

The Inconvenient Truth About Trusts

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A Perspective on Ottawa's New Policy on Trusts

Highlights

- Now that some of the dust has settled over the income trust tax announcement, we thought it appropriate to bring our own perspective to the issue. I have been covering the sector for over a decade and these are not BMO Capital Market's thoughts but my own personal observations on the new tax policy on trusts. As a starting point, we recognize the dilemma that the finance minister found himself in. The potential for a number of large corporate conversions to income trusts necessitated some kind of action. Much of the problem lies with the fact that we do not have a fully integrated tax system. The minister did not create this situation and previous finance ministers failed to deal with it.
- We have a number of concerns: The current proposals being rushed; The lack of debate and consultation among the policy makers (MPs); The consequences the proposed measures will have on income earned in retirement accounts; and the lack of consideration of other policy choices. We do believe that the proposals will effectively discourage or prevent corporations from converting to trusts and more than level the playing field. But the proposed measures in their current form go farther than they need to in order to accomplish their objectives. They have, in our personal opinion, caused unnecessary harm to a significant segment of the investing public, specifically seniors and retirees.
- We have found in the past that much of the debate about income trusts, particularly as it concerns the impact they have on current and future tax revenues, is not well understood. This is a complex issue and we note that no data or empirical evidence has been made available by the minister to the public or to the members of Parliament to quantify or substantiate the scope of the problem.
- In this report, we will examine some of the inconvenient truths about trusts, with particular emphasis on the important role trusts play in capital markets, the tax impact of trusts held inside retirement accounts, and the amount of taxes collected from non-resident investors relative to investment alternatives.

Table of Contents

| | |
|--|----|
| Opening the Door to Ordinary Investors | 2 |
| Risk versus Return..... | 4 |
| Taxes and Trusts | 5 |
| DoF Consultation Study 2005 | 6 |
| Comparing Apples to Apples..... | 7 |
| Same Assumptions, Same Problems..... | 8 |
| Trusts and Tax-Deferred Accounts | 8 |
| Impact on Retirees' Incomes | 13 |
| Trusts and Non-Resident (Foreign) Investors..... | 14 |
| The Junk Bond Economy..... | 16 |
| Where to From Here?..... | 16 |

Opening the Door to Ordinary Investors

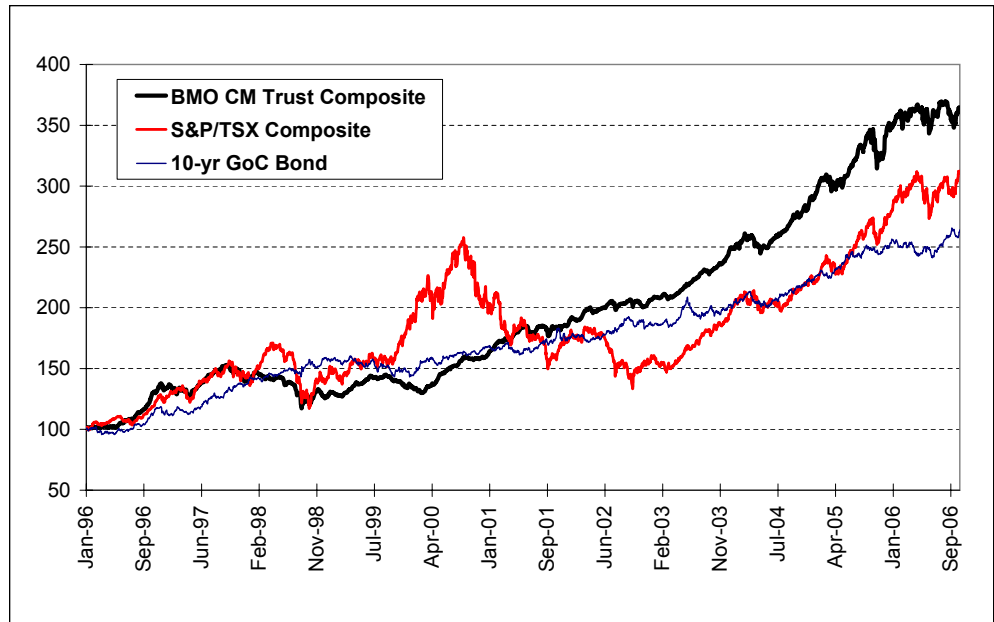
The primary motivating factor behind the development of the trust structure in Canada was the disparity between the way large institutional investors and private equity could invest versus individual Canadian taxpayers. What Enerplus founder Marcel Tremblay observed during his years of acquiring and managing oil and gas properties on behalf of institutional and corporate investors was that they had the means to directly participate in and benefit from owning cash flows generated by those investments.

His concept of a royalty trust was to bundle the cash flows together in a trust, then split them into small fractional units that could be traded on a stock exchange, so that Canadian investors could enjoy the same kind of wealth creation and cost of capital advantage that had previously been available to only large institutional and private equity players. He also recognized that many investors were willing to commit much needed capital to Canadian industry if they were given an alternative choice to the standard equity common share investment model.

Consider what the TSE (as it was known then) looked like 15 years ago. There were a number of companies traded on the TSE that were controlled by a few large conglomerates, which, in turn, were controlled by a handful of wealthy families and individuals in Canada. Income trusts put ordinary Canadian investors on the same footing from a cost of capital perspective as those previous owners. The trust structure essentially democratizes cash flows from revenue-generating assets by making them widely available, which, among other things, busted up previously high levels of corporate concentration. Trusts have shifted parts of the Canadian economy out of the hands of a few and into the hands of the many.

Millions of Canadians have earned high returns in the trust market. An enormous amount of cash has been generated and returned to investors via the distributions on these investments. Without an income trust market, this type of investment opportunity would be lost to all but institutions and wealthy investors in Canada and to private equity investors abroad.

Chart 1: BMO CM Trust Composite Index – Relative Historical Performance (1996-Present)



Note: The BMO CM Trust Composite does not assume distribution reinvestment.
 Source: BMO Capital Markets

Risk versus Return

From an investment perspective, income trusts match the investment objectives and risk profiles of a large segment of the investing population. We do not believe that one can assume that the capital invested in trusts would necessarily flow into equity investments. In many cases, equity does not meet the investment objectives or constraints of a large segment of the investing public. Pension funds, in particular, can invest directly in businesses on their own, inside or outside of Canada.

If you analyze the return of the trust market and compare it to the volatility associated with those returns (volatility is a measure of risk), it can be demonstrated that trusts have delivered higher returns with less volatility than equities. From a portfolio perspective, it results in higher Sharpe ratios or higher risk-adjusted returns, which has been to the benefit of millions of Canadian investors.

Table 1: Total Returns and Volatility (from January 1996 to October 2006)

| | Average Annual Compound Total Return | Volatility (Annual Std. Dev.) | Sharpe Ratio ⁽¹⁾ |
|-----------------------------|--|----------------------------------|-----------------------------|
| BMO CM Trust Composite | 18.8% | 13.0% | 1.06 |
| BMO CM Royalty Trust Index | 23.4% | 19.8% | 0.93 |
| BMO CM Income Trust Index | 15.7% | 12.6% | 0.85 |
| S&P/TSX Composite Index | 10.8% | 16.1% | 0.36 |
| S&P/TSX E&P Index | 16.9% | 26.9% | 0.44 |
| 10 yr. Gov't of Canada Bond | 9.4% | 7.4% | 0.59 |

⁽¹⁾ Assumes a risk-free rate of 5%.

Source: BMO Capital Markets

Since 1996, over one-half of the Trust Composite's 263% total return is from cash distributions. By contrast, only 17% of the S&P/TSX 188% total return over the same time period is from dividends.

Income trusts serve three primary roles:

- 1) **Trusts are the defacto high-yield investment vehicles in Canada.** Compare the state of our high yield market to that of the U.S. The U.S. market is populated by a wide array of high-yield investment vehicles: a well-developed high-yield debt market, a large number of flow-through entities such as infrastructure MLPs, E&P LLCs, asset-backed securities, tax free-municipal bonds, as well as royalty trusts and REITS. Outside of income trusts, what choices do Canadians have? The U.S. Flow Through Entity (FTE) market was not properly described in the Department of Finance (DoF) Backgrounder. The inconvenient truth is that there is a large and growing FTE market in the U.S., including oil and gas exploration and production entities. We will publish a report to address this issue.

- 2) **The income trust market serves to redistribute excess cash flow from mature industries or businesses that would otherwise be trapped inside non-distribution entities.** Trapped capital leads to overinvestment in slow growth businesses and to ever-diminishing rates of return on invested capital. The theory behind a trust is that the market is more efficient at allocating excess capital than a manager in one particular business or industry. This redistribution of excess capital, among other things, enhances productivity and economic efficiency. We recognize that in an economy that grows at only 2–3% most years, all businesses cannot grow at the 8–10% rates that equity investors typically demand.
- 3) **An income trust is an alternative form of organization that is well suited to many businesses and to the industries in which they operate.** In contrast to the observations of commentators who lack practical experience with the structure, many trusts have demonstrated they can operate efficiently as a trust while continuing to grow. And we note that there is no economic law or principal that prescribes one form of organization for every type of business or industry. That kind of thinking shrinks the choices and efficiency of the market.

Taxes and Trusts

From an investment perspective, income trusts should be characterized as high yield equities. But from an income tax perspective, they are treated more like bonds. This confuses some people. The structure is easily replicated by any company that employs debt and equity in its capital structure. The strength of a trust is that the debt owners and share owners are one and the same: trust unitholders. Since there is one common owner, it's less likely he's going to put himself out of business. It gives the structure resiliency and flexibility.

In contrast to what some commentators have claimed, we are of the view that income trusts do not cause a loss to government tax revenues. The tax loss estimates cited are likely not due to the difference in cash taxes collected from trust unitholders versus corporations. In a cash tax comparison, income trust investors almost always pay more. We looked at 126 businesses that converted from equities to trusts between 2001 and 2005 to prove that. We found that on average the government stood to collect 2.2 times more in taxes by taxing the distributions of the trust than had been paid by the corporations prior to their conversion. Trusts are particularly effective at accelerating the collection of deferred taxes on corporate balance sheets.

DoF Consultation Study 2005

The Department of Finance (DoF) Consultation Study dated September 28, 2005, cited Statistics Canada data from 2000–2003, which indicated that the average effective federal corporate income tax rate that Canadian corporations paid (as a percentage of EBITDA) was 6.3%. Adding in the provincial taxes would increase the tax percentage of EBITDA to approximately 10.5% for corporations.

By comparison, we estimate that for the 83 royalty and income trusts covered by BMO Capital Markets, cash taxes represent approximately 18% of EBITDA—1.7 times higher than the corporate average.

To calculate that number, we used the average effective personal tax rate of 38% cited in the DoF Consultation Study last year. We also adjusted the numbers to account for the approximate one-third of trusts held by non-residents, where there is a 15% withholding tax applied to distributions.

The following table illustrates the comparison.

Table 2: Tax Comparison Between Trusts and Corporations

| | # Trusts | CDPU/ Earnings | % Taxable | CDPU as % of EBITDA | Non-Resident Holding % ¹ | Tax as % of EBITDA |
|------------------------------|-----------|-------------------|------------|------------------------|--|-----------------------|
| Income Trusts | 59 | 1.6x | 88% | 70% | 33% | 19% |
| Royalty Trusts | 24 | 1.6x | 85% | 62% | 33% | 16% |
| Total Average Trusts | 83 | 1.6x | 87% | 67% | 33% | 18% |
| Canadian Corporations | | | | | | |
| Federal | | | | | | 6.3% ² |
| Provincial | | | | | | 4.2% ³ |
| Total Average Taxes | | | | | | 10.5% |

¹ Non-Resident Investors pay 15% withholding tax.

² Department of Finance Consultation Paper: Tax and Other Issues Related To Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships); September 8, 2005.

³ Assume a 60/40% split between the Federal and Provincial corporate income tax revenues.

Source: BMO Capital Markets and Department of Finance

There are three primary reasons for the higher rate of cash taxes:

1. Individuals pay taxes at higher rates (both marginal and average effective rates) than corporations.
2. Cash distributions from a trust form a larger tax base than income from a corporation, approximately 1.6x larger.
3. Corporations have many more ways of sheltering income from taxation than do individuals.

When you shift the burden of tax from the part of the economy that tends to pay the lowest proportion of tax and at lower rates (corporations) to the part of the economy that tends to pay the highest proportion of tax and at higher rates (individuals), we would expect that the government would tend to gain tax revenues. That is exactly what we have seen in Canada over the past few years.

Comparing Apples to Apples

The tax loss estimates calculated by some commentators are the result of applying an inconsistent methodology. When estimating the amount of taxes collected under a corporate structure, economists generally consider the amount of taxes owing from a corporation in the future (deferred taxes) as tax revenue to the government. But for some reason, certain commentators and economists do not consider future taxes owing on individuals' retirement plans also as tax revenue to the government, even though the probability of collecting taxes from an individual is likely much higher than from a corporation. It is a lopsided analysis and it skews the results.

For those who adopt this inconsistent treatment, there is an even more obvious error in their methodology: they do not attempt to segregate trusts held inside RRIF and pension accounts that currently pay tax from those held inside RRSPs, so they simply exclude current taxes collected on trusts held inside all retirement accounts in their estimates. It is an example of how flawed assumptions can lead to flawed policy outcomes. We estimate that up to 50% of the trusts held in retirement accounts are in tax-paying accounts.

Same Assumptions, Same Problems

In a report we wrote last year, “A Perspective on Taxes and Trusts,” dated October 3, 2005, we noted that several of the assumptions used in the analysis provided in the Department of Finance Consultation Study dated September 8, 2005, did not square with the empirical data, and that a proper “apples to apples” comparison between the taxation of a corporation and a trust had not been done. The inconsistencies in the methodology resulted in overstating the amount of taxes collected from corporations and understating the amount of taxes collected from trust unitholders. Many of the inconsistencies related to the treatment of tax-deferred retirement accounts. The report is available on our Research website.

In the government’s Backgrounder dated October 31, 2006, the minister refers to pension funds, RRSPs and RRIFs as being tax exempt. This of course is simply not true, particularly with respect to RRIFs and pensions plans. The truth is that income from these plans is taxed in the year it is withdrawn at individual marginal tax rates. By considering them tax exempt, the minister and some “experts” ignore the billions of dollars of taxes paid by seniors annually on income drawn from these accounts. This arbitrary exclusion forms the basis of the leakage argument. In 2004, the last year reported on the CRA website, seniors and retirees withdrew \$52 billion from retirement accounts, all of which was taxed at individual marginal rates, resulting in billions of dollars in tax revenues.

The new tax measures are aimed at primarily two types of investors in the trust market: retirement accounts and non-residents. In the case of Canadian retirement accounts, we believe there is no tax leakage as far as income trust investments are concerned. It is a closed system. Taxes paid by seniors and retirees on withdrawals from their retirement accounts amount to billions of dollars in annual revenue to the government.

Trusts and Tax-Deferred Accounts

This area creates a lot of confusion for commentators. And this is where we believe the proposed policy causes unnecessary harm to those who can least afford the income and capital losses: seniors and retirees. On the surface it may appear as though contributions to retirement plans are a loss to current government revenues. And they would be if these plans really were tax exempt. But the inconvenient truth is that they are not. Ask any of Canada’s four million senior citizens, many of whom currently pay taxes at high marginal rates on their pension income and RRIF withdrawals. Only charities and crown corporations are tax exempt.

In fact, we would argue that tax-deferred retirement accounts act like a huge bank of savings for the government, and serve to increase government tax revenues overall. There are two principal reasons for this:

1. There is no time value cost (or loss) to government revenues when trusts or other securities are held inside tax-deferred accounts. The time value cost to the government of a tax-payer's contribution to an RRSP is offset by the compound annual growth earned on the contributions. Compound growth essentially expands the tax base of these plans over time. When income is withdrawn from a tax deferred account, the entire amount is subject to income tax: the contributions plus the growth. We assume that the growth or returns earned in the accounts would necessarily be greater than the time value cost to the government.

• **What is the appropriate discount rate for the time value cost to the government?**

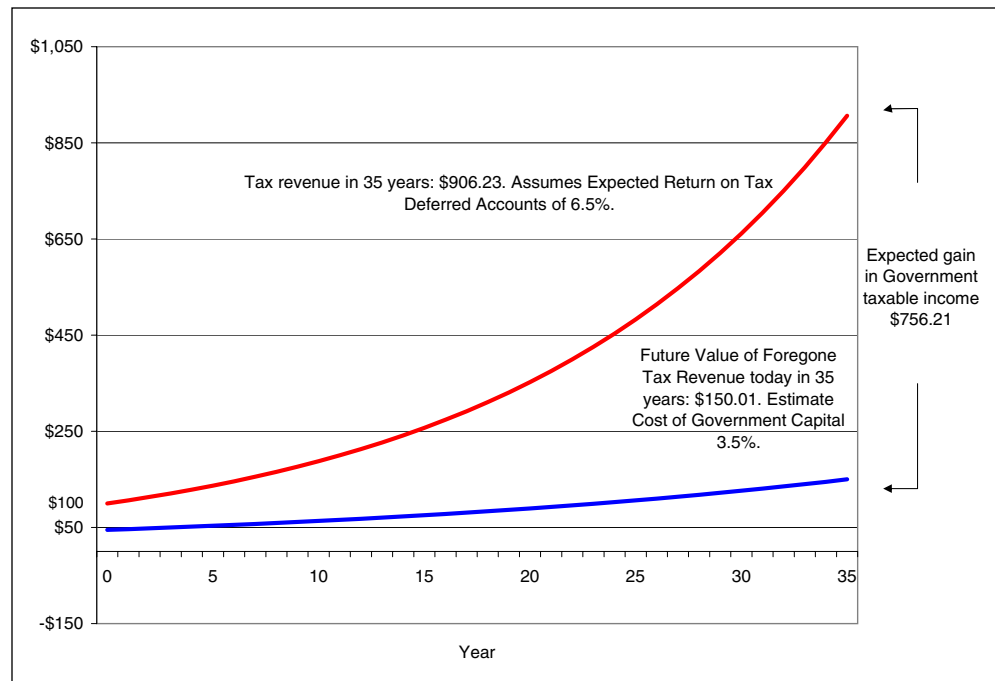
No one expects the government to earn a market rate of return. That's what businesses do, not governments. We would argue that the appropriate discount rate for the government is the rate of inflation or the risk-free rate, which we have assumed to be 3.5%. There is virtually no risk to the government of not collecting taxes on retirement plans. There are only two things in life that are certain; we know what they are.

As long as the market rate of return is in excess of the risk-free rate or the rate of inflation (and it's hard to imagine a circumstance where that wouldn't be the case for any length of time), then the compound growth of the accounts offsets the time value cost to the government. As a result, these plans act like a savings account to the government. Because this issue is not well understood, we have put together an example that illustrates how tax-deferred accounts actually serve to increase government tax revenues over time.

Example: When a 30-year-old contributes \$100 to his or her RRSP and receives a \$45 deduction (we have assumed a top marginal tax rate, so we cannot be accused of sugar-coating our numbers), on the surface, it looks as though the government's loss is the present value (PV) associated with taxing the \$100 when it is withdrawn 30 or 40 years down the road, rather than today. But that's not how it works. The government isn't going to tax only the \$100 contribution when it's withdrawn; it's also going to tax the 6–8% average annual return or compound growth the investor earns on that \$100 during the years it is held inside the plan.

When a \$100 contribution is withdrawn after 35 years of 6.5% annual compound growth, the base on which income tax will be levied would grow to \$906.23, which is 20 times greater than the \$45 of tax revenue given up in year one. It is also seven times greater than the future value of the \$45 tax savings. The increase in the tax base due to the growth of the account serves as the offset to the time value cost to the government. The diagram below illustrates the effect.

Chart 2: RRSP Future Value of an Investment



Source: BMO Capital Markets

Every dollar that is withdrawn from a tax deferred plan is taxed as income—which attracts the highest rate of tax—regardless of how it was earned. That’s the primary reason why investors tend to put income vehicles, such as trusts, GICs, and corporate and government bonds, inside RRSPs instead of equities; because otherwise you forego the favourable capital gains treatment.

- We also recognize that the entire account would not be withdrawn and taxed in the first year of retirement. In our analysis we calculated the present value (PV) of the future tax stream to the government under two scenarios:
 - i. The investor would withdraw the funds evenly over the remaining 20 years of his life.
 - ii. The RRSP would be converted to an annuity with a 20-year payout.

Other assumptions include:

- iii. The investor's effective tax rate falls from 45% (pre-retirement) to 25% (post-retirement).
- iv. Any account balances are invested in a more conservative asset mix at retirement and earn only a 5% return instead of 6.5% (pre-retirement).

We compared the present value of the tax revenues over that 20-year period to the value of the foregone tax on the initial contribution. We found that the government wins by a factor of over 1.7:1. In other words, for every \$1.00 in foregone tax on a contribution to a retirement fund, the government can expect to receive over \$1.70 in tax revenues on a present value basis. The following table illustrates the results of our example.

Table 3: Present Value of Retirement Taxes versus RRSP Contributions

| | Value at original Contribution (Age 30) | Value at Retirement (Age 66) | Value at RRIF Termination (Age 85) |
|--|---|------------------------------------|--|
| Scenario 1: Even Withdrawals | | | |
| PV of Tax on RRSP Withdrawals | \$79.32 | \$273.67 | \$526.13 |
| PV of Original Tax Contribution | \$45.00 | \$155.26 | \$298.49 |
| Net Gain to Government Revenues | 1.76x | 1.76x | 1.76x |
| Scenario 2: Annuity Withdrawals | | | |
| PV of Tax on RRSP Withdrawals | \$77.51 | \$267.42 | \$514.11 |
| PV of Original Tax Contribution | \$45.00 | \$155.26 | \$298.49 |
| Net Gain to Government Revenues | 1.72x | 1.72x | 1.72x |

Source: BMO Capital Markets

We believe we have used relatively conservative assumptions in our analysis. There is enough leeway to accommodate even more conservative assumptions and the outcome would be no different. Our conclusion is that we cannot realistically see how investments, including income trusts, held inside tax deferred plans present a loss to government revenues. As a result, there is no valid reason to tax trusts held inside these plans. The income is already taxed once upon its withdrawal; it should not also be taxed on the way in.

What we wanted to demonstrate was that on a stand-alone basis, there is no loss to government revenues due to trust units being held inside a retirement account. One could construct various "what if" scenarios to see if other investments might theoretically produce higher tax revenues. That would be data mining. The truth is there is quite a wide variety of securities which Canadian investors can put in their retirement accounts. It would be naïve to assume that an alternative choice to a trust held inside a retirement account would necessarily be a Canadian equity. In fact, we believe it would most likely be another income investment.

- We note that Canadian corporate bonds have been mainstay investments in retirement accounts for years. Interest on corporate debt reduces the taxable income of a corporation, dollar for dollar. Cash flows can therefore be shifted pre-tax into these accounts. From a tax perspective, there is no difference between a corporate debt instrument and a trust unit held inside a retirement plan. Since interest from corporate bonds is not double taxed, trust distributions should not be either.

2. The tax cost of the contributions in any given year is offset by taxes collected on the withdrawals in any given year.

We looked at the empirical evidence to see if it was consistent with our retirement tax model. Many people forget that these plans were not put in place yesterday. RRSPs have been around for almost 50 years, and registered pension plans (RPPs) even longer. Hundreds of billions have been built up in these plans and every year tens of billions are withdrawn and taxed as income in the hands of the beneficiaries. Although the government gives up some of its current income to future governments by way of annual contributions, it also benefits from taxing the withdrawals from contributions given up by previous governments, as well as the compound growth generated in the plans.

On the Canada Customs and Revenue Agency website, government revenues and expenses are disaggregated into their various components. The most recent data available is for the tax year 2004. The government accounts for contributions to registered retirement savings plans and registered pension plans as expenses or costs. It accounts for the annual withdrawals from these plans as a source of income or revenue.

- In 2003, \$34.5 billion in aggregate was contributed to RRSPs and RPPs. Offsetting that expense was \$48.6 billion in aggregate income from withdrawals. A \$14 billion surplus.
- In 2004, \$38.1 billion in aggregate was contributed to RRSPs and RPPs. Offsetting that expense was \$52.5 billion in aggregate income from withdrawals from those plans. Taxed at marginal rates, that \$52 billion in annual income withdrawals results in billions of dollars of tax revenues to the government. Not exactly what one would expect from “tax exempt” investors.

Upon analysis, the truth is that it does not appear as though tax-deferred accounts result in a loss to current government tax revenues. Any economic analysis that evaluates the impact of tax deferred accounts on government revenues has to consider two things: i) the net effect, which looks at both sides of the equation, withdrawals (which benefit the current government) and contributions (which are a cost to the current government); and ii) the compound returns earned and growth in the accounts, which effectively serve to increase the government's tax base over time, offsetting the time value cost.

Impact on Retirees' Incomes

The proposed measures would have a significant negative impact on retirees' incomes. Under the proposed legislation, a pension plan beneficiary or someone with a RRIF that has an income trust investment would see every \$1.00 of cash distributions first taxed 31.5% at the trust level. As the income is paid out to the pension beneficiary or trust unitholder, an additional 45% (top marginal rate) in individual tax would be levied on the remainder. It works out to be an effective tax rate of up to 61.5%, leaving the pensioner or retiree with only 38 cents in their pocket for every one dollar of cash distributions.

We wonder how this tax plan can be called fair. It is aimed primarily at those who can least afford it: seniors and retirees. We note that tax-funded, indexed pension plans such as those enjoyed by members of Parliament would be unaffected by these proposals. They, too, though would benefit from the proposed income splitting and other initiatives, but the costs will be borne by ordinary Canadian taxpayers.

The truth is, in contrast to what the minister has claimed, retirement accounts are not tax exempt. We believe that it does a great disservice to our senior citizens, many of whom have paid taxes all their lives, that the minister fails to acknowledge the tax burden many continue to shoulder all through their retirement years. We have heard from many who have expressed that sentiment.

As we have shown, we do not believe that trusts held inside retirement accounts result in a loss of tax revenue to the government. Therefore, we believe that the minister should not have proposed the 31.5% distribution tax for trusts held inside for RRSPs, RRIFs and pension plans. There is no reason we can see to burden seniors and retirees with double taxation on any of their income investments. And since there is no loss to government tax revenues due to trusts or other income vehicles held inside these plans, proposed tax cuts or spending initiatives cannot logically be tied to their inclusion.

Trusts and Non-Resident (Foreign) Investors

Examining the impact of foreign investment on an economy is a complex exercise. Suffice it to say that Canada needs foreign investment in order to fully develop its economic potential, and there is stiff competition for foreign investment dollars from countries around the world.

It's easy to place blame at the feet of foreign investors. They don't vote. But we think this is a short-sighted view and doesn't consider the overall impact of foreign investment and the investment alternatives to income trusts. As a starting point, it's worth looking at a cost/benefit analysis.

The cost side: Foreign investors don't use our health care system; they don't use our education system, our infrastructure, or get any of the social or other benefits that our tax system pays for. In other words, there are very few, if any, costs associated with foreign investment in Canadian securities.

The benefit side: Trusts take the dollars that foreigners invest and use them to generate economic activity and jobs, all of which generates tax revenues. We then keep 15% of the cash distributions on income trust (for tax treaty countries). Given that trust distributions average approximately 1.6x the level of net income, it equates to a corporate income tax equivalent rate of approximately 24%. For investors from non-tax treaty countries, the amount of withholding tax applied to the distributions is 25%. In both cases, it represents a substantial amount of tax revenue, particularly when you consider the alternatives.

If foreign investors were discouraged from investing in Canadian income trusts but still wanted to invest in Canadian businesses or securities, what are the alternatives, and what is the tax impact? Other than trusts, there are three principal ways that foreign investors could participate in Canadian investments: i) bonds or debt obligations, ii) common equities, and iii) direct investment.

- 1. Corporate bonds or other debt obligations.** For bonds or debt obligations with maturities of five years or longer, there is no withholding tax applied on the interest payments (10% withholding on shorter-duration obligations). For the longer-duration bonds, that means that all of the income and cash flows represented by the interest payments can be shifted to foreign investors without any corporate income tax or withholding taxes applied. From a tax perspective, it doesn't sound like a very good alternative to a trust.

2. **Common Shares.** Probably the most common way for foreigners to invest in Canada is to buy common shares of Canadian companies. The primary objective of equity investing is growth or capital appreciation. In Canada, there is no withholding tax applied on capital gains. So when a foreign investor sells his or her Canadian stock and realizes a gain, it is the IRS or some other tax agency that taxes the gain, not the CRA. Depending on the amount of cash taxes actually paid by the corporation in Canada, the investment may or may not yield greater amounts of tax than would otherwise be collected from the withholding taxes on trust distributions.
3. **Direct investment.** Foreigners can make direct investments in Canada by setting up wholly owned subsidiaries (GM, MacDonald's, The Gap, etc.) or by acquiring Canadian companies and turning them into subsidiaries of foreign-controlled corporations (Inco, Falconbridge, Dofasco and Hudson's Bay are recent examples of these). Outside of the obvious loss of control of our companies to foreign jurisdictions, what are the tax implications?

The truth is we can't say for sure. Do foreign-owned subsidiaries generally pay much tax in Canada? And if so, how much? Most are not reporting issuers here and therefore do not have to file public financial statements in Canada. And most do not disaggregate taxes paid in foreign jurisdictions in their consolidated financial statements. There are many tried and true strategies to shift profits from high-tax jurisdictions to low-tax jurisdictions, the most common being (i) transfer pricing arrangements, and (ii) capitalizing subsidiaries with debt and equity.

A substantial portion of the profits from a subsidiary can be shifted to the parent company through interest payments on internally held debt. And as we noted in point 1, there are no withholding taxes on interest payments on debt obligations with maturities of five years or longer. This structure is also commonly used by private equity firms and in leveraged buyout transactions. But from a tax perspective, there is no guarantee that this form of investment would generate any more tax revenue than foreign investment in Canadian-controlled trusts.

Our conclusion is that it is difficult to quantify a leakage problem with respect to trusts, particularly when you consider the investment alternatives. This is a complex area and we believe it requires further consultation and analysis.

The Junk Bond Economy

It is with concern that we read that the finance minister is considering eliminating the 10% withholding tax on interest payments on short-term debt obligations in order to encourage more foreign investment. If it were eliminated, all income and cash flows represented by interest payments on debt could be transferred dollar for dollar directly from Canadian corporations to foreign investors without any income tax or withholding taxes applied. There is already no withholding tax on debt obligations with maturities of five years or more.

The lack of withholding tax on interest could be the one of the biggest sources of potential tax leakage to the economy. We wonder how long the government could afford to fund its social programs if a substantial portion of the income or cash flows earned by business operating in Canada were to disappear without any taxes applied.

The 15% withholding tax applied to cash distributions from trusts ensures that the government receives a clear and substantial source of tax from non-residents for income and cash flows earned in Canada. Particularly since distributions are on average, materially greater than net income. We cannot say the same about other forms of investment. Perhaps the tax provisions on trusts need to be adjusted to ensure we get our fair share of tax, but they should not be set so high as to completely discourage foreign investment or to encourage investment by other means that may result in substantially less tax revenue to the government.

Where to From Here?

We recognize there was a need to prevent or slow down the rate of conversions. It would likely be no more beneficial to the economy to have too many trusts than the old system—with no income trusts. We believe a system that allows for both should be an objective. Currently, income trusts comprise approximately 10% of the S&P/TSX Index. That means that 90% of the companies listed on the exchange are not structured as trusts and actively seek above average growth.

The measures proposed by the minister on October 31, 2006, we believe would effectively level the playing field and stop trust conversions, without having to double tax trusts held inside retirement accounts. In that respect the measures go too far. The proposed taxes ensure that individuals will pay taxes on trusts at the highest rates of tax in Canada, while taxes on trusts held by non-residents will exceed taxes on any other kind of investment held by a non-resident by a wide margin. If needed, a conversion tax, or some other mechanism, could be temporarily introduced, then scaled back until the proposed annual tax cuts to corporate income and dividends fully eliminate any tax disparity.

Royalty and income trusts have an important role to play in Canadian capital markets. We believe there are likely many policy alternatives to the current proposal that would provide a better solution for the government, business and for all Canadians who rely on equity income vehicles for retirement income.

We also believe it is important that our policy makers—the elected MPs—are in full possession of all the facts, cited by the Minister of Finance. They need to make an effort to understand all sides of this debate and consider other policy alternatives before they are asked to cast their votes. The inconvenient truth is that poor policy choices result when elected representatives unconditionally accept facts and arguments presented in support of one side of a policy position, without considering other facts or other sides of the debate.

Analyst's Certification

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| A&W Rev. Royalties Inc. Fund (AW.UN-TSX) | | FMF Capital Group Ltd. (FMF.UN-TSX) | 15 |
| Algonquin Power Income Fund (APF.UN-TSX) | 2, 3, 7, 9, 10AC, # | Futuremed Healthcare Inc. Fund (FMD.UN-TSX) | 2, 3, 7, 9, 10AC |
| AltaGas Income Trust (ALA.UN-TSX) | | GMP Capital Trust (GMP.UN-TSX) | 5, 9, 10C |
| Altus Group Income Fund (AIF.UN-TSX) | 2, 3, 7, 10A | Hardwoods Dist. Income Fund (HWD.UN-TSX) | |
| Armtec Infrastructure Income Fund (ARF.UN-TSX) | 2, 3, 7, 9, 10AC | Keyera Facilities Income Fund (KEY.UN-TSX) | |
| BFI Canada Income Fund (BFC.UN-TSX) | | Keystone North America Inc. (KNA.UN-TSX) | 9, 10C |
| Boston Pizza Royalties Fund (BPF.UN-TSX) | | Livingston Int'l Income Fund (LIV.UN-TSX) | 9, 10C |
| CCS Income Trust (CCR.UN-TSX) | 2, 3, 7, 10A | Medical Facilities Corp. (DR.UN-TSX) | 9, 10C |
| Clean Power Income Fund (CLE.UN-TSX) | | Morneau Sobeco Income Fund (MSI.UN-TSX) | |
| CML Healthcare Income Fund (CLC.UN-TSX) | | Newalta Income Fund (NAL.UN-TSX) | 2, 3, 7, 10A |
| Consumers' Waterheater Fund (CWI.UN-TSX) | | Newport Partners Income Fund (NPF.UN-TSX) | 2, 3, 7, 9, 10AC |
| Contrans Income Fund (CSS.UN-TSX) | | Prizm Canadian Income Fund (QSR.UN-TSX) | |
| Davis + Henderson Income Fund (DHF.UN-TSX) | 2, 3, 7, 9, 10AC | SIR Royalty Income Fund (SRV.UN-TSX) | |
| DirectCash Income Fund (DCI.UN-TSX) | 5 | Superior Plus Income Fund (SPF.UN-TSX) | |
| Duke Energy Income Fund (DET.UN-TSX) | | TransForce Income Fund (TIF.UN-TSX) | 2, 3, 7, 10A |
| Energy Savings Income Fund (SIF.UN-TSX) | | UE Waterheater Income Fund (UWH.UN-TSX) | |
| Firm Capital Mortgage Inv. Trust (FC.UN-TSX) | 2, 3, 7, 10A | | |

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|-----------------|----------------|--------------|-------------------|-----------------------|
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(S) = speculative investment;

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