



**Canadian Association
of Income Funds and
the Canadian Institute
of Public and Private
Real Estate
Companies**

Executive Summary

**Risk Analysis of Tax
Revenue Implications
of Income Trusts**

Submitted by:

HLB Decision Economics Inc.
Ottawa, Ontario

March 11, 2004

HLB DECISION ECONOMICS INC.

RISK ANALYSIS • INVESTMENT AND FINANCE
• ECONOMICS AND POLICY

1. EXECUTIVE SUMMARY

Background

The Canadian Association of Income Funds (CAIF) and the Canadian Institute of Public and Private Real Estate Companies (CIPPREC) jointly retained HLB Decision Economics Inc. to ascertain the effect of income trusts on governments' tax revenues. Previous studies and press reports give an array of estimates, ranging from virtually zero net effect to about \$1 billion in net annual "tax expenditures" (i.e., foregone governments' tax revenues). Ascertaining the true impact of income trusts on governments' revenues is a matter of properly representing the tax treatment of income funds; accounting correctly for the economic and financial behaviour of the various participants in the income trust marketplace; and accurately quantifying the various factors that enter into the appropriate economic and financial calculus.

HLB employed a four-step analysis process consisting of (i) developing a detailed computer simulation model of the income fund market; (ii) quantifying the factors that enter into the simulation model based on actual income fund transactions; (iii) eliciting opinion on the soundness of the model logic and quantification from third-party experts;¹ and (iv) employing the simulation model to estimate the impact of income funds on governments' tax revenues.

A core element of the HLB methodology is called "risk analysis." Risk analysis is employed in economic research when the values of the various factors that bear importantly on the accuracy of conclusions cannot be known with absolute certainty. Probabilities are assigned to such factors as a means of accounting explicitly for the risk of data imprecision. The simulation model then yields, in addition to the findings, the risk that different outcomes would actually be realized. Much as a weather forecast might foresee a dry day with a 10 percent probability of rain, this study gives the statistically best indication of the tax impacts of income trusts together with the quantitative significance (expressed in probability) of other possible outcomes.

¹ 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 of the University of Western Ontario; Mr. Oscar Belaiche of Dynamic Mutual Funds; Professor Vijay Jog of Carleton University; Mr. Sandy McIntyre of Sentry Select Capital Corporation; and Professor Allan Maslov of Carleton University.

Findings

Table 1 provides the statistically best estimates of the annual tax impacts of income trusts in the years 2002, 2003 and 2004. These results are separated into:

- Current year tax revenue effects of income trusts;
- Out-year tax revenue effects of income trusts (the value of future government tax receipts on personal income received in the current year); and
- Total impacts, combining both current year and out-year effects.

The statistically best estimate (the “mean” estimate) indicates that, by comparison to the tax yield associated with enterprises in their previous corporate form, the conversion to income trusts produced a small net gain in governments’ tax revenues in each of the three years (about \$51 million in 2004). If taxes associated with one-time transitional capital gains are excluded, the statistically best estimate represents a small tax loss to governments’ of about \$5 million in 2004.

Current Year Impact of Income Trusts on Governments’ Revenues

The statistically best estimates indicate current-year tax losses to governments in 2002, 2003 and 2004 of \$12 million, \$154 million and \$217 million respectively. This means that current year tax receipts from income trust distributions did not offset foregone corporate income taxes and foregone personal taxes from common share appreciation and dividends.

Although risk analysis indicates a possibility that governments forfeited more than the \$217 million in 2004 indicated by the statistically best estimate, the probability that the amount foregone exceeded \$560 million is less than 10 percent. There is also a small chance that government’s revenues actually increased as a result of income funds (by about \$72 million in 2004). The probability of this outcome is less than one-in-ten, however. In other words, tax receipts from income trust distributions will offset foregone corporate income taxes and foregone personal taxes from common share appreciation and dividends one out of every ten years.

Table 1: Annual Tax Impacts of Income Trusts (\$Millions), Mean Estimates

Tax Effect	2002	2003	2004
Current Year Tax Effects			
Taxes Under Corporate Structure			
Corporate Income Taxes	(\$461)	(\$826)	(\$893)
Taxes From Dividends	(\$20)	(\$39)	(\$45)
Taxes From Capital Gains	(\$139)	(\$262)	(\$301)
Downstream Interest Effects	(\$22)	(\$39)	(\$44)
Total Taxes Under Corporate Structure	(\$642)	(\$1,166)	(\$1,283)
Taxes Under Income Trust Structure			
Corporate Income Taxes from Trusts	\$71	\$139	\$151
Personal Taxes from Trust Distributions	\$404	\$754	\$859
One-Time Transitional Capital Gains	\$155	\$119	\$56
Total Taxes Income Trust Structure	\$630	\$1,012	\$1,066
Net Current Tax Impact	(\$12)	(\$154)	(\$217)
Present Value of Deferred Taxes			
Foregone Taxes Under Corporate Structure	(\$264)	(\$476)	(\$572)
Taxes Under Income Trust Structure	\$380	\$702	\$840
Total Value of Deferred Taxes	\$116	\$226	\$268
Total Net Impact	\$104	\$72	\$51

Note: Present values are calculated with a discount rate of seven percent.

Out-Year and Total Impacts of Income Trusts on Government Revenues

Income deposited into tax-exempt accounts creates governments' tax receipts in future years when investors make withdrawals from such accounts. An examination of enterprises that converted to the income trust form as of 2004 indicates that the value of future tax receipts on income from personal investments in these enterprises is estimated to have been \$572 million (see Table 1). Personal income tax on deferred income earned

by unit holders in the trust form of these enterprises, however, is estimated to have been \$840 million -- a \$268 million gain in tax revenues to governments.

When the out-year impacts of income funds are combined with current year effects, the statistically best estimate indicates a net tax gain to governments in 2002, 2003 and 2004. In 2004, the statistically best estimate represents the small net gain to governments of \$51 million referenced earlier.

When the risk is taken into account, the analysis indicates the possibility that governments did forfeit some tax receipts in 2004 due to income trusts. The probability that such losses exceeded \$409 million in 2004 is less than ten percent, however.