

The Canadian Association of Income Trust Investors – Concerns with the “Tax Fairness Plan”:

We begin with the simple premise that:

“parliamentarians need objective fact-based information on how well the government raises and and spends funds.” The Office of the Auditor General

This fundamental principle of our system of governance is not being adhered to in the formulation or legislative enactment of the Tax Fairness Plan (“TFP”). The policy issues that the Tax Fairness Plan purports to deal with are based on “quantifiable” truths. Since these “truths” are quantifiable, then the proper analyses needs to be conducted and presented with full public transparency and subjected to peer review scrutiny. The far reaching economic consequences of the TFP to Canadians and to Canada’s economy require that this standard be met.

Because this standard has not been followed, the Notice of Ways and Means Motion to Amend the *Income Tax Act* is of dubious purpose and intent, in each of its five purported goals of:

-leveling the playing field between trusts and partnerships and corporations;

Eliminating the “lower cost of capital” form of business structure cannot be considered leveling the playing field, nor can it be considered a desirable outcome in an increasingly globally competitive marketplace, where positive economic consequences accrue to those economies where such cost of capital advantages exist, and where such advantages result in improved standards of living for residents in those countries.

-ensuring that taxes are not unfairly shifted onto the shoulders of Canadian taxpayers;

This is based on the false premise that income trusts cause tax leakage. Income trusts do not cause tax leakage. The Department of Finance’s analysis causes tax leakage. Finance’s “budget based” approach excludes all of the taxes that are paid by retirement accounts. By ignoring the retirement taxes on the 31% of income trusts held in retirement accounts, Finance reaches the wrong conclusion concerning leakage and therefore shifting of tax burden. Finance then uses this flawed analytical methodology to devise policies that are regressive to these very people: Canadians saving for retirement, and Canadians providing for retirement income. This is also regressive to the 70% of Canadians who, unlike their elected representatives or federal public service workers, are not members of defined benefit pension plans.

-strengthening Canada’s social security system for pensioners and seniors;

This falsely invokes the weakest members of our society to advance the dubious purpose and intent of the TFP. Absent the false tax leakage argument, the TFP will do nothing to strengthen the otherwise unthreatened social security system. Which Canadians does the government believe own income trusts? Which segment of the population does the government think will most suffer, today and in the future, from the loss of this important investment choice? It is seniors who have experienced the disproportionate share of the \$35 billion loss in Canadians’ hard earned savings. As a sole consequence of the TFP, these Canadians will have become more reliant on Canada’s social security system, thereby weakening it through unnecessarily induced reliance.

-helping corporations make choices that are consistent with economic growth and competitiveness;

Forcing outcomes cannot be considered making choices. The TFP actually takes important choices away: away from businesses; away from Canadians. Income Trusts have emerged as an important investment choice for Canadians providing retirement income. The repeated condemnation that Canada not become a “nation of coupon clippers” will in no way abate the need for retirement income and income investment choices on the part of an aging Canadian population. To the extent that this important “made in Canada” investment choice will be denied under TFP, Canadians will increasingly look to global capital markets to fulfill their unsated needs. This inevitable “flight” of Canadian investment capital will accrue to the benefit of near-alternative markets, most likely the US High Yield market. Canadians saving for retirement will likely find themselves funding the growth and prosperity of US companies to the benefit of the US economy by investing in replacement forms of “high coupon” debt.

As with the unsubstantiated claim of tax leakage, the notion of economic growth and competitiveness being impaired by the conversion of businesses to income trusts is an unproven assertion. Assertions cannot be the foundation of sound economic policy. There have been any number of studies that have rigorously looked at the economic evidence, and concluded the reverse condition to be true. This evidence is plain for anyone to see. Even the Governor of the Bank of Canada concluded on October 20, 2006 (just days before the TFP’s announcement):

“Evidence suggests that income trusts may enhance market completeness by providing diversification benefits to investors and a source of financing to firms that otherwise might not have had access to markets”

-bringing Canada’s approach to the taxation of trusts and partnerships in line with other jurisdictions.

Cherry picking selective economic policies of other countries is a dangerously simplistic approach to policy formation, without a complete understanding of the broader context in which those policies were formulated. It cannot even be assumed that these countries were well served by these policies, either then or today. Unlike the US for example, Canadians do not have near-alternative investment choices to fill the void left by the elimination of the income trust investment choice. Canada does not have the Tax Free Municipal Bond Market, nor do we have the enormous US High Yield market or the Master Limited Partnerships of the energy sector to fall back on.

It is hard to believe that a policy that the US adopted in 1987 is the best policy that Canada could adopt in 2007. Absent the tax leakage argument and absent the economic prosperity argument, this argument becomes devoid of any purpose.

Other concerns:

Unlevel playing field between large pension funds and average Canadian providing for retirement income;

The TFP preserves the ability of large pension funds to replicate the economics of income trusts by holding private trusts in their private equity portfolios. This will be as true for the Public Service Pension Plan as it will be for other large pension plans. How can something that is being denied the average Canadian on the basis of its presumed negative effect on Ottawa’s tax base, be allowed to persist for the benefit of those Canadians employed in the public service and others so advantaged?

Inevitable Private Equity takeout of trusts will induce the very outcome TFP seeks to avoid: tax leakage:

The TFP has created the “perfect storm” for foreign private equity firms, who will employ the dual strategies of “event driven” opportunistic buying and “income stripping” value maximization techniques. The TFP has created an event driven buying opportunity, involving very stable and cash flow rich Canadian companies that are much

sought after in today's immensely well funded global private equity market. This opportunity is not going unnoticed. In fact, the recent \$831 million hostile bid for Calpine Power by the aptly named US private equity firm, Harbinger Capital, is only the start of an inevitable wave of income trusts takeouts by foreign private equity. Most will await the formal passage of TFP.

It is under these circumstances that Canadians' paper loss of \$35 billion in hard earned savings will be "crystallized". As with the Calpine purchase, foreign private equity buyers will use the tax deductibility of interest under the corporate structure to "income strip" the pretax cash flow of these companies and repatriate these cash flows to foreign jurisdictions free of any Canadian taxation. This will lead to the inevitable "hollowing out" of not just an important segment of Canadian business but Ottawa's tax base as well. Increased foreign private equity ownership will mean the foreign "command and control" of this thriving sector of the Canadian economy will shift head office decisions to players outside our country.

The Bloc's call for a ten year phase in will be of little protection to Canadians from these larger "forces at play."

Capital Insertion Rules governing Income Trusts:

The "capital insertion rules" of TFP will only exacerbate the event driven valuation arbitrage that foreign private equity investors can exploit, and which will suppress the true value of these trusts through artificially constraining their rate of growth, whilst in the hands of average Canadians. The market value of these businesses are not only based on their distribution yields but also largely on their rate of growth in distributions. This is not "war time", these businesses do not produce "luxury goods". State control is not the current school of thought in the industrialized world to foster economic growth.

The capital insertion rules will limit the growth of public income trusts held by Canadians at a rate of 200% over the four year phase in period. This will artificially constrain investment in productivity, innovation and growth and thereby restrict recovery of the lost value by existing investors. The following article and analysis speaks to the actual unconstrained growth potential of income trusts:

TORONTO, December 7, 2006 - A review of Canada's more than 250 income trusts indicates that trusts have been making an important contribution to the economy, investing their capital and growing their businesses at impressive rates, a survey by PricewaterhouseCoopers (PwC) shows.

A study of the five-year performance of income trusts reveals that sales, net income and capital expenditure grew significantly during the period 2000-2005 even as the trusts were returning cash to their investors.

The combined population of trusts reported an accumulated increase in sales of more than 600% during the period, with net income increasing 62% in 2005 and 22% in 2004. Significantly, a total of more than \$20 billion went to capital spending during each of 2004.

The market value of income trusts is not simply derived from their level of distributions, but is also based on management's ability to grow the business and unitholder distributions from economic value added activities like investments in productivity and innovation and business expansion, both organically and through acquisition. For many income trusts, the capital insertion rules will create an artificial constraint to their natural growth prospects.

The true threat of BCE and Telus conversion to income trusts:

The main justification for the abrupt reversal of a stated campaign pledge not to tax trusts was the back to back announcement of conversions to Income Trusts by BCE and Telus. When it was correctly pointed out at the time that neither of these companies paid any taxes as corporations, Canadians were assured that both these companies were on the very verge of being taxable. That was early November. Less than six weeks later, we learn that BCE

was able to reinvent its corporate self, such that it will not pay taxes for four years. Days later Telus announced that it would not be paying any taxes for two years. Given their adeptness under the corporate model of creating “tax holidays”, who is to say 4 years isn’t 10 and 2 years isn’t 5? Putting this conjecture aside, it is a very simple thing to calculate the loss in tax revenue to Ottawa of “blocking” these conversions. Over the first four years as a trust, BCE would have paid \$2.6 billion in taxes to Ottawa as an Income Trust versus no taxes as the corporation it was forced to remain.

Canadian corporations at large are very adept at reducing their “tax burden”. According to Statistics Canada, corporations on average paid taxes at the rate of 6.2% in 2003. This is in stark contrast to the published statutory tax rates of 21% for non resource companies and 25% for resource companies. This difference between statutory rates of tax and actual tax is achieved through the aggressive use of the many tax write offs that are afforded corporations under the *Income Tax Act*, that incidentally, are not afforded income trusts.

The Real Estate Investment Trust “Carve out”:

While the “carve out” for REITs afforded some relief to investors from the overall negative value impact of the TFP, it is not clear why this sector would have been granted special exemption when compared to other subsectors of the overall income trust market. REITs differ quite substantially when viewed from the perspective of their contribution as engines of economic growth and employment and their overall strategic importance to the country, given the passive fixed asset nature of their assets. When evaluated on these bases, other asset classes within the broader income trust market would have scored considerably higher on the “endangered species” list. Subsectors that immediately come to mind would be the energy subsector or resource subsector in general.

The position of the Canadian Association of Income Trust Investors:

If the main assertions of the Notice of Ways and Means Motion to Amend the *Income Tax Act* cannot be substantiated with objective and fact based information, either from the government itself or from an independent source like the Auditor General, then the Association of Canadian of Income Trust Investors will be calling for the full repudiation of the Tax Fairness Plan in the name of fairness and good governance.

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