

**Income Trusts — Finance Canada's January 2007 Update**

- A presentation by the federal Finance Minister kicked off the hearings on the proposed tax changes for income trusts scheduled by the House of Commons Standing Committee on Finance. The presentation updated much of the information from Finance Canada's September 2005 consultation paper.
- For 2005, Finance Canada reports that flow-through-entities' (FTEs<sup>1</sup>) earnings before interest, taxes, depreciation and amortization (EBITDA) totalled \$18.3 billion, with distributions of \$10.3 billion. For tax purposes, 77% of these distributions were characterized as ordinary income, 3% as taxable dividends and 20% as capital gains.
- In its September 2005 paper, the federal government estimated that its net revenue loss for 2004 from FTEs was \$300 million. For 2006, its updated estimate is \$500 million (top table), based on assumptions that Finance Canada considers conservative. Methodology for the 2006 estimate is broadly similar to the 2004 calculation, comparing tax revenues from FTEs to the estimated receipts if the FTEs were structured as corporations. The calculation involves a number of assumptions. For example, recognizing the close correlation between growth in FTEs' EBITDA and their average market capitalization in 2005, FTEs' earnings for 2006 were conservatively estimated by marking up 2005 earnings by 75% of the rise in average market capitalization as of October 2006. For 2006 revenues related to one-time capital gains from conversions, a 15% average increase in share prices is assumed, with one-third of the federal capital gains tax deferred to future years through instruments such as exchangeable shares. In 2006, \$69 billion of conversions and IPOs were announced. As of October 2006, only \$21.1 billion had proceeded, though this was considerably higher than the \$13.7 billion volume in 2005 and \$5.5 billion in 2004.

- Finance Canada once again highlights the considerable sensitivity of its revenue loss estimates to several underlying assumptions (bottom table). For example, if the effective corporate income tax rate is assumed to be one percentage point higher at 7.6%, and the share of FTEs held in tax-deferred instruments is raised from the assumed 38% to 50%, the estimated 2006 revenue loss jumps from \$500 million to \$920 million.

- The Finance Minister released letters from the Finance Ministers of British Columbia, Alberta, Manitoba, Ontario, Quebec, Nova Scotia, Prince Edward Island and Newfoundland and Labrador indicating their support for the Tax Fairness Plan and confirming their concerns about income trusts. A number of the letters specifically endorsed the proposed four-year transition period. Alberta has updated its estimate of the Province's annual

**FTEs' Estimated Impact on Federal Income Tax Revenues, 2006**

	Business Income Trusts	Energy Trusts	Limited Partnerships	Total
<i>\$ millions</i>				
<b>1. Taxes-FTE Structure</b>				
Paid by unitholders/partners	685	760	55	1,500
Paid by third-party lenders	105	45	25	175
<b>Total</b>	<b>790</b>	<b>805</b>	<b>80</b>	<b>1,675</b>
<b>2. Taxes-Corporate Structure</b>				
Corporate income tax (CIT)	675	730	75	1,480
Paid by shareholders	255	200	30	485
Paid by third-party lenders	155	135	20	310
<b>Total</b>	<b>1,085</b>	<b>1,065</b>	<b>125</b>	<b>2,275</b>
<b>Ongoing Net Impact (1-2)</b>	<b>-295</b>	<b>-260</b>	<b>-45</b>	<b>-600</b>
One-time capital gains tax*	100	0	0	100
<b>Total - 2006</b>	<b>-195</b>	<b>-260</b>	<b>-45</b>	<b>-500</b>

\* On conversions and IPOs in 2006. Source: Finance Canada.

**Sensitivity of Federal Revenue Loss Estimates**

Effective Fed.Corp.Inc.Tax Rate		Tax-Deferred Investors' FTE Holdings		
% of FTE		% share		
% of EBITDA*	Pre-Tax Profits	25%	38%	50%
<i>revenue loss, \$ millions</i>				
6.6	14.2	255	500	705
7.6	16.4	460	710	920
8.6	18.6	665	915	1,130
10.2	22.1	1,005	1,260	1,480

\* Earnings before interest, taxes, depreciation and amortization. Source: Finance Canada.

net revenue loss from income trusts to \$450 million from the \$400 million reported in its 2006 *Budget*. Quebec has estimated that if the conversions announced by certain large corporations prominent in Quebec had proceeded, its annual tax loss would have climbed to \$150 million. Newfoundland and Nova Scotia both referenced their concerns about income trusts as their energy sectors continue to develop.

- The Finance Minister reiterated his decision on a four-year transition period with no special treatment for energy trusts. He also referenced new tax reduction initiatives in the upcoming federal *Budget* and has committed to examining the current tax structure for any possible impediment to an income trust converting to a corporation under current income tax rules.

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<sup>1</sup> Includes publicly traded business income trusts, energy trusts and limited partnerships. Finance Canada estimates do not include FTEs that are U.S. businesses.

## Federal Guidance on “Normal Growth” for Existing Income Trusts ... Further Information on How the Tax Fairness Plan Will Be Implemented

Ottawa's guidelines for existing income trusts during the four-year transition period, covering permissible growth and several other key issues such as mergers and allowed restructuring, offer some flexibility. The bottom line, however, is the same — by January 2011, Ottawa intends to remove the tax system as a deciding factor in business organization. Positive for investors is the government's aim to remove any tax consequences for an investor of an income trust converting to a corporation.

The federal **Tax Fairness Plan** for “specified investment flow-through” (SIFT) trusts and partnerships defined a Distribution Tax on Canadian business income plus other income from non-portfolio properties equal to the federal general corporate income tax rate plus 13% for provincial taxes. This tax is effective immediately for new income trusts, but deferred to January 2011 for publicly traded trusts as of October 31, 2006 (see *Fiscal Pulse* report, *Ottawa's Tax Fairness Plan*). Ottawa's guidance starts to provide the details for existing income trusts to navigate through the next four years.

**Allowing significant growth** responds to the concern of existing trusts, particularly resource trusts with depleting reserves, that sustainable earnings may depend upon periodic equity issuance to help finance growth initiatives as well as occasional restructuring. Income trusts' flexibility is raised by making the safe harbour amounts cumulative. The Finance Minister also has indicated that an existing income trust wishing to expand faster than the guidance limits may take its case to Finance for approval.

**Ottawa's guidelines are also important for allowing mergers and supporting balance sheet restructuring.** There are, however, a number of issues still to be clarified, including details for limited partnerships.

**Ottawa remains committed to the strategy outlined in the Tax Fairness Plan**, and its key parameters such as the four-year length of the transition period. Finance is clear that it will continue to monitor market developments and take action if the intent of its *Plan* — to create a more level playing field for the taxation of business — is not advancing. *Concluding the guidance is the government's commitment to examine the current tax structure for any possible impediment to an income trust converting to a corporation under current income tax rules. If impediments are discovered, changes will be recommended to ensure that appropriate rules are in place to facilitate the conversion of a trust to a corporation.*

### Highlights of the Guidance

- ❑ **The benchmark against which growth of a SIFT trust or partnership will be measured** is defined as the SIFT's market capitalization at the end of trading on October 31, 2006, prior to the announcement of the *Tax Fairness Plan*. Market capitalization of a SIFT is defined as the market value of its issued and outstanding publicly traded units. It will not include options, other interests that are convertible into units of the SIFT or debt — either publicly traded instruments or any borrowing with a conversion right.
- ❑ **A SIFT will be able to issue new equity until December 31, 2010, without incurring the new Distribution Tax, if the issuance does not exceed the greater of \$50 million or a “safe harbour” amount.** The latter, from November 1, 2006, to December 31, 2007, is defined as 40% of the October 31<sup>st</sup> market capitalization benchmark, and for each subsequent calendar year, from 2008 to 2010, 20% of the benchmark. The annual safe harbour amounts will be cumulative, with the allowed issuance growing each year by the amount of unused room during the prior years. Thus over the four-year transition period, equity issuance could equal 100% of the October 31<sup>st</sup> market capitalization. The \$50 million annual caps are not cumulative.
- ❑ **New equity issuance is defined** as units, convertible debt or other equity-linked securities.
- ❑ **New equity issuance by a SIFT will not be considered growth** if it is to satisfy the exercise by another person or partnership of a right in place as of October 31, 2006, to exchange an interest in a partnership of a share of a corporation into the new equity of a SIFT.
- ❑ **With respect to debt**, replacing a SIFT's debt outstanding as of October 31, 2006, with new equity, through a debenture conversion or otherwise, will not be considered growth, allowing a SIFT to strengthen its balance sheet. New non-convertible debt issued after October 31, 2006, will not be included in the safe harbour amount, but subsequent replacement of this new debt with equity will be deemed growth.

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## Ottawa's Tax Fairness Plan ... One Year Later, Addressing Income Trusts Again

Canada's federal government has introduced a basket of tax measures, titled "A Tax Fairness Plan", intended to remove the tax system as a deciding factor in business organization. Recognizing that income trusts are a valued retirement saving instrument, the Plan includes some compensating tax relief for Seniors.

**Finance Minister Flaherty, in introducing the Tax Fairness Plan, outlined the government's reasons for taking action on income trusts.** Over the past year, income trusts have continued to expand across Canadian industry, with two large telecom conversions currently proposed. The enhanced dividend tax credit announced by the Liberals in November 2005 to level the playing field between income trusts and corporate equities for taxable Canadian investors was a welcome reform, but demand for income trusts has continued unabated, with almost \$70 billion in new trust announcements to date in 2006. The Minister also cited the tax avoidance element in trust conversions, arguing that corporations must pay their fair share to avoid raising the tax burden on individuals and families. He indicated that several Provincial and Territorial governments had discussed this issue with him. And finally, the Minister stated that the trend towards income trusts is creating "an economic distortion that is threatening Canada's long-term growth". In constraining the expansion of income trusts, the government maintains that it is bringing Canada's approach back in line with its major trading partners, such as the United States and Australia that previously curtailed income trusts.

**The government estimates that the Plan will deliver \$570 million of net tax relief in fiscal 2006-07 (FY07), rising to \$1.02 billion in FY08 and \$1.545 billion by FY12.**

**The government intends to limit any circumvention of the proposed restrictions.** The Finance Minister indicated that details of the proposed measures will be altered, if necessary, to ensure that its policy objectives are met. If business structures or transactions are developed that frustrate the government's stated goals, immediate adjustments are promised. If an existing income trust attempts greater-than-normal expansion by raising disproportionately large amounts of capital, the government indicates that its decision to allow existing flow-through entities (FTEs) to enjoy normal growth through 2011 could be revisited.

**The recent escalation of income trust conversions underlined the Provinces' concerns with FTEs.** Currently, income received from an FTE by a non-resident

### Highlights of the Plan

- ❑ **A Distribution Tax** will be applied to the distributions of all publicly traded income trusts and limited partnerships, excluding flow-through entities (FTEs) that hold only passive real estate investments. The tax will begin in the 2007 taxation year for all trusts that begin trading after October 2006, and in 2011 for existing trusts.
- ❑ **The general corporate income tax (CIT)**, already slated to be trimmed from the current 22.12% (including the corporate surtax equivalent to 1.12 percentage points) to 19% by 2010, will be dropped a further half percentage point to 18.5% in January 2011.
- ❑ **For low- and middle- income seniors (65 years and older), the Age Credit** amount will be raised \$1,000 to \$5,066, retroactive to January 2006. The Age Credit will now be completely phased out when a senior's net income reaches \$64,043, compared with the previous \$57,377 phase-out level.
- ❑ **For pensioners, income splitting** will be allowed for all income qualifying for the existing pension income tax credit, starting in 2007.
- ❑ **The Distribution Tax will apply to specified investment flow-through (SIFT) distributions.** For FTEs, their income from businesses operating in Canada plus other income and capital gains from their non-portfolio properties will no longer be tax deductible. Instead this income will be taxed at the federal general corporate income tax rate plus 13% in lieu of provincial taxes. Ottawa will distribute the latter 13% tax to the Provinces based on an allocation methodology to be developed with them in the future. "Return of capital" for the investor will continue to reduce the unitholder's cost of investment. For taxable Canadian retail investors, the SIFT distribution will be taxed as an "eligible dividend" — grossed up by 45% and subject to the enhanced federal and provincial dividend tax credits. For tax-deferred plans such as pension plans and RRSPs, no tax will apply on the SIFT distribution. For non-residents, the non-resident "withholding tax" rate will apply.
- ❑ **Real estate investment trusts (REITs)** are excluded from SIFTs, recognizing their similarities to U.S. REITs and their unique role as collective real estate investment vehicles. A possible exception are REITs with seniors' housing and lodging segments.

<b>Simplified Comparison of Investor Tax Rates (%) for 2011*</b>				
	<b>Current System</b>		<b>Tax Fairness Plan</b>	
	FTE Income	Large Corporation Dividend	FTE: Non- Portfolio Earnings	Large Corporation Dividend
Taxable Canadian Investor	46	46	45.5	45.5
Canadian Tax-Sheltered Plans	0	32	31.5	31.5
Taxable U.S. Investor**	15	42	41.5	41.5

\* All tax rates as of 2011 for both entity- and investor-level taxes, assuming top personal income rate and provincial governments parallel the federal enhanced dividend tax credit.  
 \*\* Canadian taxes only; U.S. taxes will also apply in most cases.

Source: Finance Canada.

investor is subject only to a 15% federal withholding tax, and no tax revenue is received by the Provinces. For Alberta, with a large number of energy trusts, this was a particular concern. A second issue was that the Provincial distribution of corporate income tax revenues foregone through income trusts does not closely match the geographic pattern of income trust distributions taxed in the hands of Canadian taxable retail investors for some jurisdictions. Again, Alberta is the clearest example with its high proportion of energy trust activity relative to the trust investments of its population. In total, Alberta last spring estimated a \$400 million net revenue loss from income trusts. With the proposed BCE conversion, Quebec also faced a potential net revenue loss.

**For investors, income trusts have filled a gap in Canadian markets with respect to high-yield products.** Yet the tax revenue and economic impacts of this expanding sector have stimulated considerable debate. Dr. Jack Mintz has calculated that the net federal and provincial tax revenue foregone after the BCE and Telus conversions would have been \$1.1 billion annually. Different viewpoints also exist on the longer-term influence of income trusts on business investment, innovation and the global expansion of Canadian business. Finance plans to release the government's *Economic Plan for Canada* with its fall economic and fiscal update over the next few weeks.

<b>Estimated Revenue Impact of Proposed Tax Fairness Plan</b>							
	\$ millions						
	FY07	FY08	FY09	FY10	FY11	FY12	Total
<b><u>Tax Relief</u></b>							
0.5% CIT Rate Cut for 2011	0	0	0	0	180	725	<b>905</b>
Increased Age Credit	405	345	355	360	380	400	<b>2,245</b>
Pension Income Splitting	165	675	710	745	780	820	<b>3,895</b>
<b>Total Tax Relief</b>	<b>570</b>	<b>1,020</b>	<b>1,065</b>	<b>1,105</b>	<b>1,340</b>	<b>1,945</b>	<b>7,045</b>
<b><u>Less Increased Revenue</u></b>							
From Publicly-Traded FTEs	0	0	0	0	100	400	<b>500</b>
<b>Total Net Tax Relief</b>	<b>570</b>	<b>1,020</b>	<b>1,065</b>	<b>1,105</b>	<b>1,240</b>	<b>1,545</b>	<b>6,545</b>

Source: Finance Canada.