



**Canadian
Association of
Income Funds**

**Analysis of Proposed
Budgetary Tax
Changes Related to
Non-Resident Taxation
and the Definition of
Taxable Canadian
Property**

REPORT

**Submitted by:
HLB Decision Economics Inc.**

August 12, 2004

HLB DECISION ECONOMICS INC.

RISK ANALYSIS • INVESTMENT AND FINANCE
• ECONOMICS AND POLICY

Canadian Association of Income Funds

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FOREWARD

In March 2004, HLB Decision Economics released the study "The Risk Analysis of Tax Revenue Implications of Income Trusts". This independently peer reviewed study was conducted by HLB on behalf of the Canadian Association of Income Funds (CAIF) and the Canadian Institute of Public and Private Real Estate Companies (CIPPREC). The question addressed was whether or not, income trusts represented a tax leakage to the federal government, and if so, how significant was the tax loss? HLB concluded that while significant uncertainty surrounds the issue, income trust conversions are not expected to result in tax losses to the government.

The question of the tax leakage arises because income trusts distribute all of their taxable income to unit holders, bypassing corporate taxes. If the tax generated on distributions were not sufficient to offset the foregone corporate taxes, then a tax loss would occur. Until the HLB study, there had not been any real examination of the corporate taxes companies paid prior to converting to the income trust. That information was critical to the understanding and calculation of the tax effects of income trusts to government revenues. CAIF and CIPPREC engaged HLB to conduct an independent, peer reviewed, rigorous assessment and end the speculation.

HLB examined the financial statements of the companies that converted to an income trust both before and after conversion. The study also incorporated other important considerations such as type of investor holding the share/trusts unit holders and whether or not these assets were held in taxable or tax deferred accounts. In the final analysis, the study concluded that while the trust structure changed the timing and the nature of the tax flows, it did not likely represent a net tax loss to the government. The 2004 Federal Budget contained a similar conclusion: "Currently, the impact on tax revenues is estimated to be modest because reduced tax revenues at the corporate level are largely offset by increased tax revenues at the unit holder level." The current study builds upon the model and analysis contained in the March 2004 study.

EXECUTIVE SUMMARY

The 2004 Federal Budget proposed several changes to the tax treatment of non-resident investments in mutual fund trusts. The stated rationale for these proposed changes is to ensure that non-resident gains on investments in Taxable Canadian Property (TCP) are treated consistently whether that investment is made directly or indirectly through a mutual fund trust. These changes have posed new challenges to the income trust industry in general and the royalty trust sector in particular. Many in the income trust sector have expressed concern about what these proposed changes would mean for the ability of the sector to raise capital. The changes are:

1. Non-residents will be subject to a withholding tax on distributions of capital gains and on capital gains dividends paid by mutual fund corporations if those gains are derived from investments in TCP after March 22, 2004;
2. Non-residents will be subject to a withholding tax on otherwise non-taxable distributions after January 1st 2005 in situations where the fund is listed and the value is attributable to real estate, resource and timber property located in Canada; and,
3. The Budget specifically included Canadian resource and timber property in the definition of TCP for the purposes of determining whether or not a fund qualifies as a mutual fund trust. Any resource property trust that currently has a majority of its holdings held by non-residents has until 2007 to reduce it.

The Canadian Association of Income Funds (CAIF) has retained HLB Decision Economics (HLB) to conduct an assessment of the tax revenue implications of these proposed budgetary changes as they pertain to the income trust sector. This study represents a follow-up on "The Risk Analysis of Tax Revenue Implications of Income Trusts" study, completed by HLB prior to the 2004 Budget on behalf of CAIF and the Canadian Institute of Public and Private Real Estate Companies (CIPPREC). This current study utilizes the model developed for that study as the basis for the analysis.

For this study, it was deemed imperative to update the financial data to reflect the latest available information for fiscal year 2003. There are three primary differences between the financial data and modelling approach relative to that used in the March 2004 HLB study:

- Mean estimates of total income trust EBITDA and distributions in 2003 are approximately 15 percent lower than that projected in the previous study. Differences by sector also exist;

- The current mean estimate of non-resident holdings is 24 percent based on the HLB survey. In the previous study, a mean estimate of 15 percent was used for all income trusts; and,
- The oil and gas industry has been segmented into two sub-groups in this study. The sub-groups are interlisted trusts and non-interlisted trusts. Currently six of the 27 oil and gas income trusts are interlisted.

Table 1: Non-Resident Holdings of Income Trusts¹,

Sector	% Non-Resident
Diversified Business	10.3%
Total Oil and Gas	37.9%
Non-Interlisted Oil and Gas	22.3%
Interlisted Oil and Gas	59.9%
REITs	6.8%
Other	10.0%
Total	24%

Source: HLB Survey

Study Findings

The findings provided below highlight the key points of the study. They examine the expected tax impact; the comparability of the current year impacts of the updated model with the original study; the additional revenue generated by the proposed withholding; and the net tax effect of increasing foreign ownership. The foreign ownership impacts are examined using three case studies. In every case study, except where specified, the proposed changes to non-resident taxes have been assumed to be in effect since January 1st 2004.

Comparison with March 2004

The updates to the parameter estimates do not result in statistically significant differences from the results contained in the March 2004 study. Overall, the mean expectation of a near zero net tax revenue impact in 2004 (when deferred taxes are considered) is upheld. In fact, the mean estimate of a net tax gain has increased by \$70 million from \$50 million to \$121 million. In addition, the mean current year tax loss is estimated at \$102 million, or \$115 million less than previously estimated. These results are summarized in Table 2.

¹ The non-resident proportions represent weighted averages weighted by income trust distributions. The figure contained in the Total Oil and Gas represents a weighted average of the interlisted and non-interlisted oil and gas trusts.

Table 2: Changes in Tax Loss Estimates (Mean Estimates \$Millions)

	Mean Estimates		
	Current	March 2004 Study	Mean Difference
Current year taxes	(\$102)	(\$217)	+\$115
Deferred taxes	\$223	\$268	(\$45)
Net tax impact Pre Budget	\$121	\$51	+\$70

Changes to Non-Resident Taxation

The proposed increases to withholding taxes on real estate and resource properties would result in an expected tax gain to the Canadian government of \$83 million in 2004. The effect of the proposed withholding taxes on distributions of capital gains is not significant, amounting to less than \$1 million. As a comparison, the federal government in Annex 9 of the 2004 Federal Budget estimates the revenues of the proposed changes to be \$55 million in 2005. That is half of the study's estimated impact of \$96 million in 2005, assuming 15 percent growth in the oil and gas sector.

Table 3: Tax Revenue Impact of Budgetary Changes (Mean Estimates, \$Millions)

Withholding taxes	Tax Revenue Impact 2004
Oil and Gas Interlisted	\$53
Oil and Gas Non-Interlisted	\$23
REITs	\$6
Distributions on Capital Gains	\$1
Total Withholding Taxes	\$83

Impact of Foreign Ownership

The assessment of the impact of foreign ownership of income trusts on tax revenues is evaluated from three distinct perspectives:

- 1) Non-resident investment replaces domestic investment pre and post conversion to a trust;
- 2) Non-residents reallocate investments in oil and gas corporations to oil and gas trusts. Canadian investments in oil and gas trusts are fixed at \$23.7 billion; and,

- 3) Non-resident investment in income trusts represents a net increase in foreign investment in Canada.

Scenario 1: Non-Resident Replacement

The replacement of Canadian investors by non-residents has three separate effects. All of which are shown in Table 4.

1. The first is that current year tax loss (as illustrated in Table 2) declines. This is a result of non-residents not being eligible for Canadian tax deferral plans;
2. The tax loss in future years rises, again because non-residents do not have access to Canadian tax deferral plans. This effect is proportionally greater than the first effect; and,
3. The proposed tax measures generate sufficient extra tax to offset the future tax losses and would have the advantage of being collected in the current year, at source and monthly.

Table 4: Effects of Increased Non-Resident Ownership on 2004 Results

Expected Tax Impact	2004 Expected Values 24% Non-Resident	Non-Resident Ownership level		
		29%	34%	49%
		Effect on Current Level		
Current Year	(\$102)	\$3	\$6	\$16
Future Years	\$223	(\$33)	(\$63)	(\$141)
Net Impact	\$121	(\$30)	(\$57)	(\$125)
Value of New Provisions				
New Provisions	\$83	\$97	\$111	\$154

Scenario 2: Non-Resident Reallocation in the Oil and Gas Sector

The reallocation model of non-resident investment indicates that oil and gas income trusts do not represent a tax leakage to the federal government but a tax gain. Pre budget withholding taxes on oil and gas trust distributions were sufficient not only to offset any current loss but in fact generated slightly more taxes in the model.² The new provisions only added to the federal tax gains provided by the trust structure. Therefore, the model indicates that from taxation perspective, publicly traded oil and gas trusts are superior to publicly traded oil and

² This conclusion is based on pre conversion data gathered by HLB on the taxes and dividends paid by the exploration and production companies that converted to trusts.

gas corporations. The model indicates the three separate effects and they are numerated in Table 5.

1. Current year taxes are increased;
2. Future year revenues are unchanged because the dollar amount of Canadian investment is fixed at \$23.7 billion; and
3. The new provisions only added to the additional taxes generated by the trust.

Table 5: Tax Impacts of the Reallocation of Non-Resident Investment in Oil and Gas

Expected Tax Impact	2004 Expected Values 38% Non-Resident Level in Oil and Gas	Non-Resident Ownership level in Oil and Gas Trusts		
		45%	50%	55%
		Altered Tax Impacts		
Current Year	(\$102)	\$(88)	(\$79)	(\$66)
Future Years	\$223	\$223	\$223	\$223
Net Impact	\$121	\$135	\$144	\$157
Value of New Provisions				
New Provisions	\$83	\$108	\$129	\$156

Scenario 3: New FDI

If the publicly traded income trust structure results in additional (non-resident) investment in the Canadian oil and gas industry, that otherwise would not have occurred, then the result is a net increase in taxes only.

1.0 INTRODUCTION

The 2004 Federal Budget proposed several changes to the tax treatment of non-resident investment in mutual fund trusts. The stated rationale for these proposed changes is to ensure that non-resident gains through investments in Taxable Canadian Property (TCP) are treated consistently whether that investment is made directly or indirectly through a mutual fund trust. Specifically, the proposed changes are:

1. Non-residents will be subject to a withholding tax on distributions of capital gains and on capital gains dividends paid by mutual fund corporations if those gains are derived from investments in TCP after March 22nd 2004;
2. Non-residents will be subject to a withholding tax on otherwise non-taxable distributions after January 1st 2005 in situations where the fund is listed and the value is attributable to real estate, resource and timber property located in Canada; and,
3. The Budget specifically included Canadian resource and timber property in the definition TCP for the purposes of determining whether or not a fund qualifies as a mutual fund trust. Now any resource property trust that currently has a majority of its holdings held by non-residents has until 2007 to reduce it to an acceptable level.

These changes have posed new challenges to the income trust industry in general and the royalty trust sector in particular. Many in the income trust sector have expressed concerns about what these proposed changes will mean for the ability of the sector to raise additional capital as:

1. The relative attractiveness of investing in this sector may have been reduced through increased levels of taxation on non-residents; and,
2. The limit on non-resident holdings in the resource sector will cap non-resident investments.

In addition to the market-based concerns, the industry is also concerned with practical issues such as how to ensure that a trust is maintained for the primary benefit of Canadians.

The Canadian Association of Income Funds (CAIF) has retained HLB Decision Economics (HLB) to conduct an assessment on the tax revenue implications of these proposed budgetary changes as they pertain to the income trust sector. This study represents a follow-up on "The Risk Analysis of Tax Revenue Implications of Income Trusts" study, completed by HLB prior to the 2004 Budget on behalf of CAIF and the Canadian Institute of Public and Private Real Estate Companies (CIPPREC). This current study utilizes the model developed for the previous study as the basis for the analysis.

The impact of these proposed changes on the income trust sector and its ability to continue to raise capital has not been quantified. In reviewing the available literature (academic journals, the federal budget, media coverage, etc.) on the topic, HLB was not able to uncover any analysis of the issue. In this analysis, numerous scenarios are assessed to provide a range of what the total tax revenue impact could be. HLB has also engaged an expert peer-review panel to elicit opinion on the soundness of the model logic and quantification from third-party experts³.

This report is divided into four sections. Section 1 provides a brief introduction. Section 2 summarizes the proposed budget changes. Section 3 provides a review of the underlying data and assumptions that have been updated from the previous CAIF/CIPPREC study. Section 4 provides the tax revenue implications of the proposed budget changes. Appendix 1 provides a summary of the current non-resident tax treaty rates. Appendix 2 provides a summary of foreign direct investment in Canada.

³ Whereas HLB is indebted to the third-party experts who provided review and comment on the analysis as it evolved and as presented here, responsibility for all models, data analysis, assumptions, findings and conclusions rests exclusively with HLB Decision Economics Inc. The third-party experts were: Mr. Brian Arnold from Goodmans LLP, Mr. Timothy Wach from Gowlings, and Professor Allan Maslove of Carleton University.

2.0 PROPOSED BUDGETARY CHANGES

Overview

The 2004 Federal Budget proposed several changes to the tax treatment of non-resident investments in mutual fund trusts. The stated rationale for these proposed changes is to ensure that non-resident gains through investments in Taxable Canadian Property (TCP) are treated consistently, whether that investment is made directly or indirectly through a mutual fund trust. This section provides an overview of the current situation, the proposed changes, the government's stated rationale and potential industry impacts.

Current Situation

Classification as a Mutual Fund Trust

There are two ways to be classified as a mutual fund trust under the Income Tax Act of Canada. The first is by holding less than 10 percent of the trust assets in Taxable Canadian Property (TCP). The second comes into effect if more than 10 percent of the assets are classified as TCP and states that a trust must not have been, "...established or is maintained primarily for the benefit of non-resident persons..."⁴. The precise point at which a mutual fund trust would be considered to be primarily for the benefit of non-residents has never been clarified. Failure to meet these classification criteria means that the business is not eligible for mutual fund trust status, which can result in a number of negative tax implications including:

- Units of the trust will likely be foreign property to pension funds and others subject to foreign property limitations;
- The fund may be subject to alternative minimum tax;
- The fund will be subject to a special tax under part XII.2 of the Income Tax Act; and,
- Non-residents will be subject to Canadian tax and additional reporting requirements.

Canadian resources and timber property are now specifically included as TCP for the purpose of determining mutual fund trust status and any trust that has more than 10 percent of these assets must now meet the second classification standard.

Non-Resident Taxation

Treaties between Canada and the home countries govern the taxation of non-residents. These treaties specify the types of income and applicable tax rates that Canada can apply.⁵ As a general rule, Canada reserves the right to tax income generated by productive assets located

⁴ The Income Tax Act section 132 (7).

⁵ The actual rates by country are specified in Appendix 1.

within the country. Presently, mutual fund trusts offer a very tax efficient means of investing in Canada. Income flows through the trust untaxed and is instead taxed in the investors' hands. In many cases this results in the non-resident investor receiving a more favourable tax treatment than it would have had in its corporate form. Specifically, prior to the 2004 Budget, distributions to non-residents that represented a return of capital were not subject to a withholding tax.

Proposed Changes

The Federal Budget of 2004 contains significant changes to the manner in which mutual fund trusts are to be structured and taxed. These changes can be broken down into two categories: classification of TCP and the taxation of distributions for non-residents.

1. The Classification of TCP:

- The Budget has a proposed amendment to the definitions of what is considered TCP. It proposes to explicitly state that all resource property (including timber) is to be classified as TCP for the purposes of determining mutual fund trust status.

2. Non-Resident Taxation:

- Gains on TCP are now to be tracked by all mutual fund trusts and accounted for separately. A withholding tax is to be placed on the distribution of these gains to non-residents, at the statutory rate of 25 percent, which may be subject to a reduction (usually to 15 percent) pursuant to the provisions of an applicable treaty. This will have the effect of reducing the amount of distributions that had been considered a return of capital and increase the proportion that will be taxable. A limited tax refund for capital losses is also proposed; and,
- A second and much more significant change has been proposed for the income from real and resource properties. All of the distributions from real and resource properties is to be taxed. That means that unlike the previous situation, return of capital distributions will now be subject to withholding tax, implying that the entire distribution from royalty trusts and REITs to non-residents will be taxed.

The Government's Rationale

Classification of TCP

The Canadian government views the explicit inclusion of resource⁶ properties in the definition of TCP as a clarification only. It was introduced to help guide mutual fund trusts in their interpretation and compliance of the mutual fund trust rules. Under the previous rules, there may have been a technical argument concerning whether or not assets held in a mutual fund trust were considered as TCP. If the assets were not classified as TCP, then the

⁶ Includes timber resource properties

level of non-resident ownership would never be an issue because the trust would never exceed the 10 percent threshold of TCP.

The government has always maintained that they have the right to tax income and gains on Taxable Canadian Property. They would further argue that any interpretation of the Income Tax Act that allows for the more favourable treatment of non-residents than is prescribed by the tax treaties is contrary to the purpose for which it was designed. They want to ensure consistent tax treatment for non-residents regardless of how those assets are held. The clarification of what is considered to be TCP, for the purposes of qualification as a mutual fund trust, ensured that all non-residents are treated consistently and eliminated ways to circumvent Canadian taxes.

Non-Resident Taxation

The stated rationale for the changes in the taxation of distributions to non-residents is straightforward and is as follows:

1. Ensure that gains on taxable Canadian property remain taxable. The change eliminated the ability to reclassify the gains on TCP into a form that avoids being taxed, thereby reducing the proportion of distributions that are classified as a return of capital and eliminating the resulting tax leakage; and,
2. The government rationale for the application of withholding taxes, to the entire distribution from real and resource properties, was to limit benefits to non-residents of income trusts as well as reduce any tax leakage

Impact on Trust Operations/Compliance

From an administrative perspective, the tracking of the gains on TCP should be relatively straightforward and have a minimal impact on operations. The compliance issues for the changes to Taxable Canadian Property rules are different depending on the nature of the trust. For trusts other than royalty trusts there will not have been a substantive impact. Non-royalty based trusts will continue to have to monitor their non-resident ownership as before and take the necessary action to limit that ownership as it approaches a majority share of the trust's units. That assumes that the assets of the trust would be considered as TCP. For royalty trusts, which have much higher foreign ownership levels, the issues are more complex.

Royalty trusts have generated a great deal of investor interest in the U.S. They offer very high yields on the investment at a time when there are very few alternatives available to U.S. investors seeking high yields. These favourable market conditions have resulted in high U.S. investor demand for the financial instruments. Approximately 38 percent of royalty trust units are owned by non-residents. However, the distributions of non-resident holdings are not uniform across the sector and segmentation into interlisted and non-interlisted trusts is required for a better understanding of the issue:

- Currently, non-interlisted trusts have on average only 22.3 percent of their units held by non-resident holders. This, however, does not ensure that they will never face the

situation where their level of non-resident ownership becomes a problem. Without a mechanism to control to whom the units are sold on the secondary market, they will always face that possibility; and,

- In general, the act of interlisting makes it much easier for U.S. investors to invest in Canadian trusts. That has been a mixed blessing as all the interlisted royalty trusts have a majority of non-resident ownership. They are now faced with a situation where they must bring their level of non-resident ownership down. If they do not manage to do that they will lose their mutual fund trust status in 2007, upon the expiration of the grace period.

Impact on the Income Trust Market

The impact on the royalty and real estate income trust sectors is possibly going to be pronounced as non-resident investors will see a significant decrease in their (pre-U.S. tax) return. The primary reason for this is the predominance of return of capital distributions in those sectors. In 2003, approximately 42 percent of oil and gas and 57 percent of REIT distributions were classified as a return of capital. For the average U.S. investor, the effective Canadian tax rate on all income trust distributions increases to 15 percent from 9 percent and 6 percent for the oil and gas and REIT sectors respectively. However, this may be used to offset some, if not all, U.S. taxes on this income.

The largest potential market impact from these budgetary changes comes from the specific inclusion of real property in the definition of TCP. It will force the interlisted oil & gas trusts to reduce the level of non-resident ownership by 2007. That reduction raises some serious questions for the oil and gas industry, in particular and the economy in general. They are as follows:

- Will the restriction on non-resident ownership limit oil and gas royalty trusts ability to finance growth?;
- Will it cause a reduction in the economic activity in the oil patch?; and,
- Will it negatively affect unit prices and returns to Canadian unit holders?

3.0 RETURN TO FIRST PRINCIPLES

The Model and Data

The analysis presented in this report utilizes as a framework the previous model developed by HLB for CAIF and CIPPREC. Many of the parameter values utilized in that model were based on financial data from the income trusts' annual reports for the 2002 financial year. For this study, it was deemed as imperative to update the financial data to reflect the latest available information. Key financial data was extracted from the 2003 annual reports of income trusts. In addition, as this study focuses on non-resident investment levels, the proportion of units held by non-resident investors by trust was collected through a telephone survey of the 118 income trusts studied. In addition to parameter updates, significant changes to the original model were required. Most notably, the oil and gas royalty trust sector has been segmented by interlisted and non-interlisted trusts.

Updated Parameter Estimates

Most of the financial parameter estimates have remained relatively consistent between 2002 and 2003. In particular the break down of distributions into interest, dividends and return of capital has remained very consistent. Much of the change that has occurred can be attributed to the new entrants to the income trust market in 2003 as financial data is now available for 118 eligible trusts compared to 89 previously. There are two primary differences between the 2002 and 2003 financial parameters:

1. Mean estimates of EBITDA and total distributions in 2003 are approximately 15 percent lower than that projected in the previous study, although the distribution of EBITDA by sector has changed; and,
2. Non-resident holdings were not segmented by income trust segment in the previous study. In this study, the market has been stratified by income trust segment. On average, the current mean estimate of non-resident holdings is 24 percent based on the HLB survey. In the previous study, the mean estimate was 15 percent for all sectors.

Table 6, Table 7 and Table 8 provide key 2003 updates to the parameter estimates in HLB's income trust model.

Table 6: Income Trust Sector EBITDA and Distributions (\$Millions), 2003⁷

Sector	EBITDA	Distributions	Dist./EBITDA
Diversified Business	\$1,454.3	\$1,191.6	81.9%
Total Oil and Gas	\$4,319.0	\$2,672.9	61.9%
Non-Interlisted Oil and Gas	\$2,788.5	\$1,564.3	56.1%
Interlisted Oil and Gas	\$1,530.5	\$1,108.6	72.4%
REITs	\$1,733.6	\$873.8	50.4%
Other	\$987.7	\$784.0	79.4%
Total	\$8,494.5	\$5,522.0	65.0%

Source: 2003 audited financial statements filed on the SEDAR website. www.sedar.com.

Table 7: Income Trust Sector Distributions by Type, 2003

Sector	% of Distributions by:		
	Interest	Dividends	Return of Capital
Diversified Business	72.5%	7.1%	21.4%
Total Oil and Gas	58.0%	0.2%	41.8%
Non-Interlisted Oil and Gas	61.6%	0.0%	38.4%
Interlisted Oil and Gas	52.9%	0.6%	46.6%
REITs	34.8%	7.9%	57.3%
Other	57.0%	10.0%	33.0%

Source: Distribution breakdown Div./Int./ROC retrieved from T3 filings on The Canadian Depository for Securities website. www.cds.ca.

Table 8: Non-Resident Holdings of Income Trusts, 2003 Distribution

Sector	% Non-Resident
Diversified Business	10.3%
Total Oil and Gas	37.9%
Non-Interlisted Oil and Gas	22.3%
Interlisted Oil and Gas	59.9%
REITs	6.8%
Other ⁸	10.0%
Total	24.0%

Source: HLB Survey

⁷ Distributions figure is taken from the financing cash flows in the 2003 audited financial statements. It is not necessarily the same amount as the distributions declared in 2003.

⁸ The 10% figure was chosen by HLB. The number of responses received for the Other category, which is comprised of power, pipelines and terminals, were insufficient to be considered representative of the true situation.

Derivation of Non-Resident Holdings' Estimates

Introduction

A trust with more than 10 percent Taxable Canadian Property cannot have a majority of its units held by non-residents and still maintain its status as a mutual fund trust. This particular requirement presents an interesting challenge to the industry because there is not any easy way to track non-resident holdings. At present, the most common way to proxy the degree of non-resident ownership is to request a report from the transfer agent. This report will break down the unit holdings by geographic area. However, there are some significant inaccuracies with this approach. Large brokerages like CIBC or RBC will show up with Canadian addresses and as having a significant number of units. The transfer agents report will not indicate, however, if residents of Canada in fact hold all of the accounts registered at the brokerages. The same is true for Canadian residents (snowbirds, etc.) who might deal with a broker registered in the U.S.

Determining the Degree of Non-Resident Holdings

The study was confronted by the fact that there was not any readily available centralised source of information on the degree of non-resident ownership. Therefore, HLB decided to conduct a phone survey of all the income trusts in the study to obtain that information. The survey results were weighted using the 2003 distributions.

Findings

The results of the survey are contained in Table 4. HLB achieved an overall response rate of 72 percent to the survey. The results for diversified business, oil and gas, and REITs are considered statistically representative. For those trusts, which did not respond to the survey, there did not appear to be any pattern that might explain their decision not to respond. However, for the other sectors the averages may not be representative of the true situation because of the limited number of responses. An analysis of the types of firms, which did not respond, did not turn up any pattern that might have skewed the results.⁹

⁹ It was pointed out by the investor relations' people at many trusts that the level of non-resident ownership is not a static figure. It can and does change quickly in response to changes in demand.

Table 9: Summary of Survey Responses

Non-Resident Ownership By Sector							
Sector	Num. of Trusts	Num. of Responses	Num. Who Track	Num. Who Do Not Track	Other	Num. of Trusts With More Than 20% Non-Resident	Average Non-Resident Ownership
Power	7	4	2	2	0	0	8.5%
Pipelines	5	3	1	1	1	1	27.0%
Terminals	6	2	2	0	0	0	2.6%
Diversified Business	52	37	20	16	1	3	10.3%
Total Oil & Gas	27	22	22	0	0	13	37.9%
Non-Interlisted Oil and Gas	21	16	16	0	0	7	22.3%
Interlisted Oil and Gas	6	6	6	0	0	6	59.9%
REITS	21	17	13	3	1	2	6.9%
Total	118	85	59	22	3	19	24.0%

Outside the oil and gas sector, the results indicate that the level of non-resident ownership is relatively low. According to the survey responses, all of the other sectors' averages are below a 10 percent level of non-resident ownership. It should be noted that both diversified business and the REIT sector do have trusts that are above the 20 percent level of non-resident ownership. The results are generally in line with the analysts' expectations, although the industry average of 24 percent is greater than the 15 percent estimate of non-resident ownership parameter used in the previous study.

A number of trusts do not track the figure at all. Almost half of the diversified business trusts surveyed do not track non-resident ownership. Some of the reasons for not tracking the level are given below:

- The most common reason given is that a minimal amount of non-resident ownership was expected;
- In a number of other cases, a majority of the trust was held by large Canadian shareholders, which precluded the possibility of the trust experiencing non-resident ownership issues; and,
- Also in some cases, the original owners retained a significant interest in the operation.

The survey's results give rise to the possibility that some of the income trusts may have significant retail non-resident ownership and not know it.

The survey results also confirmed that the issue of non-resident ownership is most significant for the oil and gas sector. However, at present it is only the six interlisted trusts, which have

a majority of non-resident ownership. The levels for each of these trusts are provided in Table 10.

Table 10: Non-Resident Holdings of Interlisted Trusts

Trust	% Non-Resident
Enerplus Resources Trust	64%
Enterra Energy Trust	70%
Pengrowth Energy Trust	53%
Petrofund Energy Trust	66%
PrimeWest Energy Trust	59%
Provident Energy Trust	60%
All Interlisted	59.9%

For oil and gas trusts, which have not been interlisted, non-resident ownership is still significant but does not currently represent a majority ownership. The average non-resident ownership is 22.3 percent for the non-interlisted oil and gas trusts.

4.0 ANALYSIS OF TAX REVENUE IMPACTS

This section provides a quantitative assessment of the tax revenue impacts of income trusts from many different perspectives. This includes:

- A re-evaluation of the March 2004 study results. Based on new research and the updated income trust data collected for this study, have the conclusions of the March 2004 study changed (i.e., under pre-budget rules)?;
- A determination of the annual tax revenue impact of the proposed budget changes;
- Determining if the absence of the proposed budget measures would lead to a significant erosion of tax revenues due to increased non-resident investments. The answer to this question depends on how the non-resident investment is manifested. Three distinct scenarios are considered where there are increases in non-resident investments without the proposed budgetary changes:
 - Capital from non-residents in income trusts ownership replaces investments by Canadian market participants. Canadian investments are shifted to other sectors in Canada;
 - Capital from non-residents leads to expansion of the income trust market in the oil and gas sector. This expansion represents a reallocation only of existing investments that otherwise would have been directed to Canadian corporations in that sector; and,
 - Capital from non-residents leads to expansion of the income trust market in the oil and gas sector. This expansion represents new capital inflows in to Canada since without the ability to invest in Canadian oil and gas income trusts; the capital would have been used in other countries.

For the analysis that follows:

- 2004 is the base model year for the purposes of estimating annualised tax revenue impacts;
- The estimates provided represent mean expectations; and,
- The Budget measures are assumed to be in place as of Jan 1st 2004¹⁰

¹⁰ The changes to the withholding on resource and timber property do not come into effect until 2005 but for comparability purposes with the original report, the changes were assumed to be in effect from the beginning of 2004.

Impact of Changes in Parameter Estimates on the March Study Results

The updates to the parameter estimates do not result in statistically significant differences to the results of the March 2004 HLB study. Overall, the mean expectation of a near zero net tax revenue impact in 2004 (when deferred taxes are considered) is upheld. In fact, the mean estimate of the net tax gain has increased by \$70 million from \$51 million to \$121 million. In addition, the mean estimated current year tax loss is \$102 million, or \$115 million less than that previously estimated. These results are summarized in Table 11.

Table 11: Changes in Tax Loss Estimates (Mean Estimates \$Millions)

	Mean Estimates		
	Current	March 2004 Study	Mean Difference
Current year taxes	(\$102)	(\$217)	+\$115
Deferred taxes	\$223	\$268	(\$45)
Net tax impact	\$121	\$51	+\$70

There are two factors that contribute most to the deviation in the mean estimates. The first is the additional tax losses associated with increased levels of non-resident holdings. The second is the reduced corporate income tax losses from the diversified business sector, which more than offset the tax losses.

Impact of Proposed Budget Measures

The increased withholding taxes on real and resource properties would have resulted in an estimated tax gain to the Canadian government of \$83 million in 2004. The \$83 million assumes that the withholding taxes were applied from January 1st 2004 and applies to survey's non-resident holding levels to the distribution. The effect of the increased withholding taxes on capital gains was insignificant and amounted to less than \$1 million. In 2005 the amount would be \$96 million assuming a 15 percent growth rate over 2004 and is almost double the government's own estimate of \$55 million for 2005¹¹.

Table 12: Tax Revenue Impact of Budgetary Changes (Mean Estimates, \$Millions)

Withholding taxes	Tax Revenue Impact 2004	Tax Revenue Impact 2005
Oil and Gas Interlisted	\$53	\$61
Oil and Gas Non-Interlisted	\$23	\$26
REITs	\$6	\$7
Capital Gains Distributions Withholding Tax	\$1	\$1
Total Withholding Taxes	\$83	\$96

¹¹ The \$55 million dollar figure is contained in Annex 9 of the 2004 Federal Budget.

Impact of Changes of Varying Levels of Non-Resident Ownership

It is methodologically important to define the non-resident investment alternative for modelling purposes. The true alternative for non-resident investments is debatable. Therefore, three distinct scenarios or case studies are assessed:

- Non-resident investments replace investments by Canadians in income trusts. Canadian investment shifts to other sectors in Canada;
- Non-resident investments increase the size of the Canadian income trust market. This expansion represents a reallocation only of existing investments that otherwise would have been directed to Canadian corporations in that sector (i.e., it leads to more income trust conversions); and,
- Non-resident investments in income trusts represent a net increase in, or new foreign investment in Canada. This capital would otherwise not have entered Canada (e.g., restrictions on the level of foreign investment in Canadian income trusts results in that capital not being invested in Canada).

Case Study 1: Non-resident investments replace investments by Canadians in income trusts.

In this scenario, the (pre-budget) tax revenue impacts of varying levels of non-resident ownership are assessed. Non-resident investment is assumed to replace Canadian investment in income trusts. The Canadian investment that was displaced is assumed to have occurred prior to conversion. It is presumed that non-resident investors took an interest in the pre trust companies and the tax impacts are assessed on the replacement being independent of the corporate structure. Canadian investment is assumed to have shifted into similar companies, which did not convert to trusts. The reference point or base case for this assessment is the current level of non-resident holdings and the figure comes from the survey. The survey levels of non-resident ownership contained in Table 8 were applied equally to diversified business, oil and gas, REITS and others pre and post conversion to a trust. The changes in non-resident ownership were then added or subtracted from each sectors initial amount. Table 13 summarizes the results of each of the changes.

Table 13: Case Study 1: Tax Revenue Impact of Varying Levels of Non-Resident Holdings (Mean Estimates - \$ Millions)

Impacts	Base Case	Deviation from the Base Case				
	NA	-10%	-5%	+5%	+10%	+25%
	Non-Resident Level					
	24%	14%	19%	29%	34%	49%
Current Taxes	(\$102)	(\$107)	(\$105)	(\$98)	(\$95)	(\$85)
Deferred Taxes	\$223	\$289	\$257	\$190	\$160	\$82
Pre Budget Net Tax Impact	\$121	\$182	\$153	\$92	\$65	(\$3)
Change From Pre Budget Base Case of Changing Non-Resident Ownership Levels						
Current Year	N/A	(\$5)	(\$3)	\$3	\$6	\$16
Future Years	N/A	\$66	\$34	(\$33)	(\$63)	(\$141)
Impacts as Compared to the Net Taxes in the Pre Budget Base Case						
Change in Non-Resident Level	NA	\$61	\$31	(\$30)	(\$57)	(\$125)
New Tax Provisions	\$83	\$57	\$69	\$97	\$111	\$154
Combined Effect of Non-Resident Changes & New Tax Provisions	\$83	\$118	\$100	\$67	\$54	\$29

This scenario illustrates two key points about the issues surrounding non-resident ownership and the new withholding taxes contained in the Federal Budget:

- The first is that increasing levels of foreign ownership actually improve current year tax revenues marginally, as non-residents cannot defer taxes. This is offset by a correspondingly larger reduction in the tax revenue expected in future years. The

overall effect is as the level of foreign ownership increases the net tax revenue decreases. For example, in the case where non-resident ownership is taken to be 25 percent higher than the survey values the effect is to cause trusts to have a negative \$3 million impact on the tax base as compared to if they were all still corporations; and,

- The second key point is that the new budget provisions resulted in significantly increased taxation. Adding an additional \$83 million to the base case and an increase of up to \$154 million in the scenario where the average level on non-resident ownership was increased by 25 percent.

The net effect of the new provisions contained in the Federal Budget is that the tax base is enhanced from the base case. Meaning that the new provisions are sufficient to offset any tax erosion caused by the increased non-resident levels.

Case Study 2: Non-resident investment reallocation increases the size of the Canadian income trust market.

This scenario is specifically targeted at the oil and gas sector. Several oil and gas trusts currently have a majority of non-residents unit holders. In this scenario unlike the previous one, a reallocation of non-resident investment is assumed. This reallocation does not change the level of non-resident investment in the oil and gas industry in Canada. Rather it represents a change in preferences where non-resident investment in oil and gas corporations is reallocated to oil and gas trusts.

The base case for this analysis is the current 37.9 percent non-resident ownership level in the oil and gas sector. The reallocation of non-resident assets into this side of the oil and gas industry increases the size of trust capitalization. The reallocation of non-resident investment does not have any direct impact on Canadian investments in oil and gas trusts. Therefore, the dollar value of Canadian investment remains the same (\$23,734 million) but the proportion of total ownership declines. Increasing increments of non-resident investment levels are analysed to evaluate their net effect on tax revenues.

Table 14: Tax Revenue Impact of Varying Levels of Non-Resident Holdings in the Oil and Gas Sector (Mean Estimates - \$ Millions)

	Base Case	Alt 1	Alt 2	Alt 3	Alt 4
Market Cap of Oil and Gas Trusts (\$Billions)	\$32,919	\$37,198	\$40,819	\$45,428	\$51,024
% Non-Resident Ownership	37.9%	45%	50%	55%	60%
Tax Revenues Impacts of Income Trusts (\$ Millions)					
Current Year	(\$101)	(\$88)	(\$79)	(\$66)	(\$51)
Future Years	\$223	\$223	\$223	\$223	\$223
Pre Budget Net Tax Impact	\$121	\$134	\$145	\$156	172
Change in Tax Revenues Impacts of Income Trusts (\$ Millions)					
Current Year	NA	\$13	\$24	\$35	\$50
Future Years	NA	\$0	\$0	\$0	\$0
Impacts as Compared to the Net Taxes in the Pre Budget Base Case					
Change in Non-Resident Level	NA	\$13	\$24	\$35	\$50
New Tax Provisions	\$83	\$108	\$129	\$156	\$189
Combined Effect of Non-Resident Changes & New Tax Provisions	\$83	\$121	\$153	\$191	\$239

There are two key findings that are apparent in the above table:

- The first is that pre budget withholding taxes on oil and gas trust distributions were sufficient not only to offset any current loss but in fact generated more taxes in the model.¹² That means that from the government's taxation perspective, the publicly traded oil and gas trust is superior to a publicly traded oil and gas company; and,
- The second is that the additional withholding taxes only increased the government's tax revenues from oil and gas trusts.

These findings are consistent with those in Table 11, which showed an overall improvement of the tax effect of income trusts versus the corporate form. It went from \$51 million to \$121 million being the estimated positive tax impact of income trusts before the budget provisions have been factored in. A portion of the \$70 million increase can be attributed to the survey and the fact that the model was modified to allow for sector specific non-resident ownership, thereby allowing the oil and gas sector to have a positive impact on the results.

¹² In the original study the taxes paid as a percent of EBITDA used in the model had a median value of 5 percent additionally, dividends were set at a minimum of 2.9 percent of EBITDA. In both cases these parameters were higher than estimates.

Case Study 3: Non-resident investments in income trusts represent a net increase in foreign investment in Canada. This capital would otherwise not have entered Canada.

This scenario is specific to oil and gas trusts. Taking the survey's level of non-resident ownership and applying it to the interlisted oil and gas trusts market capitalization, gives a figure of approximately \$1 billion in excess non-resident investment. If those investments are assumed to be new foreign direct investments in Canada that would not otherwise be invested in the country, then any restrictions on that investment would result in a decrease, in the overall level investment. Given the fact that it appears to be the act of interlisting by the six oil and gas trusts which has caused this excess investment, it may not be an unreasonable assumption.

Under such a situation, the impact is a net tax loss to the Government of Canada and a net economic loss to the Canadian economy. The numbers work as follows and do not reflect any potential indirect tax revenue gain associated with increased levels of economic activity:

- \$1 billion in market cap generated \$110 million in distributions from an oil and gas trust in 2003. Of that \$110 million 58 percent or \$63.8 million are taxable distributions under the pre budget rules;
- Applying a 15 percent withholding tax to that \$63.8 million generates an additional \$9.6 million in taxes; and,
- Under the new provisions where the entire distribution is subject to a withholding tax that figure rises to \$16.5 million in taxes.

It is apparent that if the trust structure is encouraging additional foreign direct investment then it is providing a net gain to current taxes.

5.0 CONCLUSIONS

The Canadian Association of Income Funds retained HLB Decision Economics to perform a study on the tax implications the changes contained in the Federal Budget regarding the taxation of non-residents in income trusts. The three Budget provisions were:

1. Non-residents will be subject to a withholding tax on distributions of capital gains and on capital gains dividends paid by mutual fund corporations if those gains are derived from investments in TCP after March 22, 2004;
2. Non-residents will be subject to a withholding tax on otherwise non-taxable distributions after January 1st 2005 in situations where the fund is listed and the value is attributable to real estate, resource and timber property located in Canada; and,
3. The Budget specifically included Canadian resource, and timber property in the definition TCP for the purposes of determining whether or not a fund qualifies as a mutual fund trust. Now any resource property trust that currently has a majority of its holdings held by non-residents has until 2007 to reduce it to an acceptable level.

The Study's Conclusions Are As Follows:

1) Withholding Taxes on Capital Gains

The expected impact of the withholding taxes on the distribution of capital gains is minimal. It is expected to generate less than \$1 million a year in additional revenue. Income trusts typically are mature businesses that are not expected to alter their assets and property often, precluding the possibility of significant capital gains.

2) Withholding Taxes on the Return of Capital

The withholding tax placed on real estate, resource and timber property will generate significant revenues for the federal government. It is estimated that if the tax were in place as of January 1st 2004, it would generate an additional \$83 million in taxes.

3) Definition of TCP

If the inclusion of resource and timber property as Taxable Canadian Property were introduced to mitigate tax leakages, it will not likely have the desired result.

HLB found that a publicly traded oil and gas trust is superior to the publicly traded oil and gas corporation from a taxation perspective¹³. In other words, oil and gas trusts do not represent a net tax leakage to the government. The calculations showed that two corporate

¹³ This conclusion is based on pre conversion data gathered by HLB on the taxes and dividends paid by the exploration and production companies that converted to trusts.

structures were almost equivalent from a taxation perspective, prior to the budget, with income trusts generating slightly more taxes than the corporations from non-residents. Once the budget measures regarding the withholding tax on the return of capital were taken into effect, the income trust generated significantly higher taxes from non-residents.

APPENDIX 1: NON-RESIDENT TREATY RATES

This table represents selected information taken from the Information Circular 76-12R5 entitled Applicable Rate Of Part XIII Tax On Amounts Paid Or Credited To Persons In Countries With Which Canada Has A Tax Convention. Immovable property, in this case, has the same meaning as real estate, resource and timber properties in the report. Multiple rates indicate that for different groups or investment types there are different applicable tax rates.

Country	Estate or Income Trust	Interest	Dividends Including Patronage Dividends	Immovable Property ¹⁴
Australia	15%	10%	5/15%	25%
Brazil	25%	15%	15/25%	25%
Chile	15%	15%	10/15%	25%
China	25%	10%	10/15%	25%
France	15%	10%	5/10/15%	25%
Germany	25%	15%	5/15%	25%
India	15%	15%	15/25%	25%
Ireland	15%	0/15%	15%	15%
Italy	25%	15%	15%	25%
Japan	25%	10%	5/15%	25%
Mexico	15%	10%	10/15%	25%
Netherlands	15%	10%	5/10/15%	25%
New Zealand	15%	15%	15%	25%
Russia	25%	10%	10/15%	25%
Singapore	15%	15%	15%	25%
Spain	15%	15%	15%	25%
United Kingdom	15%	10%	10/15%	25%
United States	15%	10%	5/15%	25%

The table is for information purposes only and is subject to change; for more specific and up to date information contact the Canada Customs and Revenue Agency.

¹⁴ Exact definition of Immovable Property contained in the circular “-Immovable Property- Payments made for the use of or the right to use real or immovable property including natural resources in Canada are subject to withholding tax at the rate indicated. The category also applies to timber royalties.”

APPENDIX 2: FOREIGN DIRECT INVESTMENT

The following table is from Statistics Canada and shows the largest sources of FDI in Canada, as well as, the largest beneficiaries of Canadian FDI.

Foreign Direct Investment Positions At Year End				
Direct Foreign Investment In Canada (Billions of Dollars)	2000	2001	2002	2003
United States	193.7	220.2	223.2	228.4
United Kingdom	24	26.5	27.6	27.1
France	37	31.5	31.3	31.6
Netherlands	15.3	13.7	14	15.3
Japan	8	7.9	8.9	9.7
All other countries	41.1	41.2	43.9	45.4
Total	319.1	341	348.9	357.5
Canadian Direct Investment Abroad	2000	2001	2002	2003
United States	177.9	190.5	197.1	164.9
United Kingdom	35.2	39.8	40.2	40.7
France	4.6	3.8	4.5	11.6
Netherlands	10.5	12	11.1	10.7
Japan	5.6	7	9.5	9.1
All other countries	122.7	145.8	167.2	162.1
Total	356.5	398.9	429.6	399.1