

Canadian Association of Income Trust Investors (“CAITI”)
January 22, 2007

**Pre-submission to the Standing Committee of Finance
on the Matter of the Tax Fairness Plan (“TFP”)**

Given that the committee has decided to allot 6 hours to these public hearings, no doubt your intention will be to maximize their efficiency by allowing a debate whereby opposing views can be aired and challenged in front of the Finance Committee. Also this allotment of time would mean that you intend to properly focus the public hearings on the five Provisions of the **Ways and Means Motion** which was passed by Parliament and which enables this tax legislation.

Other tangential issues and unintended negative consequences of the TFP will have to be dealt with separately in the proper forum, upon first determining whether the five provisions themselves hold up to public scrutiny. Our association looks forward to discussing with the Officials of the Department of Finance (Finance) at the public hearings, the policy intent of these Provisions and the quantifiable foundations on which they were based. Attached is our association’s Position Paper and Exposé de position, also available at www.caiti.info.

As you know, repeated attempts by leading research analysts under the Freedom of Information Act and public calls by our association to the Auditor General have gone unanswered or unsatisfied. This has made the public hearings necessary.

Ways and Means Motion Issues:

All five provisions of the Ways and Means Motion are quantifiable propositions. Therefore, the following standard needs to be met:

***“Parliamentarians need objective fact-based information
on how well the government raises funds (taxes)”***

The Office of the Auditor General

The following is a summary of the key issues on each of the five provisions which we will be raising with the Department of Finance at these public hearings:

- 1. Ensuring that taxes are not unfairly shifted onto the shoulders of Canadian taxpayers***
- 2. Strengthening Canada’s social security system for pensioners and seniors***

These two provisions are basically one and the same as each is predicated on the notion of tax leakage. As can be readily understood from the work by HLB Decision Economics in their definitive report entitled Tax Revenue Implications of Income Trusts, it is the exclusion of retirement taxes from Finance’s analysis that causes tax leakage, not Income Trusts themselves.

.../2

This result is caused by the fact that Finance employs a “budget based” approach in their analysis. This flawed approach arbitrarily excludes all the retirement taxes that the government receives on the 31% of Income Trusts that are held in retirement accounts and RRSPs. These accounts are falsely treated by Finance as “tax exempt” accounts, when in fact they are fully taxable upon withdrawal. Retirement taxes are the second largest source of personal taxes to Ottawa, second only to taxes on income from employment.

During 2004, Ottawa collected \$9 billion in retirement taxes from \$52 billion in retirement income. By not properly acknowledging these retirement taxes, matters are made worse by creating policies that are regressive to those very people who are saving for retirement or providing retirement income. As such, the TFP is the product of circular logic and creates a “circular injustice” for average Canadians providing for retirement income.

The urban legend of tax leakage is simply that, a legend. The following is a quote in private correspondence from a widely cited professor of taxation: *“I do want to point out that there is a serious flaw in some analyses especially on the taxation of pension and RRSP accounts. Finance was wrong to treat the impact as zero.”*

The second of these two Provisions falsely invokes the weakest members of our society to advance the dubious purpose and intent of the Tax Fairness Plan, as the following links on CARP’s website would more fulsomely attest to (go to www.carp.ca and enter: *income trusts*):

- Rage against Proposed Taxation of Income Trusts
- CARP Warns: Income Trust Tax Change will Slash Senior’s Quality of Life
- Our audience issues a clear verdict: government did the wrong thing

Or perhaps, better to quote from Stephen Harper’s opinion editorial of October 25, 2005 in which he cites a letter from CARP which states: *“Seniors are actually enraged frightened and panicked about potentially losing retirement savings that they count on for the essentials of daily living.”*

Or from one of many similar comments received at contact@caiti.info from supporters of various parties, this from a long-standing Conservative supporter:

“So now at age 55 my future retirement plans are ruined, and plans for my family's future are gone too. And being a small business owner all my life I don't have the juicy pensions and perks that the people in Ottawa have.

Stupid me, I should have put my brain in neutral and got a government job when I was young. Instead, I went on my own at the age of 20 and created hundreds of new jobs, many new products, new export markets, and lots of new taxes. And now my just reward is to get beaten up by my own government lead by the party I supported all my life. Stupid me.”

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Or this from a long-standing NDP supporter, in a letter forwarded to contact@caiti.info :

“The NDP is guaranteed to lose our votes and financial support if you continue to support the Harper government’s attack on Income Trusts. While we support the NDP on many issues – especially on environmental concerns, we are shocked that the NDP has supported the Harper government on its attempts to steal our retirement monies. My parents and relatives helped found the CCF and the NDP. I am sure they are turning over in their graves at what seems to be an illogical political move by the NDP.

Honesty and openness has long been an NDP claim – please ensure that such ethics continue or the NDP will certainly lose our support and vote. Once the NDP fails to act on facts and principals, it is done! We expect and require you to support the Liberal and Bloc request to have the Finance Committee study the actual facts on the Income Trust taxation issue. No support – no vote and no money. I look forward to a positive and ethical response.”

Whereas the TFP does nothing to strengthen Canada’s social security system, and in fact will make many more senior Canadians reliant upon it, we do note that the TFP will introduce a significant new inequity between those, like the members of the civil service in Ottawa, who are Members of defined benefit pension plans and the 70% of Canadians who are not.

Unlike the changes contemplated last year, Mr. Flaherty’s version of fairness “carves out” the ability of Canada’s largest pension funds to replicate the economics of income trusts by holding private trusts in their private equity portfolios. We therefore will be asking the officials representing Finance at the public hearings the policy reasons behind this subtle yet profound change by asking the question:

“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 in our public civil service and others so advantaged?”

For more information on how the TFP will negatively affect those who it falsely invokes as being its beneficiaries (i.e. seniors and retirees), please refer to the section The Retirement Dilemma in RBC analyst Dirk Lever’s report dated December 5, 2006 entitled Business Trusts: Where to From Here? Or the section Impact on Retirees’ Incomes in BMO analyst Gordon Taint’s report dated December 4, 2006 entitled The Inconvenient Truth About Trusts.

3. Helping corporations make choices that are consistent with economic growth and competitiveness.

The TFP eliminates choice - important choices for business but particularly galling to our association is the elimination of an important “made in Canada” investment choice that many Canadians had embraced as a means to provide retirement income in a protracted low rate interest environment. TFP forces outcomes, it does not aid in choice. It does however “help corporations”. Namely those corporations who wish to eliminate the market pressures exerted upon them by individual Canadian investors’ preference for the discipline of monthly distributions of corporate earnings.

Certain corporations consider themselves ill-served by the democratization of the Canadian capital markets by individual investors as represented by the emerging “threat” of Income Trusts. (See: The Inconvenient Truth About Trusts, page 2 entitled Opening the Door to Ordinary Investors) False assertions of tax leakage significantly aid these certain corporations’ cause which is to the detriment of ordinary investors.

It needs to be understood by the committee that we represent the capital providers, and we should have the freedom to invest in the manner that we determine best suits our investment needs. Actions by government that would stand in the way of this would be an abrogation of the most basic rule governing the investment industry, the so-called “know your client rule.”

This rule is as true for government as it is for the investment industry. **Know your client.**

4. Leveling the playing field between trusts and partnerships and corporations.

Eliminating the competition from the playing field should not be considered “competition” nor leveling, but rather contrivance. Canada is not an economic island unto itself. How is Canada’s competitive position in an ever increasingly competitive world enhanced by the elimination of?

This low cost of capital alternative in favour of the high cost “status quo”? To quote the Governor of the Bank of Canada:

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

We look forward to Finance’s answer to this question as many studies by PricewaterhouseCoopers and HLB Decision Economics attest otherwise about the competitive consequences of income trusts.

5. Bringing Canada’s approach to the taxation of trusts and partnerships in line with other jurisdiction.

Just to be clear, this pertains to the United States. What is less clear are the pronouncements made by Finance on just what the “US model” we are being asked to emulate consists of. Canadians would be surprised to learn that the trust market that we are being led to believe was shut down in 1987 in the US actually today has a market capitalization of over US\$465 billion. This is a vibrant and growing market and recent changes have been implemented to broaden the scope of eligible investors.

The very strength of these US companies will allow them to readily acquire their Canadian counterparts, who will have been weakened and constrained by the measures of TFP, this will be one of the inevitable consequences of the many unintended consequences of the TFP. As unintended as these consequences may have been, they are readily foreseeable to anyone with rudimentary knowledge of the dynamics of capital markets. (See January 2007 issue of the US publication, Oil and Gas Investor) or go to www.oilandgasinvestor.com.

We also note that many of the statements made about the actions taken by the U.S. are incorrect. Whether these incorrect and misleading statements were made purposefully or because Finance didn't know the facts, we believe that Canadians should be provided with accurate information on an important policy decision.

Assessment of Conservative Party Talking Points:

The following claims were made in a set of “talking points” provided to Conservative MPs just prior to the winter recess. The actual fact-based information contained below, demonstrates that the principle messages being disseminated to the public by Conservative MPs as they returned to their ridings were false or misleading.

- **Statement 1: The US also has energy trusts – and they are taxed as corporations.**

FALSE – Energy trusts are taxed, as fixed investment trusts with no tax applied at trust level. “For federal income tax purposes, the Trust constitutes a fixed investment trust which is taxed as a grantor trust. A grantor trust is not subject to tax at the trust level. The Unitholders are considered to own the Trust’s income and principal as though no trust were in existence.” (San Juan Basin Royalty Trust 2005 Annual Report)

- **Statement 2: If MLPs maintained their structure beyond the 1997 deadline, they were subjected to a 3.5% tax on their total revenue (not “income”), regardless of profits or losses.**

FALSE – “Grandfathered” MLPs are taxed at 3.5% of gross income. Section 7704 (g)(3) of the Internal Revenue Code states “for each taxable year on the income of each 1987 electing partnership a tax equal to 3.5% of such partnership’s gross income for the taxable year from the active conduct of trades and business by the partnership”.

- **Statement 3: The transition period was conditional upon certain growth rules (related to new lines of business – 15%).**

MISLEADING – There were no restrictions for growth within existing business lines of the partnership or into new business lines that also generated “qualifying income”.

- **Statement 4: The only permanent exclusions from the tax are for MLPs that get 90%+ of their gross income from passive investment.**

FALSE - “Qualifying income” covers active investment in a broad range of industries including oil & gas (exploration, production, transportation, and refining), mining, fertilizer, propane distribution, timber, and real estate. And while non-qualifying “grandfathered” MLPs are not exempt permanently, they are exempt indefinitely.

Statement 5: The US forced trusts to convert after their transition period.

Not only is this statement **FALSE**, but it contradicts Statement 2. MLPs that did not meet the qualifying income requirements were exempted indefinitely so long as these “grandfathered” partnerships paid a 3.5% tax on their gross income.

Our Conclusion:

If the Finance Minister’s various assertions including tax leakage, cannot be fully substantiated following a thorough audit and a comprehensive peer review by independent experts with proven expertise in the workings of the Canadian capital markets, then our association will be calling for the repudiation of the Tax Fairness Plan in the name of fairness and good governance.

Should you require additional information on the many negative secondary repercussions of the TFP, please read our attached Position Paper (English) or Exposé de position (French).

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Attachments:

CAITI Position Paper (English)
ACIFR Exposé de position (French)

Related Reference Documents (Available on request from CAITI)

HLB: Tax Revenue Implications of Income Trusts
HLB: Income Trusts and the National Economy
BMO: The Inconvenient Truth About Trusts by Gordon Tait CFA
BMO: Digging Deeper by Cameron Renkas CFA
RBC: Where to from Here? by Dirk Lever CA
RBC: Deep Dive Into Tax Issues: Canadian Pensioners Taxed Twice by Dirk Lever CA
PwC Income Trust Financial Survey December 2006 and Executive Summary