

## **INCOME TRUSTS AND SHAREHOLDER TAXATION: GETTING IT RIGHT**

By

Lalit Aggarwal and Jack Mintz

\*Prepared for the Capital Markets Institute, University of Toronto.

Lalit Aggarwal is a policy analyst at the C.D. Howe Institute  
Jack Mintz is with the J. L. Rotman School of Management and the C.D. Howe Institute.

## I. INTRODUCTION

The recent surge of income trust financing of corporate capital, accounting for close to \$42 billion of corporate financing since 1995<sup>1</sup>, has raised age-old questions about the taxation of shareholder income in Canada. Income trusts are in part a manifestation of a system that fails to fully integrate corporate and personal income taxes on shareholder income so that investors are willing to hold corporate securities, independent of tax effects. Our task in this paper is to assess the economic impact of income trusts on economic efficiency and to suggest options for reforms that would create a more neutral tax system that would not distort the allocation of capital financing in Canada amongst different types of businesses.

In 1972, tax reform led to a substantial change in the taxation of shareholder income by introducing capital gains taxation and a new form of dividend tax credit to improve the integration of corporate and personal income taxes. Interest on debt securities is deductible from corporate taxable profits and fully taxed in the hands of investors. Dividends are not deductible at the corporate level and are subject to personal income tax. Since 1972, a dividend tax credit has been provided to offset corporate tax levied prior to the distribution of profits so that the investor would bear the same corporate and personal income tax on distributions as personal tax on interest income. The effect of the dividend tax credit is therefore to establish tax neutrality between equity and debt financing of corporations. Until recently, capital gains taxes, after providing a partial exclusion of capital gains from income, were assessed at same tax rate on dividends so that high income investors would be indifferent between paying out profits as dividends and reinvesting them in the corporation.

---

<sup>1</sup> According to the IDA, total issuance (IPOs and secondary offerings) of income trust units from 1995 through the second quarter of 2003 amounted to \$41.974 billion.

However, the dividend tax credit is based on the small business corporate income tax rate (about 20 percent)<sup>2</sup>, which creates tax neutrality only for small Canadian-controlled private corporations. Therefore, for corporations, the dividend tax credit fails to fully integrate corporate and personal taxes. Thus, for example, a large company would find it cheaper to raise capital as debt rather than conventional preferred or common equity from investors (tax-exempt institutions like pension plans would also favour debt financing for tax reasons since interest is deductible at the corporate level while dividends are not).

As we discuss in more detail below, the development of real estate, royalty and business income trusts have been in part a result of the inadequate integration of corporate and personal income taxes for large corporations. Although non-tax benefits accrue to businesses and investors to arrange income trusts, the tax benefit is to effectively eliminate the unintegrated portion of the corporate tax by substantially converting equity into debt or lease financing. Since the income trust is a tax-exempt vehicle of which the distributions of income are subject to tax paid by the investors<sup>3</sup>, companies have been able to lever ownership of assets used by operating companies with payments made to investors holding a greater mixture of debt and equity securities through the income trust, often eliminating any corporate tax to be paid by the operating company.<sup>4 5</sup>

---

<sup>2</sup> The small business tax rate applies to the first \$300,000 of active business income earned by a Canadian-controlled private corporation. The benefits of the low rate are clawed back when the corporation has capital that is more than \$10 million (capital defined according to the concept used for the large corporations tax). Investment income and the profit of public corporations are fully taxed.

<sup>3</sup> Income trusts are subject to tax if taxable income is not distributed to investors. Undistributed income held by the trust is subject to tax based on the top personal tax rate.

<sup>4</sup> Income trust arrangements have also led to avoidance of capital tax payments when the income trust owns assets that are leased to the operating company.

<sup>5</sup> Unlike limited liability partnership arrangements that similarly eliminate the unintegrated corporate income tax (since income is only subject to tax accruing to the partners), income trust units can be held by investors as Canadian investments in registered retirement savings and pension plans, thereby increasing their attractiveness in the retail market. Limited liability partnership units are treated as foreign property and are therefore less attractive to pension and RRSP plans that can only hold up to 30% of assets in foreign property.

The tax policy issue is whether income trust arrangements that have exploited non-neutral treatment of equity and debt finance create specific economic distortions that undermine the efficiency of capital markets in Canada. On one hand, to the extent that companies are able to arrange acquire cheaper financing due to tax-efficiency, they will face a lower cost of capital for investment, improving Canada's capital stock and productive capacity. On the other hand, if only certain types of corporations are in position to take advantage of income trust corporations, capital is allocated to those companies that are able to raise capital through income trusts. We empirically evaluate the tax benefits of income trust arrangements and suggest that a conservative estimate of the tax benefits is \$500 to \$700 million annually. However, some specific economic distortions are implied by the growth of income trust financing in Canada in that capital has been allocated to businesses operating in slower growth, low rate of return to capital environments.

Given our understanding the economic impacts of income trust arrangements, we consider tax amendments to reduce non-neutralities in the tax treatment of different forms of corporate financing, an issue raised by the report of the Technical Committee on Business Taxation (1998). Our preferred recommendation is to improve the dividend tax credit regime so that corporate and personal income taxes are better integrated, thereby improving the climate for conventional equity finance and creating a more tax-neutral environment.

## **II. BACKGROUND**

The income trust segment has exploded to a current market capitalization of approximately \$57 billion as of September 9, 2003 from \$15 billion in May 1999 according to Scotia Capital. Over the same period, the number of issuers has almost doubled from 65 to over 123. As a

result, income trusts now represent about 7% of the entire capitalization of the TSX. Income trust arrangements are the dominant form of financing available in the public markets at present and represented 87% of all initial public offering proceeds in 2002 according to PricewaterhouseCoopers. As a share of total Canadian equity issuance, income trust accounted for 41% in 2002, 37% in 2001 and 12% in 2000 (King (2003)). The recent spate of income trust arrangements is even stronger than the previous popular trend for income trust financing, which in 1997 accounted for 29% of equity financing.

**Table 1: Income Trusts – New Issues**

	1999	2000	2001	2002	2003 YTD (1)	Total
Energy	9	13	23	21	6	72
Consumer	1	0	4	17	4	26
Power	5	2	7	6	2	22
Industrials	1	0	4	15	2	22
REITs	5	7	19	18	2	51
Resource	1	0	0	5	2	8
Util. & Infr.	2	2	5	6	2	17
<b>Total</b>	24	24	62	88	20	218
Energy	37.5%	54.2%	37.1%	23.9%	30.0%	33.0%
Consumer	4.2%	0.0%	6.5%	19.3%	20.0%	11.9%
Power	20.8%	8.3%	11.3%	6.8%	10.0%	10.1%
Industrials	4.2%	0.0%	6.5%	17.0%	10.0%	10.1%
REITs	20.8%	29.2%	30.6%	20.5%	10.0%	23.4%
Resource	4.2%	0.0%	0.0%	5.7%	10.0%	3.7%
Util. & Infr.	8.3%	8.3%	8.1%	6.8%	10.0%	7.8%

(1) Data as of April 22, 2003

Source: Scotia Capital

Two predominant developments that underlie the recent surging popularity of the asset class are a change in investor sentiment towards growth equities given the collapse of the NASDAQ by almost two-thirds from peak in spring 2000 and the admission of fraud at the

headquarters of such market stalwarts as Enron, WorldCom, Tyco and Adelphia. Although one might expect equity risk to drive investors into short-term fixed income instruments, instead income trusts became popular with cash distributions and the average unit yielding as much as 5 percentage points higher than government debt securities. The sector appears to be an ideal compromise for discouraged investors seeking lucrative cash flows.

Income trust units offer higher valuations for two reasons: increased liquidity for investors and tax-efficiency. All else equal, higher quality businesses offer a higher valuation to investors by paying out not only a return on capital but also the return of capital as a cash distribution, leaving reinvestment of distributed profits in the hands of the investor. The value of the units is bid up since the investors perceive a lower risk in the distribution. Prevailing low interest rates are also a key variable in determining the value of an income trust. Tax-efficiency arises primarily from a reduction in income and capital taxes paid by the corporation. Goodmans' Guide to REITs and Income Funds (2003) states that "a subordination feature attached to units retained by existing equity owners may enhance the value of the units offered to the public. Similarly, improving tax efficiency can increase a unit-holders' after-tax cash flow, thus increasing value." Strong investor demand, the rate environment and structural advantages all make up the attractiveness of the income trust structure that transforms assets originally valued at 5 – 6 times EBITDA into some worth 10 – 12 times. It is no surprise that issuers, who are rationally trying to maximize the value of their assets, are quick to adopt such structures.

Business trusts now comprise the fastest growing sector in the income trust segment (see Table 1) as compared to the more traditional royalty trusts and real estate investment trusts. Royalty trusts and real estate investment trusts represented 90% of the market in 1995 but now only account for about 50%. Businesses selling such items as telephone directories, hamburgers

and mattresses represent the now popular form of income trust, although the business trusts have been in place for many years. In essence, business trusts attempt to emulate characteristics shared by royalty and real estate investment trusts, namely the sustainability and predictability of cash flows. These characteristics are often what private equity investors are seeking when pursuing leveraged buyout opportunities. Some market participants consider a conversion to an income trust as a method to effect a public market LBO.

Canadian retail investors and mutual funds are the two main players in the market although attractive yields continue to appeal to non-resident investors and in the case of Provident Energy, have raised concerns over a potential violation of the mutual fund trust requirements. Pension funds do participate in the segment but to a lesser degree than they do in the equity markets and much of the reason has to do with its concerns with the current unlimited liability framework governing traditional trust structures. Pending legislation should alleviate these concerns as it proposes to protect unit holders of publicly traded trusts by affording them the same protection against personal liability as shareholders of a corporation. This legislation was tabled in Ontario prior to the latest legislative session being dissolved and should remain a top priority whoever wins the provincial election this fall. Other provinces are considering whether income trusts should be eligible for limited liability protection.

In looking at the composition of retail investors versus mutual funds investing in income trusts, there is a bias towards retail investors. According to sources at Merrill Lynch, this is due to questions about underlying business stability as well as the liability issue mentioned above. In terms of investors holding income trusts, sources at Merrill Lynch say that the market is very much fragmented. On one side there are the traditional issuers (pipelines, real estate etc.) and on the other, the more risky business trusts. The more traditional income trusts are said to be

"institutionally-gearred" because of the perceived longer life of the underlying assets and perceived greater stability and visibility. In terms of allocations, ML would characterize the traditional IT market to be 30%-40% institutionally-held and 60%-70% retail, while it would characterize the business trust market as one that is about 10-20% institutionally-held. This estimate is supported with data obtained from CIBC that provides a breakdown of the offering allocations for new issues. In a sample of 24 representative transactions, on average, about 63.75% of the initial investor base is retail. These numbers are particularly important when trying to understand the tax implications of the income trust segment especially since the tendency is for investors to buy and hold such issues opposed to actively trading them.

### **III. SPECIFIC TAX CONSIDERATIONS**

An income trust is a mutual fund trust for purposes of the Income Tax Act. The four criteria are that the income trust must have Canadian resident trustees, limit its activities to passive investing although it can hold both Canadian and foreign property, act in accordance with specified conditions (qualified for distribution and minimum of 150 holders holding 100 units each having a value of at least \$500) relating to the distribution and ownership of its units and not be established or maintained primarily for the benefit of non-resident persons (more than 50%). Once established, these mutual fund trust units are sold to investors who are the beneficiaries.

The income trust is a flow-through vehicle for tax purposes. Income earned by the trust flows through to investors who will pay tax on dividends, interest or capital gains earned by the trust. The unit-holders must also pay capital gains taxes on changes to gains realized from the sale of the units.

Three specific tax issues are important in discussing the income trust arrangement: (i) payment of corporate income and capital taxes, (ii) qualification as an investment for registered savings and education savings plans, deferred profit-sharing plans and registered retirement income funds, (iii) taxation of distributed and undistributed income held by the trust and, (iv) tax issues related to cross-border investments.

(i) *Corporate and capital taxes*: The basic structure of an income trust is consistent across all industries. A Canadian resident trust indirectly purchases a business or income producing assets using the proceeds garnered from the public offering of trust units. The trust, however, also acts as a lender to the operating company and capitalizes the firm with a serviceable debt load that reduces or eliminates the amount of equity capital required. This is in essence what private equity funds do when structuring a leveraged buyout although they often rely on external lending and supply only the equity capital. Since interest payments are tax-deductible, the taxable operating company effectively reduces its tax liability by paying interest on the loan to the trust. Should there be a seasonal boon in revenue one year, it is possible that some of the operating income will not be sheltered by the interest payments to the trust. As a result, the operating company will incur a tax liability since operating companies pays taxes according to regular rules for corporations. The after-tax proceeds in such an instance, however, might lead to a dividend stream to the trust.

The income trust arrangement employs a similar technique to shelter income in the less common example that sees the trust acquiring the assets from the operating company and leasing them back to it. The lease payments are deducted from operating income generated at the operating company, thereby reducing corporate income taxes payable by the operating company.

If the assets are held by the trust rather than the operating company, an additional tax advantage arises by avoiding capital tax payments to federal and provincial governments. Given that the trust is non-taxable flow-through vehicle not subject to either corporate income or capital taxes, the resulting distributions to unit-holders are often some bundle of interest income, dividend income, lease payments, capital gains and even returns of capital packaged at the trust level.

Personal income taxes, however, are applied to income received by unit-holder. If the beneficiary of the income trust distributions is a non-resident, withholding taxes would apply to dividend, interest, royalty, and rental payments. Distributions are also taxable in the hands of the corporate investors and, as such, are not eligible for the inter-corporate dividend exemption.

(ii) *Foreign Property Restrictions*: If the income fund is a mutual fund trust, its units will be a qualified investment for registered retirement savings plans, registered income funds, registered pension plans, deferred profit sharing plans and registered education savings plans. By qualifying tax-assisted savings plans, the income may then be exempt from taxation.<sup>6</sup> Otherwise, it would be treated as foreign property and be less attractive since registered funds must hold less than 30% of their investments as foreign property or otherwise be subject to a penalty tax.

The income trust itself can invest in foreign property although its investments in shares and debt of a corporation will be determined to be foreign property if their value is directly or indirectly derived by primarily (50%) foreign property or the corporation has a “substantial

---

<sup>6</sup> Tax is applied to withdrawals of income and principal from the registered retirement savings plan or pension plan. However, an investor can deduct contributions to income trust funds if placed in a registered asset. So long as tax rates do not vary over time, the present value of taxes owing on registered savings plans is zero, implying that the income is equivalently exempt. We assume this to be the case when we empirically assess the tax implications of income trust arrangements.

Canadian presence” which can be satisfied by a number of tests, including incorporation, office in Canada, and sufficient employment in Canada.

Given its eligibility for tax-assisted saving plans, the income trusts have been favourably accepted by the market in comparison to limited liability partnerships, for example, that could otherwise accomplish similar objectives of reducing corporate income taxes but not qualify for registered retirement savings plans.

(iii) *Distributions*: If a trust were to allocated less than its taxable income to unit-holders (which would have to be possible under its trust indenture terms), the undistributed amount would be subject to tax in the trust and possibly subject to further tax to the unit-holders on subsequent distributions. The double taxation of undistributed taxable income is a significant penalty that can be avoided by fully distributing taxable income.

Further, distributions in excess of taxable income may be made on a tax-free basis as a return of capital. The excess distribution would reduce the tax basis of the unit-holders investment and contribute to a capital gain or reduce capital loss when the unit-holder disposes the investment. The deferral of capital gains taxes until units are sold provide another tax benefit to unit-holders when distributions are in excess of taxable income rather than reinvested in the operations of the company to earn future distributed dividends that are more highly subject to tax as dividends.

(iv) *Cross-border Investments*: A recent trend is the growth of cross-border income trust arrangements, which we shall only touch upon briefly here. As discussed above, Canadian income trusts can hold US or other foreign property and still qualify for the tax benefits

discussed above<sup>7</sup>. The main issues related to cross-border income trust issues are related to US tax treatment of interest expense and withholding taxes. For a cross-border income trust to be tax-efficient, the operating company in the US would need to be capitalized with debt to reduce US corporate income tax (dividend distributions can be remitted tax-free to the Canadian entity). US rules based on “substance over form” can result in debt being characterized as equity for tax purposes, if the debt is viewed as substitute equity held by the investor. Given that income trust units derive a combination of income from bonds and equity held in the operating company, US rules could result in restricting interest deductions, an issue that has just been raised with respect to one recent transaction.

Further, even if debt is not characterized as equity, US earnings-stripping rules applied to related non-resident investors could limit interest expense deductions. Such rules apply when interest is more than 50% of adjusted income (adjusted income is taxable income prior to the deduction of interest and depreciation) and the indebtedness is more than 1.5 times equity. Currently, the earnings-stripping rule is being reviewed by the US administration and Congress that could result in considerable change, reducing the ratio of interest expense to adjusted income and lowering the threshold in which the rules apply.

US withholding taxes on interest applies unless ownership is less than 10% of the combined voting power of the payor and the fund is structured as a fixed investment trust for US income tax purposes and the term of the notes cannot be renegotiated.<sup>8</sup> Dividends paid from current or accumulated earnings and profits to non-residents are subject to withholding tax of 5% when paid to the income fund.

---

<sup>7</sup> Cross-border income trusts, like other specific tax structures, can sometimes achieve other tax-efficiencies. Bernstein (2003).

<sup>8</sup> Goodmans’ Guide (2003). A fixed investment trust can only hold securities in one entity, new offering of the fund units must be used to purchase common shares and subordinated notes of subsidiaries entities in proportion to the initial distribution of shares and notes.

#### **IV. VALUE OF TAX BENEFITS ASSOCIATED WITH INCOME TRUSTS**

The emergence of the income trust sector has triggered an emotional debate among market participants about the value of the tax benefits of income trust financing to investors, which is the mirror of the associated tax-revenue impact to the provincial and federal governments. Despite the lack of formal analysis by Finance Canada, several brave analysts have attempted to estimate such a number. Hayward (2002) suggests the loss in corporate tax revenue to governments attributable to the income trust sector at \$1 billion. Shenfeld (2003) argues that there is virtually no tax benefit to investors since personal taxes offset most of the loss in corporate tax revenues. Both Hayward and Shenfeld provide the endpoints to frame the discussion and as is often the case, the true value often lies somewhere within that range. As we will describe in our analysis, the complexities inherent in estimating the integrated tax impact are quite numerous and as Shenfeld rightfully emphasizes, the aim of such work is to provide an order a magnitude.

When assessing the tax benefits accruing to investors of income trust asset class, one must look both at corporate and personal incomes separately. Starting with corporate income tax, the tax benefit is quite evident and meaningful. When firms employ the trust structure to reduce the amount of income tax paid, the government loses revenue equal to the product of the aggregate net income of income trust funds and the weighted average corporate tax rate across all industries. We estimate the loss in corporate tax by applying an effective tax rate on operating cash flow, which is derived from the historical financial and taxation statistics published by Statistics Canada to the projected aggregate operating cash flow of the income trust asset class<sup>9</sup>.

---

<sup>9</sup> Such data aggregates tax-paying and non-paying companies and might therefore underestimate true corporate tax costs for income trusts. However even if we could match actual corporate tax payments of operating companies prior to the income trust transactions we would not know the true savings in the anticipated corporate taxes that were being avoided by creating the income trust.

Most of this operating cash flow will result in distributions to trust unit holders but this ratio differs across REITs, royalty trusts and business trusts. Likewise, the effective tax rate on operating cash flow differs across industries and since all industries are not represented in the asset class, it would be slightly inaccurate to aggregate statistics and we attempt to correct for this by looking at different industries individually when possible.

In addition to the decline in corporate income taxes paid, the income trust arrangement allows firms to avoid paying capital taxes if assets are transferred to the income trust. Although federal capital taxes are currently in the process of being eliminated, income trust financing could result in a diminished amount of provincial taxes to be collected. Our estimate does not include capital tax revenue losses since we do not know how many leasing arrangements were undertaken (see below for a suggested amount).

However, an analysis of the tax revenue impact of the income trust sector must extend far beyond a simple look at corporate taxes. While the income trust sector results in an evident reduction of the corporate tax base, there arises a commensurate increase in the personal income tax base as trusts distribute pre-tax cash flow as more highly taxed interest rather than dividends or capital gains to unit holders. These distributions are, in turn, taxable at personal marginal income tax rates that are substantially higher than the otherwise applicable corporate tax rates.

The personal income taxes apply not to the whole yield earned in the income trust but instead only to the distributions that are a return on capital. To measure taxable distributions, the ratio of distributions to pre-tax cash flow using market analyst estimates are applied to earnings before the deduction of depreciation, interest and taxes (EBITDA). Although often quite marginal, firms do tend to allocate some portion of their operating cash flow to maintain capital expenditures and changes in working capital with result in a distribution ratio that is less than

100%. Further, some of the distributions paid from EBITDA that are in excess of EBITDA are a return of capital.

As discussed above, when the distribution ratio rises to above 100% of taxable income, such that some portion of the underlying capital is being returned to the investor, then no personal tax would be collected on that part of the yield. However, a return of capital will impact the underlying cost/book basis of the trust and as a result, will impact future capital gains tax calculations should the trust units be sold. It is important to distinguish between the return on capital and a return of capital as the issue often arises in various trust arrangements. We do not explicitly try to adjust for this issue in our calculation (which would be the difference between the personal tax rate and the accrual-equivalent capital gains tax rate) but note that if we did, personal tax revenues would likely be lower.

An erosion of the corporate tax base and an increase in investment income tax receipts are the two main drivers of the overall net tax revenue impact of the income trust segment. Although relatively small in magnitude, one must also include an estimate of the potential loss of capital gains and ordinary dividends to investors when conducting such an exercise. Capital gains and dividends are features of traditional corporate structures and historically, have driven nominal equity returns in a 70/30<sup>10</sup> proportion respectively. We account for the increase in personal tax collections due to income trust distribution above but we must note that this distribution already encompass what investors might have ordinarily collected as dividends through ownership of common shares. Without reducing the increase in investment income tax receipts by the decrease in taxes resulting from lost dividends, we would be overstating the net increase in personal taxes paid by the investors on distributions.

---

<sup>10</sup> Post-WWII (1946-2001) average arithmetic stock return was 12.8% in the US according to Siegel (2002) with 8.7% of the return stemming from capital appreciation and the remaining from dividends.

In addition to making the adjustment for lost dividends, we must also consider the issue of capital gains. Whereas in the case of income trusts investors rely disproportionately on a consistent stream of income rather than capital appreciation, traditional equity investors have historically, as mentioned above, relied on capital gains for approximately 70% of their returns. This follows from the concept of retained earnings and management teams reinvesting profits into a business rather than distributing them as dividends. With the dividend yield having declined in recent years, investors are increasingly anticipating higher capital gains to compensate themselves for the lower dividend portion of their total return. Although only 50% of capital gains are now taxable in Canada, the net effect of the emergence of the income trust sector on tax receipts from capital gains is material. Given that capital gains taxes are only paid when units are actually sold, we calculate the accrual-equivalent capital gains tax paid each year based on 10-year holding period for shares.

As discussed above, one could argue that income trust units offer the potential for capital gains as well, and this is indeed the case, but from the limited historical data we do have, we find the average capital gain to be 1.0% (with a standard deviation of 19%) from 1997 to 2001. This is substantially lower than what equity investors would expect and given the higher likelihood of income trust units to experience risk as a result of missed or lower distributions, we feel that relying on capital gains from income trust units, although entirely possible in a volatile state, goes against the rationale behind the structure of these securities.

Therefore, we conclude that the aggregate tax revenue impact of the income trust sector has four primary drivers. The first is an erosion in the corporate tax base which is somewhat mitigated by the second, an increase in receipts relating to the rise in interest income for unit-holders. The third and fourth drivers, a reduction in dividends paid and capital gains realized,

result in lower tax receipts. Our calculations suggest that the erosion in the corporate tax base along with the reduction in dividends paid and capital gains realized are not fully covered by an increase in interest income tax receipts and as a result, result in some overall tax-leakage for the sector.

In looking at the three drivers above that relate to the investing community, one must consider a number of nuances when estimating the tax impact. For instance, different holders will be subject to different tax rates (i.e. pension funds versus non-resident investors). We divide our shareholder bases into three main components, namely: institutional, retail and non-resident investors. The institutional category is further divided into pension and mutual funds. We employ personal tax rates weighted according to income tax bracket obtained from the Department of Finance Canada to our aggregate cash flow estimates in order to calculate the overall tax impact. Note that such tax rates only apply to the mutual fund and retail investor categories as the pension funds are tax-exempt and the non-resident investors are subject to only the 15% withholding tax. Although these tax rates apply to the mutual fund and retail investor categories, they do not apply to the entire amount of the cash flow received since some proportion of such holdings are in tax-exempt retirement account. We estimate this number from the average household balance sheet as derived by Statistics Canada.

Up until this point, our focus has been on the primary drivers relating to the net aggregate tax impact of the income trust sector. There are a number of other secondary influences that might affect the value of tax benefits to investors but such estimates are quite difficult to derive. For example, for business owners looking to convert their holdings into some sort of income trust vehicle, their likely is some level of transition capital gains tax that is payable should some existing units be offered in an initial public offering. This is especially important as

entrepreneurs attempt to exploit higher valuations available to them in the income trust sector as compared to the traditional equity markets. Also, as some distributions comprise a return of capital in addition to the return on capital that investors are more accustomed to, the underlying tax basis for original unit-holders is changing. Should unit prices not track the book value of capital and instead result in some sort of multiple expansion with respect to that metric, one would expect a higher capital gains tax to be paid upon sale in the future. There are a number of issues of this nature that one could concoct that do have an impact on the net tax revenue impact resulting from the income trust sector but we judge these amounts to be immaterial, especially since a number of them relate to taxes paid in or current taxes deferred to the future which imply a lower present value impact.

In the Tables 2 to 4 below, we estimate the impact of income trust arrangements on tax revenues. Table 2 estimates the corporate tax revenue loss based on the EBITDA earned by the income trust, assuming that arrangements eliminate fully corporate tax payments through leverage or leasing. The total corporate tax revenue reduction is estimated to be \$1.4 billion dollars, under the assumption that operating companies would have otherwise paid taxes at the average rate of EBITDA as reflected for the industry. Table 3 provides the net personal tax loss to investors from income trust arrangements, whereby the personal tax on interest and leasing income is more highly taxed than dividends and capital gains (the latter measured according to an accrual-equivalent tax basis). The amount of personal tax paid depends on estimating a typical tax rate faced by unit-holders, including assets held in tax-exempt form. We assume that the typical owner of income trusts would be investors receiving dividend income. The personal tax loss to investors would be \$980 million in taxes on interest income, offsetting the personal tax gains of avoiding personal taxes on dividends, equal to \$130 million and accrual-equivalent

capital gains taxes of about \$65 million. Thus, net personal tax revenue loss to investors would be approximately \$785 million.

**Table 2: Estimated Corporate Tax Revenue Impact**

**(A) Corporate Tax Loss**

	Operating Cash Flow (EBITDA)	Cash Distribution / EBITDA (%)	Estimated Distributions	Taxes Paid / EBITDA (%)	Corporate Tax Loss
Business Trusts	3,419.2	66.1%	2,260.4	16.8%	573.3
Power Trusts	577.7	82.1%	474.3	14.3%	82.6
Resource Trusts	1,127.8	76.6%	863.7	17.4%	195.7
Royalty Trusts	2,328.2	80.2%	1,867.1	10.2%	237.5
Real Estate Its	1,989.7	57.1%	1,135.8	15.1%	300.4
<b>Total Trust Universe</b>	<b>9,442.6</b>	<b>69.9%</b>	<b>6,601.3</b>	<b>14.7%</b>	<b>1,389.5</b>

**Reduction in Dividends**

	Dividends Paid / EBITDA (%)	Estimated Dividends
Business Trusts	17.8%	607.5
Power Trusts	14.6%	84.1
Resource Trusts	18.0%	202.4
Royalty Trusts	10.5%	244.5
Real Estate Its	18.7%	372.1
<b>Total Trust Universe</b>	<b>16.0%</b>	<b>1,510.5</b>

**(B) Capital Tax Loss**

**Negligible**

**Table 3: Estimated Personal Tax Revenue Impact**

**(C) Interest Income Tax Gain**

		Estimated Distributions	Proportion Held Tax-Exempt	Weighted Avg. Tax Rate	Personal Tax Gain
Institutional Investors	25.6%				
Pension Funds	6.2%	407.4	100.0%	0.0%	-
Mutual Funds	19.4%	1,282.6	52.3%	34.0%	208.2
Canadian Retail Investors	45.0%	2,972.1	52.3%	34.0%	482.4
Non-Resident Holders	29.4%	1,939.1	0.0%	15.0%	290.9
<b>Total Trust Universe</b>		<b>6,601.3</b>		<b>14.9%</b>	<b>981.4</b>

**(D) Dividend Income Tax Loss**

		Estimated Dividends	Proportion Held Tax-Exempt	Weighted Avg. Tax Rate	Personal Tax Loss
Institutional Investors	45.9%				
Pension Funds	22.1%	334.3	100.0%	0.0%	-
Mutual Funds	23.8%	359.1	52.3%	17.7%	30.3
Cdn. Retail Investors	24.7%	373.4	52.3%	17.7%	31.5
Non-Resident Holders	29.4%	443.7	0.0%	15.0%	66.6
<b>Total Trust Universe</b>		<b>1,510.5</b>		<b>8.5%</b>	<b>128.4</b>

**(E) Capital Gains Incomes Tax Loss**

Current Mkt Yield	1.8%			Inclusion Rate	50%
Implied Market Value	83,917.1			Accrual Rate	80%
Stk Market Appr.	6.0%				
Total Capital Gains	5,035.0				
		Estimated Capital Gains	Proportion Held Tax-Exempt	Weighted Avg. Tax Rate	Personal Tax Loss
Institutional Investors	45.9%				
Pension Funds	22.1%	1,114.4	100.0%	0.0%	-
Mutual Funds	23.8%	1,197.0	52.3%	13.7%	31.4
Cdn. Retail Investors	24.7%	1,244.6	52.3%	13.7%	32.6
Non-Resident Holders	29.4%	1,479.0	0.0%	0.0%	-
<b>Total Trust Universe</b>		<b>5,035.0</b>		<b>1.3%</b>	<b>64.0</b>

<b>Table 4: Estimated Net Tax Revenue Impact</b>		
(A)	Corporate Tax Loss	1,389.5
(B)	Capital Tax Loss	Negligible
(C)	Interest Income Tax Gain	981.4
(D)	Dividend Income Tax Loss	128.4
(E)	Capital Gains Incomes Tax Loss	64.0
<b>Net Impact</b>		<b>(600.5)</b>

**Table 5: Sensitivity Analyses**

		<b>Weighted Average Tax Rate Applied to Interest Income from Trust Units</b>				
		20%	25%	30%	35%	40%
<b>Downside to EBITDA Estimate</b>	0%	(885.2)	(783.7)	(682.2)	(580.8)	(479.3)
	5%	(840.9)	(744.5)	(648.1)	(551.7)	(455.4)
	10%	(796.6)	(705.3)	(614.0)	(522.7)	(431.4)
	15%	(752.4)	(666.1)	(579.9)	(493.7)	(407.4)
	20%	(708.1)	(627.0)	(545.8)	(464.6)	(383.5)
	25%	(663.9)	(587.8)	(511.7)	(435.6)	(359.5)

Note: Base case assumes a tax rate of 34.0% on interest income implied from the effective average dividend tax rate as calculated by Finance Canada. The actual average effective tax rate on interest is approximately 24.9%.

		<b>Pension Funds as a % of Institutional Investor Base in the Income Trust Market</b>				
		0%	25%	50%	75%	100%
<b>Downside to EBITDA Estimate</b>	0%	(534.3)	(602.9)	(671.5)	(740.1)	(808.6)
	5%	(507.6)	(572.8)	(637.9)	(703.1)	(768.2)
	10%	(480.9)	(542.6)	(604.3)	(666.1)	(727.8)
	15%	(454.2)	(512.5)	(570.8)	(629.0)	(687.3)
	20%	(427.5)	(482.3)	(537.2)	(592.0)	(646.9)
	25%	(400.8)	(452.2)	(503.6)	(555.0)	(606.5)

Note: Base case assumes pension funds are 24.1% of the institutional investor base. This is simply half of the 48.2% share of the institution investor base that pension funds occupy in the traditional equity markets.

Combining the two impacts in Table 4, the federal and provincial tax benefits from income trust arrangements for investors is estimated to be an annual \$600 million. Of course, the estimation requires a number of assumptions so we undertake some sensitivity tests to obtain a range of possible values (Table 5). The first is to note that we estimated EBITDA to be about \$9 billion for the income trust sector, which would be 17% of capitalization (similar to typical estimates of pre-tax rates of return on investments). We provide some sensitivity analysis related to cutting the EBITDA estimate that would therefore shrink the estimate of tax losses. The second test is to change the personal tax rate on distributions, measured to be 34% since the income trust unit-holder might perhaps be different than an investor typically receiving dividends. Further, the tax will be applied to only income rather than the return of capital, thereby lowering the personal tax applied to interest distributions. For example, if the effective tax rate is 25% on interest, the tax benefits associated with income trust arrangements rises to \$785 million (with 0% adjustment in the size of EBITDA). The third is to reduce the portion of income trust held by tax-exempt pension institutions, which would imply an increase in the effective personal income tax rate assessed on income trust distributions. If only one-quarter of institutional financing is provided by tax-exempt pension plans, the revenue loss would be \$600 million. Overall, we would suggest as a reasonable range that the tax benefits associated with income trusts is in the \$500 million to \$700 million.

The above estimate does not account for capital gains tax paid by unit-holders when disposing the units, thereby lowering the revenue cost. Nor does it take into account the loss of capital taxes.<sup>11</sup>

---

<sup>11</sup> For example, by assuming that \$42 billion in income trust financing results in the elimination of capital taxes, the tax benefit could be increased by \$150 million (based on an average provincial capital tax rate of 0.35% on taxable capital). However, this would imply all income trust arrangements are implemented as leasing arrangements whereby the income trust owns the assets.

## V. ECONOMIC EFFICIENCY AND TAX PROPOSALS TO IMPROVE IT

The emergence of income trusts has prompted a number of questions with regards to the implications for economic efficiency. Economic efficiency implies that investments, no matter how they are structured, would bear the same level of tax. Some argue that income trusts are valued by investors by putting cash in their hands to make portfolio decisions rather than leaving it in the hands of the corporate managers to make decisions in their behalf. While this may be correct, in other instances, corporations might be in better position to use cash flows in investments highly complementary to existing assets thereby providing investors higher returns on their asset portfolios. We view that the tax system should not distort payout decisions of businesses – instead, the decisions are best left to markets to sort out.

### An Evaluation

Economic efficiency is enhanced to the degree that tax benefits associated with income trust arrangements lowers effective tax rate on capital for businesses which at the present time is roughly 30%, including corporate income, capital and sales taxes on capital expenditures (Chen and Mintz (2003)). A lower tax cost would encourage investment. For example, assuming that the corporate tax benefits are \$1.4 billion for about \$57 billion in capitalization, the cost of capital would be reduced by 1.3 percentage points.<sup>12</sup> Roughly, this would correspond to an increase of investment equal to \$11 billion.<sup>13</sup>

---

<sup>12</sup> The above statement assumes that the personal tax impacts of income trust arrangements are not relevant to investment plans of large corporations that borrow from international markets.

<sup>13</sup> This assumes that the after-tax risk-adjusted rate of return on marginal investments is 4.0%, the effective tax rate is 30% and the elasticity of capital demand to the cost of capital is 0.4.

Although a lower cost of capital is beneficial to firms on the one hand, we must ask whether such financing opportunities are available to all firms without prejudice. One view is that some firms are more likely to benefit from the income trust structure since they are able to make large distributions to investors with high degrees of leverage financing. Firms needing cash flows to invest in capital would not wish to use the income trust structure since leverage would increase their risk and, further, a penalty tax would be applied to undistributed taxable income. These features are essentially what entice a private equity investor into reconfiguring the capital structure of a target investment with increased debt to lower the overall cost of capital in a leveraged buyout. Target investments are mature but stable cash generating firms that are under-levered and present the opportunity for operational improvements and as a result, are undervalued due to an unnecessarily high cost of capital and sub-optimal margins.

The unintegrated portion of the corporate income tax has already led to some inter-firm distortions by favouring debt over conventional financing of businesses. Income trust financing vehicles provide an opportunity to use debt financing more easily since the unit-holders are both the owners of the equity and debt, rather than the debt being held by a third-party. To the extent that income trusts are more easily used by certain types of companies, capital will be allocated to those more able to take advantage of this form of financing. This could impair the efficiency of capital markets by directing capital to certain types of investments more suitable for income trust arrangements.

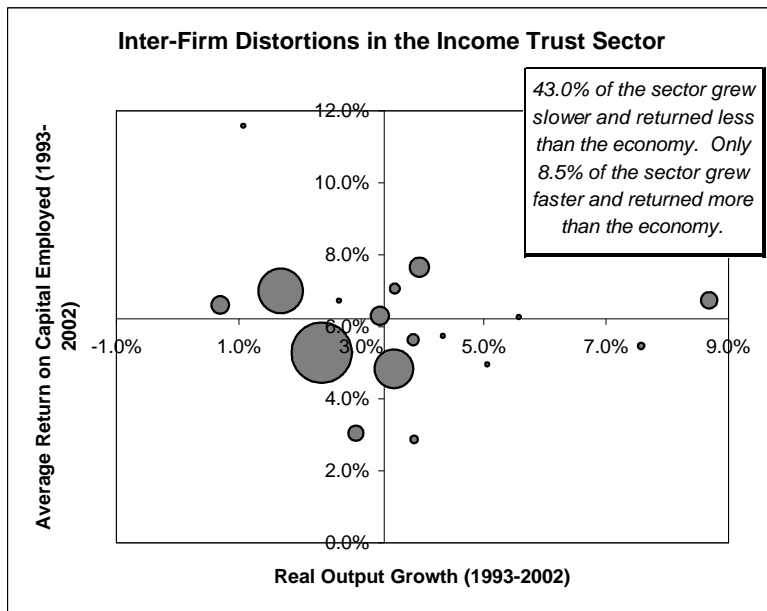
For the ten-year period dating from 1993 to 2002, total real output growth for all non-financial industries in Canada was 3.38%. The average return on capital employed for the same industries over the same period was 6.22%. Theoretically and on a risk-adjusted basis, capital should flow to the fastest growing and highest returning investment opportunities. Of the

different non-financial economic sectors as defined by Statistics Canada, only four both grew faster and yielded a higher return on capital than the economy as a whole. They are: professional, scientific and technical services, wholesale trade, manufacturing and administration, waste management and remediation services. Although the manufacturing sector does boast some income trust issuers, its cyclical nature does not suit the requirements of cash flow stability of the income trust arrangement. The consumer and industrials sectors accounted for only a 20.4% weighting in the Scotia Capital Income Trust Index. There is limited representation from the four fastest growing and highest yielding sectors in the income trust universe.

On the flip side, of the two sectors that both grew slower and yielded a lower return on capital than the economy as a whole, we find an abundance of income trust issuers. The two sectors are mining and oil/gas extraction (energy enjoys a 31.6% weighting in the Scotia index alone!) and accommodation and food services. Of the remaining eleven sectors, five grew slower than the economy but yielded a higher return on capital while six grew faster than the economy but yielded a lower return on capital. The utilities and agriculture, forestry, fishing and hunting industries represent the slower-growing but higher-yielding income trust issuers while the real estate and rental/leasing sector is the major income trust issuing sector that grew faster than the economy but yielded a lower return on capital.

Although the income trust segment is still quite young when compared to the traditional equity markets, the early indications are that the fastest growing and highest yielding sectors have not accessed this capital market while the slowest growing and lowest yielding sectors have. From an economic efficiency viewpoint, this is a significant inter-firm distortion to be aware of, especially since part of its causation lies in the unintegrated part of the corporate tax.

In terms of a real estate and rental/leasing, the lower return on capital could explain the price volatility in some issues such as the Legacy REIT and might suggest that not all types of properties are suitable for such arrangements. The chart below shows the relationship of the rate of return on capital, growth of the sector and the importance of income trust financing by industrial sector as represented by the size of the bubbles. Clearly, businesses with lower economic performance benefit more from income trust financing.



### Policy Options

Given the economic efficiency issues raised above, the question is what the government should do about its tax policies, if anything. The issue related to income trust financing was raised by the Technical Committee on Business Taxation (1998) in its report, McDonnell (1997), Pesando, Smart and Wilson (1997) and Hayward (2002) raises some tax policy approaches as well.

The income trust arrangement is, as discussed, a manifestation of high taxes imposed on conventional common or preferred equity financing due to corporate and personal taxes on income derived from equity being more than on debt for taxpayers, including tax-exempt institutions. Other structures could achieve the same aim of lessening the corporate tax to be paid by businesses but the income trust arrangement has been most popular since investments qualify for registered retirement savings and pension plan investments.

Further, given that capital gains taxes are below dividend taxes, financing structures aim to replace more highly taxed dividends by capital gain income to provide a tax-efficient source of income to investors. Companies that reinvest profits in a business are provided a tax advantage since the reinvestment profits gives rise to more lightly taxed capital gains.

The problem is, therefore, does not rest with income trust financing but with the lack of neutral treatment of different forms of corporate financing. From a tax perspective, conventional equity financing is less favoured than reinvested profits since dividends are more highly taxed than capital gains. Leveraged income trust financing is more tax-efficient than conventional equity financing and even more tax-efficient than conventional debt finance if capital tax payments are also eliminated.

Neutrality among different forms of financing could be established but it would require quite significant changes to the tax system<sup>14</sup>.

---

<sup>14</sup> Some radical changes, that will not be discussed here, including disallowing the deduction for interest expense, similar to dividends and provide an interest tax credit, similar to the dividend tax credit as an offset for underlying corporate income tax paid. Alternatively, dividends could be deductible from profits and fully taxed in the hands of investors. The latter approach would be contrary to income tax principles and could impair tax crediting given by foreign governments for Canadian income taxes paid by their resident taxpayers.

### Lowering the Personal Tax Rate on Dividends

One approach would be to simply increase the dividend tax credit to eliminate the unintegrated corporate income tax for corporations paying tax at general corporate tax rate (small business income is taxed at a rate of approximately equal to 20%). For example, the top federal-provincial corporate income tax rate by 2005 will be approximately 33%. If dividends were grossed by a factor of 150% (instead of 125%) for personal income tax purposes and a combined federal-provincial tax credit of 33% (instead of approximately 20%) were provided, corporate and personal taxes on dividends would be fully integrated with a total tax rate applying to income similar to other forms of income. Income trusts would therefore provide little tax advantage over conventional common or preferred equity financing.

Two implications would be implied by the above. The first is that the personal tax rate on dividends for upper income investors would be close to 20% (net of the credit and adjusting for the dividend gross-up), somewhat less than that for capital gains, which would be taxed at close to 23%. The capital gains tax rate would need to be somewhat reduced further to limit the scope for taxpayers to convert capital gains into dividend income. The second is that tax-exempt assets (e.g. pensions) would still find income trust arrangements attractive since these assets do not qualify for a dividend tax credit that would offset any corporate tax paid prior to the distribution of income. The third, and most critical, dividends paid by small businesses taxed at a federal-provincial corporate tax of 20% would be much more lightly taxed (once taking into account the new dividend tax credit) than salary or other income.

The latter issue is the most important one, making it very difficult to increase the overall dividend tax credit to reflect higher corporate income taxes. One could address the small business integration issue by applying a corporate distribution tax on small businesses to increase

corporate tax payment on distributions to 33% to eliminate tax planning. Alternatively, a two-dividend tax credit regime could be introduced. The tax credit could be raised for dividends paid by all public and non-Canadian-controlled private corporations, which are taxed at 33% and for dividends derived from “high-tax” sources income in Canadian-controlled private corporations that are eligible for the low corporate income tax rate of 20% on active business income. Canadian-controlled private corporations would therefore be required to create pools of high-tax income (similar to another pool created for capital dividends) in order for the dividends to qualify for the higher dividend tax credit (the pool could apply to current and future high-taxed sources of income). Dividends paid from low-taxed profits to public or private corporations might need to be subject to a special distribution tax to bring the effective tax rate up to 33%.

Reducing the tax on dividends is appealing for other reasons, including removing tax distortions applying to corporate payouts, equity financing and corporate re-organizations. However, the dividend tax rate can only be reduced if adjustments are made to dividend taxes applied at the small business level where corporate and personal income tax are integrated for active business income. Further, the lower dividend tax rate would not eliminate the incentive for tax-exempts to avoid corporate tax payments since no (refundable) dividend tax credit is payable to tax-exempts.

#### Other Less Appealing Solutions

Other approaches, less appropriate from our perspective, is to limit the scope for interest (and leasing) deductions at the corporate level but either restricting deductions for corporations or applying taxes at “investor” level.

To reduce tax arbitrage accomplished by income trust arrangements, interest deductions at the corporate level, currently facing few restrictions, could be more tightly limited. As in the United States, debt, if in substance is the same, could be characterized as equity thereby disallowing the interest expense as a deduction. In Canada, under the existing “thin-capitalization” rule, interest deductions are disallowed on indebtedness in excess of twice the level of equity held by non-resident related taxpayers in Canadian corporations. A general “thin-capitalization” rule could be introduced that would apply to indebtedness to resident or non-resident related parties. While this approach may be appealing as a way to limit tax arbitrage, it can create other economic hardship where high leverage might be a necessity to conduct business (e.g. financial institutions, new companies and failing companies with low equity values).

An alternative approach is to apply a tax at the investor level. For example, income earned by trust derived from active business (passive income would remain exempt) could be subject to a special tax. However, if the tax is applied, a credit would need to be provided when the income is paid to the investor. Otherwise, double taxation would be applied and trusts would effectively be excluded from earning active business income. An alternative would be to apply this special tax only on business assets held by pensions and other tax-exempt investors in order to eliminate the incentive to lease assets to corporations. However, this issue extends beyond questions related to income trusts and would undermine the incentive for people to save for retirement purposes.

None of these other solutions seem appealing to us. We think reducing the dividend tax rate for corporations would be more sensible to improve economic inefficiency by moving to a more neutral tax system with respect to financing structures.

## VI. CONCLUSIONS

Income trust financing is in part a reaction to high taxes levied on equity financing due to the lack of full integration of corporate and personal taxes. Two economic efficiency issues arise from income trust financing. First, such financing results in a lower cost of capital for businesses due to tax benefits received by investors. We estimate that tax benefits are \$600 million although allowing for sensitivity in assumptions suggests that the likely range is \$500 to \$700 million. The second efficiency effect of income trust arrangements is to favour certain types of businesses that are best able to take advantage of the financing structure. Typically, these businesses are those with stable earnings. We find, however, that the industries that benefit the most from the income trust arrangements are ones with lower economic performance, suggesting that the income trust financing is distorting capital markets towards slower growth companies.

Governments should seek tax policies that are neutral amongst different forms of financing. We suggest that cutting dividend taxes by enhancing the dividend tax credit for distributions from high tax sources of income should be considered as an approach to improve efficiency of capital markets.

## References

- Bernstein, Jack [2003], “Canada-U.S. Tax Arbitrage: A Canadian Perspective”, *Tax Notes International*, May 19, 683-685.
- Chen, Duanjie and Jack Mintz (2003), “Taxing Investments: On the Right Track, But at a Snail’s Pace”, *C.D. Howe Institute Backgrounder*, June, Toronto.
- Goodman’s Guide to REITs and Income Funds (2003), Toronto, Ontario.
- Hayward, Paul (2002), “Income Trusts: A Tax-Efficient Product or the Product of Tax Inefficiency,” *Canadian Tax Journal*, 50(5), 1529-69.
- King, Michael (2003), “Income Trusts – Understanding the Issues”, Working Paper 2003-25, Bank of Canada, Ottawa.
- McDonnell, Thomas (1997), “Tax-exempt Organizations and the Financing of Taxable Businesses”, Working Paper 97-9, Technical Committee on Business Taxation, Finance Canada, Ottawa.
- Pesando, James, Michael Smart and Thomas Wilson (1997), “Tax-exempts and Corporate Capital Structure: An Analysis of Efficiency and Revenue Implications”, Working Paper 97-10, Technical Committee on Business Taxation, Finance Canada, Ottawa.
- Shenfield, Avery (2003), “The Economic Benefits of Income Trusts”, CIBC World Markets, *Economic Perspectives*, March 7.
- Siegel, Jeremy (2002), “Stocks for the Long Run, 3<sup>rd</sup> Edition”, McGraw-Hill, New York.
- Technical Committee on Business Taxation (1998), *Report*, Finance Canada, Ottawa.

## **Appendix – Sources of Data**

- We derive our EBITDA estimate for the income trust universe using the projections of research analysts at Scotia Capital. Of the 119 income trusts comprising the Scotia Capital Markets Income Trust Index in the August 2003 Income Trust Monitor, Scotia Capital has projected 2004 EBITDA for 50 of them. Although these 50 income trusts make up only 42.0% of the universe on an absolute basis, on a market value basis, this number rises to 63.6%. Using this data, we extrapolate to estimate aggregate EBITDA for the universe.
- We calculate the Distribution percentage using Scotia Capital estimates as well. In order to do so, we take the product of number of units outstanding and the 2004 projected cash distribution per unit and divide this number by the EBITDA estimate for that particular income trust.
- We estimate the proportion of EBITDA paid in taxes and paid out in dividends on a sector basis using data available from Statistics Canada in Table 187.
- To estimate the non-resident ownership base, we use the proportion of savings of non-residents to total savings documented in Table 46 from the National Income and Expenditure Accounts.
- Our institutional versus retail investors estimate for the income trust sector is attributable to a CIBC World Markets sample of 24 representative offerings over the last year.
- Tax-exempt ratio based on data from Statistics Canada. We exclude Principal Residences from the calculation.
- Tax Rates for Interest, Dividends and Capital Gains from the Department of Finance.
- Our estimate of the institutional versus retail mix for the equity market comes from conversations with professionals at Merrill Lynch. Initial allocations tend to be kept to 15 – 25 % retail but with institution liquidating in the secondary market to take advantage of the initial public offering discount, a fair estimate of stable institutional ownership is 60 – 70 %.
- We back into an estimate for the proportion that pension funds make up of the institutional shareholder base using the following methodology. On July 31, 2003, the market capitalization of the TSX was \$795 billion. If we reduce this amount by the amount held by non-resident investors and Canadian retail holders, we are left with approximately \$365 billion held by Canadian institutions. Reducing this amount by the IFIC data for Balanced, Canadian Common Shares and Dividend and Income fund types on July 31, 2003, we are left with approximately \$176 billion that is held by Canadian pension funds (or about 48%) of the institutional arena. With pension funds not participating in the income trust segment as vigorously as they do the traditional equity markets, we assume that their share of the institutional investor base in the income trust segment to be half that number but run a sensitivity on it.