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TAXING INCOME TRUSTS: RECONCILABLE OR IRRECONCILABLE DIFFERENCES?

Report of the Standing Committee on Finance

Brian Pallister, MP
Chair

FEBRUARY 2007

39th PARLIAMENT, 1st SESSION

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has the honour to present its

FOURTEENTH REPORT

Pursuant to its mandate under Standing Order 108(2), the Committee has studied proposals on Income Trusts and has agreed to report the following:

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TAXING INCOME TRUSTS: RECONCILABLE OR IRRECONCILABLE DIFFERENCES?

INTRODUCTION

In January and February 2007, the House of Commons Standing Committee on Finance held public hearings on the taxation of income trusts. During our study, the Committee received written submissions and oral presentations from more than 100 groups and individuals representing a wide range of stakeholders. In listening to the presentations made to us, and in reading the submissions made by those who did not appear, we were struck by the range and extent of disagreement among witnesses on a variety of issues.

In this report, the Committee briefly summarizes the submissions and presentations received by us about announcements made by the Minister of Finance and the Department of Finance regarding income trusts. The report also provides our thoughts and recommendations about the range of issues that have arisen since the 31 October 2006 federal announcement regarding the taxation of income trusts.

THE ANNOUNCEMENT ABOUT THE TAXATION OF INCOME TRUSTS

A. The Distribution Tax

On 31 October 2006, the federal Minister of Finance announced that the government would apply a tax on distributions from publicly traded income trusts or publicly traded partnerships, other than those that only hold passive real estate investments, in order to level the playing field between income trusts and businesses having a traditional corporate structure.

The Minister indicated that the proposed Distribution Tax would apply to certain distributions of income from a flow-through entity beginning in the 2007 taxation year for income trusts starting to trade after 31 October 2006 and beginning in the 2011 taxation year for income trusts already trading on that date. In particular, these distributions would be subject to taxation at corporate income tax rates. Investors in a flow-through entity would be taxed as if the distributions were dividends. The Distribution Tax for flow-through entities beginning to trade

after 31 October 2006 would be 34% for 2007, 33.5% for 2008, 33% for 2009 and 32% for 2010; the tax rate for all income trusts would be 31.5% for 2011 and subsequent years.

B. Normal Growth

Since deferred application of the measures announced on 31 October 2006 was conditional on existing specified investment flow-through entities respecting the policy objectives of the federal income trust tax proposal, guidelines on "normal growth" for income trusts and other flow-through entities during the four-year transition period were released by the Department of Finance on 15 December 2006. The Department indicated that it would not recommend any change to the 2011 date in respect of any such entity whose equity capital grows, as a result of issuing new equity, by an amount not exceeding the greater of $50 million and an objective "safe harbour."

The Department announced that the safe harbour amount would be linked to the value of the flow-through entity's market capitalization at the end of market trading on 31 October 2006, with reference to issues and outstanding publicly traded units; debt, options or other interests that were convertible into units of the entity would not be included in the value of the market capitalization. Moreover, income trusts could seek permission to grow beyond the proposed limits.

The safe harbour for the 1 November 2006 to 31 December 2007 period would be 40% of the 31 October 2006 market capitalization benchmark, while the safe harbour for each of the years in the 2008 to 2010 period would be 20% of the benchmark; together, growth of up to 100% over the four-year transition period would be allowed. The annual safe harbour amounts would be cumulative, although the $50 million amounts would not be, and new equity would include units and debt convertible into units. Moreover, growth would not include replacing debt that was outstanding on 31 October 2006 with new equity; new, non-convertible debt could be issued without affecting the safe harbour, although the replacement of that new debt with equity would be considered to be growth. Finally, the merger of two or more specified investment flow-through entities — each of which was publicly traded on 31 October 2006 — or a reorganization of such an entity would not be considered to be growth to the extent that there would be no net addition to equity as a result of the merger or reorganization.

C. Conversions to Corporations

On 15 December 2006, it was also announced that conversions of a specified investment flow-through entity to a corporation would be permitted to occur without any tax consequences for investors.

D. Consultations on the Draft Legislative Proposals

Draft legislative proposals to implement the proposed Distribution Tax were released by the Department of Finance on 21 December 2006, and it was indicated that constructive comments on the technical aspects of the proposals would be accepted until 31 January 2007.

MEASURING THE TAX LEAKAGE

A. Witnesses' General Comments

In his appearance before the Committee, the Minister of Finance spoke about a growing trend towards corporate tax avoidance, with tax avoidance considerations influencing business investment decisions and resulting in gains for non-resident investors at the expense of Canadian taxpayers. In his view, actual and anticipated conversions from a traditional corporate structure to an income trust structure represented a danger to the Canadian tax system and the nation's economic structure; such conversions are not the way to build a dynamic competitive economy. He also suggested that income trust distributions are being received by a large number of foreign investors who, in his opinion, are experiencing a financial windfall at the expense of Canadian taxpayers and are paying far less in taxes than those paid by income trust unitholders.

Documents provided to the Committee by the Minister indicated support by the provinces of British Columbia, Manitoba, Ontario, Quebec, Prince Edward Island, Nova Scotia, New Brunswick, and Newfoundland and Labrador for the 31 October 2006 announcement regarding the proposed taxation of income trusts and the four-year transition period. The province of Saskatchewan indicated its support for the transition period, while the province of Alberta provided an estimate of its net revenue loss resulting from income trusts.

The Minister informed the Committee that, based on a sound and consistent methodology, a conservative estimate of the federal revenue loss associated with income trusts was about $500 million in 2006. He noted that, in his view, the estimate is similar to that calculated by Professor Jack Mintz of the Rotman School of Management at the University of Toronto.

In speaking about the sensitivity of the estimated federal revenue loss to key assumptions, the Minister indicated that a one percentage point change in the effective federal corporate tax rate from 6.6% to 7.6% would result in an estimated federal revenue loss of $710 million annually. He also noted that the 2006 estimated federal revenue loss of $500 million does not include any conversions by other companies or provincial tax impacts.

According to the Canadian Institute of Chartered Accountants, prior to the 31 October 2006 federal announcement, tax leakage was occurring with respect to the units held by tax-exempt and by non-resident investors. In the Institute's view, the magnitude of the leakage was growing.

In the view of Ms. Diane Urquhart, the proposal to tax income trusts removes tax advantages. She believed that where there are tax advantages, there are — by definition — government revenue leakages. She suggested that there is a permanent government revenue leakage and a tax-deferred loss associated with Registered Retirement Savings Plans and pension funds. Ms. Urquhart also said that she is prepared to accept the Department of Finance and its expertise, although — in her opinion — the estimated tax leakage is substantially more than $500 million if tax-deferred accounts are considered.

While Mr. Jeffrey Olin expressed his faith in the analysis provided by such persons as Professor Jack Mintz and the Department of Finance, he recognized the existence of other analysis and argued that the question of tax leakage should be considered on a more fundamental and perhaps intuitive basis.

A number of the Committee's witnesses commented on the methodology and assumptions underlying the Department of Finance's analysis and estimation of the federal revenue loss — or tax leakage — associated with income trusts. Some witnesses suggested that the actual tax leakage is lower than the estimate provided by the Minister, if a leakage exists at all. In the view of Mr. Don Francis, for example, there is no tax leakage. Similarly, Mr. Cameron Renkas said that studies done by BMO Capital Markets have not shown any tax leakage.

According to Mr. Yves Fortin, the allegation of the existence of a tax leakage is unfounded, and the tax leakage argument is incorrect and unsubstantiated. In his view, the measures contained in the draft legislative proposals — rather than the existence of income trusts — would lead to a loss of tax revenue. He noted that any allegation that income trusts are not taxed is incorrect, since they are taxed at the level of the trust unitholder rather than at the level of the trust. Moreover, he characterized the methodology used by the Department of Finance in its 2005 consultation paper — which the Committee was told has not changed — as faulty. Mr. Gordon Tait suggested that, in his view, some of the assumptions used by the Department of Finance are flawed.

Mr. Tait also told the Committee that income trusts do not reduce government tax revenues. He believed that the tax loss estimates are unlikely to result from differences in cash taxes collected from trust unitholders versus corporations, since — in a cash tax comparison — income trust investors always pay more. He cited three primary reasons for the higher rate of cash taxes in the analysis he conducted: individuals pay taxes at relatively higher marginal and

average effective tax rates; cash distributions from a trust form a larger tax base than income from a corporation; and corporations have relatively more ways to shelter income from taxation.

In Mr. Tait's view, when the burden of taxation is shifted from those that tend to pay the lowest proportion of tax and at lower rates — corporations — to those that tend to pay the highest proportion of tax and at higher rates — individuals — the government would be expected to gain tax revenues. He believed that the government should be indifferent between the payment of taxes indirectly by corporate shareholders and the payment of taxes directly by trust unitholders; in his opinion, investors should decide.

The Canadian Association of Income Funds described the tax leakage estimate as grossly exaggerated and not supported by fact, and indicated that there are no clear, credible data that have been released by the Department of Finance to prove its claim. The Association told the Committee that HDR|HLB Decision Economics Inc. — its independent third-party consultants — agreed with the Department of Finance in 2005 about a methodology, and concluded that there was no federal tax leakage due to the existence of trusts. Moreover, in its view, the federal tax revenues generated from income trusts exceed the revenues that would be generated if these trusts were structured as corporations.

Written submissions to the Committee from individual Canadian investors also indicated a belief that there is no tax leakage. Moreover, the written submission from the iTrust Institute asserted that there is no tax leakage from income trusts and questioned the calculations used to justify the proposed taxation of them.

In the view of HDR|HLB Decision Economics Inc., differing assumptions with respect to four key factors might explain a difference between its analysis and that of the Department of Finance: the effective corporate tax rate for energy trusts; the proportion of income trust units held in tax-exempt accounts; the value of deferred taxes; and the impact of future legislated tax changes. In its view, using exactly the same methodology as the Department of Finance and after making appropriate adjustments to the approach adopted by the Department, the estimated tax leakage is $164 million for 2006 and would be $32 million for 2010.

B. Witnesses' Comments on Tax-Exempt Versus Tax-Deferred

In documents provided to the Committee, the Minister of Finance asserted that it is very difficult to estimate future tax revenues from tax-deferred accounts because the timing of pension income, and of withdrawals and annuities from Registered Retirement Savings Plans (RRSPs) or payments out of Registered Retirement Income Funds (RRIFs), is not known. When estimating the impact on fiscal revenues, the federal government takes into account only the current year,

and future tax revenues from tax-deferred accounts would be included in revenue estimates for those future years. Consideration of future tax revenues from tax-deferred entities would yield a tax revenue gain only to the extent that the projected rate of return on flow-through-entity investments exceeds the rate of return that would have been achieved if those investments had instead been made in other investment vehicles.

HDR|HLB Decision Economics Inc. told the Committee that, in 2005, it worked with the Department of Finance to develop a common methodology and assumptions for deriving tax leakage estimates. The organization and the Department agreed on a general methodology, with one exception: they agreed to disagree on the issue of whether to include the value of deferred taxes. We were informed that while not immediately taxable, distributions received in tax-exempt accounts are taxable on withdrawal and, consequently, have economic value.

According to HDR|HLB Decision Economics Inc., while budgeting is done on a current basis, policy analysis should be done on a life-cycle basis. From this perspective, accounting for the life-cycle effects of deferred taxes is appropriate when changes to tax policy are contemplated.

In the view of the Canadian Association of Income Trust Investors, it is the exclusion of retirement taxes from the Department of Finance’s analysis, rather than income trusts themselves, that is the cause of the tax leakage. Mr. Yves Fortin indicated that the Department considers tax-deferred retirement accounts to be, by far, the most significant source of tax leakage. In his view, tax leakage cannot be attributed to RRSPs and pension funds, even on an annual budgetary basis, since taxable annual withdrawals from such retirement accounts far exceed annual tax-deferred contributions.

Similarly, Mr. Gordon Tait shared his view that the exclusion of taxes paid annually on the income drawn from pension funds, RRSPs and RRIFs — which he characterized as arbitrary — form the basis of the tax leakage argument. According to Mr. Tait and the Canadian Association of Income Funds, only charities and crown corporations are tax-exempt.

Other witnesses, including the Coalition of Canadian Energy Trusts, also noted that retirement accounts are tax-deferred, rather than tax-exempt, while Mr. Tait told the Committee that some analysis does not segregate trusts held inside RRIFs and pension accounts that currently pay tax from those held inside RRSPs, and current taxes collected on trusts held inside all retirement accounts are excluded from estimates. In his view, up to one-third of the trust units held in retirement accounts are in tax-paying accounts.

Regarding taxable accounts that are not tax-deferred, Mr. Fortin indicated that the federal government collects more taxes from these income trust investors

than would be collected if the trusts operated as corporations. In this case, there is no tax leakage because, as suggested above, the amount of distributions — which occur on a cash flow basis — exceed the net income that would be taxed in the case of corporations. Moreover, the distributions are taxed at personal tax rates that usually exceed the effective tax rate paid by corporations and the rate applicable to dividends. In his view, if trusts reconvert to corporations, both the tax base and the rates of taxation will decline; at the extreme, if all trusts reconvert by 2011, the government could collect 50% of the amount of taxes that are currently paid by non-deferred trust investors.

C. Witnesses' Comments on the Energy Sector

The Minister of Finance, in his appearance before the Committee, said that it would be a mistake to exempt the energy sector from the proposed income trust proposal and to provide the sector with a permanent tax holiday. Moreover, he indicated that it is reasonable to expect all sectors of the economy to pay their fair share of taxes.

The Minister also made five additional points: Canada has no intention of mimicking the U.S. tax code; U.S. Master Limited Partnerships (MLPs) are almost exclusively owned by domestic investors, whereas Canadian energy income trusts are, to a considerable extent, foreign owned; structural impediments in U.S. law have the practical effect of limiting the investment of U.S. mutual funds and tax-exempts in MLPs; the federal government does not accept that the U.S. MLP rules will provide a tax advantage as compared to Canadian energy trusts; and the value of Canadian publicly traded energy trusts represents about 4% of the market capitalization of the Toronto Stock Exchange and income trusts comprise more than 15% of Canadian oil and gas production, while the total value of U.S. MLPs is less than one-third of 1% of the market capitalization of the New York Stock Exchange and the NASDAQ. Moreover, he told the Committee that, in Canada, foreigners — primarily Americans — own 50% of large Canadian energy trusts and pay a 15% withholding tax; in the United States, MLPs are almost exclusively owned by domestic investors.

In the view of Ms. Diane Urquhart, who informed the Committee about a special shareholder tax that is paid by U.S. investors who own MLPs within their U.S. individual retirement accounts, MLPs are — for the most part — taxed identically to the manner in which Canadian income trusts would be taxed should the 31 October 2006 federal income trust tax proposal become law. She also believed that it is incorrect to argue that MLPs, because of their competitive advantages, would acquire Canadian oil and gas assets as a consequence of the income trust proposal; she expected that the reverse situation would occur.

The Coalition of Canadian Energy Trusts told the Committee that federal and provincial revenues are enhanced by the energy trust structure, with the Coalition's member trusts generating higher taxes — provincially and federally — in the past five years than would have occurred had they been structured as corporations; there is no firm evidence that tax leakage is occurring from energy trusts. In the Coalition's view, oil and gas exploration and production companies have historically paid minimal corporate taxes, while distributions from energy trusts generate current personal income taxes from Canadians, additional tax from compounding investment in tax-deferred accounts and a 15-25% withholding tax from non-resident investors.

According to Pengrowth Energy Trust, energy royalty trusts — which were described as a pivotal part of the Canadian oil and gas industry over the past two decades — are fundamentally different from Real Estate Investment Trusts (REITs) and from existing businesses that may have structured themselves as income trusts. In its view, their differences include a long history, substantial ongoing capital requirements in the energy sector and an active business model. It believed that the energy royalty trust structure has promoted growth, been efficient in facilitating the movement of capital within the oil and gas industry, resulted in innovation, enhanced productivity in the ultimate recovery of mature fields and had minimal environmental impacts. It argued that energy trusts are at the forefront of carbon dioxide injection and other technologies that will increase recovery and productivity as well as minimize the environmental impact of the energy industry and the substantial capital requirements of Canada's mature oil and gas industry in the future.

Moreover, Pengrowth Energy Trust argued that there is no tax leakage associated with energy royalty trusts compared with traditional Canadian oil and gas companies. In its view, the federal government would lose approximately $1 billion annually in tax revenues if energy royalty trusts are forced to convert back to a corporate structure. It also noted the exemption for REITs and energy trusts in the United States, and argued for the grandfathering of Canadian energy royalty trusts.

D. Witnesses' Comments on Provincial Tax Implications

In his appearance before the Committee, the Minister of Finance noted the unanimous support by provincial/territorial governments for the 31 October 2006 federal announcement. In the view of these governments, income trusts have had a negative impact on provincial revenues and economies.

From his perspective, the Provincial Treasurer for the Government of Prince Edward Island indicated that, in 2006, the sudden increase in income trust conversions was becoming a threat, recognizing the obligation to manage and protect public finances and the provincial economy as well as to provide public

services. He commented on the number, size and types of companies that were becoming — or were proposing to become — income trusts and noted that when a conversion occurs, provincial corporate income taxes are no longer paid to the province(s) in which it operates. Instead, unitholders are taxed provincially in their province of residence; since unitholders tend to reside in larger provinces or outside Canada, there is a detrimental impact on smaller provinces.

Other witnesses also spoke about the impact of the proposed income trust tax regime on provincial/territorial tax revenues. Mr. Yves Fortin told the Committee that the proposed Distribution Tax would be collected by the province where the trust resides, rather than by the province(s) where the unitholders reside, as is now the case. In his view, the consequence of this proposal is that provinces with an active investment community but few or no trusts would lose most of the taxes now collected from trust unitholders.

A similar point was made by the Coalition of Canadian Energy Trusts, which told the Committee that since most Coalition unitholders live outside Alberta — which is where all energy trusts are based — Canadians in all regions of the country share in the distributions paid, with the result that their province of residence benefits from increased tax revenues.

E. Witnesses' Comments on the Transition Period

The Minister of Finance, in his appearance before the Committee, indicated that extending the proposed 4-year transition period for existing income trusts — a period of time that he described as fair and reasonable — to 10 years would involve an estimated federal fiscal cost of about $3 billion. Provincial fiscal costs would also occur, with Alberta losing more than $2 billion and Quebec losing hundreds of millions of dollars. In his view, an extension to the transition period would be a policy reversal and would involve getting through the back door a policy change that cannot be obtained through the front door; it would also mean tax unfairness for a longer period of time and would do nothing for some investors who decided to sell their trust units between 1 November 2006 and 30 January 2007. The Minister also indicated that the proposed growth guidelines for existing income trusts during this transition period are generous. Moreover, we were informed that the transition period in Australia was three years.

The Department informed the Committee that the $3 billion estimate is calculated based on corporate tax rate reductions, including the resource tax rate reductions going from 2006 or 2007 for six years. HDR|HLB Decision Economics Inc. indicated, however, that this result could only be the case assuming unreasonably high growth in income trust distributions over the next several years.

Some witnesses, including Ms. Diane Urquhart, did not support a change to the proposed four-year transition period. She argued that a change would cause a short-term rally in the income trust market, with the result that seniors would increase their involvement in an asset class which she considers to be too risky for them.

In his appearance before the Committee, the Provincial Treasurer for the Government of Prince Edward Island reiterated his support for the proposed four-year transition period for existing income trusts.

Mr. Finn Poschmann characterized the selection of the length of the transition period as an exercise in line drawing and judgment. That being said, however, he believed that the proposed four-year transition period is a reasonable timeframe within which corporations or affected trusts could rearrange their affairs; a longer time period would allow a problem to continue to exist unnecessarily.

The TAMRIS Consultancy told the Committee that it could see no advantage in extending the transition period beyond the proposed four-year period. In its view, income trusts should convert back to a traditional corporate structure as soon as possible.

In its appearance before the Committee, HDR|HLB Decision Economics Inc. calculated an estimated tax leakage of $192 million — $32 million in each year — if the proposed transition period is extended from 4 years to 10 years. In its view, its methodology is identical to that used by the Department of Finance, yet estimates of the cost of such an extension differ sharply; it believed the Department overstates, by a factor of 15, the tax leakage associated with an extension of the proposed transition period to 10 years.

In the view of Mr. Cameron Renkas, a proposed 10-year transition period for Canadian income trusts would have meant a negative market impact of about 8%, rather than 12.5%, and would have saved Canadian investors approximately $10 billion.

Witnesses commented that other countries had a longer transition period when changes were made to the tax treatment of existing publicly traded partnerships, with some noting the 10-year transition period in the United States during which there were no restrictions on partnerships expanding within their existing lines of business or into businesses that generated qualifying income; expansion into a new business that generated non-qualifying income and that was not closely related to the existing business was not allowed to exceed 15% of either gross income or assets.

The Canadian Association of Income Funds told the Committee that future income trust conversions should be limited, thereby implicitly supporting a policy of grandfathering for existing trusts. Mr. Yves Fortin supported criteria and regulations to determine which types of businesses should be, and should not be, allowed to convert to income trusts.

Similarly, Mr. Dave Marshall argued for limits on the creation of new trusts. Mr. Tait, who supported a longer transition period, mentioned that the federal government might have clearly indicated what sectors it believes would be inappropriate for income trust structures, with corporations of a certain size perhaps having to be reviewed prior to conversion.

While advocating an exemption from the proposed income trust tax regime — in essence, grandfathering — as the preferred option, Canada's Association for the Fifty-Plus said that, at the very least, current income trusts should have a 10-year transition period, consistent with the U.S. approach; this longer period of time would give retail investors a chance to readjust and redirect their investments without panic and perhaps recoup a portion of their losses. Grandfathering was also supported by Mr. Don Francis, who advocated grandfathering of all existing income trusts, without any constraints on their growth, until the 31 October 2006 federal income trust tax proposal is honestly and fully studied.

A 10-year transition period was also supported by Mr. William Barrowclough, who mentioned the decade-long transition period that existed in the United States when similar changes were made in that country.

Written submissions to the Committee from a number of individual Canadian investors also argued that existing income trusts should be grandfathered; the view was also expressed that the 4-year transition period should be extended to 10 years, consistent with the approach taken in other countries. Moreover, it was suggested that a cardinal rule of tax policy is that existing transactions that were in compliance with the previous rules are grandfathered when new adverse measures are introduced.

F. Witnesses' Comments on Real Estate Investment Trusts

Regarding Real Estate Investment Trusts, the Minister of Finance told the Committee that, internationally, REITs are treated separately in other jurisdictions that are comparable to Canada. In his view, this separate treatment in other jurisdictions justifies continuing this practice in Canada.

A number of witnesses identified the existence of a lack of clarity regarding the exemption for REITs in the 31 October 2006 federal announcement. The Canadian Association of Income Trust Investors commented on the passive fixed nature of REIT assets and their relative contribution as engines of economic growth and employment as well as their overall strategic importance to Canada.

Written submissions to the Committee from individual Canadian investors referred to the REIT exemption as favouritism, and indicated that it is unfair to allow REITS to prosper and continue unchanged while not granting an exemption to the energy sector. It was argued that REITs — as well as private trusts and private income trusts — should be subject to the proposed income trust tax regime.

The Real Property Association of Canada, in its written submission to the Committee, indicated that it is pleased with the decision to continue to recognize REITs. That being said, it identified four issues requiring resolution: the requirement to have foreign property ownership restrictions; the need to require each company in a REIT ownership group to comply separately with all rules; clarification regarding what constitutes income from property for purposes of REIT exceptions; and the need for continuous compliance.

ACHIEVING TAX NEUTRALITY

A. Witnesses' Comments on Taxable Investors

The Committee was reminded that the *The Budget Plan 2006* announced an increase in the gross-up and dividend tax credit in order to eliminate the double taxation of dividends from large corporations at the federal level. This change, however, does not affect tax-deferred or non-resident investors, who — for tax reasons — continue to prefer the income trust structure.

B. Witnesses' Comments on Tax-Deferred Investors

A number of the Committee's witnesses pointed out that investors in tax-deferred accounts are not eligible for the dividend tax credit that is available to those who invest in taxable accounts. According to Mr. Dirk Lever, this situation could result in a form of double taxation, which can be avoided through investment in income trusts. The Committee was told that taxation of income trusts in the manner that has been proposed would result in double taxation of tax-deferred investors.

In the view of Mr. Don Francis, the objective is to kill income trusts through double taxation of income trust distributions in retirement accounts.

Mr. Gordon Tait told the Committee that, under the proposed income trust tax regime, a pension plan beneficiary or someone with a RRIF that has an income trust investment would have every $1 in cash distributions taxed at the rate of 31.5% at the trust level; as the income is paid out to the pension beneficiary or the trust unitholder, additional taxes would be paid. For some unitholders, an effective tax rate of up to 58.5% would be faced, with the result that 41.5 cents of every $1 in cash distributions would be received by the unitholder. Mr. Tait believed that the proposed Distribution Tax should not be applied to trusts held inside RRSPs, RRIFs and pension plans.

According to Ms. Diane Urquhart, however, net double taxation within RRSPs and pension funds does not occur. In her view, the absence of net double taxation is a consequence of the structural benefits within RRSPs and pension funds themselves, since there is an up-front deduction and the deferral of taxes on investment income.

Mr. Tait also questioned why only publicly traded trusts would be assessed the proposed 31.5% Distribution Tax. In his view, only smaller Canadian investors — who buy publicly traded trusts because of the limited capital they have to invest — would pay the proposed tax, while public pension funds, large private equity funds in Canada, and U.S. private and public investors would not be required to pay the proposed tax. He indicated that the proposed taxation of income trusts would create a two-tiered investing landscape.

Mr. Cameron Renkas also commented on the need to level the playing field — from a tax perspective — not only between corporations and trusts, but also to ensure that publicly traded trust unitholders are treated the same as non-publicly traded trust unitholders.

This point was also made by the Canadian Association of Income Funds, which noted that the 31 October 2006 federal announcement would not include private trusts and other non-public partnership arrangements.

C. Witnesses' Comments on Non-Resident Investors

In his appearance before the Committee, the Minister of Finance indicated that income trust distributions are being received by a large number of non-resident investors who, in his view, are reaping a financial windfall. He noted that the 15% withholding tax paid by these non-resident investors is far less than the tax rate paid by Canadian trust unitholders.

Mr. Yves Fortin commented on non-resident trust investors and suggested that the proposed Distribution Tax would lead to virtually complete divestment from trust units; it is unlikely that these investors would reinvest those funds in other

Canadian instruments, which have a lower yield. He also noted that the government would lose the withholding taxes that are currently paid, thereby reducing tax revenues.

D. Witnesses' Comments on Selected Implications of the Proposed Income Trust Tax Regime

1. International Parity?

A number of the Committee's witnesses suggested that the assertion that other countries — particularly the United States and Australia — had, in the past, acted to shut down flow-through structures similar to Canadian income trusts is not entirely accurate. Mr. Cameron Renkas informed the Committee that U.S. flow-through structures — which include about 214 publicly traded flow-through entities with a market capitalization of more than $465 billion — are virtually the same as Canadian income trusts. Like the Canadian Association of Income Trust Investors, he also suggested that — unlike Canada — the trend in the United States appears to be increased support for the flow-through structure. Moreover, he noted that, in the United States, exemptions were provided for such sectors as: oil and gas; production; transportation; refining; mining; fertilizers; propane distribution; timber; and real estate.

The Canadian Association of Income Trust Investors also commented that selectively choosing the economic policies of other countries is a dangerously simplistic approach to policy development when it occurs without a complete understanding of the broader context within which those policies were developed. Moreover, according to the Association, it cannot be assumed that the countries have been well served by the policies, either at the time they were developed or since they have been implemented. Finally, it told the Committee that it is hard to believe that a policy adopted in the United States in 1987 is the best policy for Canada in 2007.

Similarly, Mr. Renkas said that it is difficult to make comparisons to one small aspect of a country's tax policy without regard to how it fits into the broader tax system.

Written submissions to the Committee from individual Canadian investors questioned why Canada must be aligned with other jurisdictions if Canada has an investment class that is unique and beneficial to Canadian markets and investors,

and that is attracting foreign capital. The question of whether the federal government would consider doing away with the dividend tax credit because such a credit does not exist in the United States was posed.

2. Foreign Ownership and Control?

Mr. Cameron Renkas informed the Committee that, in his view, U.S. flow-through entities could, in the future, acquire Canadian trust assets, given their significant cost of capital advantage and the suitability of these assets for their structure. In his opinion, such acquisitions would most likely occur with respect to energy and resource-related trusts.

The Canadian Association of Income Trust Investors described the 31 October 2006 federal announcement as having created “the perfect storm” for foreign private equity firms, who would engage in opportunistic buying and income-stripping value-maximization techniques. Such private equity ownership would, in the Association’s view, lead to foreign control of sectors of the Canadian economy and could lead to head office decisions being made outside of Canada.

Similarly, the Canadian Association of Income Funds told the Committee that, with depressed valuations, many income trusts are susceptible to acquisition by private equity funds or by private investors.

In the view of the Coalition of Canadian Energy Trusts, should a significant portion of trust assets revert to foreign ownership, tax value would most likely be lost to Canada in the form of deductible interest which would be subject to a 0-10% withholding tax and of taxation of capital gains in foreign jurisdictions. Comments were also made about the exposure of Canadian corporations to leveraged buy-outs, a loss of head office jobs and a repatriation of $10 billion in previously foreign-controlled assets by the trust sector.

In the context of the existing 15-25% withholding tax on distributions to non-resident investors and the tax revenues that are collected as a consequence, witnesses noted that non-resident investors do not use Canadian services or infrastructure even though taxes are paid by them. From this perspective, Mr. Gordon Tait noted that withholding taxes do not need to be as high as Canadian tax rates, since non-resident investors do not use Canadian health, education or social security systems or infrastructure.

In a written submission to the Committee, Swank Capital, LLC. asserted that, with the proposed income trust tax regime, Canadian conventional oil and natural gas production would suffer and U.S. energy firms would become more aggressive acquirers, with Canadian control of the Western Canadian Basin

reduced. As well, the submission, which largely focussed on oil and gas, suggested that implementation of the proposed income trust tax regime would result in the disappearance of trusts.

3. Losses to Investors and Income Security Implications?

Witnesses told the Committee that Canada's seniors have borne a disproportionate share of the $30-$35 billion loss in market value that occurred following the 31 October 2006 federal announcement. Written submissions received by the Committee from individual Canadian investors commented on such issues as: income trust investments that were made following assertions that trusts would not be taxed; the extent to which retirement plans must be changed, and some returns to work must occur, as a consequence of the loss in trust unit value; and the extent to which economic prosperity may be harmed by the more limited ability of seniors to purchase goods and services.

The Coalition of Canadian Energy Trusts also spoke about the capital and income losses for investors — with the associated loss in tax revenues — as well as the ripple effect of these losses, including for charitable organizations. The Canadian Association of Income Funds characterized the response to the 31 October 2006 federal announcement as a multi-billion dollar meltdown of investor savings that sounded the death knell for the income trust sector.

Mr. Yves Fortin suggested that, because of nearly double taxation of distributions, holders of RRSPs and RRIFs as well as pension funds would have to shift their investments to assets that have a lower yield, which would result in lower annual retirement income in addition to the heavy capital losses that have been experienced. In his view, lower retirement income would lead to lower tax revenues and more pressure on Canada's social welfare system. In characterizing the attitude of the Minister of Finance as callous, he argued that there is a clear need to adopt measures to compensate those who lost a "chunk" of their retirement savings.

In describing the 31 October 2006 announcement as a rash and reckless action by the Minister of Finance and as the Halloween massacre, Mr. William Barrowclough commented on the reduced stream of income that some retirees are likely to experience. In his view, regular cash flow is of primary importance to retirees. Moreover, he believed that what he characterized as the impending death sentence for income trusts is likely to limit the extent to which income trust values will rebound, which has implications for the capital held in income trusts.

Similarly, Mr. Dave Marshall indicated that the 31 October 2006 federal announcement resulted in a sledgehammer being taken to retirement savings and future income, while Mr. Jean-Marie Lapointe described the financial losses he has experienced since the announcement.

Canada's Association for the Fifty-Plus shared its view that if the federal government implements its income trust tax proposal as planned, there would be more loss of income after four years on a regular basis.

The written submission by the iTrust Institute to the Committee questioned how recouping an estimated $500 million annually in taxes from existing taxpayers justifies an instant destruction of $20 billion from the tax base and a decline in the relative value of the Canadian dollar.

A number of the Committee's witnesses as well as some of the written submissions received by us commented that the tax fairness plan announced on 31 October 2006 will result in more Canadian seniors becoming reliant on the nation's social security system. Mr. Gordon Tait questioned the longer-term repercussions of not providing sufficient income alternatives for retirees as well as the cost of the additional burden on the government.

E. Witnesses' Comments on Other Options

1. General Comments on Other Options

Witnesses appearing before the Committee commented that it is not necessary to destroy the entire income trust sector in order to control the undesirable proliferation of income trust conversions. According to the Canadian Association of Income Funds, a sledgehammer approach to the income trust sector was taken when only tax-exempt entities and non-resident investors were the root cause of the problem; a chainsaw was used rather than a scalpel.

According to Mr. Gordon Tait, a system that allows both traditional corporate structures and income trusts should exist, recognizing that certain industries and/or large corporations could be prohibited from becoming trusts, consistent with the concept of restrictions on foreign ownership levels that currently exist for key Canadian industries. He believed that there are alternatives to the proposed income trust tax regime that would provide a better solution for the federal government, businesses and investors, and urged elected Members of Parliament to consider other policy alternatives.

According to the Canadian Institute of Chartered Accountants, prior to the 31 October 2006 federal announcement, the taxation of income trusts did not meet the criteria that are thought to be desirable in a tax system: the promotion of economic growth and competitiveness through a broad tax base and low tax rates; neutrality; and fairness. In the Institute's view, tax neutrality did not exist, since there was an incentive to structure as an income trust rather than a traditional corporation, and a growing tax leakage was occurring with respect to both the units held by tax-exempt and non-resident investors. Of these two factors, the Institute argued that the lack of tax neutrality was the more important.

A similar point was made by Mr. Finn Poschmann, who mentioned the Technical Committee on Business Taxation's central recommendation of a neutral tax policy with respect to corporate capital structures. As noted by him, this neutrality would be possible through a corporate distributions tax, which he characterized as being similar — with respect to income trusts — to the mechanism proposed by the federal government on 31 October 2006. While suggesting that the government's decision was ultimately correct, he also argued that there is greater scope for reforming the tax system.

2. Tax-Deferred Investors

Within the context of the potential income trust conversions that prompted the 31 October 2006 federal announcement, Mr. Gordon Tait shared his view that much of the problem is the result of a tax system that is not fully integrated. Moreover, he noted the lack of consideration of other policy choices as well as of debate and consultation among policy makers. Mr. Tait suggested that the proposed income trust tax regime goes farther than is needed to accomplish the federal government's objectives, and is causing unnecessary harm to seniors and retirees. He believed, however, that the proposed regime would more than level the playing field and would effectively discourage or prevent corporate conversions to income trusts.

Mr. Tait argued that if the system of double taxation were eliminated with respect to both taxable and non-taxable accounts, and if corporate income and dividends were taxed at the same level as interest, then there would be no tax incentive to convert to an income trust. While he supported the proposed and enacted measures regarding corporate taxes and the dividend tax credit, which would create a level playing field between trusts and corporations for taxable Canadian investors, he expressed the view that a two-tiered investing landscape — which favours large institutional investors, private equity investors and large pension funds over ordinary Canadians — should be avoided. In his opinion, the refundable portion of the dividend tax credit should be extended to dividends on shares held inside retirement accounts.

Mr. Cameron Renkas recommended a refundable dividend tax credit based on actual corporate taxes paid, available for dividends paid to all Canadians; this measure would eliminate the double taxation of dividends and should remove the incentive for corporations to convert to income trusts simply for tax reasons. He believed that the decision to convert to an income trust should be based on the merits of the particular business and its suitability for the trust structure.

Mr. Dirk Lever presented a proposal to the Committee that he believed would level the playing field but that would protect business values and eliminate double taxation. In his proposal, Canadian corporate dividends received by Canadian taxpayers and pension beneficiaries would be taxed once and would be eligible for the dividend tax credit, while non-resident investors would face corporate income taxes and withholding taxes on the dividends they receive. Regarding trust distributions, Canadian taxpayers and pension beneficiaries would be taxed once and would be eligible for a distribution tax credit, while non-resident investors would face corporate income taxes and withholding taxes on the distributions they receive. The proposal for a refundable tax credit was supported by Mr. William Barrowclough in his appearance before the Committee.

Mr. Finn Poschmann indicated that upstream taxes paid on distributions to pensions and RRSPs should be refunded to unitholders and to shareholders.

According to the Canadian Institute of Chartered Accountants, while the 31 October 2006 federal announcement was an important step in the right direction in order to level the playing field between traditional corporations and income trusts as well as to address the issue of tax leakage, an additional change should be studied by the Department of Finance to enhance the neutrality and fairness of the tax system: the proposed Distribution Tax and the dividend tax credit should be fully refundable to all Canadian investors. In the Institute's view, this additional change would make the Canadian tax system fully integrated, with no discrimination among Canadian investors. Nevertheless, issues that would have to be considered include: fiscal and interprovincial implications; the need for such sector-specific exemptions as REITs; and adequate sources of financing for small and medium-sized businesses that wish to trade publicly.

A number of written submissions also commented on the issue of double taxation, and supported a distribution tax credit and/or extension of the dividend tax credit to tax-deferred investors.

3. Non-Resident Investors

Mr. Cameron Renkas told the Committee that the income trust asset class is maturing and may require certain refinements. He also indicated that, like other jurisdictions, income trusts play an important role in Canadian capital markets. That

being said, in order to address the issue of tax leakage to non-resident investors, he recommended one of two alternatives to increase the taxes collected from non-resident investors without harming the savings of Canadians: increase withholding taxes to non-resident investors in a direct manner, or indirectly increase the withholding tax through a combination of a small distribution tax of 5-10% and a fully refundable tax credit available to all taxable and tax-deferred Canadian investors.

Mr. Gordon Tait also suggested, as an issue that needs additional study, a measured increase in the amount of tax charged to non-resident investors by 5-15%. In his view, the proposed income trust tax regime would increase the rate of tax applied on a trust held by non-resident investors to a level that he described as inexplicably high.

Mr. Yves Fortin shared his view that, due to much higher taxation under the proposed income trust tax regime, non-resident investors would divest their income trust units, with the result that the federal government would lose the quasi-totality of the withholding taxes currently collected.

Pengrowth Energy Trust suggested that capital, which seeks the highest return at the lowest risk, does not have to come to Canada.

EFFICIENT CAPITAL MARKETS AND BUSINESS STRUCTURES

A. Witnesses' Comments on the Productivity of Income Trusts

In his appearance before the Committee, the Minister of Finance suggested that conversions to income trusts were starting to occur in areas of the Canadian economy that require investment and reinvestment; he characterized this situation as dangerous for our economic growth and our future prosperity. Particular mention was made of the knowledge-based sectors of our economy.

Witnesses provided the Committee with divergent views on the extent to which income trusts make productivity-enhancing investments. In commenting on the growth potential of income trusts, the Canadian Association of Income Trust Investors cited an article which asserted that income trusts have invested their capital and grown their businesses at an impressive rate; this assertion is based on a PricewaterhouseCoopers survey.

Mr. Don Francis told the Committee that, in his view, the income trust structure is not associated with reduced productivity and competitiveness.

Within the context of general economic principles and his understanding of the structure of the Canadian economy, the Governor of the Bank of Canada told the Committee that while the income trust structure might be very appropriate in circumstances where firms need only to manage existing assets efficiently, the structure is definitely not appropriate in circumstances where innovation and new investment are key. In his view, to the extent that the income trust structure was being favoured in these cases, incentives for innovation and investment were lower, as was the potential for future productivity growth.

In the view of Mr. Al Rosen, in some income trusts, money is not being reinvested.

According to Mr. Finn Poschmann, an income trust cannot grow organically through retained earnings. In his view, it can only grow through issuing new debt (which is costly, raises total risk and reduces distributions to unitholders) and/or issuing new trust units, which is dilutive to existing unitholders.

Professor Ramy Elitzur suggested that companies that are naturally income trusts do not invest in capital, which means that they do not grow. He believed that the long-term detrimental effect of this situation on the economy is very intuitive.

Standard and Poors Canada told the Committee that it is difficult to generalize about the extent to which income trusts engage in sufficient appropriate reinvestment within their businesses. We were informed that this issue requires a fundamental, case-specific examination of each income trust, including its business risk and financial risk characteristics; in this regard, income trusts are like traditional corporations.

B. Witnesses' Comments on Investment Options

A number of witnesses commented on the need by Canadian investors for investment options, particularly for income-producing investments. According to the Governor of the Bank of Canada, income trusts can benefit investors through the opportunities they provide for diversification, since they can have different risk-return characteristics than equities or bonds. To the extent that this result occurs, income trusts can be said to enhance market completeness and, thereby, to support financial system efficiency. He also noted, however, that different risk-return characteristics may not enhance market completeness if they arise from differences in tax treatment.

Mr. Cameron Renkas identified flow-through structures as a tax-efficient means by which excess cash flow can be passed from mature businesses to investors, who then have such options as reallocating this capital to higher-growth investments, spending the capital (with the associated economic benefits) or using the capital to enhance their savings. In his view, the structure meets the needs of an ageing population for high-yielding investment options.

Mr. Renkas also told the Committee that while the U.S. flow-through market totals $475 billion, it comprises a small part of the nearly $6 trillion high-yield market in the United States; despite having a similar demographic profile in terms of the need for income, Canada's high-yield market is approximately $200 billion, consisting almost entirely of income trusts. In his view, given a ten-to-one population equivalent, Canada should have a $500-$600 billion high-yield market. He questioned why the federal government would want to limit the investment alternatives available to investors and wondered about the longer term repercussions of not providing sufficient income alternatives for Canadian retirees.

In describing income trusts as an important "made-in-Canada" investment choice, the Canadian Association of Income Trust Investors suggested that, to the extent that this choice will be denied to Canadian investors, Canadian investment capital will move to global capital markets. If this situation occurs, Canadian retirement savings will finance the growth and prosperity of U.S. companies for the benefit of the U.S. economy. According to the Association, income trusts need to remain as a vibrant and sustainable part of Canadian capital markets going forward; people's lifestyles and standards of living are fundamentally at stake and the only investment vehicle that has any hope of providing retired Canadians with the ability to maintain their lifestyle after they no longer receive employment income should not be lost.

Mr. Gordon Tait shared his view that income trusts meet the investment objectives and risk profiles of a large segment of investors; it cannot be assumed that the capital invested in trusts would necessarily be invested in equity. He indicated that trusts have provided higher returns with less volatility than equities, and are the de facto high-yield investment vehicle in Canada. In his opinion, given the demographic profile of Canadians, the preference for income trust vehicles rather than equities had little to do with tax considerations and much to do with the preference for income-oriented returns rather than capital appreciation-oriented returns. He questioned why the federal government would want to limit investment alternatives for Canadians and where Canadians who do not belong to defined benefit pension plans would turn for yield and income.

According to Mr. Jeffrey Olin, investors — including seniors — have investment alternatives to income trusts which can provide predictable, yield-driven returns and cash flow in excess of Guaranteed Investment Certificates or bonds. As an example, he mentioned convertible debentures, which provide a regular

distribution of interest income and, compared to income trusts, would generally be a less risky investment since debenture holders have an entitlement to a corporation's cash flow in preference to equity holders.

Mr. Tait also commented on Canada's need for foreign investment in order to fully develop our economic potential. He told the Committee that, in theory, non-resident investors who are discouraged from investing in Canadian income trusts could invest in bonds, debt obligations or common equities, or could engage in direct investment; in practice, however, bonds or other debt obligations are not a very good alternative to a trust from a tax perspective, the Canada Revenue Agency does not collect taxes on capital gains realized by foreign investors and the tax implications of direct investment are not clear. In his view, this complex area requires additional consultation and analysis.

Not all witnesses, however, agreed that investments in income trusts are appropriate for all investors. Ms. Diane Urquhart described these investments as too risky for seniors and other conservative investors because the income trust business model is flawed, there are financial reporting concerns with income trusts, and income trusts are marketed on the basis of a cash yield measure that — in most cases — is inaccurate, misleading and inflated. She suggested that the income trust product has benefited the vendors and the promoters of income trusts.

Ms. Urquhart also asserted that the majority of income trusts pay distributions that exceed their income, without disclosure to distinguish between income and the return of capital. She cited evidence which suggests that return of capital distributions are being financed by funds saved by not maintaining and not replacing depreciating capital assets (which will reduce the future value of the business and will ultimately require reduced distributions or the raising of equity) and raising credit in advance. She also indicated that excess distributions might occur through debt financing, cash reserves from prior equity issuances and accumulated retained earnings, changes in working capital and customer purchase goodwill.

The TAMRIS Consultancy similarly argued that many income trusts have been distributing a portion of their capital in addition to a return on their capital. In its view, many trusts are also using debt and capital raised from new issuance to fund distributions that exceed their cash flow. It argued that investors have been led to believe that income trusts provide both high yield and high rates of capital growth over the long term, which they do not; income trusts have a short-term investment objective.

Mr. Jeffrey Olin also told the Committee that many income trusts pay out distributions that exceed the value of their taxable income in order to be competitive from a yield perspective.

Similarly, Mr. Al Rosen told the Committee that it is frequently the case that income trusts distribute a return of capital. He expressed his view that there is nothing wrong with returning capital, provided unitholders understand that their distributions include a return of capital. Within the context that income trust unitholders were not fully informed about their yield and the basis of their distributions, Mr. Rosen also indicated that the federal announcement on 31 October 2006 was long overdue, since action was needed.

According to the Canadian Association of Income Funds, the term “return of capital” is a misnomer and infers that people are receiving their own money, which is not correct. The Association said that, in fact, return of capital is the tax deferral of that particular corporate entity being flowed through into the hands of the unitholder.

The disclosure issue highlighted by Ms. Urquhart was also noted by The TAMRIS Consultancy, which indicated the existence of asymmetrical information: trust unitholders are unaware that a portion of their yield is a return of their capital and that a portion of their recent return is highly leveraged to the economic cycle and the demand for income trusts. Moreover, it believed that income trusts have grown through Initial Public Offering (IPO) issuance as well as through post-IPO acquisition, and that much of the gain results from the transfer of capital from other business structures, economic sectors and asset classes; income trusts focus on acquisitions that provide cash flow and tend not to operate in the growth sectors of the future. Finally, it argued that income trusts have not been sold to assist retired individuals in meeting their income needs but rather because of the revenue they generate for financial institutions as well as for private equity and institutional investors that used them as exit routes.

Similarly, the Small Investor Protection Association indicated, in its written submission to the Committee, that business income trusts can be risky investments and that many are not suitable as investments for seniors. A similar point was made by the National Pensioners and Senior Citizens Federation, which advocated a regulator to address concerns about investment losses resulting from inappropriate advice from investment professionals.

C. Witnesses’ Comments on Business Structure Options

In his appearance before the Committee, the Governor of the Bank of Canada stated that the income trust structure appears to improve access to market financing for some firms. In a manner similar to the diversification benefits for investors, to the extent that these firms have improved access to capital, market completeness is enhanced and financial system efficiency is supported. He also noted, however, the existence of very significant tax incentives to use the income trust structure in cases where this structure would not have been the appropriate form of corporate organization from a business efficiency perspective; by providing

incentives that resulted in the inappropriate use of the income trust structure, the tax system created inefficiencies in capital markets that, over time, would lead to lower levels of investment, output and productivity.

The Governor also indicated that the proposed federal income trust tax regime would appear to level the playing field in a substantial manner. In his view, for the income trust sector to deliver efficiency benefits through its enhancement of market completeness, it is critical that the tax system provide a level playing field. He said that the proposed changes to the taxation of income trusts would make the system more neutral and more conducive to higher output and better performance in the future.

A level playing field was also supported by Mr. Jeffrey Olin, who expressed his general support of governmental pursuit of policies that level the playing field — from a tax perspective — between trusts and corporations.

Mr. Gordon Tait told the Committee that the income trust structure is well suited to many businesses and the industries in which they operate. He believed that many trusts have demonstrated their ability to operate efficiently as a trust while continuing to grow. In his view, there is no economic law or principle which prescribes a single form of business organization for each type of business or each industry.

The Canadian Institute of Chartered Accountants shared the view that income trusts have a role to play in Canada's capital markets and are appropriate for some businesses, since they provide a source of financing that might not otherwise be available, particularly for small and medium-sized businesses. It also indicated, however, that the status quo was not an option and commended the federal government for taking action.

Similarly, Mr. Dirk Lever told the Committee that income trusts have been a viable source of capital for many small and medium-sized Canadian businesses. He believed that income trusts can "live alongside" corporations.

In the view of Mr. Cameron Renkas, flow-through structures encourage investment in mature businesses or industries which, without attractive reinvestment options, would otherwise have their capital trapped without an efficient use. He believed that the flow-through structure is an efficient means by which excess cash flow can be passed from mature businesses to investors.

The Committee was informed by the Coalition of Canadian Energy Trusts that the trust structure is the ideal model for the nation's mature hydrocarbon basins, having — since their introduction in 1986 — played a unique role in maximizing oil and gas production and reserve recovery as well as in providing

essential capital to the energy industry. The Coalition indicated that a focus on optimization of existing conventional oil and gas pools extends their effective working life, with associated direct and indirect economic benefits, and creates new productivity in certain areas. In the Coalition's view, the traditional corporate structure is less efficient for mature oil and gas assets and would result in lower provincial and federal tax revenues. It believed that the proposed taxation of income trusts could have such unintended consequences as a reduced energy supply and environmental impacts, since trusts are the primary entities focussed on material reductions in the nation's greenhouse gas emissions through carbon dioxide-enhanced oil recovery and sequestration projects.

The Canadian Energy Infrastructure Group, in its written submission to the Committee, asserted that the income trust structure is ideal for Canadian energy infrastructure assets. It believed that the trust structure in this sector has been a catalyst for investment and growth in long-life, physical assets that are critical to the development of new energy supplies and the establishment of Canada as a world energy superpower; as well, the structure maintains Canadian ownership of critical energy infrastructure.

In mentioning the situation that exists in the U.S., the Canadian Energy Infrastructure Group noted the precedent provided for unique treatment of energy infrastructure. It also drew a parallel to REITs, noting that energy infrastructure trusts — like REITs — represent stable, long-life, hard assets. In its view, with the proposed taxation of income trusts, there is a higher potential for acquisition of critical Canadian energy infrastructure; it is unlikely that these assets would be owned by publicly traded Canadian corporations.

In the view of Mr. Jeffrey Olin, such fundamentally important decisions as corporate or ownership structures, as well as investment decisions, should not be exclusively — or even primarily — driven by tax considerations. He noted that the traditional corporate structure provides greater flexibility for boards of directors and the management team to manage the business affairs of the entity than is associated with the income trust structure; that being said, conversions may occur in order to gain tax benefits, even if the trust structure is not the structure that is most suited to the business model. He believed that the consequence may be that trusts have less internal capital available to pursue growth initiatives or reinvestment in capital expenditures, which could compromise the long-term prospects of the entity or the economy in general.

According to Mr. Finn Poschmann, income trusts do not have special governance features that make them more responsive to unitholder interests, and nor do they do a better job of holding managers to account for financial

performance. He also argued that the risks and assets that income trusts bring to the retail marketplace do not differ from those available through traditional corporate structures.

Manulife Financial told the Committee that the Canadian income trust sector is increasingly populated by businesses other than those whose principal activity is the operation of real estate or royalty-producing assets, and suggested that it is worth remembering that it was for these businesses that the current income trust regime was originally designed. It was argued that the income trust structure may not be appropriate for some of the businesses that have converted and the desirability of a tax regime that would discourage the accumulation of an appropriate level of retained earnings by the corporate sector was questioned. Moreover, it was suggested that, if left unchecked, the income trust sector would encompass the core of the Canadian economy, which would not be good for the country.

In the view of Professor Ramy Elitzur, who supported the proposed income trust tax regime as a step in the right direction, many existing income trusts should not have this corporate structure. In his view, in order to convert to an income trust, a company should meet certain conditions: it should be mature; it should have a lot of time remaining as a mature company; and it should have stability in revenues and expenses.

D. Witnesses' Comments on Accounting

A number of the Committee's witnesses argued that some income trusts suffer from incomplete and inaccurate disclosure of information. According to Ms. Diane Urquhart, the Canadian Accounting Standards Board should require income trusts to report both income distributions and return of capital distributions. She also believed that provincial trust laws should restrict distributions to income, with periodic return of capital distributions occurring through transparent special return of capital distributions. In her view, provincial/territorial securities commissions should establish and enforce a requirement for income trust prospectuses and other public disclosure documents. In the view of Mr. Dave Marshall, the reporting standards of existing income trusts should be reformed.

In his appearance before the Committee, the Governor of the Bank of Canada identified two areas in which the standards for income trusts differ from those for corporations, and where improvement is needed: accounting and the distribution of revenue; and governance.

Standards and Poors Canada told the Committee that a study of the consistency and adequacy of financial reporting by income trusts identified substantial inconsistencies in the reporting practices of income trusts which, in some

cases, resulted in significant overstatements of distribution capabilities. We were also informed, however, that market participants have — in recent months — improved the quality and consistency of income trust reporting and disclosure, in part as a result of disclosure standards issued by the Canadian Securities Administrators and the Canadian Institute of Chartered Accountants.

The Canadian Institute of Chartered Accountants told the Committee that it had issued guidance for income trusts which recommended standardized reporting for the term "distributable cash" and enhanced disclosure of the strategies used by management to determine what percentage of a trust's cash is distributable to investors; the focus is the source of the cash and whether the cash flow is sustainable.

In its written submission to the Committee, the Small Investor Protection Association argued that seniors are losing their savings due to inappropriate actions and outright wrongdoing by the investment industry. It noted the lack of a federal authority with responsibility for investment protection or the prevention of financial elder abuse; accounting issues were also noted in the submission. Mr. Al Rosen also commented that, in Canada, there is no one looking at the interests of investors.

In the view of Mr. Don Francis, income trust accounting is not worse than corporate accounting.

CONCLUSION

The Committee agrees with those who advocate a tax system that: promotes the growth and competitiveness of the Canadian economy, with a broad tax base; is neutral; and is fair.

While the Committee believes that elements of the proposed income trust tax regime announced on 31 October 2006 could contribute to the attainment of these goals, we feel that additional actions are needed.

Moreover, the Committee urges all federal departments and agencies — but particularly the Department of Finance — to be as complete and transparent as possible in providing the information and rationale for proposed tax and spending changes. In our view, the broad range of income trust stakeholders would have been well served had the information provided to us by the Minister of Finance during his presentation been made available on a more timely basis.

Within the context of our hearings on the proposed taxation of income trusts, the Committee makes the following recommendations.

RECOMMENDATION 1

It is imperative that a democratic government be as transparent as possible when levying a new tax so that it can be held to account by its citizens. The Committee, therefore, recommends that the federal government release the data and methodology it used to estimate the amount of federal tax revenue loss caused by the income trust sector.

RECOMMENDATION 2

The proposal to tax income trusts is of such significance and has had such a devastating effect on Canadian investors that Members of Parliament deserve a clear vote to best represent the interests of their constituents. The federal government should, therefore, separate it from the other sections of the Ways and Means Motion and table it in a stand-alone piece of legislation. The pension income splitting, the 0.5% reduction in the corporate tax rate in 2011 and the increase in the age credit amount should proceed as quickly as possible in their own separate piece of legislation.

RECOMMENDATION 3

Overwhelming evidence indicates that superior and far less damaging alternatives were available to the federal government. The Committee urges the government to consider implementing one of two such alternative strategies:

> **a) the federal government reduce its proposed 31.5% Distribution Tax on income trusts to 10%. This tax should be instituted immediately and should be made refundable to all Canadian investors. Furthermore, the government should continue the moratorium on new income trust conversions while remaining open to representations from sectors that feel they are well suited to the income trust structure; or**
>
> **b) the federal government extend the proposed transition period from 4 years to 10 years.**

APPENDIX A
LIST OF WITNESSES

Organizations and Individuals	Date	Meeting
As Individual	2007/01/30	59
Dianne Urquhart, Independent Consulting Analyst		
BMO Capital Markets	2007/01/30	59
Cameron Renkas, Royalty and Income Trust Analyst		
Canada's Association for the Fifty-Plus	2007/01/30	59
William Gleberzon, Co-Director, Government and Media Relations		
Canadian Association of Income Funds	2007/01/30	59
George Kesteven, President		
Canadian Association of Income Trust Investors	2007/01/30	59
Brent Fullard, President and Chief Executive Officer		
Department of Finance	2007/01/30	59
Robert Wright, Deputy Minister		
Mark Carney, Senior Associate Deputy Minister, G-7 Deputy for Canada		
Brian Ernewein, General Director, Tax Legislation Division, Tax Policy Branch		
Bob Hamilton, Senior Assistant Deputy Minister, Tax Policy Branch		
House of Commons	2007/01/30	59
The Honourable Jim Flaherty, Minister of Finance		
Total Asset Management Research & Investment Rights Consultancy	2007/01/30	59
Andrew Teasdale		
As individual	2007/02/01	60
Yves Fortin		

Organizations and Individuals	Date	Meeting
Bank of Canada	2007/02/01	60
David Dodge, Governor		
BMO Capital Markets	2007/02/01	60
Gordon Tait, Managing Director and Research Analyst		
Canadian Institute of Chartered Accountants	2007/02/01	60
Kevin Dancey, President and Chief Executive Officer		
Coalition of Canadian Energy Trusts	2007/02/01	60
Gordon Kerr, Co-Chair		
Department of Finance	2007/02/01	60
Brian Ernewein, General Director, Tax Legislation Division, Tax Policy Branch		
Denis Normand, Senior Chief, Financial Institutions, Business Income Tax Division, Tax Policy Branch		
Desjardins Securities Inc.	2007/02/01	60
Jeffrey Olin, Managing Director, Ontario, Head of Investment Banking		
Government of Prince Edward Island	2007/02/01	60
The Honourable Mitchell Murphy, Provincial Treasurer, Department of Provincial Treasury		
HDR|HLB Decision Economics	2007/02/01	60
Dennis Bruce, Vice-President		
Manulife Financial	2007/02/01	60
Dominic D'Alessandro, President and Chief Executive Officer		
National Pensioners and Senior Citizens Federation	2007/02/01	60
Art Field, President		
RBC Capital Markets	2007/02/01	60
Dirk Lever, Managing Director, Global Equity Research, Chief Income Trust Strategist		

Organizations and Individuals	Date	Meeting
Standard and Poors	2007/02/01	60
Kevin Hibbert, Chief Accountant		
University of Toronto	2007/02/01	60
Ramy Elitzur, The Edward Kernaghan Professor, Financial Analysis, Rotman School of Management		
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William Barrowclough		
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Dianne Urquhart, Independent Consulting Analyst		
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Finn Poschmann, Director of Research		
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Denis Normand, Senior Chief, Financial Institutions, Business Income Tax Division, Tax Policy Branch		
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Dennis Bruce, Vice-President		
Pengrowth Corporation	2007/02/13	64
Jim Kinnear, President and Chief Executive Officer		
Rosen & Associates Limited	2007/02/13	64
Al Rosen, President		

APPENDIX B
LIST OF BRIEFS

Organizations and individuals

Ahern, **Sean**

Baker, **Jim**

Ballentine, **Richard**

Bennett, **Paul**

Bennett, **Marilyn**

Blair, **Michael**

Bonar, **L.G.**

Buell, **Stan**

Chase, **Bruce**

Crespo, **Ralph**

Ferguson, **Daniel**

Fortin, **Yves**

Gaider, **Kathy**

Gaudet, **Paul**

Harley, **Gerry**

Houston, **Pamela Lee**

Jeffrey, **Doug**

Kazakoff, **Ken**

Keyser, **Jim**

Keyser, **Mary**

Konigsberg, **Phil**

Lapointe, **Jean-Marie**

Organizations and individuals
Lloyd-Price, **Heidi**
Mair, **Andrew**
Moss, **Graham**
Philbrick, **Lorna**
Pinnow, **Rachelle**
Playfair, **John**
Reynolds, **Michael**
Sather, **Elmer**
Schug, **Frederick**
Smith Jr., **Harold**
Turner, **Bertram**
Turner, **Carey**
Urquhart, **Dianne**
Walker, **James**
Wilcox, **Michael**
Yarboro, **John**
AIG Financial Advisors
AltaGas Income Trust
Amtelecom Income Fund
ARC Energy Trust
Bank of Canada
Baytex Energy Trust
Bell Aliant Regional Communications
BMO Capital Markets

Organizations and individuals
Builders Energy Services Trust
Canaccord Capital Inc.
Canada Cartage Diversified Income Fund
Canada's Association for the Fifty-Plus
Canadian Association of Income Funds
Canadian Association of Income Trust Investors
Canadian Energy Infrastructure Group
Canadian Institute of Chartered Accountants
Canadian Retired & Income Investors' Association
Canetic Resources Trust
Clearwater Fine Foods Incorperated
Coalition of Canadian Energy Trusts
Council for Social and Economic Studies
Crescent Point Energy Trust
Daylight Resources Trust
Enbridge Income Fund
Energy Savings Income Fund
Enerplus Resources Fund
Essential Energy Services Trust
Focus Energy Trust
Fort Chicago Energy Partners L.P.
Futuremed Health Care Income Fund
Government of Manitoba
HDR|HLB Decision Economics

Organizations and individuals
Income Trust Research
Inter Pipeline Fund
iTrust Institute
Kayne Anderson Capital Advisors, L.P.
Keyera Facilities Income Fund
Newport Partners Income Fund
Northland Power Inc.
Palos Income Trust Fund, L.P.
Paramount Energy Trust
Pembina Pipeline Income Fund
Pengrowth Corporation
Penn West Energy Trust
PrimeWest Energy Trust
Provident Energy Ltd.
RBC Capital Markets
Real Property Association of Canada
Red Investments
Ross Smith Energy Group
SentrySelect Capital Corp.
Shiningbank Energy Income Fund
Spectra Energy Income Fund
Standard and Poors
Swank Capital, LLC.
Taylor Gas Liquid Ltd.

Organizations and individuals
Trimac Transportation Services inc.
Vault Energy Trust
Vermillon Energy Trust

REQUEST FOR GOVERNMENT RESPONSE

Pursuant to Standing Order 109, the Committee requests that the government table a comprehensive response to this Report.

A copy of the relevant *Minutes of Proceedings* (Meetings Nos. 59, 60, 61, 64 and 69) is tabled.

Respectfully submitted,

Brian Pallister, MP
Chair

DISSENTING OPINION OF THE CONSERVATIVE PARTY OF CANADA

With the introduction of the Tax Fairness Plan on October 31st, 2006, the Government of Canada took decisive action to restore fairness to the tax system. On November 7th, 2006, the House of Commons voiced its support for the plan with the adoption of Ways and Means Motion No. 10 and the Standing Committee on Finance also reiterated its support for the motion when it decided to hold hearings to study the Tax Fairness Plan.

The Conservative Party believes the preponderance of evidence presented at Committee provided overwhelming support for the Tax Fairness Plan and further justification for the Government's decision. At its own political disadvantage, the Government showed leadership in leveling the tax playing field. The decision of the Liberals and Bloc to take advantage of this report to advocate a radically different set of recommendations is, in our view, not based on the evidence or the greater good of Canadians.

THE WEIGHT OF THE EVIDENCE

The Liberal - Bloc report fails to reflect the majority of evidence presented to the committee. The Conservative Party is of the opinion that certain witnesses who spoke against the plan are overrepresented in the report (i.e. Gordon Tait, BMO Capital Markets analyst) relative to those speaking in favour of it (e.g. David Dodge, Bank of Canada Governor). The Liberal-Bloc recommendations exhibit a disregard for the facts presented by the overwhelming majority of independent analysts and public representatives, including the highly respected forensic accountant Al Rosen, every single provincial finance minister, and federal Department of Finance officials.

Furthermore, the report includes inflammatory and unsubstantiated editorial statements. We regret that the Liberal-Bloc report chose to include such evidence.

We want to state that in our opinion the actual committee proceedings do not provide the basis for the Liberal-Bloc recommendations.

OPENNESS AND TRANSPARENCY

The Minister of Finance appeared before the Committee to provide a detailed accounting of the estimated federal revenue lost due to income trusts (along with the release of extensive background material).

The Liberal's preferred witness, Dennis Bruce, Vice-President, HDR | HLB Decision Economics, only further underlined the inconsistency of their position. While in government the Liberals rejected Bruce's methodology, and affirmed that a $300 million annual tax leakage existed. Now, relegated to opposition, the Liberals have seemingly embraced what they once derided as flawed. Even Liberal Finance Critic John McCallum initially supported the Government's plan, stating, *"It was absolutely the right thing, and we had started on this track to protect the tax base, to ensure tax fairness and to work for the productivity of the nation."*[1]

Solid evidence was presented in support of the key principles of the Tax Fairness Plan.

[1] "Question Period" CTV 5 November 2006

TAX LEAKAGE

The case for tax leakage was strongly made in person by the Minister of Finance of Canada, the Provincial Treasurer of Prince Edward Island, and in written submissions from all provincial finance ministers.

As highly regarded independent analyst Diane Urquhart pointed out, the assertion that there was no tax leakage is not based on objective fact:

> *The income trust tax plan removes tax advantages, and where there are tax advantages there is by definition government revenue leakage. If there were no tax advantages, there would not be this aggressive income trust lobby to reverse the income trust tax plan. If corporations had less combined business and personal taxes, then income trusts would be rushing to convert back to corporations to achieve these relative tax advantages.*[2]

Governor of the Bank of Canada, David Dodge agreed:

> *What has happened since the October 31 announcement is that we've seen something like a $20-billion or $25-billion reduction in the market value of these trusts. It has not been even, of course, across all trusts. So what does that represent?… It can only represent two things: number one, the present value of all the future taxes that the government would have lost; and number two, the inefficiencies that were there by organizing some businesses in the form of trusts that should have been organized in the form of corporate businesses.*[3]

The current government used the same methodology employed by the previous Liberal government in 2005. Add an additional $70 billion in conversions in 2006 and any questioning of the existence of tax leakage, now $500 million a year at the federal level, is more about political opportunism than providing an objective analysis.

TRANSITION PERIOD

Many witnesses, including **every provincial government, supported the 4-year transition period.**

When Andrew Teasdale, Total Asset Management Research & Investment Rights Consultancy, was asked what the advantage of extending the transition period beyond the four years would be, he replied, *"I can't really see any advantage at all."*[4]

Finn Poschmann of the CD Howe Institute also supported the decisive action to have a 4-year transition period:

> *The honeymoon (transition) period… is very much an exercise in line drawing and judgment. I don't think there's any way around that. The four-year period is a reasonable adjustment frame for corporations or affected trusts to rearrange their affairs. To let it drag on would let the problem fester unnecessarily.*[5]

The Bloc, together with the Liberals, has taken a position that is detrimental to the interests of Quebecers. As the Minster of Finance stated:

> *Extending the transition period from four to ten years would cost the federal treasury approximately $3 billion. It would also cost provincial treasuries. Alberta would lose over $2 billion, and Quebec would lose*

[2] Standing Committee on Finance Evidence (No. 64, 1st Session – 39th Parliament) 13 February 2007, pg. 11
[3] Standing Committee on Finance Evidence (No. 60, 1st Session – 39th Parliament) 1 February 2007, pg. 9
[4] Standing Committee on Finance Evidence (No. 59, 1st Session – 39th Parliament) 30 January 2007, pg. 21
[5] Standing Committee on Finance Evidence (No. 64, 1st Session – 39th Parliament) 13 February 2007, pg. 18

hundreds of millions of dollars. I would say to the Member for Joliette, are you in favour of a wealth transfer of hundreds of millions of dollars from the pockets of Quebec taxpayers by extending the transition period to 10 years?[6]

The Government of Quebec clearly stated such measures would be highly injurious to the province's fiscal capacity: *"Extending the transition period could only increase governments' tax losses and perpetuate inequitable business tax treatment."*[7] The Conservative members applaud the federal government for its awareness of the concerns of the provinces, including Quebec.

The recommendations in the report represent a return to uncertainty and indecision. **Changing the rules would be unfair to those investors who acted based on the Tax Fairness Plan.**

THE NEED FOR DECISIVE ACTION

The income trust landscape changed dramatically in 2006 as evidenced by a rapid increase in the number and size of conversions. The committee heard from witnesses that corporations were converting for tax reasons rather than business reasons. This required decisive action to level the playing field. The Liberal-Bloc plan, a 10% tax, would permanently entrench a tax disadvantage for corporations and would continue a shift in the tax burden to individuals. The Liberals latest income trust policy, their third in two years, has already been identified as *"politically funky stew."*[8]

As the Governor of the Bank of Canada observed:

> *For the income trust sector to deliver the efficiency benefits through its enhancement of market completeness, it is absolutely critical that the tax system provide a level playing field… a step was taken to level the playing field and it was a step absolutely in the right direction.*[9]

Clearly, the trust structure began to lead to unintended and unforeseen consequences in 2006. The consequences were bleak according to Domenic D'Alessandro of Manulife:

> *In time, if left unchecked, the income trust sector would spread to encompass the core of our economy, and I don't think that would be a good thing for Canada… I do applaud the government for dealing with an important issue.*[10]

Jeffrey Olin, Managing Director, Ontario, Head of Investment Banking, Desjardins Securities Inc. added:

> *Many business models may not be best suited to a trust structure but they may be drawn to the structure simply because of the tax savings. As a result, trusts may have less internal capital available to pursue growth initiatives or reinvestment in capital expenditures. This could be quite detrimental to the long-term interest of the entity or the economy in general.*[11]

The committee heard from witnesses such as Kevin Dancey, President and Chief Executive Officer, Canadian Institute of Chartered Accountants, stating that the Tax Fairness Plan was the right response:

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[6] Standing Committee on Finance Evidence (No. 59, 1st Session – 39th Parliament) 30 January 2007, pg. 4
[7] "Letters of Support From Provincial Finance Ministers" 25 January 2007 http://www.fin.gc.ca/news07/data/07-007_4e.html
[8] Vieira, Paul. "Should be 'embarrassed'" National Post 15 February 2007
[9] Standing Committee on Finance Evidence (No. 60, 1st Session – 39th Parliament) 1 February 2007, pg. 4
[10] Standing Committee on Finance Evidence (No. 60, 1st Session – 39th Parliament) 1 February 2007, pg. 3
[11] Standing Committee on Finance Evidence (No. 60, 1st Session – 39th Parliament) 1 February 2007, pg. 5

> *The tax system was not neutral, as there was a significant incentive to use a trust, rather than a corporation, for tax purposes, and business structure should be created and selected for good business reasons, not for tax reasons… there was tax leakage with respect to both the units held by tax-exempts and non-residents, and this leakage was growing. The next issue is whether the solution proposed on October 31 was the right one. In my view, it was an important step in the right direction that had to be done now… it levelled the playing field between corporations and trusts; and second, it addressed the tax leakage issue.*[12]

It is not credible to suggest that every provincial government from all political stripes, every finance department in the country and a broad range of experts are wrong. We find it puzzling that the Liberals and Bloc would reject the weight of evidence and point to the New Democratic Party's unwavering support for doing the right thing in supporting the Tax Fairness Plan.

CONCLUSION

The Minister of Finance made a difficult but necessary decision on October 31st, 2006. The Liberal-Bloc report appears to take a contrary view simply to avoid being seen to support the government. In doing so, they do a disservice to taxpayers and the country.

The Government's decision is about leadership and above all, fairness: fairness for Canadian taxpayers who would otherwise shoulder an ever increasing share of the tax burden while seeing tax dollars sent out of the country to foreign investors; fairness within the corporate sector where the current rules give income trusts a tax advantage and distort investment decisions; and fairness for federal and provincial governments, who would be less able to pay for important programs such as health care, education, pension splitting for seniors, and of course, to address the Fiscal Imbalance, if the Finance Minister did not act.

The rapid and unexpected trend towards trust conversions was creating economic distortion that threatened Canada's long-term economic growth and productivity. Left unchecked such corporate decisions would result in billions of lost revenue for the federal and provincial governments to invest in the priorities of Canadians and weaken the corporate community's connection to the social fabric of the country.

RECOMMENDATION

> **The federal government implement the Tax Fairness Plan as outlined in Ways and Means Motion No. 10 – including a 31.5% tax on income trust distributions, a four-year transition period for existing trusts, and pension income splitting for seniors – adopted November 7th, 2006 with the support of the majority of the House of Commons.**

Standing Committee on Finance
Diane Ablonczy, M.P., Parliamentary Secretary to the Minister of Finance
Dean Del Mastro, M.P.
Rick Dykstra, M.P.
Mike Wallace, M.P.

[12] Standing Committee on Finance Evidence (No. 60, 1st Session – 39th Parliament) 1 February 2007, pg. 6

Report to the House of Commons
on the decision to tax income trusts

Liberal opinion

Having listened to all the witnesses, the Liberal Members of the Finance Committee believe that the government's decision to tax income trusts was reactionary and ill conceived and reflects a poorly executed policy initiative.
The Committee heard from witnesses who made investment decisions based on a promise made by the Prime Minister not to tax income trusts, and lost substantial amounts of their savings when the Prime Minister broke that promise. The Liberal Members of the committee believe that the government acted recklessly and as a result ordinary Canadians have suffered unnecessarily.

The Finance Minister was unable to confirm that an impact analysis was conducted on the effect the new tax on income trusts would have on investors. Liberal Members of the committee believe that such a study should have been conducted and the results of that study considered when developing the government's policy on income trusts.

The Minister of Finance justified the exemption of Canadian Real Estate Income Trusts by pointing out that they were exempted in the United States, but dismissed a similar American exemption for the energy income trust sector as irrelevant. The Liberal Members of the committee are concerned that such a contradictory approach to public policy is dangerous and not in the best economic interests of Canadians.

The Liberal Members of the committee are deeply concerned about the Minister of Finance refusal to release the data that supports his assertions regarding tax leakage, despite the Committee's repeated requests for it. In the absence of such data, committee Members have had to rely solely on the advice of outside experts, who have calculated the amount of 'tax leakage' to be as low as $32 million or 14 times less than the Minister's estimate.

While 70% of Canadians are not part of a defined benefit pension plan, the Liberal Members of the Committee recognize that income trust distributions provided many seniors with the regular income they require to maintain their lifestyle. There is no other high-yield investment vehicle available to average Canadian investors. (I'm not sure where John wanted the following comment added in, but he did remark: "The contrast of 25 billion market loss is painful and incomprehensible to investors."

The Liberal Members of the committee recognize that not all corporations are well suited to the income trust structure. That said, several witnesses clearly indicated that certain sectors have used the income trust structure successfully to make reinvestments and increase their productivity. The Governor of the Bank of Canada has suggested that income trusts have been useful as a high yield savings vehicle, especially for seniors, and in contributing to the success and productivity of certain industries, notably in the energy sector.

The Liberal Members of the committee believe that reducing the 31.5 % tax to 10 % and making it refundable to Canadian investors is a better alternative to the plan proposed by the Minister, and the other alternatives discussed in committee. While a ten year "grandfathering" or extension would return some of the value to hurt investors' portfolios, the former proposal would return far more of that which was lost.

Furthermore, the 10 % proposal would ensure that entities that are well suited to the income trust structure can continue to grow and invest in themselves, while the 10 year phase out would simply delay their death sentence.

As compared to the government proposal, the 10 % tax proposal is clearly superior. Experts agree that it would return some two thirds of the losses suffered by investors, would preserve Canada's only high yield savings vehicle that is so valuable to seniors, and it would preserve a productivity-enhancing energy-sector. At the same time, expert testimony confirms that a 10 per cent tax that is refundable to Canadians would be enough to capture off shore leakage and ensure tax fairness. The income trust sector would not reduce government revenues or impose a higher tax burden on Canadian households.

Finally, under this proposal the moratorium on new trusts would be maintained for the time being while the government began consultations with sectors that feel they are well suited to the income trust structure. It is clear to the Liberal Members of the committee that the government did not think through the consequences of its ill-advised policy before taking action.

Bloc Québécois
Complementary Opinion

Report of the House of Commons Standing Committee on Finance
The report does not take into account the Bloc Québécois's recommendation

While the Bloc Québécois agrees with the report's general direction as regards changes to the way income trusts are taxed, it stands firm on its position that the proposed four-year transition period should be extended to ten years. The Bloc maintains that the Conservatives' election promise not to tax income trusts was irresponsible, given the structure of the Canadian economy. As a result of the Conservatives' sudden policy shift on October 31, 2006, countless investors, caught by surprise, suffered major losses when unit values plummeted. Given this scenario, the Bloc Québécois would have recommended a transition period of ten years rather than four in order to mitigate the impact on small investors. This impact was artificially inflated by the Conservative's decision to renege on their election promise.

The trust structure as a tax loophole: a threat to Canada's economic growth

The Bloc acknowledges the importance of changing the way income trusts are taxed. At the outset, the income trust structure was intended to be used for mature asset classes that required little or no new capital; the reason being that all of a trust's annual income must be distributed to unitholders, otherwise it is taxed at the highest marginal rate.

Because of the tax rates applicable to income trusts, corporations operating in fields that often require new capital investments started turning to the trust structure. Certain companies decided to convert to income trusts, not out of consideration for long-term growth but in order to take advantage, in the short term, of the beneficial tax rates that apply to trusts.

To avoid seriously compromising Canada's potential for long-term economic growth, the government should definitely put an end to the open-ended opportunity of corporate conversions to income trusts. The Bloc acknowledges the appropriateness of this measure.

A four-year transition period penalizes small investors who trusted the Conservatives

The Conservatives made an irresponsible election promise that they would not touch income trusts during their term in office. The announcement that two key players, Bell and Telus, were planning to convert to income trusts changed things. The government had to take action, not only to preserve Canada's potential for economic growth, but also to avert what could amount to significant revenue leakages for the federal and provincial governments.

Nonetheless, the Bloc deplores the fact that the Conservatives chose to impose a transition period of only four years for existing trusts, rather than the ten-year period recommended by the Bloc Québécois. Given the election promise that income trusts would not be touched, this investment vehicle continued to be a relatively safe option, at least while the minority government was in power. That is why the value of income trust units remained so high. The Conservatives' surprise announcement, together with such a short transition period, magnified the effect of the market adjustment that struck the income trust sector.

That is why the least that could have been done in this situation would have been to allow a longer transition period, so as to somewhat mitigate the drop in the value of income trust units.

The argument that extending the transition period by six years would involve an enormous revenue loss—in the order of $3 billion, according to the Finance Minister—became unconvincing when we discovered that the Finance Minister was including tax deferred losses associated with RRSPs and RRIFs in this figure. Dennis Bruce, Vice President of HDR-HLB Decision Economics Inc., estimates this tax leakage to existing income trusts at $32 million a year. According to Mr. Bruce, extending the transition period to ten years would result in a federal revenue loss of $192 million. While the actual loss is probably higher, the Finance Minister has grossly exaggerated his tax leakage estimates.

Québec's Finance Minister, Michel Audet, acknowledged this fact in a letter to the federal Minister of Finance, in which he wrote, “In this regard, although until now Quebec has largely been spared tax losses resulting from conversions of corporations to flow-through entities, the conversions announced by certain large corporations that are more prominent in Quebec would have increased these losses to $150 million annually”.

Therefore, the Bloc Québécois believes that, while putting an end to conversions to income trusts, the government has the financial means to extend the transition period from four to 10 years, so as to allow some 2.5 million individuals who have invested in income trusts—thousands of whom are small unitholders—to mitigate the impact of the October 31, 2006 decision.

Double taxation

In general terms, double taxation occurs when the tax treatment of income does not look at whether other taxes have already been applied on this income. Double taxation exists when the tax system is not fully integrated. This is currently the case as regards the distributions and dividends paid to tax-exempt investors such as holders of pension plans or Registered Retirement Savings Plans (RRSPs). The Bloc Québécois recommends that the Finance Minister seriously consider the following two measures in order to eliminate double taxation.

1. A refundable tax credit for withdrawals from registered accounts based on taxes already paid on trust distributions. Withdrawals from registered plans would be taxed as they are now; however, the refundable credit would avoid double taxation.

2. A tax credit for dividends paid by corporations and held in registered accounts. Withdrawals from registered plans would be taxed as they are now; however, pensioners would be entitled to a dividend tax credit, as is currently the case with fully taxable accounts (no tax deferral).

These two measures are designed to resolve the problem of double taxation. In order to completely eliminate double taxation, the amount of the tax credit should be equal to the corporate tax rate or the tax rate applicable to income trust distributions, and should apply to all tax-exempt investors. In short, these two measures would significantly mitigate, if not eliminate, the problem of double taxation described above.

Conclusion:

The Bloc Québécois acknowledges that the decision to tax income trusts at a rate comparable to other businesses is justified, both in terms of Canada's long-term economic competitiveness and in terms of the pressures that the growing number of corporate conversions to income trusts could have had on the public treasury.

However, the Bloc condemns the fact that the Conservatives did not take into consideration the Bloc's recommendation to extend the four-year transition period to ten years for existing income trusts. The Conservatives' decision led to the severe market correction that impacted the income trust sector. In other words, the Conservatives could have backed down on their irresponsible election promise in a responsible manner, but did not.

New Democratic Party Dissenting Opinion

The NDP offers this dissenting opinion as part of our ongoing search for the best public policy to ensure the sustainable growth and prosperity of the Canadian economy and the role, if any, of income trusts in that context. We have concluded, based on the expert evidence presented to the Finance Committee, that our longstanding position of phasing out income trusts is appropriate public policy and that the taxation of such trusts is required.

Conservative double-cross

The unexpected Conservative decision on Oct. 31st to break their campaign promise not to touch income trusts justifiably ignited a storm of controversy. The Conservative election promise was ill-conceived and opportunistic. It is unfair that those who had trusted the Conservative promise and invested on that basis suffered personal financial losses.

The unfortunate fallout from having to reverse that promise serves to highlight the pitfalls of the political opportunism that has plagued the treatment of income trusts by both this and the previous Liberal governments. It also points to the recklessness of continuing to put partisan political gain on this issue ahead of promoting sound public policy — a course currently being enthusiastically pursued by the Liberal Party.

Indeed, the continued Liberal political exploitation of this issue has been utterly shameless. They have proceeded as though every point they and the trust lobbyists have argued has been proven accurate rather than flawed and contentious. They have even turned on the very Finance Department officials upon whose expertise they themselves had relied until just over a year ago.

By attacking the government for its belated but necessary corrective action on trusts and the NDP's support of that public policy decision, the Liberals are trying desperately to divert attention from their own responsibility in this matter — something conveniently not reflected in the Liberal/Bloc Report. The Conservative broken promise is only part of the story.

Liberal double-talk

What is the Liberal record? In income trusts, like so many other areas while government, they did what they do best — nothing! The Liberals stood by and watched while income trusts grew from a relatively obscure tax gimmick to $200 billion in capital holdings. Finally in the fall of 2005, they had acknowledged the threat of tax leakage and economic drag and appeared ready to act. On the eve of the election, however, they backed off, crassly putting their political fortunes ahead of the public interest.

This was a particularly cynical move as the need for action was blatant. Trusts had ballooned tenfold in just over three years (from 2004 to 2005, the sector increased more than 18 per cent). Business trusts, in particular, were on the rise with giants like BCE

rumoured to be readying to carve off elements into trusts. Even financial institutions like RBC publicly entertained the possibility. As expected, these trends continued.

If the Parliament that followed has been faced with the need for urgent action on trusts, it was the Liberals that created that need.

The Liberal-corporate alliance

It is generally accepted that the government's tax change sounds the death knell for the future of income trusts. It is no surprise, therefore, that it has triggered a ferocious lobbying effort by those with a stake in the trust sector to force the government to reverse course.

The impact on small investors pales in comparison to the hit on Bay Street's banking elite. The banks themselves have projected that closing down new income trust conversions could cost them as much as 2 to 4.5 per cent of earnings. It will mean losses in wealth management, investment banking commissions, associated legal fees and more. Small wonder that the elite community of investment bankers, corporate lawyers, underwriters and other trust 'mechanics' are lobbying so hard to turn back the clock.

Neither is it surprising that this elite corporate group is working hand-in-hand with its natural political ally — the Liberal Party — in an effort to revive the income trust corpse. The Liberals have manufactured one political issue out of holding Finance Committee hearings that would have been scheduled within weeks anyway, and another from demanding Finance Department documents that it knows to be beyond departmental officials' authority to release.

The Liberal/Bloc Report

Now we have the Liberal/Bloc Report with Liberal-authored recommendations that aim to prolong the income trust tax holiday, re-open new income trust conversions, tilt the investment playing field back in favour of trusts, and segregate income trust taxation from inter-related measures in the forthcoming legislation.

Recommendation demanding information: Anyone who ever tried to pry even the most basic information from the Liberal bunker when they formed the government can appreciate the depth of irony in the current Liberal crusade to have Cabinet documents unlocked for the asking.

Recommendation on splitting the government's ways & means motion: This would separate inter-related elements of the motion that, taken together, improve the income security of Canadian seniors. It signals more Liberal antics ahead and demonstrates their refusal to acknowledge the overall public policy merits of the motion.

Recommendation to reduce income trust taxation to 10 per cent and to conditionally allow new trust conversions: This is simply a back-door attempt to negate the government's actions. Although in the short-term it would mitigate losses to remaining individual and major investors and speculators, it would permanently restore trusts' pre-

announcement advantage over standard corporations. It totally ignores the negative features of trusts drawn to the Committee's attention repeatedly by independent expert witnesses.

Recommendation to extend grandparenting from four to 10 years: While presented in the guise of a compromise, this maneuver would, in fact, negate the positive effects of the announcement and would mean business-as-usual for trusts. It was not supported by the independent witnesses before the Committee – referred to by one as "letting a problem fester unnecessarily". The market value would rebound slightly giving major investors an opportunity to unload their units on unsophisticated newcomers. Any gain, of course, is unfairly denied to those who have already sold off their investment at deflated prices. This measure has the support of the Bloc which has come down squarely on both sides of the trust issue.

Critical accountability issue ignored

What the Liberal/Bloc Report fails to recommend is action on the serious transparency and accountability issues raised by independent analysts. We believe these should be at the core of any discussion about the future of income trusts. The Chair of the Accounting Standards Board has called income trust yield reporting "inaccurate and potentially misleading". This same message was delivered by witnesses.

The NDP, in the interests of protecting seniors and other individual investors, has repeatedly drawn this problem to the public's attention. We have introduced a bill in Parliament to clarify where the higher returns on trusts are coming from and hope the government will incorporate this initiative into its forthcoming bill.

Also of concern, independent studies show that income trusts have been overvalued by as much as 40 per cent and will inevitably drop in value. More than 20 per cent of the business trusts that have come on stream since 2001 are down 20 percent in value, while two out of three business trusts and paying out more than the underlying business is bringing in. Industry studies do not mention this. Neither does the Liberal/Bloc allialnce.

What about tax leakage?

Corporations have openly admitted that their attraction to income trusts has been because of the tax advantage. Concern over the resulting loss in tax revenue has been noted by the federal and all provincial governments, irrespective of political stripe. Industry studies claiming no tax loss from trusts or even increased tax revenue have not survived rigorous scrutiny, characterized by one expert witness as "simply nonsense on stilts". Deferred taxes do not answer the needs of governments for stable, adequate and predictable revenue sources today and in the short-term. It has been pointed out that industry calculations ignore the generous tax benefits already in place for RRSPs and pension funds, for example. The upfront contribution deduction for such plans and not having to pay taxes on investment income within them offsets other tax factors. It has been shown that there is, in fact, both a short-term and permanent revenue loss when

income trusts in RRSPs and pension funds are compared to corporations in the same plans.

Similarly, arguments that the proposed changes will disadvantage us in relation to US Master Limited Partnerships do not hold up when the special tax added by the IRS on MLPs in tax deferred accounts is factored in. The proposal actually evens things up.

Finally, that corporations may have access to other loopholes to avoid tax payment should be a cause of concern. It is not a justification for income trust tax leakage. Now that this tax loophole has been closed, it is time for the government to move on and tackle international tax havens and other schemes that are unfairly shifting a greater share of tax onto ordinary working Canadians.

A dynamic economy

Witness after witness, including the Bank of Canada, supported NDP concerns that business income trusts were inappropriate business structures that could undermine the long-term growth of a dynamic economy. Problems, we were told, could be acerbated by an economic downturn and a tightening of access to capital — trusts' lifeblood. Suggestions that trusts lead to stricter management practices and investor control were also contested. Only the banking elite could find it humbling that the average trust CEO reportedly makes only $1.4 million annually.

Despite Liberal and Bloc political maneuvering, multi-million dollar campaigns, e-mails, attack ads and the unprecedented use of investor lists, the case for reviving income trusts has failed on the evidence. Despite the appalling route through Liberal inaction and Conservative betrayal that brought us here, the public interest is now best served by decisive action on taxing income trusts and getting on with building the dynamic economy that will benefit all Canadians and provide income security well into the 21st century.