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Minister of Finance announces decision to postpone issuing advance tax rulings on income trusts pending outcome of consultations

On September 19, 2005, the Minister of Finance announced that, effective immediately, the Canada Revenue Agency has postponed issuing any advance tax rulings with respect to income trusts and other flow-through entity structures pending the outcome of the recently announced consultations (described below) and until the Federal Government announces what measures it may take.

The announcement included the following statement:

“We launched consultations because of our concern about how the increased use of this type of business vehicle may affect economic growth”, said Minister Goodale. “We have a viable and productive corporate sector that invests, creates jobs and contributes its fair share of tax. I want to make sure that government tax revenues are appropriately safeguarded, but even more importantly I want strong and vibrant Canadian enterprises of all sizes in all sectors contributing to a dynamic and growing economy.”

The Minister went on to say that, while the consultations are underway and until the Government announces what action it may take, it would be inappropriate for the Government to issue advance tax rulings on these matters.

Although most corporations do not seek advance tax rulings to become income trusts, the September 19th announcement still resulted in large declines in the stock prices of corporations that had previously announced that they intended to convert into income trusts or which are seen as prime candidates for such conversions. The announcement initially did not have a material effect on unit prices of existing income trusts, but price declines did occur within a few days of the announcement.

The Consultations

On September 8, 2005, the Department of Finance issued its consultation paper (the “Consultation Paper”) on tax and other issues related to publicly listed income trusts and limited partnerships. The Consultation Paper, which can be found on the web at <http://www.fin.gc.ca/news05/05-055e.html>, launched the consultation process promised by the Federal Government in the 2005 Budget in response to the continued growth of income trusts in Canada.

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The Consultation Paper focuses on the tax and economic efficiency implications of flow-through entities, or FTEs, and whether the current tax system is appropriate or should be modified in response to the increasing prevalence of FTEs. The Department of Finance estimates that the use of FTEs resulted in federal tax revenues being \$300 million lower in 2004 than they would have been if FTEs were structured as corporations, but the Department of Finance acknowledges that this estimate is very sensitive to certain key assumptions including the proportion of FTEs held by tax-exempt investors. The Consultation Paper also reviews the taxation of FTEs in the United States, the United Kingdom and Australia and notes that, with certain limited exceptions, FTEs are taxed as corporations in those countries.

In addition to the effect of FTEs on tax revenues, the Department of Finance also is seeking input with respect to the impact of FTEs on economic efficiency. In particular, the Consultation Paper asks whether the preferential tax treatment afforded to FTEs distorts structuring and investment decisions thereby reducing economic efficiency.

Scope of Consultations

Specifically, the Department of Finance is seeking input on a number of key questions, including:

1. Does the tax advantage of FTEs relative to public corporations have a significant impact on how businesses are organized in Canada?
2. Have FTEs had a significant impact on tax revenues? Is there potential for revenue losses to grow in the years to come?
3. 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?

4. Given the important role tax exempt investors play in Canadian capital markets, and could play in the FTE market, what impact could this have on government revenues and economic efficiency?
5. 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 address these concerns?

The Consultation Paper does not raise any new issues or policy concerns nor does it include any specific proposals. A number of policy responses are offered for consideration, however, including possibly limiting the deduction of interest expenses by operating entities, taxing FTEs in a manner similar to corporations or better integrating the personal and corporate income tax system.

Consultation Framework

Interested parties may make written submissions to the Department of Finance on or before December 31, 2005. Additionally, the Canadian Tax Foundation will be hosting symposiums as another vehicle for public input.

For further information or assistance in making a submission, please contact:

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