

Déjà vu All Over Again – New Tax Regime for Income Trusts and Publicly Listed Partnerships

The federal Minister of Finance announced on October 31, 2006, a “Distribution Tax” on publicly traded income trusts and publicly listed partnerships. His aim is to discourage corporations from converting to income trusts and effectively force existing trusts to consider either restructuring or abandoning the income trust model. The announcement creates a new tax regime for publicly listed flow-through entities. It reflects a fundamental shift in the tax system and departs from the government’s earlier commitment to leave the tax rules for income trusts unchanged.

Despite its name, the Distribution Tax is not a direct tax on distributions. Instead, certain distributions will not be deductible to publicly traded income trusts and partnerships. These entities will be taxed on their non-deductible distributions, in effect as corporations (at a rate comparable to the general combined federal/provincial corporate income tax rate). These distributions will be taxed as taxable dividends to investors. Distributions to Canadian resident individuals will be deemed to be “eligible dividends,” qualifying for the enhanced dividend tax credit.

For trusts and partnerships that begin to be publicly traded after October 31, 2006, the new regime will apply starting in the 2007 taxation year. Other publicly traded trusts and partnerships will have just four years to adjust their business, operations, commitments, obligations, plans and strategies to the changes, because these entities will be subject to the new rules starting in the 2011 taxation year.

Draft legislation implementing the October 31, 2006 proposals has not been released. Therefore, more changes likely will be forthcoming to address technical and policy concerns. In particular, the announcement refers to potential changes that would deal with any alternative structures that emerge to frustrate the government’s policy objectives.

The Minister also announced that:

- the general corporate income tax rate will decrease by 0.5 percentage points, declining to 18.5% on January 1, 2011;
- the age credit amount will increase by \$1,000, reaching \$5,066, commencing 2006; and
- Canadian residents will be permitted to allocate up to one-half of their pension income to a spouse or common-law partner, starting 2007.

The changes affecting income trusts and partnerships are discussed in detail below.

Objectives of new regime

The federal government’s concern regarding the taxation of income trusts and other flow-through entities triggered the 2005 pre-election federal proposal that reduced personal income taxes on eligible dividends (i.e., dividends from large Canadian corporations). The October 31, 2006 announcement comments that, despite this change, the conversion of corporations to flow-through entities continues because of the tax advantage these entities offer to non-resident and tax-exempt investors. The new tax regime for flow-through entities is intended to stop this trend.

Highlights

The new regime is premised on the following rules:

- **Specified investment flow-throughs (SIFTs)** – The new regime will apply to SIFTs, which include certain publicly-listed income trusts and publicly listed partnerships.
- **Non-portfolio properties** – An entity can be a SIFT only if it holds non-portfolio properties, which are entities in which the trust or partnership holds a significant interest.
- **Real estate investment trusts (REITs)** – Under a narrow definition, REITs that earn passive income will not be subject to the new rules.
- **Non-portfolio earnings** – Non-portfolio earnings include income from businesses carried on in Canada, income from non-portfolio properties and taxable capital gains from dispositions of non-portfolio properties. A distribution of these earnings is non-deductible to a SIFT trust and subject to the new Distribution Tax.
- **Distribution Tax** – Non-portfolio earnings of a SIFT are subject to a new tax that equals the general federal corporate income tax rate, plus a 13% provincial tax.
- **Return of capital** – The new regime does not alter the tax treatment of amounts returned as capital by a trust.
- **Taxation of trust distributions and partnership allocations of non-portfolio earnings** – These amounts are taxed as dividends to investors.

Implications of new regime

The new regime creates important consequences for publicly listed flow-through entities and their investors. For example:

- **Distributions to unitholders** – Distributions from trusts and partnerships affected by the new rules will decline due to the Distribution Tax. While most taxable Canadian individual unitholders should be indifferent, given the availability of the dividend tax credit, the reduced distributions will be an absolute cost to other types of investors, such as pension funds, Registered Retirement Savings Plans (RRSPs), non-residents and lower-income Canadians who are unable to fully use the dividend tax credit.
- **Tax-exempt investors** – Despite being referred to as tax-exempt, investors such as pension plans and RRSPs are actually only tax-deferred. Accordingly, the proposals result in significant double taxation of SIFT distributions to these entities. The Distribution Tax applies and personal tax will apply when funds are distributed to beneficiaries of the pension plan or RRSP. As a consequence, large pension plans will have a strong preference to invest directly in private businesses (which can be structured as flow-through entities) over investing in publicly listed entities. This may create an incentive for pension funds to acquire and privatize income trusts.
- **Current and future tax accounting** – When the new rules are substantially enacted, trusts and partnerships will be required to account for income taxes and future taxes, just as corporations do. Financial statement earnings, distributable cash and various financial ratios will be significantly affected.
- **Debt covenants** – Debt covenants of trusts and partnerships based on distributable cash, financial ratios and other measures may have to be renegotiated. The Distribution Tax will reduce the lender's ability to access the entity's cash flow by more than 31%, placing the borrower in a substantially different position when renegotiating debt. Typical interest-only loan arrangements may be more difficult to renew even at reduced levels. To reduce debt levels, cash flow may be needed.
- **Deductibility of interest** – The rules do not limit the deductibility of interest. Canadian businesses may consider raising financing through a "new high-yield bond" instrument. As well, interest in income securities (a publicly listed unit comprising both equity and debt) may be renewed. The income securities structure appears to bypass the proposals, because it does not involve trusts or partnerships. Such a structure also provides a tax-efficient means of distributing U.S. income to Canadian investors.
- **Strategic and economic issues for existing entities** – When existing entities were established, the Distribution Tax was not anticipated. Therefore, their business strategies, tax planning and cash flow predictions must now be revisited. Despite concerns about the ability of trusts to reinvest and grow, many have done so. Now, however, their growth strategies may be difficult to pursue, if they are unable to raise new capital. Existing trusts will have to consider their options, which include doing nothing, restructuring

(perhaps back into corporate form), issuing debt directly to the public or privatizing.

- **Value of existing trusts and publicly listed partnerships** – The new rules will continue to depress the market value of existing flow-through entities, particularly as the 2011 effective date draws near. The reduced valuation will make these entities more attractive take-over targets, particularly for pension funds and foreign investors. It would be a perverse result if these proposals lead to further foreign takeovers of Canadian companies and the consequential loss of future tax revenues.
- **Exchangeable interests in subsidiary entities** – The implications to investors that hold exchangeable interests in subsidiary entities of a SIFT are not specifically addressed. Perhaps distributions on these interests will not be subject to the Distribution Tax. However, a footnote in the government's release suggests that such interests may be considered to be units of the trust if they derive their value from public trust units.
- **Alberta trusts** – Existing trusts that operate in Alberta may prefer to transfer their business operations into subsidiary corporations. The Alberta corporate tax rate of 10% is less than the 13% provincial component of the Distributions Tax.
- **Other tax rules required** – Some trusts may prefer to convert back into corporate form. In most cases, eliminating the trust would have associated tax costs. Given the government's stated policy intent, it would seem logical to provide a mechanism for a tax-deferred conversion of a trust back into corporate form.
- **Capital dividend account** – Because the new regime does not provide trusts and partnerships with a capital dividend account, these entities will be unable to distribute one-half of capital gains arising on the disposition of non-portfolio property tax-free. Under existing rules, such tax-free gains flow through trusts and partnerships.

Details of the new regime

Specified investment flow-throughs

In general, the new regime will apply to publicly listed income trusts (other than certain real estate investment trusts) and partnerships. These entities are referred to as "specified investment flow-throughs" or SIFTs.

An entity will be a SIFT if it meets all the following conditions:

- **Residency** –

Trusts*	Resident in Canada
Partnerships	<ul style="list-style-type: none"> • A "Canadian partnership," (i.e., all of its members are resident in Canada) • Central management and control are in Canada • Formed under the laws of Canada or a province <p>or</p> <ul style="list-style-type: none"> • Would be resident in Canada if it were a corporation

* Except certain real estate investment trusts, as discussed below.

- **Listing** – units must be listed on a stock exchange or other public market.
- **Holdings** – must hold one or more "non-portfolio properties."

Non-portfolio properties

An entity can be a SIFT only if it holds one or more non-portfolio properties. Non-portfolio properties include Canadian-resident corporations, Canadian-resident trusts or partnerships that meet any of the residence tests in the table above (referred to as "subject entities"). A subject entity will be a non-portfolio property if the investor (e.g., the public trust) holds securities in the investee:

- that comprise at least 10% of the fair market value (FMV) of all the investee's issued and outstanding shares or interests; or
- that together with securities held in entities affiliated with the investee have a FMV that exceeds 50% of the FMV of all issued and outstanding shares or interests of the investor itself.

Non-resident corporations, trusts or partnerships will also qualify as non-portfolio properties if their principal source of income is in Canada and either of these two tests is met.

For this purpose, securities are defined broadly and include not only shares and units, but also debts and other liabilities owing by the investee, rights to revenue or income and options to acquire a security of the investee. Liabilities and other obligations arising in the normal course of the investee's business are excluded.

Non-portfolio property also includes certain Canadian resource properties, timber resource properties and real properties, as well any property owned by the trust or partnership (or a person or partnership with which it does

not deal at arm's length) that is used in carrying on a business in Canada. These properties will be non-portfolio properties only if their total FMV exceeds 50% of the equity value of the investor (e.g., the public trust).

Real estate investment trusts

Certain real estate investment trusts (REITs) are excluded from the SIFT definition, and therefore are not subject to the new regime. This exclusion appears narrow and will not apply to all trusts that are ordinarily considered REITs. It will apply to REITs that earns passive income. Therefore, hotel REITs and retirement-resident REITs do not qualify for the exclusion.

Specifically, the REIT exclusion will apply if:

- the trust does not hold any non-portfolio property (other than real property situated in Canada) at any time in the year;
- at least 95% of the trust's income for the year is income from properties (from Canada or abroad, and including dividends, interest, rents and taxable capital gains from dispositions of real property);
- at least 75% of the trust's income for the year is from rents from, mortgages on, or gains from the disposition of, real properties situated in Canada; and
- the FMV of real properties situated in Canada, cash, debt or other obligations of governments in Canada held by the trust throughout the year is at least 75% of the REIT's equity value.

For this purpose, real property situated in Canada will include securities issued by any entity that itself satisfies these four conditions. Therefore, a REIT can hold its Canadian property through intermediary entities. However, real property situated in Canada will exclude depreciable property with a capital cost allowance rate that exceeds 5%.

Non-portfolio earnings

A SIFT trust is prohibited from deducting distributions relating to non-portfolio earnings and must pay the Distribution Tax on these earnings. Similarly, a SIFT partnership is required to pay the Distribution Tax on non-portfolio earnings. Non-portfolio earnings refer to:

- income from businesses the trust or partnership carries on in Canada;
- income from non-portfolio properties; and
- taxable capital gains from dispositions of non-portfolio properties.

However, taxable dividends that the trust or partnership could, if it were a corporation, deduct for income tax purposes, are excluded. These dividends will retain their character when taxed to the unitholder.

Distribution Tax

The non-portfolio earnings that a SIFT trust distributes or that are allocated by a SIFT partnership will be subject to a Distribution Tax. This tax consists of federal tax at a rate equal to the general federal rate, plus an additional 13% that will be distributed to the provinces. As a result, the applicable rate will be as follows:

	2007	2008	2009	2010	2011
Federal*	21%	20.5%	20%	19%	18.5%
Rate Additional	13%				
Total	34%	33.5%	33%	32%	31.5%

* All federal rates are enacted, except the 2011 rate, which was announced in the October 31, 2006 release.

Return of capital

The proposed rules do not change the tax treatment of a "return of capital" made by the trust. A return of capital will remain non-deductible to the trust and is not included in the unitholder's income. Instead, the amount reduces the unitholder's investment cost.

Taxation of investors

Under the new regime, both trust distributions of non-portfolio earnings and partnership allocations of non-portfolio earnings will be taxed as dividends to investors. The tax consequences to investors will be as follows.

		Tax treatment
Distributions and allocations to:	Canadian-resident individuals	Deemed to be "eligible dividends" eligible for the enhanced dividend tax credit
	Canadian-resident corporations	Deductible from the recipient's income
	RPPs, RRSPs, RRIFs*	Not taxed (nor will these "tax-exempts" be entitled to any refundable dividend tax credit)
	Non-residents	Subject to non-resident withholding tax

* Registered pension plans, registered retirement savings plans or registered retirement income funds

For more information

The new tax regime for publicly listed flow-through entities is complex and will have significant consequences for these entities and their investors. For help understanding the implications of the new rules, please contact your PricewaterhouseCoopers adviser or any of the individuals listed below.

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