

## DEPARTMENT OF FINANCE CONSULTATION PAPER ON TAX AND OTHER ISSUES RELATED TO INCOME TRUSTS AND LIMITED PARTNERSHIPS

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Earlier today, Canada's Department of Finance released its long-awaited consultation paper entitled "Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)". Given the explosive growth over the past five years in the use of income trusts and similar structures, the consultation paper will be of interest to anyone who is involved in the income fund sector including existing and potential income fund issuers, investors and myriad professional advisers.

The consultation paper does not contain any surprises for those familiar with these structures. That is, the paper is primarily an overview of income trust and limited partnership structures (referred to as "flow-through entities", or "FTEs") and a general discussion of the Canadian federal income tax treatment of them. It discusses the background of FTEs; provides a high level comparison of the tax treatment of (i) public corporations and their shareholders, and (ii) FTEs and their investors; describes briefly the use of FTEs in some foreign jurisdictions (Australia, United Kingdom and United States); explores economic efficiency issues related to FTEs (i.e., are they helpful, harmful or neutral to the development of economic activity in Canada); and discusses the all-important issue of tax revenue implications of FTEs and potential policy approaches in response to those implications.

The consultation paper clearly focuses on the tax efficiency that is realized through the use of an FTE and leaves the impression that the Department of Finance believes this is the primary, if not only, reason that the FTE structure has been popular with investors. This singular focus overlooks the discipline imposed on management by an FTE structure—namely, that cash generated by the business and not otherwise required to maintain the business is returned to the stakeholders on a monthly or, in some cases, quarterly basis. A reasonable argument can be made that this degree of discipline would not be achieved if, as some have suggested, the Canadian tax system were revised to eliminate the impact of double taxation of corporate income, since management would not be under any obligation to pay out excess cash as dividends to shareholders and would be able to use, or misuse, that cash to develop new businesses or make other investments.

The key question on everyone's mind is the quantification of tax revenue lost to the federal (and provincial) government as a result of the growing use of FTEs. On this point, the consultation paper provides some guidance, but leaves open many avenues of debate and difference. The Department of Finance's best estimate appears to be a federal revenue loss in 2004 of \$300 million. Relatively modest changes to key assumptions, however, can produce a range of estimates from a revenue gain of \$230 million to a revenue loss of \$1.2 billion. It is somewhat comforting to see that some of the wilder estimates of revenue loss have not been given credence in the consultation paper. Nevertheless, it is important for interested parties to pay attention to this key issue and provide whatever input they can through the consultation process.

Taxation revenue loss is not the only issue of interest to the Department of Finance. The consultation paper also seeks input on a number of other key questions including these:

- Does the tax advantage of FTEs relative to public corporations have a significant impact on the way businesses are organized in Canada?
- What impacts are FTEs having on investment decisions and the allocation of capital in Canada? Is the overall impact on the economy positive or negative?

- Given the important role that tax-exempt investors play in Canadian capital markets, and could play in the FTE market, what impact could changes to this market have on government revenues and economic efficiency?
- Overall, are there public policy concerns about FTEs and how the tax system influences their existence, and if so, what actions should be considered to deal with these concerns?

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The consultation paper and related materials are available from us and on the Department of Finance's website at

[www.fin.gc.ca/news05/05-055e.html](http://www.fin.gc.ca/news05/05-055e.html)

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