INVESTMENT DEALERS
ASSOCIATION OF CANADA

ASSOCIATION CANADIENNE DES
COURTIERS EN VALEURS MOBILIÈRES

SUBMISSION ON FLOW-THROUGH ENTITIES

TO THE MINISTER OF FINANCE

INVESTMENT DEALERS ASSOCIATION OF CANADA

November 28, 2005

EXECUTIVE SUMMARY

The Investment Dealers Association of Canada, as the national self-regulatory organization and representative body of the Canadian securities industry, has a keen interest in the concerns raised by the government in its Consultation Paper on FTEs, or "Income Trusts", and in suggested remedial actions to address these concerns. FTEs have made a significant contribution to the liquidity and efficiency of Canada's capital markets. FTEs, as a high yield equity investment, offer issuers and investors an attractive financing and investment alternative in capital markets. The government must be careful in implementing remedial policy to ensure the viability of FTEs, and the unique investment and financing opportunities of the instrument, are not adversely affected, and the efficiency of capital markets is not damaged.

The IDA also recognizes that the non-neutralities resulting from the taxation of FTEs have contributed to inefficiencies in respect of corporate restructurings and the allocation of capital. The rapid growth of the sector has, in addition, raised concerns on the part of government concerning the soundness of its tax base. The objective of this submission is to discuss these issues, and provide the Department of Finance with recommendations to address policy concerns. The IDA believes the issues of revenue losses and economic efficiency can be remedied without putting at risk an instrument and market that have yielded considerable benefit to Canadian investors and issuers over the last two decades and, if preserved, can and will play a significant role in future capital formation and growth in the Canadian economy.

The IDA recommends that the government act quickly and decisively to correct identified problems in the FTE marketplace and, in doing so, remove the uncertainties prevailing in the marketplace. Government actions should proceed in measured steps to avoid unnecessary disruptions in the income trust market. To ensure that the policy response does not overshoot objectives and unnecessarily harm the FTE market, the IDA recommends the government begin with a targeted reduction in corporate and dividend tax rates. Since these measures will, by themselves, lower the incentive for conversion into a trust structure the government should monitor the success of these tax changes before taking further action. In the event that further remedial steps are warranted, the government should consider limitations on FTE holdings by tax-deferred investors[1] and avoid the more complex and unnecessarily disruptive option of taxing the distributions of trusts.

Non-residents are significant investors in Canadian FTEs, holding an estimated $35 billion and 21% of outstanding FTEs at the end of 2004. Canada taxes distributions to these investors less heavily than it taxes distributions to Canadians, and also less heavily than non-resident FTE holdings are typically taxed in other jurisdictions. The government should examine this issue carefully and consider policy changes to address these inequities. However, any such remedy is complicated by the fact that it may involve changes to existing tax treaties. Moreover, given the significant FTE holdings and the large tax advantages to non-resident investors, adjustments in the tax treatment on distributions to non-residents could trigger severe valuation effects across the income trust sector in general as well as impede financing in those industries and sectors that have in the past attracted substantial foreign capital. The government should proceed cautiously and incrementally if it chooses to bring its tax system more into line with international norms through higher effective taxation on FTE distributions to non-residents.

IDA Recommendations

1. ***Amendments to*** *the Income Tax Act* (Canada*)* ***to lower the general corporate income tax rate and increase the dividend tax credit rate so that individual taxable investors are more neutral from a tax perspective with respect to distributions from a corporation or an FTE.*** Amending the Income Tax Act (Canada) in this manner will ensure that investment and financing decisions by taxable investors in respect of FTEs are based on economic rationale rather than

[1] In this submission, pension funds and RRSPs are referred to as "tax-deferred investors". This category of investor might also generally include charities and endowments. However, charities and endowments are not specifically analyzed in this submission since they control a capital pool which is very much smaller than the capital pool controlled by pension funds and RRSPs and thus they are less central to the analysis.

relative tax advantage. These changes to the *Income Tax Act* should also promote the growth of high yield equity securities in capital markets, providing issuers and investors with broader choice in equity markets.

2. ***A monitoring period following the implementation of lower corporate and dividend taxation during which time the government would evaluate the efficiency of these measures and need for further action.*** At the end of this period, if the initial reduction in the corporate tax rate and dividend tax rate are insufficient to blunt the incentive for large scale trust conversions through purchases by tax-deferred investors, resulting in further erosion of the tax base, then further remedial action might be warranted. In such an event, it may be appropriate for the government to consider limitations on FTE holdings by tax-deferred investors at levels consistent with the stability of the marketplace and containment of tax revenue loss. These investment limits would not apply to REITs and Energy Trusts. The government should refrain from introducing the complex and unnecessarily disruptive option of taxing income trusts.

TABLE OF CONTENTS

Introduction **2**

Description of the Market **3**

The Importance of Income Trusts **6**

FTEs and Business Efficiency **10**

Sources of Valuation Premiums **11**

Impact on Tax Revenues **13**

Impact on The Canadian Economy **15**

Analysis Of Alternative Responses **16**

INTRODUCTION

1. Preliminary Comments

The Investment Dealers Association of Canada (the "IDA") is the national self-regulatory organization and representative body of the Canadian securities industry. The IDA's mission is to protect investors and enhance the efficiency and competitiveness of the Canadian capital markets. The IDA welcomes this opportunity to participate in the government's public consultations on FTEs. FTEs, or Income Trusts, have become an important segment of Canada's capital markets in recent years and are contributing importantly to the efficiency of our marketplace. The securities industry has an important stake in this. Liquid and well-functioning capital markets are at the foundation of any successful economy. FTEs allow investors to obtain the yield and diversification required to reach their investment objectives, and allow users of capital to attract the low cost capital they need to finance infrastructure and growth. In responding to the government's concerns about FTEs we note that the recent rapid growth in this sector reflects in part inefficiencies of the tax system and the impacts of these inefficiencies on the decisions of issuers and investors. The purpose of this submission is to highlight the issues, and to provide the government with a recommended course of action.

2. Market Efficiency

The prosperity of any economy is dependent on the extent to which firms have access to the capital needed for productive expansion. Capital markets which are most "complete", in the sense of having the broadest range of available financial instruments, are able to contribute most efficiently to this process. Complete markets have the capacity to finance projects and offer savings vehicles across the full breadth and depth of activity, terms to maturity, and at risk levels that market participants desire. Capital markets which have important gaps in any of these areas are less than fully efficient, and impose productivity costs on economic activity.

3. High Yield Financing Options

Canadian FTEs have played an important role in providing a high yield equity security to the capital markets during the last two decades. Aside from Income Trusts, entities with high yield financing needs have had few alternatives in the Canadian marketplace. New issue high yield debt markets, for example, are virtually non-existent in Canada. Large Canadian companies with high yield debt financing requirements tend to go to the world's largest market, the United States, with $800 billion to $1 trillion in high yield debt outstanding. Smaller, non-investment grade Canadian companies, however, have fewer opportunities south of the border, and are typically limited to domestic funding in bank loans or private equity. High yield equity issuance is similarly limited in Canada. As later discussed, the development of a high dividend yielding preferred share market in Canada has been severely constrained by a tax system which actively discourages preferred share issuance.

4. Important to Preserve FTEs

FTEs have developed in Canada in response to fundamental economic and financial needs and in the face of an otherwise incomplete marketplace in the area of high yielding securities. In deliberating on a course of action to deal with concerns about FTEs, the IDA urges the government to pay full regard to the important role that these instruments play in market efficiency and the promotion of economic growth and prosperity for Canadians.

DESCRIPTION OF THE MARKET

5. Overview

Currently the Income Trust market in Canada is approximately $160 billion in market cap and growing rapidly – compound annual growth (CAGR) of 32% since 1997. The current total market cap of Income Trusts represents 9% of the TSX market cap, up from less than 1% just 8 years ago. In contrast, the TSX

Composite Index, with a $1.2 trillion market cap, has grown at a CAGR of 8% over the same period.

6. Market Segments

A summary of the growth and development of Income Trusts by market segment reveals that markets for the various trust types are at different stages of development, and growing at substantially different rates. The REIT market cap at roughly $20 billion has grown at a compound annual growth rate of 22% since 1997. Infrastructure Trusts at $16.5 billion have grown 17% annually over the same period. The much larger sectors of Oil and Gas Trusts ($72.6 billion) and Business Trusts ($48.5 billion) have been growing much more rapidly, 40% annually since 1997, and with marked acceleration since 2001.[2]

Table 1: Market Cap of the Canadian Trust Market

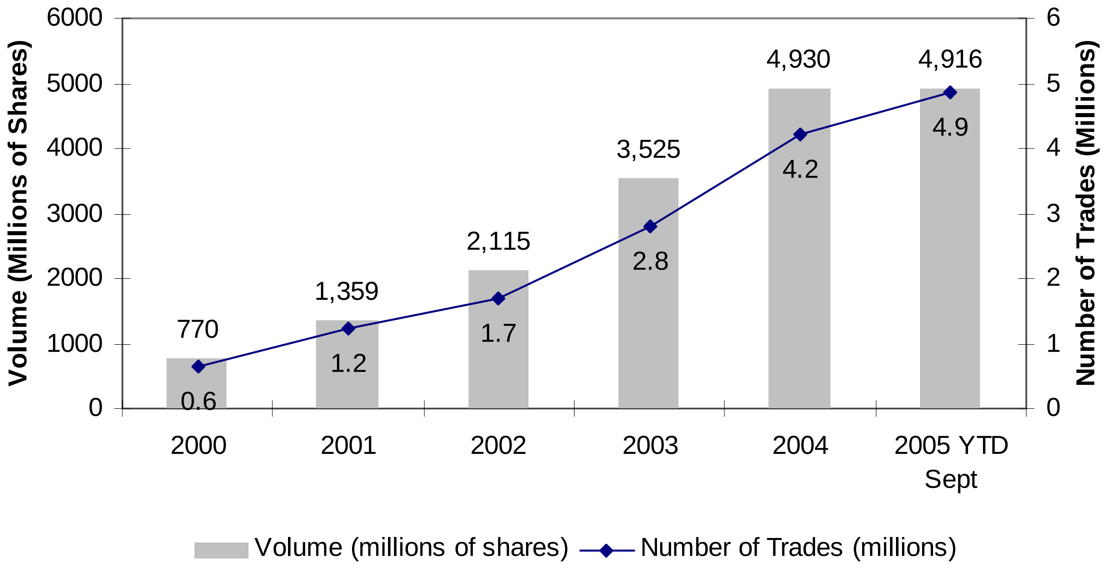
	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**Current (01-10-05)**
Business	3.3	3.0	2.8	3.1	4.4	13.8	28.4	43.7	48.5
Infrastructure	4.8	4.8	4.4	5.4	7.3	8.7	12.8	17.0	16.5
Oil & Gas Production	4.8	3.0	4.7	6.7	9.8	12.7	27.3	42.4	72.6
REITs	4.0	4.0	4.3	4.9	7.7	9.4	13.2	17.6	19.8
Totals	16.9	14.9	16.3	20.2	29.2	44.6	81.8	120.7	157.5

[2] **REITs** - It has been government policy to permit flow-through investments by pension funds in real estate since the 1970s. Since that time the trend in many other developed jurisdictions has been to permit flow-through investments by non-taxable persons in real estate. The provisions added to the *Income Tax Act* (Canada) in the early 1990s permitting in the creation of REITs put RRSPs on essentially the same footing as pension funds with respect to investing in real estate. There is no obvious reason at this time to change the policy of permitting flow-through investments in real estate by pension funds and RRSPs. The Department of Finance would appear to have acknowledged this policy in the Consultation Paper. In the commentary on the measures announced in the 2004 Budget, the Consultation Paper states as follows: "Those measures were proposed not to apply to energy trusts and REITs given that pension funds can invest directly in the types of property held by energy trusts and REITs." There are no statements in the Consultation Paper which can be interpreted to suggest that the Department of Finance wishes to reconsider this policy. **Energy Trusts** - The same considerations apply with respect to permitting flow-through investments by pension funds and RRSPs in energy properties. The only small factual difference (which would not appear to be of any policy relevance) is that the provisions permitting pension funds to invest in energy properties were enacted in the early 1980s.

7. Trading Volumes

The recent growth of Income Trusts is also reflected in investor activity – with trading volumes rising at a compound annual growth rate of 45% since 2000. The TSX estimates that one million Canadians are currently holding Income Trusts. Last year these investments distributed more than $6 billion to their holders.

Chart 1: Investor Activity in Income Trusts



Source: TSX

8. Causes of Growth in Trading Volumes

Some of this growth has been related to fundamental and economic factors – the shift in investor preference from growth to income following the collapse of the tech bubble, the low interest rate environment, and the bull markets in commodities and oil and gas of the last few years. But there has been as well an unmistakable acceleration of growth in the last three years which may partly arise from non-neutralities in the tax system.

THE IMPORTANCE OF INCOME TRUSTS

9. A Role for Income Trusts

Income Trusts are filling an important void in our marketplace for both investors and issuers. In the current low interest rate environment, investors with an income focus have few alternatives to income trusts. It has been pointed out, for example, that after adjusting for inflation the after-tax yield on a Government of Canada bond is effectively zero, and there are few alternatives in Canada in terms of high yield debt or high dividend yielding preferred shares.

10. The High Yield Security Issue

Canadian investors need a form of security which allows them to receive the income and diversification benefits available from high-yielding equity investments. This is particularly important for retired persons seeking to maintain a reasonable standard of living. The availability of these high yielding investments also promotes capital formation in the economy by lowering the cost of capital for corporate issuers. There are a number of important observations related to these issues:

(a) As noted above, other than income trust units, the availability of high yield equity securities is limited in Canada. While the U.S. market may offer similar investment opportunities, Canadian investors are faced with currency risk or hedging strategies on these investments.

(b) Dividend distributions by a public corporation can be sourced from either taxable income or capital. To the extent that dividend distributions paid by a corporation to its shareholders are not sourced from taxable income and therefore constitute returns of capital, there should arguably be no current taxation to the shareholders. In other words, if there is no taxable income, there should be no income tax. The Canadian tax rules applicable to income trusts permit this result. Similarly, the US tax system permits this result in the case of dividend distributions. However, the Canadian tax system imposes tax on the portion of any dividend distribution by a public corporation which constitutes, in effect, a return of capital. In the case of a top marginal tax rate taxpayer, the effective tax rate after taking account of the dividend tax credit is approximately 30%.

(c) The current tax system actively discourages raising capital by the issuance of high dividend yielding preferred shares. Such shares will generally constitute either "taxable preferred shares" or "short term preferred shares". The issuer will typically be required to pay a tax on dividends paid on any such shares at the rate of either 40% or 60%. Where the issuer is taxable, this tax should generally be effectively creditable against the income tax otherwise payable by the issuer. However, if the issuer is not taxable, income tax will still have to be paid. This possibility will make it unlikely for a company with any potential to become non-taxable to issue preferred shares.

The IDA believes that the foregoing is inappropriate. It is a consequence of an approach to the taxation of corporate distributions that is quite different from the approach of most other developed countries. While it may not be possible at this time for the government to reopen the issue of the taxation of dividends on preferred shares, it is important that the government recognize the need for an instrument to fill the void created by provisions of the *Income Tax Act* (Canada) which have effectively limited the growth of a market for preferred shares.

11. Importance to Retirees

Income trusts as a result have become important features in the portfolios of many retirees and Canadians saving for retirement. With more than one in five Canadians expected to retire within 25 years, now is the time to encourage and assist Canadians in the accumulation of retirement savings, and not the time to impose measures that would limit or erode their investment choices. Despite the recent increases to RRSP contribution limits, the limits are still inadequate when measured against both international benchmarks[3] and acceptable standards for income replacement. The Income Trust market needs to be preserved so that Canadians continue to have access to the income and diversification benefits of these instruments in preparing for their retirement.

12. Importance to Issuers

From an issuer's perspective, low-growth, stable, mid-sized companies are relatively disadvantaged in the public equity market. Equity markets are traditionally most receptive to companies with high growth prospects and the larger cap, better-known names. These are the companies that are the most followed by analysts and market participants – either because they garner widespread attention due to their high growth prospects, or because they are among the largest and most recognizable companies in the corporate sector. It has been more difficult for mature, mid-sized companies to capture the level of market enthusiasm for their common shares that is crucial for a successful common equity IPO.

13. 2001 to 2003 Equity Markets

The importance of a complete marketplace was clearly evident in the downturn of equity markets between 2001 and 2003, when Canada maintained an active Income Trust IPO market while the US IPO market was virtually closed. With the collapse of the growth sector and declining investor demand for common equity in both countries, few companies were willing to test the waters for new share capital in public markets. In Canada, retail investors who had shied away from common equity continued to be attracted by the steady promised cash flows

[3] According to calculations from the Retirement Income Coalition, maximum contribution to tax sheltered savings plans in the U.S is in the vicinity of $56,000 Cdn and $40,000 - $90,000 Cdn in the UK. Canada’s maximum RRSP dollar contribution limit for 2005 is just $16,500.

and high yields available on Income Trusts. As a result, Income Trust IPOs accelerated in Canada even though common equity IPOs remained in the doldrums. This proved to be of great benefit to private equity firms who were able to use Income Trusts as a strategy to transfer ownership and exit the investment, and to many small and mid-sized companies who otherwise would not have had access to public markets. Follow-on financing by income trusts was also significant in the period, a good portion of which was done to finance acquisitions and business expansions, both in Canada and abroad.

Table 2: Dollars Raised – IPOs ($ billions)

	2000	**2001**	**2002**	**2003**	**2004**	**2005 YTD Sept**
Income Trusts	0.01	1.24	4.74	4.43	2.92	4.01
Structured Products	3.74	7.14	3.26	6.24	9.54	7.06
Corporate	4.90	0.88	1.11	0.60	3.17	1.72
Totals	8.65	9.26	9.12	11.27	15.63	12.80

Source: TSX

Table 3: Follow-on Financing by Income Trusts ($ billions)

	2000	**2001**	**2002**	**2003**	**2004**	**2005 YTD Sept**
Business Trusts		0.21	0.81	0.87	1.96	4.07
Energy Trusts	0.45	1.32	1.33	3.52	5.03	3.40
Power & Pipelines	0.15	0.66	0.33	1.53	1.50	0.55
REITs	0.19	0.70	0.72	1.10	2.03	1.56
Totals	0.79	2.88	3.19	7.02	10.52	9.59

Source: TSX

FTEs And Business Efficiency

14. Is FTE Taxation Impacting Business Organization?

Corporations have been converting themselves to Income Trusts in increasing numbers over the last several years. For some companies this is an optimal choice, notably for mature companies, companies facing limited competition, little or no technological change, companies with a limited need for new capital expenditure, companies having products with strong consumer loyalty and low sensitivity to the business cycle. Other companies, possessing these features in lesser degrees were attracted to the trust structure by the valuation premium, or valuation "bump" in share price, that is available to shareholders on conversion.

15. Impact of Converting for Valuation Gains

When companies are driven to convert more for the valuation gain than for the advantages of the income trust business model, it can result in sub-optimal results, for the company inappropriately constraining itself within a trust, and for the investor who owns an asset that could underperform, in terms of investment returns. The risk is that the large valuation gain becomes an attraction for companies to convert to or structure themselves as a trust when they may be better suited to a corporate structure.

16. Corporate versus Trust Structure

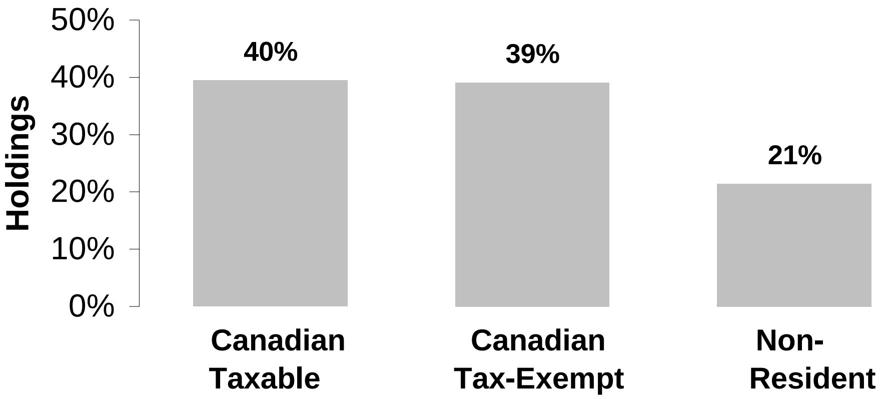
Companies may be better suited to a corporate than a trust structure for a variety of reasons. Companies with unpredictable cash flows may be better suited to non-dividend paying or low dividend corporations. In addition, the requirement for payout of distributable cash may not be consistent with an entrepreneurial company facing growth opportunities. In some cases, management of a company is in the best position to make reinvestment decisions to maximize shareholder returns. Also, a company may not wish to subject itself to the uncertainties that arise from a significant reliance on externally-sourced financing implicit in many trust structures.

SOURCES OF VALUATION PREMIUMS

17. The Investor Groups

The Consultation Paper provides statistics on the percentage holdings of FTEs in the three major investor segments: taxable Canadian retail and mutual fund investors (40%), tax-exempt investors (39%), and non-residents (21%).

Chart 2: Estimated Holdings of FTEs by Investor Group



Source: Department of Finance

18. Valuation Premiums

While some of the valuation premium on income trusts may be attributed to demand factors such as the search for yield by retail investors, low interest rates and desirable features of the trust structure, a significant portion can also be traced to the after-tax return differential between corporate shares and trust units that is due to the tax system. An analysis by RBC Capital Markets[4], for example, shows that trust valuation premiums in the range of 35% to 45% may be theoretically justified for tax reasons alone. These premiums arise because of non-neutralities in the impact of taxation on the returns to corporate shares and trust units. The drive to premium valuation is provided by arbitrage; investors bid up the price of a trust until it generates the same economic return as an after-tax corporate dividend. How high will depend on the tax status of the investor, and the final price impact will be determined by the collective views of all investors. Non-neutralities differ across the three investor groups – the taxable investor, the tax-deferred investor, and the non-resident investor.

(a) **Taxable Investors -** From a taxable investor's viewpoint (an investor subject to taxation in the current period), a premium is warranted to the extent that double taxation is paid on corporate dividends and avoided through the trust structure. The same $100 of pre-tax income in the corporate and trust structures provides $44 after tax to the top marginal tax rate shareholder compared to $54 to the top marginal tax rate unitholder, a 23% advantage for the trust. Of the $56 in taxes paid under the corporate structure, $10 represents the "double taxation" of dividends. The price per unit of the trust is bid up relative to the share price to equalize expected after-tax returns on the investments.

The RBC Capital Markets analysis estimates the trust valuation premium from the perspective of taxable investors at between 22% (Alberta and Ontario) and 28% (BC). The extent of double taxation will depend on the interplay of federal and provincial income tax rates.

(b) **Tax-Deferred Investors -** From the tax-deferred investor's viewpoint, the distributions of the trust will exceed the after-tax corporate dividend by

[4] RBC Capital Markets *"Income and Royalty Trusts: The Trust Valuation Premium – A Theoretical Perspective"* December 15, 2004.

the amount of corporate tax paid. Tax-deferred investors will arbitrage valuations until trust cash distributions generate the same economic return as dividends after corporate tax. For the same $100 of pre-tax income in the corporate and trust structures, the tax-deferred shareholder receives $64 while the tax-deferred unitholder receives $100, a 56% advantage for the trust. The RBC Capital Markets analysis estimates that for a fully taxable corporation, the trust value premium can be as much as 50% to 60%, depending on the combined federal and provincial corporate income tax rate. This is much larger than the taxable investor premium of 22% to 28%.

(c) **Non-Resident Investors** - A third set of investors which has become increasingly important is the non-resident investor. The non-resident investor is often subject to only withholding tax on income trust distributions at a rate of 15% for a treaty country. Using the same analysis as above, the tax advantage of the income trust structure over the corporate structure in this situation works out to a valuation premium of 56%.

IMPACT ON TAX REVENUES

19. Impact on Tax Revenues

A major concern of the government is the potential loss of tax revenue due to increased participation by tax-deferred investors in the FTE markets. The loss of current tax revenue arising from tax-deferred investors is primarily one of tax deferment – pension and RRSP recipients eventually pay income taxes on the value of the funds withdrawn (including income and capital gains earned within the plans), and possibly at higher tax rates than corporations pay. It is an open question whether this represents a loss or a gain in present value terms for the government. On a current basis, however, there is a greater likelihood of a revenue shortfall.

20. Effect of Tax-Deferred Investors

Some commentators have argued that the tax losses arising from tax-deferred investments in FTEs are not of concern since the taxes will eventually be collected. In fact, depending upon the assumptions made[5], it is possible to show that there will be a present value gain to the government from FTEs. It has also been argued that the conversion of businesses from corporation to income trust can result in the disposition of assets and securities and the payment of significant amounts of current income taxes. Since governments must manage fiscal resources with a priority on avoidance of budgetary deficits, however, the loss of any current revenues, potential or actual, may be an issue. Moreover, this problem may become more pronounced in the future with increased participation of tax-deferred investors in FTEs. With concerns about unlimited liability now explicitly removed for unitholders in several provinces, the Department of Finance should expect to see additional institutional capital flow into the trust sector. Additionally, commencing December 17, 2005, Income Trusts will be included in the S&P/TSX Composite Index. Passive investors, or investors whose mandate it is to mirror the performance of this popular benchmark, may be required to allocate additional capital to the income trust sector.

21. Effect of Non-Resident Investors

Revenue loss in the case of non-resident investors is not only a cash problem; it represents a permanent revenue loss from the federal and provincial treasuries. Aside from withholding tax, capital gains on non-resident holdings are not generally subject to Canadian taxation either in the current period or in a future period.

[5] The most critical assumptions are the rate of return earned by the tax-deferred investor and the discount rate used to determine the present value of the future taxes payable to the government

IMPACT ON THE CANADIAN ECONOMY

22. Impact on the Canadian Economy

A tax system that biases a company's decision in favour of a trust rather than a corporate structure through its impact on valuations has the potential to divert investment capital from more productive to less productive use. Inefficiencies can arise in several ways. Less efficient companies may convert to a trust structure to take advantage of the valuation premium and draw capital from more productive corporate enterprises. Further, inefficiencies also arise when companies better suited to the corporate structure for operations convert to an income trust.

In observing the recent trends in trust conversions, and the significant valuation gains that are realizable in today's markets through conversion, this may be a factor. If tax arbitrage is affecting the decisions of companies on how to structure, then the above-noted inefficiencies in the allocation of capital could have long-term negative implications for productivity and economic growth.

23. Productivity and Corporate Canada

The potential for a theoretical jump of up to 50% to 60% (or more realistic premiums of 35-45%) in share price on conversion to a trust creates an incentive difficult for the management of a company to ignore. Given the size of investible assets in Canada's pension fund industry, there is clearly enough funding available to support premiums of this magnitude for some of Canada's largest corporations. The above-noted concerns regarding inefficient allocation of capital take on added importance when applied to companies of this scale.

Tax-driven conversions of large Canadian corporations, however, have not yet begun to occur to any meaningful degree. Moreover, the conversion premium for any given corporate security will be much lower once the government has moved to reduce the prescribed corporate tax rate and dividend tax rate. Further, the reduction in the effective dividend tax rate to achieve neutrality for taxable investors would help deter large dividend-paying companies from converting to trusts. Finally, ongoing government scrutiny of the trust market should cause companies to proceed cautiously with conversions. The implication is that the government should be measured in its policy response and not risk cumulative policy error by moving at once through multiple policy actions.

ANALYSIS OF ALTERNATIVE RESPONSES

24. A Measured Response

The IDA recommends the government respond in a staged and gradual way so as not to further disrupt valuations in the trust sector. The IDA believes that overlaying corporate and dividend tax rate reductions aimed at reducing non-neutralities for the taxable investor with other measures to address non-neutralities faced by other investor groups, before the full effects of the initial measures are fully understood or factored into market pricing, could run the serious risk of additional market disruption. An excessive policy response could result in:

(a) overcompensating and exacting severe valuation losses for all FTE investors;

(b) collapsing a market for a viable investment vehicle that many Canadians, including retirees and individuals saving for retirement, rely upon for investment income;

(c) closing off an issuance avenue for companies suited to the trust structure and otherwise having limited access to public equity financing; and

(d) eliminating a viable exit strategy for private equity firms and institutional money managers.

The IDA therefore recommends a staged and gradual approach with initial measures followed by a monitoring period during which time the government can evaluate the impact on FTEs and market behaviour of the initial response and can assess the need for additional action. The remainder of this submission analyses the potential policy responses in greater detail.

25. Non-Neutrality

As noted above, the tax system is non-neutral with respect to distributed earnings of a corporation and earnings flowed through an income trust. The magnitude of the non-neutrality differs depending on whether the investor is taxable, tax-deferred or non-resident. The following table (the "Non-Neutrality Table") shows the various degrees of non-neutrality on the basis of the tax rate and other assumptions made in Part 3 of the Consultation Paper[6]. It is clear from the table that non-neutrality is considerably more pronounced with respect to tax-deferred investors and non-resident investors than taxable investors. What is not clear from the table, and is not directly observable, is what tax adjustments would be required to neutralize returns for all investors, and the impact of a given remedy across investor classes. For example, tax increases to achieve neutrality for tax-deferred investors may, through their valuation effects, create substantial losses for taxable investors. This underscores the importance of moving in a measured and incremental way to minimize the potential for market disruption.

[6] Among the assumptions, the corporation is assumed to be fully taxable and to have a comparable capital structure pre- and post-conversion.

Table 4: The Non-Neutrality Table

	Taxable Investor		Tax-Deferred Investor		Non-Resident Investor	
	Corporate Structure	**FTE Structure**	**Corporate Structure**	**FTE Structure**	**Corporate Structure**	**FTE Structure**
Entity revenue	$100.00	$100.00	$100.00	$100.00	$100.00	$100.00
Entity tax	$35.00	Nil	$35.00	Nil	$35.00	Nil
Distribution by entity	$65.00	$100.00	$65.00	$100.00	$65.00	$100.00
Recipient tax	$14.50	$38.00	Nil	Nil	$9.75	$15.00
Total tax	$49.50	$38.00	$35.00	Nil	$44.75	$15.00
After-tax cash flow to investor	$51.25	$62.00	$65.00	$100.00	$55.25	$85.00

26. Taxable Investors

The IDA believes that it is reasonable to expect the tax system to be neutral for taxable investors whether they invest in corporations or income trusts. This statement has a number of implications:

(a) The integrated effective tax rate on dividend distributions by public corporations to taxable individuals is currently approximately 10 percentage points higher than the integrated effective tax rate on income trust distributions to taxable individuals. In order to achieve neutrality for taxable individuals, the following approaches should be considered:

(i) The dividend tax credit could be increased in order to make the treatment of the two alternative investments more equal. For example, if the effective tax rate applicable to dividends was reduced to approximately one half of the current effective tax rate, the integrated effective tax rate on dividend distributions by corporations to taxable individuals would be approximately the same as the integrated effective tax rate on trust distributions to taxable individuals.

(ii) Alternatively, the basic corporate tax rate could be reduced. For example, if the aggregate federal/provincial corporate tax rate were reduced to approximately 25%, the integrated effective tax rate on dividend distributions by corporations to taxable individuals would again be approximately the same as the integrated effective tax rate on trust distributions to taxable individuals.

(iii) Some combination of the two above changes could be adopted.

It is significant to note that lower corporate tax rates and a more integrated personal and corporate tax regime are both consistent with the government's objectives for greater efficiency and competitiveness of our tax system.

(b) Eliminating or narrowing the return differential for individual taxable investors would also reduce, through a lower conversion premium, the incentive for businesses to convert from a corporation to a trust. Whether or not this will be sufficient to stem any acceleration of tax-exempt conversions from public corporations to trusts will only be clear after the passage of time.

In summary, the IDA recommends that the government reduce the after-tax return differential between corporate and trust investments for taxable investors through reductions to the tax collected from investments in corporations (either by an increase in the dividend tax credit or a reduction in the general corporate income tax rate or some combination of the two).

27. Non-Resident Investors

A second non-neutrality issue for FTE taxation concerns non-resident holdings. The Non-Neutrality Table indicates that there is no entity level tax paid in respect of income received by a non-resident investor from an FTE and thus the only Canadian tax payable is the 15% Canadian withholding tax. In the case of a US investor, it is likely that the 15% Canadian withholding tax will be the only significant tax payable. The US will generally treat the distribution as a dividend subject to US income tax at the rate of 15%. However, the 15% Canadian withholding tax will generally be creditable against the 15% US income tax so that no additional US federal income tax will be payable. This contrasts with the situation where a Canadian invests in a foreign FTE. For example, if the FTE is in the United States, distributions of business income by the FTE will typically be subject to both ordinary income tax and withholding tax so that the effective US tax rate will typically be 40% or more. A partial exception applies in the case of REITs. However, the applicable withholding tax rate in this situation is 30%. The normal reduction in the rate of withholding tax for residents of Canada is only applicable in the case of investors who are individuals. There is no reduced withholding tax rate for investors which are corporations or trusts. Thus, Canada's tax system has arguably fallen out of line with international norms.

Non-residents are significant investors in FTEs, holding $35 billion of the securities and accounting for 21% of oustandings, based on Finance estimates. The government should examine this issue carefully and consider policy changes to address the inequities. However, this issue is complicated. Depending on the technical approach adopted, it may require Canada to modify the treatment it has agreed to provide under a number of tax treaties. In addition, given the substantial non-resident holdings, any tax adjustments could have damaging impacts on foreign investment in the sector, and resulting large negative valuation effects on income trusts generally. The government should proceed cautiously in moving Canada’s tax system more in line with international norms in this area.

28. Tax-Deferred Investors

The third problem faced by the government with respect to FTEs is how to deal with the participation of tax-deferred investors. The following are some observations:

(a) Institutional tax-deferred investors[7], while not the predominant holders of FTEs, face return differentials that are sufficient to drive valuation premiums for corporations converting to trusts as high as 50% or 60%. These conversion premiums, and the considerable investment weight that institutions could represent, could result in the conversions of some of Canada's major corporations to trusts. This has not occurred as yet on a scale that would significantly undermine the government's tax base.

(b) There is a current revenue loss where tax-deferred investors invest in income trusts as opposed to corporations. As noted previously, this is not a debatable point. The IDA recognizes that the Department of Finance has a responsibility to protect the current tax base of the Government of Canada. In this regard, the government should monitor the impact of the initial corporate and dividend tax changes for a time sufficient to allow for full adjustment in the market. If at the end of the monitoring period the government has concluded that the changes are not sufficient to deter tax-induced corporate conversions and to minimize the risk of destabilizing revenue losses, then additional measures would be warranted.

(c) In the event further action is warranted by the government it is recommended that limitations be set on FTE holdings of tax-deferred investors. The IDA does not support the taxation of trusts. The following observations are made with respect to these two options:

[7] That is, tax-deferred investors other than RRSPs. Industry analysts have commented that individual investors (including RRSPs) account for as much as 70% of FTE holdings.

(i) The government could limit the FTE holdings of tax-deferred investors at a certain percentage of the total assets. The 2005 Budget proposed a maximum of 1% for the investments of a pension fund in FTEs. This proposal was subsequently withdrawn by the government in response to criticisms that the limits were too restrictive and inequitable in their treatment of tax-exempt investors. However, a higher maximum than proposed earlier could both accommodate a significant volume of private equity exit transactions by pension funds and deter potentially destabilizing future growth of institutional demand for FTEs[8].

(ii) The IDA does not recommend a refundable or creditable tax on income earned by an income trust. Such a tax could be developed as an expansion of the current Part XII.2 tax system. Part XII.2 tax is designed to put trusts which carry on a business on a similar footing with corporations.

This option has been rejected on the grounds that it would be too complicated a tax to design and risks exerting unnecessary and excessive damage to the viability of the trust market. Complications of this approach are as follows:

(A) Current Part XII.2 does not accommodate multiple tiers of entities. For example, suppose that a taxable individual is

[8] An alternative way to set a specified level would be to limit the total participation by tax-deferred investors in any single FTE to a certain percentage, say 10%. However, this would be a difficult concept to implement. The various ownership registration systems in Canada do not currently track the identity of investors other than non-resident investors. In addition, quite complicated provisions would be needed to address the situation of tax-deferred investors holding investments through intermediaries, such as mutual fund trusts. For example, tax-deferred investors may be significant investors in exchange-traded index funds (e.g., the S&P/TSX 60 Index Fund). If a particular exchange-traded fund holds units of an FTE, the FTE will not generally be able to determine the fraction of units held for the benefit of tax-deferred investors. Finally, the sanction for going offside should presumably be borne by the tax-deferred investors and not by the rest of investors. It is not clear how this could be done.

an investor in a mutual fund trust. There are also tax-deferred investors in the mutual fund trust. The mutual fund trust is conventional in the sense that it holds a portfolio of securities of other entities. One such entity is an income trust. In this circumstance, the refund or credit entitlement would need to be flowed through the mutual fund trust to the taxable individual (as well as to any other persons who should be entitled to the refund or credit). There is nothing in current Part XII.2 providing for such a flow-through. This is because current Part XII.2 operates largely as an anti-avoidance rule rather than a rule which is designed to actually raise taxes.

(B) A set of provisions would be necessary to deal with potential abuses by persons entitled to a refund or credit as a result of investing in an income trust, but who have hedged in their investment by entering into some sort of transaction with a person not normally entitled to the refund or credit. These provisions would presumably be similar to the current provisions aimed at "dividend rental arrangements".

In summary, the IDA recommends that the government establish a monitoring period following the implementation of lower corporate and dividend taxation in which to evaluate the success of these measures and the need for further action. After a sufficient period is passed, and if further action is deemed necessary, it may be appropriate for the government to consider limitations on the FTE holdings of tax-deferred investors. These limitations would not apply to REITs and Energy Trusts. The IDA does not view the taxation of trusts as a viable policy option.

CALGARY
Suite 2300
355 Fourth Ave. S.W.
Calgary, Alberta
T2P 0J1
Tel.: (403) 262-6393
Fax: (403) 265-4603

HALIFAX
TD Centre, Suite 1620
1791 Barrington St.
Halifax, Nova Scotia
B3J 3K9
Tel.: (902) 423-8800
Fax: (902) 423-0629

MONTRÉAL
Bureau 2802
1 Place Ville Marie
Montréal, Québec
H3B 4R4
Tel.: (514) 878-2854
Fax: (514) 878-3860

TORONTO
Suite 1600
121 King St. W.
Toronto, Ontario
M5H 3T9
Tel.: (416) 364-6133
Fax: (416) 364-0753

VANCOUVER
Suite 1325
P.O. Box 11614
650 West Georgia St.
Vancouver, BC
V6B 4N9
Tel.: (604) 683-6222
Fax: (604) 683-3491

Ce rapport est aussi disponible en français sur demande.

The Investment Dealers Association of Canada is the national self-regulatory organization and representative of the securities industry. The Association's mission is to protect investors and enhance the efficiency and competitiveness of the Canadian capital markets.