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Business income trusts

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Business Income Trusts

James A. Hutchinson, "Department of Finance Places Restrictions on Business Income Trusts" pp. 466-469.

Our Strategic Summary

The Federal Budget was released by the Department of Finance on March 23, 2004 (the "2004 Federal Budget"). Among the changes aimed at the investment fund community were the restrictions on pension funds investing in business income trusts. The proposals are designed to curb the perceived erosion of the federal tax base if pension funds, that are tax exempt, begin investing in business income trusts on a large scale.

Although the business income trust has been a popular financing mechanism in Canadian capital markets over the past few years, the structure and the objectives of an income trust are not a recent development. The business income trust has its origins in the royalty trusts in the resource sector and the real estate investments trusts that were prevalent in the 1980s and 1990s. The traditional royalty trust would own a revenue royalty in a producing asset and would pass this royalty income on to the investor. The royalty income was to some extent sheltered by the cumulative Canadian oil and gas property expense. By comparison, a real estate investment trust is an investment trust that owns, maintains, and manages real property. The rental income that is earned by the REIT is passed on to investors and can be sheltered from tax by way of the capital cost allowance that can be claimed on the real property and if an operating company is used, the interest expense claimed by the operating company. Regardless of the structure, the objective of any income trust is to maximize the after-tax returns for investors.

To date, the large institutional investors (including the pension funds) have shied away from investments in business income trusts due to concerns about potential liability for third party claims made against the business income trust or the underlying company. It is not clear whether an investor (beneficiary) in a business income trust will be liable to the trustee for an amount that exceeds their investment in the business income trust. The provincial governments are addressing this ambiguity by introducing legislation that will clearly state that unit holders will not be liable for an amount that is over and above their initial investment.

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The Ontario and Alberta governments initiated the process of resolving this problem by introducing legislation to limit the liability of trust unit holders.

With the removal of the perceived liability exposure, the Department of Finance is concerned about the unlimited participation of pension funds in the business income trust market. To date, the majority of the investors in business income trusts are individual retail investors and as such are taxed on income realized from the business income trust at their marginal rates. To address the issue of pension funds making large investments in business income trusts, the 2004 Federal Budget proposes two measures that will limit the pension funds investments in business income trusts. The proposed amendments will apply to "designated taxpayers" which is defined as pension trusts, pension corporations and pension fund real estate corporations set out in paragraphs 149(1)(*o*) to (*o*.2) of the Act, respectively. The proposed amendments will also apply to the Canadian Pension Plan Investment Board. (For the purpose of this article, these tax exempts are referred to as "Registered Pension Plans" or "RPP.") Notably, the proposed amendments do not apply to the largest pension fund manager in Canada, the Caisse de dépôt et placement du Québec, as the Caisse is an agent of the Crown in Quebec and the Constitution does not allow one level of government to impose tax or taxation penalties on another level of government. The proposed amendments do not apply to other tax-exempt entities such as RRSPs and RRIFs.

The proposed changes to the business income trust market are controversial and will be debated at length within the pension fund community. The Department of Finance has made a clear distinction between the tax-exempt institutional investor and the tax-exempt retail investor. On May 18, 2004, the Department of Finance announced that the investment limits (i.e., 1% of a RPP's net assets, 5% of a single business income trust) set out in the business income trust proposals in the 2004 Budget would be suspended pending further consultation with the pension fund industry and the provincial governments. Following the consultations, the Department of Finance will release further legislative proposals.

In this article, Hutchinson examines controversial proposals regarding the investment of registered pension plans in business income trusts in the Federal Budget released by the Department of Finance on March 23, 2004.