

# **Canadian Association of Income Funds**

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

Submitted by:

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## EXECUTIVE SUMMARY

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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 1<sup>st</sup> 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 Trusts<sup>1</sup>**

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 1<sup>st</sup> 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,

<sup>1</sup> 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.

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.

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

	Mean Estimates		
	Current	March Study	2004 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.<sup>2</sup> 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 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.

<sup>2</sup> 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.

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## 5.0 CONCLUSIONS

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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 1<sup>st</sup> 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 1<sup>st</sup> 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 perspective<sup>3</sup>. In other words, oil and gas trusts do not represent a net tax leakage to the government. The calculations showed that two corporate 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.////

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<sup>3</sup> 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.