Draft Budget 2004 Legislation

Submission by

CANADIAN ASSOCIATION OF INCOME FUNDS

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CAIF CANADIAN ASSOCIATION OF INCOME FUNDS

L'ASSOCIATION CANADIENNE DES FONDS DE REVENU ACFR

Overview

This submission by the Canadian Association of Income Funds (CAIF) relates to the Finance Department's Draft legislation released on September 16, 2004 to implement certain measures from the 2004 Federal Budget.

It is our respectful submission that the Government has gone well beyond measures to address 'tax leakage' with its Budget and legislative proposals to cap foreign investment in income trusts. In fact, a new study by HLB Decision Economics shows that any issue related to 'tax leakage' is addressed by the Budget announcement of the withholding tax of all distributions to non-resident Unitholders of trusts. Following the Budget, all trust distributions paid to non-residents would be subject to a 15% withholding tax including return of capital distributions that are currently exempt.

The industry therefore submits that the series of measures taken to impose a 50% cap on foreign investment is not necessary to address the issue of 'tax leakage'. Taken together these measures represent a major shift of Canadian public policy governing foreign investment in the income trust industry. Above and beyond its stated goal of addressing 'tax leakage', these measures suggest the Government has made a decision that it wants to reduce U.S. or other foreign investment in income trusts, that U.S. investment will neither be welcomed nor permitted to grow in the future, and that these properties must be returned to Canadian hands.

Specifically, the industry has significant concerns about the following Budget and Draft Budget implementing legislation measures:

- A new 50% foreign investment restriction on income trusts was proposed. Trusts in violation of this cap as of the Federal Budget date of March 22, 2004 'that would otherwise cease on March 23, 2004, to qualify as a trust because of this proposal will have until January 1, 2007, to comply with the modified rule'. Where foreign Unitholders become in excess of 50% after March 23rd, 2004, those trusts have until January 1, 2005 to comply with the new foreign investment limit.
- The definition of Taxable Canadian Property would be changed so that resource and timber based trusts would be subject to caps on foreign investment through the 50% foreign ownership restriction.
- A new measure appearing only in the Draft Budget implementing legislation on September 16 and without any prior notice, changes the basic legal definition of Canadian and non-resident ownership. The current requirement is that a trust be established and maintained for the 'substantial benefit of Canadians' in order to maintain their mutual fund trust status. The new test is a 'Fair Market Value' test where the fair market value of all the issued and outstanding units of non-residents must not exceed 50%. This presents an unworkable challenge of tracking fluctuating market valuation on a daily basis against a fixed cap on non-resident investors. The legislation also provides no remedies for trusts to restore their status if the market value test is not met on a single day of trading.

- Restrictions on pension fund ownership in business trusts. (Currently suspended pending further consultations by the Federal Department of Finance).

In summary, the government has imposed a withholding tax on all distributions to non-resident investors in income trusts to address 'tax leakage' but then additionally imposed new foreign investment restrictions, a timeline for repatriation of units from the U.S. back to Canada, a 'fair market value' test to further restrict access to foreign investors, and a cap on pension fund investments in income trusts. Whether intentionally or not, the Government is substantially closing off major sources of capital funding for the income trust sector and sectors of the economy that rely on them.

The industry is further concerned that the Finance Department's well-established record of conducting deliberate, transparent and open reviews of these kinds of major public policy decisions was not observed in this case. The normal process of conducting dozens of major policy and technical consultations that the Department has undertaken on financial industry issues in recent years to ensure the best policy decisions are arrived at was not undertaken for these changes.

On behalf of the income trust industry, this submission urgently requests that the Government:

- **Withdraw those aspects of Budget 2004 that impose a cap on foreign ownership in income trusts;**
- **Withdraw those aspects of the Draft Budget legislation related to foreign investment restrictions including the imposition of the 'fair market value' test; and,**
- **Initiate a full public consultation process to provide a reasonable opportunity for all industry stakeholders and investors to be heard on these proposed major changes to Canadian public policy.**

Income Trusts and the Economy

The growth of the income fund sector in Canada has contributed significantly to Canadian capital markets in recent years. However, they are not a brand new development. Historically, royalty and income trusts were most often associated with the oil and gas and real estate sectors. However, in recent years a wide variety of industries are making use of this structure to the point where income funds accounted for over 80% of IPOs in 2003. The Toronto Stock Exchange reported the market capitalization of income trusts at $124.4 billion as of June 30, 2004.

The following types of income trusts are available on the TSX in Canada:

- Business Trusts
- Energy (Oil and Gas Royalty) Trusts
- Exchange Traded Funds (ETFs)
- Financial Capital Trusts

- Financial Split Share Corporations
- Financial Trusts / Structured Products
- Other Sector Income Funds
- Real Estate Investment Trusts (REITs)

Income trusts play a key role in the Canadian economy by:

- Helping to meet the capital requirements of major infrastructure and resource development projects. As an example, in the oil and gas sector, the flow of capital into royalty trusts is helping preserve Canadian development of our natural resources, enable efficient redevelopment of existing oil and gas fields, and contribute to increased productivity and longer reserve life.
- Assisting pension fund managers in meeting the funding requirements of mature pension plans.
- Providing cash flow to individual investors caught in a low interest rate environment.
- Attracting foreign investors to Canada in an environment of tremendously competitive global capital markets.

Access to Capital A Key Challenge

Accessing capital is a key challenge for Canadian income trusts. The Canadian capital markets can only absorb finite quantities of securities in any form. As an example of this challenge, today increasing amounts of capital are needed to develop Canada's oil and natural gas reserves and large-scale projects such as open-pit mining of oil sands and coal, as well as primary, secondary and tertiary recovery schemes. Oil and gas trusts also purchase many Canadian assets from foreign companies thus transferring the mind and management of these assets back into Canada. The experience of recent years in the oil and gas sector shows that where resource trust products are concerned, Canada cannot supply the capital needed to fully exploit our reserves over the long term. Therefore, the additional capital needed must come from foreign investors. The Canadian resource sector has a long history of foreign investment. Indeed the recent sale of the Governments' remaining shares in Petro Canada demonstrated that access to resident and non-resident investors is critical in today's capital markets. Moreover, the need for capital is not restricted to oil and gas trusts. Many other companies look to the market for financing growth and expansion projects in the business and income trust sector.

Income Funds Attract Investors to Canada

In an environment where global competition for investment capital is the greatest it has ever been, it is understandable that as a matter of public policy, Canadian Governments have made attracting investment to this country a high priority. Indeed in the recent Speech from the Throne, the Government indicated that 'promotion of trade and investment is the fifth pillar of the Government's economic strategy'.

Yet despite the challenge of competing for global capital, the income trust sector has successfully been attracting billions of dollars in new investment to Canada in recent years. From this standpoint, income trusts have been a solid Canadian success story.

Government Concern Over Tax Leakage

It is the industry's general understanding that the 2004 Budget measures came as a result of government concerns over 'tax leakage' through the non-resident ownership of income trust units. To address this concern, the Government chose to implement two separate measures in the Budget – a withholding tax measure and a foreign investment cap of 50%.

To address Government's concern with respect to 'tax leakage', CAIF commissioned a study by HLB Decision Economics Inc. to analyze the proposed Budget measures related to non-resident taxation. A copy of the HLB study is available from CAIF.

The main findings of the HLB study are as follows:

- The Budget 2004 measure to increase withholding taxes on the otherwise non-taxable portion of foreign distributions by income trusts would increase government revenues by $83 million in 2004.
- Tax losses due to increased foreign ownership are relatively minimal – the Budget 2004 measure to increase withholding taxes would more than compensate for that reduction.
- Withholding taxes on foreign owned trust units resulted in a net increase in tax revenue where non-resident investment shifted from oil and gas corporations to Trusts.

Conclusion from HLB Study

The Canadian Association of Income Funds respectfully suggests that the Federal Government did not have the benefit of comparable data to that contained in the HLB Study when putting forward the 2004 Budget proposals impacting income trusts.

The HLB study shows that any issue related to 'tax leakage' is addressed by the withholding tax on non-resident Unitholders of Canadian trusts. This measure is entirely sufficient to address Government concerns about 'tax leakage' and ensuring a level playing field between Canadian and non-resident owners of income trust units.

The industry therefore submits that the second set of measures imposing a cap of no more than 50% foreign investment in income trusts is not necessary to address the issue of 'tax leakage' and in fact runs contrary to the Government's stated goal of increasing investment in Canada.

Given this, our concern is that the Government has made a decision – without any kind of public policy review - to limit the growth and development of income trusts by reducing access to U.S. investors. These measures, if implemented, effectively say that U.S. investment will neither be welcomed nor permitted to grow in the future, and that income trusts must be returned to Canadian hands.

In addition, the manner in which the Government has chosen to act imposes dramatic and negative consequences on the income trust sector. It will severely impair the ability of players to raise new capital and keep investing in future developments that contribute to a stronger Canadian economy.

Draft Budget Legislation Imposes Unworkable Rules

Although not announced in the 2004 Budget, a further change to the basic ownership rules governing trusts was contained in the Government's Draft Budget legislation released on September 16, 2004.

Until the draft legislation was released, trusts were generally seen to be subject to a requirement that they be established and maintained for the 'substantial benefit of Canadians' in order to maintain their mutual fund trust status.

However, when the Draft legislation was released several weeks ago, the Department of Finance adopted – without advance notice – a different test - the Fair Market Value (FMV) test. Under this test, a mutual fund trust only keeps its trust status if the 'fair market value' of all its issued and outstanding units owned by Canadians does not exceed 50%.

Moreover, this FMV test must be met each and every trading day – so that a one day trade in units of a trust temporarily putting over 50% of 'fair market value' in non-resident hands - places that trust offside, meaning it loses its mutual fund trust status. There is no provision in the legislation for regaining the trust status. Clearly this legislative approach is unworkable in practice and in principle does not address the issue of 'tax leakage'.

Inadequate Consultations with Industry

The series of measures proposed by the Government establishing a new cap on foreign ownership of income trusts represents a major shift in public policy governing foreign investment in the sector, go well beyond addressing the issue of 'tax leakage', and will severely harm the sector's future growth and development.

We are very concerned that the Finance Department’s long and well-established record of conducting deliberate, transparent and open reviews of such major public policy decisions - particularly those related to restricting foreign investment in an important sector of our economy – was not observed in this case.

Recommendation

The foreign investment limits proposed in Budget 2004 along with Draft legislation released in September are no less onerous than the Department’s proposed cap on pension fund investments in the trust sector. We applaud the Government’s intent to submit the pension cap issue to an open public consultation process.

Given the far-reaching nature of the public policy changes proposed with respect to foreign investment in the income trust sector, we would consider it only reasonable that the Government submit these proposals to a similar, fair and open public consultation process as well.

On behalf of the income trust industry, this submission urgently requests that the Government:

- **Withdraw those aspects of Budget 2004 that impose a new cap on foreign ownership in income trusts;**
- **Withdraw those aspects of the Draft Budget legislation related to foreign investment restrictions including the imposition of the ‘fair market value’ test; and,**
- **Initiate a full public consultation process to provide a reasonable opportunity for all industry stakeholders and investors to be heard on these proposed major changes to Canadian public policy.**