Income Trusts: A Challenge for Regulators

By Amanda Tait and John Lawford
Public Interest Advocacy Centre
1204 – ONE Nicholas St.
Ottawa, Ontario
K1N 7B7

June 2007

The Public Interest Advocacy Centre
(PIAC)
Suite 1204
ONE Nicholas Street
Ottawa, ON
K1N 7B7

Canadian Cataloguing and Publication Data

Lawford, John
Tait, Amanda

Income Trusts: A Challenge for Regulators

ISBN 1-895060-83-4

PIAC received funding from Industry Canada's Contributions Program for Non- Profit Consumer and Voluntary Organizations. The views expressed in the report are not necessarily those of Industry Canada or the Government of Canada.

TABLE OF CONTENTS

TABLE OF CONTENTS 3
EXECUTIVE SUMMARY 5
INTRODUCTION 8
WHAT IS AN INCOME TRUST? 9
Tax Advantages 10
Legal Structure 11
Security Offerings 11
Unitholder Rights 11
Nature of the Business 12
Types of Income Trusts 12
Energy / Royalty Trusts 12
Real Estate Investment Trusts (REITs) 13
Business Trusts 13
Other Types of Trusts 14
WHAT MAKES TRUSTS SO POPULAR? 17
The Tax Advantages 17
Business Perspective 18
Consumer Perspective 19
BACKGROUND 19
Rapid Sector Growth 20
Economic Conditions 20
Implementation of Limited Liability Acts 21
Inclusion of Income Trust on the S&P/TSX Composite Indexes 21
GOVERNMENT REFORM 22
The Tax Fairness Plan 24
The New Tax Structure for Income Trusts 25
Reactions 27
EXAMINATION OF THE ISSUES 30
Parliamentary Committee Hearings 33
Provincial Implications 35
International Experience 36
Foreign Takeovers 38
EFFECTS ON THE ECONOMY 39
Boost Consumption at Expense of Capital Investment 39
NOT AN APPROPRIATE FORM OF ORGANIZATION FOR MOST BUSINESSES 41
Market Completeness 43
Overall Assessment 45
REGULATORY CHALLENGES OF TRUSTS 46
Rate of Return Regulation 46
Price cap regulation 47
Trusts and Rate of Return Regulation 47
AltaLink and TransAlta Utilities Corporation 48
Pacific Northern Gas Ltd. Income Trust Application 49

Price Cap Regulation and Income Trust Conversion 51
THE REAL DEVIL: LACK OF CORPORATE GOVERNANCE 64
Governance 64
CSA 66
AcSB 67
Standard & Poor's 67
Accountability Research Study 67
Mandatory Reporting Standards Needed 68
DRAFT LEGISLATION 69
Grandfathering 69
Conversion to Corporate Status 70
Undue Expansion 71
Anti-avoidance 72
REITs 72
Conclusion on Draft Legislation 73
RECOMMENDATIONS 73
Recommendation #1: Take Proactive and Decisive Action to Close Tax Loopholes 73
Recommendation #2: Increase Investor Protection 74
Recommendation #3: Creation of a Governance Structure for Income Trusts 75
Recommendation #4: Mandatory Governance Structures for New Security-Issuing Entities 77
Recommendation #5: Increased Consumer Awareness of the Financial Industry 78
Recommendation #6: Proposed Regulatory Treatment of Tax Consequences 80
Recommendation #7: Increased Transparency for Tax Policy 80
CONCLUSIONS 81

EXECUTIVE SUMMARY

This report examines the legal, regulatory, political and social issues raised by the sudden rise and the effective curtailment of the income trust as a corporate form and investment option in Canada. It concludes that while the response of the federal government of October 31, 2006 was required, more needs to be done to protect consumers and to prevent a reoccurrence of similar problems caused by aggressive tax minimization schemes.

The income trust is an investment trust that holds assets which are income producing. The trust invests the funds in assets that provide a return based upon the cash flows of the underlying business. The trust distributes the return back to the investors called unit holders who are the beneficiaries of the trust. The return is achieved through the acquisition of equity, debt, real property or royalty payments. Income trusts provide increased access to capital markets while providing unitholders with a steady income stream and an opportunity to participate in the growth of the company. There are currently about 250 income trusts trading on the Canadian market with a market value estimated at $200 billion.

However, the principal driver for the popularity of the income trust was the tax advantages it conferred. The income trust is not the operator of the business but the owner of assets or a stream of income from the business. As the trust flows all of its income out to unitholders, it is the unitholders that are generally taxed on trust distributions or capital gains. The business that actually generates the income borrows money from the trust and offsets any income with interest, royalty or lease payments to the trust. Thus, no corporate tax is paid by the business on its income and the end investor or unitholder may pay little or no tax to the extent that the income trust units are held in a registered plan. These tax advantages eventually triggered a government response.

On October 31, 2006, Finance Minister James Flaherty announced that the government would begin taxing income trusts immediately, essentially eliminating the difference between the taxation of trust distributions and corporate dividends. This sparked a market reaction that saw the income trust sector lose an estimated $20 billion in the following days. The Conservative party had previously made an election promise not to tax income trusts. Minister Flaherty stated that the change was necessary for reasons of fairness. He could not allow companies to evade taxation by restructuring themselves into trusts. The “tax leakage” attributed to trusts was estimated by the government at an annual amount of a half billion dollars which was destined to grow with income trusts planned by Bell Canada, TELUS and possibly Encana. The growth of this tax leakage was said to threaten the federal government’s ability to fund its programs.

The income trust tax announced on Hallowe’en 2006 was a necessary step in reining in the abuse of the income trust structure. However, there are other problems in relation to income trusts that remain outstanding, and the income trust saga reveals some inherent weaknesses in the making of Canadian taxation policy, the governance of trusts and the education of investors.

Critics of the government’s new tax fairness policy have questioned the actual amount of tax leakage, claiming government has overstated it by such oversights as failure to recognize the taxation of post retirement withdrawals from a trust. On the other hand, provincial governments were increasingly concerned that they were seeing the depletion of provincial tax revenues on in-province business organized into income trusts that featured out of province or foreign investors, not subject to provincial tax. In its last budget, the Government of Alberta estimated the net revenue loss as a result of trusts to be about $400 million per year. For its part, the Department of Finance has not helped its case by refusing to release a detailed breakdown of the claims of a half-billion dollar loss.

Income trust supporters have touted the use of such trusts as a measure that enhances “market completeness” that provides diversification benefits. The difficulty is that the income trust form of organization may not be appropriate from a business efficiency standpoint. The income trust might be appropriate where firms only need to manage existing assets effectively, but is problematic when new investment and innovation is needed. There is no incentive for income trusts to retain income for new investment, only for enhancing the stream of income to investors. This has implications for productivity growth in the economy as a whole. The threat of further large corporate conversions to the income trust structure exacerbated the government’s concern.

Another criticism of the government’s new trust taxing policy involves the likelihood of foreign takeovers of existing trusts which might result in a tax loss by the elimination of Canadian trust unit holders. There has been an increased pace to foreign takeovers of income trusts which the government ascribes to the attractiveness of investments in the Canadian economy.

The report also details the weak investor protection rules and the lack of uniform standards of trust governance. Unscrupulous financial reporting allowed income trust promoters to mislead unsophisticated investors with expectations of high yields. Income trusts were likely overvalued, trading at a 53% premium to corporate equities. By inflating the payout ratio of a trust, by increasing cash distributions by underestimating maintenance and working capital needs, higher selling prices can be obtained for trust units that are not reflective of underlying value. Mandatory and enforceable reporting standards for income trusts are needed.

The government’s draft income trust tax legislation appears to have certain defects involving lack of clarity that should be remedied prior to passage. There is some confusion as to what trusts qualify for grandfathering arrangements, the removal of impediments to conversion to corporate status if desired, the limits to growth of a trust during the grandfathered period and the extent to which tax minimization can be pursued by existing trusts seeking to avoid the tax consequences of the government’s policy.

The report closes with seven recommendations. The first recommendation, to “Take Proactive and Decisive Action to Close Tax Loopholes” was already undertaken by the Conservative government in the midst of writing this report, but is a caution to act more rapidly in future when a similar situation arises.

Recommendation 2 involves pro-active and decisive measures to “Increase Investor Protection” on the part of the federal government, quasi-regulatory and self-regulatory agencies when faced with a new investment vehicle such as the income trust. However, the recommendation goes further, demanding a greater consumer and citizen voice in tax policy-making and asking the federal government to consider using the recently created Ombudsman for Taxation Services as a focal point for this public voice.

Recommendation 3 is straightforward: “Creation of a Governance Structure for Income Trusts”. Remarkably, such a legal framework has not been decisively created due to jurisdictional challenges and a reticence to make necessary rules and regulations for the operation of income trusts, unitholder rights and governance, and performance reporting of the income trust sector.

Recommendation 4 follows in the same vein and suggests that in future there are “Mandatory Governance Structures for New Security-Issuing Entities”, that is, if and when an innovative corporate governance structure is created, there will be a legal framework at the ready to ensure investors and businesses are operating in a legal environment that closely parallels that which exists for corporations and corporate securities.

Recommendation 5 suggests the federal government do more to inform the investing public. “Increased Consumer Awareness of the Financial Industry” could be undertaken by the Financial Consumer Agency of Canada, a federal agency with a clear mandate to inform Canadians about financial matters, but which has so far shied away from advising Canadians about prudent investments.

Recommendation 6 calls for tax policy-makers at the federal level to consider, and to publish as part of the regulatory review process, a “Proposed Regulatory Treatment of Tax Consequences” from each action. This means policy-makers should consider the effects of tax changes on major regulated industries such as energy and telecommunications, in order to provide guidance to regulators and to avoid the possibility that ratepayers will pay twice for tax policy changes: once by increased personal taxes if corporate taxes are somehow reduced and again if, as was the case with income trusts, regulated companies in these industries apply to the regulator for rate increases linked to federal tax policy changes.

The report’s final recommendation “Increased Transparency for Tax Policy” concludes that the making of tax policy in Canada is obscure, despite its obvious core relation to democracy. In particular, the report criticizes the refusal to respond to access to information requests about tax policy-making, often under the overused and inappropriate “national economic interests” exemption.

Each of these recommendations runs counter to the past and current emphasis on market and business concerns and focuses on social and individual concerns. The recommendations seek to banish the “strike it rich” mentality that appears to have captured corporate Canada, with little government restraint, since income trusts burst out of the well-defined resource and real estate holdings sector and into operating companies. Whatever the fate of the income trust structure for operating business entities in Canada, it is clear that a set of ground rules and investor protections is needed.

INTRODUCTION

Over the past 10 years, the growth of income trusts in Canada has exploded. In fact, according Morningstar Canada, a leading investment fund research firm, income trusts have emerged as "the fastest growing segment of Canada's capital markets".[1] Income trusts operate in virtually all sectors of the economy and have gained popularity with a wide range of investors – from seniors and small-time investors, to large pension funds and investment firms.

There are currently about 250 income trusts trading on the Canadian market, with a market value estimated at $200-billion.[2] The exponential growth of the trust sector has been attributed to its favourable tax treatment (relative to corporations), and an unrelenting investor appetite for high-yield investment products. However, as the saying goes, 'there's no such thing as free money' – and trusts have come under fire for draining the public purse and creating economic inefficiencies in their wake.

On October 31st, 2006 the Conservative government shocked industry experts and business leaders with the surprise Hallowe'en decision to impose strict new tax requirements on income trusts. On the heals of campaign pledges to keep the income trust structure in-tacked, the Conservatives blindsided the trust industry with a new tax regime that would see the eventual elimination of the significant tax benefits previously enjoyed by trusts. The government claimed that it was left with no choice but to tax trusts, following the release of Department of Finance estimates that placed the combined federal-provincial loss of tax revenue dollars from trusts at $600-million annually.[3]

The Hallowe'en announcement left a sour taste in the mouths of many investors and income trust managers who vowed to fight the new tax rules. It was not long before high-powered industry leaders, investment firms, and trust managers joined forces to create well-funded coalitions to pressure the federal government to back off its proposed new income trust regime. To date, a parliamentary Committee has been convened, aggressive media campaigns have been launched, and accusations of deception lack of transparency, and broken campaign promises have been hurled. Critics vehemently dispute the government's tax leakage estimates along with claims of economic inefficiencies. With so much money at stake, it is little wonder that the income trust debate has gotten so ugly.

In this report, PIAC seeks to explore some of the key issues in the fierce battle raging over the government's decision to tax income trusts. Part I of the report will take a broad look at income trusts as a business model and will provide an overview of the income trust structure, including: the different types of income trusts, how they work, and the reasons behind why they have become such a popular investment vehicle. Part II of the report will explore the history of income trusts in Canada and examine the factors leading to the unprecedented growth of the trust

---

[1] See Morningstar Canada website at: <http://www.morningstar.ca/globalhome/industry/news.asp?articleid=ArticleID91920051581>.

[2] Jim Brown, "Income trust issues back on the boil as critics parade to parliamentary hearings" *The Canadian Press* (28 January 2007).

[3] Department of Finance Canada "Canada's New Government Announces Tax Fairness Plan" (News Release) (31 October 2006).

sector in recent years. Part III will examine the history of government attempts at reforming the trust sector, and in particular, will highlight the current government's proposed tax regime for trusts. Part IV of the report provides a brief overview of stakeholder reactions and the political and economic fallout from the government's decision to tax trusts. Part V provides a detailed examination of the some of the most controversial issues surrounding income trusts, including: claims of serious tax leakages; the fear of mass conversions; the threat of foreign takeovers; economic inefficiencies; and the theory of market completeness. Part VI explains various contentious issues of regulatory law involving industries that have had a high degree of income trust conversion, such as energy and telecommunications, and whether and how economic effects of such conversions should be handled by the regulator. Part VII of the report looks at the issue of corporate governance of income trusts. It seeks to evaluate the claims of weak disclosure requirements, overvaluation of trust units, marketing and reporting discrepancies, the need for mandatory practice standards, and the lack of effective regulatory and oversight provisions for the trust industry as a whole. Part VIII examines the draft legislative amendments to the *Income Tax Act*[4] proposed by the federal government. The section reviews criticisms launched by lawyers and tax experts that the proposed legislation lacks clarification on a number of the finer points of the new policy, including: the grandfathering clause; conversions to corporate status; 'undue expansion' provisions; the 'anti-avoidance' provisions; and the treatment of real estate investment trusts. Finally, in part IX, PIAC provides a number of important recommendations and policy considerations for government, industry and taxpayers.

WHAT IS AN INCOME TRUST?

Definition

Essentially, an income trust is an investment trust that holds assets which are income producing. The income trust acts as an investment syndicate that pools its money to buy a cash-flow-generating asset. The trust then uses the cash flow (after expenses) to distribute income back to the investors, called "unitholders".[5]

The "unitholders" are the beneficiaries, or equitable owners, of the trust. As such, they have a right to participate in the income and capital of the trust. The income is passed on to the unitholders through monthly or quarterly distributions, similar to the distribution of dividends by a corporation. Typically, an income trust works like this: the income trust invests funds in assets that provide a return based on the cash flows of an underlying business. The trust then receives royalty income from the producing asset and then sells interests in the trust (called trust units) to investors.[6]

---

[4] (R.S.C. 1985, c. 1 (5th Supp.)).
[5] "Income Trusts: An Introduction" FormerAboutGuides.Com, online: <http://www.formeraboutguides.com/investingcanada/library/weekly/2001a/aa012501.htm>.
[6] "Income Trusts – Frequently Asked Questions" TSX Group, online: <http://www.tsx.com/en/listings/sector_profiles/income_trusts/faq.html>.

This return is often achieved through the acquisition by the trust of equity and debt instruments, royalty interests or real properties. The trust can receive interest, royalty or lease payments from an operating entity carrying on business, as well as dividends and return of capital.[7]

The distinguishing features of all income trusts are:

1. They are closed-end funds[8];
2. They are publicly traded on a stock exchange – in Canada, they are all traded on the Toronto Stock Exchange (TSE) with the suffix UN; and
3. They are focused on income distribution to unitholders.[9]

Purpose

The generally stated purpose of the income trust form of business organization is to provide companies increased access to capital markets[10] while providing unitholders with a steady income stream and opportunity to participate in the growth of the company.[11]

Trusts vs. Corporations

Even though many trusts are created as a result of a conversion from a corporation to a trust structure, there are many important distinctions between the two business models. Below is a brief overview of the most significant differences, all of which will be discussed in further detail throughout the paper.

Tax Advantages

Of course, the most notable difference between income trusts and corporations lies with the tax treatment of income trusts. Prior to the government's October 31st, 2006 decision to tax trusts, they were a much more efficient way to hold assets from a tax perspective.[12]

---

[7] Department of Finance Canada, "Tax and other Issues Related to Publicly Listed Flow-Through Entities: Income Trusts and Limited Partnerships" (Consultation Paper) (September 2005) at 8.

[8] A "closed-end" fund has a number of characteristics that distinguish it from a typical mutual, or "open-end" fund. Closed-end funds behave more like stocks than open-end funds: closed-end funds issue a fixed number of shares to the public in an initial public offering (IPO), after which time shares in the fund are bought and sold on a stock exchange. Unlike open-end funds, closed-end funds are not obligated to issue new shares or redeem outstanding shares. The price of a share in a closed-end fund is determined entirely by market demand, so shares can either trade below their net asset value ("at a discount") or above it ("at a premium"); as cited in investorwords.com, an online resource for investment-related topics, online at: <http://www.investorwords.com/893/closed_end_fund.html>.

[9] "Income Trusts: An Introduction" FormerAboutGuides.Com, online: <http://www.formeraboutguides.com/investingcanada/library/weekly/2001a/aa012501.htm>.

[10] Income trusts often are created to provide access to capital in markets where the company manages a resource which is limited or in regulated industries which may have pricing or other constraints to induce institutional investors to lend more money when one of these "stodgy" companies wishes to raise money for, say, acquisition of a rival.

[11] "Income Trusts: An Introduction" FormerAboutGuides.Com

[12] "Income Trusts – Frequently Asked Questions" TSX Group, online: <http://www.tsx.com/en/listings/sector_profiles/income_trusts/faq.html>. See also heading 'Tax Leakages' below.

Legal Structure

Income trusts are not incorporated like traditional companies. Incorporation of limited liability companies has, since they were created by statutes in the late 19th century, allowed individual investors, whether or not they also are officers or employees of the company, to participate in growth of companies (to "take an equity position" or "play the stock market") without having to pay the debts of the company if it failed.

Trusts are an entirely different creation of English law. Trusts arose by the law and practice in the English courts of "Equity". In simple terms, a trust is a legal entity where one party (the "settlor") contributes to a fund which is held by another party (called the "trustee" – although the settlor and trustee can be and often are the same person for simple trusts) who in turn manages the fund for the benefit of a third party (the "beneficiary"). Trustees must never profit by the trust (besides a reasonable management stipend) and are required by the terms of the trust the settlor has written to distribute the fund to the beneficiary. The law does not class trusts as "legal persons"; unlike corporations, which are legal persons. As such, a trust is a completely unique type of legal entity.

The result is that income trusts (and their units) attract entirely different treatment for legal and tax purposes, than traditional corporations (and their shares), largely because trusts are not legal persons and corporations and individuals are. Due to these differences, an income trust itself is very often not the actual operator of the company, but rather the owner of assets or a stream of income generated by the company.

Security Offerings

What can be confusing is that income trust units, like stocks, are now treated as an equity-type investment traded on securities exchanges. The income trust units pass on income to their unitholders through regular payments of distributions (generally in the form of monthly or quarterly distributions). As such, income trust distributions are similar to dividend-paying shares; however, these distributions are typically much higher, offering yields of up to 10 percent a year (up to 20 percent for riskier trusts). However, similar to shares, capital gains or losses are possible through fluctuations in the unit prices and distributions may vary from year to year (depending on business conditions) and are not guaranteed.[13]

Unitholder Rights

Another distinction arises in the area of unitholder rights and responsibilities. Although unitholders appear to share similar rights and responsibilities to those of shareholders, they are not necessarily the same and can differ significantly based on the governance structure of the income trust. For instance, there may be differences in voting rights between trust unitholders and corporate shareholders. The area of potential unitholder liability is also a marked difference from that of shareholders. Unlike for corporate shareholders, there is no specific legislation that provides limits to unitholder liability in many provinces. Instead, trust law and the particular trust

---

[13] "Income Trusts – Frequently Asked Questions" TSX Group, online: <http://www.tsx.com/en/listings/sector_profiles/income_trusts/faq.html>.

agreement governs the unitholder's responsibilities and such law is far from clear. Therefore, to date, five provinces[14] have enacted limited liability acts attempting to deal with income trust unitholders like shareholders; however, the remaining complexity and uncertainty of trust law has caused some to believe there is more potential liability risk to a unitholder than a shareholder, perhaps even in light of these acts, although this possibility has been described as "extremely remote".[15]

Perhaps even more crucially for the creation and use of income trusts, liability of the "trustees" or income fund managers to outside parties and indeed to trust beneficiaries also is not clear without legislation. Again, the provincial legislation does provide limited liability for trustees/fund managers but the legislation may not completely extinguish liability in the same way or as efficiently as corporation limitation of liability acts.[16]

Nature of the Business

Finally, there are differences in the nature of the underlying business. Typically, an income trust will not engage in exploration, development, construction or manufacturing. – all of which are the typical staples for growth and expansion of corporations. Rather, income trusts focus on ownership and management with a view to generating income.[17] As noted above, income trusts are used to make predictable, stable or "stodgy" companies interesting to a securities market that provides returns on riskier investments at a level high above usual returns on shares and dividends of these predictable companies: "An ideal candidate for an income trust is an asset or business that generates reasonably stable distributable cashflows and has modest or predictable capital expenditure requirements."[18]

Types of Income Trusts

There are three primary types of income trusts that have emerged on the market:

Energy / Royalty Trusts

Energy or Royalty Trusts, sometimes referred to as "resource trusts", engage in the development, acquisition and/or production of natural resources such as oil, gas, coal or some type of industrial metal. Conventional oil and gas royalty trusts are actively managed portfolios holding assets of

[14] Five provinces - Alberta, British Columbia, Manitoba, Ontario and Quebec - have all introduced limited liability legislation to protect income trust investors from liability.

[15] See *The Uniform Income Trusts Act: Closing The Gap Between Traditional Trust Law And Current Governance Expectations*; Report of the Uniform Income Trusts Act Working Group to the Uniform Law Conference of Canada, Civil Law Section (ULCC: August 2006) ("ULCC Draft Uniform Income Trusts Act Report") at p. 22. Online: http://www.ulcc.ca/en/poam2/Uniform_Income_Trusts_Act_Report_En.pdf

[16] See ULCC Draft Income Trusts Act Report. The limitation of liability of trustees in ss. 26 and 27 of the Act attempt to duplicate liability protections of corporate officers and directors.

[17] "Income Trusts: An Introduction" FormerAboutGuides.Com, online: <http://www.formeraboutguides.com/investingcanada/library/weekly/2001a/aa012501.htm>.

[18] Peter Beck and Simon Romano, Canadian Income Funds: Your Complete Guide to Income Trusts, Royalty Trusts and Real Estate Investment Trusts (John Wiley & Sons Ltd.: Toronto, 2004), (Beck & Romano), at pp. 27-30; as cited in the ULCC Report, above.

mature producing properties. An example would be the Enerplus Resources Fund, which has a large portfolio of crude oil and natural gas properties.[19] Substantially all of the cash flow generated by the oil and gas assets, net of certain deductions (e.g. administrative expenses, management fees) is passed on to the unitholders as royalty income. The amount of distributions can be highly variable and will vary based on production levels, commodity prices, royalty rates, costs and expenses, and deductions. In general, the largest variable in determining the level of cash flow is prices for crude oil and natural gas. Royalty trusts provide an alternative means for investors to participate in the oil and gas sector, apart from owning the shares of individual corporations.[20]

Real Estate Investment Trusts (REITs)

Real Estate Investment Trusts, or "REITs", invest in residential, commercial and retail properties and will generally acquire real estate, income-producing real property and/or mortgage-backed securities. They earn income leasing the property to an operating entity, or earn interest income through the holding of equity and debt of an operating entity.[21] The REIT structure was designed to provide a similar structure for investment in real estate as mutual funds provide for investment in stocks. REITs are typically closed-end investment trusts that trade on an exchange and use the pooled capital of many investors to purchase and manage income properties. Each REIT will typically focus on a particular property sector like nursing homes, hotels, apartment buildings or shopping centers. An example would be the Legacy Hotels REIT, which has 24 luxury hotels and resorts all operated by Fairmont Hotels & Resorts Inc.[22] By taking advantage of the trust structure, REITs offer tax advantages (beyond traditional common equity investments) to investors and provide a liquid way to invest in real estate, which is an otherwise illiquid market.[23]

Business Trusts

Business Income Trusts are individual companies that have converted some or all of their shares (also called "stock" or "equity") into an income trust capital structure for tax reasons. They typically acquire all or substantially all of the issued equity and debt of an operating entity. Under a typical business income trust structure, the trust earns income primarily from interest payments received on the debt of the operating entity. In a typical business trust structure, the trust will hold the assets of a revenue-generating operating business in a wholly-owned subsidiary, usually a corporation or limited partnership.[24] A distinguishing feature of business

---

[19] Trevor Williams, "In Income Trusts, You Trust?" *The Valuation Times* (June 2005) at 000064 of the ATIP package – article disclosed by the Canada Revenue Agency under an Access to Information Request submitted by PIAC.

[20] "Income Trusts – Frequently Asked Questions" TSX Group, online: http://www.tsx.com/en/listings/sector_profiles/income_trusts/faq.html

[21] Department of Finance Canada, "Tax and other Issues Related to Publicly Listed Flow-Through Entities: Income Trusts and Limited Partnerships" (Consultation Paper) (September 2005) at 9.

[22] Trevor Williams, "In Income Trusts, You Trust?" *The Valuation Times* (June 2005) at p. 000063 of the ATIP package – article disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request.

[23] "Income Trusts – Frequently Asked Questions" TSX Group, online: <http://www.tsx.com/en/listings/sector_profiles/income_trusts/faq.html>.

[24] The subsidiary itself may be a trust rather than a corporation for tax reasons, making organizational charts of business trusts very complex. See ULCC Uniform Income Trusts Act Report, above, at p. 2, para. 9.

trusts are that they do not possess the characteristics of a classic investment trust, since cash flows are generally related to one individual company's assets; as opposed to a diversified portfolio found with many other types of income funds. Business income trusts have exploded in popularity and are found in virtually every sector of the economy, including manufacturing, food distribution, and power generation and distribution.[25] For example, the Big Rock Brewery Income Trust owns all the shares of Big Rock Brewery Ltd.; and the E.D. Smith Income Fund, produces a wide range of food products including jams, pie fillings and sauces.[26]

Other Types of Trusts

Just as energy trusts focus on the oil and gas sector and REITs are comprised of portfolios of real estate, there are other popular income trust sectors as well. Generally these sectors tend to be populated with mature businesses with steady cash flows, such as public utilities.[27]

Utility trusts invest in or operate public assets like pipelines, power plants or telecommunications. An example would be the Algonquin Power Income Fund, which owns hydroelectric, co-generation and alternative fuel facilities. These types of trusts are broadly categorized as business trusts, however, they are sometimes put in a separate category, as they are inherently less growth-focused.[28] Again, many are found in industries that are price-regulated or face other fairly extensive regulatory constraints, which may limit them from attracting the equity investment monies available on the securities exchanges and from institutional lenders without the flexibility of the income trust structure.

Most of the REITs, utility and business trusts earn their cash flow from interest on debt instruments and dividends from shares. In contrast, resource trusts primarily earn royalty income. There are, however, many exceptions. For instance, the A&W Revenue Royalties Income Fund, is a business trust that earns a royalty of 3 percent of the gross sales from the A&W Restaurants in Canada.[29]

How Income Trusts Work

Income trusts are structured so as to qualify as mutual fund trusts under the *Income Tax Act* (ITA).[30] This structure allows operating companies to finance their operations by selling "trust units" – full or partial ownership of operating assets in return for commitments to pay a steady

---

[25] Department of Finance Canada, "Tax and other Issues Related to Publicly Listed Flow-Through Entities: Income Trusts and Limited Partnerships" (Consultation Paper) (September 2005) at 9.
[26] Trevor Williams, "In Income Trusts, You Trust?" *The Valuation Times* (June 2005) at p. 000064 of the ATIP package – article disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request.
[27] "Income Trusts – Frequently Asked Questions" TSX Group, online: <http://www.tsx.com/en/listings/sector_profiles/income_trusts/faq.html>.
[28] Trevor Williams, "In Income Trusts, You Trust?" *The Valuation Times* (June 2005) at p. 000064 of the ATIP package – article disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request.
[29] *Ibid*.
[30] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s. 132(6).

stream of income to investors – some of which may involve a “return of capital”[31]. Once again, under the ITA, a return of capital is treated more favourably than a dividend payment.

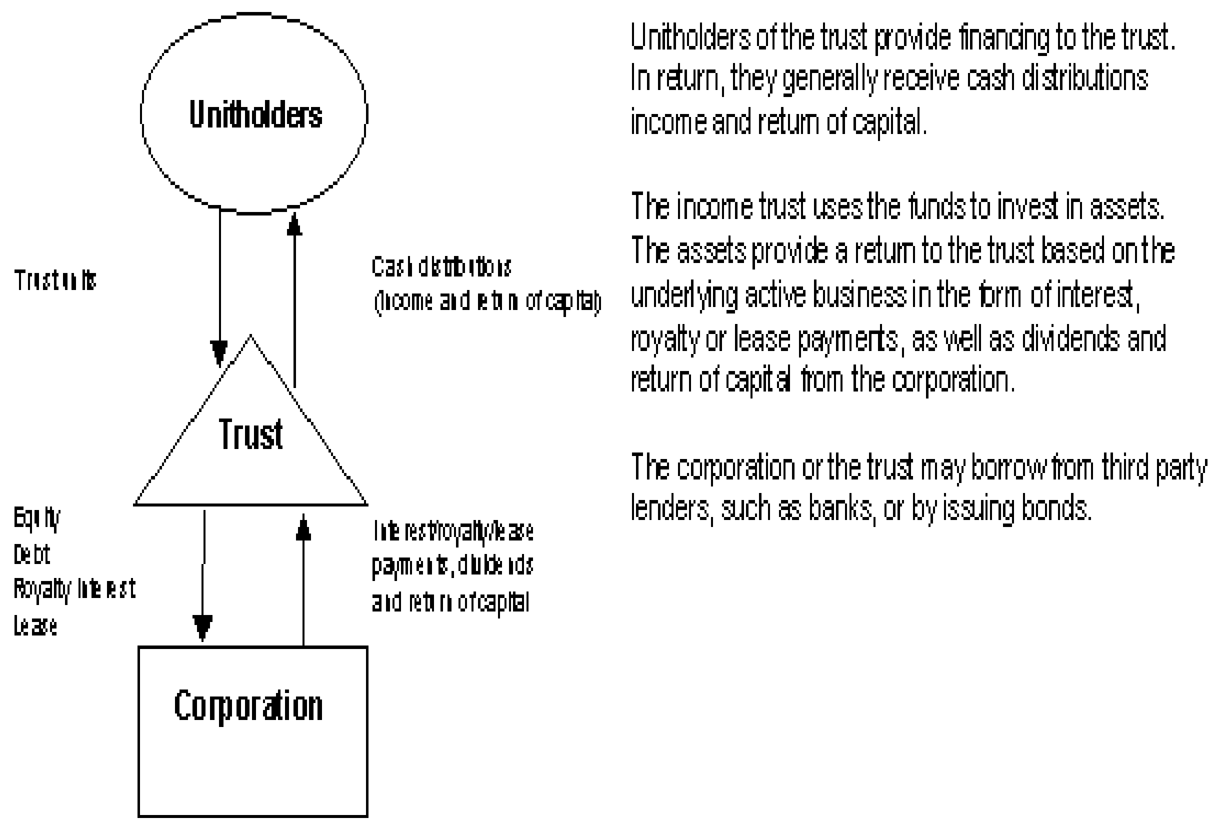
In computing income for tax purposes, income trusts may deduct income distributions paid or payable to unitholders as a distribution to beneficiaries. As a result, a trust that “flows” all of its income out to unitholders would not pay any income tax. Instead, the income would generally be taxed in the hands of the unitholders as trust distributions, dividends or capital gains. In fact, there is a strong incentive for income trusts to flow out *all* of its income to unitholders, since failing to do so will attract heavy penalties in the form of income tax payments. Under the ITA, the income of mutual fund trusts that is not distributed is taxed at a federal tax rate of 29 percent, representing the top personal income tax rate. The average federal-provincial income tax rate on mutual fund trusts is about 45 percent.[32]

The underlying principle behind income trusts is that any income earned in a trust is not subject to taxation within the trust, provided the trust distributes the profits (income) to the beneficiaries (unitholders) each year. A common income trust structure works this way: A corporation earns business income, but fully, or largely offsets that income by borrowing money from a trust (the income trust), and making large deductible interest payments to the trust. The income paid to an income trust by the operating entity may take the form of interest, royalty or lease payments, which are normally deductible in computing the operating entity’s income for tax purposes. The interest expense to the company is designed to virtually eliminate any profits in the operating company and flow that income to the trust. The trust in turn, “flows” all of its income received from the operating entity out to its unitholders. Then, the income trust distributes the income to the end investor, and claims a deduction for the amount distributed. So the net result is that a trust pays little or no income tax. Moreover, the end investor may pay little or no tax on the income distributed to the extent the income trust units are held in a registered plan, such as a Registered Retirement Savings Plan (RRSP), or the investor is a non-resident.[33]

The figure below represents a simplified income trust structure. Note that this example uses a corporation as the operating entity, but the trust may also use an operating trust or a limited partnership as the operating entity.[34]

[31] “Return of capital” is defined as: “A return from an investment that is not considered income. The return of capital is when some or all of the money an investor has in an investment is paid back to him or her, thus decreasing the value of the investment. This is not a gain of any type because it is not in excess of the original investment.” See <http://www.investopedia.com>. See also Geoffrey Hale, “Income Trusts – What Will Ottawa Do?” University of Lethbridge, Department of Political Science (September 16 2005) at 1.
[32] Department of Finance Canada, “Tax and other Issues Related to Publicly Listed Flow-Through Entities: Income Trusts and Limited Partnerships” (Consultation Paper) (September 2005) at 15.
[33] Tim Cestnick, “Income Trust: Web Exclusive” online: *The Globe & Mail* <http:www.theglobeandmail.com/servlet/story/RTGAM.20061101.wcestnick01/BNStory/Business>.
[34] Department of Finance Canada, “Tax and other Issues Related to Publicly Listed Flow-Through Entities: Income Trusts and Limited Partnerships” (Consultation Paper) (September 2005) at 8.

Figure 1. Simplified Example of an Income Trust Structure



(Source: Canadian Department of Finance)

Corporations can be restructured as income trusts using legal techniques of varying degrees of complexity. In some cases, income trusts are used to "spin-off" business assets to a separate organization, which may or may not remain under the effective management of the "parent" company. This type of structuring allows a company to raise capital from the sale of assets to use in more productive ways. For instance, this approach is used by a variety of utilities, energy firms, and even Air Canada with its Aeroplan frequent flyer program. Corporations may choose to spin off assets entirely into new business structures, or retain effective control by maintaining ownership of a significant minority share of income trust units.[35]

[35] Geoffrey Hale, "Income Trusts – What Will Ottawa Do?" University of Lethbridge, Department of Political Science (September 16 2005) at 3.

Large-scale company conversions will generally entail more elaborate structures to deal with issues like multiple tiers of operating subsidiaries, foreign operations, and the need to retain adequate cash for technological changes and capital spending.[36]

WHAT MAKES TRUSTS SO POPULAR?

Income trusts are simply businesses that may have otherwise raised capital as corporations issuing shares on the stock market. So what accounts for their tremendous popularity? What makes them such an attractive form of investment and business structure?

The Tax Advantages

The tax advantages of income trusts largely stem from the relatively unfavourable tax treatment of dividends, and the effect of income trusts in reducing the costs of capital to many corporations. In fact, many analysts agree that "[w]ithout their tax advantages there would be no need for trust structures."[37] This is because the trust structure eliminates or significantly reduces the corporate level of taxation. Indeed, the objective of an income trust is to have the income of the underlying business taxed only in the hands of the unitholders – thereby avoiding the income tax rates typically paid by large corporations, which range from 30-35 percent, depending on the province in which their operations are located.[38]

The real benefit of income trusts is that they serve as a form of tax arbitrage. Under the corporate structure, investors are subject to double taxation - first, income tax is paid by the corporation on its corporate profits, then when dividends are paid out to shareholders, a second level of income tax is paid at the personal level by the individual shareholders. In contrast, the tax structure of an income trust avoids the problem of double taxation by substituting a mutual fund trust for a corporation.[39] As a result, income trusts pay little or no tax, because most of their cash flow is channeled to investors through monthly distributions. The investors pay personal tax, but according to the federal government, the total take is nowhere near what it would be if the trusts were taxed at corporate levels.[40] Moreover, if the trust units are held in a tax-exempt structure like an RRSP or a pension fund then the distributions may not have been taxed at all.

An October 2004 article appearing in the *Globe and Mail* provides a useful summary of the tax advantages of income trusts (prior to the October 31st change in tax policy):

---

36 Chris Sexton, "Finance's Trust Tax Denies Tax Benefits to New Income Funds" KPMG Wireless Telecom (Issue Three 2006) at 46.
37 Trevor Williams, "In Income Trusts, You Trust?" *The Valuation Times* (June 2005) at p. 000064 of the ATIP package – article disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request.
38 Although the nature of the business operations may result in wide variations within and between sectors. See Geoffrey Hale, "Income Trusts – What Will Ottawa Do?" University of Lethbridge, Department of Political Science (September 16 2005) at 3.
39 Tim Cestnick, "Income trust values are justifiably higher than shares" *The Globe & Mail* (30 October 2004) B9.
40 Jim Brown, "Income trust issues back on the boil as critics parade to parliamentary hearings" *The Canadian Press* (28 January 2007).

1. A significant deferral or elimination of tax at the operating company level through the use of high-yield debt owing to the mutual fund trust.
2. An elimination of tax at the income trust level as a result of the availability of deductions for any income holders of the trust.
3. A deferral of tax on the income distributed by the trust to the unit holders of the trust to the extent the units are held inside such plans as Registered Retirement Saving Plans, Registered Retirement Income Funds and Registered Pension Plans.
4. Where the units are not held in registered plans, a deferral of tax on the income distributed to unitholders of the trust is available to the extent the distributions are characterized as a return of capital.[41]

Business Perspective

Income trusts have proven to be an attractive form of business organization, especially for owners seeking increased access to capital markets for acquisitions and growth.[42] The growth of "investment capitalism" has created a large market for the conversion of businesses to income trusts. This is due to the belief that a company's cash flow can be used more productively through the distribution of a larger share of its profits to investors; rather than by reinvestment in the business. The income trust structure is especially attractive to small and mid-sized companies because it provides them with improved access to capital markets. Such access, under a traditional corporate structure, would be prohibitively expensive for many smaller companies.[43]

Income trusts have also proven equally attractive for owners seeking an exit strategy from businesses that would not otherwise have access to conventional public markets. Prior to October 31, 2006, there was a distinct advantage for sellers of businesses and investment bankers in choosing to structure the business as a trust – simply stated, businesses organized under the income trust structure commanded higher prices than their corporate counterparts. Even though income trusts have the same operating risk (based on its underlying business) as any other corporation, prior to October 31, 2006, the markets tended to value income trusts as if they were debt instruments with fixed rates of return. This was evidenced by the fact that prior to the government's October 31st decision, the mere announcement by a company of its intention of converting could add 10-20 percent to its share price.[44]

---

[41] Tim Cestnick, "Income trust values are justifiably higher than shares" *The Globe & Mail* (30 October 2004) B9. See also ULCC Uniform Income Trusts Act Report at pp. 3-4, paras. 14-18, which notes as mentioned that corporations cannot deduct dividends paid to shareholders (but see below regarding tax changes allowing this avoidance of "double taxation" by the Liberal government in 2005); retention of the tax character of capital and income to the income trust (it is lost when paid out by a corporation to shareholders) and income trusts are not subject (or were, before October 31, 2006) to a provincial or federal tax similar to corporate taxes such as the federal Large Corporations Tax or provincial corporate tax statutes.

[42] Chris Sexton, "Finance's Trust Tax Denies Tax Benefits to New Income Funds" KPMG Wireless Telecom (Issue Three 2006) at 45.

[43] Geoffrey Hale, "Income Trusts – What Will Ottawa Do?" University of Lethbridge, Department of Political Science (September 16 2005) at 3.

[44] Chris Sexton, "Finance's Trust Tax Denies Tax Benefits to New Income Funds" KPMG Wireless Telecom (Issue Three 2006) at 45.

Consumer Perspective

The main attraction of income trusts for investors is their ability to generate constant cash flows. Investors are attracted to trusts because they provide a regular, and largely predictable, cash flow to investors on a monthly basis. They are also attractive because they generally provide a higher, more stable rate of return than many other investment products. Investors have grown accustom to, and increasingly demand, relatively high-yield investment products. As a result, they are attractive both to many older investors seeking regular income from their investments, as well as others seeking more stable returns following the dot-com bust of the late 1990s. In fact, prior to the government's October 31st announcement, income trusts were the fastest growing segment of Canada's capital market.[45]

Income trusts were also attractive to investors because they resulted in a substantial tax deferral if they were held within pension funds, RRSPs, RRIFs, or other retirement savings vehicles. Personal income from these sources is taxed only when actually paid to, or withdrawn by, individual pensioners. As a result, prior to October 31st, well-managed income trusts represented a more desirable RRSP investment than most fixed-income securities on the market at the time.[46]

BACKGROUND

The Birth of the Income Trust

The Canadian precursor of what would eventually become known as an "income trust" was created more than 20 years ago in the Calgary energy sector. It began as an idea to turn royalty income from the oil, gas and commodity resource sectors, into an investment package and sold to retail investors seeking income. In December 1985, Canada's first income trust, Enerplus Resources Fund, was launched. At the time, this novel concept barely registered on investors' radar screens. It eventually caught on in the real estate investment market, but it was not until the development of the business trust that the trust sector truly gained momentum.[47]

The first corporate conversion into a trust was the Enermark Income Fund in 1995. The move attracted little attention at the time, however, over the past few years, a broad range of companies, from mattress makers to phone-book publishers, have converted into trusts, and the sector now has a market value of almost $200-billion.[48]

---

[45] Geoffrey Hale, "Income Trusts – What Will Ottawa Do?" University of Lethbridge, Department of Political Science (September 16 2005) at 2.
[46] *Ibid.* at 3.
[47] Ross Healy, "A Critical Look at Income Trusts" Strategic Analysis Corporation (April 2004) at 2.
[48] Doug Hawkins, "Cashing in on the EnerMark Income Fund: EIF, Canada's largest oil and gas royalty trust, offers good monthly income potential" *Money Digest* (October 1996).

Rapid Sector Growth

In the last 10 years, publicly listed income trusts, and the trust sector more generally, have gained popularity as investment vehicles. The characteristics of firms adopting an income trust structure have broadened since energy and real estate firms first used them as funding vehicles. The past few years have seen a substantial increase in the percentage of business trusts, with a corresponding decline in the proportion, but not in the number, of energy, real estate, and utility trusts. Income trusts have also emerged in non-traditional sectors, such as financial services, telecommunications, and health care.[49]

The market capitalization of income trusts in Canada has grown significantly over the past several years. There are currently over 250 income trusts in Canada, worth a combined $200 billion and operating in a range of sectors.[50] There are air-cargo trusts, sardine trusts and film-distribution trusts. There are newspaper, liquor-store and sugar trusts. There are trusts that sell hothouse tomatoes, doors, water heaters and peat moss.[51] Since 2000, the trust sector growth accelerated sharply and appeared poised to continue to grow – that is until the federal government's fateful decision to tax income trust announced on October 31st, 2006.

Aside from the obvious tax advantages, additional factors can be attributed to the surge in popularity of income trusts and the phenomenal sector growth that resulted. These are examined below.

<u>Economic Conditions</u>

The growth of income trusts has been linked to the low interest rate environment, investors' desire for cash distributions, and high commodity (oil and gas) prices.[52] The trusts structure gained momentum after the dot-com crash of 2000, as investors were looking for easy access to high-yield producing investment products. The first high-profile conversion to the trust structure was the former Bell Canada Enterprises unit, Yellow Pages Group, becoming the Yellow Pages Income Fund, and raising $1-billion in the process. In the 2002-2003 period, income trusts dominated the IPO market, raising a gross profit of nearly $8-billion. During that same period, 14 public companies reorganized to income trust structures.[53]

---

[49] Stacey Anderson, "Recent developments in the income trust market" Financial System Review: Development and Trends (June 2006) at 23, online: <http://www.bank-banque-canada.ca/en/fsr/2006/dev_trends.pdf>.
[50] Jim Brown, "Income trust issues back on the boil as critics parade to parliamentary hearings" *The Canadian Press* (28 January 2007).
[51] Eric Reguly, "Capitalism for Slobs" *The Globe & Mail*, Report on Business (March 2005).
[52] Department of Finance Canada, "Tax and other Issues Related to Publicly Listed Flow-Through Entities: Income Trusts and Limited Partnerships" (Consultation Paper) (September 2005) at 4.
[53] Vijay Jog & Liping Wang, "The Growth of Income Trusts in Canada and the Economic Consequences" *Canadian Tax Journal*, (2004) vol. 52, no 3. By 2002, income trusts accounted for 79 percent of all money raised through IPOs in Canada, with only 38 percent in the traditional sectors of petroleum and real estate; "Income Trust" Wikipedia, online encyclopedia, online: <http://en.wikipedia.org/wiki/Income_trust>.

Implementation of Limited Liability Acts

Prior to the adoption of Limited Liability Acts in several provinces, the issue of investor liability was a serious impediment to the growth of the trust sector. The problem had to do with the non-incorporated status of income trusts. Because of this status, investors do not enjoy the same level of liability protection as they would were they investing in corporations. In fact, it was feared that investors could face unlimited liability in litigation against the income trusts in which they invest. Some market experts even noted that investors could face unlimited liability depending on their degree of involvement in the direction and administration of the income trust.[54] In response to these fears, five provinces - Alberta, British Columbia, Manitoba, Ontario and Quebec - now offer limited liability protection to income trust investors.[55] This legislation, which brings the treatment of trust unitholders in line with that of corporate shareholders, protects investors from being held personally liable for losses of the trust and has limited the liability of trust investors to the amount invested.

The clearing up of liability concerns with respect to trust investments paved the way for investments in trusts by the large institutional investors such as the Ontario Teachers Pension Fund. Institutional investors had largely stayed away from trusts due to the small chance that they could face legal issues without the limited liability protection.[56]

Inclusion of Income Trust on the S&P/TSX Composite Indexes

On May 18, 2005, Standard & Poor's (S&P) and the Toronto Stock Exchange (TSX) announced plans to add the largest income trusts to the S&P/TSX Composite Index, starting with a 50 percent weighting and gaining full representation by March 2006. The addition of income trusts represented a major change to the S&P/TSX. The change was precipitated by the exponential growth of income trusts and their status as the fastest growing segment of the TSX. For instance, in June of 2005, there were over 300 different trust units listed on the TSX. The inclusion of income trusts on the S&P provided added legitimacy and support to the trust sector and prompted additional involvement from fund managers and institutional investors.[57]

---

[54] Gregory Chrispin, "Income Trusts: The Changing Canadian Landscape" State Street Global Advisors (31 May 2005) online: http://www.ssga.com/library/esps/gregchrispincanadianlandscape20050531/page.html>. See also ULCC Draft Uniform Income Trusts Act Report, at pp. 15-17 and 22.

[55] Such legislation existed in Quebec since 1994. See, Stacey Anderson, "Recent developments in the income trust market" Financial System Review: Development and Trends (June 2006) at 23, online: <http://www.bank-banque-canada.ca/en/fsr/2006/dev_trends.pdf>.

[56] Trevor Williams, "In Income Trusts, You Trust?" *The Valuation Times* (June 2005) at p. 000064 of the ATIP package – article disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request.

[57] *Ibid*. at p. 00063.

GOVERNMENT REFORM

Efforts by federal governments to reform the income trust sector have been underway since 2004. In what was largely considered a fumbled attempt at reform, former Liberal Finance Minister Ralph Goodale sought to limit access to the income trust sector by pension funds in an attempt to curb future revenue losses to untaxed investment entities.[58] Goodale's proposal would have limited pension funds to holding no more than 1 percent of their assets in trusts and no more than 5 percent of the units of any trust.[59] However, following an intense storm of protest, the proposals were suspended on May 18, 2004, with the government citing the need for further consultation with the trust industry. This change of heart was largely seen as a capitulation to the powerful trust lobby.

The concern over income trusts, however, did not diminish. On September 8, 2005, the Canadian Department of Finance issued a consultation paper suggesting that the trust industry had cost it at least $300-million in taxes losses the preceding year, with provincial governments possibly losing another $300-million.[60] One week later on September 19, the Department of Finance announced that they were suspending advance tax rulings on all future trusts. Advance tax rulings are considered essential for investor confidence, and, not surprisingly, corporate Canada erupted into a storm of lobbying against any changes. The Finance Minister found himself the subject of a severe attack by the big pension funds (who own a substantial portion of the trust market). The resulting market uncertainly caused an immediate slump in the trust market, losing a staggering $9-billion in market capitalization during the following weeks.[61]

The political climate surrounding income trusts was growing increasingly uncomfortable for the government. It was also clear that any decision on trusts would affect the finances of an unknown proportion of the government's voting base. Following intense criticism from pension funds, retirees, and major elements of Canada's financial sector, Minister Goodale retreated. In a surprise announcement after the close of markets on November 23, 2005, Goodale announced that the government would not tax income trusts, and would instead cut dividend taxes. He also announced that the advance tax rulings would resume.[62]

To add insult to injury, the Liberal government then found themselves under fire for the strong stock market rally that immediately preceded the announcement (sending the S&P/TSX Composite Index to a new five-year high). This strong surge in stock market performance suggested, to some, leaks from government insiders to financial circles. Following opposition

---

[58] Geoffrey Hale, "Income Trusts – What Will Ottawa Do?" University of Lethbridge, Department of Political Science (September 16 2005) at 8.
[59] Trevor Williams, "In Income Trusts, You Trust?" *The Valuation Times* (June 2005) at p. 000065 of the ATIP package – article disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request.
[60] Department of Finance Canada, "Tax and other Issues Related to Publicly Listed Flow-Through Entities: Income Trusts and Limited Partnerships" (Consultation Paper) (September 2005) at 5.
[61] Carrie Tait, "Senator blasts Finance over trust issue: 'Recipe for disaster'" *The National Post* (29 September 2005) FP1.
[62] Department of Finance Canada, "Minister of Finance Acts on Income Trust Issue" (News Release) (23 November 2005).

requests for an official investigation into insider trading activity on that day, the Royal Canadian Mounted Police launched an inquiry on December 28, 2005.[63]

Dividend Tax Cut

Having failed in 2004 at implementing changes to the income trust tax structure, the Liberal government made another attempt at improving the tax system's neutrality – this time by implementing a reduction in income taxes payable on eligible dividends. This tax reduction takes the form of an enhanced "gross-up" and dividend tax credit (DTC) for eligible dividends received by eligible shareholders. According to the government, this move was designed to make the total tax on dividends more comparable to the tax paid on distributions of income trusts. It was also designed to eliminate the "double taxation" of dividends at the federal level and better reflect existing and proposed corporate tax rates.[64] The eligible dividend is now grossed-up by 45 percent, meaning that the shareholder includes 145 percent of the dividend amount, for the purposes of calculating the dividend tax credit. The result is a larger DTC, which when multiplied by the taxpayer's federal income tax rate, reduces the total income tax payable on dividend income..[65] In announcing the dividend tax cut, former Finance Minister Goodale stated: "Reducing the tax individuals pay on dividends will encourage savings and investment and will help establish a better balance between the tax treatment of large corporations and that of income trusts."[66]

The government estimated that the enhanced dividend tax credit would cost approximately $300 million per year starting in 2006.[67] This represents an expensive enticement to investors, but did it work? Sadly, the answer appears to be no. The policy largely failed to eliminate tax distortions between income trusts and corporations. The reason: businesses can increase their value by more than a third by converting corporate assets into income trusts. Moreover, investors who pay little or no personal tax on investment income remain unimpressed, because they obviously cannot take advantage of the tax break - this includes owners of pension funds, RRSPs and non-resident investors in Canadian equities. As such, the tax distortions remain. These investors, who comprise over 60 percent of the equity market, prefer companies to convert business assets into income trusts since they can avoid paying corporate taxes at a 35 percent rate. As well, they pay

---

[63] To date, the results of the RCMP inquiry have only led to charges against one individual. In February 2007, a Department of Finance employee was charged with breach of trust after it was discovered that he had profited nearly $7,000 from transactions involving income trusts shortly before the government's announcement that it would not be taxing trusts. A criminal investigation is ongoing into allegations that members of Bay Street profited from leaked information regarding the changes in tax policy. See, Jim Bronskill & Jim Brown, "Insider made $7,000: RCMP" The Toronto Star (17 May 2007).

[64] Department of Finance Canada, "Minister of Finance Acts on Income Trust Issue" online: Department of Finance website <http://www.fin.gc.ca/news05/05-082e.html> .

[65] Department of Finance Canada, "Backgrounder: Income Trusts" online: Department of Finance website <http://www.fin.gc.ca/news05/data/05-082_1e.html>.

[66] Department of Finance Canada, "Minister of Finance Acts on Income Trust Issue" online: Department of Finance website <http://www.fin.gc.ca/news05/05-082e.html>.

[67] Department of Finance Canada, "Backgrounder: Income Trusts" online: Department of Finance website <http://www.fin.gc.ca/news05/data/05-082_1e.html>.

no tax on income trust distributions, in the case of RRSP and pension plan owners, or a 15 percent tax in the case of non-residents.[68]

The dividend tax cut, although welcomed by investors, was widely criticized by commentators for failing to accomplish the elusive tax neutrality that the government was striving for. As one commentator aptly stated: "Did it not occur to the Liberals that the dividend tax credit is irrelevant to the very investors – foreign investors, pension plans and tax sheltered mutual funds – for whom the income trust tax dodge was most lucrative? The increase in the dividend tax credit was an expensive and unsolicited give-away that accomplished nothing."[69]

Following the failure of the dividend tax credit, it was obvious that further tax policy actions were required if tax neutrality between trusts and corporations was to be achieved. The trust debate turned into a critical campaign issue in the 2006 election, as any decision on trusts would affect the finances of a substantial proportion of the voting base. The Conservatives took a bold approach by aggressively campaigning on a platform that included a policy promise not to tax income trusts. This campaign promise may have helped get them elected, but it would come back to bite the Conservatives in the months to come.

The Tax Fairness Plan

With the new Conservative government in power for less than nine months, Finance Minister Jim Flaherty shocked financial markets on October 31, 2006 with a surprise announcement that the government would begin taxing income trusts immediately; thereby going back on the Conservative's campaign pledge to avoid taxing trusts. The announcement sparked a market panic that saw the sector lose an estimated $20 billion in market value in the following days.[70]

Minister Flaherty portrayed the move as one of simple fairness, saying he could not let companies continue to evade corporate income tax by restructuring themselves as trusts. "If corporations don't pay their fair share of taxes, this tax burden would be shifted onto the shoulders of hard-working individuals and their families," the Finance Minister declared in announcing his policy reversal.[71] His argument rests, in large part, on the contention that the so-called "tax leakage" suffered by the federal government already amounted to a half-billion dollars. He further warned that tax revenue hemorrhaging would continue to grow if left unchecked, until it threatened the federal government's ability to fund priorities such as health care, education and infrastructure.[72]

---

[68] Jack M. Mintz, "Unfinished Business: Achieving Neutral Taxation of Corporations and Income Trusts" *C.D. Howe Institute*, e-brief (21 December 2005) at 2.
[69] "For Finance Minister Flaherty – and for Bay Street – tomorrow is another day" Editorial, Canadian Centre for Policy Alternatives (CCPA) (8 November 2006), online:
http://www.policyalternatives.ca/Editorials/2006/11/Editorial1479/index.cfm?pa=AE5DAA5F>.
[70] Jim Brown, "Income trust issues back on the boil as critics parade to parliamentary hearings" *The Canadian Press* (28 January 2007).
[71] *Ibid.*
[72] Steven Chase, "Finance refuses to divulge key trust data" The Globe & Mail (23 January 2007) online update: <http://www.theglobeandmail.com>.

It has been widely speculated that the government was forced to backtrack on its election promise in order to stop the wave of corporate conversions to income trusts. Indeed, the government's announcement came just three weeks after BCE Inc. proposed the biggest trust conversion in Canadian history. It proposed to convert its Bell Canada subsidiary to a trust – a move that would save it an estimated $800 million in tax by 2008.[73]

During the announcement, Minister Flaherty cited the $70 billion worth of new trust conversions that were announced in 2006 – something he said is hurting the economy. He called trust conversion "a growing trend in tax avoidance."[74] The Finance Minister also said the decision was motivated by the fear that Canada's economy is slipping further into the income-trust model and out of step with global trends (in reference to the decision by other countries, notably the United States and Australia, to cut off the tax advantages of similar flow-through entities).[75]

In an effort to relieve some of the sting from the announcement to tax trusts, the government also announced plans to reduce corporate income tax rates. The 2006 Budget revealed that the general corporate income tax rate would be reduced from 21% to 19% by 2010. The Government also intends to reduce the rate by a further one-half percentage point, to 18.5%, beginning in 2011.[76]

The New Tax Structure for Income Trusts

On December 21, 2006 the government released new draft tax legislation in response to its change in tax policy. The proposed legislation would apply to certain publicly traded income trusts and limited partnerships – which the government has termed "Specified Investment Flow-Through Entities" (SIFTs). Thus, a typical income trust is known for tax purposes as a SIFT. Under the new regime, the tax treatment of SIFTs will be similar to that of corporations, and investors will be taxed like their corporate shareholder counterparts, as follows:

- Distributions of certain SIFT income will be subject to tax at corporate income tax rates;
- Income trusts will not be able to deduct the amount of the distributions for tax purposes; and
- Investors will be taxed as though the distributions were dividends.[77]

The proposed rules will affect all Canadian resident trusts and partnerships (i.e. SIFTs) whose units are listed on a stock exchange or other public market and that hold one or more "non-portfolio properties" (essentially, property used in carrying on a business in Canada). The government did, however, spare one class of trusts – real estate investment trusts. The proposal

---

[73] "Flaherty imposes new tax on income trusts" CBC News (31 October 2006) online: <http://www.cbc.ca/money/story/2006/10/31/flaherty.html>.
[74] *Ibid.*
[75] Scott Deveau, "'Clear and present danger' prompted trust move" The Globe & Mail (1 November 2006) online update: <http://www.theglobeandmail.com/servlet/story/RTGAM.20061101.wflaherty1101/BNStory/Business/home>.
[76] "Backgrounder on Income Trusts" disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request, at p. 000137 of the ATIP package.
[77] Chris Sexton, "Finance's Trust Tax Denies Tax Benefits to New Income Funds" KPMG Wireless Telecom (Issue Three 2006) at 46-47.

outlines that it will not affect trusts that hold passive real estate investments, if they meet strict conditions.[78]

The effective tax rate to be paid by trusts on distributions will start at 34 percent, to mirror federal and provincial taxes on corporations and drops to 31.5 percent by 2011. In addition, the federal government will remit to the provinces a 13-percentage-point share of the revenue.[79] The proposals will affect these SIFT trusts by not permitting the trusts to deduct certain distributions that would normally be deductible. Basically, any part of a distribution that can be attributed to a business carried on in Canada or to income from (or capital gains on) non-portfolio properties will not be deductible.[80]

These changes will affect the income trust itself, and those who invest in income trusts. The bottom line is that income trust will now pay tax. That tax will be at the same rate that a corporation would face if it had earned the income. This should reduce the level of distributions that an income trust can make to an investor, and therefore should have an impact on income trust values. Moreover, any amount that is not deductible to the SIFT trust and that becomes payable by a SIFT trust to an investor, will be taxed as though it is a taxable dividend from a Canadian corporation. The bottom line is that the tax treatment will be no different to investors than if they had invested in a corporation instead of an income trust. This structure has been referred to as a "deemed dividend" and will be eligible for the reduced tax rate on dividends, as announced in the 2006 Federal Budget.[81]

The new tax policy took effect immediately following the government's announcement, meaning that new income trusts that began trading after October 31, 2006, were subject to the new tax policy, beginning with their 2007 taxation year. Existing trusts and other FTEs, on the other hand, were given a four-year transition period (or "grandfathered") until 2011 – meaning they will not be subject to the new tax until their 2011 taxation year.[82]

Legislative amendments to implement these proposals must be passed by Parliament and receive Royal Assent before they become law. To date, this has yet to take place; however, the government remains adamant that they will move forward with the new tax proposals, despite intense lobbying efforts to kill the tax.

Income Splitting for Seniors

The trust tax is certain to hurt the retirement savings of million of Canadians who rely on returns from trusts, including many seniors. In order to cushion the blow, the government announced $1-

---

[78] Tim Cestnick, "Income Trust: Web Exclusive" online: *The Globe & Mail* <http:www.theglobeandmail.com/servlet/story/RTGAM.20061101.wcestnick01/BNStory/Business>.
[79] Scott Deveau, "'Clear and present danger' prompted trust move" *The Globe & Mail* (1 November 2006) online update: <http://www.theglobeandmail.com/servlet/story/RTGAM.20061101.wflaherty1101/BNStory/Business/home>.
[80] Tim Cestnick, "Income Trust: Web Exclusive" online: *The Globe & Mail* <http:www.theglobeandmail.com/servlet/story/RTGAM.20061101.wcestnick01/BNStory/Business>.
[81] *Ibid.*
[82] Department of Finance Canada "Canada's New Government Announces Tax Fairness Plan" (News Release) (31 October 2006).

billion in annual tax breaks for seniors. The new tax rules will allow senior citizen couples to split their retirement income as of the 2007 taxation year. It works like this: Canadian residents who receive income that qualifies for the existing pension income tax credit will now be entitled to allocate to their resident spouse (or common law partner) up to one-half of that income. According to the government, the measure was designed to significantly increase the incentive to save and invest for family retirement security. Until now, income splitting was limited to Canada Pension Plan payments and spousal RRSPs.[83]

In addition, the government announced an immediate increase in the old age credit amount for seniors, increasing from $1,000 to $5,066. The age credit, a special federal income tax credit for Canadians 65 years of age and older, will be significantly enhanced, with the increase taking effect retroactively to January 1, 2006. The age credit is calculated by multiplying the lowest personal income tax rate by an amount that is indexed to inflation; for 2006, this amount is $4,066. The credit is subject to an income test that targets the assistance to seniors who need it most. The unused portion of the credit may be transferred to a spouse or common-law partner. "Approximately two-and-a-half million retired Canadians will benefit from this move, it's really huge for them," said Independent MP Garth Turner, a longtime advocate of income splitting.[84] Many seniors have come to rely on income from income trusts. Finance Minister Flaherty said these new measures aimed at seniors would allow them to "retain more of their income in their retirement years."[85]

Reactions

Not surprisingly, the government's surprise announcement to tax trusts met with a wide range of reactions from industry insiders, investors, investment firms, trust managers and the general public. Below is a review of the general views expressed by different stakeholders in the income trust saga:

Financial Reactions

The day after the government's surprise announcement that it would impose new taxes on income trusts, the aftermath was already being felt. The announcement triggered a 324-point plunge on the Canadian stock market and erased $20-billion in market value. Notably, the announcement also stopped a number of high profile conversions from taking place – primarily Telus Corp. (down 13 percent on the TSX following the announcement) and BCE Inc. (down 12 percent).[86] In the month following the tax announcement, the unit price for all 250 income trusts on the TSX dropped by a median of almost 13 percent, as investors tried to sort out what would be left of the market once the smoke cleared. Since the October 2006 announcement, trusts have

[83] "Backgrounder on Income Trusts" disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request, at p. 000138 of the ATIP package.
[84] *Ibid.*
[85] "Flaherty imposes new tax on income trusts" CBC News (31 October 2006) online: <http://www.cbc.ca/money/story/2006/10/31/flaherty.html>.
[86] Tavia Grant & David Parkinson, "TSX income trust sector sheds $20-billion" *The Globe & Mail* (1 November 2006) online update: <http://www.theglobeandmail.com/servlet/story/RTGAM.20061101.wstocks1101/BNStory/incomeTrusts>.

rebounded, but most are still trading below their pre-announcement highs. Studies by Leslie Hayman, publisher of the iTrust Report, indicated that the change in tax policy announced on October 31st was the second most significant volatility event in the market followed only by the suspension of advance tax rulings by the former Finance Minister, Ralph Goodale in 2005.[87]

Political Reactions

While the move was lauded by both the Bloc Quebecois and NDP, it was panned by the opposition Liberals, who criticized the government for breaking a central election promise and for betraying the trust of Canadians. The Conservatives had promised in their election platform to preserve income trusts by not imposing any new taxes on them, after accusing Liberals of attacking the retirement savings of seniors. Liberal Finance Critic, John McCallum, later said the move was the "single biggest blow" to Canadians' wealth ever dealt by a finance minister, referring to the day as "Black Wednesday."[88]

Following calls by the Opposition Liberals and the Bloc Quebecois, a parliamentary Committee held special hearings in January to probe the controversial income trust tax. Both the Liberals and the Bloc indicated that they may work together to extend the tax-free transition period, from four years to as much as 10 years, when the legislation comes before the Committee later this year. The length of the transition period will likely be a key factor in approving the legislation, as the minority Conservative government has yet to pass a law enabling the tax, and opposition parties could push for significant overhauls to its provisions.[89]

Industry Reaction

Reaction from industry was mixed – with many corporate executives relieved at the prospect of not having to face pressure to convert to trust status, while income trust managers were left fuming.

Shortly after the government's announcement, there were already declarations by established income trusts that they planned on converting to corporate status. For instance, Energy Savings Income Fund announced early plans to convert away from its current income trust business structure in response to the new tax. Rebecca MacDonald, Chairman, said that she expects to convert away from the trust structure in "less than two years" - well before the government's proposed tax law on trusts is set to take effect, at the start of 2011. MacDonald said she is not willing to wait to see if the government changes its mind or extends the deadline for the tax to take effect. "I'm not going to allow government to control the way we do our business on an ongoing basis," she said. Energy Savings is a retail marketer of natural gas and electricity. The company is considered one of the best models for the income trust structure, because its revenue

[87] "Income Trust" Wikipedia, online encyclopedia, online: <http://en.wikipedia.org/wiki/Income_trust>.
[88] Scott Deveau, "'Clear and present danger' prompted trust move" *The Globe & Mail* (1 November 2006) online update:
<http://www.theglobeandmail.com/servlet/story/RTGAM.20061101.wflaherty1101/BNStory/Business/home>.
[89] Steven Chase, "Special hearings will probe trust tax" *The Globe & Mail* (18 January 2007) online update:
<http://www.theglobeandmail.com/servlet/story/LAC.20070118.RTRUSTS18/TPStory/Business>.

stream from existing customers is guaranteed under the fixed-price contracts, while the costs for its gas and electricity supplies are also locked in by contracts with producers.[90]

Reaction among foreign investors, who have enjoyed feasting on the uniquely Canadian income-trust offerings, was decidedly negative. Following the October 2006 announcement, some U.S. clients of one Canadian trader were describing Mr. Flaherty as the "Chavez of Canada" in reference to the Venezuelan President with an affinity for nationalizing oil companies.[91]

Opposition Coalitions

Opposition groups have warned that the debate over the taxation of income trusts is far from over. A new, hastily formed coalition, the Canadian Association of Income Trust Investors (CAITI), immediately called for Canada's Auditor General to examine the government's justifications for its controversial income trust tax. In addition, CAITI called for a public audit into the Finance Minister's Tax Fairness Plan before Parliament passes it into law:

> If the minister's assertion of tax leakage cannot be fully substantiated following a thorough audit by the auditor general and a comprehensive public peer review by independent experts with proven expertise in the workings of the Canadian capital markets, then CAITI will be calling for a full repudiation of the (Tax Fairness Plan) in the name of fairness and good governance.[92]

CAITI claims that Minister Flaherty's "tax leakage" assertion is based on analysis that excludes taxes paid on income trusts held in retirement accounts, which are subject to the highest level of personal taxation. Brent Fullard, head of CAITI and one-time chief of equity capital at BMO Nesbitt Burns, argues the long-run implications of Flaherty's new policy could be staggering for the Canadian economy. He reasons that, as a result of the market panic last fall, many trusts are now seriously undervalued and potentially ripe for takeover by foreign buyers at bargain prices. Once that happens, the new owners could revert from trust to corporate status, strip the company assets and repatriate profits to their home countries.[93] In fact, many analysts are now warning that this is exactly what's been happening, with the announcement of foreign takeovers of Canadian income trusts.[94]

The Coalition of Canadian Energy Trusts has added their voice to the growing dissent, warning of dire consequences to the oil and gas sector - such as lost foreign investment and a reduction in

---

[90] David Parkinson, "Energy Savings 'will not be a trust'" *The Globe and Mail* (25 January 2007) online update: <http:www.theglobeandmail.com/servlet/story/LAC.20070125.RENERSAV25/TPStory/?query=income+trust>.
[91] Sinclair Stewart & Andrew Willis, "Income-trust crackdown: The inside story" *The Globe & Mail* (2 February 2006), online at: <http://www.theglobeandmail.com/servlet/story/RTGAM.20061102.wtrusttick02/BNStory/Business/home>.
[92] Lauren Krugel, "Coalition opposed to income-trust tax pushes for probe by auditor general" Canoe Network (16 January 2007) online: <http://www.money.canoe.ca/News/Other/2007/01/16/pf-3388040.html>.
[93] Jim Brown, "Income trust issues back on the boil as critics parade to parliamentary hearings" *The Canadian Press* (28 January 2007).
[94] Stephen Chase, "Trust tax linked to private equity buyouts" *The Globe and Mail* (June 13, 2007), p. B-1.

energy production in Canada - should the government's plan be brought to bear.[95] Critics insist the government analysis is flawed. They say the government is failing to take account of the billions held by trust investors in RRSPs and other accounts that will eventually be taxed when their holders retire. To date, the Finance Minister has refused to make public the figures used to calculate the tax leakage, despite numerous access to information requests.[96]

Consumer Reaction:

The trust tax is certain to hurt the retirement savings of millions of Canadians who rely on returns from trusts, including many seniors. As well, many small-time investors have seen substantial losses in the value of their trust units following the sharp decline of the trust sector. Both seniors and other investors are likely to be angry over how the government went about taxing trusts. However, commentators have suggested that most Canadians see the income trust fiasco as a tax loophole. As this report will show, the majority opinion is largely correct. The problem caused by the loophole was allowed to balloon in size thanks to the apathy or ineptitude of the governments of the day but finally has been closed.[97]

EXAMINATION OF THE ISSUES

This section will examine a number of important, and contentious, issues surrounding the use of income trusts as a form of business organization and will evaluate the economic impacts of this unique business structure. The issues under review are some of the most controversial issues surrounding income trusts, including: claims of serious tax leakages; the fear of mass conversions; the threat of foreign takeovers; economic inefficiencies; and the theory of market completeness.

Tax Leakages

Income trusts have been highly criticized as being an unnatural product of tax distortion – encouraging business owners to reorganize their operating businesses primarily to reduce the businesses' corporate income tax exposure.[98] The difference in tax exposure between the traditional corporate structure and the income trust structure creates a tax imbalance – with corporations paying significantly more corporate tax. In fact, it is claimed that the tax imbalance is so significant that it is almost single-handedly responsible for the increased appeal of income trusts in recent years. Inevitably, this heavy tax imbalance between the two structures leads to a tax leakage – the government collects less in taxes when a business is structured as a trust,

---

[95] Jason Kirby, "Who will benefit from the Conservatives taxing income trusts?" *Macleans Magazine.Ca* (13 November 2006), online: http://ca.news.yahoo.com/s/13112006/21/benefit-conservatives-taxing-income-trusts.html>.

[96] Jim Brown, "Income trust issues back on the boil as critics parade to parliamentary hearings" *The Canadian Press* (28 January 2007).

[97] "For Finance Minister Flaherty – and for Bay Street – tomorrow is another day" Editorial, Canadian Centre for Policy Alternatives (CCPA) (8 November 2006), online: http://www.policyalternatives.ca/Editorials/2006/11/Editorial1479/index.cfm?pa=AE5DAA5F>.

[98] Geoffrey Hale, "Income Trusts – What Will Ottawa Do?" University of Lethbridge, Department of Political Science (September 16 2005) at 5.

thereby depriving the government coffers of important tax revenues. According to the government, the increasing leakage was responsible for forcing its hand over income trusts – the government claiming that it had to act to stop the hemorrhaging of essential tax revenues.[99]

In 2005, the income trust market was worth $170-billion - with over 250 income trusts on the market and announcements of new conversions happening weekly. With little incentive for corporations not to become income trusts, the government feared the gradual elimination of its entire $28-billion a year corporate tax-base.[100]

The income trust lobby has aggressively campaigned against the government's tax leakage assertions. The lobby has produced studies by leading tax experts that suggest that the notion of a significant tax leakage is unfounded, and deceptive.[101] They accuse the federal government of trying to use the income trust issue to gain political votes and contend that the government is engaging in deceptive messages and scare-tactics by suggesting to the public that their public services are being threatened because of corporate greed. The experts contend that the government has failed to include a key factor in its tax leakage calculations – the deferred taxes that will eventually be paid by unitholders upon retirement. When RRSP holders reach the age of 69, the government mandates that they start withdrawing their sheltered savings at an annual rate prescribed by the government. These withdrawals are subject to the highest level of tax for individuals, as they are treated as 'ordinary income' for tax purposes. Thus, taxes held in sheltered retirement accounts are merely *deferred* until the age of retirement. Moreover, since retired unitholders will be subject to the highest personal tax bracket, they will therefore pay more tax on their trust units than had those units been initially taxed as dividends. In a 2006 article, "Taxation of Income Trusts: Is it Worth the Cost and the Turmoil?", economist Yves Fortin accuses the government of misconstruing the tax effects of trusts, stating:

> The Tax Fairness Plan wrongly treats [income trusts] as "tax exempt". The reality is that they are not "tax-exempt" but "tax-deferred". Ultimately all capital and income accumulated in such accounts is taxed at personal tax rates when the monies are withdrawn sometime in the future. The crux of the issue is whether there is a difference between the present value of future taxes and the value of foregone tax revenue in the short run.[102]

Fortin says that before the government makes dramatic tax change policies, a study is needed to determine what, if any, differences exist between the value of future and foregone taxes.[103] Fortin, and other income trust supporters, claim that the tax deferral more than makes up for any leakage that may occur. Some have even gone so far as to suggest that when the tax deferral is

---

[99] "Flaherty imposes new tax on income trusts" CBC News (31 October 2006) online: <http://www.cbc.ca/money/story/2006/10/31/flaherty.html>.
[100] Matt Price, "The Real Income Trust Scandal" online: TheTyee.ca <http://thetyee.ca/Views/2006/01/04/RealIncomeTrust.html>.
[101] See for instance, Yves Fortin, "Taxation of Income Trusts: Is it Worth the Cost and the Turmoil?" written on behalf of the Canadian Association of Income Funds (November 2006); and Gordon Tait, "The Inconvenient Truth About Trusts" BMO Capital Markets (4 December 2006)
[102] Yves Fortin, "Taxation of Income Trusts: Is it Worth the Cost and the Turmoil?" written on behalf of the Canadian Association of Income Funds (November 2006) at 2.
[103] *Ibid.*

taken into account, the government will actually collect more tax revenue under the trust structure than under the traditional corporate structure.

It is true that the government stands to collect deferred tax revenue upon the retirement of unitholders. However, there seem to be a number of problems with the assertion that this deferred tax revenue will more than make up for any immediate tax loss. First, the deferred tax collection at the highest personal tax bracket only applies to unitholders who choose to put their investments into a registered plan, such as an RRSP (nearly 40 percent of all trust are held in non-RRSP accounts). Second, it does not apply to the increasing numbers of foreign investors eager to gain a piece of the income trust pie. Non-resident investors represent nearly a quarter (22 percent) of all trust unitholders. Non-resident investors, however, are only subject to a 15 percent federal withholding tax on trust distributions (provinces collect no tax on non-resident investors).[104] As such, no tax deferral applies. Third, it assumes that the government would be in a position to wait years, if not decades, to realize the supposed tax gains. No government would be willing to forgo current tax revenue for an indeterminate length of time, in order to realize a speculative amount of tax revenue. Moreover, it would be incredibly hard to determine with any accuracy the amount of the tax deferral, never mind the added complexities involved in attempting to forecast an accurate revenue stream for future years.

Despite the arguments put forward by trusts, it would seem that the conversion of a corporation into a trust means some degree of lost of tax revenue for the government; although the exact amount is the subject of much debate. By some estimates, the federal and provincial governments stood to lose as much as $1 billion in annual tax revenue to trusts, prior to the government's October 2006 change in tax policy.[105]

In 2003, the C.D. Howe Institute published some of the first estimates of the extent of the tax leakage from income trusts. The Institute estimated that the federal and provincial governments were losing between $600 million to $700 million a year in tax revenues from income trust structures.[106] Two years later, the federal government released its own estimates, which seemed to corroborate the Institute's findings. In a consultation paper issued on September 8, 2005, the Canadian Department of Finance suggested that the income trust sector had cost it at least $300-million in tax losses in 2004, with provincial governments possibly losing another $300-million.[107]

---

[104] *Ibid.* at 10.

[105] According to Jack Mintz, a professor at the University of Toronto's Rotman School of Management, income trust conversions were on track to leave a gaping, $1-billion hole in government coffers; Jason Kirby, "Who will benefit from the Conservatives taxing income trusts?" *Macleans Magazine.Ca* (13 November 2006), online: http://ca.news.yahoo.com/s/13112006/21/benefit-conservatives-taxing-income-trusts.html>. See, "Flaherty imposes new tax on income trusts" CBC News (31 October 2006) online: <http://www.cbc.ca/money/story/2006/10/31/flaherty.html>.

[106] Trevor Williams, "In Income Trusts, You Trust?" *The Valuation Times* (June 2005) at p. 000065 of the ATIP package – article disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request.

[107] Department of Finance Canada, "Tax and other Issues Related to Publicly Listed Flow-Through Entities: Income Trusts and Limited Partnerships" (Consultation Paper) (September 2005) at 3.

These figures have been corroborated by some analysts,[108] while sharply disputed by others. Critics of the government's tax policy vigorously dispute the amount of tax leakage, particularly when the effects of deferred tax revenues paid by individuals at retirement are taken into account.

Parliamentary Committee Hearings

Due to opposition pressures, a formal Parliamentary Committee was established in January 2007 to examine the government's proposed changes to income trust taxation. In January and February of 2007, the House of Commons Standing Committee on Finance heard testimony from numerous stakeholders from government and industry. During the parliamentary hearings, Minister Flaherty, the first witness called by the Committee, claimed that the federal treasury stood to lose $500 million a year unless the tax rules for trusts were changed.[109]

The Committee heard different versions of the federal government's method for estimating future tax leakage from income trusts. To his embarassment, Minister Flaherty was contradicted by his own department on trust-tax leakage methodology. This left plenty of room for opposition critics to raise questions about the competency of the Finance Department and its data.[110]

Adding to the uncertainty over the government's claims over tax leakages, Finance Department bureaucrats have steadfastly refused to offer a detailed explanation for the $500 million figure. Moreover, attempts to uncover further information regarding the rationale and methodology used through the *Access to Information Act*[111] have been unsuccessful.[112]

To date, the Finance Department has justified its censorship using a section of the *Access to Information Act* that allows it to withhold data dangerous to Canada's economic interests. The law allows the Department to keep secret information "which could reasonably be expected to be materially injurious to the financial interests" of the federal government, or could hinder the government's ability "to manage the economy of Canada" or could provide "undue benefit" to anyone. The law, however, also makes clear this is a discretionary rule rather than a mandatory protection and thus is at the Department's discretion.[113]

---

[108] Don Drummond, chief economist at Toronto-Dominion Bank, has produced his own estimates based on the Finance Department's own rule of thumb for what an increase in trust activity means for tax revenue. According to Drummond: "Using Finance's sensitivity analysis, the cost has already leaped to $600-million per year". See, Steven Chase, "Trust tax loss $600-million, economist says" *The Globe & Mail* (23 September 2005).
[109] Jim Brown, "Income trust issues back on the boil as critics parade to parliamentary hearings" *The Canadian Press* (28 January 2007).
[110] David Parkinson, "Flaherty contradicted by his own department on trust tax-leakage methodology" *The Globe and Mail* (1 February 2007) online update:
<http://www.theglobeandmail.com/servlet/story/RTGAM.20070201.wtrustfinance0201/BNStory/Business/home>.
[111] R.S., 1985, c. A-1.
[112] Jim Brown, "Income trust issues back on the boil as critics parade to parliamentary hearings" *The Canadian Press* (28 January 2007).
[113] Steven Chase, "Finance refuses to divulge key trust data" *The Globe & Mail* (23 January 2007) online update:
<http://www.theglobeandmail.com>.

It is unclear why the Finance Department is hiding calculations from public scrutiny. Trusts have produced experts to repudiate the government's tax leakage estimates, but the Finance Department has so far rebuffed all requests to demonstrate how it derived those figures. Not surprisingly, income trust lobbyists decried the government's decision to shelter the bulk of its calculations from public scrutiny. Releasing the information would promote transparency by allowing for a step-by-step review of the Department's calculations. Holding the Department's calculations up to public scrutiny would also allow Canadians to judge for themselves whether the leakage estimate is based on sound reasoning.[114]

Dennis Bruce, vice president of economics consulting firm HRD/HLB Decision Economics, testified to the Committee that the Finance Department's tax-leakage estimates were "sharply overstated". According to Bruce, his company's analysis, which used the same basic methodology as the Finance Department, found that 2006 federal tax leakage from trusts was about $164-million, a far cry from the $500-million claimed by Finance. Further, as a result of other legislated taxation changes for future years, Bruce testified that the leakage in the future would be only $32-million annually.[115]

Gordon Tait, a leading research analyst at BMO Capital Markets and critic of the controversial trust tax, also questioned the government's estimate that it had lost at least $500-million in tax revenue in 2006 through income trusts. According to his own research, which looked at taxes paid by companies and their investors both before and after converting to the trust structure, Tait found that the government actually collected more tax revenue under the trust structure than under the traditional corporate structure.[116]

Yves Fortin, a retired Finance Department economist, has also challenged the government's reasons for the change in tax regime. In a research paper, *Recipe for Tax Revenue Loss*, which he wrote on behalf of the Canadian Association of Income Funds, Fortin disputes the government's claims that the income trust sector has caused major losses in tax.[117]

Fortin also takes issue with the Finance Minister's October 31, 2006 policy statement in which the Minister stated that conversion would result in billions of dollars in lost tax revenue for the federal government to invest in the priorities of Canadians. Fortin criticizes the Minister for not producing documentation to support his allegations and for failing to present any research to back up his claim.[118]

Fortin told the parliamentary Committee that "the legislative proposals should be put on hold" until three key issues of concern can be cleared up: the tax-leakage question, the impact of the

---

[114] *Ibid.*
[115] David Parkinson, "Flaherty contradicted by his own department on trust tax-leakage methodology" *The Globe and Mail* (1 February 2007) online update: <http://www.theglobeandmail.com/servlet/story/RTGAM.20070201.wtrustfinance0201/BNStory/Business/home>.
[116] *Ibid.* Analyst Gordon Tait has also raised concerns about the lack of consultation and misconceptions surrounding the change in tax policy on trusts. See also, Gordon Tait, "The Inconvenient Truth About Trusts" BMO Capital Markets (4 December 2006).
[117] Yves Fortin, "The Draft Legislative Proposal: A Recipe for Tax Loss Revenue" prepared on behalf of the Canadian Association of Income Funds (CAIF) (17 December 2006).
[118] *Ibid.*

trust tax announcement on investors, and the definition of what constitutes a trust under the proposed law. He called on the government to commission an independent, unbiased study into the impact of income trusts on tax revenues. He also said the government should come up with a compensation plan for investors who lost money because of the government's surprise announcement of the proposed trust legislation last October, which reversed an election promise not to raise taxes on trusts.[119]

Meanwhile, the Canadian Association of Income Funds launched a massive public "education campaign" to coincide with the parliamentary Committee hearings. The campaign was aimed at dispelling what they believe are "myths" such as Finance Minister Flaherty's assertions that trusts hurt Canadian productivity and cost the federal government $500-million a year in lost tax revenue.[120]

A review of the extensive literature written on the subject of tax leakages due to trusts reveals a general consensus that a tax leakage does, in fact, exist. However, the extent of the leakage remains hotly debated. However, one thing is certain – the government's refusal to justify its calculations or release its methodology means that significant questions regarding the true state of the trust tax leakage will remain in doubt. In order for the income trust tax to gain legitimacy in the eyes of the Canadian public, and in an effort to at least appear to be transparent and accountable, the government should release its research, methodologies and calculations for public scrutiny and allow for an open and frank discussion regarding the need for the new tax regime on trusts.

Provincial Implications

In addition to delivering a federal tax advantage to certain investors, income trusts and other SIFTs create two serious difficulties for Canadian provinces. First, to the extent they have non-Canadian investors, income trusts deplete overall provincial tax revenues even more significantly than they deplete federal revenues. This occurs because although federal non-resident tax applies to income that a foreign-resident investor earns through an income trust, that income is not subject to tax in any province. (In contrast, the dividends that a foreign-resident shareholder of a Canadian corporation receives are paid out of income that has already been taxed both federally and provincially).[121]

Second, to the extent an income trust's Canadian investors reside in provinces other than where the trust itself operates, tax revenue is shifted between provinces. A corporation's home province ordinarily expects to be able to tax the corporation's earnings. But if the corporation becomes an income trust, that province may lose a large portion of the associated corporate tax revenue. Instead, the provinces where the investor resides will get the tax, if any, on the distribution. Several provinces have expressed concerns about the impact this has on their economies and

[119] David Parkinson, "Energy trust coalition repeats call for exemption from trust tax law" *The Globe & Mail* (1 February 2007) online update:
<http://www.theglobeandmail.com/servlet/story/RTGAM.20070201.wtrustchanges0201/BNStory/Business>.
[120] Steven Chase, "Special hearings will probe trust tax" *The Globe & Mail* (18 January 2007) online update:
<http://www.theglobeandmail.com/servlet/story/LAC.20070118.RTRUSTS18/TPStory/Business>.
[121] "Backgrounder on Income Trusts" disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request, at p. 000135-136 of the ATIP package.

their tax revenues. For example, in its last Budget, Alberta estimated its net revenue loss as a result of income trusts to be about $400 million per year.

It would seem that it is incumbent upon the federal government, having a unique role in the federal-provincial tax environment, to address this potentially debilitating loss of tax revenue at both the federal and provincial levels.[122] There is little doubt that the federal government was facing significant pressure from provincial ministers to cut off the flow of tax leakages from trusts, before the provincial levies run dry.

International Experience

A review of the tax treatment of income trusts and similar flow-through entities in other countries is beyond the scope of this paper. However, it should be briefly mentioned that Canada is not the only country that has faced issues around the tax treatment of income trusts and similar entities. Australia and the United States, for example, have tax systems broadly comparable to Canada's, and both have had to deal with the distortions that flow-through entities (FTEs), like income trusts, can cause. Although the particulars of the Australian and U.S. rules are necessarily unique, both have foreclosed the kind of inappropriate avoidance of entity-level tax that Canada's FTEs now exploit.[123]

Fear of Mass Conversions

A number of analysts and industry watchers have express concern that "the tremendous success of income trusts in financial markets is prompting the inappropriate conversion of many companies into income trust status in pursuit of short-term investment gains."[124] Setting aside the obvious tax advantages, certain types of businesses are better candidates for income trust conversion than others. For instance, businesses whose activities are highly cyclical, or those who require capital for growth or development, may not be able to sustain the kinds of high yields promised to investors. Yet, despite these reservations, an increasing number of corporations were announcing plans to convert to income trust status prior to the government's October 31st tax announcement.[125]

The staggering growth of the trust sector over a few short years led the government to fear a mass conversion of corporate Canada toward the highly valued income trust business model. In the fall of 2006, as the wave of trust conversions neared $70-billion, it became glaringly obvious that the government could no longer turn a blind eye and needed to address the politically volatile income trust issue – even if it meant a reversal of the Conservative's 2006 election campaign promise to preserve the trust market and not impose any new taxes.[126] However, it was

---

[122] *Ibid.* at 000136
[123] *Ibid.*
[124] Geoffrey Hale, "Income Trusts – What Will Ottawa Do?" University of Lethbridge, Department of Political Science (September 16 2005) at 5.
[125] *Ibid.* at 4.
[126] Sinclair Stewart & Andrew Willis, "Income-trust crackdown: The inside story" *The Globe & Mail* (2 February 2006), online at:
<http://www.theglobeandmail.com/servlet/story/RTGAM.20061102.wtrusttick02/BNStory/Business/home>.

not until the announcement by Canada's two largest companies, Telus Corp. and BCE Inc., of plans to restructure as income trusts, that the government felt compelled to act.

In the fall of 2006, BCE Inc., announced that it was planning to follow the lead of its telecom rival Telus Corp., and transform its telecommunications operations into a $27-billion income trust. "It was clear from the BCE people that they felt compelled to follow Telus, and that taught us a lesson – quite clearly and dramatically – that if other sectors imitate that sector, we'll see a domino effect," Minister Flaherty told *The Globe and Mail*'s editorial board shortly after his October 31st announcement.[127] "Both companies [BCE and Telus] had indicated that the primary reason they were converting was the tax situation, not business reasons," Flaherty said. "We see them converting solely to avoid paying corporate taxes and that's a clear and present danger to fairness in the Canadian tax system. I felt we needed to act."[128]

It would appear that Minister Flaherty was concerned that the conversions of Telus and BCE would incite other corporate titans to convert and set off a domino effect throughout corporate Canada. Indeed, Flaherty himself said that rumours that income trust conversions deals could spread into other sectors of the Canadian economy prompted the governments' surprise decision to impose new taxes on trust distributions. But, the Finance Minister refused to go into details about which companies or sectors were rumoured to be considering the move. "I can't say with certainty, because I don't make these decisions," Mr. Flaherty said. "We had concerns in other sectors in the Canadian economy, including financial institutions and energy sector that would be large."[129]

It has been widely reported that for several months prior to the decision, Mr. Flaherty and his team had been debating how to handle the storm of conversions. According to accounts, the Minister heard rumours that Suncor Energy Inc. and EnCana Corp. were each modeling trust conversions that could be valued at close to $40-billion, opening the door to mass conversions in the oil patch.[130]

Meanwhile, accounts say that Minister Flaherty was being approached by numerous high-profile directors and CEOs, who expressed concerns that they were being pressed into trusts because of their duty to maximize shareholder value, despite their misgivings about the structure. Newspaper accounts have Paul Desmarais Jr., the influential chairman of Power Corp of Canada, suggesting to Prime Minister Steven Harper that he should act quickly to stop the raft of conversions, during a trip to Mexico. Sources also report that Michael Sabia, CEO of BCE, was never a fan of the proposed trust conversion and "there was dancing in hallways at Bell" after the government's tax announcement.[131]

---

[127] Ibid.
[128] Scott Deveau, "'Clear and present danger' prompted trust move" *The Globe & Mail* (1 November 2006) online update:
<http://www.theglobeandmail.com/servlet/story/RTGAM.20061101.wflaherty1101/BNStory/Business/home>.
[129] *Ibid*.
[130] Sinclair Stewart & Andrew Willis, "Income-trust crackdown: The inside story" *The Globe & Mail* (2 February 2006), online at:
<http://www.theglobeandmail.com/servlet/story/RTGAM.20061102.wtrusttick02/BNStory/Business/home>.
[131] *Ibid.*

Another high-profile CEO, Dominic D'Alessandro, of Manulife, also expressed strong reservations about the trust structure, suggesting that many companies were converting to trusts for the wrong reasons, and adopting a structure that discouraged reinvestment in capital. He also noted that in many companies, management and board of directors were under increased pressure to hive off parts of their company that looked attractive under a trust model: "We would all, in time, have faced tremendous pressure to break up our businesses," he said.[132]

The temptation among CEOs to convert their business into income trusts was no doubt overwhelming. Since trusts are structured to minimize paying tax themselves, and because they pay out almost all of their cash flow to the unitholders (who pay tax on the distributions), trusts trade at higher price-to-earnings multiples than comparable listed companies with conventional shares.[133] As one chief executive officer put it, "considering a trust conversion isn't just an academic exercise; it's his fiduciary duty to shareholders."[134]

Thus, it would seem that Minister Flaherty's fear of mass conversions in the trust sector was well-founded. Prior to the government's change in tax policy, the trust sector was showing little signs of slowing down. In fact, the twin announcements of Telus and BCE, Canada's two largest telecommunications giants, would have seen the creation of an expected $48-billion in value and meant a doubling in size of the trust sector since 2004.[135] Moreover, there is little doubt that the conversions of Canada's telecommunications titans would have created a domino effect, with an increasing number of corporations lining up to convert, or face being left out of the booming trust market.

Foreign Takeovers

Critics have warned that the new income tax regime is propelling the foreign takeovers of trusts. They contend that foreign takeovers will likely result in tens of millions of dollars in lost annual revenue for the government that would otherwise have been paid by trust unitholders.[136]

An April 5 report from CIBC World Markets counted 15 foreign takeover attempts in the business and infrastructure trust sector since October 31, 2006 with a combined enterprise value of over $8-billion. Of the 15 foreign takeovers, some have been completed, some are pending and one was terminated. Many analysts and investors fear the furious pace of takeover activity is not about to ease. Moreover, they place the blame squarely on the government's decision to tax trusts.[137]

But Minister Flaherty contends that the takeovers are not a result of his policy. "This is not something that has to do with a particular tax policy," Mr. Flaherty told the *Globe and Mail* in

[132] David Parkinson, "Trust structure may contribute to inefficiency: Dodge" *The Globe & Mail*, online update: http:www.theglobeandmail.com/servlet/story/RTGAM.20070201.wincometrust0201/BNStory/Business/home>.
[133] Eric Reguly, "Capitalism for Slobs" *The Globe & Mail*, Report on Business (March 2005).
[134] "Look past the trusts to fix the tax system" *The Globe & Mail* (date unknown) A18.
[135] Jack M. Mintz, "Income Trust Conversions: Estimated Federal and Provincial Revenue Effects" *Canadian Tax Journal*, 2006, Volume 54, Issue Number 3.
[136] Roma Luciw & Steven Chase, "Foreign money snags 3 more trusts" *The Globe & Mail* (17 April 2007) online: <http://www.theglobeandmail.com/servlet/story/LAC.20070417.RUE17/TPStory/Business>.
[137] *Ibid.*

April 2007. "It has to do with large pools of capital that have been accumulated and are looking for purchases in various parts of the world."[138]

Flaherty has steadfastly dismissed the idea that the trust tax is triggering these takeovers, suggesting that what is really driving the buyouts is the attractiveness of target firms: "The ones with strong underlying businesses are attractive to takeovers … This is a worldwide phenomenon where there is underlying value in the assets."[139] The Minister further suggested that it would be hypocritical to oppose foreign takeovers of Canadian firms when Canadians expect other foreign markets to welcome corporate investment from Canada: "It's difficult for Canadians to, on the one hand, say 'We don't wish to have any of our businesses acquired by people outside Canada' while at the same time some of our global corporations are doing exactly that," he said.[140] The Finance Minister concluded his defence against accusations that his tax policy has directly contributed to the plundering of Canadian income trusts, stating: "Canadians are on a net basis investing more abroad than is being invested in acquisitions here."[141]

The Minister's comments may be true, however, it does not explain away the fact that there has been an increased pace of foreign takeovers of Canadian income trusts since the government's October 2006 change in tax policy. It would seem that fears surrounding the foreign takeovers of income trusts are certainly valid, and they present a dilemma for the Canadian economy should the acquisition of Canadian income trusts by foreign firms continue at its present pace.

EFFECTS ON THE ECONOMY

Income trusts have been accused of representing bad economics. Critics of income trusts contend that they threaten the vitality of the economy because they seek short-term financial gains at the expense of the long-term health of the broader Canadian economy. The section below will examine two of the most widespread criticisms of trusts – that they boost consumption at the expense of capital investment and that they are an inappropriate form of business organization for the majority of businesses. The section will also examine the theory backed by supporters of trusts - that they actually strengthen the economy by enhancing 'market completeness'.

Boost Consumption at Expense of Capital Investment

Tax expert and corporate finance lawyer, Paul Hayward, in his article "Income Trusts: A Tax-Efficient Product or the Product of Tax Efficiency", characterized the income trust market as an example of "lazy capitalism". According to Hayward, income trusts simply use financial and tax planning techniques to convert one form of corporate security into another. As such, the

---

[138] Roger S. Conrad & David Dittman, "For Sale: Canada" KCIinvesting, Maple Leaf Memo (10 April 2007), online: < http://www.kcifinance.com/MLM01.2281.html>.
[139] Roma Luciw & Steven Chase, "Foreign money snags 3 more trusts" *The Globe & Mail* (17 April 2007) online: <http://www.theglobeandmail.com/servlet/story/LAC.20070417.RUE17/TPStory/Business>.
[140] *Ibid.*
[141] *Ibid.*

conversion of an income trust is merely a financial transaction that adds little value to the overall economy.[142]

Others commentators have been even harsher in their criticisms of trusts: "At best, a trust is lazy capitalism. At worst, it is the opposite of capitalism, in the sense that a trust converts capital into income; normal companies turn income into capital so they can spend it on growth."[143]

Can something that has proven so popular with investors really pose such a danger to the economy and corporate efficiency? The effect of income trust conversion on corporate and economic efficiency has become a major concern for many industry observers. Thus, the question to ask becomes: do the benefits of income trusts outweigh their disadvantages, not only for investors but for the Canadian economy?

Income trusts have achieved a lower cost of capital for business investments; produced better returns for investors by avoiding the high corporate and dividend taxes associated with corporations; they have allowed businesses to sell (possibly over-priced or undervalued) assets; and significantly enriched investment banks. However, these advantages come at a price.[144]

From a macroeconomic perspective, income trusts are dangerous because they are guilty of boosting consumption at the expense of capital investment. By converting long-term capital into short-term income, they are threatening the future of the underlying business while jeopardizing the Canadian economy's financial security of future generations. "As attractive as they may *appear* to be in bridging the need for more income against a background of very low yields, what makes no sense in macroeconomics cannot make sense in microeconomics."[145]

The root of the problem lies with the tax system, which, prior to the October 2006 change in tax policy, encouraged the depletion of capital investment by trusts. Income trusts were encouraged to make excessive distributions under the tax system, since a retention of profits in the trust would mean incurring onerous taxation. For instance, undistributed income is subject to the top personal income tax rate in the province where the trust resides (such 46 percent in Ontario) and distributions from income earned in prior years is further taxed as capital gains in the hands of the unitholder. Thus, in order to avoid the onerous taxation, trusts are practically forced to pay out all of their profits in distributions to unitholders. This is attractive to investors looking for high-yield investments; however, it severely limits the ability of the underlying business to fund investments and expansions with cheaper internal sources of capital.[146]

The reason why this represents such a problem lies with the differing motivations driving either business structure. For instance, a corporation will typically pay out its surplus earnings (i.e. income it does not need for future expansion) as dividend income to shareholders. Shareholder

---

[142] Paul Hayward (2002), "Income Trusts: A Tax-Efficient Product or the Product of Tax Efficiency", *Canadian Tax Journal*, 50(5). See also Geoffrey Hale, "Income Trusts – What will Ottawa Do?" Department of Political Science, University of Lethbridge (September 16 2005).
[143] Eric Reguly, "Capitalism for Slobs" *The Globe & Mail*, Report on Business (March 2005).
[144] Ross Healy, "A Critical Look at Income Trusts" Strategic Analysis Corporation (April 2004) at 1.
[145] *Ibid.*
[146] Jack M. Mintz, "Unfinished Business: Achieving Neutral Taxation of Corporations and Income Trusts" *C.D. Howe Institute*, e-brief (21 December 2005) at 2.

returns are therefore a combination of income and future growth. In contrast, income trusts exist to pay out their profits. Trust managers are not concerned with conquering new markets, because the capital they would need for expansion or innovation is being funneled wholesale to unitholders. As such, there is no real incentive for the income trust to grow profits or plan for long-term expansion, as that would require significant investment of capital, which would detract from the income stream. Of course, many income trusts do seek to reinvest in the underlying business, but this investment is necessarily minimal, as it is usually motivated to simply maintain the payout as long as possible. This represents a far cry from the traditional corporate mantra on risk-taking, conquering new markets and investing in innovation.[147]

This scenario has led many observers to conclude that income trusts amount to "a clear case of short term gain and a lot of long term pain."[148] Income trusts, they contend, are preoccupied with attempts to maximize immediate shareholder value (i.e. price and income payout) in the short tem, without regard to the long-term sustainability of the underlying business.[149]

So why are income trusts so popular? The simple answer is that they allow for the 'manufacture' of higher levels of income in an era of otherwise very low yields. They are "lazy capitalism", or as one commentator proclaimed: "Income trusts are the glazed doughnuts of the financial world, and the investors who gorge on them are becoming fat and happy. Soon, they will become lethargic, their arteries and brains clogged with trust lard."[150]

NOT AN APPROPRIATE FORM OF ORGANIZATION FOR MOST BUSINESSES

There has been strong pressure on many larger companies with more or less steady and predictable income flows to convert into income trusts.[151] Unfortunately, this pressure is misguided as the income trust structure is not an appropriate form of organization for most businesses. This is because the ideal candidate for conversion to an income trust is a mature business with a stable cash flow capable of making large, regular payments to unitholders without jeopardizing the stability or competitiveness of the underlying business. Moreover, the business itself must not require large amounts of capital investment for such things as growth, research and development, or innovation. This leaves relatively few ideal candidates for the trust structure. Yet, despite this seemingly narrow field of candidates, corporation after corporation, from all sectors, have lined up to convert to income trust status.[152]

This is not to say that the income trust model does not have its place. For instance, the traditional royalty trust model is a sound business model. Royalties are ideally suited to be sold off to those who want a stream of income. But converting vibrant and competitive businesses into income trusts simply does not make much sense from a business perspective, unless of course the goal is

---

[147] Ross Healy, "A Critical Look at Income Trusts" Strategic Analysis Corporation (April 2004) at 4-5
[148] *Ibid.* at 5.
[149] *Ibid.* at 4-5.
[150] Eric Reguly, "Capitalism for Slobs" *The Globe & Mail*, Report on Business (March 2005).
[151] Ross Healy, "A Critical Look at Income Trusts" Strategic Analysis Corporation (April 2004) at 3-4.
[152] "Income Trusts – Frequently Asked Questions" TSX Group, online: <http://www.tsx.com/en/listings/sector_profiles/income_trusts/faq.html>.

to raise unit prices and make a lot of money in the short run – with little regard to capital formation in Canada in the long run.[153]

Concern over the inappropriate use of the income trust model has also been expressed by one of the most powerful and influential men in Canadian economics, Bank of Canada Governor David Dodge. During his testimony, Dodge told the House of Commons Standing Committee on Finance that the tax advantages of the income trust structure may have contributed to business and market inefficiencies. Dodge supported the government's efforts to remove the tax advantages of the trust structure, arguing that companies should not select a business structure based on tax benefits. "You want to pick a structure that allows capital to be allocated to its most efficient use," he said.[154] Dodge told the parliamentary Committee that: "while the income trust structure may be very appropriate where firms need only to manage existing assets efficiently, it is definitely not appropriate in cases where innovation and new investment are key." Rather, Dodge suggested that the inefficiencies caused by such conversions constrained productivity of the companies involved, and this would "eventually" erode the potential for productivity growth in the broader economy.[155]

The parliamentary Committee also heard testimony from representatives of energy trusts who were seeking an exemption to the new tax rules. Energy trusts put forward strong arguments for why the income trust structure was a necessary business model for their firms. "We believe energy trusts are different, and should be exempt," Mr. Kerr said in testimony. He argued that energy trusts have actually generated more tax revenue for the federal government than the same companies would have under a more traditional corporate structure. Kerr added that the trust structure was an efficient way for companies to exploit the aging, depleting oil and gas wells that make up much of the Western Canadian Sedimentary Basin, as it encourages companies to "focus on maximizing recovery from mature assets pools."[156]

For his part, David Dodge did not disagree. He allowed that companies whose business is based on running down an existing asset – such as an oil well or a mine – might not need reinvestment or innovation and therefore might find the trust structure the most efficient model, "In any other business… the income trust structure is not the appropriate structure to maximize the efficiency of capital."[157] This would suggest that maybe the energy trusts have a good case. On the other hand, Dodge went on to state that there was no specific sectors that were better suited to income trusts, saying it depended on the individual business rather than the industry.[158]

---

[153] Ross Healy, "A Critical Look at Income Trusts" Strategic Analysis Corporation (April 2004) at 2.
[154] David Parkinson, "Trust structure may contribute to inefficiency: Dodge" *The Globe & Mail*, online update: http:www.theglobeandmail.com/servlet/story/RTGAM.20070201.wincometrust0201/BNStory/Business/home>.
[155] "Bank of Canada statement on income trusts" *Reuters* (1 February 2007).
[156] David Parkinson, "Energy trust coalition repeats call for exemption from trust tax law" *The Globe & Mail* (1 February 2007) online update: <http://www.theglobeandmail.com/servlet/story/RTGAM.20070201.wtrustchanges0201/BNStory/Business>.
[157] David Parkinson, "Trust structure may contribute to inefficiency: Dodge" *The Globe & Mail*, online update: http:www.theglobeandmail.com/servlet/story/RTGAM.20070201.wincometrust0201/BNStory/Business/home>.
[158] Louise Egan, "Bank of Canada's Dodge supports income trust tax" *Reuters* (1 February 2007).

Market Completeness

Supporters of income trusts have long argued that income trusts contribute to the economy by enhancing market completeness, because they exhibit characteristics that are unique from those of common stocks.

It is argued that income trusts provide diversification benefits to investors, an improved source of financing to firms that might not otherwise have had access to markets, and serve to release capital for more efficient use.[159] Certainly, Canada's energy sector is a perfect example of the financing opportunities available to energy trusts. According to analysts, the Canadian energy industry has reaped an "investment windfall" from the growth of the energy trust sector. 2005 figures put the resulting recaptialization at more than $41 billion in energy sector investments (about 31 percent of market capitalization in the income trust sector).[160] According to Professor Geoffrey Hale, "[t]hese trends have vastly expanded the pool of capital available to Canadian-based energy and related infrastructure firms – an important factor at a time when it is estimated that the development of Canada's oil sands, conventional energy resources, and a new pipeline capacity needed to bring it to market will require close to $100 billion in new investment over the next 5 to 10 years."[161] Hale also suggests that the income trust structure, by providing Canadian firms with an alternate source of capital, decreases their reliance on foreign investments in order to expand.[162]

David Dodge gave a somewhat favourable account of the idea that income trusts enhance market completeness. During his testimony to the parliamentary Committee, he referred to the June 2006 edition of the Bank of Canada's Financial System Review, saying that:

> [L]imited evidence suggests that income trusts can enhance market completeness in a couple of ways. First, income trusts can provide diversification benefits to investors, because trusts can have different risk-return characteristics than either equities or bonds. Second, the income trust structure appears to allow some firms improved access to market financing. So insofar as income trusts allow investors to achieve risk-return benefits that they could not otherwise achieve, and serve as a source of financing to firms that might not otherwise have had access to markets, it can be said that income trusts enhance market completeness, and therefore support financial system efficiency.[163]

However, Dodge tempered his statement by cautioning that:

> [T]he different risk-return characteristics of income trusts may not enhance market completeness if they arise from differences in tax treatment. Clearly, there has been very significant tax incentive to use the income trust form of organization in cases where this

---

[159] Stacey Anderson, "Recent developments in the income trust market" Financial System Review: Development and Trends (June 2006) at 24, online: <http://www.bank-banque-canada.ca/en/fsr/2006/dev_trends.pdf>.
[160] Geoffrey Hale, "Income Trusts – What Will Ottawa Do?" University of Lethbridge, Department of Political Science (September 16 2005) at 8.
[161] *Ibid.*
[162] *Ibid.* at 2.
[163] "Bank of Canada statement on income trusts" *Reuters* (1 February 2007).

> would not have been the appropriate form of organization from a business efficiency point of view. By giving incentives that led to the inappropriate use of the income trust form of organization, the tax system was actually creating inefficiencies in capital markets, inefficiencies that, over time, would lead to lower levels of investment, output and productivity.[164]

Dodge ultimately endorsed the government's proposed tax changes for trusts stating that the changes "would appear to substantially level the playing field". Dodge told the Committee that in order for the income trust sector to deliver efficiency benefits through the enhancement of market completeness, it was necessary that the tax system provide a level playing field.[165] Dodge, however, acknowledged that "the Bank has done no specific research" on the impact of the trust structure on Canadian economic growth or productivity. "I'm speaking here on the basis of general principles," he said.[166]

Interestingly, the Department of Finance, in its 2005 discussion paper entitled, "Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships),"[167] briefly addressed the issue of market completeness. Finance acknowledged that economic utility may be increased through the distribution of large shares of income by mature businesses with limited growth potential if the distributions meant a more efficient redeployment of capital by the individuals and institutional investors who invest in the trusts. Finance also acknowledged that income trusts may serve to reduce the cost of capital by "providing a larger pool of investors for mature business assets".[168] The Finance paper, however, quickly notes that income trusts can produce inefficient economic outcomes where "the tax system [is] driving decisions on how businesses structure themselves." Examples cited by the paper include businesses converting to FTEs before being fully mature (that is, when still requiring growth and innovation to compete) and, significantly, lost overall market efficiencies if "shareholders [sic] do not have perfect information on which to make investment decisions".[169] On a more macroeconomic level, the paper also notes possible inefficiency if income is attracted to "low-growth industries" rather than higher growth ones, simply because low-growth industries convert to income trust or other FTE structures.

Thus, while there is some merit in the theory that income trusts may serve to enhance market completeness, the theory depends on the financial actions of the individuals and institutional investors who invest in trusts. The theory only holds up if these actors actually redeploy the capital in a more efficient manner than would otherwise be done by the underlying business or capital markets. Unfortunately, as Geoffrey Hale aptly points out, the investment behaviour of individuals or different groups of investors cannot be determined easily or with much

---

[164] *Ibid.*
[165] *Ibid.*
[166] David Parkinson, "Trust structure may contribute to inefficiency: Dodge" *The Globe & Mail*, online update: http:www.theglobeandmail.com/servlet/story/RTGAM.20070201.wincometrust0201/BNStory/Business/home>.
[167] Department of Finance Canada, "Tax and other Issues Related to Publicly Listed Flow-Through Entities: Income Trusts and Limited Partnerships" (Consultation Paper) (September 2005), disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request, at pp. 001079-1118 of the ATIP package.
[168] *Ibid*., at pp. 35-36 (001111-12); cited in Geoffrey Hale, "Income Trusts – What Will Ottawa Do?" University of Lethbridge, Department of Political Science (September 16 2005) at 8.
[169] *Ibid.*

certainty.[170] This may in turn be a function of the adequacy of disclosure of risks and return to investors in the income trust model. Therefore, the extent to which the enhancement of market completeness would offset the other disadvantages of income trusts (i.e. loss of tax revenue and other economic inefficiencies) is difficult, if not impossible to predict. As such, it would seem unwise to base an income trust tax policy on an untested theory that may not accord with reality and may require, for example, a higher level of monitoring for market fairness than presently exists.

Overall Assessment

The above review of the contentious issues surrounding income trusts reveals that there are no clear-cut answers in the complicated world of corporate taxation. Regardless of the steps taken by government, some investors, businesses, trusts managers and investment bankers will not be happy.

What seems evident is that despite the previous attempts at reform and missteps taken by past and present governments, the proposed changes to the tax rules will, overall, provide a more appropriate tax regime. Under this regime, the tax treatment for trusts will be more like that of corporations, and their investors will be treated more like shareholders. The measures will bring about a much needed rebalancing between corporations and trusts. As a result, the legal form a given business takes – whether a corporation or an income trust – will be dictated by the substantive business attributes of each business model; as opposed to the peculiarities of the tax law. The decision will be made on an economic efficiency basis, rather than by tax considerations.[171]

However, despite the government's claims that their new tax regime will "level the playing field" between trusts and corporations, this result is unlikely to materialize. Rather, it is likely that the new tax regime will actually serve to swing the tax policy bias in favour of public corporations. Although the combined entity and investor level tax burden for income trusts and public corporations will be roughly the same, the trust will be required to distribute all of its non-portfolio earnings to unitholders in order to achieve that neutral result. On the other hand, a public corporation will have the freedom and flexibility to retain its income to invest in its business and future growth. Under the new tax rules, there will be few reasons to remain a trust – other than perhaps the cost of converting back.[172] This, however, would seem to be a reflection that the trust structure was not an appropriate business model for the vast majority of businesses, rather than another peculiarity in the tax laws.

It is hard to ignore the fact that the advantages of trusts (higher yields for investors, expanded availability of capital for some businesses, and the possibility of enhanced market completeness),

---

[170] Geoffrey Hale is an Associate Professor in the Department of Political Science at the University of Lethbridge and has published numerous articles in the area of Canadian fiscal and tax policy. See, Geoffrey Hale, "Income Trusts – What Will Ottawa Do?" University of Lethbridge, Department of Political Science (September 16 2005) at 8.

[171] "Backgrounder on Income Trusts" disclosed to PIAC by the Canada Revenue Agency under an Access to Information Request, at p. 000136 of the ATIP package.

[172] "Impact of changes to trust taxation" Deloitte & Touche LLP, online: <http://www.deloitte.com/dtt/article/0,1002,cid%3D137724%26pv%3DY,00.html>.

simply do not outweigh the resulting costs to society in terms of lost tax revenues, lost economic efficiencies, and the potentially harmful effects to Canada's future economic vitality. In the words of David Dodge:

> By giving incentives that led to the inappropriate use of the income trust form of organization, the tax system was actually creating inefficiencies in capital markets, inefficiencies that, over time, would lead to lower levels of investment, output and productivity."[173]

Despite the unpopularity in some circles of the government's move to tax trusts, it was the right thing to do. No government could sit by idly while corporate tax revenues disappeared; or while conversions that only made sense from a tax avoidance standpoint threatened the investment, risk-taking and entrepreneurial activities that are fundamental to economic growth.[174] The bottom line is that the tax advantages of income trusts were cancerous to the health of the Canadian economy and a radical treatment, in the form of a tax change, was the only cure.

REGULATORY CHALLENGES OF TRUSTS

As noted, many income trusts operate in traditional "utility" areas of the economy such as energy and telecommunications. These industries typically have been heavily regulated in Canada. Due to high infrastructure costs, most of these areas have traditionally been dominated by one "monopoly" provider or, at most a few companies, often operating in certain territories to avoid duplication.

Therefore the Federal and provincial governments, in order to keep prices low in a near monopoly market for services such as gas, electricity, water and telephone, which are typically thought of as 'essential' to customers, have created special acts governing these areas and dedicating an industry-specific regulator to implement that act.

Rate of Return Regulation

During most of the 20th century, when such industries were dominated by a particular carrier, and even today where such monopoly exists, most regulatory regimes were based on "rate of return" regulation. Under rate of return regulation, the regulator sets utility prices which seek to balance the public's right to access these services at "just and reasonable" rates with the desire to allow the company providing the service a "fair rate of return". In setting the correct rate of return for the company the regulator adds up the carrier's "revenue requirement" for an upcoming number of years, basically forecasting how much the company will make at current rates and then subtract what it will need to spend on operating expenses, cost of capital and taxes. If this number comes out negative, the utility will seek a corresponding rate increase to cover the shortfall. If positive, a rebate to customers may be ordered.

---

[173] "Bank of Canada statement on income trusts" *Reuters* (1 February 2007).
[174] "For Finance Minister Flaherty – and for Bay Street – tomorrow is another day" Editorial, Canadian Centre for Policy Alternatives (CCPA) (8 November 2006), online: http://www.policyalternatives.ca/Editorials/2006/11/Editorial1479/index.cfm?pa=AE5DAA5F>.

As a result, much effort goes into calculating what will be the revenue requirement, and there is an examination by the regulator of each component of the revenue requirement.

Price cap regulation

In the 1990s in several utility markets regulators such as the Canadian Radio-television and Telecommunications Commission (CRTC) moved away from rate of return regulation to a new form of regulation deemed better suited to an emerging competitive market. In a decision in 1994,[175] for example, the CRTC moved to this new form of regulation, called performance-based regulation by way of a ‘price cap’, and established the new regulatory framework for all services it continued to price regulate.

Price cap regulation differs from rate of return regulation in that the regulator sets an upper “price cap” on a company’s rates. The price cap contains a productivity target. The price cap sets the annual rate of change for the regulated service. It contains an allowance for inflation less a decrease for productivity gains that the regulated company is expected to achieve. There is also an allowance for adjustments caused by events beyond the control of the regulated company. Any savings the company can achieve during the period of the price cap in becoming more efficient in operating the company can be kept by the company, without a corresponding rate decrease. Such a system is said to foster innovation and make large incumbent carriers more efficient while still providing enough room for new competitors to enter the market and ensuring “just and reasonable” rates to customers.

Trusts and Rate of Return Regulation

Income trusts pose a number of challenges for regulators in areas still subject to rate of return regulation. Principally, these relate to whether the income trust itself or its operating FTEs such as limited partnerships may claim a revenue requirement for income tax to be paid, when the income tax actually will be paid by unitholders, rather than these flow-through entities. On the one hand, such an allowance seems reasonable, since tax will be paid in any case, and the FTEs such as the income trust are merely acting as a conduit. In effect, they are representing the unitholders by asking for an income tax allowance. On the other hand, it appears that ratepayers are paying, in rates, for income tax the income trust will never pay, violating the principle that rates should reflect real expenses of the operating entity.

This conflict was examined in a number of regulatory decisions in the energy field in Alberta and B.C. in the years 2003-7. The results indicated regulators had difficulty reconciling the principles of regulatory law with the (lack of) regulatory guidance on income trusts. As a result, some variety of decisions on the effect of income trusts was made and nearly as crucially, tremendous effort was expended in regulatory proceedings to come to a conclusion.

---

[175] CRTC Telecom Decision 94-19.

AltaLink and TransAlta Utilities Corporation

In Alberta, the Alberta Energy and Utilities Board (EUB) considered the question of FTEs (limited partnerships and to some extent, income trusts) and rate regulation in a number of proceedings throughout the years 2003-2006.

The first, and most important decision, was *AltaLink Management Ltd. (Re*), Decision 2003-061 of the EUB. In this proceeding, the EUB had to consider the income tax element as a revenue requirement for AltaLink. AltaLink was a complicated corporate/limited partnership hybrid. An initial Limited partnership owned AltaLink (the operator) and that limited partnership was in turn owned by a limited partnership with four partners, three corporations and one pension fund. Therefore the Board was presented with arguments on the treatment of flow-through entities, namely limited partnerships, although it was not dealing with an income trust at that time.

AltaLink took the position that the entire income tax liability of its limited partners was a revenue requirement, despite the fact that the income tax liability was actually flowed through to other "downstream" corporations and holding companies. Ratepayer associations and the City of Calgary argued that none of the income tax liability should be counted in rate-setting as AltaLink had not offered any evidence that the downstream entities would actually pay any of the taxes.

AltaLink then argued that the "standalone principle" of calculation of revenue requirements applied. This standalone principle requires the regulator (here, the EUB) to consider the operation of the utility as if it were a separate entity, even if it is wholly owned as part of a larger corporate or other structure. The policy for this principle is that the utility segments of the business should not subsidize other parts of the larger business (which would raise the revenue requirements and therefore raise rates) nor should the larger business subsidize the utility (which would artificially lower rates. AltaLink therefore argued that the standalone principle of regulation, when applied to income tax liability of a FTE like a limited partnership would calculate the notional tax liability of the utility and allow it as a revenue requirement. According to AltaLink, whether such tax was ultimately paid at the end of the FTE chain was irrelevant.

Calgary and the consumer groups naturally disagreed, arguing that despite the standalone principle, the income tax had to actually be payable somewhere down the line and that due to the structure of the limited partnerships and the debt the limited partners undertook to be part of the overall structure that was AltaLink, it was very unlikely any tax would actually be paid at all. Since no real tax was to be paid, ratepayers should not be asked to fund, through rates, this virtual revenue requirement, based on a non-existent income tax payment.

The EUB found that three of the limited partners themselves were <u>liable</u> to pay tax, being corporate entities. The Board took the position that the application of the standalone principle did not require the Board to look into whether the income tax amounts paid by the limited partners matched the revenue requirement nor that any tax was actually paid at all. However, the Board refused the income tax revenue requirement to the pension fund, as the pension fund had only at the last minute converted to a taxable corporation. The Board found that the pension fund, which had entered the AltaLink deal to set up the entity was, at that time, non-taxable and should have known that it did not have a real revenue requirement, as it was not liable to pay any tax on amounts paid out to their pensioners.

The net effect of the AltaLink decision was that flow-through entities like limited partnerships and trusts probably could continue to build income tax liability into consumer rates, provided they maintained the appropriate legal structure and did not assume one where the liability for tax payments was impossible. Thus, it was possible ratepayers were funding non-existent tax claims, in the sense that the tax never would be paid in reality.

Pacific Northern Gas Ltd. Income Trust Application

In British Columbia, the issues surrounding income trusts and rate of return regulation came to a head more directly than in Alberta.

In 2004, Pacific Northern Gas (PNG), a large energy provider, had financial troubles due to the cancellation of service to some major corporate customers. As a result, the utility sought to find ways to refinance and the income trust structure was proposed as a way to raise new capital while providing a structure that would continue to function at regulated rates. The income trust structure was proposed by advisors and PNG made an application to the regulator, the B.C. Utilities Commission, in 2004 to convert to an income trust.

The BCUC initially denied the application, as PNG had hoped to "deem" its capital structure based on its previous capital structure. In other words, PNG asked the BCUC to assume on a going forward basis, that PNG's capital had not changed, and that no inquiry into the actual state of capital of the company would be undertaken. This capital would include a deemed income tax amount as if the amount was being paid by PNG as a taxable entity, before it became an income trust. In its Decision, the BCUC stated, "deeming a component of the cost of service equivalent to income taxes otherwise previously payable by a taxable corporation that had put in place a financial structure to minimize those taxes would establish a regulatory precedent with unknown implications". The BCUC was clearly uncomfortable, unlike the Alberta regulator, with basing rates on taxes that might never be paid.

In a follow-up application, however, the BCUC did approve the income trust structure for PNG. However, it focused on the issue of cost of capital as part of the calculation of the revenue requirement. PNG proposed that the utility would raise capital by having a 60% equity layer, consisting of 53% subordinated debt and 7% common equity. This would be raised by converting most of the utility's third party debt to debt owed to the new income trust. This was to be done by issuing units in the Income Trust to the utility's former shareholders. The effect of the subordination of the debt was to allow the utility to have an income tax deduction (for interest payments on the subordinated debt issued to the parent income trust). Therefore, the utility would pay little income tax and more cash could be flowed out through the income trust parent to unitholders.

The difficulty faced by the Board and pointed out by the ratepayer association B.C. Old Age Pensioners Organization et al. (BCOAPO), was that the yields promised to investors in the income trust units by the income trust for the proposal were significantly higher than typical historical returns on comparable income trusts (and much higher than comparable utility dividends). In effect, it was argued, ratepayers would be financing these higher distributions through higher rates.

The BCUC did not agree that rates were subsidizing this attractive return to unitholders (the former shareholders). The BCUC also did not question that the replacement of shares with subordinated debt (that is, third party "secured" creditors would get their money out first if PNG failed). The BCUC did, however, order that there be no "make whole" payments on subordinate debt, that is, if the utility repaid the debt early, there would be no penalty for doing so (the interest that would have been earned under full debt term could not be accelerated and added to the repayment).

Whether the BCUC was overly generous in the permissible capital structure of PNG is a debate that would be difficult to answer without more history under this type of rate regulation. However, in order to avoid problems as this history played out, the BCUC ensured a high level of control and placed several conditions on the conversion process.

Firstly, it required that customers be "held harmless," if there was any risk or cost associated with the conversion to an income trust. This included ensuring that there would be no costs of income trust conversion hearing itself to ratepayers. In effect, the BCUC determined that between the utility (or its shareholders) and customers, the utility must bear all risk in converting its corporate structure to an income trust.[176]

The BCUC also had other conditions: – Condition #1 – The income trust could only hold debt or equity or property of the utility and no other entity. Otherwise, the regulator would be unable to unravel the real revenue requirements of the utility. To quote the BCUC: "The purpose of Condition #1 is to ensure that the Commission can determine fair and reasonable returns, particularly prior to the development of standard tests, and to ensure that capital allocation decisions by the PNG Income Trust are not detrimental to the management and operation of the Utility. Once standard tests to determine fair and reasonable returns to be paid by PNG to the PNG Income Trust are established with sufficient trading history to make them workable, PNG may apply to have Condition #1 removed."

Conditions 2 &3 were designed to give control over who owned the subordinate debt to the regulator. These conditions effectively required that the subordinated debt could be replaced by third party debt if ordered by the BCUC (presumably so it was not just paid off by the utility (by rates)).

Condition #4 stated that if the BCUC could not, by law, order replacemnt of subordinated debt with third party debt, that PNG could be ordered to show cause why the income trust structure was still in the public interest (and therefore also ensure that payments due to the income trust from the utility were "neither determinative of nor relevant to the cost of capital recoverable in

---

[176] BCOAPO submitted that this conclusion was appropriate and in line with the reasoning in the Supreme Court of Canada's decision in *ATCO*. Since the shareholders are ultimate beneficiaries of corporate profit, they also should bear loss when a restructuring that seeks that profit goes bad: "A change in operational or market conditions puts the utility's investment in the assets at risk. Shareholders bear this risk as the residual claimants to the utility's profit."

rates" in other words, that rates were not subsidizing an inefficient or overly generous deal for income trust unitholders.

Condition #5 was that the Commission had the power to inquire into the income trust structure and order it unwound at any future time.

These conditions appear fairly intrusive, however, they also appear quite prudent given the financial history of PNG and the tendency of the income trust towards overvaluation in the short-term. Such overvaluation may be achieved by inflated rates, return of capital and reduced investment in the business. By preserving the regulator's control over the corporate structure of the utility, the BCUC was able to hedge its bets on whether an income trust would truly benefit customers and the utility.

As it transpired, the caution was prescient, as the October 31st taxation announcement effectively killed PNG's plans to convert to an income trust. As a result, the ratepayers were spared the costs of partial conversion to an income trust – even down to not having to pay for the proceedings to decide if the income trust was a proper corporate vehicle for the utility.

Price Cap Regulation and Income Trust Conversion

As noted above, telecommunications regulation in Canada has moved to the price cap model for regulation. This model eschews a detailed inquiry into the operating revenues of the companies regulated and instead bases its control of pricing on a rate cap, with a formula for determining the rate cap based on inflation and productivity. However, at least for the first price cap, the regulator must set the "going in" rates, that is, the initial accounting of the companies' incomes and expenses in light of the obligation to set "just and reasonable" rates.

The CRTC did this for telecommunications companies prior to the first rate cap decision in 1997. It has since not updated the initial rate base calculation despite two subsequent price cap decisions.

As such, the only place a consideration of the effect income trusts could have on telecommunications companies under price cap regulation was in an examination of the effect on the productivity factor: if companies reorganized to be more tax efficient, and therefore more profitable, should this be considered a productivity gain and if so, should a portion of the productivity gain be "shared" with ratepayers under the price cap formula?

Unfortunately, this question was only raised, but not answered, at the CRTC hearings leading to the third price cap decision. At the time of the hearings, the incumbent local exchange providers such as Bell Canada were contemplating moving to income trusts but after the close of hearings the Minister of Finance's October 31, 2006 tax announcement had been made, and the Bell income trust conversion was abandoned, thus the CRTC did not have to rule on the matter.

However, at the hearing, shortly after the trust conversions for both Bell and TELUS were announced, Commissioner Langford asked about including income trust restructuring into account in the productivity or “X” factor:

> 3851 COMMISSIONER LANGFORD: Thank you for that. I noticed you used a very interesting phrase and I wrote it down, a sentence right off the top, that unlike rate base rate of return under price cap, there are incentives, and you said "to become more efficient, to find ways to organize itself," incentives for companies.
>
> 3852 You have found a new way to organize yourself [*i.e.*, in an income trust], and I wonder why those subscribers who don't have the benefits of market-based competition that we all would so dearly love to rely on, why wouldn't we recognize this type of way to organize itself as something they could benefit from as well, and set an X factor?
>
> 3853 I mean, let's face it, you came to us with an X factor of zero. Then under interrogatories, you came back with kind of a movable feast anywhere from .3, possibly as high as 1.9 under certain very well-defined circumstances. But still it wasn't a set one figure.
>
> 3854 Why couldn't we add this as one of the elements to be looked at as one of the ways that, all right, it is not productivity in the sense of working faster or hanging wires faster, driving your trucks faster, but it is, in a sense, a saving and has the same effect. For those who can't benefit from competition, why couldn't they benefit from this saving partially with an increased X factor?

Responses from TELUS “policy panel” of regulatory lawyers were that income trust conversion should not be considered in productivity, as it was not considered an “input or output” in classical economics. The question was again raised, therefore, with TELUS’s economist witnesses the following day. This fascinating exchange took place. It has been quoted in full for the benefit of readers.

> 5021 [COMMISSIONER LANGFORD]:I don't know if either or both of you -- I think I saw you in the audience, Dr. Weisman, yesterday. I'm not sure if I saw you, Dr. Bernstein, if you were here when I asked some questions about the possible impact of the conversion to an income trust situation and got some answers on what I thought was a policy level and an approach level from Ms Yale and Mr. Grieve.
>
> 5022 I wonder if I could take it a step farther with both of you gentlemen.
>
> 5023 I know it is asking you to sort of step into the realm of the speculative, I suppose, but it is as new to me as it is to you, particularly with the announcement yesterday that essentially the whole face of kind of the ILEC structure, former corporate structure, is changing. So I am tentatively feeling myself along the way here, and I hope you will be kind, I suppose is what I am looking for here.
>
> 5024 It occurs to me, as I said to the Policy Panel yesterday, that when you prepared your papers and even your most recent interrogatories -- with the possible exception of Dr. Bernstein's response in September 6th, Interrogatory 2106, saying that he thought it would have no impact on the proposition he had put forth. And I take that as fact and accepted.

5025 I would like to look at the notion of this conversion in a somewhat different way, in the sense of: Is it possible to somehow bring this changed element, in the sense of costs to the TELUS company -- and we will see it to Bell, I assume, as well -- and somehow work it as a part of the productivity factor, obviously not using Dr. Bernstein's formula because it doesn't fit in there?

5026 Is there another way to look at it in a more general way, in a way of looking at it as a saving, if I can put it that way, and a saving that then perhaps to be fair should be reflected through the price cap formula and somehow see consumers benefit from this as well?

5027 Can you talk to that in any way, either one of you, in general terms?

5028 DR. BERNSTEIN: I am not talking specifically about the specific income trust conversion but just generally at a high level about this notion of saving.

5029 I guess what you mean by saving is the saving on income taxes. Is that what you mean?

5030 COMMISSIONER LANGFORD: Absolutely. And to put it in context, there was a phrase that Dr. Weisman used -- isn't it awful how you can find one little phrase in 83 paragraphs. But it is an interesting phrase in the middle of paragraph 83.

5031 He says:

"In similar fashion to stage two in the U.S. experience, British regulators had previously set the value of X so as to pass along to consumers anticipated industry-wide productivity gains." (As read)

5032 I guess I'm trying to think: Can somehow the spirit of this passing along of savings, if I can put it that way, capture the savings that one can I think reasonably anticipate will flow from this change of structure and pass some of that along to consumers?

5033 DR. BERNSTEIN: Well, traditionally the way the X factor works in a monopoly environment is that the productivity that is calculated is for the industry as a whole and not for the particular firm under consideration. So any productivity improvements that the firm has earned is precisely what price caps is designed to do.

5034 Since under price caps the firm is the residual claimant to those benefits, then the firm keeps those benefits because it has out-performed the industry.

5035 So in that sense, the conversion to an income trust should be independent to the X factor.

5036 If the firm undertakes savings -- let's forget about the income trust, let's say just particular savings in terms of efficiencies in their operations. Then the next time the price cap formula is looked at in a proceeding and the regulator proceeds to take those savings away, then that is essentially rate of return regulation with a lag. It is not price cap regulation.

5037 So the whole idea of the X factor is that it is designed to be immutable to the firm's behaviour.

5038 COMMISSIONER LANGFORD: The way to calculate X factors have changed in different proceedings at different times. Could we go on a firm-by-firm basis with an X factor?

5039 Could we say look, at this point in time anyway, MTS is still a corporate structure, still theoretically faces the possibility of paying income taxes, whereas Bell and TELUS are not, so we are going to have different X factors for different firms?

5040 DR. BERNSTEIN: There are two considerations there.

5041 Having different X factors for different firms is a possibility, but one should not base the X factor for a particular firm, its own X factor that is, on its past behaviour alone.

5042 If the firm has engaged in productivity improvements over the interim of the price cap period and then the next time that the firm appears before the regulatory body and the regulatory body calculates those productivity improvements and says given that we have had these productivity improvements, we are going to raise the X factor going into the next price cap period, again that is essentially rate of return regulation.

5043 So we have to distinguish between different X factors for different firms. That is a possibility, given different operating characteristics.

5044 For example, if you had firms that were subject to price cap regulation operating in urban environments and other firms operating in rural environments where the cost differences were greater, one could have different X factors.

5045 But each of those X factors should not be based on the firm's own past performance.

5046 COMMISSIONER LANGFORD: All right.

5047 What if we regulators set ourselves up like that famous God Janus that is looking both ways, that Roman God, so that we are looking both forward and backward. I agree with you that it would be inherently unfair to say you have done well, my good and faithful servant. You have been productive. You have done it cheaper, faster, higher, whatever. So we are going to penalize you.

5048 That does seem inherently unfair.

5049 In a sense, I am suggesting we look forward and say looking forward, there is an absolutely unexpected new element on the horizon, and that is you are not paying taxes.

5050 So it isn't penalizing them for having fewer workmen, fewer trucks, faster stringing of wire, more productivity in the way we think of it normally. It is simply recognizing that there is a brand new element going forward, and perhaps those consumers who rely on price cap for a fair deal, because there isn't market competition, should benefit from that as well.

5051 DR. BERNSTEIN: If we just substitute the word "innovation" for income trust, then we would have the same phenomenon. A firm would enter into a technological innovation. This is truly new. So if this was truly new, the firm should reap the benefits of that innovation according to price cap regulation.

5052 That's the first point.

5053 The second point is, as a practical matter, my understanding is that TELUS indeed has had its income taxes deferred historically. The conversion to an income trust will not change TELUS' income tax position going forward. It still will not pay income taxes in the sense that its corporate income taxes will be deferred.

5054 So if one is concerned about the tax issue alone, apart from the savings issue -- I prefer to keep those elements separate. I have addressed the savings element in terms of the innovation, which I believe the X factor is immutable to the firm's performance and therefore those innovations should be irrelevant to the calculation of the X factor.

5055 If we then focus on the specifics of the income tax payable by the corporation, in this particular instance there isn't any change in the income tax position at all.

5056 COMMISSIONER LANGFORD: Let me try this on you, if I could, if I'm not wearing out your welcome.

5057 DR. BERNSTEIN: I'm very happy for the questions.

5058 COMMISSIONER LANGFORD: Excellent.

5059 Let's go back to the very beginning of price cap when we initiated prices. The re-initiation of prices is not on this agenda; it is not in the scope of it. But you did speak historically, so I suggest it is fair for me to go back and look at the whole historic perspective. It isn't that long.

5060 When we initiated prices or did going-in prices, as some people referred to it -- I wasn't part of that process but I am reasonably familiar with it -- income tax liabilities were factored in as one of the elements that had to be considered in establishing the going-in price.

5061 Then you are quite right, in TELUS' case they made some purchases which some people thought were unwise -- and those same people are now clapping them on the back and saying "well done". But that is history as well.

5062 So their income tax situation changed. But it didn't change permanently; it didn't change forever. Sooner or later the tax benefits that they inherited when the purchased Microcell will wear out. They will terminate and they will come back to being taxpayers, or maybe they will make another "unwise" decision.

5063 But nowhere could one draw a line and say permanently they didn't have to pay taxes. It was part of what they were doing.

5064 I would argue that perhaps it's not the same thing as them finding a way now -- and in no way am I questioning the legitimacy of their structuring themselves. I am just looking at the effects of it.

5065 It is quite unlike finding a way to permanently remove one of the elements that was specifically included in setting the going-in price.

5066 Shouldn't that then be reflected in some way? We can't do a new going-in price but perhaps we could reflect it as what I call a saving and lump it in with productivity.

5067 DR. WEISMAN: Commissioner Langford, if you look at this conversion to an income trust as a business decision on the part of the TELUS, which I think we all could agree that it is, any business decision has an upside and a downside.

5068 I think you also spoke earlier to this issue of symmetry. Let's suppose you did adjust these rates or a change in tax liability supposedly exists, and this decision turned out not to be a wise one. Then the principle of regulatory symmetry would basically expose consumers to greater risk right at the time that these competitive markets are emerging, and you would essentially be forced then to say: Well, I adjusted tax liability before you before, now I have to come back and do it again.

5069 You would be exposing consumers to this risk. It wouldn't be good for consumers and it wouldn't be good for the competitive process.

5070 As far as price cap regulation is concerned and the general principle, these are risks that the firm agrees to take on. Some are going to be wise decisions, as you pointed out; some less wise.

5071 But the point is they own it at either state of the world. It is TELUS' share owners if it's good; it is TELUS' share owners if it's bad.

5072 If you move away from that, particularly in an increasingly competitive environment, it seems you are moving in the direction of exposing consumers to the very risk that price caps are supposed to shield them from.

5073 DR. BERNSTEIN: Also, as a practical matter, going back in history with respect to the revenue requirement and factoring in the tax liability, just as a practical matter, in the Phase 2 studies that we developed to look at the unit cost trends upon which an X factor could be based, in those studies the actual marginal statutory rate is used for the corporate income tax rate.

5074 So in that sense, subject to no change in the federal legislation on changing the corporate income tax rate, those statutory rates have actually been included and is consistent with the historical initial revenue requirement in actually computing our Phase 2 costs.

5075 COMMISSIONER LANGFORD: But they are gone now. So what is the impact of that?

5076 DR. BERNSTEIN: No. We were using the statutory rates.

5077 COMMISSIONER LANGFORD: Okay.

5078 DR. BERNSTEIN: There are essentially two ways in which one can do tax studies.

5079 Let's say Finance Canada or Industry Canada hires me to look at the effect of changes in corporate income taxes on behaviour of particular industries, employment, investment, pricing and output decisions. In that particular context, one would want to use the statutory corporate income tax rates, the capital cost allowance rates and any particular credits and other allowances.

5080 However, if, for example, Finance Canada called me up and wanted to look at the utilization of the R&D tax credits or the lack of utilization of R&D tax credits, in that particular instance you would use the actual credits that the industry used to get at a measure of the utilization rate.

5081 So here we are talking about the treatment of taxes in two separate ways.

5082 One way is to include the statutory rate and to do that historically from the first time period that you are going to calculate the Phase 2 costs all the way through to the terminal period. And we use the statutory corporate income tax rates.

5083 The alternative would be if you wanted to use the actual tax liability. If you were going to use the actual tax liability, you cannot just incorporate the actual tax liability in 2007 going forward and use the statutory rate for 2006 going backwards. If you are going to use the actual tax liability, because you want to get a methodologically consistent trend in Phase 2 costs, you have to go back to the initial year of your study and use the actual tax liability all through time.

5084 That is what I meant in both cases. Subject to very little change in the federal corporate income tax rate, there would be virtually no difference in the unit cost trends that I would calculate and therefore in the X factor due to the advent of the income trust going forward in 2007.

5085 COMMISSIONER LANGFORD: And yet we also have this concept of -- I think I understand what you are saying academically and as a fair exercise on paper. And I don't mean that derogatorily. But now we go to the real world in a sense, and I know that sounds like I'm trying to play that ivory tower stuff and I'm not. I'm just trying to make a delineation.

5086 We look at the average consumer, the subscriber. If tomorrow the Canadian government were to raise corporate rates -- highly unlikely; the trend seems to be the other way. But if they were, just raise them monstrously.

5087 That would qualify as what we call an exogenous factor. I'm pretty sure it would, anyway. They would make an application.

5088 The applications would come through our door so quickly to allow the phone companies to raise rates and pass these unexpected costs on to consumers that it would be mind-boggling.

5089 I quite understand that a self-imposed tax change doesn't qualify as an exogenous factor. But when you wave that in front of a consumer, it must be very cold comfort indeed, because it appears to be that when taxes go up, they have to pay the price; and when taxes go down, they don't get the benefit, unless they are pushed down in some exogenous way.

5090 I don't know if you want to respond to that before I give you one more. I have one more example in my quiver and then I think I'm pretty well gone.

5091 I am very grateful for this, by the way.

5092 DR. BERNSTEIN: With respect to the academic point, let me say that the Canadian government is very interested in these kinds of exercises. They have contacted me numerous times over the years to do precisely these kinds of exercises and analyses.

5093 COMMISSIONER LANGFORD: I only use that to sort of delineate between what a consumer gets when they get their bill and no matter how wonderful your studies are, how little comfort that would bring a consumer.

5094 DR. BERNSTEIN: I just want to say they weren't purely academic. That's all I meant to say.

5095 COMMISSIONER LANGFORD: Thank you.

5096 DR. BERNSTEIN: I think in some sense you answered your own question, because you said in the unlikely case that corporate income taxes would rise. So corporate income taxes, the rates have been going down. And to the extent that the statutory rate has been going down, those have played a role in Phase 2 costs and have lowered the unit cost trends.

5097 Therefore, to the extent that the statutory rate has gone down, that has essentially increased the X factor that we find in our Phase 2 cost studies.

5098 So we are actually picking up the effect that you want us to pick up.

5099 You are just saying: Well, would you pick that up if corporate income tax rates rose? And the answer would be yes, if they rose.

5100 In point of fact, if they rose, then essentially the cost of capital would rise and that would lower the X factor. The lowering of the corporate income tax rate lowers the cost of capital and therefore raises the X factor.

5101 We capture all of that in our Phase 2 cost studies.

5102 COMMISSIONER LANGFORD: So will you capture, if you do a Phase 2 cost study next year, assuming that TELUS' plan goes through and there is absolutely no tax at all --

5103 Of course, that wouldn't make a change from last year, would it?

5104 Would you capture that if it were a change?

5105 If they had been paying taxes this year and switched over to an income trust next year, would you capture that in your Phase 2 study?

5106 DR. BERNSTEIN: If I went back and re-did the Phase 2 studies based on using actual tax liabilities from the start of the study through to the end, if I were using that approach, and if the company was paying tax, and then there was a shift in terms of their tax payment to a decrease in their tax payment, or no tax payment, then I would capture that effect.

5107 But I would also have to reflect any other aspects that that would impact on the cost of capital.

5108 If there were, for example, a view by, let's say, the regulator, or other entities, as Dr. Weisman mentioned, that there was an increase in the riskiness of the proposition, that riskiness would increase the cost of capital, and therefore lower the unit cost trend and lower the X factor.

5109 So we have these countervailing elements at work.

5110 But then we also have to remember one important fact; that is, it is not just the unit cost trend of the telecommunications industry that is relevant for the X factor, it is the trend in the unit cost for the telecommunications industry relative to the unit cost trend for the economy as a whole.

5111 So even if, for example, the tax payment for a particular company decreased in a movement to an income trust in the telecommunications industry, if there were significant movement toward income trust by other firms in the economy as a whole, that relative difference might still balance in showing a lower X factor, even though the tax liability of the telecommunications firm has decreased.

5112 Because the tax liability for many other firms operating in the economy has decreased much more rapidly going forward, and therefore the relative difference shows that, if you look at the economy relative to the industry, income trusts have a greater impact on the economy than the particular industry at hand, and the X factor would go down, notwithstanding the increase in the income tax payment.

5113 COMMISSIONER LANGFORD: One last real life example, again thinking of it just from a consumer's point of view, what they experience.

5114 This is, in my mind, quite interesting.

5115 Just after the first price cap proceedings were finished, in fact even before the decision came out, I think -- anyway, if I haven't got the timing right, very soon afterwards -- Manitoba's telephone company, which had been a Crown corporation, was privatized, and it became obvious that Manitoba's telephone company, now called MTS, would have to pay taxes.

5116 It is not quite as clean as that because there were some tax credits given to help them through the transition and whatever, but it was fairly obvious to everyone at that time that once those tax credits were used up and once the transition was over, they would have to pay taxes like all other corporations.

5117 So they made an application to the Commission, a proceeding carried through and examined it, and they were given approval to raise rates, quite substantially, and a number of consumer groups weren't happy about that, and a number of consumers, I'm sure, weren't happy.

5118 I am going by memory, but I think we might be talking close to $3 a month, staged over some -- I may have that wrong, but it was a substantial increase for the average citizen out there.

5119 Theoretically, if they had come back a year later and changed to an income trust, how do you explain to consumers that they had this substantial increase a year ago, but now it is an income trust and there is no way to somehow capture that corporate saving and pass those raises back down again to pass on the savings?

5120 We passed on the cost -- this is a real life example -- but now -- and I am not saying they did become an income trust, but if they had there would be no way to reverse the process because it didn't qualify as an exogenous factor. It didn't come from the government, it came from the company.

5121 I wonder how we explain that to consumers. All of the calculations you so capably make, and the studies you do so well, and the theories and history you have laid out for us so clearly, but how do you explain that factor?

5122 Why cannot the productivity factor, or something like it, be altered to correct for that sort of thing?

5123 DR. WEISMAN: Commissioner Langford, I am not going to try and pass myself off as an expert on income trust, because I am not, but I do know enough to know that privatization and the creation of an income trust are fundamentally different.

5124 It seems to me, when I hear you speak to this example, that what troubles you is the apparent asymmetry of the situation, and I think that is the point. I think that Ms Yale spoke to this yesterday. TELUS is assuming the risk for this conversion. They hope it is a good business decision. Maybe it will be, maybe it won't be, but in either state of the world they own it, and that is the symmetry property.

5125 I understand why the asymmetry property, or the practise of this asymmetry would trouble you, but I hope it would provide you some comfort in this example, because that is what the company, in my understanding, is committing to.

5126 They made a business decision, they are going to stick to it, and in the good state of the world their shareholders reap the benefits, and in the bad state of the world they bear the consequence.

5127 That symmetry property is important. It protects consumers. It insulates consumers from the decisions of the corporation, and it is particularly important in a competitive marketplace where, if you ruled some other way, you would essentially be insulating the company from prospective competitive losses down the road, and I don't think that is good regulatory policy.

5128 COMMISSIONER LANGFORD: I have one last question. It is an interesting point that you have made. I hadn't thought of it that way.

5129 Let me, then, look forward -- I think this is the last question.

5130 Suppose that I take your view -- the Commission takes your view and we accept this and we say: It can't be worked into the X factor. It is exactly as you have described. It is exactly as Ms Yale described it, and that's the way it goes.

5131 Then, a year from now, the government decides to lay some kind of new tax on which will recoup what they have lost.

5132 Maybe they are going to call it the "Income Trust Doing Business Tax", or something. I am sure they will come up with something snappier, if they do. All the gains are lost. Would you advise, as an authority -- would either one of you gentlemen advise that they come to us and say that there has been an exogenous factor, that something unforseen has happened, and it has come from above, and it is not our doing, and we would like to raise rates?

5133 MR. RYAN: Mr. Chairman, if the question is, "Would that qualify as an exogenous factor," I think it is appropriate for this panel. But if the question is, "What would their advice to the company be in that situation," I don't think it would be, with respect, an appropriate question.

5134 THE CHAIRPERSON: I am sure the panel will answer appropriately, whatever the intent of the question.

5135 COMMISSIONER LANGFORD: Perhaps they could start, Mr. Ryan, and if you are not happy with the way they are going, you could hit the button.

5136 Does that give you enough comfort?

5137 MR. RYAN: Yes, sir.

5138 COMMISSIONER LANGFORD: Speak slowly, he may want to hit the button.

--- Laughter / Rires

5139 DR. WEISMAN: I hope the panel answers appropriately, as well.

5140 I think the difference is, in the case of an income trust, the decision on the part of the company makes it an endogenous decision. They decide to do it.

5141 In the case of a tax change, that is exogenous. That is imposed upon them separately.

5142 So if you look at the three criteria that the Commission has put in place for an exogenous adjustment, or an X factor, the tax change that you hypothesize, presumably, without having more detail, would qualify as an exogenous adjustment.

5143 It is outside the control of the firm, it is exogenous rather than endogenous, and that would be the key distinction.

5144 COMMISSIONER LANGFORD: Then we would have this situation. Let's go back to the MTS example again. This is what could happen, I think.

5145 You could have a Crown corporation, which pays no tax, and subscribers up until the point it ceased being one benefited from that. They had lower prices.

5146 They become a private corporation, subject to tax, and are allowed, on application, to considerably raise their prices.

5147 They then become an income trust -- we are now into the realm of fiction, but it's an example -- and because it's not exogenous they don't have to give back the rate increases. Your advice would be that it shouldn't be factored into an X factor because they are taking the risk.

5148 Then, later, assume that a new tax comes down which puts them exactly in the same position they were, in terms of dollars, before they became an income trust.

5149 You are suggesting that that, conceivably, would be a reason for them to raise subscriber rates yet again?

5150 DR. WEISMAN: I guess we started off this line of questioning. It is my understanding that the privatization decision and the income trust conversation are fundamentally different. I think we are moving outside my area of expertise.

5151 Clearly, in the case of an income trust, we are talking about an endogenous decision on the part of the firm, and in your example of a tax change, that is clearly exogenous.

5152 That's about as far as I think I can go with that.

5153 COMMISSIONER LANGFORD: Dr. Bernstein, in the example I have just given you, is there any way -- given those facts, would you feel more sympathetic to somehow trying to expand your views on X factors?

5154 Could you make a stronger case for it yourself?

5155 DR. BERNSTEIN: No, I think I would include the tax payment, the movement from privatization and the tax scenario that you laid out, if I was looking at the behaviour or the unit cost trends of a particular firm.

5156 But you have to distinguish between this hypothetical that you are laying out and the determination of the X factor that takes place under price cap regulation.

5157 The whole point of it is that the X factor is to be immutable to the firm's own behaviour.

5158 You are focusing on the income tax changes. That is why I asked you before: You can think about it in terms of innovations. Are you going to take those savings away from the firm?

5159 We wouldn't under the rules of price cap regulation.

5160 I think what is important here is to understand the difference between the elements that govern the responses of firms to changes in government policy, which you are describing perfectly, on the one hand, and on the other hand the rules governing the determination of an economically efficient X factor under price cap regulation. Those are two separate propositions.

5161 COMMISSIONER LANGFORD: I won't ask you to do it, but I would ask you if you could do it.

5162 If you were retained by the consumers and asked to solve this problem for them by restructuring a whole brand new way of looking at X factors, could it be done?

5163 MR. RYAN: Mr. Chairman, I am not comfortable with questions of that sort that relate to the advice the witnesses might give. I think it is appropriate to ask them, within the area of their expertise, which is, in the case of Dr. Bernstein, the calculation of the X factor, how that, as a matter of economic principle, is done.

5164 If he is being asked to address questions of public policy or something of the sort, I don't think it is appropriate.

5165 COMMISSIONER LANGFORD: Let me try to rephrase it, Mr. Ryan, to give you some comfort.

5166 I am almost coming full circle to my first question, really. In light of the discussion we have had and the scenarios and historical situations I have presented to you --

5167 You will remember that my first question, or one of my first questions was: Can you look at this X factor basically as a way to reflect savings that are not normally reflected in productivity, as we think of it? Could that be done?

5168 I am not asking you to do it on the back of an envelope, but could it be done?

5169 DR. BERNSTEIN: You wouldn't do it in the calculation of an X factor. That's not what an X factor is going to do under price cap regulation.

5170 If you are asking me, "Could you do a study for us analyzing all of the savings through a company's own decisions -- innovative decisions, tax decisions, et cetera -- could you calculate those dollar savings and add them up," yes, I would be able to do that, but that is a separate study than actually calculating an X factor.

5171 I don't mind saying, if I may, that if I were consulted by Mr. Janigan, I would say that, with respect to the X factor, my analysis would stand. I would present the same analysis and the same Phase 2 cost trends now, under contract to TELUS, as I would to the consumer groups.

5172 COMMISSIONER LANGFORD: Thank you very much, gentlemen.

5173 Mr. Chairman, that is as far as I am competent to go this afternoon. Thank you.

5174 THE CHAIRPERSON: Thank you, Commissioner Langford.

As noted by Commissioner Langford, there appears to be a “heads-I-win-tails-you-lose” effect of income trust tax savings on customer rates under price cap regulation. This occurs because the company is permitted to view the conversion to an income trust as an “innovation” and therefore keep the benefit of the savings without passing them on, as long as the decision to convert is considered “endogenous” or emanating solely from the business plan of the company. By contrast, when the government changes tax policy, this is an “exogenous factor” outside the business’s control and again, rates may be permitted to rise to cover the “shortfall”.

What may be unfair in this view of the ambit of price cap regulation is that it does not adequately take into account an industry-wide trend to income trust restructuring. This trend could be viewed as a new method to raise, or a legitimate influence on any capital used in the making of a price cap. The existence of industry-wide innovation in tax planning is at least as relevant as developments like digitization.

Without actually recalculating rates based on the income trust savings, the net result is the telecommunications providers would solely have the benefit of their innovation or efficiency gains. The larger policy question is whether clever restructuring to avoid paying income taxes really reflect a long-term benefit to the companies, customers and the Canadian economy? Or should companies be encouraged to make productivity gains in more real world areas such as faster and more efficient computer systems, revolutionary equipment with amazing capabilities or fantastic yet efficient customer service?

There is no reason why the Commission could not have considered income trust conversion as a "virtual" input to the productivity factor calculation much as the western utilities claimed the "virtual" tax payment for the utility under rate of return regulation.

Finally, Bell Canada and TELUS both took the position at this hearing that rates should not change upon conversion to an income trust structure and customers would not be called upon to pay for the unwinding of income trust conversions if the companies decided to reorganize into corporations after conversions to income trusts.[177] This suggests that the phone companies either believed no income trust tax would ever be imposed or that they were confident of significant gains.

THE REAL DEVIL: LACK OF CORPORATE GOVERNANCE

Governance

Concern has arisen over the governance practices of the income trust industry. Because they are not corporations, income trusts are not subject to statutory corporate laws such as the *Canada Business Corporations Act* (CBCA)[178] or equivalent provincial legislation. As a result, unitholder rights, which are defined in the Declaration of Trust, are somewhat different for each trust. While unitholders have most of the same protections afforded to shareholders, they are not afforded all of the same legal remedies as their shareholder counterparts.[179]

The lack of governance practice standards has resulted in a lack of uniformity amongst income trust practices, making it difficult to evaluate and compare them. There is, however, a general consensus in the marketplace that some kind of legislation or regulation is needed to remedy this situation.[180]

Moreover, the general lack of governance throughout the income trust industry has led many to predict that the sector was headed for a crash, even before the government's October 2006 announcement to tax trusts. Allegations of weak investor protection rules and unscrupulous reporting have plagued the industry for some time. It has been widely suggested that such weak investor protection rules have allowed income trust promoters, and particularly investment firms,

[177] See, for example, questioning of TELUS by consumer group BCPIAC. Transcript, Review of Price Cap Framework, October 11, 2006 (online: http://www.crtc.gc.ca/eng/transcripts/2006/tt1011.htm) at para. 3297.
[178] R.S., 1985, c. C-44.
[179] For example, income trust investors cannot table shareholder proposals for a vote at annual meetings. See, Stacey Anderson, "Recent developments in the income trust market" Financial System Review: Development and Trends (June 2006) at 25, online: <http://www.bank-banque-canada.ca/en/fsr/2006/dev_trends.pdf>.
[180] Gregory Chrispin, "Income Trusts: The Changing Canadian Lanscape" State Street Global Advisors (31 May 2005) online: http://www.ssga.com/library/esps/gregchrispincanadianlandscape20050531/page.html>.

to mislead unsophisticated investors with the expectation of high yields. Seniors were particularly hard hit by the government change of policy. Following the October announcement, there was a barrage of newspaper accounts of seniors who had loaded up their portfolios with income trusts, some with as much as 90 percent of their savings tied up in trusts, only to see their investments come crashing down. But, according to many analysts, chances were that those investors were headed for disaster, regardless of the government's change in tax policy.[181]

Diane Urquhart, an independent analyst who works with the National Pensioners & Senior Citizens Coalition, had been warning seniors for years that trusts were too risky. According to Urquhart, much of the risk associated with income trusts was and is produced directly as a result of poor disclosure. Urquhart's analysis showed that trusts were headed for a major correction, regardless of the government's change in tax policy. According to Urquhart, income trusts were being overvalued – a dangerous situation, especially if Canada were to enter a recession. On that basis, trusts were hardly an ideal investment for seniors looking for stability, she says. In an October report, she compared business income trusts to large Canadian public corporations on the basis of pre-tax income. The results showed trusts traded at a 53 percent premium to corporations. Even after the fall in trust value from the government's tax announcement, Urquhart believes trusts have further to fall. "I'd figure another 13 to 20 per cent more," she says.[182]

The quality of income trust accounting has been increasingly questioned to date. Of particular concern is the reporting of "distributable cash," a measure that is crucial to the financial analysis of income trusts. Distributable cash is not defined under the Generally Accepted Accounting Principles (GAAP); rather, it is left to the discretion of trust managers. This means that the trusts' reported cash available for distribution to unitholders is often overestimated, which may cause investors to make incorrect conclusions about the sustainability of distributions. Moreover, "the lack of transparency may obscure the fact that a firm is not reinvesting enough" in its underlying business.[183]

The problem stems from the fact that many trusts are not setting aside enough money for maintaining and reinvesting in their capital assets when it comes to calculating how much money (i.e. distributable cash) is available for unitholders. It did not take trust managers long before they figured out that they could artificially boost distributable cash by underestimating maintenance and working capital growth needs, thereby getting a higher selling price for their units. In such cases, cash distributions are being maximized in the short term, allowing owners to then sell the company at an inflated price.[184]

---

[181] Jason Kirby, "Who will benefit from the Conservatives taxing income trusts?" *Macleans Magazine.Ca* (13 November 2006), online: http://ca.news.yahoo.com/s/13112006/21/benefit-conservatives-taxing-income-trusts.html>.
[182] *Ibid.*
[183] Kevin Hibbert & Ron Charbon, "Canadian Income Funds and the Perceptions of Distributable Cash" *Standard and Poor's* (Part 1 published Jan. 16, 2006, and Part II published March 9, 2006, on RatingsDirect and on www.stabilityratings.com) at 1-11; as cited in Stacey Anderson, "Recent developments in the income trust market" Financial System Review: Development and Trends (June 2006) at 25, online: <http://www.bank-banque-canada.ca/en/fsr/2006/dev_trends.pdf>.
[184] Al Rosen, "How the game works: the latest way income trusts can fool investors" *Canadian Business Magazine* (10-23 October 2005).

The relative attractiveness of a trust is based in large part on its “payout ratio” - broadly defined as the amount of funds distributed to unitholders as a proportion of distributable cash. Payout ratios can vary substantially by firm and by industry. Typically, firms with more variable cash flows and those with large capital expenditure requirements, such as energy trusts, tend to have lower payout ratios; whereas firms with the opposite characteristics, such as utilities, can support higher payout ratios. However, as many trusts have discovered, cash flows can be too volatile to allow for sustainable distributions.[185] At the end of 2005, almost three dozen business trusts (or about 20 percent of all business trusts) had either cut distributions or suspended them at least once since their creation. A suspension of the distributions can spell disaster for a trust, since the trust sector is attractive to investors because of the steady and supposedly predictable cash flow that is generated and paid out.[186] The reasons most often cited for a cut or suspension of distributions is a decrease in demand for the trust’s products, followed closely by fluctuations in the value of the Canadian dollar. Also frequently cited are risks related to the prices of raw materials and commodities.[187]

Inadequate financial reporting throughout the income trust sector has been a recurring theme for many years and has been the subject of four recent reports - two by Canada’s quasi-regulatory bodies: the Canadian Securities Administrators (CSA) and the Canadian Accounting Standards Board (AcSB); and two independent reports by Standard & Poor’s and Accountability Research Corp., respectively.

CSA

The Canadian Securities Administrators – the umbrella group for the provincial regulators – released its second report in August 2006 on the continuous disclosure practices of business trusts (the first was released back in 2004). The CSA found numerous problems with the 45 trusts it examined. The CSA chose not to disclose the names of the trusts, but it did say that they came from across the country. The findings were alarming: Only seven of the 45 trusts reviewed had "no issues" with their accounting. A whopping 84.5 percent of the trusts examined by the CSA failed to meet the required standard. Perhaps even more disturbing was that, despite the widespread reporting abuses, the CSA did not impose any sanctions for the reporting lapses.[188]

In its report, the CSA was particularly critical of the way in which funds report or calculate distributable cash, finding that it "continues to cause considerable confusion”. The report found that some trusts are funding their distributions through long-term credit facilities and reserves held back from prior periods. The CSA report further noted that the disclosures for distributable cash were deficient in three areas: liquidity (*i.e.*, the sources of funding); risks and uncertainties (*i.e.*, the factors that affect the performance of the underlying entity on which the trust is based); and overall performance and results of operations.[189] The CSA recognized that the over-reporting

[185] Stacey Anderson, “Recent developments in the income trust market” Financial System Review: Development and Trends (June 2006) at 23, online: <http://www.bank-banque-canada.ca/en/fsr/2006/dev_trends.pdf>.
[186] Barry Critchley, “Light shone on income trust lapses” *The Financial Post* (11 September 2006).
[187] Stacey Anderson, “Recent developments in the income trust market” Financial System Review: Development and Trends (June 2006) at 23-24, online: <http://www.bank-banque-canada.ca/en/fsr/2006/dev_trends.pdf>.
[188] Barry Critchley, “Light shone on income trust lapses” *The Financial Post* (11 September 2006).
[189] *Ibid.*

of distributable cash is a problem, and stated that: "trust issuers need to improve the nature and extent of their disclosure". Yet, amazingly, when it came time to take action, the CSA stated that it “might” require companies to improve disclosure on the issue in their prospectuses.[190]

AcSB

Another report, issued by the Canadian Accounting Standards Board (AcSB) noted that the Council believed that income trust disclosures were generally *inadequate*. The report went on to list many of the disclosure concerns that exist. Nevertheless, the AcSB ultimately concluded that: “there is no need to change accounting standards as the issues are largely unrelated to the standards.”[191] The lack of action, or as one commentator put it, “jaw-dropping apathy,”[192] on the part of Canada’s so-called regulators is astonishing.

Standard & Poor’s

Analysts at Canada’s independent bond rating agency, Standard & Poor’s (S&P), conducted their own review of the income trust sector. Again, the findings were not encouraging. According to S&P analysts, Kevin Hibbert and Ron Charbon, co-authors of “Canadian Income Funds and the Perceptions of Distributable Cash,"[193] Canada’s income trust sector is riddled with “distortion and information risks” caused by obscure and inconsistent financial reports. S&P’s report notes that “distributable cash” is a key reporting factor for income trusts, however, there was no standardization on how trusts calculate it, or what they call it. The S&P study looked at 40 trusts – all of which were identified. The trusts covered all sectors, including: business trusts, REITs, oil and gas trusts and pipelines and utilities. It found 19 different names were used to characterize the same concept of “generating and making available cash for distribution to unitholders” (or “distributable cash”). The study found that four of the funds examined “had cash generated and available for distribution that was lower than what was reported by management and insufficient to cover distributions over a two- to three-year period.”[194] S&P noted that reporting distortions for distributable cash came from accounting distortions and discretionary items. The study also noted that the situation was getting worse.[195]

Accountability Research Study

A 2005 report from Accountability Research Corp., an affiliate of Rosen and Associates forensic accountants, suggested that despite the $10-billion stock market decline of Canadian income trusts following the government’s October 2006 tax announcement, the sector may still be

---

190 Al Rosen, “Investing in The Dark: poor disclosure for income trusts” *Canadian Business Magazine* (12-25 September 2005).
191 *Ibid.*
192 *Ibid.*
193 Kevin Hibbert & Ron Charbon, “Canadian Income Funds and the Perceptions of Distributable Cash" *Standard and Poor’s* (Part 1 published Jan. 16, 2006, and Part II published March 9, 2006, on RatingsDirect and on www.stabilityratings.com) at 1-11.
194 *Ibid.* at p. 1-2. As cited in, “Income trust sector under fire” *Business Edge* (2 February 2006) at p.15.
195 Kevin Hibbert & Ron Charbon, “Canadian Income Funds and the Perceptions of Distributable Cash" *Standard and Poor’s* (Part 1 published Jan. 16, 2006, and Part II published March 9, 2006, on RatingsDirect and on www.stabilityratings.com) at 1-11; As cited in *ibid* at 1-2.

overvalued by 28 percent, or a total of $20-billion. The report lays blame for the wild market discrepancy on "abuses" in trust accounting and salesmanship, stating: "Much of the overvaluation stems from abuses in the financial reporting, valuation and marketing of business trusts". According to the study, the tax advantage of the trust structure has been overstated, creating the "opportunity for selling owners to receive inflated prices well above what strategic industry buyers and professional investors alone would be willing to pay." The study further warns that: "Investment bankers have been motivated by the $1.4-billion of inflated underwriting fees that they have received since Jan. 1, 2001. Many have taken advantage of ill-informed investors seeking higher cash-yielding investments."[196]

In conducting its study, Accountability Research said it examined the 50 biggest income trusts (excluding the energy and real estate industries). The results of the study were sobering. Less than two-thirds of their cash distributions are from actual income – the rest amounting to a return of investors' own capital. Widespread abuses in calculating distributable cash were also revealed – with cash distributions of the 50 big trusts having exceeded their reported net income by 58 percent. Ironically, the report also found that investments banks are just as much to blame for the reporting fiascos, stating: "Even more overvaluation results from the flawed methodologies being pushed by the investment banks." The report ominously predicts that "the prospects for serious declines in business trusts are already evident," with the unit prices of 22 trusts down by 30 percent or more from their offering prices.[197]

Mandatory Reporting Standards Needed

To date, various entities have acknowledged the need for improvement in the reporting of income trusts and have provided "guidelines" regarding the calculation of distributable cash.[198] Unfortunately, this guidance is more of a suggestion rather than a requirement, and seems to be based on some sort of honour system. For example, the CSA wants companies to provide "detailed disclosure that explicitly states that the reconciliation has been prepared using reasonable and supportable assumptions."[199] It is unlikely that a company is going to admit that their forecasts are completely unfounded or unrealistic. With the widespread reporting abuses among many trusts, it seems unlikely that "guidelines" will prove a sufficient incentive. What is needed is a set of mandatory standards that govern the income trust industry, similar to those for corporations.

Progress on this front is underway. For instance, the Canadian Coalition for Good Governance has undertaken a project to consider governance issues for trusts; and the Uniform Law Conference of Canada has also released a report[200] and draft *Uniform Income Trusts Act*, which

---

[196] "Income trusts overvalued, study says" *The Globe & Mail* (23 November 2005) online: <http://www.theglobeandmail.com/servlet/story/RTGAM.20051123.wtrusts1123/BNPrint>.
[197] *Ibid.*
[198] These entitles include the AcSB, Standard & Poor's, and the Canadian Association of Income Funds (CAIF). In the case of REITs, the Real Property Association of Canada (REALpac) has published standards for calculating funds from operations.
[199] Al Rosen, "Investing in The Dark: poor disclosure for income trusts" *Canadian Business Magazine* (12-25 September 2005).
[200] "Governance should be top of mind" Deloitte & Touche LLP, online: <http://www.deloitte.com/dtt/article/0,1002,cid%3D150315%26pv%3DY,00.html>.

provides a framework for governing trusts. Unfortunately, the ULCC report does not recommend investor disclosure standards, instead leaving any new ones for income trusts to provincial securities legislators.[201]

DRAFT LEGISLATION

On December 21, 2006,[202] the Department of Finance released draft legislation[203] and explanatory notes, intended to amend the *Income Tax Act* to implement the new rules for "specified investment flow-through trusts", or SIFTs.[204]

In general, the draft legislation accords broadly with the government's initial announcement of the new tax rules on October 31, 2006. The legislation is highly technical, and makes use of a series of defined terms and complex formulae. Following the release of the draft legislation, many lawyers and tax experts complained that the proposed legislation is overly complex and contains a number of drafting flaws and which may lead to unintended consequences.[205] Moreover, they contend that the draft legislation still lacked the much-needed clarification on the finer points of the new policy.[206]

The December 21st draft legislation came shortly after the Department of Finance released further "guidance" on the new income trust tax regime in a December 15th news release. The new guidance policy was designed to spell out the details of how trusts will be treated in the transition period before they all face taxation.

Unfortunately, neither the December 21st proposed legislation, nor the government's December 15th guidance release, have served to clarify a number of key issues that have left investors, trust managers and lawyers perplexed. These include the following issues.

Grandfathering

In the government's initial October 31st announcement, it was revealed that existing trusts which were "publicly traded" before November 1, 2006 would not be subject to the new tax regime until 2011 (as long as strict conditions were met). However, the December 21st draft legislation provides for grandfathering (until 2011) of existing trusts if units in the trust were *listed* on a stock exchange or other public market before November 1, 2006. Since the draft legislation only refers to units that are "listed" before November 1, 2006, it appears that there is no requirement

---

[201] http://www.ulcc.ca/en/poam2/Uniform_Income_Trusts_Act_Report_En.pdf
[202] See Department of Finance Media Release "Canada's New Government Releases Draft Legislative Proposals to Implement the Distribution Tax on Income Trusts and Partnerships", online: http://www.fin.gc.ca/news06/06-086e.html
[203] See Department of Finance, "Legislative Proposals and Explanatory Notes Concerning Specified Investment Flow-Through Trusts and Partnerships" December 12, 2006, online: http://www.fin.gc.ca/drleg/ITA-l_ftt1206e.html
[204] Paul Tamaki, "Taxation of Income Trusts and Other SIFT Trusts" Blakes Bulletin on Tax, Blake, Cassels & Graydon LLP (January 2007).
[205] *Ibid.*
[206] Carrie Tait, "Still seeking clarification on income trust rules" *The Financial Post* (12 January 2007).

that they also be publicly traded before that date (in contrast to the government's October 2006 declaration).[207]

Many people, including critics and supporters of the new tax policy, have called for the lengthening of the transition period, beyond the current 2011 deadline; others have argued that all existing trusts should be grandfathered outright. However, an outright grandfathering of existing trusts would be highly problematic. If existing trusts were permitted to continue to operate and take advantage of their preferential tax treatment, it would provide them with a huge advantage over competing corporations who are saddled with significantly higher tax requirements.[208]

Both the Liberals and the Bloc Quebecois are pushing for an extended transition period. Existing trusts need a transition period to prepare for the significant changes in tax policy. It is also likely that many trusts will use the time to restructure back to corporate status. The length of time is a matter of judgment. In the past, it has not been unusual to give long periods of transition – as much as seven or 10 years – for major tax-policy changes.[209] Nevertheless, extending the transition period is simply extending the inevitable. Since the government has made the decision to tax trusts, it makes little sense in prolonging the result – especially when doing so would mean more lost tax dollars (the primary reason given by the government for the change in tax policy in the first place). Extensions after the surprise announcement to tax trusts also will not bring back the lost value of the income trust investments.

Conversion to Corporate Status

In the December 15th news release guidelines, the Finance Department indicated that conversions to corporate form would be allowed to take place without tax consequences to investors. Specifically, the guidelines confirmed that trust investors will not face any capital gains taxes when an income trust converts to a corporation. However, the guidelines were silent on whether there would be entity-level tax on a conversion. In addition, the guidelines indicated that if impediments to conversion exist under current income tax rules, changes would be recommended. However, the December 21st proposed legislation did not include any changes relating to these comments. Trust managers have expressed frustration at the lack of clarity in the proposed legislation, as a conversion to corporate status is complex and costly. There are various methods to converting under the existing rules, but according to experts, they are administratively difficult and likely to result in complicated structures.[210]

---

[207] Paul Tamaki, "Taxation of Income Trusts and Other SIFT Trusts" Blakes Bulletin on Tax, Blake, Cassels & Graydon LLP (January 2007).
[208] Jack Mintz, "Give a little back" *Canadian Business Magazine* (20 November 2006).
[209] *Ibid.*
[210] "Impact of changes to trust taxation" Deloitte & Touche LLP, online: <http://www.deloitte.com/dtt/article/0,1002,cid%3D137724%26pv%3DY,00.html>.

Undue Expansion

During the initial October 31st announcement, the government made it clear that while there was no intention to prevent grandfathered trusts from undergoing “normal growth” during the transitional period, it may be reviewed by Finance if there is any “undue expansion” on the part of the trust.

Then, during the December 15th news release, the Department of Finance released further guidance on the meaning of “normal growth.” The news release set a maximum-permitted dollar value of growth for existing trusts taking advantage of the grandfathering clause. Even slightly exceeding the limit would cause the trust to be non-compliant. Given potential fluctuations in unit value, this could result in negative impacts in situations where the trust seeks to utilize units to fund acquisitions.[211]

According to the December 15th release, income trusts will be allowed to grow over the next four years without jeopardizing their tax-free status, *if* they stay within strictly defined limits, or “safe harbours”. Existing trusts will be allowed to double their equity capital by 2011 – 40 percent in 2007, and 20 percent in each of 2008, 2009, and 2010. The Department of Finance warned that if a trust exceeds the “safe harbour” threshold, its four-year tax deferral will be rescinded and it will have to begin paying taxes on its distributions immediately.[212]

Surprisingly, despite the government’s “guidance” release, there was no mention in the December 21st draft legislation as to when grandfathering could be denied. The failure to include any reference to this issue suggests that Finance has no current intention to incorporate its “guidance” into the final legislation. As a result, it appears that existing trusts are left with the threat of future amendments to the legislation to deny grandfathering if Finance’s “safe harbours” are exceeded.[213]

It is unfortunate that the draft legislation does not set out statutory language for when grandfathering could be denied because of “undue expansion.” Existing trusts are now left in the uncertain position of having to interpret the general and imprecise language used in the December 15th guidance, and face a possible loss of their grandfathered status should Finance take issue with the trusts’ interpretation.[214]

---

[211] *Ibid.*
[212] “Ottawa lays out growth guidelines for income trusts” CBC News (15 December 2006) online: <http://www.cbc.ca/money/story/2006/12/15/flahertytrustrules.html>.
[213] “Ottawa lays out growth guidelines for income trusts” CBC News (15 December 2006) online: <http://www.cbc.ca/money/story/2006/12/15/flahertytrustrules.html>.
[214] *Ibid.*

Anti-avoidance

Although the December 15th news release warned taxpayers and their advisors against alternative arrangements designed to frustrate the government's policy objectives, the proposed legislation did not contain specific anti-avoidance rules. Yet again, the proposed legislation fails to mention an important issue raised in the government's earlier declarations on the new taxation rules surrounding income trusts. This lack of clarity makes it extremely difficult to discern tax policy objectives beyond what is actually provided for in the legislation and forces trust managers, lawyers and investors to deduce legal responsibilities from vaguely worded "guidance" policies.[215]

For instance, the December 15th guidance release simply states: "If there should be structures or transactions that are clearly devised to frustrate those policies objectives, any aspect of these measures may be changed accordingly and with immediate effect." The draft legislation that followed, however, makes no mention of what kind of financial structures or transactions would cross the line. By leaving this area undefined, lawyers cannot safely advise clients on whether a certain deal would land the trust offside of the Finance Department's growth rules – an offence that could be punishable by the loss of its important four-year grandfathered status.[216]

REITs

The new taxation rules apply only to SIFTs, as defined. A SIFT trust is defined not to include a "real estate investment trust," as specifically defined. However, the definition of a REIT under the draft legislation is extremely narrow. As a result, many existing trusts commonly referred to as REITs may be unwittingly exposed to the new tax regime.[217]

The December 15th guidelines only dealt with the REIT exemption broadly. It is widely believed among observers that REITs dealing with seniors properties and hotels, as well as those with sizable business outside of Canada, might face problems. But most observers are under the assumption that commercial and residential REITs will qualify for the exemption.[218] Unfortunately, this is only speculation, and has done little to quiet the concerns among many REIT managers and investors.

Some major REITs in the commercial property sector have decided, on advice from their lawyers, to tell investors they might be swept up in the new tax rules on income trusts. Not surprisingly, REITs are aggressively lobbying the government to clarify the exemption for

---

[215] "Impact of changes to trust taxation" Deloitte & Touche LLP, online: <http://www.deloitte.com/dtt/article/0,1002,cid%3D137724%26pv%3DY,00.html>.
[216] Carrie Tait, "Still seeking clarification on income trust rules" *The Financial Post* (12 January 2007).
[217] Paul Tamaki, "Taxation of Income Trusts and Other SIFT Trusts" Blakes Bulletin on Tax, Blake, Cassels & Graydon LLP (January 2007).
[218] Tara Perkins, "REITs fear hit from income trust tax" The Globe & Mail (5 March 2007) online: <http://www.theglobeandmail.com/servlet/story/LAC.20070305.RREIT05/TPStory/Business>.

REITs, and to do so quickly because they fear they might face restrictions on their growth in the meantime. Michael Brooks, executive director of the Real Property Association of Canada, said the Finance Department is "non-committal, but they've listened attentively and we're hoping to see some technical edits to allow the existing structures to continue."[219]

A number of REITs have already publicly stated that they fear their trust structure will not qualify under the exception, as currently worded. For instance, Calloway Real Estate Investment Trust said that, "based on the draft legislation, it would appear that the trust, as currently structured, may not qualify for the REIT exclusion." Calloway further warned that: "The proposals do not fully accommodate the current business structure used by many Canadian REITs and contain a number of technical tests that many Canadian REITs may find difficult to satisfy."[220] Dundee REIT echoed the sentiments of Calloway, saying that "based on the draft legislation it would appear that Dundee REIT, as currently structured, would not qualify for the REIT exception."[221]

Conclusion on Draft Legislation

Overall, the government's draft legislation is a good starting point in the process of trying to define the legal responsibilities surrounding the government's new tax policy on income trusts. However, it is clear that the draft legislation has some major gaps that need addressing in order to clarify rights and responsibilities and ensure the smooth transitioning of the new tax rules. Unfortunately, many commentators have speculated that the lack of clarity was no mistake, and the resulting uncertainty was exactly what the government was hoping for. Speculation is rising that the without the ability for lawyers to hand out a legal opinion on a transaction, the income trust is less likely to go ahead – which according to some, is exactly the point.[222]

RECOMMENDATIONS

There are a number of important lessons that can be learned from the income trust fiasco. After reviewing the income trust saga in depth, PIAC has formulated a number of recommendations for government and industry.

Recommendation #1: Take Proactive and Decisive Action to Close Tax Loopholes

At the first indications of the growing problems brewing in the trust sector, successive federal governments could have acted proactively and decisively to avoid the looming tax troubles. Instead, they opted to turning a blind eye, hoping the problem would simply go away. By choosing to ignore the millions of tax dollars being lost through what amounts to a clever tax

---

[219] *Ibid.*
[220] Tara Perkins, "REITs fear hit from income trust tax" The Globe & Mail (5 March 2007) online: <http://www.theglobeandmail.com/servlet/story/LAC.20070305.RREIT05/TPStory/Business>.
[221] *Ibid.*
[222] Carrie Tait, "Still seeking clarification on income trust rules" *The Financial Post* (12 January 2007).

loophole; by allowing one conversion after another to proceed unabated for years; and by actually encouraging the growth of the trust sector through campaign promises – governments brought on the current income trust headaches, and created financial headaches for millions of Canadians in the process. When tax loopholes appear, they should be dealt with immediately – not allowed to balloon in size until they become unmanageable.

Recommendation #2: Increase Investor Protection

The federal government has passed off responsibility for public and investor protection to the industry's self-regulatory bodies, which clearly have not done a very good job when it comes to protecting small investors. Despite the numerous warnings regarding the lack of investor protection and the weak disclosure rules, the government's new regime for income trusts does not include anything requiring greater disclosure and protection for the general public.[223] The federal government, quasi-regulatory and self-regulatory agencies should act cooperatively, proactively and decisively to protect the public and investors.[224]

PIAC feels that one way to accomplish this is to provide consumers with a voice in important taxation issues in Canada. To date, the consumer voice has been largely absent in taxation matters, however, a new initiative recently announced by the federal government may see important changes. On May 28, 2007, the federal government announced the creation of two new initiatives, a Taxpayer Bill of Rights and a Taxpayers' Ombudsman.[225]

Of particular interest is the creation of a Taxpayer Ombudsman, which will serve to "enhance accountability and service to the public".[226] Unfortunately, in an accompanying fact sheet on the creation of the Ombudsman, the government has stated that the Ombudsman "will not have the authority to review complaints relating to tax policy or program legislation".[227] PIAC believes that this decision should be reconsidered.

---

[223] Toby Sanger, "Flaherty finally did the right thing on income trusts" *The Toronto Star* (2 November 2006).

[224] The Accountability Research report cited above recommends provincial securities regulators conduct a review and take enforcement actions for "distributable cash misrepresentations in business trust prospectuses and continuous disclosure documents" and that the provincial regulators warn financial advisors to review what portion of income trust returns are simply returns of capital and advise their clients, especially vulnerable clients such as retirees. The Report goes further and suggests a "Federal Investor Protection Act" and Agency to "supersede" provincial authorities where there are abuses in the income trust market. PIAC feels that it does not matter what actions are taken provided there is an enforcement and disclosure push in the income trust sector, whether that is effected by provincial cooperation or done federally. However, given the delicacy of federal-provincial relations in the securities area, this may be a matter properly referred to the federal-provincial Consumer Measures Committee for joint action. See also below PIAC's "Recommendation #5: Increased Consumer Awareness of the Financial Industry", which suggests an investor protection and information role for the Financial Consumer Agency of Canada (FCAC).

[225] "Canada's New government announces Taxpayer Bill of Rights and Taxpayers' Ombudsman" Government of Canada (28 May 2007) online: <http://news.gc.ca/web/view/en/index.jsp?articleid=309429>.

[226] *Ibid.*

[227] Fact Sheet: Creation of the Taxpayers' Ombudsman" Government of Canada (May 2007) online: <http://www.cra-arc.gc.ca/newsroom/factsheets/2007/may/fs070528-e.html>.

An independent Ombudsman authorized to deal with taxation issues is the perfect forum in which the public could voice their concerns regarding the effects of major tax policy decisions. Taxation issues will otherwise likely be discussed from a business and industry perspective, with individual taxpayers largely absent. This is somewhat ironic, given that taxation policy intimately affects the lives of every Canadian. In many other areas of federal public policy, public opinion is welcomed and sought.

The Taxation Ombudsman would provide a national forum to hear consumer views dealing with important taxation policy issues. Moreover, it would provide a mechanism to proactively identify important tax policy issues that will impact Canadians. It may serve to alert government to issues that may not necessarily be on its radar, while providing government the opportunity to tackle such issues before they become unmanageable. If such a forum had been available to the public when the income trust boom was in its early stages, it may have helped to avoid some of the problems that developed. There was certainly no lack of warnings by tax experts and industry analysts that there were serious problems on the horizon with trusts. The resulting tax leakages were placing a heavy burden on ordinary taxpayers, who were forced to shoulder an ever increase amount of the load for public services, while many wealthy investors and income trust insiders were reaping the financial benefits.

An Ombudsman that would allow consumer to voice their concerns over questionable tax loopholes and other potentially threatening tax policies would allow for a consumer voice in an area that has traditionally operated in secrecy, behind closed doors. The government has already indicated that the Ombudsman role would only extend to addressing individual taxpayer complaints regarding service-related matters. PIAC feels that this approach is too narrow and unnecessarily restricts consumer voice in tax policy development.

Recommendation #3: Creation of a Governance Structure for Income Trusts

The weak disclosure and reporting requirements for trusts are inadequate – especially given the strict requirements imposed on their corporate cousins. Moreover, these lax requirements have allowed small and unsophisticated investors to be misled by income trust promoters. Seniors have been hit especially hard, with some investing as much as 90 percent of their retirement savings into trusts. Warnings regarding the lack of investor protection in the trust sector have been sounding for years; with some of the most respected independent actors in the investment community, including Standard & Poor's, adding their voice to the growing chorus of concern.[228] Yet, despite these warnings, little has been done to curb the heavy-handed (and possibly dishonest) marketing and reporting activities of trust managers, marketers and investment firms.

Trusts are created by a "Declaration of Trust" and are not subject to statutory corporate laws such as the Canada Business Corporations Act (CBCA). Publicly traded trusts are subject to the same provincial securities legislation, regulation and corporate governance standards as other

---

[228] Toby Sanger, "Flaherty finally did the right thing on income trusts" *The Toronto Star* (2 November 2006).

Canadian public companies.[229] This, however, does not mean that unitholders of income trusts are provided the same level of protection as their shareholder counterparts.

Following an Access to Information (ATIP) request submitted to the Department of Finance, PIAC received a 2005 memorandum by Goodmans LLP, prepared at the request of Industry Canada.[230] The Goodman's memorandum contained a report that compared the declarations of trust ("DOTs") of a representative sample of income trusts to comparable governance provisions of corporations under the *Canada Business Corporations Act* (CBCA). The comparison focused on the duties and liabilities of trustees, disclosure and communication with unitholders, rights and remedies of unitholders, and whether the management structure of income trusts present particular challenges to corporate governance. The Goodman's study compared the DOTs of 54 income trusts from all sectors of the industry and evaluated them against 21 chosen criteria. The report found that the main differences between the DOTs and the CBCA provisions related to unitholders rights and remedies. The report ranked the performance of the DOT according to a scale of "A", "B", or "C" – with "A" meaning that the DOT offers more protection of governance concerns than is provided for in the CBCA; "B" meaning that the DOT offers a substantially similar level of protection; and "C" meaning that the DOT fails to provide the same level of protection as that afforded under the CBCA. Under the 21 categories of provisions examined, the report found only 4 instances of an "A" ranking, 19 instances of a "B" ranking, and 12 instances of "C" rankings among DOTs.[231] Thus, the majority of the DOTs examined provided a substantially similar level of protection in the majority of the categories evaluated. However, the report also revealed that there were certain categories in which all or substantially all of the DOTs evaluated provided <u>no form of protection</u>. For instance, 53 out of the 54 DOTs did not provide for proposals by unitholders[232]; 53 DOTs did not provide for the right to dissent for fundamental changes[233]; none of the DOTs provided for the right to bring a derivative action[234]; and none of the DOTs provided for the right to exercise an oppression remedy.[235]

---

[229] "Governance Should be Top of Mind" Deloitte & Touche LLP, online: <http://www.deloitte.com/dtt/article/0,1002,sid%253D70880%2526cid%253D150315,00.html?theme=trusten>.
[230] Memorandum submitted by Goodman's LLP to Industry Canada, entitled "Governance of Income Trusts in Canada" (31 December 2005), obtained by PIAC from the Department of Finance as part of an Access to Information Request [Goodman's Report].
[231] Specifically, the Goodman's Report found that at least one of the 54 income trusts sampled had DOTs that received a "C" ranking in following areas: quorum, removal of directors, material interest of trustees, financial disclosure, the removal of auditors, notice of shareholder meetings, proposals, ability of a minority of unitholders to call meetings, unitholder approval of fundamental changes, right to dissent, availability of derivative actions, and availability of an oppression remedy. See Goodman's Report, *ibid* at p. 1-7 (Schedule A).
[232] Under the CBCA, shareholders who are entitled to vote may submit notice of a proposal to the corporation and may discuss any related matter at a meeting (subject to exceptions). The proposal must be set out in the management proxy circular. See Goodman's Report, *ibid* at p. 5 (Schedule A).
[233] Under the CBCA, shareholders who oppose fundamental changes approved by special resolution are entitled to demand to be paid the fair value of their shares. See Goodman's Report, *ibid* at p. 7 (Schedule A).
[234] Under the CBCA, a complainant (shareholder, director/officer, or other person) may apply for leave to bring an action in the name of, or on behalf of, the corporation. See Goodman's Report, *ibid* at p. 7 (Schedule A).
[235] Under the CBCA, a complainant may apply to court for remedy if the business and affairs of the corporation have been carried on, or the directors' powers exercised, in a manner that is oppressive, or unfairly prejudicial to, or unfairly disregards the interests of, any securityholder, creditor, director or officer. See Goodman's Report, *ibid* at p. 7 (Schedule A).

Thus, according to the results of the Goodman's report, it can be said that there are three general areas where trusts fail to provide for the CBCA equivalent rights and remedies:

1. Shareholder Proposals
2. Dissent Rights; and
3. Oppression Remedy and Derivative Actions.

As previously mentioned, PIAC believes that the trust industry is urgently in need of mandatory governance standards, similar to those already in place for corporations. Moreover, the trust industry ought to be governed by its own federal statute, such as an 'Income Trust Act' that would oversee (to the extent possible jurisdictionally) all necessary rules and regulations for the operation, unitholder rights, and performance reporting of the income trust sector.

Such an undertaking has been underway for some time, with the Uniform Law Conference of Canada's release of a draft *Uniform Income Trusts Act*, which provides a framework for governing trusts.[236] Unfortunately, progress seems to have halted, as the proposed Act is still in draft form, and there has been no indication to date that the government is even thinking about enacting similar legislation. Further, the draft Act does not contain requirements for minimum governance standards. The draft Act should therefore be revived once the political dust settles and reworked to provide comprehensive regime for the income trust sector that parallels present levels of corporate regulation.

Recommendation #4: Mandatory Governance Structures for New Security-Issuing Entities

Many of the hardships that have arisen from the lax investor protections associated with income trusts could have been avoided. There should have been a requirement that any type of new security-issuing entity have a governance structure in place to protect investors and the industry as a whole. The governance structure should include such things as the rules and regulations specifically defining: reporting requirements, marketing requirements for securities, a standardized methodology for calculating performance measures, and a set of standardized terminology, especially if new terms are introduced (such as "distributable cash" for income trusts).

The new governance structure should be comparable to those that exist for well-established business structures, such as corporations. These well-established business structures, have benefited from years of tried and tested rules and regulations. Thus, it makes sense that when a new, innovative corporate structure appears on the marketplace, it should be required to develop a governance structure that is broadly comparable to its well-established counterparts (taking into account considerations for differences in structure and operations). This way, rather than having no governance structure to speak of, investors can at least be assured that certain standard protections are in place that are broadly comparable to the more familiar existing corporate

[236] "Governance should be top of mind" Deloitte & Touche LLP, online: <http://www.deloitte.com/dtt/article/0,1002,cid%3D150315%26pv%3DY,00.html>.

structures. Thus, when a new corporate structure appears, it should automatically have a governance structure in place to govern the new security-issuing entity – whatever its form.

Recommendation #5: Increased Consumer Awareness of the Financial Industry

The vast majority of consumers are not financial gurus, and have little time to invest in educating themselves of the complexities of the investment market. Some rely on investment advisors, while others choose to wade through the complexities of the stock market on their own. Regardless, the investment landscape can be daunting - even to the seasoned professionals. Many new investors can feel overwhelmed by endless choices, evaluating and weighing risks, learning to track their assets, complicated prospectus language, and the general flood of complex information.

Although it is not realistic to expect all consumers to become financial experts, it is important that they have a certain level of comfort in the stock market before they risk their hard-earned money. This is why it is important that consumers be given the proper resources to make informed financial decisions. PIAC believes that the federal government, through the Financial Consumer Agency of Canada (FCAC), could serve as an important source of independent financial information for Canadian consumers. The FCAC was established in 2001 by the federal government "to strengthen oversight of consumer issues and expand consumer education in the financial sector."[237] It is an independent federal agency that works to protect and inform consumers of financial services. According to the FCAC website, the agency "provides consumers with accurate and objective information about financial products and services, and informs Canadians of their rights and responsibilities when dealing with financial institutions."[238] As such, PIAC feels that it is within the FCAC's mandate to provide important financial information to consumers on investing in the stock market, the rights and responsibilities of investors, and information on emerging investment structures and their benefits and risks to consumers.

Below, PIAC has complied a list of risk factors associated with income trusts that are, perhaps, not commonly known to the average consumer. It is hoped that in the future, this type of important consumer information will come from a consumer protection agency, such as the FCAC.

Risk Factors Associated with Income Trusts

1. No Guarantee of Profit: It is important for consumers to remember that income trusts are equity investments that carry risks. They are not fixed income securities. As such, they share many of the same risks as stock ownership. The operating risk of each trust is based on its underlying business, and as with stocks, the higher the distributions (or yield), the higher the risk. Income trusts do not guarantee minimum distributions or a return of capital. If the underlying business loses money, the trust can reduce or even eliminate distributions. The

---

[237] See the Financial Consumer Agency of Canada (FCAC) website at: <http://www.fcac-acfc.gc.ca/eng/about/default.asp>.
[238] *Ibid.*

reduction or suspension of distributions can spell disaster for investors, as such occurrences are usually accompanied by sharp losses in the trust units' market share.

2. Over-Valuation: When distributions to unitholders include the return of capital, the investor is merely receiving his own capital back through the distributions. The unit valuation is most frequently derived from a multiple applied to the whole distribution; as such, units may be priced above their economic value.[239] As previously discussed, studies have suggested that prior to the government's new tax regime for trusts, they were trading at values that far exceeded their corporate counterparts. It is unlikely that the high valuations are accurate reflections of the true value of the underlying business.

3. Inappropriate Business Structure: When businesses make organizational decisions based on tax benefits, as opposed to a proper business case, it can result in the selection of an inappropriate business structure for the continuing needs of the business. Income trusts pass income directly on to unitholders through distributions, rather than reinvest in the underlying business. This means that income trusts necessarily forgo the retention of capital for such things as growth, expansion, innovation and development. Although some of the better trusts will retain a certain amount of capital for growth, it is usually minimal. In some cases a trust can become a wasting asset. Because many income trusts pay out more than their net income, the shareholder equity (capital) may decline over time. For example, according to one recent report, 75 percent of the 50 largest business trusts in Canada pay out more than they earn.[240]

4. Exposure to Regulatory Changes: To the extent that the value of the trust is driven by the deferral or reduction of tax, any change in government tax policy may remove the benefit and will likely reduce the value of the trusts.[241] Given that the amendments to the *Income Tax Act* have yet to be passed by Parliament, there is still considerable uncertainty with regards to what the final legislation will entail. This uncertainty should serve as warning to investors that the current income trust market is far from stable.

5. Liability: Depending on the local regulations, income trusts may be considered partnerships that do not provide the same limited liability protection as common stocks. Not every province has enacted Limited Liability Acts, so investors may not be fully covered.

6. Lack of Diversification: Unlike mutual funds, income trusts are generally single-sector or even single-enterprise. As such, investments may be acutely sensitive to business cycles, especially for real estate and commodities. Investors should be careful not to ignore the basic rule of investment risk management - *diversification*.[242]

---

[239] "Income Trust" Wikipedia, online encyclopedia, online: <http://en.wikipedia.org/wiki/Income_trust>.
[240] "Who should you trust on trusts?", *Financial Post*, November 23, 2005.
[241] "Impact of changes to trust taxation" Deloitte & Touche LLP, online: <http://www.deloitte.com/dtt/article/0,1002,cid%3D137724%26pv%3DY,00.html>.
[242] "Income Trust" Wikipedia, online encyclopedia, online: <http://en.wikipedia.org/wiki/Income_trust>.

Recommendation #6: Proposed Regulatory Treatment of Tax Consequences

The Department of Finance should consult on regulatory treatment of major tax structures such as income trusts to assist in consistent approach across provincial and federal regulatory boards of regulated industries. Finance should issue policy statements or circulars indicating the intent of tax legislation and policy to assist regulators in this regard. Such an approach would avoids endless proceedings deciding whether income tax efficiencies and inefficiencies are dealt with in regulatory proceedings and their effect counted or not in ratemaking. Due to questions of jurisdiction and constitutionality, regulators of course would be free to fine-tune the regulatory response to their situation. However, by turning its mind to this question, Finance would be in a better position to judge the downstream effects of its tax policy on taxpayers in their ratepayer role and companies in their regulated industries role. This guidance process could be added as part of the regulatory overview part of the legislative process.

Recommendation #7: Increased Transparency for Tax Policy

PIAC experienced its own difficulties in using the *Access to Information Act* to request for tax policy documents. In particular, the use of the "materially injurious to the financial interests of a government institution" or which "could reasonably be expected to result in an undue benefit to any person"[243] exemption in the context of the income trusts file appears out of place, as the making of such large scale tax decisions is a fundamental right of electors in a free and democratic society. In particular, this exemption, while perhaps justified before the announcement of the taxation of income trusts,[244] seems unnecessary after such an announcement. Hiding information from scrutiny in the name of the "economic interest of Canada" unjustly deprives Canadians of the right to judge the actions of their government on their management of public finances. Removing the right of the government to rely upon this exception when dealing with requests for information about large issues of domestic tax policy, where the public interest in disclosure outweighs the interest in secrecy, would encourage a more pro-active public discussion of tax policy challenges. Finance secrecy should be sparingly used at all times. Here it is a burden – a potentially very costly one for Canadian taxpayers and investors, as the income trusts fiasco has so ably demonstrated.

---

[243] *Access to Information Act*, s. 18(d), specifically subsection 18(d)(iii).

[244] The exemption appears to be written to avoid situations where secrecy is required to prevent a windfall to investors akin to insider information trading in the corporate world, or to avoid speculation on the market in the run-up to an announcement like the income trusts one. It loses force after the secrecy "moment" has passed.

CONCLUSIONS

Income trusts were products of flawed taxing regime that caused a distortion that, had it been allowed to continue, would have jeopardized the economic health of the government and skewed the design of corporate operations to the detriment of the country as a whole. Inevitably, the heavy tax imbalance between trusts and corporations led to mismatches between economic efficiency and taxation. The differential tax treatment associated with income trusts was causing a measure of tax leakage that threatened to overwhelm the federal treasury. Although the exact amount of the tax leakage is open to debate (since the government is unwilling to make public its calculations), there is little doubt that whatever the figure, it meant a decreasing amount of tax revenue for both federal and provincial governments – tax revenues that go to funding, among other things, essential government services, such as health care and education.

Moreover, the tax imbalance was creating artificial incentives for corporations to convert to trusts. The record of ongoing and planned conversions appeared to justify the governments' fear of mass corporate conversions. It is likely that the twin conversions of two of Canada's largest corporations, TELUS and BCE, would have resulted in a domino effect throughout major sectors of the Canadian economy. Spurred on by shareholder desire for quick profits, business owners seemed all too willing to the incompatibility of income trust structure with the needs of most businesses. Yet, despite the seemingly narrow field of candidates, corporation after corporation, from all sectors, were lining up to convert. Bank of Canada Governor, David Dodge, went so far as to suggest that the inefficiencies caused by inappropriate trust conversions led to productivity constraints of the companies involved, and this would "eventually" erode the potential for productivity growth in the broader economy.[245]

The feared declines in productivity and entrepreneurial activity were reason enough to stop the continued onslaught of trusts. Large profits had already been made by cannibalizing businesses of their investments and future returns through the use of the income trust. Commentators have equated it with a modern-day financial plundering of corporations. One such analyst has noted:

> "The people working in these corporations are being converted from being entrepreneurs in the larger sense of the word into broom-wielding caretakers of slowly depleting assets."[246]

Hayward's characterization of income trusts as "lazy capitalism" also aptly describes the trust phenomenon.[247] Making money, by simply converting one form of corporate security to another, without adding significant value to the economy is relatively little work for high reward. However, while it may be arguable that the income trusts industry deserves to be deprecated in this fashion, it is clear that the trusts' economic effects of boosting consumption at the expense of capital investment were potentially ruinous. It is difficult to believe that the supposed benefits

---

[245] "Bank of Canada statement on income trusts" *Reuters* (1 February 2007).
[246] Ross Healy, "A Critical Look at Income Trusts" Strategic Analysis Corporation (April 2004) at 2-3.
[247] Paul Hayward (2002), "Income Trusts: A Tax-Efficient Product or the Product of Tax Efficiency", *Canadian Tax Journal,* 50(5).

of enhanced market completeness could offset the potentially serious threat posed by trusts to the long-term health of the economy.

However, it is clear that investors had grown addicted to their high-yield returns from income trusts. Wealthy investors trust managers and investment bankers had grown to expect the profits of income trusts. As one commentator put it: “If you’ve missed the income trust bonanza, you’ve missed one of the great portfolio-puffing opportunities of recent decades.”[248] Thus, it is little wonder that those who have rode the income trust wave are the very same people who are now in the forefront of those opposing the government’s decision to tax trusts.

However, it is not simply the rich that are angry over the government’s change of tax policy. Seniors were hit hard by the news – many with significant proportions of their retirement savings tied up in trusts. No doubt, some of the upset is a matter of public trust: the Conservative government initially told Canadians that it had no intention of taxing trusts, making it an election campaign issue

Yet, while some have made the government the scapegoat for the hardships of investors, there is reason to believe that a large part of that outrage should be directed at the investment professionals, whose aggressive marketing of trusts and investment advice led inexperienced investors to believe that the trust tax loophole was secure. This caused such investors to ignore the basic rule of risk management – investment diversification. Trust managers whose dubious reporting has led to an overvaluation of the value of trust units on the stock market should also not escape censure. In the words of Ross Healy, CEO of Strategic Analysis Corp. and long-time critic of income trusts:

> [The only way they could be sold at the price levels that they were, and are, is if they’re sold to unit holders of income trusts who believe, I think, that the word ‘trust’ means something… The term trust, as in income trust, carries a very unfortunate connotation that many buyers will live to regret.[249]

In the end, those who treated income trusts as if they were fixed income securities and ignored the inherent risks of investing, got burned. It is ironic that their enthusiastic participation in trust investment probably doomed the long-term survival of the income trust.

However, not every income trust is going to be flattened by the new tax rules. Quality income trusts are still likely to be good investments; just not as high yielding as they used to be (the average yield on trusts before the October 2006 tax change was more than three times the average dividend yield on stocks trading on TSX). And, since the government has to date, refused to clamp down on the widespread reporting abuses and weak investor protection in the trust industry, the overvaluation of trust units is likely to continue, at least until the new tax rules take effect in 2011. Nevertheless, investors have the next four years to take advantage of the tax holiday on existing trusts, and many are still enjoying relatively high yields.[250]

---

[248] Eric Reguly, “Capitalism for Slobs” *The Globe & Mail*, Report on Business (March 2005).
[249] “Income trusts overvalued, study says” *The Globe & Mail* (23 November 2005) online: <http://www.theglobeandmail.com/servlet/story/RTGAM.20051123.wtrusts1123/BNPrint>.
[250] Mathew Ingram, “The dust has settled” *Trade By Numbers Magazine* 4:4 (April 2007) at 1.

The denouement of the income trust may not necessarily create a happy ending for this, or succeeding governments. The threat of increased foreign takeovers may well be real. In the government's rush to stop the flood of lost tax dollars, it may have left the door open for foreign firms to go on a feeding frenzy of Canadian trusts. If the acquisition of Canadian trusts by foreign firms continues at its present pace, the country may lose more than tax dollars. However, it is unclear whether the trust sector is being targeted by outside firms because of the change in tax regime, or whether it is simply, as Prime Minister Harper has suggested, that the underlying businesses are attractive to foreign investors.

Another worrisome trend, unaffected by the government's new trust taxing policy is the lack of governance practice standards in the trust industry. Despite a general consensus in the marketplace that some kind of legislation or regulation is needed to remedy this situation, the government has yet to even mention the need for such reforms.[251] What is needed is a set of mandatory standards that would govern the income trust industry, similar to those governing corporations.

The legislating of such mandatory standards should be incorporated with the government's tax fairness package which itself also requires improvement. Now that the government has decided to act on trusts, it needs to do so in an open and transparent manner. The new tax regime needs to be clear to all stakeholders. If the government wants a smooth transitioning to the new rules for trusts, much more clarity is needed on some of the finer points of the new policy.[252]

There are a number of lessons that can be learned from the checkered history of the income trust. First, previous governments should have acted to close tax loopholes sooner, rather than later. Secondly, political parties must exercise more care in the election promises made, especially when the retirement savings of millions of investors is at stake. Finally, the government should chose to protect the public and investors at the first sign of unfair practices and should not attempt to slough off responsibility onto self-regulatory bodies.[253]

At the end of the day, most Canadians now see the income trust controversy for what it is – the debate about a tax loophole, the importance of which ballooned in size thanks to governments that were asleep at the wheel. Now that it will be closed, it is hoped that business operators will go back to being entrepreneurs, that investments in their businesses will be societally productive, and that investors will be better informed and protected when the next investment bandwagon rolls through the market. We can do something to make that happen: take responsibility for tax policy as citizens, consumers, investors, taxpayers and voters.

[251] Gregory Chrispin, "Income Trusts: The Changing Canadian Landscape" State Street Global Advisors (31 May 2005) online: http://www.ssga.com/library/esps/gregchrispincanadianlandscape20050531/page.html>.
[252] Carrie Tait, "Still seeking clarification on income trust rules" *The Financial Post* (12 January 2007).
[253] Toby Sanger, "Flaherty finally did the right thing on income trusts" *The Toronto Star* (2 November 2006).