CIBC

CIBC WORLD MARKETS

ECONOMICS
www.cibcwm.com/research

Economic Perspectives

March 7, 2003

Avery Shenfeld (416) 594-7356

The Economic Benefits of Income Trusts

A recent Canadian Tax Journal article looked at investment trusts from a tax policy perspective, and argued for legislation that would impede the development of this growing and important segment of the Canadian capital market. In fact, Ottawa has shown no concern over these structures, and for good reason, as there are many benefits of the income trust structure for the Canadian economy and its productivity:

- Income trusts encourage the flow of investment capital to projects with solid rates of return, and correct a bias in the tax system that favors retaining earnings.

- Recent evidence demonstrates that low payout ratios tend to lead to poor profit growth for the market as a whole due to the inefficient use of retained earnings. Returning cash flows to shareholders, as is the case in income trusts, allows them to judge the best use of these funds in reinvestment decisions.

- Income trusts also help narrow a corporate tax gap between Canada and the U.S., consistent with other steps by the federal and provincial governments to address Canada's competitive position in attracting investment spending.

- The elements of tax policy that effectively shelter operating companies from corporate tax do not represent special treatment for income trusts.

- Government revenue impacts from reduced corporate income taxes are substantially offset by increased and accelerated personal tax collections.

The Economic Benefits of Income Trusts

Avery Shenfeld

Income trusts, a growing segment of the Canadian capital market scene, have attracted some notice from a public policy perspective. In a recent Canadian Tax Journal paper, Paul Hayward argues that "some form of legislative response will be necessary" to address what he views as "troubling questions" arising from their impact on the corporate tax base[1]. That perspective has in turn been cited in the media in challenging the tax-policy merits of income trusts.[2]

The good news for both the economy and investors is that the Canadian federal government doesn't seem to judge things that way. One media report cited a Department of Finance official confirming that Ottawa doesn't see trusts as a tax loophole or a drain on government coffers.[3] Indeed, the Department of Finance is reportedly moving to facilitate this market by recommending changes to allow income trusts to be qualified securities for lending under the Income Tax Act.[4] That, along with momentum to address concerns about whether trusts have the same limited liability characteristics as common equity, should improve their liquidity and pave the way for inclusion in benchmark stock indexes.

In fact, income trusts are in many respects no different than other financing forms in terms of their ability to shield investment flows from corporate income taxes. Moreover, they can be viewed as a partial solution to existing inefficiencies in the tax system, which fails to treat various flows of investment income on an equivalent basis and thereby distorts financing and investment decisions. Income trusts have encouraged higher payout ratios, and recent research points to the benefits of such payouts in allocating capital across the economy.[5] They also help narrow an existing tax gap that provides a disincentive to business investment in Canada relative to the US. Barring an unlikely, comprehensive restructuring of the entire corporate and personal-investment-income tax system that addresses all of these issues collectively, there are many reasons to leave the existing tax treatment for trusts in place.

Not-So-Special Treatment

At the personal tax level, there's really nothing particularly unusual about the treatment of investment returns from a trust. Income is taxed at the same rate as on income from other property. It does not typically benefit from the special tax treatment on dividends.

Some income trust payments are a combination of income and a return of principal, when they exceed that year's income of the trust. That can be the case since cash flows can be greater than income due to non-cash depreciation costs included in the latter. Such returns of principal are, of course, not subject to personal income tax, just as would be the case if one owned a laddered series of zero coupon bonds of different maturities, and each year received a mix of income and principal. If the trust units are later

[1] Hayward, Paul D., "Income Trusts: A Tax-Efficient Product or the Product of Tax Inefficiency," Canadian Tax Journal, Vol 50; Toronto; 2002.
[2] e.g., Lang, Amanda, Globe and Mail Report on Business, February 10, 2003.
[3] "New Trusts Aren't a Big Drain on Government Coffers," Toronto Star, January 25, 2003.
[4] Rubin, S. "Trust Changes Coming" National Post, February 13, 2003.
[5] Arnott, Robert D. and Clifford S. Asness. "Surprise! Higher Dividends = Higher Earnings Growth." Financial Analysts Journal. Jan/Feb 2003.

sold, the principal returned becomes part of the adjusted cost base for capital gains tax purposes, and any resulting capital gain is treated no differently than gains on other investments.[6]

Also a non-issue that is sometimes raised in the media is the fact that income trusts may be owned by non-taxable entities, such as RRSPs, RRIFs, and pension plans. (Indeed, once issues of limited liability are clarified, they will hold a particular attraction to such funds relative to other assets since non-taxable entities do not benefit from the favorable tax treatment on dividends.) In such cases, the income doesn't escape personal taxes; the taxes would effectively be deferred until the funds are tapped as retirement income. But that deferral is a well-established element of tax policy designed to enable Canadians to support themselves in their retirement, subject to the statutory limits on the total amount thus sheltered. In fact, holdings of income trusts in these portfolios will leave less room for other assets that will then lose their deferral from personal income taxes.[7]

The only real issue for tax policy arises in the way in which corporate income tax applies to income trusts. In essence, the operating company is financed in a manner that sees the bulk of its cash flow through to income trust shareholders without being subject to corporate tax. The income trust itself avoids tax by paying out most if not all of its net income to unit holders, through the deduction for interest payable to the trust. But this isn't really a special case applicable to income trusts alone. Rather, it is merely a consequence of the general tax policy that pertains to corporate debt.

Consider the case of a corporation that finances a new plant with a debt issue to the public, expecting that much of the pre-tax income from the new facility will be used to pay interest payments on that debt. Since interest payments are deductible as a cost for corporate tax purposes, much of the new plant's earnings-before-interest-and-tax (EBIT) will therefore not be subject to corporate income tax. Only the sums left over for equity holders would be taxable, with the bond interest payments, of course, still subject to personal income tax.[8] The only restrictions on the use of debt in this fashion is the "thin capitalization rule" that applies on foreign owned corporations, which could otherwise shift all of the EBIT to their home country for tax purposes.

The corporate tax-sheltering impact of income trusts largely works through this same mechanism, driven by the deductible status of interest payments. The shareholders in the income trust become, in effect, indirect holders of subordinated debt issued by the operating company, debt that in effect pays out nearly all of the EBIT earned by the company. Those payments are deductible for corporate tax purposes by the operating company, just as would be the case cited above.[9] What differs from a typical corporate entity is the higher degree of leverage obtainable due to the common ownership of the debt and equity of the operating entity by the trust, and therefore the extent to which the companies' pre-tax, pre-interest earnings are directed towards interest payments. Note, however, that during the heydays of the leveraged buyout era, companies used high-yield

[6] Haywood rightly notes that investment advisors should in this regard be advising clients of the distinction between such flows and net income in terms of judging the rate of return on income trust investments, and clarifying that they do not truly represent a tax free return on investment.

[7] As noted in Wilson, Thomas and Steve Murphy, Tax Exempts and Corporate Capital Structure: An Empirical Analysis. Working Paper 97-5. Technical Committee on Business Taxation.

[8] Where the bond is then owned by an individual. Where the bond interest is held in an RRSP or by a pension fund, the personal tax is deferred. Where a taxable financial institution, such as a bank, owned the corporate debt, it would be subject to corporate tax, but only on the spread between that debt issue and its marginal cost of funds.

[9] Similarly, in an oil and gas royalty trust, the operating company's shelter from corporate taxes is being provided by the standard deductibility of royalty payments that would still be the case if the royalty had been bought directly by an individual or, say, a pension fund.

debt financing to achieve very high degrees of leverage.

What is being avoided relative to companies financed through common equity is what's commonly termed "double-taxation," taxing the income at the corporate level, and again at the personal level in a tax on dividends. **Canada has already recognized that such double-taxation is a barrier to investment** by granting partial relief through the use of dividend tax credits, but this still leaves dividends more heavily taxed (at the combined corporate and personal level) than corporate interest payments.

Promoting Investment and Competitiveness

The purists in the economics profession would argue that a simplified, restructured tax system would be preferable: one that harmonized the aggregate corporate and personal tax on investment income, and eliminated the distortions between corporate and trust forms, and between interest and dividends. But that ideal world isn't a political reality, and in its absence, income trusts play a useful role. Within the current system, a move to alter the tax treatment of income trusts would run counter to Canada's interests in an era of increased global competition for investment and jobs.

That same issue has already been recognized in Ottawa's phased reductions in corporate income tax rates. But even with those rate reductions, **Canada is still at a tax disadvantage in competing for corporate activity.** Simply looking at the corporate tax rate misses differences in depreciation allowances and other factors that impact effective tax rates. A recent study found that, even after the phase in of recent tax reductions on business, Canada's 2006 aggregate effective tax rates on large corporate capital investments will still be much higher than in the US (22.2% vs 16.8%).[10] The same study showed that total taxes paid at the corporate and personal level combined are also higher in Canada than in the US.

While Haywood cites the fact that the US has greater restrictions on the use of similar structures (limited liability companies or "S corporations"), American policy is a moving target. The latest initiative from the Bush Administration is designed to eliminate double-taxation on *all* dividend flows by exempting them (or the capital gains arising when they are kept as retained earnings) from personal income tax. While the passage of the full exclusion is in some doubt, a Republican majority is likely to achieve a substantial sheltering of dividends from double taxation. The only difference is that the favorable treatment will be at the personal tax level, rather than on corporate taxes as is the case with income trusts.

Encouraging Efficient Capital Allocation

As a structure that promotes the return of investment income to shareholders, income trusts may also serve as a means of promoting effective management and the efficient allocation of investment capital. In the standard corporate structure, the company is given a tax incentive to retain earnings, since in doing so, it defers the personal tax on dividend income, allowing the shareholder to pay the tax on an associated capital gain much later on.

Management may also seek to retain capital as a means of promoting the importance of their position rather than as a result of superior investment opportunities. As Harvard's Michael Jensen put it, "The problem is how to motivate managers to disgorge the cash rather than investing it below the cost of capital or wasting it in organizational inefficiencies". That tendency, for example, underscored the poor performance of firms that have retained earnings for

[10] Chen, D and Mintz, J., "How Canada's Tax System Discourages Investment" CD Howe Institute; Toronto; January 2003. That comparison was made prior to the announced phase out of capital taxes, but the relative positions would still hold.

diversification rather than return them to shareholders.[11]

Where a project has a high immediate cash flow, with limited reinvestment needs, as is typically the case in income trusts, retention of the income might not be the best use of the funds.[12] Allowing shareholders to reassign that income elsewhere enhances the ability of the market system to allocate capital to its most productive use.

That not only shows up for individual companies, but also affects the performance of the overall economy. **A recent study by Robert Arnott and Clifford Arness found that periods in which US companies retained more earnings and reduced payout ratios have been associated with poor growth in corporate profits** over the subsequent decade. They note that the results are consistent with anecdotal evidence of management engaging in inefficient empire building with retained earnings.[13]

The demand for high payouts in income trusts also serves as an effective check on management spending decisions, encouraging the operation of the company in a lean fashion that maximizes the income stream for investors. That may be of particular benefit in encouraging savings and investment in the near term, given the distrust engendered by recent US corporate accounting and management scandals.

Moreover, **one lesson of the 1990s boom and subsequent bust in the equities market was that too much money was funneled into businesses plans with limited prospects for cash returns**. That left an overhang of unproductive excess capacity in communications and other tech sectors, capital that could have been better employed elsewhere. **Income trusts are a helpful reminder to markets in allocating capital to viable business plans, given the requirement for high cash payouts.** Note as well that the tax treatment of income trusts did not arise as a result of government policy to direct capital to a particular business sector, as has been the case in special incentives aimed at movies, scientific research, and the like, where economists have been critical of the implications for economic efficiency.

Costs to Government Overstated

Some raise the concern that these benefits of income trusts for the economy are coming at the expense of foregone corporate tax revenues, with an unsubstantiated figure cited in the media of a $1 bn revenue loss. That figure may have arisen by erroneously applying the corporate tax rate on all income trust distributions, some of which would not be net income for tax purposes.

But estimating the overall, integrated tax impact is much trickier than might appear on the surface. As noted in an earlier look at this issue, the net impact depends on the extent to which income trusts are substituting for equity or debt financings, since the latter provide a similar shielding from corporate tax. Many of the less-easily-quantified impacts work in the direction of making up some of the direct cost to government revenues from the loss of corporate income taxes.

As a case in point, the 64 publicly traded diversified industry income trusts[14] tracked by our analysts are forecast to pay out roughly $2.2 bn to investors this year, which at a typical 90% payout rate, would have been financed by some

[11] In The Cost of Diversity: The Diversification Discount and Inefficient Investment (NBER working Paper No. 6368), Raghuram Rajan, Henri Servaes, and Luigi Zingales find that the "excess value" of diversified firms relative to single segment firms is, on average, negative at -9.6 percent.

[12] Of course, there are sectors in the economy where maintaining the business requires considerable reinvestment, and where such reinvestment offers high rates of return. But those types of projects would then not be deemed suitable for conversion into an income trust structure.

[13] Arnott, Robert D. and Clifford S. Asness. "Surprise! Higher Dividends = Higher Earnings Growth." Financial Analysts Journal. Jan/Feb 2003.

[14] As opposed to REITs or energy trusts.

$2.4 bn in operating cash flow. Had that cash flow been earned by a typical non-financial corporation (rather than a trust), it would have been divided between taxable income, depreciation, and interest payments on corporate debt[15]. Statistics Canada data[16] on the ratio of income taxes to cash from operations for the non-financial corporate sector shows an average corporate income tax to operating cash rate of 26%. At that effective rate, the $2.4 bn in operating cash earned by income trusts would have generated some $630 mn in corporate income tax had the same activities taken place in a typical corporation.[17] In practice, that is likely to be an overstatement of potential corporate income tax collections, since income trusts are dominant in sectors that typically have higher leverage than average (and therefore greater interest deductions from EBIT), or have been used to take earlier leveraged buyouts public.

In any event, **take the calculations one step further and most of the government revenue cost disappears**. Because most of the payout of income is interest rather than dividends, income trust distributions are typically taxed at the full personal income tax rate,[18] rather than the lower effective rate that applies on dividends (after allowing for credits). Moreover, higher payout rates for trusts result in the government collecting more upfront tax payments.

For the total non-financial sector, dividend payments average 30.9% of cash from operations. Applying that rate to $2.4 bn in cash, at the top marginal rate of 31.3% (after allowing for the dividend tax credit), governments would reap roughly $230 mn in personal taxes on just under $750 mn in dividends, had the firms been financed by common equity. In contrast, the larger $2.2 bn in payouts from the same firms in an income trust structure will generate almost $920 mn in personal taxes, or nearly $690 mn higher than in the typical corporate case, based on the typical share (90%) of such distributions that are immediately taxable.[19]

Some of that additional personal income tax revenue would be deferred to the extent that these trusts are held within RRSPs or tax sheltered pension plans. In CIBC's client base, such funds account for about 30% of the total holdings. But even deducting those deferred taxes (under both the common equity and trust structures), income trusts will generate nearly a half billion dollars in additional personal income taxes relative to the same assets in a corporate form. That offsets most of the $630 mn in foregone corporate income tax revenues.

We cannot, however, claim to have modeled the entire aggregate tax difference between the two structures. The higher retention rate for corporate earnings in the common equity structure should in theory be associated with subsequent capital

[15] As noted above, that interest payment might have then represented an element in corporate income where the debt is held by a taxable corporation, but that firm in turn would have had a deduction for its own debt financing costs, and would in effect pay tax only on the spread.

[16] Statistics Canada, Quarterly Financial Statistics for Enterprises Our results for dividend pay-outs to cash flows are based on the full series available (Q2 1999 to Q3 2003). For the tax to cash ratio, we use only the most recent four quarters, due to changes in tax rates.

[17] That might be an overstatement of foregone corporate tax. Wilson and Murphy, op cit, note that some assets in income trusts were acquired from other entities that would have not been subject to corporate taxes, such as governments, pension funds and foreign entities.

[18] for sums that are in fact a return on investment rather than a return of principal.

[19] The remainder are almost entirely a return of principal, which reduce the deemed acquisition cost for the shares and which are therefore ultimately taxed as a capital gain when the shares are sold. A very small share (<5%) of distributions are treated as dividend income and eligible for the dividend tax credit, and these relate to income on equity sheltered at the operating company level by amortization of issuance costs. The figures cited are for diversified industry trusts. For REITs, only about 40% of distributions in 19 REITs tracked by CIBC World Markets are expected to be taxable income, some of which are capital gains, while for oil/gas royalty trusts, the group average is roughly 60%. While that reduces the extent of personal tax payments per dollar of cash distributed in these sectors, the foregone corporate tax revenue would also be lower since, in the case of REITs for example, the corporate entity would also have sheltered the cash flow through the same depreciation allowances that finance the return of principal flows to trust unit holders.

gains income for their shareholders, assuming the funds are used effectively. Those capital gains income taxes would be deferred until the shares are sold, and are subject to only a 50% inclusion rate for personal taxes. We have also not followed the downstream taxes on corporate interest payments made by a standard corporation.

But there are tax revenues attributable to income trusts that are similarly missing from these figures. First, to the extent that, in aggregate, the income trust structure offers a tax savings, it will raise the value of assets sold into the trust. The original owners of the company being turned into a trust would then receive a capital gain that will be subject to tax, albeit again potentially subject to deferral in some transactions. Second, the portion of distributions treated as a return of principal later forms part of the taxable capital gain when the units in the trust are sold. Third, the operating company in the income trust case may also carry some debt not provided by the trust, and we have not tracked the downstream taxes on the related interest payments.

To date, neither Ottawa nor the provinces have expressed any urgency to addressing the revenue implications of income trusts. We note, for example, that this issue was raised as far back as 1996-97 in work done for the Department of Finance by the Technical Committee on Business Taxation in its broad review of business tax policy. Indeed, any erosion of the corporate tax base through the growth in income trusts fits well within the general trend in Ottawa's fiscal policy since then, which has been to reduce its reliance on corporate income taxes in order to enhance Canadian competitiveness.

Finally, it's clear from recent developments that **income trusts have become an important vehicle for financing activity in the Canadian economy, in a period in which taking companies public through common share issues has been very difficult.** While income trusts will go in and out of favor like any other asset class, in a low interest rate environment in which common equities are struggling after major declines, they are clearly a useful substitute in ensuring that economic activity is not undermined by financing constraints.