those dividends, when received by the shareholders, are taxed again at the applicable tax rate of the shareholder. However, if that shareholder is an individual, the individual shareholder can use a dividend tax credit meant to offset the taxes paid on the dividends at the corporate level. Although an individual shareholder gets the opportunity to reduce his or her tax liability, tax-deferred plans like pension plans and RRSPs do not have that opportunity under the act. It is no surprise, then, that pension funds and mutual fund managers favor investments in income trusts to corporations because there is a distinct tax advantage and there is no mechanism to offset that advantage.

To address that uneven playing field, Mintz and Aggarwal have proposed that a refundable dividend tax credit be instituted for pension funds and other tax-deferred plans. That would, in essence, act as a refund of the taxes paid by a corporation in which they are invested.\textsuperscript{15} That dividend tax credit would

\textsuperscript{15}Aggarwal and Mintz, supra note 11 at 816.
serve a similar purpose as the dividend tax credit for taxable individuals, but in that particular case, it would make investments in corporations as attractive as investments in income trusts for pension funds and other tax-deferred plans. When the income is eventually distributed to the beneficiaries of the pension fund, it is taxed at their federal-provincial tax rate. A refundable dividend tax credit would eliminate pension fund bias toward income trusts, which merely repackage equity to resemble fixed-income debt offerings. Instituting such a tax credit, however, would require a fundamental rethinking of the way pension funds and other tax-deferred plans are treated under the act. There are also issues with the determination of the quantity of the tax credit and matching such a credit to applicable federal and provincial corporate tax rates.

Although a dividend tax credit would make corporations and income trusts equally attractive to tax-exempt investors, the federal government’s biggest problem with that alternative would be that it would not address its fundamental concern, tax leakage from investments by tax-exempt investors in the income trust market. If anything, the refundable dividend tax credit would exacerbate the situation by providing a tax break for tax-exempt investors. That has the potential to offset substantial current corporate tax revenues in favor of deferred future taxes, which may not be the federal government’s first preference.

**Alternative 2**

If one were to put the federal government’s motivations underlying the 2004 federal government proposals in sharp focus, it is immediately obvious that the problem is one of timing more than anything else. Pension funds and RRSPs are not truly tax-exempt because their cash flow is ultimately taxed at the individual beneficiary level when it is withdrawn at a future date, presumably to fund retirement benefits. Therefore, if pension funds and other types of tax-deferred plans increase their participation in a growing income trust market, the fundamental issue is the erosion of the federal government’s current tax revenues and deferral of those tax revenues to the future rather than a complete “loss” of that revenue. Inevitably, there might be some net tax leakage because the present value of future taxes may not equal the value of the tax revenues foregone at the present time, unless of course the value of the taxable future income rises to such a point that the present value of future taxes and the value of foregone tax revenues offset each other. Nonetheless, if it is assumed that there is some net tax leakage, the best policy alternative would be to institute a distribution tax on current income distributions to ensure that at least some portion of the taxes on income trust distributions are collected now and not deferred.

That distribution tax could be quite similar to the part XII.2 tax in the act. Part XII.2 was originally enacted to prevent a nonresident avoiding Canadian taxes through the use of a resident trust to earn income from a business carried on in Canada or from a disposition of taxable Canadian property. In essence, part XII.2 imposes a tax equal to 36 percent of the “designated income” of a trust payable to any beneficiary, resident, or nonresident. Designated income in that context refers to real properties, timber resource properties, Canadian resource properties, and businesses carried on in Canada. However, section 210.1 provides an exemption from the application of part XII.2 tax to a mutual fund trust.

It is important to note that most, if not all, income trusts are structured as mutual fund trusts (essentially unit trust residents in Canada) because that ensures that the units of the trusts are eligible for investment by RRSPs, RRIFs, registered education savings plans (RESPs), DPSPs, and pension plans. Mutual fund status also ensures that holders of exempt plans are not subject to special taxes, such as the part XII.2 tax on designated income of some trusts except mutual fund trusts. Therefore, the simplest way to ensure that a distribution tax would apply to income trust distributions would be to not exempt mutual fund trusts from the application of

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17*Id.*


19*Id.*, subsection 210.2 (1).

20*Id.*, subsection 210.2 (2). The Feb. 27, 2004, draft legislation s. 112 will repeal this subsection, and the definition of designated income will be included in the new section 210(1).

21*Id.*, section 210.1. This section is being repealed and will be replaced by new subsection 210(2).

22*Id.*, paragraph 132(6)(a).
part XII.2 tax by revising the subsection that includes mutual fund trusts in section 210.1, that is, subsection 210.1(b)23 and any associated references.

Given the specific concern we are trying to address, that is, investments by tax-exempt investors in income trusts, it is very important to revise that subsection to apply to distributions made by mutual fund trusts to resident tax-exempt investors alone, rather than all types of investors, because that would impose the distribution tax on taxable investors as well, which is certainly not the desired outcome. If that careful revision is undertaken, the distribution tax will in essence act as a withholding on the income distributions by income trusts to tax-exempt investors alone. Further, given that one of the key criteria for good tax policy is equity and fairness, it would be prudent to include all types of income trusts, not just business income trusts, as well as all types of tax-exempt investors, including RRSPs and pension plans. In addition, the distribution tax of 36 percent is very close to the average corporate tax rate of 35 percent. That also serves to ensure compliance with the criterion of tax neutrality.

To illustrate, if the distribution tax is applied to income distributions by income trusts to tax-exempt investors, then the after-tax cash inflow from that income distribution to a pension fund would approximate the after-tax cash inflow from a dividend payout. The distribution tax would be easy to administer because the income trust will have the responsibility of withholding the distribution tax based on the taxable status of the unitholders. That is not an unrealistic expectation because it is similar to the scenario when those trusts are required to withhold taxes on distribution of income to nonresidents. Further, given concerns raised about all types of FTEs in the Department of Finance’s consultation paper, an argument could also be made that the distribution tax discussed above should be applied to distributions of limited partnerships to tax-exempt investors to discourage tax-exempt investors from favoring limited partnerships over other FTEs.24

Similar to the dividend tax credit given to individual investors to offset corporate taxes paid by a corporation, a distribution tax credit could also be instituted to offset the distribution taxes paid by an income fund. That distribution tax credit should only apply when the distribution is originally paid into a tax-exempt plan resident in Canada and later withdrawn by the taxable Canadian investor. Therefore, an individual investor who receives a distribution of income from an RRSP invested in an income fund would be eligible for the distribution tax credit because a distribution tax would have been withheld on the original income fund distribution to the RRSP. However, an individual taxable investor directly investing in an income trust would not be eligible for that credit because the income trust is not obliged to withhold a distribution tax on income distributions to taxable Canadian residents.

**Conclusion**

In sum, the policy alternative that would work best to limit pension fund involvement in the business income trust market would be one that focuses not on the level of pension fund involvement directly, but instead on the fundamental reasons why pension funds prefer investing in income trusts to corporations. Therefore, the policy alternative that would best address that issue is one that would level the playing field between the taxation of income trusts and corporations, and ensure that tax-exempt investors such as pension funds are not motivated to choose one type of investment over another merely by their tax advantages. Most importantly, implementation of a tax policy that eliminates tax advantages will effectively annul the need for federal government intervention in 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 proposed in the 2004 federal budget proposals.

**Implementation of a tax policy that eliminates tax advantages will effectively annul the need for federal government intervention in capital markets.**

Of the two alternatives proposed in this article, the first proposal, providing a dividend tax credit to pension funds and other tax-exempt investors, would require a fundamental change in the way pension plans and RRSPs are treated. Although an idea with considerable merit, it is highly unlikely that the federal government could be convinced to offer a refundable dividend tax credit to tax-exempt investors, notwithstanding the intuitive appeal of that suggestion. Therefore, the second alternative, imposing a distribution tax on the distributions of FTEs to tax-exempt investors alone, may be a more feasible policy alternative. The second policy alternative achieves the dual objectives of leveling the
playing field between corporations and FTEs for tax-exempt investors and ensuring that some portion of deferred taxes are converted to current tax revenues. That should effectively alleviate the federal government’s primary concern of tax leakage from increased involvement by pension funds in the business income trust market.

The recent proposal does not completely address the tax leakage issue with tax-exempt investors.

The proposed alternative could conceivably encompass all types of FTEs, as well as all types of tax-exempt investors, thereby satisfying the equity and fairness criterion of good tax policy. A distribution tax credit (similar to a dividend tax credit) for the beneficiaries of pension funds and other tax-deferred plans could be instituted to offset the distribution taxes withheld, thereby avoiding double taxation on those income distributions. Last, but not least, appropriate mechanisms must be put in place to ensure that the application of that distribution tax credit is coordinated effectively between the federal government and the various provinces, as well as effective, well-thought-out transitional rules.

Postscript

On Wednesday, November 23, 2005, more than five weeks before the official end of the consultation process, Canada Minister of Finance Ralph Goodale announced a reduction in the personal income tax on dividends to level the playing field between income trusts and corporations. The announcement put an abrupt end to the consultation process and was most certainly motivated by political expediency for the minority Liberal government, which was faced with the threat of a nonconfidence vote in Parliament the very next Monday. Still, the news did bring welcome relief to the income trust sector in particular, and the Canadian investor community in general.

The government’s proposal called for an enhanced gross up of 45 percent (up from 25 percent) and a dividend tax credit on eligible dividends received by individual investors. Eligible dividends would include dividends paid after 2005 by public corporations and other corporations resident in Canada and subject to the general corporate income tax rate. Dividends paid by Canadian controlled private corporations, which are automatically subject to a lower corporate tax rate, would generally not be considered eligible dividends unless their income (other than investment income) is subject to tax at the general corporate tax rate. The end result of that proposal is, of course, better integration of the tax system in Canada, in effect equalizing the total personal and corporate tax paid on dividends from corporations and the personal tax paid on income received from income trusts.

The initial reaction of the capital markets to this announcement has been favorable. And the proposal ensures that taxable individual investors will have the incentive to invest in corporations as well as income trusts. However, the recent proposal does not completely address the tax leakage issue with tax-exempt investors. In spite of the announcement, some tax-exempt investors may be biased toward income trusts merely because their distributions are flowed through without any imposition of tax and therefore remain more attractive and tax-efficient when compared with corporate dividends. In addition, notwithstanding the exuberance of the Canadian capital markets, there are fundamental issues to be resolved in terms of the sometimes irrational overvaluation of a significant number of Canadian income trusts.

Still, integration of the personal and corporate tax regime, as done in this proposal, is a commendable policy initiative and, if anything, provides welcome relief to millions of taxable individual investors. Hopefully, a majority of tax-exempt investors, including pension fund managers, will see this as an opportunity to be less biased toward income trusts vis-à-vis corporations and make investment decisions based on company fundamentals rather than the company’s structure for tax purposes.

References


