

“The Insanity of Income Trusts”

Part 1

Taxation and the Valuation Premium

The TAMRIS Consultancy

April 2007

CONTENTS

1

INTRODUCTION 4

2

TAX LEAKAGE & OTHER FUNDAMENTAL DYNAMICS..... 7

2.1 DYNAMICS AT THE CASH FLOW AND THE PORTFOLIO LEVEL 7

 2.1.1 *The dynamics and complications of capital consumption and time*..... 8

2.2 THE COMPLEXITY OF CALCULATING TAX LEAKAGE 8

2.3 TAX DEFERRED VERSUS TAX EXEMPT..... 10

3

THE TAXATION ARGUMENTS..... 11

3.1 MINTZ AND AGGARWAL..... 11

3.2 DEPARTMENT OF FINANCE 11

3.3 HDR/HLB DECISION ECONOMICS “TAX REVENUE IMPLICATIONS OF INCOME TRUSTS” 12

3.4 THIRD LEVEL, INDUSTRY PRO INCOME TRUST GROUP ARGUMENTS 12

 3.4.1 *CAIF, A recipe for tax revenue loss by Yves Fortin* 13

 3.4.2 *BMO “The Inconvenient Truth About Trusts”* 14

 3.4.3 *RBC December 2006*..... 15

4

TAMRIS MODELS & ANALYSIS 18

4.1 THE MODEL’S DYNAMICS AND ASSUMPTIONS 18

 4.1.1 *A simple growth model*..... 18

 4.1.2 *Additional modeling assumptions* 20

 4.1.3 *Basic modeling process* 22

 4.1.3.1 Tax deferred/tax exempt 23

 4.1.3.2 Accumulated tax liability and latent tax calculations 23

5

SCENARIO MODELLING & RESULTS 24

5.1 YVES FORTIN CAIF REPORT 24

 5.1.1 *Yves Fortin CAIF Scenario 1 – Return of capital taxable*..... 24

 5.1.1.1 Accumulated tax liability – return of capital taxed..... 27

5.1.2	<i>Yves Fortin CAIF Scenario 1B – return of capital taxable</i>	28
5.1.3	<i>Yves Fortin CAIF Scenario 2 – Return of capital not taxable</i>	30
5.1.3.1	100% shares 100% income trusts	31
5.1.3.2	Accumulated tax liability – return of capital not taxed	33
5.1.4	<i>Yves Fortin CAIF Scenario 2B – return of capital not taxed</i>	34
5.1.5	<i>Yves Fortin CAIF Scenario 3 - RRSP</i>	37
5.1.5.1	RRSP tax analysis	40
5.1.6	<i>Yves Fortin CAIF Scenario 3B - RRSP</i>	40
5.1.7	<i>Yves Fortin CAIF Scenario 4 - 2011</i>	42
5.2	BMO	47
5.2.1	<i>BMO Scenario 1 – taxable accounts</i>	47
5.2.1.1	Accumulated tax liability – taxable accounts	50
5.2.2	<i>BMO Scenario 1B – return of capital taxable</i>	51
5.2.3	<i>BMO Scenario 2 – taxable accounts, return of capital not taxable</i>	53
5.2.4	<i>BMO Scenario 2B – return of capital tax free</i>	55
5.2.5	<i>BMO Scenario 3 – lower rate taxpayers</i>	57
5.2.6	<i>BMO Scenario 4 – RRSP</i>	59
5.2.7	<i>BMO Scenario 4B - RRSP</i>	64
5.2.8	<i>BMO Scenario 5 – Post 2011</i>	65
5.3	CERTIFIED GENERAL ACCOUNTANTS	65
6		
<hr style="border: 1px solid black;"/>		
MODELING CONCLUSIONS		68
6.1.1	<i>Taxable accounts</i>	68
6.1.1.1	No valuation premium no return of capital	68
6.1.1.2	Valuation premium, return of capital taxed	68
6.1.1.3	Valuation premium, no taxation of return of capital – purchase post conversion or at IPO.....	69
6.1.1.4	Valuation premium, no taxation of return of capital – purchase pre conversion	70
6.1.2	<i>Tax exempt accounts – purchase post conversion or at IPO</i>	70
6.1.3	<i>Tax exempt/deferred accounts – purchase pre conversion</i>	70
6.1.4	<i>Post 2011</i>	70
7		
<hr style="border: 1px solid black;"/>		
CONCLUSION		71

Introduction

The first of a string of in depth reports on income trusts, this report provides a structural analysis of the income trust versus corporate taxation debate from an alternative perspective.

The report directs its principal analysis from a relative valuation (*corporate security valuation relative to income trust security valuation*) and hence portfolio perspective (*assessing impact of valuation differentials on portfolio taxation, risk, return and at the margin asset allocation*) with a focus on price paid per unit of earnings and total tax per unit of initial capital invested. In other words how much tax is paid by the individual investor, how much tax can continue to be paid and what is the impact on tax and return of the two different structures at the portfolio level.

At a technical level it does this by integrating the income trust valuation premium into a simple comparative model which analyses the basic relationships between the two structures (*income trusts and corporate structures*) and the impact of cash distributions and equivalent withdrawals¹ (*for portfolios based on corporate structures*) for a given set of assumptions which include variable valuation premiums, variable corporate and income tax rates and variable tax treatment of return of capital.

The report will also touch on the dynamics of the total taxation equation, since the dynamics are important in defining overall taxation, economic and investment return.

While investors may consume capital, the way in which capital is consumed is different for the corporate structure (*ownership rights to capital are sold for cash but capital is not generally systematically consumed at the business level*) and income trust structure (*capital is generally and systematically consumed at the business level while ownership rights are retained*).

One of the problems with the entire income trust debate is that it does not just centre on the amount of taxation that is paid on cash flows from corporate and income trust structures, or the ability of those structures to generate future tax revenue. It has come to rest on claims that income trust investors are paying significantly higher levels of personal taxation via their allocation to income trusts and via tax deferred accounts in particular and, that this is positive for investors' financial security and government fiscal policy.

In fact the lines of argument with regard to the taxation of income trusts and the justification of that taxation have become **blurred** and **selective**. The original tax arguments stated that income trusts led to tax leakage at the statutory rates, with the greatest tax leakage at the tax exempt/tax deferred and foreign investor level, which is correct and which the modelling in this report confirms. The counter argument stated that well maybe at the taxable and foreign investor level, but not at the tax deferred/tax exempt level because of the future net present value of future tax arising from these accounts. The second set of arguments had therefore switched from the taxation of cash flows to the taxation of capital, which is slightly different. The second set of arguments led to the final complexity, the third set of arguments that income trusts provide both higher levels of taxation and higher levels of return².

In fact, income trusts, at a fundamental level only lead to higher levels of taxation and higher levels of return for one set of investors in specific and restricted circumstances.

According to many, income trusts have financially enfranchised the Canadian private investor. This report in tandem with future reports argues otherwise and **concludes** that at a fundamental level income trusts

¹ The net after tax income trust cash distribution is used as the withdrawal for the corporate option; withdrawals equal dividends and interest plus capital withdrawn from cash and bonds or equities.

² By switching to the taxation of capital we also switched to the dynamics of taxation over time and the impact of the consumption and the recycling of capital which has economic and tax impacts.

should only ever have been sold (sell high) and not bought (buy low).

The report will briefly discuss a) the issue of tax leakage, b) the fundamentals of taxation of cash flow (business level) and capital and cash flow (the portfolio level), c) the complexity of determining precise tax leakage calculations and d) the three sets of arguments discussed above and summarised below.

- 1) Those arguments determining tax at the cash flow level.
- 2) Those arguments determining tax at the both the cash flow and the portfolio level.
- 3) The third set of arguments from the pro income trust lobby groups and financial institutions that state income trusts provide both higher taxes and greater total return benefits to investors.

The report will then draw on the assumptions and arguments used by the pro trust groups to model the nature of tax and return between the two competing business and investment structures within a portfolio context relevant to the private investor.

- The report will conclude that for taxable accounts the selection of income trusts (at the portfolio level) for purchasers of income trusts results in significant less tax being paid over the long term on a per unit of initial capital invested basis and that the valuation premium accorded by tax exemption poses a cost to taxable investors that over the full market and economic cycle dwarfs the “supposed” tax benefits.
 - The report will also conclude that for this group of investors, under certain assumptions, income trusts do in fact yield an initial higher level of taxation for non tax exempt accounts at both the cash flow and the portfolio level but that this is ephemeral at the portfolio level.
- It will argue that for existing holders of equities that continue to hold the income trust post conversion and IPO, the total tax paid and the return achieved are both higher than for a straight corporate investment but that return is only higher if return of capital is not taxed.
- The report will argue that at the portfolio and the cash flow level that the tax leakage on income trusts within tax exempt/deferred accounts is significant. The tax leakage equation at the tax exempt/deferred account level is very much influenced by the valuation premium accorded to tax exempt cash flows and the dynamics of this relationship as well as the accumulated liability³ of corporate tax foregone. The tax exempt/deferred account is in fact a complex case since it is not the earnings of the corporate or income trust structure that is taxed but the capital value withdrawn from these plans.
 - The report will dispute the arguments made by income trust proponents that deferred income trust taxation within tax exempt accounts results in a higher level of taxation from income trusts.
 - On the contrary, at higher valuation premiums, within the structural confines of the models used in this report the corporate structure can deliver the two objectives of higher taxation and total long term return⁴ more effectively than an income trust structure.
 - Even from the perspective of the original holder of the corporate structure, the total tax take from income trusts and the accumulated opportunity costs foregone means that the corporate structure is likely to yield a higher level of taxation.

³ Tax revenue not received needs to be borrowed in the fixed interest market at a cost which needs to be accounted for and accumulated.

⁴ At consensus valuation premiums; the lower the valuation premium the less effective the corporate structure within a tax exempt account at beating the total return from the income trust structure.

TAMRIS; Independent, Impartial, Objective

- The report does conclude that the proposed taxation of the income trust structure, post 2011, places the new income trust holder at a significant disadvantage to the corporate structure if the effective corporate tax rate on taxable earnings⁵ is in fact well below the statutory rate and if, which seems to be the case, income trusts do not correctly quantify return of capital. However the report argues that to use this as an argument to retain the income trust structure and format is ill informed.

This report as with the other reports in the TAMRIS series will argue that the supposed tax benefits of income trusts were never more than a device to engineer higher valuations for existing investors or insiders. There have without doubt been a number of accommodating factors that have helped sustain the income trust illusion and these are discussed in later reports.

The report does not attempt to specify the exact amount of taxation that income trusts and corporations and investors pay, nor does it attempt to calculate a specific amount for tax leakage. This report is part of a series of reports that will address wider economic, structural, valuation and regulatory issues. As such reference will be made to technical details and analysis that will be dealt with in these later reports.

The TAMRIS Consultancy has never felt that the amount of tax levied at a point in time has been the central issue of income trusts. It has been more concerned over the fundamental nature of their valuation, their risks and their returns within the portfolio and the financial services industry's misrepresentation of their valuation, their risks, their returns and their rationale for being.

This report does not argue that businesses should not be distributing cash flow or that they should not be returning capital to varying degrees. It argues that paying high valuation premiums for the privilege does not make sense and it argues that the overall tax and return argument from a portfolio and investor perspective is weighted firmly in favour of the corporate structure. In this context the interest of those selling income trusts and those facilitating the sale of income trusts are contrary to the interests of the private investors who have been buying them.

Finally the report does not argue that investors do not have cause for complaint. They have many but their ire should be directed towards a financial services industry and those who have latched onto the coattails of that industry. After all the difference between the tax take from an income trust and the tax take from a corporation is dwarfed by the annual fees, transaction and commission costs levied by the financial services industry on income trusts and by the returns to those institutions and private equity investors who were able to take advantage of the loophole to sell at a far higher price.

⁵ Note this is not the corporate tax to EBITDA rate fondly used by many when discussing the difference between taxation on income trusts and corporations.

Tax Leakage & Other Fundamental Dynamics

The issue of how much taxation corporations and income trusts are responsible for has at times resulted in heated debate. In a recent revision to his estimate of potential tax leakage (made just prior to 31 October 2006) Professor Jack Mintz estimated that potential tax leakage would rise to \$1.1bn if the BCE and Telus conversions had gone ahead. As a percentage of total corporation tax \$1.1bn is close to 4% of the total corporation tax take.

But, let us define exactly what tax leakage is and what it means. Tax is government revenue used to fund government expenditure. Economic output that is not taxed ends up in the hands of individuals and corporations who make their own spending decisions. Placing a higher level of economic output in the hands of individuals and corporations will result in changes in investment, consumption, savings, output and the balance of trade. Private individuals and corporations do not independently finance federal and provincial government services. Where there is tax leakage a government will need to borrow to fund the gap between its expenditures and its revenues.

On the other hand governments will often reduce personal and corporate taxation to stimulate consumption, savings and investment. Therefore any tax leakage is also likely to have an impact on economic activity and hence may well result in higher future government tax revenues.

Changes in taxation need to bear in mind the current and long term economic imperatives since changes in taxation can also have unwarranted consequences. Overly exploited tax loopholes represent unplanned changes in government economic and fiscal policy that can have significance well in excess of the immediate tax take.

Since taxation of an economic activity can significantly affect its relative attractiveness to capital, loopholes may not only reduce the tax take but may also cause undesirable economic distortions. Any government that wants to stimulate economic growth or efficiency in the economy will need to carefully plan changes in taxation.

Income trusts represented a tax loophole that was being overly exploited. This exploitation was set to expand to a level which could have significantly impacted the ability of the government of the day to make necessary changes to tax policy. It also challenged the government's right to make tax policy and the right of the public to vote according to the tax policy they wanted. Voters have the power to throw out the current government but they have no such power over the financial institutions that have exploited the tax loophole at issue. In the end it is the government of the day that should determine tax policy and not unaccountable special interest groups.

2.1 Dynamics at the cash flow and the portfolio level

At the cash flow level the taxation of earnings is simply the tax paid on taxable earnings and dividends distributed for a corporate structure and the taxable cash distributed by an income trust.

The taxation paid on retained earnings for the individual is at the portfolio level since this value is capitalised in the price of the security which is determined by the market and paid for by the individual. While earnings are determined by prices paid for goods and services, capital values are determined by the price that investors are willing to pay for the attached cash flows. As such capital gains tax paid on income trust and corporate share transactions in non taxable accounts and tax paid by tax exempt accounts on withdrawals are likewise determined at the portfolio level. In tax exempt accounts the taxation of interest, dividends and income trust cash distributions pass from the taxation of cash flows to the taxation of capital values within the portfolio. Therefore at the portfolio level we need to acknowledge the impact of valuation multiples (since they impact capital values) on the calculation of tax leakage at the portfolio level.

But the reallocation of portfolio demand and hence portfolio capital to income trust structures does not

necessarily impact cash flows, only their taxation and their valuation. At one level all that will happen is that the capitalised cost of other cash flows will fall as relative demand shifts increasing the return per unit of capital purchased on other assets and hence tax at the portfolio level for these assets while also enhancing long term total return on these assets. The sum total of cash flows remains the same.

The reallocation of capital at the business level will however impact cash flows. Companies with tax advantaged securities will be able to raise capital for investment limiting the ability of non tax advantaged securities to raise capital for investment. If capital resources are tied up in activities with lower returns on capital, this will ultimately result in a loss of tax revenue. Poor allocation of economic resources can impact long term economic growth and hence future tax revenue.

2.1.1 The dynamics and complications of capital consumption and time

What complicates the visualisation of the calculation of taxation at the portfolio level is the fact that capital is being consumed at the portfolio level (securities sold in exchange for cash) within a corporate structure and at the cash flow or business level in an income trust structure.

Within the modelling shown in section 5 income trust capital is being consumed at the business level through distributions in excess of earnings to consumers who spend this capital. In this modelling of income trust taxation at the portfolio level we will see the tax stream from the income trust holding declining over time. This is not a portfolio effect (that is the income trust holding is not declining because we are selling units for cash) but is the result of a decline in capital employed at the business level.

Within the corporate structure capital is not generally consumed at the business level. Instead the investor sells capital (shareholding) to other investors in exchange for cash which is either immediately consumed or invested in lower risk interest bearing assets.

Within the market place investor capital held in corporate entities is redistributed through the pricing of return on capital. Within the income trust structure, outside of the initial IPO or conversion, capital is being reallocated through consumption and expenditure of capital.

Therefore while a corporate holding within a portfolio may be consumed through the sale of shares the ability of the underlying business to generate taxable earnings is not affected. This is not the case with an income trust. Once you move beyond the taxation of cash flow at a point in time the calculation of the future stream of taxation becomes more complex. It moves into the realm of the efficient allocation of capital within the economy and the overall balance of consumption, investment, saving and output within the economy. Corporate capital is more likely to be recycled within the business while income trust capital is more likely to be immediately recycled within the economy.

While it makes perfect sense for mature low growth businesses to be recycling capital to higher growth areas of the economy it does not make sense to make to provide a tax advantage to these areas thereby encouraging a higher allocation of capital to these areas of the economy.

As such, while the earnings capability of income trusts that distribute in excess of earnings will deplete over time, all else being equal, the earnings potential of corporate investments will be determined by the rate of reinvestment and the return on that investment.

In order for the tax take from income trusts not to be depleted, new capital needs to be coming in at a rate that replaces the capital depleted in a manner that does not dilute the earnings per unit of existing holders. The reallocation of capital from mature industries to growth sectors of the economy impacts future economic growth and future tax revenues.

2.2 The complexity of calculating tax leakage

Over and above the issues raised above, the issue of whether income trusts pay a higher level of taxation

has become a complex one.

On the face of it, for taxable accounts, it should be a simple case of applying corporate tax rates to taxable earnings, income tax to dividends distributed and an allowance for potential capital gains tax on after tax earnings retained and then to compare this to the tax paid by income trusts and you have your answer. Likewise for pension or tax exempt accounts it should be a simple case of assessing the corporate tax paid on earnings and the potential income tax to be paid on both tax exempt corporate investments and tax deferred income trust investments.

For foreign investors it should also be a simple case of assessing the difference in taxation between what they would pay under the corporation tax regime and tax paid under the income trust regime.

Following the increase in the dividend tax credit in 2006, non tax exempt accounts were generally perceived to be tax neutral for tax exempt investors and the battle ground for tax leakage appeared to have shifted to tax exempt accounts. However, as noted in the Certified General Accountant's "Demystifying Income Trusts", whether more tax is paid via an income trust or not is not dependent on an individual's personal income tax rate which varies from province to province and the total corporation tax rate which is also impacted by varying provincial rates.

According to income trust proponents, corporations do not pay tax at the full corporate rate on earnings after interest, depreciation and amortization. Various estimates put the actual corporate tax rate as a percentage of taxable income at between 26% and 28%, although the TAMRIS consultancy has not seen a formal assessment of such. A lower effective corporation tax rate reduces the corporate tax take relative to income tax raised on income trust cash distributions.

Most of the studies that attempt to calculate the corporate tax leakage use historical corporation tax rates as a percentage of EBITDA⁶, instead of attempting to calculate tax yield at the individual corporation or income trust level. Use of EBITDA allows you to use historic tax, dividend and cash distribution data to develop general estimates of tax paid under both business structures.

Further complications arise due to the fact that income trusts also pay corporate taxes on income with some paying a significant amount. Additionally, income trust proponents argue that income trust cash distributions which on average exceed taxable earnings are much more highly taxed to the point that they argue that the return of capital component is so low as to be able to ignore it in comparable tax calculations. That which would ordinarily not be taxable within a corporate structure is within an income trust.

Analysis of income trust financial statements show that there is a very wide discrepancy between the return of capital quoted on the tax statements and the actual consolidated net earnings⁷ of the trust. Many trusts that distribute well in excess of earnings have little or no return of capital noted on their tax returns. Return of capital is therefore not only being misrepresented as return but is also being taxed. BMO's report, the "Inconvenient Truth About Trusts" quoted distributions of 1.6 times earnings with 87% of distributions being taxable. This raises the 45% income tax rate used in their analysis to an effective tax rate of 63% on income trust distributions.

The application of capital gains is also difficult. Many would include transitional gains on conversion from a corporate to an income trust structure in the calculation of total taxation arising from income trusts. However such gains are not only one off but they also represent the net present value of the capitalized tax advantage. In this case the gain would need to be a) netted against the gain on the competing share structure not realized over the modeling period and b) apportioned over the time frame in which the discounted present value would apply, c) adjusted for tax exempt holders of shares that converted and tax exempt institutional holders and d) foreign and foreign private equity firms that would not be taxed on

⁶ What often confuses the issue is the use of corporate tax rates as a percentage of EBITDA and loosely comparing these rates to the full corporate tax rates applied to taxable income.

⁷ Although even here reported earnings within income trusts are impacted by future tax liabilities.

capital gains in Canada and, e) companies that benefited from deferral of capital gains tax via transfer of holdings to a limited partnership. Furthermore, this capital gain is only indirectly associated with the income trust structure and it is not something which would apply to those who purchased income trusts via Initial Public Offerings (IPO) and secondary issues⁸.

There are of course other factors which determine how much tax is or is not lost and these include the allocation of trust holdings between taxable and non taxable accounts and the allocation to business, oil and gas and REITS, all of which have different tax and return characteristics.

2.3 Tax deferred versus tax exempt

Please note that for the record the TAMRIS Consultancy believes that personal income taxes are deferred within pension funds and that taxation of capital gains and dividends are tax exempt. An income trust investment would be considered a tax deferred investment whereas a corporate structure would represent capital receiving both tax exemption and tax deferral.

⁸ In truth the capital gains tax paid on conversions is really the cost of the benefit to those who were able to sell at inflated prices.

The Taxation Arguments

There have been three main studies into tax leakage arising from “flow through entities” which include income trusts. There have also been a number of secondary assessments relating to the taxation of income trusts and corporations, some of which have put forward the argument that there is no tax leakage.

In 2003 Lalit Aggarwal and Jack Mintz reported their analysis of income trust revenue loss in their paper “Income Trusts and Shareholder Taxation: Getting it Right” which was revised in 2004.

In their 2004 revision Aggarwal and Mintz concluded that revenue loss to the government was forecast to be some \$600m in 2004 and in a possible nod to the HDR/HLB report of the same year, stressed that while there existed a wider range of possible outcomes, that the extremes of such outcomes were not reasonable estimates of tax loss or gain. In 2006 Mintz⁹ revised his estimate of annual tax leakage to include the potential tax loss from the planned BCE and Telus income trust conversions to \$1.1bn.

Aggarwal and Mintz’s arguments were countered by the Canadian Association of Income Funds in a report by HDR/HLB Decision Economics in 2004 titled “Risk Analysis of Revenue Implications of Income Trusts”, which was revised and updated in 2005.

In the 2005 report, HDR/HLB reported that the “Federal” tax loss of \$255m assessed in the Department of Finance’s own review was closer to \$71m. After adjusting for future reductions in corporation tax they even surmised that the loss would turn into a small net gain of \$56m. This small net gain included the impact of transitional capital gains. The HDR report therefore supported the pro income trust lobby group assertion that there was no tax leakage associated with income trusts.

The Department of Finance¹⁰ provided its own estimate of Federal tax loss for 2004 (\$300m and \$255m less revenue loss on REITS) in its 2005 Consultation paper “Tax and other Issues Related to Publicly Listed Flow-Through Entities”. These figures as with the HDR analysis did not include provincial tax leakage.

3.1 Mintz and Aggarwal

Briefly, the Mintz and Aggarwal methodology compared the difference between the sum of the corporate taxation on income trust EBITDA¹¹, taxation on dividends as a percentage of income trust EBITDA and capital gains tax on capital that would have otherwise been allocated to shares against the sum of taxation of taxable distributions from income trusts.

In other words, a) how much corporate tax would income trusts have paid out based on the average corporate tax take for that industry sector, b) how much tax would have been received on dividends distributed from EBITDA and, c) how much in capital gains would be received by investors turning over their holdings every 5 years. Mintz and Aggarwal’s analysis was both simple and direct and covered both provincial and federal tax leakage.

Mintz and Aggarwal used assessments of corporate tax as a percentage of EBITDA as the analytical tool for calculating tax leakage. The analysis itself was a predominantly cash flow based analysis.

3.2 Department of Finance

According to the Department of Finance in their 2005 report, their calculation of tax leakage depended very

⁹ Income Trust Conversions: Estimated Federal and Provincial Revenue Effects.

¹⁰ http://www.fin.gc.ca/toce/2005/toirplf_e.html

¹¹ Earnings before interest taxation and depreciation.

much on the allocation held by tax exempt investors and the effective rate of corporate tax on earnings before interest, depreciation and amortisation. It estimated the Federal tax loss to be some \$300m¹² (\$220m excluding REITs) in 2004 and \$500m in 2006¹³.

It also stated in the 2005 review that revenue losses would increase if corporations *“increasingly put their mature business assets in FTEs and keep the growing part of the business in a corporation. Corporations may, for example, put a portion of their mature business assets in FTEs and retain sufficient assets in the corporation to shelter capital cost allowance, exploration, development or other deductions of the corporation. This approach would allow the corporation to generate tax savings on most of its mature business assets through the FTE. This could result in little income tax being paid by the corporation.”*

Since the department of finance argument depended fundamentally on the role of tax exempt investors it was only natural that industry supporters of the income trust would focus on this particular area. Again the department of finance study was principally a cash flow based analysis.

3.3 HDR/HLB Decision Economics “TAX Revenue Implications of Income Trusts”

The HDR/HLB report acknowledged the sensitivity of tax leakage calculations to the potential variance in the assumptions used to calculate taxation. It considered the impact of these variances by developing a range of tax estimates that would reflect the tax paid under a range of probable different scenarios. They used an average of their estimates to form their assessment of the tax loss to the government¹⁴.

Aside from the statistical technique used to estimate the variance of tax loss, the major difference between the HDR/HLB report and the other studies was in their assessment of the deferred taxes on tax deferred accounts. In keeping with the pro income trust lobby group the report asserted that it was the omission to include future taxes from income trust holdings in tax deferred/exempt accounts that created the illusion of tax leakage.

However, it is here that the predominantly cash flow based analysis of tax leakage crossed over to the portfolio level since tax on tax deferred accounts is based on capital withdrawn at the portfolio level and not cash flow at the business level. The only way a discounted present value calculation of deferred taxes could result in a higher level of taxation for income trusts would be if the impact of the valuation differential on capital employed at the portfolio level was ignored.

By moving to analysing the impact of tax deferral within tax exempt/deferred accounts the HDR analysis moved beyond the confines of the Aggarwal and Mintz and the Department of Finance analysis to one that incorporated taxation from the portfolio perspective. This is subtle because it transferred the tax leakage argument from the tax loss or gain on the taxation of earnings to one of tax loss or gain on a unit of capital invested. This is important because it is logical that the pro income trust groups' tax arguments have evolved from this analysis and therefore their own arguments suffer from the same flaw. The TAMRIS modelling looks at both perspectives; including and excluding the impact of the valuation premium.

3.4 Third level, industry pro income trust group arguments

It should be noted that all the reports that counter the assertion that income trusts lead to tax leakage come from pro income trust ranks.

¹² http://www.fin.gc.ca/toce/2005/toirplf_e.html; http://www.fin.gc.ca/activty/consult/flwthruent_e.html;
http://www.fin.gc.ca/consultresp/flwthruent_29e.html ; http://www.fin.gc.ca/consultresp/flwthruent_36e.html

¹³ http://www.fin.gc.ca/news07/data/07-007_2e.html

¹⁴ They used a Monte Carlo (Latin squares) simulation to come up with their range of estimates. If the simulation was sufficiently large the extremes should be averaged out and the tax calculation would more or less be based on their central estimates. If this central estimate is based on inputs that are not too dissimilar from other studies, the tax analysis should more or less reflect that of other studies with the exception of tax on deferred tax revenues.

3.4.1 CAIF, “A Recipe for Tax Revenue Loss” by Yves Fortin¹⁵

This 30th January 2007 report from the Canadian Association of Income Funds made the following statements which laid the foundation for of their report’s subsequent analysis and conclusions.

- Trust distributions received by investors in their taxable accounts are presently taxed at a federal/provincial personal tax rate averaging about 38%. This is a significantly higher tax rate than the 27% effective corporate tax rate applicable to their earnings.
- Trust distributions are based on distributable cash flow and not on earnings. Distributable cash flow is about 1.5 times earnings. Dividends paid by corporations are based on their after-tax earnings. On average, only 28% of corporation earnings are paid out to shareholders in the form of dividends.
- Shareholders of public corporations pay very little tax on dividends they receive given the enhanced dividend tax credit and the fact that dividend yield rarely exceed 3%.
- If a trust reconverts to the corporate structure the government will only collect about 27% -- the effective tax rate according to Statistics Canada -- of its earnings and the shareholders would pay very little tax on their dividend income.
- As things are now the government collects more taxes from trust investors than it would collect if the trusts reconverted to the corporate structure.

Based on the above assumptions the CAIF report concludes that income trusts result in a higher level of taxation than corporations and that moving back to corporations will reduce the overall level of tax received by the government. The CAIF report supports this conclusion with a point in time analysis of the tax paid on trust distributions versus the tax paid on corporate earnings and dividends.

The CAIF conclusion depends partially on the assumption that income trusts distribute 150% of net earnings and that the entire distribution (capital and income) is taxed under the current regime and will be taxed in the post 2011 regime. Although a footnote does acknowledge the existence of return of capital and dividend impact no attempt is made to factor this into the analysis.

For non tax exempt accounts using only a point in time analysis it is no wonder that tax paid under the income trust structure using the stated assumptions dwarfs that paid out under the corporate structure. As far as taxable accounts are concerned, the CAIF report concludes that the change to corporate status would result in a significant loss in tax revenue.

As far as tax exempt/deferred accounts the CAIF report argues that there can be no tax leakage because the discounted present value of the future total return from an income trust portfolio is greater than the current tax being paid. The report also assumes that an 8% cash distribution is accumulated giving rise to an 8% annual accumulation in the capital value. This conflicts with assumption that 150% of earnings are distributed, in which case the actual accumulation should be 5.33% per annum compound and not 8%.

Income trusts are meant to be “mature” low growth investments that distribute all cash flow because there are no internal growth opportunities. Reinvesting distributions in a low growth company would obviate the so called “rationale” for income trust investment for a number of reasons.

The CAIF report makes a passing observation on foreign holders. Apparently there is no tax loss here because foreign owners do not consume domestic services. This is a strange comment to be made by a

¹⁵ <http://www.caif.ca/content/TaxLossRecipe.Fortin.pdf>

report produced by a group that has often espoused the risks of foreign private equity taking out cash flow from Canadian businesses without paying tax. While this would have relevance to the taxation of dividends, profits generated from Canadian business activities should be taxed since these businesses are resident in Canada and benefit from federally and provincially funded services; for example a work force benefits from investment in education and healthcare.

The TAMRIS Consultancy's report disagrees with the CAIF report and its findings counter the conclusions of the CAIF report. Importantly the CAIF report ignores the impact of the income trust pricing differential or valuation premium on total tax paid and return available at the portfolio level.

With the recent increases in the dividend tax credit, the tax take for taxable investors is considered to be more or less the same for both corporate and income trust cash flows. Unfortunately the taxable income trust holder who bought post conversion or post IPO has paid a premium for these earnings. At a valuation premium of 40% a taxable investor need only apply \$71 to a corporation for every \$100 invested in an income trust to get the equivalent net earnings. Therefore in order to get an estimate of tax paid for \$100 invested in both a share and an income trust we would need to multiply the tax from the share investment by 1.4, or 1 plus whatever the valuation premium is. As far as the tax exempt investor is concerned, the purchaser of the corporate option is able to compensate themselves for the tax advantage of the income trust by applying the valuation premium to the purchase of an additional corporate holding.

The CAIF analysis ignores taxation paid by the valuation differential under a portfolio option using the corporate security and appears to focus only on those investors who held shares pre conversion and retained the income trust units post conversion. Effectively this valuation differential places non tax exempt purchasers of income trusts post IPO or conversion at a severe disadvantage while allowing tax exempt/tax deferred investors of shares to neutralize the income trust tax advantages through either the purchase of additional corporate holdings or lower risk asset classes. This contradicts the claim in the report that individuals within tax deferred vehicles would be forced to buy lower yielding investments with the loss of income trusts.

3.4.2 BMO “The Inconvenient Truth About Trusts”

The BMO report as with the other pro income trust reports argues that income trusts do not result in tax leakage. Importantly it also focuses on the tax deferred/exempt accounts as the main reason why government estimates of revenue loss are incorrect. But here it does not perform a comparative analysis of the tax take under a corporate structure relative to an income trust structure within the tax deferred/exempt accounts and the reason for the omission is unclear. The following excerpt is taken from this report.

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

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

As the analysis in section 5 will show, the tax take from the corporate structure is clearly superior to the income trust structure in tax exempt/deferred accounts. Rightly or wrongly holding corporate investments in tax exempt accounts produce a higher level of overall taxation. The BMO analysis also ignores the

TAMRIS; Independent, Impartial, Objective

income trust valuation differential and therefore wrongly believes that the income trust phenomenon has “put ordinary Canadian investors on the same footing from a cost of capital perspective as those previous owners.”

As should be obvious, the ability to sell to ordinary Canadian investors at a far higher price does not afford the ordinary investor the same footing, but a much more tenuous one.

The TAMRIS Consultancy is concerned over what it considers to be a positively portrayed negative attribute of income trusts. According to the BMO sample of trusts, cash distributions yield 1.6 times the earnings of a corporation and so “*form a larger tax base than income from a corporation*”. Taxation of return of capital should not be a positive attribute of income trusts but a negative one compounded by higher valuations.

*“In a cash tax comparison, **income trust investors almost always pay more**. We looked at 126 businesses that converted from equities to trusts between 2001 and 2005 to prove that. We found that on average the government stood to collect 2.2 times more in taxes by taxing the distributions of the trust than had been paid by the corporations prior to their conversion....”*

If we adjust for a) the taxation of return of capital and b) valuation differentials, the figure of 2.2 times taxes reduces substantially. For example in the BMO report, its own sample of income trusts showed cash distributions of 1.6 times earnings. These distributions were 87% taxable meaning that 65% of return of capital was taxed when it should not have been. Adjust the 2.2 times by a factor of 1.39 (1.6 / 87%) to take out the capital that was taxed but should not have been and we have a tax take that should be closer to 1.58 times the prior taxes. If we adjust this for a valuation premium of say 40% (1.58/1.40) we get an adjusted tax multiple of 1.13 times. A 13% increase in tax revenue could easily be justified by cyclical factors.

Our conclusion is that we cannot realistically see how investments, including income trusts, held inside tax deferred plans present a loss to government revenues. As a result, there is no valid reason to tax trusts held inside these plans. The income is already taxed once upon its withdrawal; it should not also be taxed on the way in. What we wanted to demonstrate was that on a stand-alone basis, there is no loss to government revenues due to trust units being held inside a retirement account. One could construct various “what if” scenarios to see if other investments might theoretically produce higher tax revenues. That would be data mining.

The truth is that the BMO analysis ignores the accumulated opportunity cost of corporation tax lost on income trusts within tax exempt/deferred accounts and the impact of valuation premiums on total returns. This report does not present a comprehensive analysis of the relative tax take between the corporate and the income trust structure in the context of the individual portfolio.

3.4.3 RBC December 2006

In its Dec 2006 report RBC commented on the “35% to 45%” trust conversion premium and noted that the income trust structure and its tax exemptions had given “*fundamental financial benefits*” to foreign, domestic and tax deferred investors. The report also stated that “*it is likely that only the small Canadian retail investor will be shutout from tax-advantaged investing. We are rather surprised at the lack of outrage by those people most impacted by the “fairness” proposals, the tax paying Canadian investor; the very people who were paying income taxes on the distributions from trusts.*”

The TAMRIS report disagrees with this conclusion and finds that on the contrary, Canadian investors have been placed at a disadvantage by the supposed tax advantaged investing of the income trust structure.

The RBC report referred to the after tax lift in taxable Canadian cash flows of 14% for pre 2006 tax regulations. For investors who held these corporate structure prior to conversion this did indeed represent a lift in net cash flows. But this was not the case for those who purchased via an IPO or through the market. These investors are assumed to have paid upwards of an additional 56% of capital to purchase

TAMRIS; Independent, Impartial, Objective

the additional 14% of cash flow. They would have been better off at a fundamental¹⁶ level spending the additional 56% on a traditional corporate investment or lower risk asset class.

Table 1 – Pre 2006 data and analysis from RBC December 2006 report

Taxable Investor	Corporation A	Trust A	Corporation A - Capital adjustment
Cashflow before taxes	100	100	156
Corporate Income Taxes	36	0	56
Cashflow after taxes	64	100	100
Value Multiple	10	10	10.00
Cash yield	10%	10%	10%
Business Valued	640	1000	1,000
Capital allocated	640	1000	1,000
Investor Income	64	100	100
Dividend gross up	16		25
Taxable Income	80	100	125
Canadian Income Taxes			
Income Tax	37	46	58
Dividend tax credit	20		31
Total Canadian Taxes	17	46	26
Net cashflow after tax	47	54	74

Table 1 incorporates the 56% valuation premium used by RBC in its calculation of conversion premiums in its analysis of a pre 2006 scenario. The original analysis focused on a 14% increase in net cash flow but forgot to adjust for the impact of the valuation premium. The above does just that showing that if someone decided to invest the assumed valuation premium into more shares, that the net cash flow for taxable investors from the corporate structure would have been substantially higher. Of course, equities do not distribute all their cash flow and hence such valuation differentials and their importance were not immediately obvious to the investor but should have been to the advisors.

For tax exempt investors the above conclusions should also be obvious. With the net cash flow after taxes the same for the income trust holding and the 156% of the corporate shareholding, there is theoretically no total return benefit from holding the income trust even in a tax exempt account.

The differential between corporate net cash flow and income trusts increases (i.e. corporate structure becomes more attractive) as the corporate tax rate falls and falls as the income trust valuation premium narrows (income trusts become more attractive within a tax exempt account).

The above analysis effectively implies that there was no long term rationale whatsoever for non tax exempt investors to hold income trusts and no marginal benefit for tax exempt investors prior to the changes announced in 2005 for a valuation premium of 56%. This therefore contradicts the following RBC statement; *“As a result of the proposed changes to the trust sector, retail investors could be shutout from the future cash flows from some of the better trusts.....So we ask; where is the “fairness” in proposals*

¹⁶ There are many reasons why income trusts appeared to be a high yield/high capital return asset class during a period of strong cyclical growth, easy credit conditions, demand for income trust securities and a commodity price boom. At a fundamental level means looking through the full market and economic cycle and understanding the physical nature of risk and return of the asset class in question.

TAMRIS; Independent, Impartial, Objective

that effectively just shut out smaller investors and punish taxable Canadian investors? Well, it is not “fair”, those are just words, empty words. The claimed “leaks” were sinking no boat because the Canadian taxpayer was filling the federal coffers at an even faster rate. And if the Canadian taxpayer did not like it, they could invest somewhere else. It was voluntary”.

The RBC report also attacked the governments plan to tax income trusts as an attack on “*Canadian retirement plans’ ability to invest in the Canadian economy....Expect some of those funds, now turned away from Canadian businesses, to invest in foreign businesses*”.

It is difficult to believe that an action which has merely taken away the ability for sellers of businesses to sell at inflated prices and to tax return of capital is an attack on Canadian retirement plans’ ability to invest in the Canadian economy. Indeed, it was not the current Canadian government that sold large numbers of income trusts to the public. For these institutions to now blame the government for their own omission and indulgence would seem insane. The financial community that deigns to look after the investors interest needs to be able to mitigate investment risk. That the closing of the loophole is a risk that should have been mitigated is a note worth making. The risk was obvious, it was clear and it was ever present.

TAMRIS Models & Analysis

Do the arguments of the pro income trust lobby group stack up? Will individual investors pay a higher level of tax by holding the income trust rather than the corporate investment? Have investors been robbed of their ability to invest in the Canadian economy by taking away the tax advantages of the income trust? Or have investors been duped into believing that they are not only funding the Federal government's coffers but have also been party to a valuable investment opportunity?

The next section of the report will look at these questions and provide answers. It will do so by modelling the income trust proponents' assumptions with respect to valuation premiums, corporate taxation, cash distributions and taxation of return of capital over time within a portfolio context. It will specifically look at the following three issues.

- Taxable accounts – according to the HDR/HLB 2005 report (based on 2004 data) 60% of Canadian retail investors holdings were in taxable accounts. If this percentage held through 2006 then retail investors held their biggest chunk of income trust capital outside a tax deferred environment.
- Tax exempt accounts – do income trust holdings in tax exempt accounts really provide a higher level of tax deferred revenue than corporate investments? Do investors really benefit from the supposed tax advantaged investment opportunities said to be afforded by income trust investment?
- Post 2011 – are the post 2011 tax changes fair and is the one instance where the pro income trust lobby group is correct?

These issues will be analysed under a number scenarios using a range of assumptions drawn from the CAIF report prepared by Yves Fortin, a BMO Capital Market's report prepared by Gordon Tait and RBC's December 2006 and January 2007 communications. Modelling will be performed from two perspectives, the first that of an investor that has purchased the income trust post conversion or at IPO and the second that of an investor that held the business under the original corporate status and continued to hold the income trust post conversion.

4.1 The model's dynamics and assumptions

The model is a comparative model in that it compares a generic business under a set of assumptions governing both the income trust and the corporate structure. It relates the modeling of the two structures by setting a common annual portfolio withdrawal. This financial withdrawal is the after tax distributable cash flow from the income trust structure.

4.1.1 A simple growth model

The model's growth and return assumptions are linear and based on the simple growth $(g) = \text{retained earnings } (b) \times \text{return on equity (ROE)}$. It is assuming an average long term return on equity and hence a growth or capital depletion rate determined by the level of earnings distributed. Therefore, cash distributions in excess of taxable earnings imply a steady depletion in the earnings' producing capabilities of the business. The linearity of the assumptions is to be able to better focus on the fundamentals of taxation and the impact of the valuation premium on taxation and relative return.

There are of course valid reasons why a business's ability to produce similar year on year earnings would not be immediately impacted by cash distributions in excess of earnings and these are discussed below.

- Capital does not need to be replaced at exactly the same rate and time at which it is depreciated;

your car often drives as well in the second and third year as it does in the first.

- However, this would apply to both the corporate and the income structure in the comparative analysis and its impact and relevance are compensated for by the model's framework. A corporation could use cash flow to expand the business and the income trust to meet distributions. Therefore ergo the corporate structure would grow at a higher rate than that noted in the model while the income trust would depreciate at a slower rate, the relative difference changing little.
- Depreciation of operating assets build up future liabilities that will at some point in time have to be met from cash flow. A model that allowed for the fact that depreciation may not immediately impact return on equity would need to factor in these future liabilities, which should more or less offset the higher current cash flows.
- The models assume that the income trust starts from a position of no prior capital depreciation. However many income trust businesses have already accumulated significant capital depreciation related liabilities, in which case the point at which these liabilities impact cash flow will be much nearer. In this instance the analysis is conservative for income trusts that have been depleting capital for some time.
- The risks of running down tangible and intangible assets are great and, a company may well cease to be able to generate meaningful earnings from these assets long before they have been fully depreciated. Sometimes you have to run just to stand still in this world.
- Firms can employ leverage to increase capacity or to finance working capital needed to meet higher utilization of capacity.
 - Again within a comparative model the impact of this is absorbed since both structures are able to use the same method of enhancing return on equity. Use of leverage of course implies that businesses are under leveraged and many income trusts have tended to be fairly highly leveraged with third party debt.
 - A great many business income trusts are from private equity stables and these business were usually brought to market with an "optimal balance" of debt and equity. In this case assuming an increase in leverage would have been unrealistic.
 - There is a limit to the ability of leverage to improve the operating performance of a business and excessive leverage can impact future return on equity. Since many income trusts have effectively used leverage to finance cash distributions leverage will need to be cut during an economic downturn and hence so will cash distributions. Leverage used to finance cash distributions is a liability which will impact the net present value of future cash flows.
 - Many of the assumptions used by the pro income trust lobby group show cash distributions exceeding taxable earnings by a wide margin. Such a high level of distributions means that the level of debt which an income trust can safely finance is much lower than within the corresponding corporate structure.
- Firms can make accretive acquisitions through the use of debt and equity.
 - These tend to be cyclically inspired transactions where subsequent risks to earnings can be significant. A number of income trusts are already suffering from an overly aggressive acquisition strategy^{17,18}. TAMRIS analysis into income trust acquisitions has unearthed

¹⁷ Research by the Tanaka Business School, Imperial College London suggests that firms that invest in product capital (marketing, R&D and sales force) have the highest acquisition success rates. Such investment is not

examples of companies only managing to accrete a cash flow component which could only be characterized as a return of capital.

- Firms can cut costs and manage their resources more efficiently.
 - While it is generally assumed that income trusts are more focused on cutting costs, there is of course a limit to how far you can cut costs before you impact on the quality of your output and the value of your brand. A significant element of the purchase price of an income trust acquisition is held in intangibles and unallocated intangibles (goodwill) and failure to maintain brands and other intangibles will result in falling revenues and hence the capitalised value of those intangibles.
 - Many income trusts were brought to market by private equity firms who presumably have already conducted a significant element of cost cutting. Other areas, in particular the Oil and Gas sectors have seen conditions that tend to favour rising costs as opposed to the need to cut costs.
- Cyclical factors in the economy and dynamic factors at the business level that would allow for earnings expansion without the need for adding to productive capacity.
 - These factors would be felt by both corporate and income trust structures and hence would not be significant in a relative valuation analysis.
 - Cyclical upswings will be compensated for by cyclical downswings.
 - A company that successfully moves to higher margin products and services would also see an increase in return on equity, but such a move would presumably require sizeable research and development and other costs.

The use of the simple linear model based on the retention ratio and return on equity is therefore seen as sufficient and fundamental assumption for the objectives at hand.

4.1.2 Additional modeling assumptions

The remaining modelling assumptions are noted below and where necessary are expanded on.

- **Inflation;** return on equity is not adjusted for inflation and neither is the withdrawal rate. If inflation was brought into the model an assumption would need to be made over an increase in the withdrawal rate which would automatically absorb inflationary increases in return on equity.
- **Specific industry/sector assumptions** – no assumptions have been made with respect to a specific industry or segment of the business structures being modelled.
- **Corporate tax rates;** scenarios have been based on a number of different corporate tax rates and the relevant rates used are noted and explained in each individual scenario analysis.
- **Valuation premiums** – valuation premiums are used to calculate the earnings per share for the income trust relative to the corporate portfolio option and to determine the allocation to lower risk asset classes that could be made in lieu of the income trust valuation premium. The valuation premiums used are taken from a range of sources.

associated with income trusts.

¹⁸ A McKinsey study of more than 100 mergers in Britain and the US in the 1990s found that 60 per cent earned returns on capital less than the cost of capital and only a quarter ever recovered the costs of the merger.

TAMRIS; Independent, Impartial, Objective

- The RBC communications discussed in this report noted valuation premiums in the range of 35% to 45% and up to 56% for pre 2006 valuation metrics.
- In December 2005 a DC Howe report prepared by Professor Jack Mintz looked at an average 35% valuation premium post the changes to the dividend tax credit in late 2005 and 54% prior to those changes.
- The Accountability Research November 2005 Report “The Worst is Yet to Come” looked at valuation premiums of some 64% on business income trusts pre changes to the dividend tax credit. Note the Accountability Research Report looked at the valuation of income trusts relative to taxable accounts. Adjusting for the 56% valuation premium noted by RBC driven by tax exempt accounts, Accountability Research were effectively looking at a 5% differential from the top end of industry estimates.
- Other commentary has looked at valuation premiums relative to the market. A CIBC November 2006 report suggested a market relative valuation of 30% pre 31 October 2006 changes. However it is not valuation relative to the market that is important but the valuation of a company relative to what it would be valued as a corporation.
- Most valuation premium analysis, with the exception of the Accountability Research report is derived from an assessment of trusts distributing 100% of their earnings and does not include any additional premium or costs incurred as a result of returning capital. The modelling of taxation and return within the comparative models illustrates the impact of this.
- **Return of capital** – return of capital is assessed under a number of different taxable scenarios ranging from the total taxation of Yves Fortin’s report to the partial but still significant taxation of BMO (87% of distributions taxable where cash distributions are a 1.6x multiple of earnings) to scenarios that treat return of capital as not taxable. Taxation of return of capital should theoretically reduce the net present value of future cash flows, further elevating effective valuation premiums on taxable accounts. In 2006 the Department of Finance calculated business trust distributions as 80% taxable (of which 5% were classified as dividends) and energy trusts as 84% taxable.
- **Personal tax rates** – the analysis is conducted on tax rates used in the CAIF, the BMO and the CGA studies.
- **Capital gains tax** – capital gains tax is incorporated into the main models but only in so far as shares are realised to meet equivalent withdrawals. Equivalent withdrawals are the withdrawals that need to be made from the corporate portfolio option to match the net after tax withdrawals taken from the income trust portfolio option. In many of the illustrations there is substantial latent capital gains tax built into the corporate portfolio option and an analysis of the latent capital gain relative to the capital gain arising from the income trust conversion is also shown separately.
- **Accumulation of tax liability**– a tax differential between the two portfolio options is accumulated at a rate which is assumed to represent the cost to the government of tax revenue. This rate is the cost at which the government must borrow money from the public. This analysis takes a rate of 4.5%, which is close to a 10 year government bond rate. An after tax rate 2.79% (assuming average tax rate of 38%) is used. This rate is conservative since not all borrowers are taxable and the opportunity cost should theoretically be compounded at a higher rate. Capital gains tax paid by income trusts on conversion is added to this analysis as are the latent capital gains on corporate structures.
- **Risk premium** – in the analysis of the CAIF Fortin report we have looked at low equity risk premium of some 1.5% above the low risk return used in the models because of the 8% distributable cash assumption used in this report. In the analysis of the BMO report an annual

TAMRIS; Independent, Impartial, Objective

average equity risk premium of 3.55% has been used. Specific references to long term Canadian equity risk premiums are drawn from “The Triumph of the Optimists: 100 years of Global Investment Returns” by Dimson, Marsh and Staunton.

- **Corporate portfolio option** – the valuation premium on income trusts increases the cost per unit of earnings. For a 40% valuation premium the income trust investor could have bought a share with an equivalent net total return for 71% of the capital allocated to the income trust. This would have left them with 29% available to spend on a low risk cash and bond investment, used in the model to support withdrawals in the early years. The larger the valuation premium the less that needs to be allocated to a share and the more that can be allocated to cash and bonds and vice versa. This is not really a bona fide portfolio option and is only used to illustrate the impact and costs to both risk and return of the income trust valuation premiums. A more detailed assessment of the portfolio issues associated with income trusts is dealt with later in the series of reports on income trusts.
- **The income trust portfolio option** is only ever the capital allocated to income trusts.

4.1.3 Basic modeling process

The model derives the relationship between pre tax earnings per income trust unit and per share from the valuation premium. It then allocates to the corporate portfolio option (shares and cash bonds) in accordance with the valuation premium. A 40% valuation premium = 71.4% share and 28.6% cash and bond allocation.

Where the impact of conversion is analysed (5.1.2, 5.1.4, 5.1.6 etc) the valuation premium is used to determine the capital allocation that the holder would have had without any conversion. For example, for every 100 dollars in the income trust they would only have held 71.4 dollars of shares and no cash and bond allocation is made.

It models forward the impact of the cash distributions (whether these be 100% of earnings or an amount in excess of earnings) on the capital value of the income trust, separating out the return on capital and the return of capital and taxing in accordance with the assumptions used. Where cash distributions exceed earnings income trust operating capital is depleted.

Income trust capital in each period = income trust capital in the prior period times the * growth rate, where the growth rate is the retention ratio times the return on equity in the current period. Cash distributions are made at the end of the period and are comprised of earnings during the period plus the depreciation in capital from over the period, see figure 1.

Figure 4-1

	Year 0	End year 1	End year 2	End year 3	End year 4	End year 5
Income Trust	100.00	95.69	91.56	87.62	83.84	80.22
Return of capital		4.31	4.13	3.95	3.78	3.61
Yield/income		7.19	6.88	6.58	6.30	6.02
Cash distribution		11.50	11.00	10.53	10.07	9.64
Gross income/return on capital yield		7.2%	7.2%	7.2%	7.2%	7.2%
Net return on capital yield		5.2%	5.2%	5.2%	5.2%	5.2%
After tax distribution		9.26	8.86	8.48	8.11	7.76

After tax cash distributions (personal income tax) are used to determine the withdrawals required from the corporate portfolio option.

The corporate portfolio option is likewise modelled forward. The growth rate for share capital is the retention ratio times the after corporation tax earnings yield. Any withdrawals that need to be made from the share component to meet the equivalent cash distribution from the income trust are taken at the end of

the year and adjusted for capital gains tax on the shares sold. The dividend yield is applied to share capital at the start of the period, see figure 2.

Figure 4-2

	Year 0	End year 1	End year 2	End year 3	End year 4
Capital return to corporate equity	71.43	74.81	78.34	82.05	85.93
Gross dividend		2.01	2.11	2.21	2.31
Gross Yield as % of income trust capital		2.0%	2.2%	2.4%	2.6%
Net dividend		1.87	1.96	2.05	2.15
Net yield as % of income trust capital		1.96%	2.14%	2.34%	2.56%
Cash/bond allocation & return	28.57	21.97	15.67	9.68	3.98
Capital depletion		7.39	6.90	6.43	5.96
Base capital withdrawal		7.05	6.29	5.59	4.96
Capital gains tax		-	-	-	-
Interest return		1.14	0.88	0.63	0.39
Net interest return - tax 38%		0.79	0.61	0.43	0.27

Capital allocated to low risk asset classes are accumulated at a net after tax rate. Capital from the low risk asset class section is used to fund the deficit between the cash distribution from the income trust and the net yield from the equity until the cash and bond component is run down. It is assumed that the allocation to cash and bonds is based on asset and liability modelling with bonds maturing to meet liabilities rather than having to be sold.

Within tax exempt accounts corporate securities are taxed at the corporation tax assumption and income trust investments accumulate tax free until withdrawn at which point withdrawals are subject to personal income tax at the rates used for each scenario.

4.1.3.1 Tax deferred/tax exempt

A 100% equity allocation (for both the income trust and corporate portfolio options) is accumulated until withdrawals commence, at which point in time the corporate portfolio option will allocate to low risk assets in accordance with the valuation premium. Withdrawals commence in this analysis after 10 years of accumulation. While the RRSP accumulation phase is much longer than 10 years it was assumed that income trusts would not be added to RRSP accounts until at least 10 years prior to retirement.

4.1.3.2 Accumulated tax liability and latent tax calculations

The difference between the tax paid on the corporate option and the income trust option in any given year is accumulated at a rate which represents the borrowing costs to the government of having to fund the tax shortfall. Where income trusts yield a higher tax take the corporate tax opportunity cost is negative implying that income trusts yield a higher tax take and when positive that corporation tax would have yielded the higher rate of tax. Capital gains tax paid on conversion are integrated into this analysis and compounded by the borrowing cost rate while latent capital gains on the corporate portfolio option are also included in this analysis. This allows us to assess the impact of opportunity costs and capital gains tax on the total tax take from either portfolio option.

5

Scenario Modelling & Results

This section focuses on modelling the assumptions used by the pro income trust lobby groups under the TAMRIS modelling framework and summarises the results and conclusions. It models the Yves Fortin assumptions in the January 2007 CAIF report "A Recipe for Tax Revenue Loss" and the BMO assumptions in the report "The Inconvenient Truth About Trusts" as well as the Certified General Accountants figures from their "Demystifying Income Trusts" in January 2006.

5.1 Yves Fortin CAIF report

5.1.1 Yves Fortin CAIF Scenario 1 – Return of capital taxable

In this scenario we mainly use the assumptions stated in the CAIF January 2007 report "A Recipe for Tax Revenue Loss" with the exception of the valuation premium, the allocations to the corporate option portfolio (shares and cash and bonds) and the returns on the cash and bond portfolio.

Table 2

Assumptions	
Income trust distribution	8.00%
Income trust earnings	5.33%
Distribution rate % earnings	150.00%
Income trust growth rate/depletion	-2.67%
Corporate earnings per share - price adjusted for valuation premium	7.47%
Corporate tax rate	27.00%
Corporate earnings after tax	5.45%
Payout ratio of earnings before tax	28.00%
Corporate dividend yield	2.09%
Corporate earnings growth rate	3.36%
Gross cash and bond return	4.00%
Net cash and bond return	2.5%
Capital allocated to income trust	100.0
Income trust Premium	40%
Valuation premium capital allocated to low risk = 1, to equities 2	1.0
Capital allocated to corporation	71.4
Capital allocated to cash and bond	28.6
Tax rate	38.0%
Tax rate return of capital	38.0%
Dividend tax rate	20.3%

With an effective corporate tax rate of 27%, a 40% premium results in a net after corporate tax earnings yield that exceeds that of the income trust; 5.45% versus 5.33%. A 40% premium means that 71.4% of the income trust allocation can be applied to a share leaving 28.6% to be allocated to more shares or a cash and bond allocation for additional yield and capital for consumption. One of the criticisms of taking away income trusts is that investors will be forced to buy lower yielding fixed interest investments. Based on these assumptions a lower priced equity naturally allows for a cash and bond allocation.

While an income trust distributing in excess of earnings is depleting the capital base of the company, this short term depletion is physically represented in the corporate portfolio model (shares 71.4% Cash and bonds 28.6%) by running down cash and maturing bonds. This is a much lower risk method of running

down capital.¹⁹

Chart 1 shows the performance of the income trust versus the corporate structure with an initial cash and bond allocation for assumptions noted in table 2. Withdrawals of dividends, interest and capital²⁰ are taken from the corporate portfolio option at a rate equivalent to the income trust cash distribution which sets the annual withdrawals. Chart 1 chart shows the impact of valuation premiums, distribution policy and taxation of return of capital on the income trust and the corporate options (71.4% shares and 28.6% cash and bonds).

Chart 1

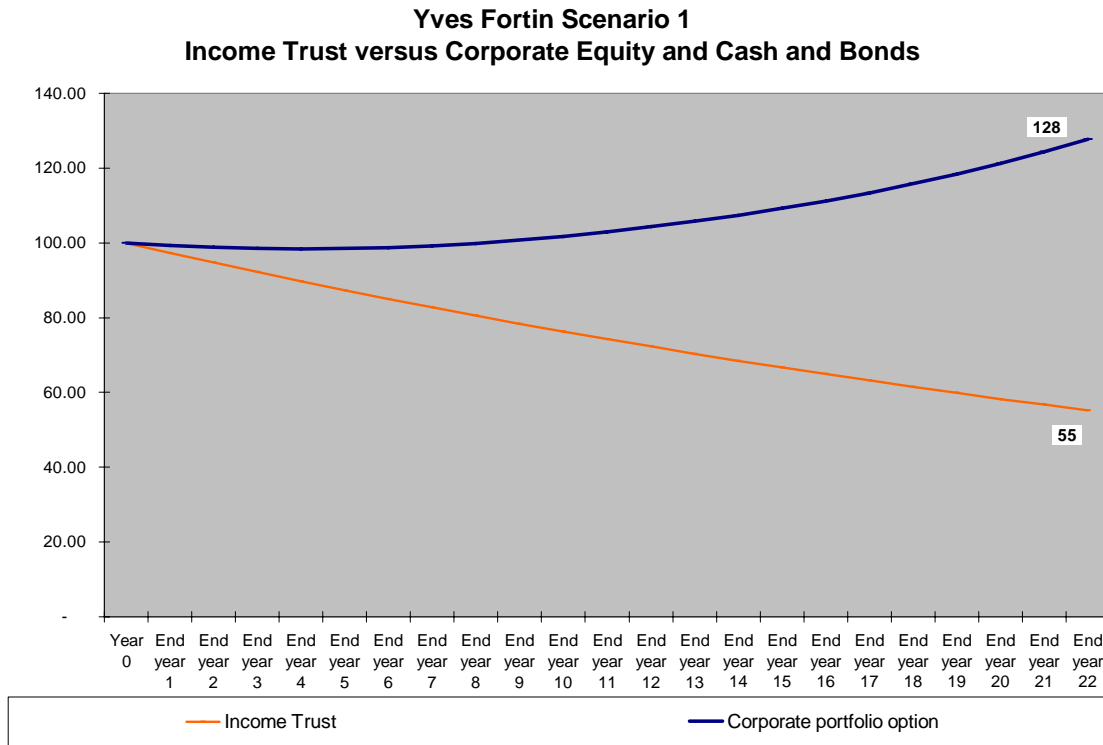
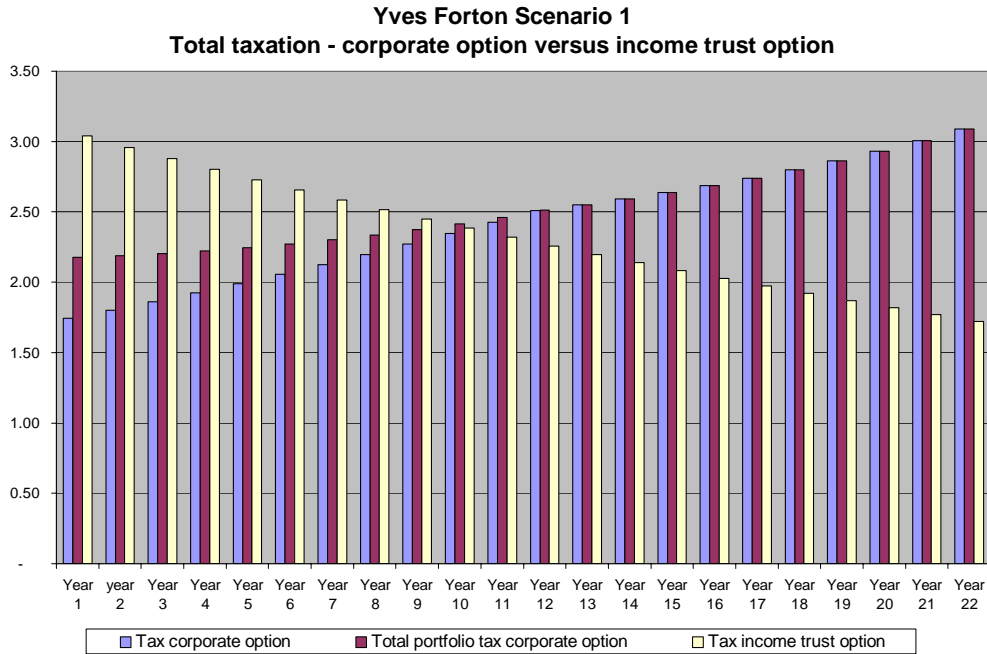


Chart 2 shows the tax take from the two options with the assumed taxation of return of capital creating significant additional short term tax revenue.

¹⁹ While the depletion of capital within a business can be measured and controlled, the fact that investors hold this capital via marketable securities means that risks to capital depletion are accentuated within an income trust.

²⁰ First from cash and bonds, then once cash and bonds depleted from equities.

Chart 2 – 40% valuation premium return of capital taxed



The blue column in chart 2 shows corporate, dividend and capital gains taxation²¹ while the dark red includes taxation on interest from cash and cash and bonds. Chart 3 shows the tax take for a valuation premium of 15% and chart 4 for a valuation premium of 0%.

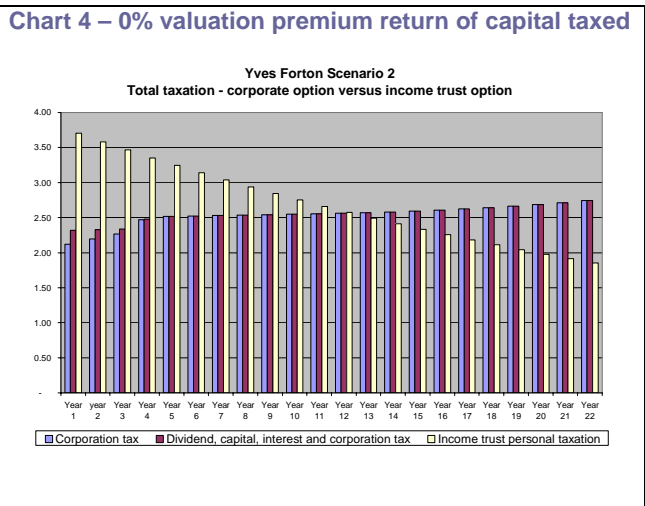
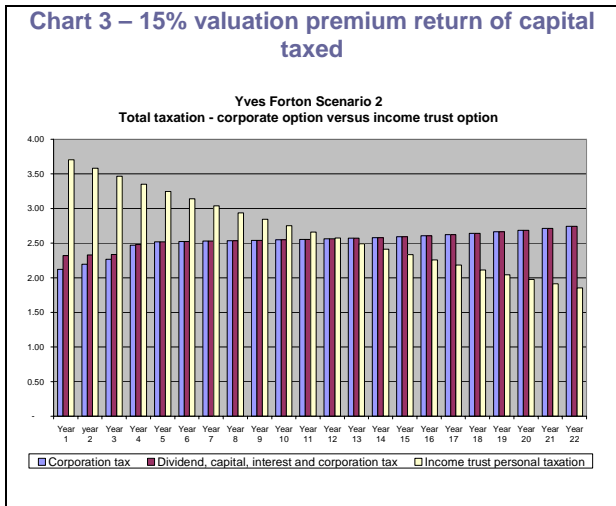


Table 3 below summarises the total tax paid for a range of valuation premiums for both the income trust and the corporate portfolio option as well as the range of capital values at the end of the modelling.

²¹ On shares needed to fund withdrawals.

Table 3

150% distributable cash - return of capital taxable								
Premium	Income Trust end value	Tax paid		Portfolio option end value	Tax paid		Portfolio option asset allocation	
		10 year	22 year		10 year	22 year	Cash & Bonds	Shares
56%	59	25	47	134	22	56	36%	64%
40%	55	27	51	128	23	57	29%	71%
15%	48	32	59	106	25	56	13%	87%
0%	43	36	65	86	25	53	0%	100%
Required rate of return - Income Trust								
Premium	Cash distribution rate	Required rate of return on equity		Original return on equity	% Increase ROE required			
56%	15.2%	10.1%		4.79%	211%			
40%	15.3%	10.2%		5.33%	191%			
15%	15.5%	10.4%		6.50%	160%			
0%	15.7%	10.5%		7.47%	140%			

The top half of table 3 shows the income trust and portfolio option end values at the end of 22 years²² for different valuation premiums based on an 8% cash distribution rate (150% of earnings). The higher the valuation premium the less tax that is paid under the income trust option relative to the corporate option. This is due to a number of factors.

- Withdrawals on the corporate option are determined by cash distributions on the income trusts. The higher the valuation premium the more expensive the cost of meeting withdrawals under the income trust option, the lower the potential return and the faster the absolute income trust cash distributions decline.
- The higher the valuation premium the greater amount of earnings relative to the income trust that can be purchased via a corporation and hence the greater the corporation tax.
- The higher the valuation premium the higher the allocation that can be made to interest bearing (and hence taxable) lower risk investments that can be made.

The bottom half of the table shows how much higher the return on income trust equity would need to be if the end values (or net present value) of the income trust option were to be the same as the corporate option. For those who state that income trusts are much more efficient business structures, the above shows how much more return on equity an income trust would need to generate to create an equivalent return for a given valuation multiple bearing in the mind the assumption over the taxation of return of capital.

5.1.1.1 Accumulated tax liability – return of capital taxed

The above analysis did not include the impact of capital gains tax on the tax outcome for modelling simplicity. The following chart integrates the capital gains tax paid on the conversion with the opportunity cost of the tax from the income trust option that would be foregone if the corporate structure was selected. It also includes the latent (unrealised) capital gain on the corporate structure. In this analysis tax on

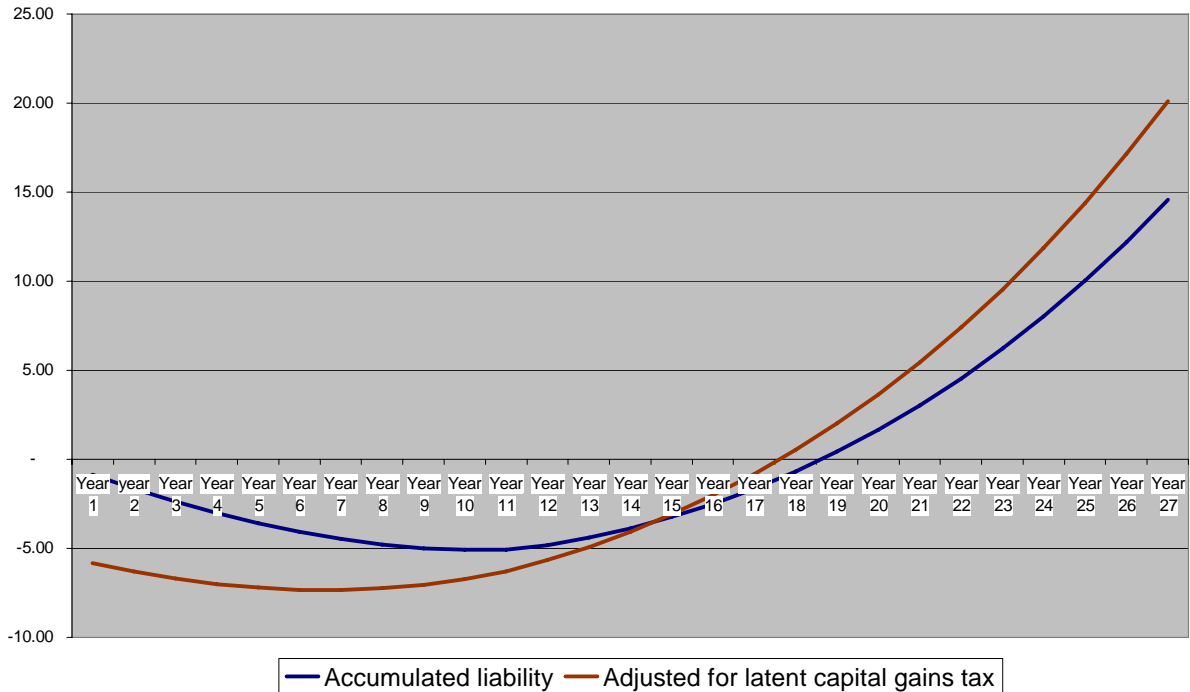
²² No specific rationale for a 22 year period other than it was the term of the modelling at the time the assumptions were input into the table.

TAMRIS; Independent, Impartial, Objective

income trusts is higher in the first few years but declines thereafter. The blue line represents the accumulated tax liability shown in chart 2. The dark red line includes the income trust capital gains tax on conversion and the latent capital gains tax on the corporate structure.

Chart 5 – 40% valuation premium

Yves Fortin Scenario 1 Accumulated tax liability at 2.79% annual interest



5.1.2 Yves Fortin CAIF Scenario 1B – return of capital taxable

In this analysis the holder of the income trust is assumed to have owned the corporate structure prior to conversion and continues to hold it beyond conversion. Therefore the starting capital value of the corporate option is the capital value of the company pre conversion and the value of the income trust the value of the company post conversion. When viewing this analysis it must be borne in mind that the portfolio capital allocated to the income trust in the market place is greater than the capital allocated to the share or corporate option in the analysis. Therefore, the analysis here is not a valid analysis of the total tax take of the income trust structure in the economy. It only has relevance from the holder of the share who converts to an income trust and retains the income trust. Chart 6 shows the total return profile for a 40% valuation premium where return of capital is taxed.

Chart 6 – 40% Valuation premium

Yves Fortin Scenario 1b
Income Trust versus Corporate Equity

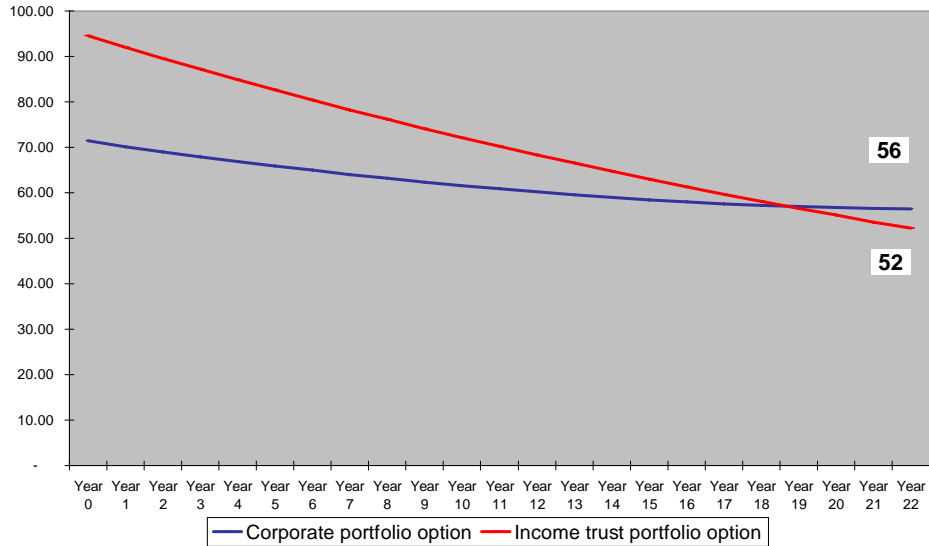
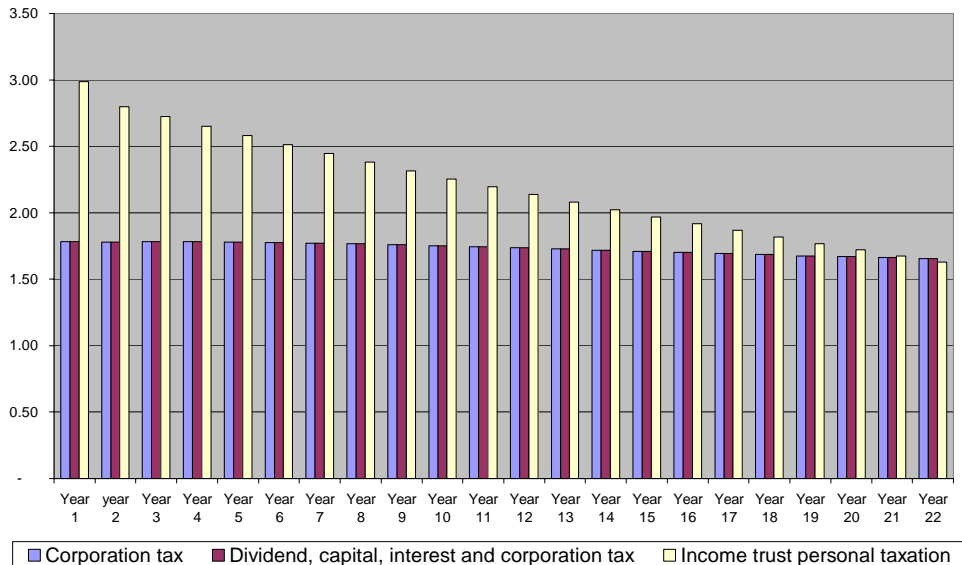


Chart 7 shows the tax profile with respect to the above return chart. This shows a much higher level of taxation at the portfolio level for holders of the pre conversion corporate structure where return of capital is also taxed. As noted this has an impact at the portfolio return level which should rule out taxable investors holding these investments

Chart 7

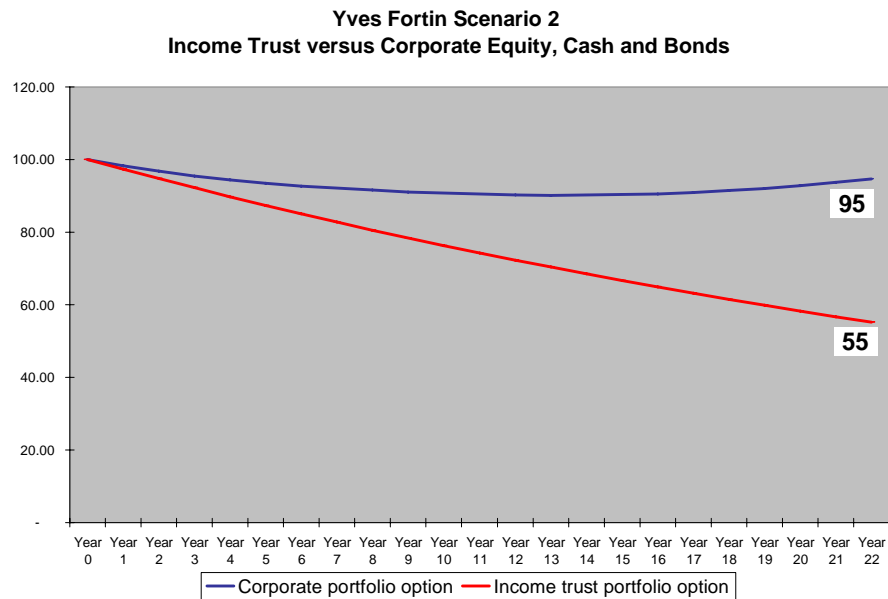
Yves Forton Scenario 1 B
Total taxation - corporate option versus income trust option



5.1.3 Yves Fortin CAIF Scenario 2 – Return of capital not taxable

Chart 8 shows us what the situation would be if only return on capital was taxed while retaining the remaining Fortin Assumptions over corporate taxation and cash distribution rates.

Chart 8



At a 40% valuation premium with no taxation of return on capital the corporate portfolio option still outperforms. Chart 9 illustrates the tax take under this analysis. As far as tax is concerned, income trusts produce less tax than a corporate based portfolio option when only distributable earnings are taxed. While income tax exceeds corporation tax and dividend taxation (assuming a 40% valuation premium) for the first three years, total taxation from the portfolio option (tax on cash and bond interest) exceeds taxation arising from income trusts given the assumptions noted.

Chart 9 40% valuation premium 71% shares, 29% cash and bonds

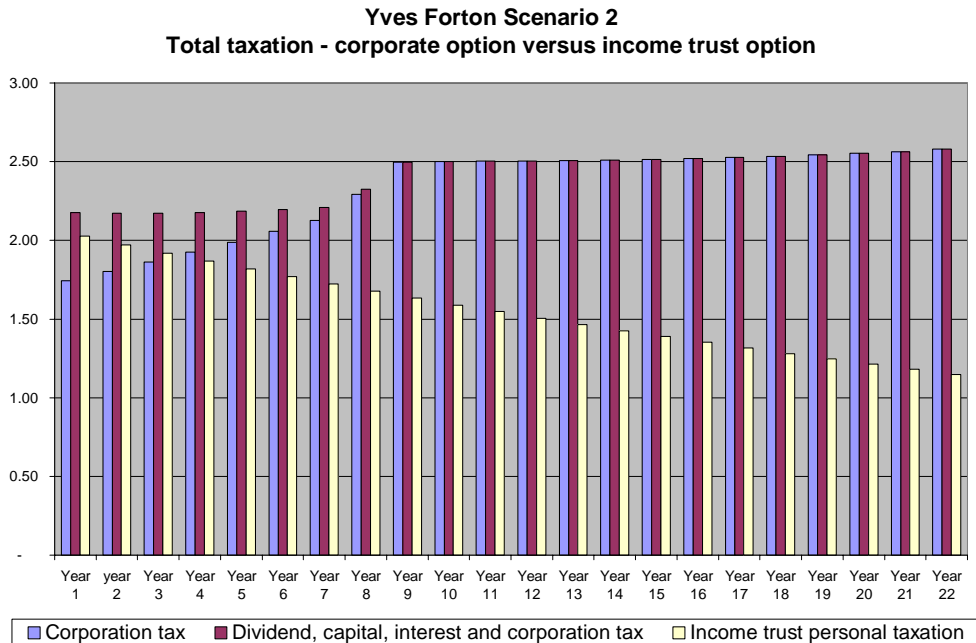


Table 4 provides summary data for a wider range of valuation premiums.

Table 4

150% distributable cash - return of capital non taxable								
Premium	Income Trust end value	Tax paid		Portfolio option end value	Tax paid		Portfolio option asset allocation	
		10 year	22 year		10 year	22 year	Cash & Bonds	Shares
56%	59	16	31	107	22	53	36%	64%
40%	55	18	34	95	23	53	29%	71%
15%	48	21	39	66	24	50	13%	87%
0%	43	24	43	41	24	46	0%	100%
Required rate of return - Income Trust								
Premium	Cash distribution rate	Required rate of return on equity		Original return on equity	% Increase ROE required			
56%	10.6%	7.1%		4.79%	148%			
40%	10.8%	7.2%		5.33%	134%			
15%	11.0%	7.3%		6.50%	113%			
0%	11.1%	7.4%		7.47%	-1.4%			

5.1.3.1 100% shares 100% income trusts

Instead of using the valuation premium to allocate to cash and bonds, let us look at the tax impact with the full corporate portfolio allocated to equities. This is to assess the total tax take from the two business structures alone without any portfolio adjustment. Chart 10 shows tax for a 40% valuation premium analysis, Chart 11 tax for a 15% premium analysis.

Chart 10 – 40% valuation premium 100% share allocation

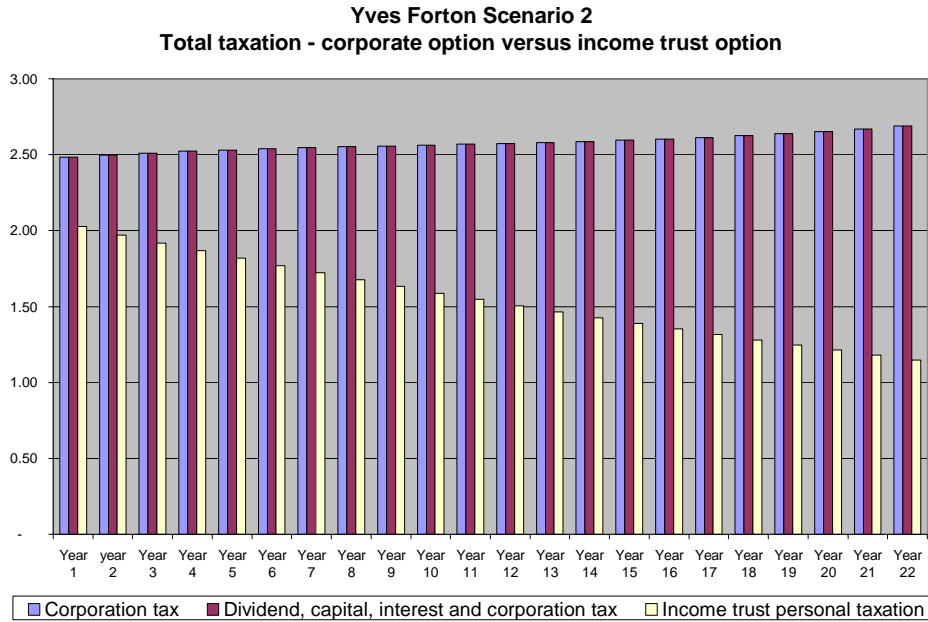
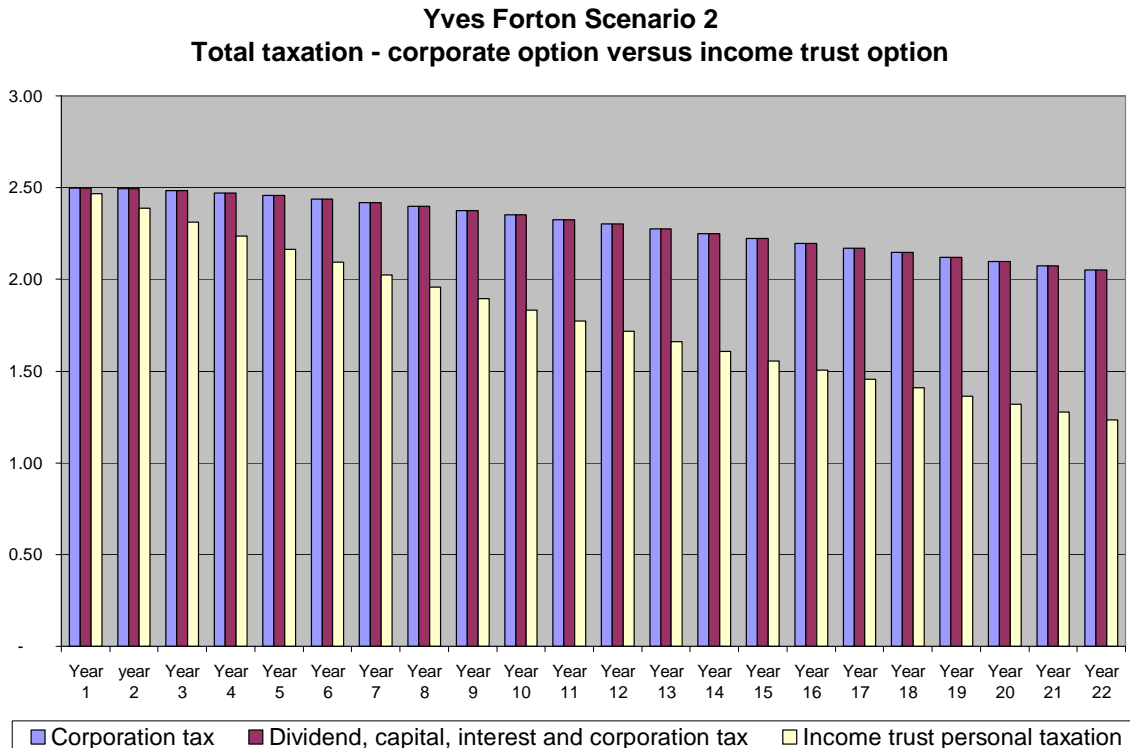


Chart 11 – 15% valuation premium 100% share allocation



Note that the above two charts show a higher initial tax take for the corporate option even with the lower effective corporation tax rate use in the CAIF Fortin report.

5.1.3.2 Accumulated tax liability – return of capital not taxed

An explanation of the rationale for this is found in 4.1.3.2 and 5.1.1.1. The following chart shows the accumulated tax liability between a corporate structure portfolio and income trust portfolio option at a valuation premium of 40% assuming no taxation of return of capital. The chart shows the opportunity cost for moving to an income trust route for this scenario. The dark red line includes capital gains tax on income trust conversion and latent capital gains tax on the corporate option. The blue line is the accumulated tax liability for chart 9.

Chart 12

Yves Fortin Scenario 2
Accumulated tax liability at 2.79% annual interest

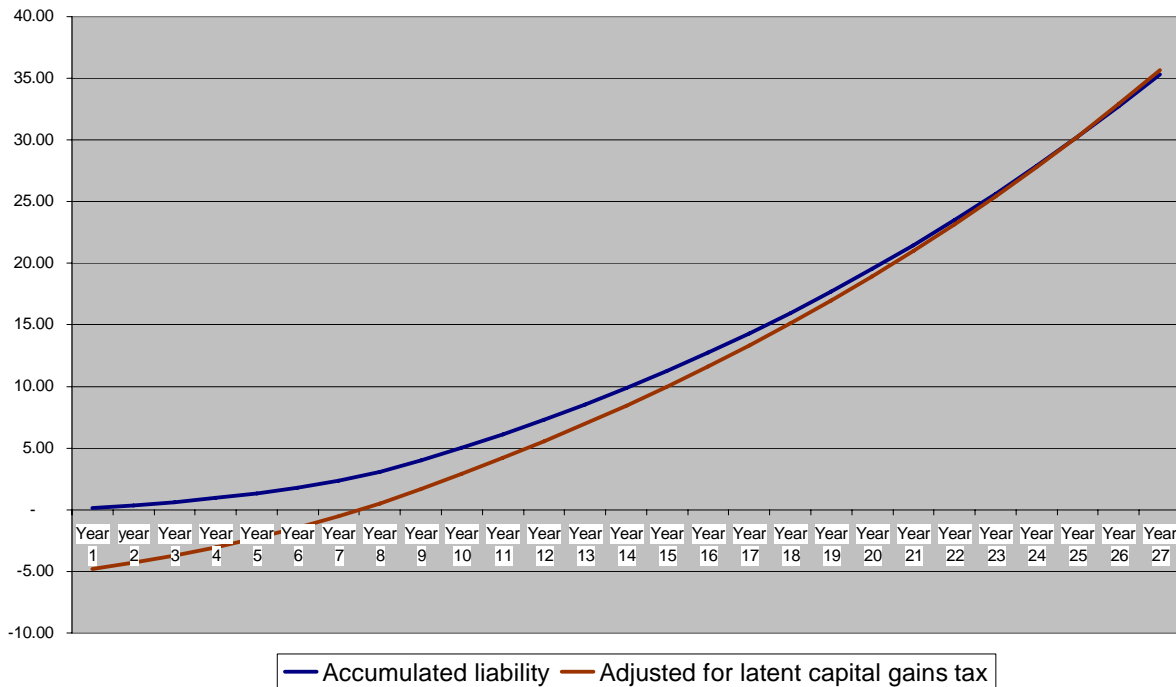
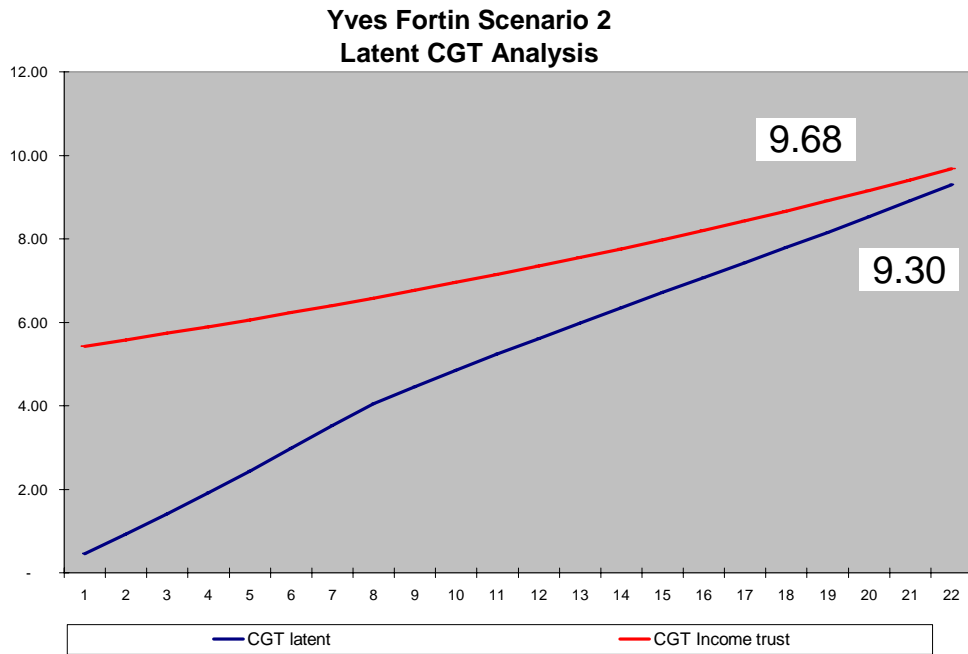


Chart 13 shows the latent capital gains tax on the corporate option portfolio relative to the opportunity cost of the capital gains tax on the income trust conversion.

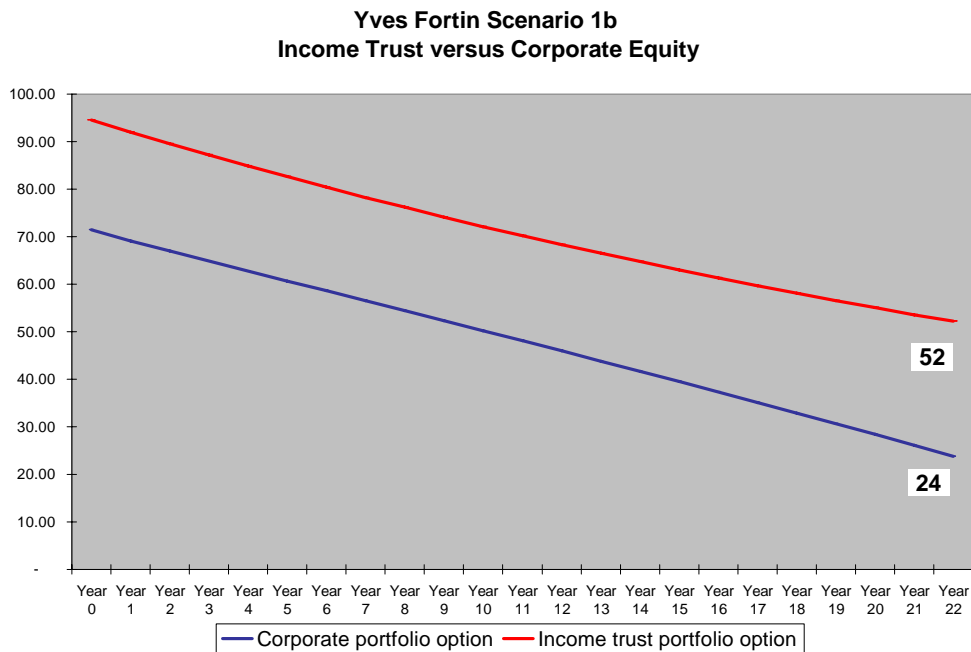
Chart 13



5.1.4 Yves Fortin CAIF Scenario 2B – return of capital not taxed

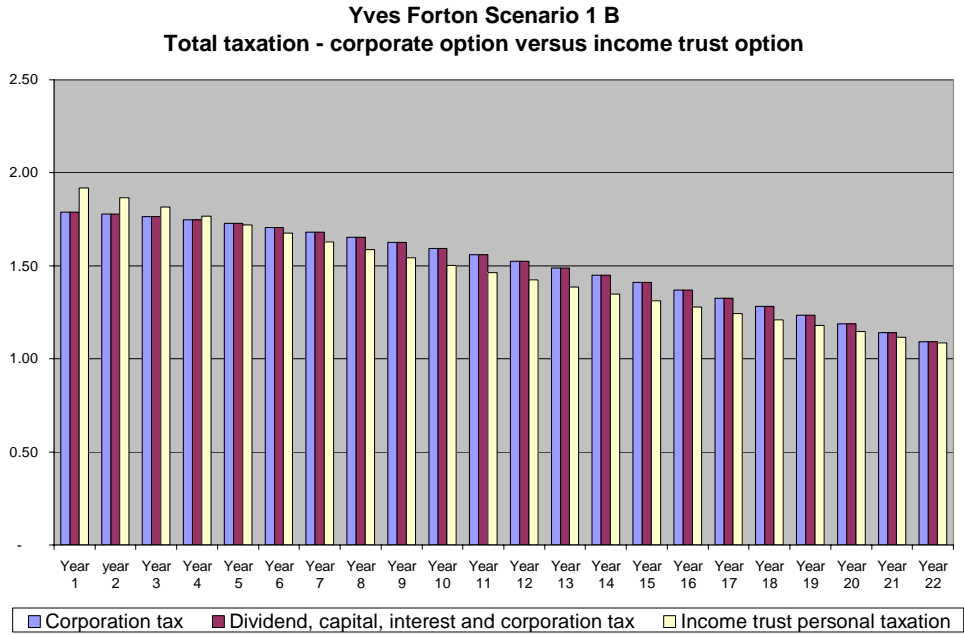
As with scenario 1b the following analysis relates to the performance and taxation of the two options where the income trust holder is assumed to hold the share prior to conversion as well as the income trust post conversion. This time return of capital is not taxed.

Chart 14



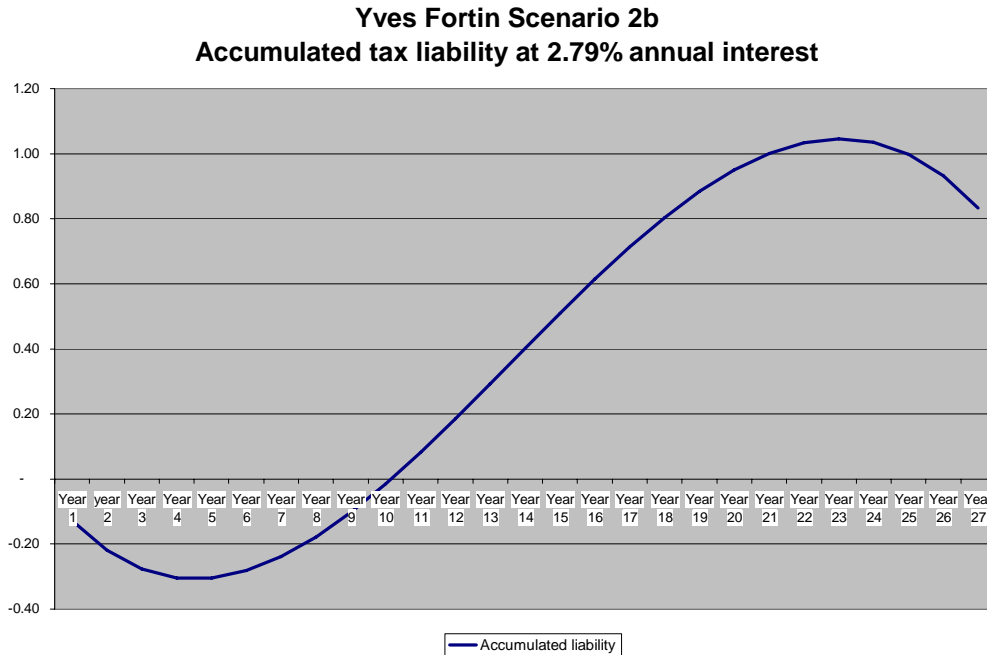
In Chart 14 we see the income trust option clearly outperforming the equity option. But let us look at the tax situation in chart 15.

Chart 15



If the return of capital is not taxed the tax situation is more complex. Let us look at another perspective by accumulating the tax differential between the two options. Any differential is accumulated at a rate of 2.79%. Chart 16 shows this and shows that the tax take from an income trust (where holders were also shareholders of the corporate structure) and where return of capital is not taxed is lower than the corporate option.

Chart 16



TAMRIS; Independent, Impartial, Objective

If on the other hand cash distributions are not 150% of earnings but only 100%, the following charts apply. Chart 17 shows the total return of the share converging on the income trusts, chart 18 the tax take in favour of the corporate structure and chart 19 shows the accumulated opportunity cost of taxation under the corporate versus the income trust structure.

Chart 17

**Yves Fortin Scenario 1b
Income Trust versus Corporate Equity**

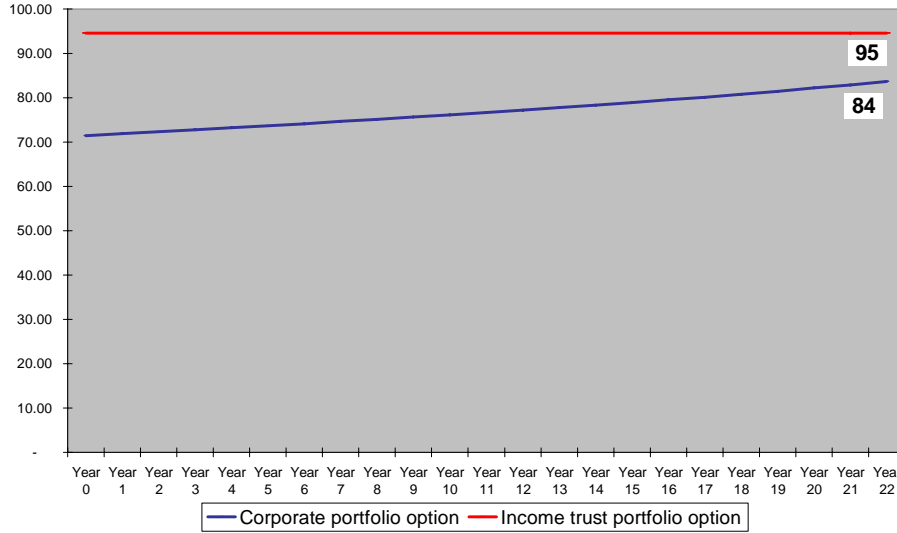


Chart 18

**Yves Fortin Scenario 1 B
Total taxation - corporate option versus income trust option**

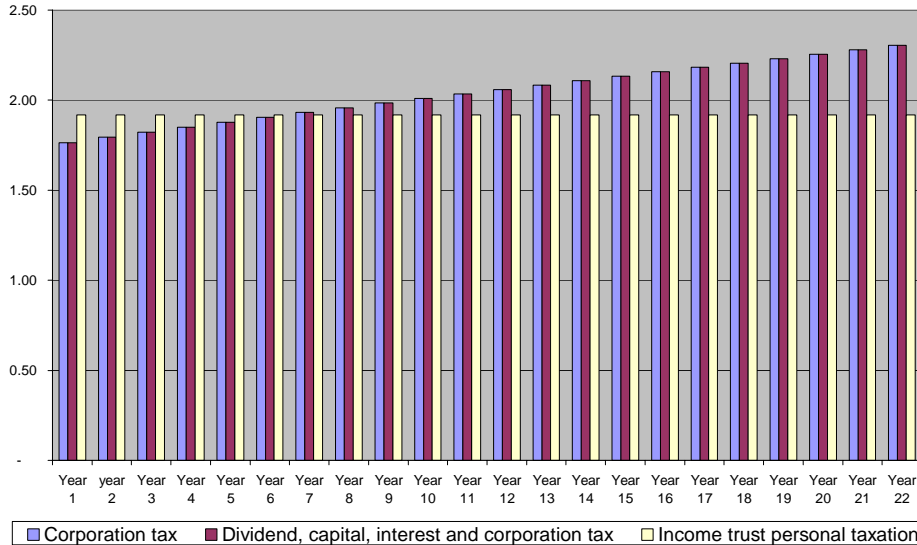
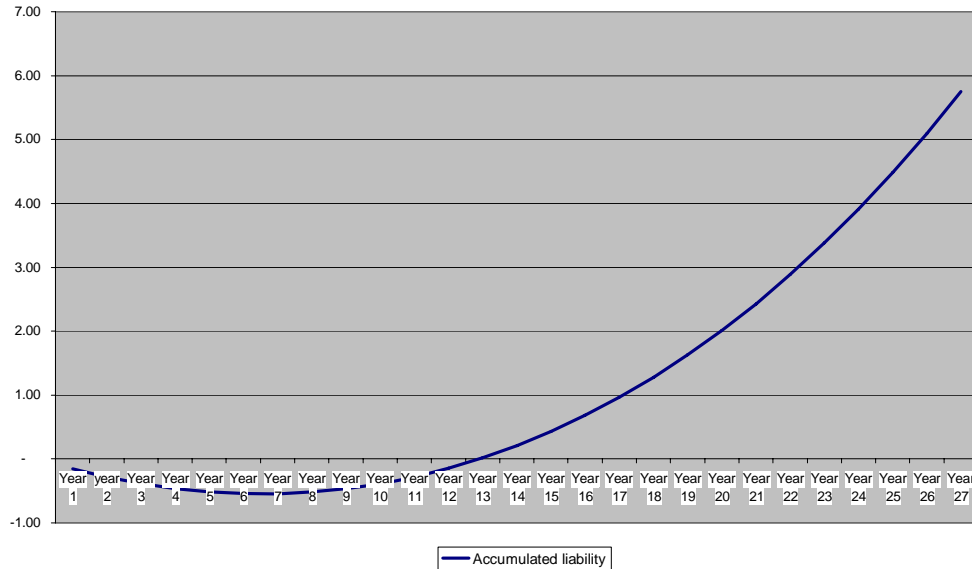


Chart 19

**Yves Fortin Scenario 2b
Accumulated tax liability at 2.79% annual interest**



5.1.5 Yves Fortin CAIF Scenario 3 - RRSP

In chart 20 corporate and income trust returns accumulate until year 10, after which the 8% distributable cash (150% of earnings) is distributed from the income trust. As with all the models in this document the net after tax withdrawals from the income trust option is used to determine the target withdrawals from the corporate option. The following two charts show the relative performance of an income trust and a portfolio option with a valuation premium of 40% and 15% respectively. The primary reason for the performance differential at lower valuation premiums is the higher tax paid by the corporate portfolio option.

Chart 20

Yves Forton Scenario 3 - RRSP
Corporate option versus income trust option - 40% valuation premium

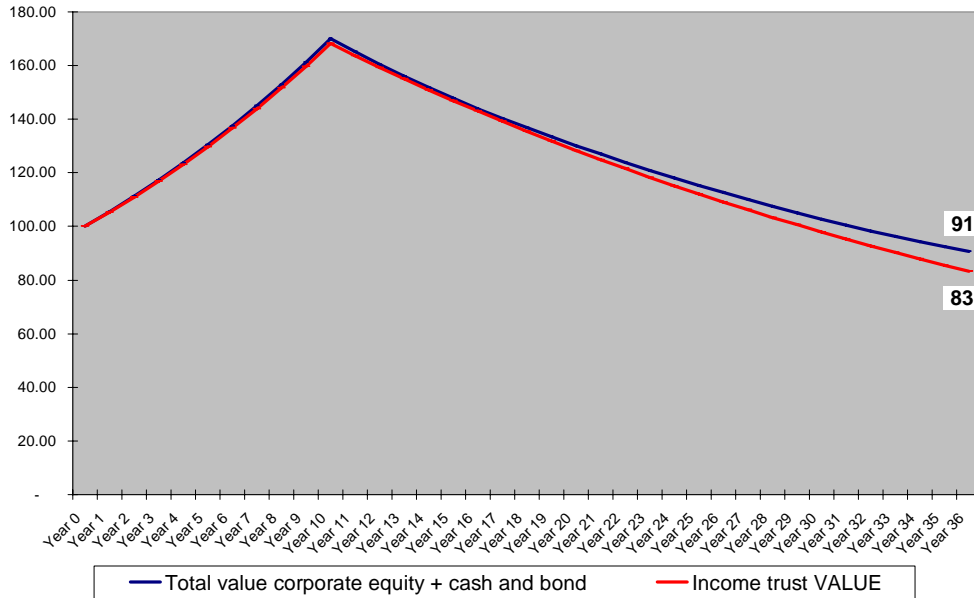
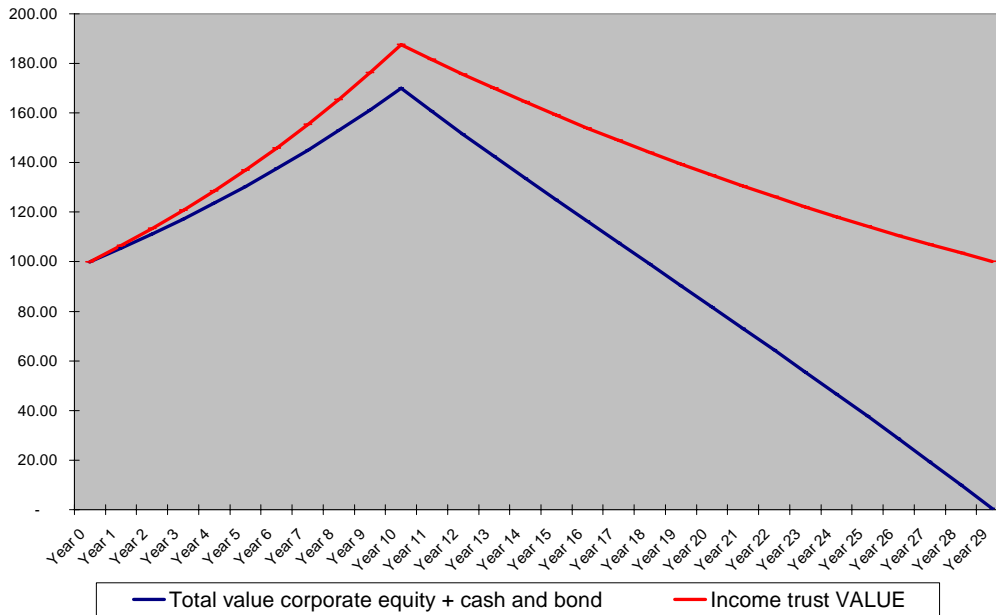


Chart 21

Yves Forton Scenario 3 - RRSP
Corporate option versus income trust option - 15% valuation premium



The taxation angle is different as the following two graphs depicting taxation paid under the above two scenarios illustrate.

Chart 22

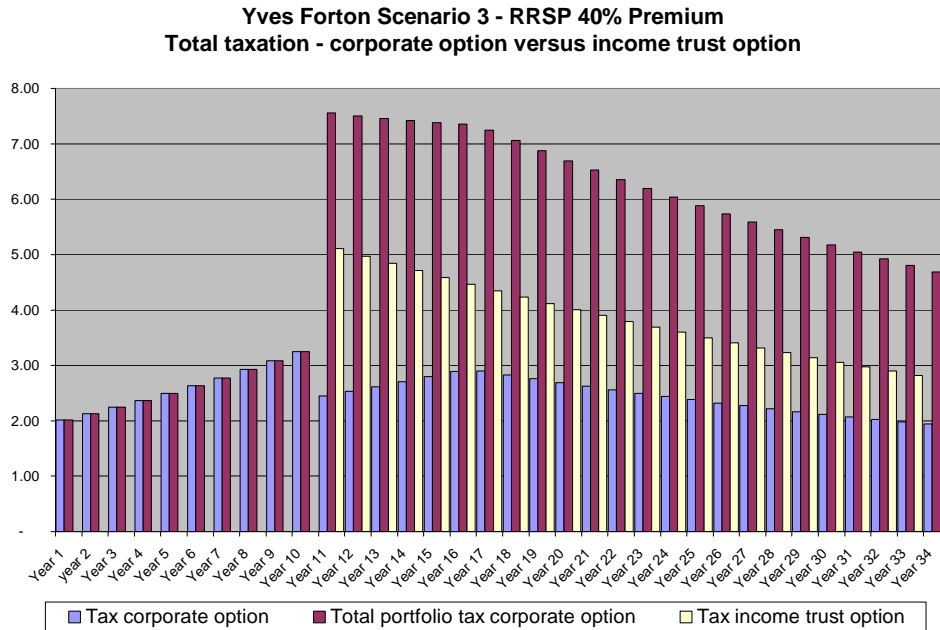
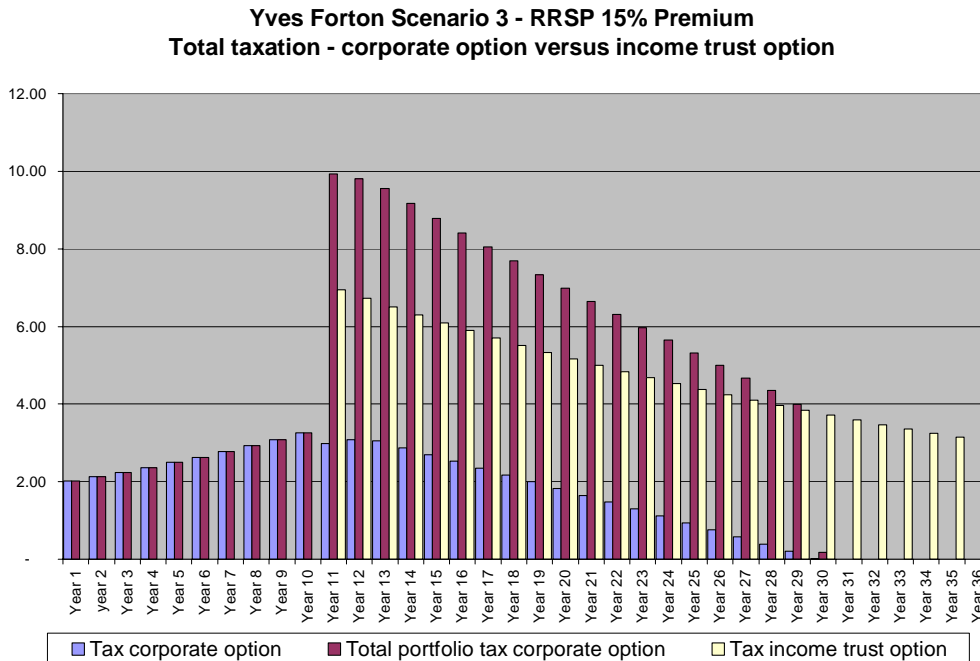


Chart 22 above shows corporate tax (blue column) and total taxation under the corporate option (dark red) clearly exceeding taxation under the income trust option. Chart 23 shows total tax paid assuming a 15% premium.

Chart 23



Corporation tax as a percentage of the corporate portfolio capital is some 1.9%, less than your average mutual fund MER. In this context, again, the relative benefits of an income trust can be obtained by forsaking high annual industry management expenses and transaction fees by shifting to lower cost index funds.

5.1.5.1 RRSP tax analysis

Just what is the corporate tax take for a starting portfolio value of \$100 over a 41 year time period (10 years accumulation, 31 years of withdrawals and just what is the tax take for an income trust? The following table provides this analysis and clearly shows the higher corporate tax take.

Table 5

Tax per option over 41 years	Premium										
	56%	45%	40%	35%	30%	25%	20%	15%	10%	5%	0%
Corporate structure tax	212	209	206	203	199	183	171	160	151	140	110
Income trust structure tax	96	105	109	113	119	124	130	137	145	153	162
Accumulated liability	205	192	183	174	163	139	115	90	67	38	- 23

While the sum of tax paid by income trusts exceeds that paid by corporate structure investments at low valuation premiums (which are unrealistic), it is the accumulated liability that is of importance. Here the tax differential between the corporate structure and the income trust is accumulated at a rate which is intended to match the cost of government borrowing. The annual rate assumed is 4.5% less 38% tax (conservative assumption) the government will receive back in tax revenue (dependent on who purchases the bonds). In the lower valuation premium scenarios the corporate investment portfolio runs out and hence income trust tax receipts are used to pay back the liability assumed by the government to fund the tax deficit.

At any one point in time the government's tax revenue from tax deferred/exempt accounts will be the sum of tax from all individual accounts. Each individual account profile will therefore impact total tax depending on where they are in the accumulation and depletion of capital.

5.1.6 Yves Fortin CAIF Scenario 3B - RRSP

The following analysis looks at the impact on personal taxation of tax exempt accounts when the income trust holder has benefited from the conversion lift in valuations. Chart 25 shows the total return for the corporate and the income trust options. Note that the corporate investment assumes that the corporation had not converted to an income trust. The ability to convert clearly benefits the investor in a tax exempt account.

Chart 26 shows that taxation for the corporate option clearly exceeds that provided by the income trust until the capital in the corporate entity is consumed (ownership rights to capital sold in the market for cash). However the accumulated opportunity cost of having to borrow capital in the fixed interest market exceeds the tax that would be due on the remaining income trust capital held in the tax exempt account. That is if the entire capital was withdrawn from the income trust and taxed at the personal tax rate

The accumulated tax liability depends on the equity risk premium over the government bond used to fund the tax deficit. According to figures provided by Dimson, Marsh and Staunton in "Triumph of the Optimists: 101 Years of Global Investment Returns", the annual average Canadian equity risk premium over bonds from 1900 to 2000 was 4.5%, from 1960 to 2000 2.1%, from 1970 0.5% and from 1980 to 2000 -1.1%. Chart 27 based on the CAIF data shows a risk premium of 1.45%. In the BMO analysis this risk premium increases to 3.55%. The red line is the latent income tax on the income trust capital held within the tax deferred/tax exempt account.

Chart 24

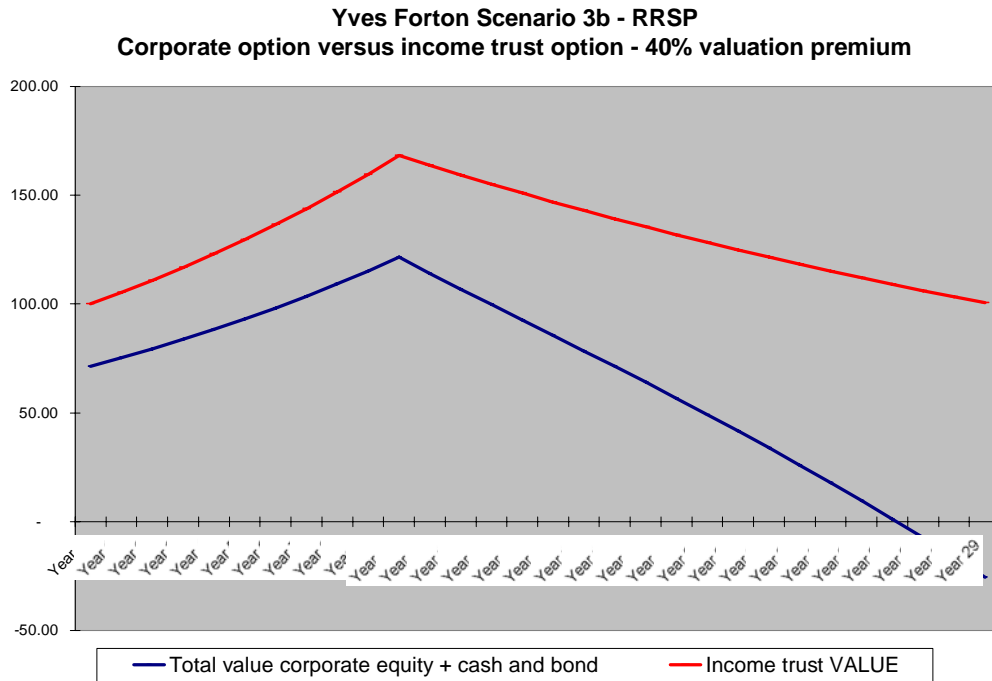


Chart 25

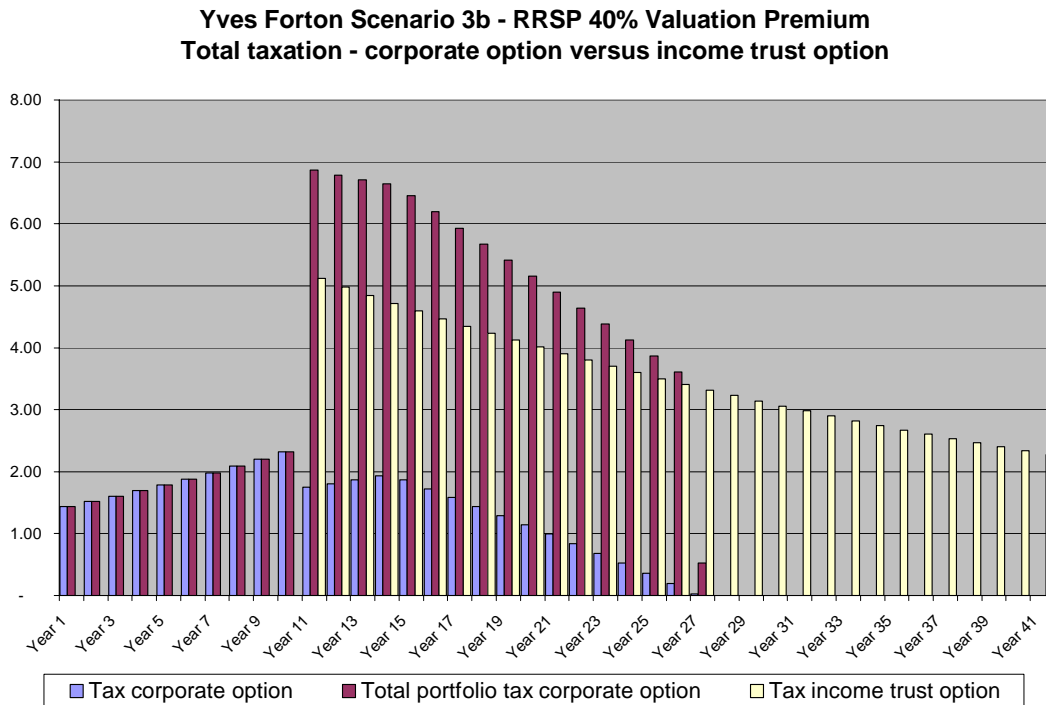
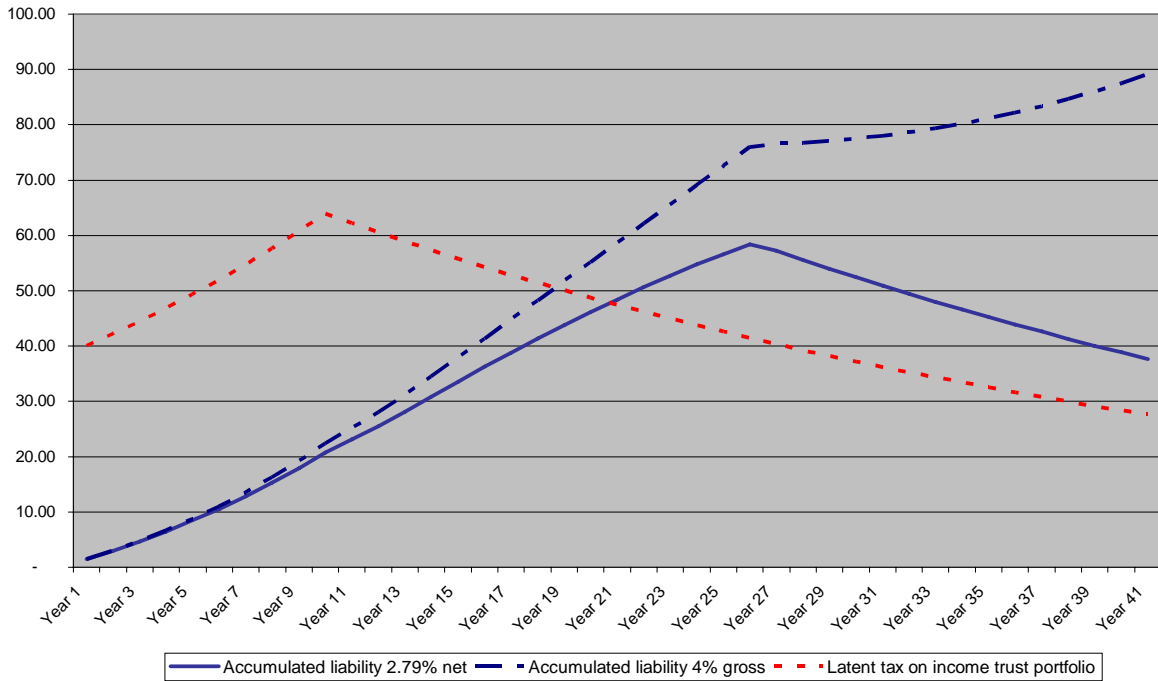


Chart 26

**Yves Fortin Scenario 3b
Accumulated tax liability**

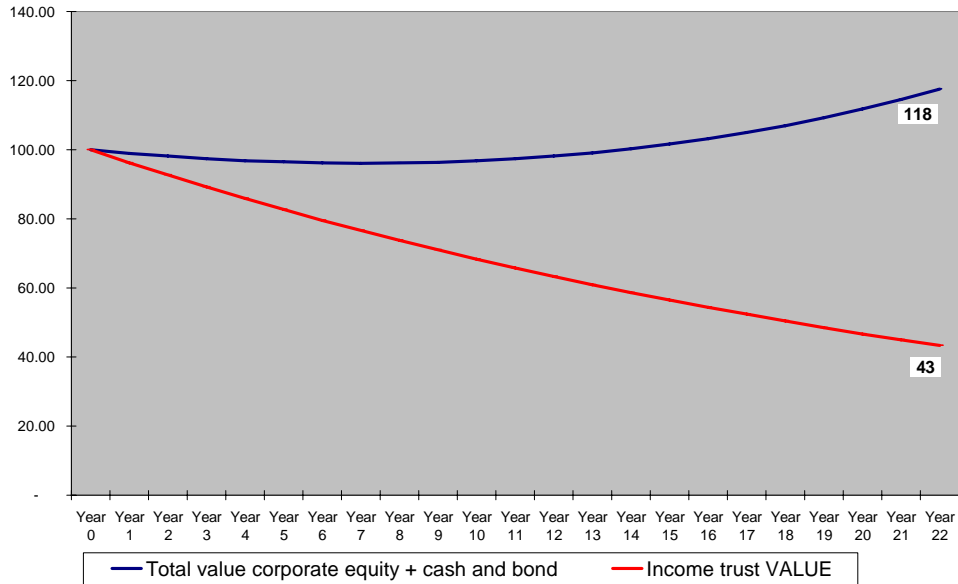


5.1.7 Yves Fortin CAIF Scenario 4 - 2011

Post 2011 income received by the trust will be subject to tax at 31.5%. Individual investors will then be subject to further dividend tax on the distributions. Fortin’s analysis assumes that all return of capital is taxed within the trust and taxed again as a distribution. His report also assumes an effective corporation tax of 25%. Post 2011 there is not expected to be any valuation premium for income trusts. As such the following analysis assumes no pricing premium. Assuming that all the cash distribution is taxed, the total return within an income trust structure relative to a corporate option with no valuation premium is as shown in the next graph.

Chart 27 – Return of capital taxed

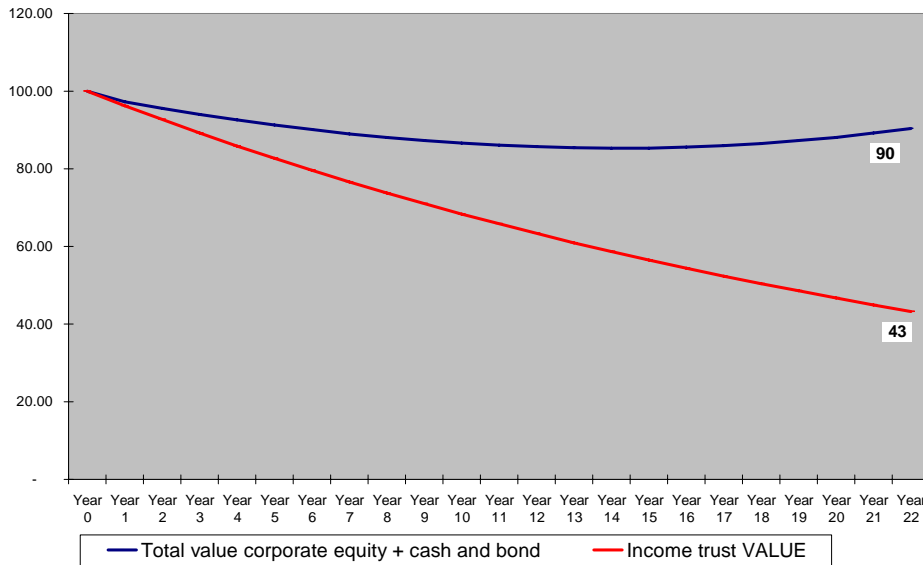
Yves Forton Scenario 4 - Post 2011
Corporate option versus income trust option



Assuming that return of capital is not taxed (either within the trust or in the hands of the investor) chart 29 shows the respective situation.

Chart 28 – Return of capital not taxed

Yves Forton Scenario 4 - Post 2011
Corporate option versus income trust option



The following two charts show the reason for the relative performance. Chart 30 shows the total taxation assuming that all the return of capital is taxed, in accordance with Yves Fortin assumptions.

Chart 29 – tax take, return of capital taxed

Yves Forton Scenario 4 - Post 2011
Corporate option versus income trust option

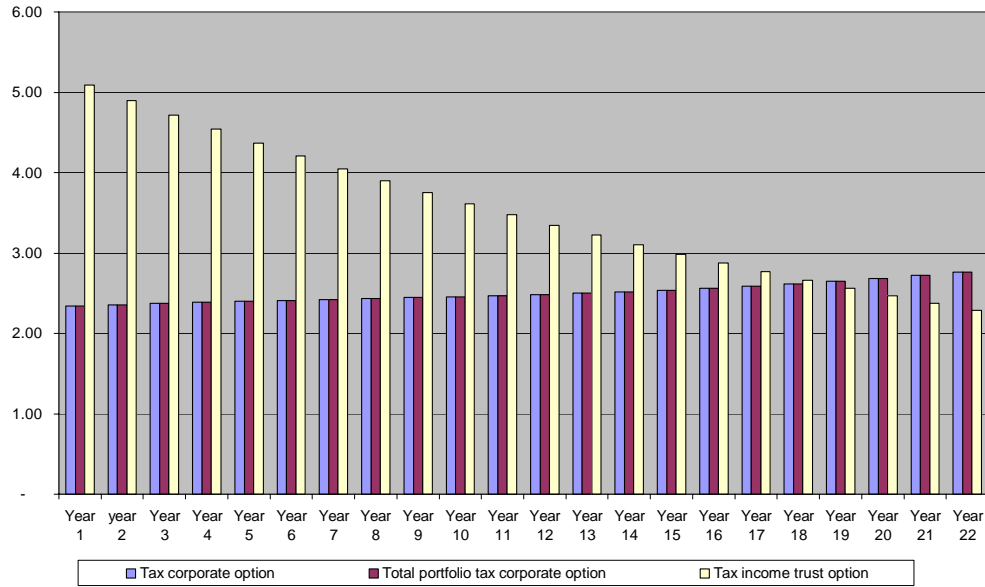


Chart 31 shows the tax assuming return of capital is taxed within the trust but not in the investor’s hands and chart 32 makes the assumption that return of capital is not taxed at all.

Chart 30 – Return of capital taxed in within trust but taxed as dividend

Yves Forton Scenario 4 - Post 2011
Corporate option versus income trust option

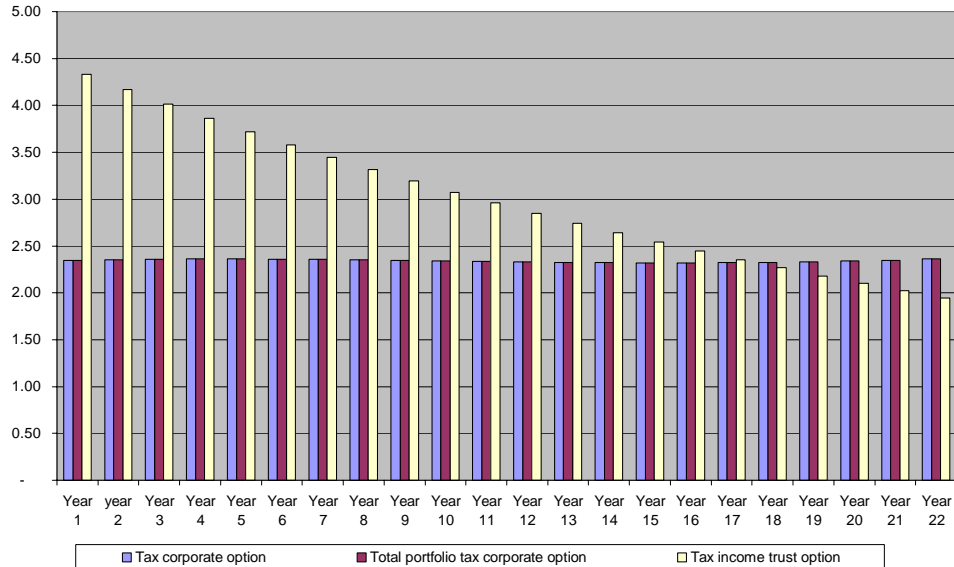
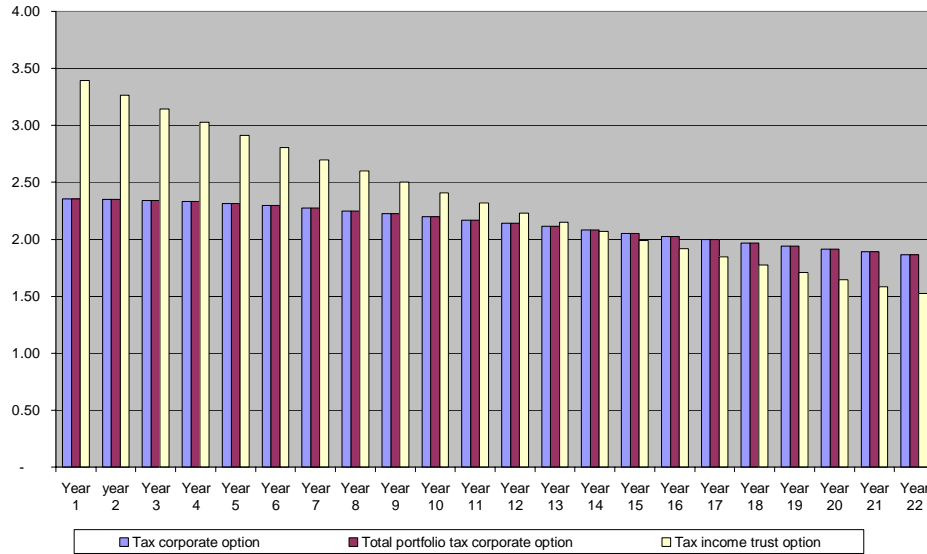


Chart 31

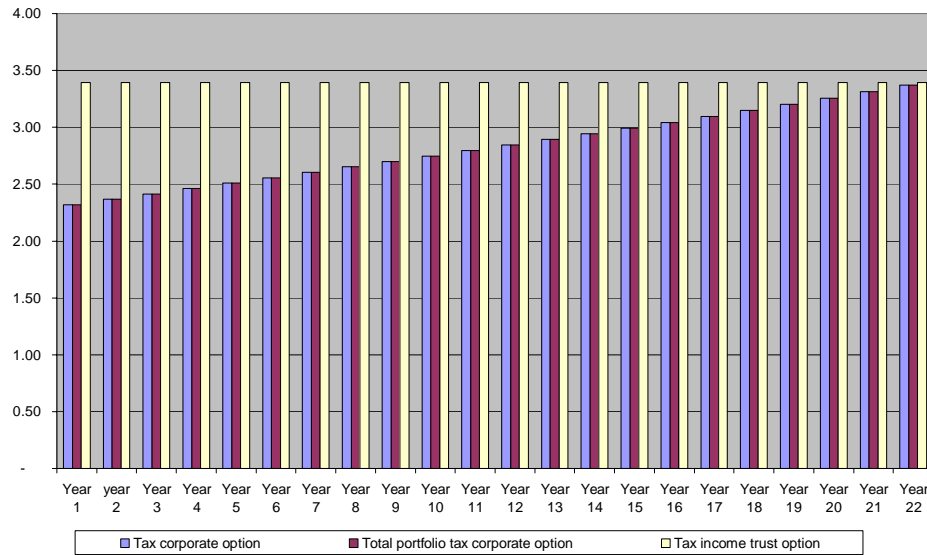
Yves Forton Scenario 4 - Post 2011
Corporate option versus income trust option



In fact if the underlying corporate entity distributed only their taxable earnings and not cash in excess of earnings the following tax situation in chart 33 should arise. This chart is based on an effective corporate tax rate of 25%.

Chart 32 – Distributions = taxable corporate income

Yves Forton Scenario 4 - Post 2011
Corporate option versus income trust option

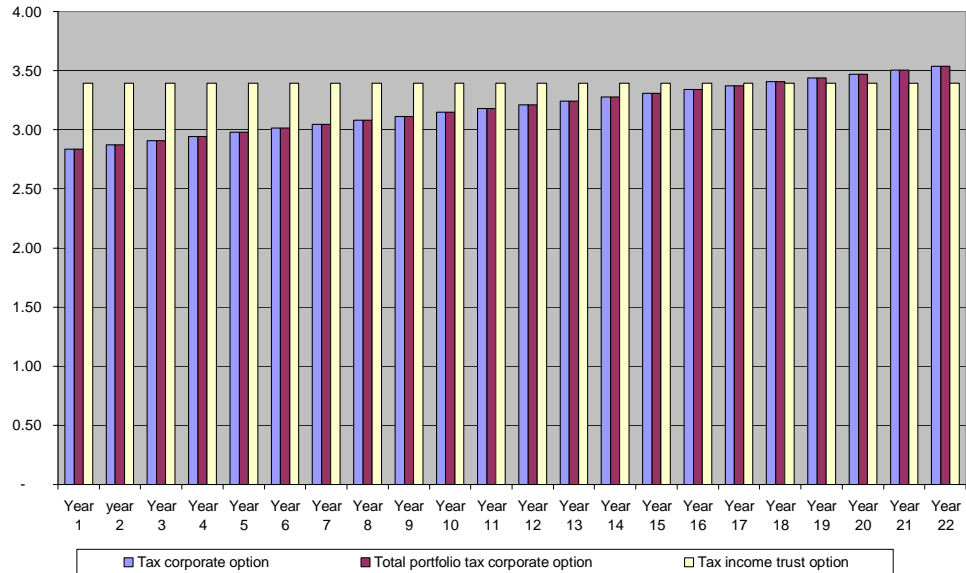


If we look at a corporate tax rate of 32% in 2011 for trusts that only distribute taxable income chart 34 applies.

TAMRIS; Independent, Impartial, Objective

Chart 33 – Corporate tax rate 32%, distributable cash = taxable income

**Yves Forton Scenario 4 - Post 2011
Corporate option versus income trust option**



Therefore in the context of the statutory rate of corporate tax and distribution of taxable earnings only, the income trust structure is being more or less appropriately taxed from 2001 onwards.

5.2 BMO

In this section of the report we use the assumptions noted in the BMO report by Gordon Tait titled “The Inconvenient Truth About Income Trusts”.

This report stated that distributions were 160% of earnings, that corporate taxation as a percentage of EBITDA was 10.5% and that 87% of income trust cash distributions (based on their own trust sample) were taxable. This translates into an equivalent corporation tax rate of 25% with 65% of return of capital subject to personal income tax. The BMO analysis also assessed the outcome assuming an investor’s effective marginal tax rate fell to 25% post retirement from a higher rate of 45% pre retirement.

The following table represents the set of assumptions that will be used in the following analysis²³. A higher cash distribution yield has been used for this analysis to more accurately reflect long term earnings relationships and risk premiums. At an 11.5% cash distribution yield income trust earnings are some 7.2% with a valuation premium of 40%, or 10.06% before corporation tax for a corporate structure. Corporate after tax earnings are some 7.55%.

Table 6

Assumptions	
Income trust distribution - 160% earnings	11.5%
Distributions/earnings	160%
BMO taxable distribution rate	87%
Income trusts earnings	7.19%
Income trust growth rate/depletion	-4.31%
Corporate earnings per share - price adjusted	10.06%
Corporate tax	25.0%
Corporate earnings after tax%	7.55%
Payout ratio	28.0%
Corporation dividends payout	2.82%
Corporate earnings growth rate	4.73%
Gross cash and bond return	4.00%
After tax cash and bond return	2.2%
Capital allocated to income trust	100
Income trust Premium	40%
Capital allocated to corporation	71.43
Capital allocated to cash and bond	28.57
Personal tax rate	45.00%
Effective personal tax rate - incl non taxable return of capital	39.15%
Dividend tax	23.20%

5.2.1 BMO Scenario 1 – taxable accounts

The high personal tax rate in this analysis and the lower corporate tax rate provide a stark reminder of the physical impact of such on total portfolio return. As with the Fortin Analysis a 40% valuation premium allows for a 29% cash and bond allocation.

Chart 35 clearly shows the income trust portfolio suffering from a high valuation premium and taxation of a significant portion of return of capital. Chart 36 on the other hand clearly shows the higher initial tax take from the income trust option; this declines thereafter and by year 9 tax from the corporate structure exceeds the income trust.

²³ A number of the assumptions will be varied – taxation of return of capital, personal tax rates, valuation premiums.

Chart 34 – 40% valuation premium and 65% of return of capital taxed

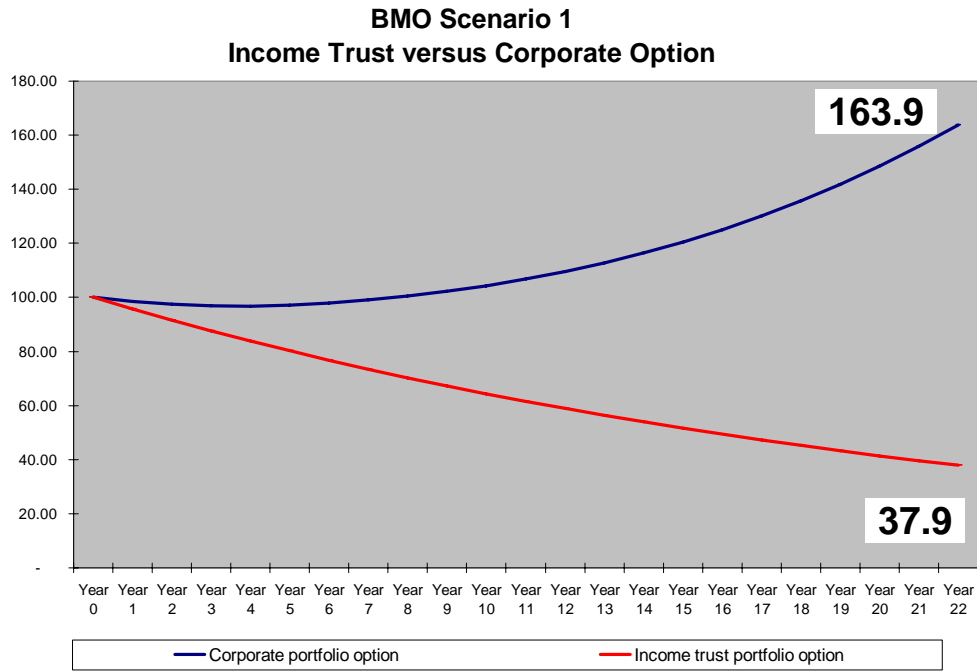
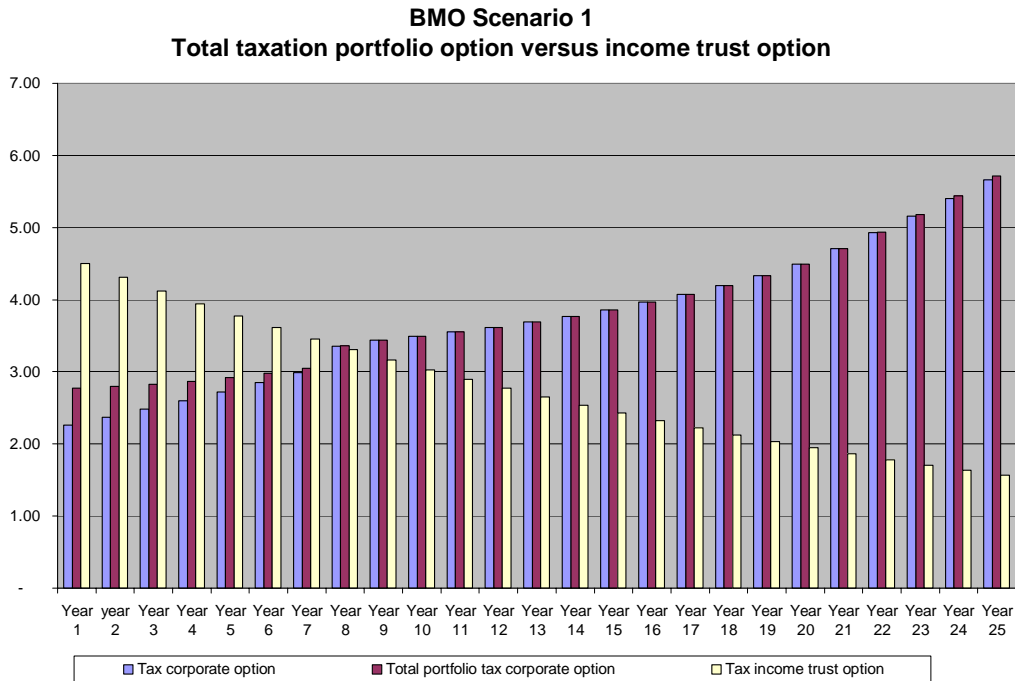


Chart 35 – 65% of return of capital taxed

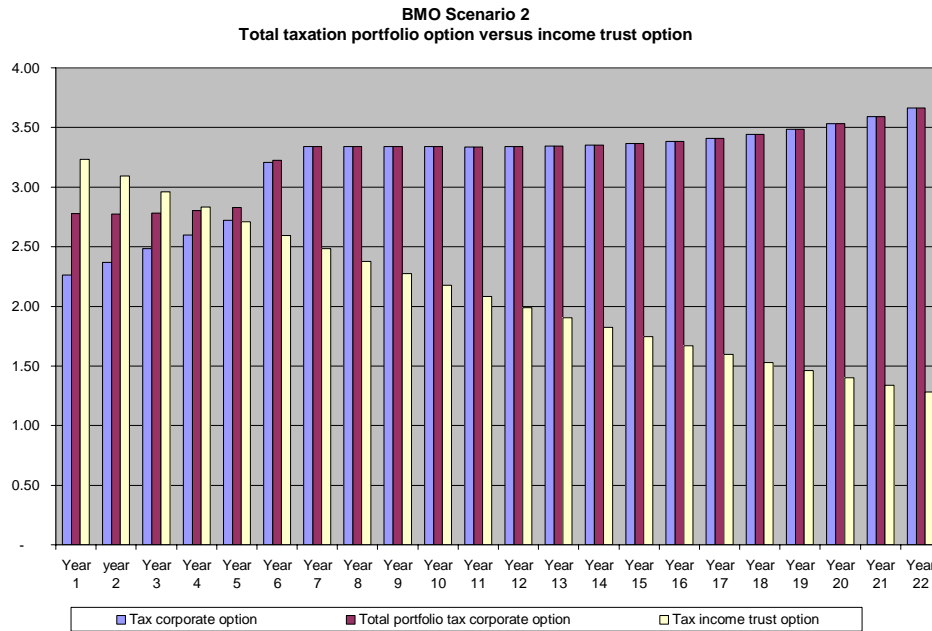


In the “Inconvenient Truth About Trusts” reference was made to the fact that income trusts raised 2.2 times the level of tax corporations provided. In chart 36 income trust tax to corporation tax is a ratio of 2 at outset.

Chart 37 (overleaf) is taken from Scenario 2. In this we exclude the taxation of return of capital. The ratio of income trust to corporate tax should then fall from 2 to 1.4. Indeed, add the tax on cash and bond

interest and the actual tax take ratio falls to 1.16 at outset.

Chart 36 – Return of capital not taxed



Why investors would want to support a product whose tax take is higher than it should be because return of capital is being taxed and, why this should be a reason to reinstate these vehicles is difficult to comprehend.

Table 7

160% distributable cash - return of capital taxable								
Premium	Income Trust end value	Tax paid		Portfolio option end value	Tax paid		Portfolio option asset allocation	
		10 year	22 year		10 year	22 year	Cash & Bonds	Shares
56%	42	34	61	172	29	79	36%	64%
40%	38	37	65	164	31	80	29%	71%
15%	31	44	73	137	32	76	13%	87%
0%	25	48	78	111	32	69	0%	100%
Required rate of return - Income Trust								
Premium	Cash distribution rate	Required rate of return on equity		Original return on equity	% Increase			
56%	24.5%	15.3%		6.45%	237%			
40%	25.0%	15.6%		7.19%	217%			
15%	25.5%	15.9%		8.75%	182%			
0%	26.0%	16.3%		10.06%	162%			

Table 7 above shows the data range for the BMO assumptions. In the above analysis cash distributions at a 40% premium are equivalent to a cash yield of 11.5%. As the valuation premium falls the cash distribution rises since earnings per unit are rising and cash distributions represent some 160% of earnings. Please note that the cash distribution from the income trust as a percentage of the share capital

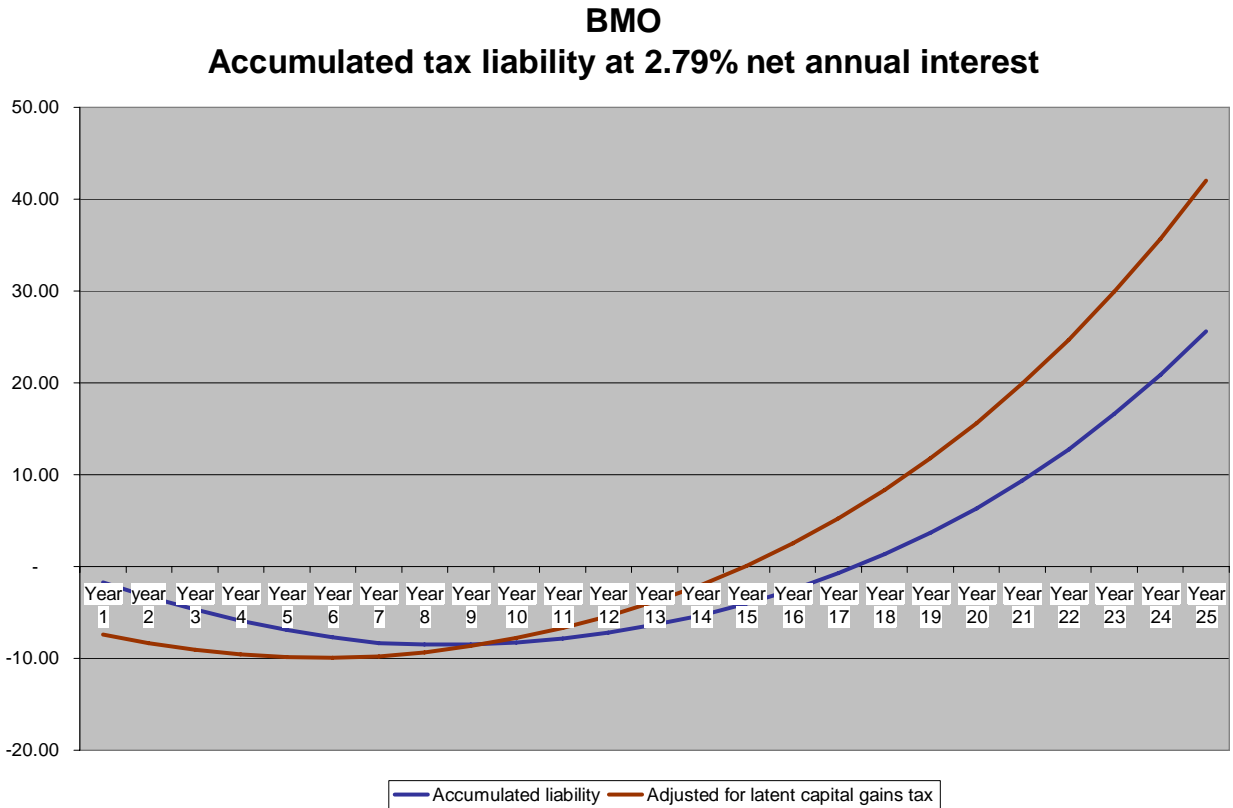
TAMRIS; Independent, Impartial, Objective

remains constant as valuation premiums change (valuation premium falls, distribution rises, distribution as a percentage of corporate structure remains constant). Table 7 also shows that a) whatever the premium, the impact of taxing return of capital at 45% results in significant long term risks to return, b) the costs of taxing capital means that earnings within an income trust need to be significantly higher than the corporate structure.

5.2.1.1 Accumulated tax liability – taxable accounts

The accumulated tax liability of selecting the corporate option over the income trust option is in deficit in the early years, but moves into significant surplus in later years. The size of the surplus declines and the time frame of the cross over point increases the smaller the valuation premium. Please see section 5.1.1.1 and 5.1.3.2 for further detail on this particular aspect of the modelling²⁴.

Chart 37 – 40% valuation premium, taxation of return of capital



²⁴ Equity risk premium 3.55%, opportunity cost 2.79%; opportunity cost is the cost of the government having to issue debt to borrow capital to fund

Chart 38

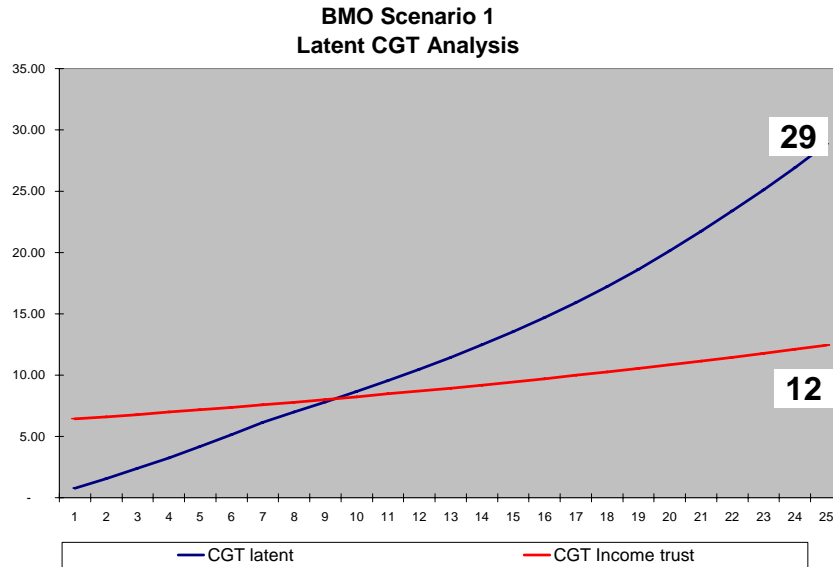


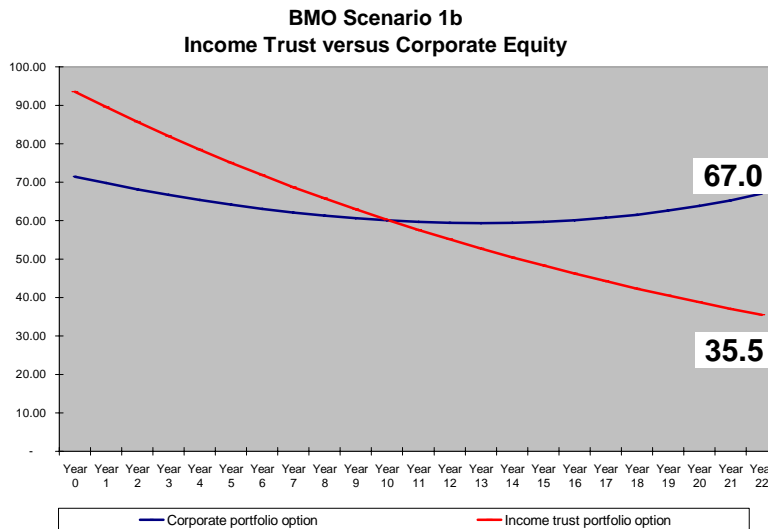
Chart 39 shows the latent CGT in the scenario relative to the opportunity costs of the capital gains tax on conversion.

5.2.2 BMO Scenario 1B – return of capital taxable

The changed assumption for this analysis is that the holder of the income trust is assumed to have the corporate structure/share prior to conversion and continues to hold it beyond conversion. Therefore the starting capital value of the portfolio option is the value of the company pre conversion and the value of the income trust the value of the business post conversion.

Chart 40 shows the total return for the income trust and share assuming 65% of return of capital is being taxed. Chart 41 shows a valuation premium of 15% and chart 42 a valuation premium of 56%. Chart 43 shows the tax take for chart 40. Clearly in this scenario the tax take from the income trust structure is higher, but the impact of taxation on return of capital remains significant.

Chart 39 - 40% valuation premium



TAMRIS; Independent, Impartial, Objective

Chart 40 – 15% valuation premium

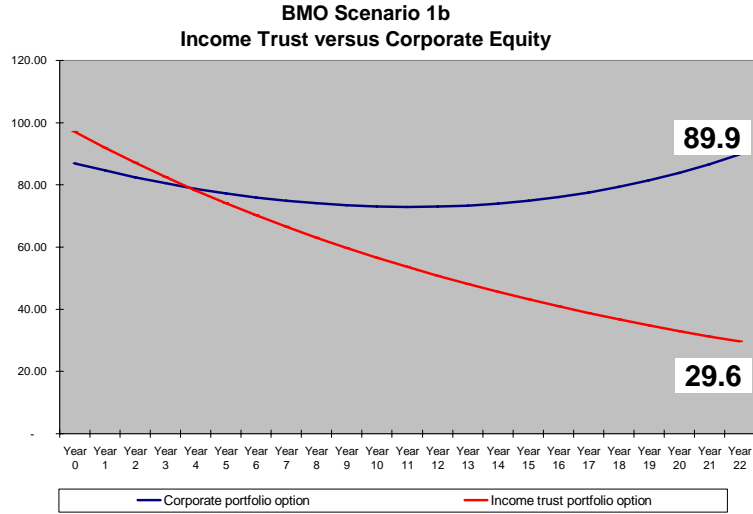


Chart 41 – 56% valuation premium

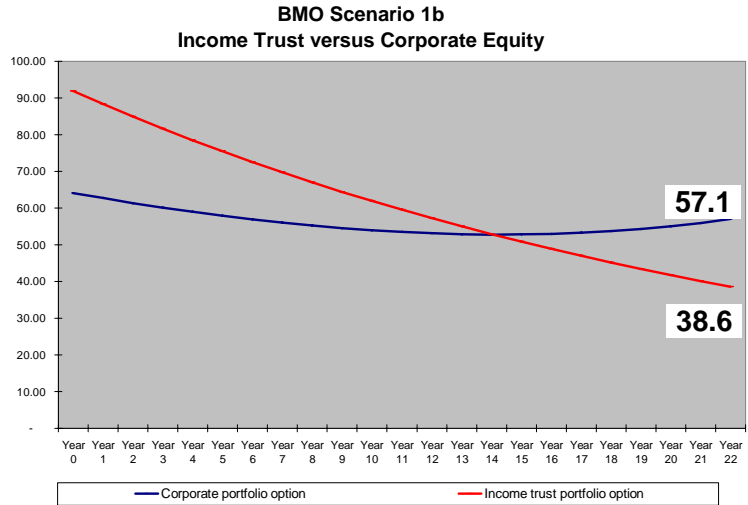
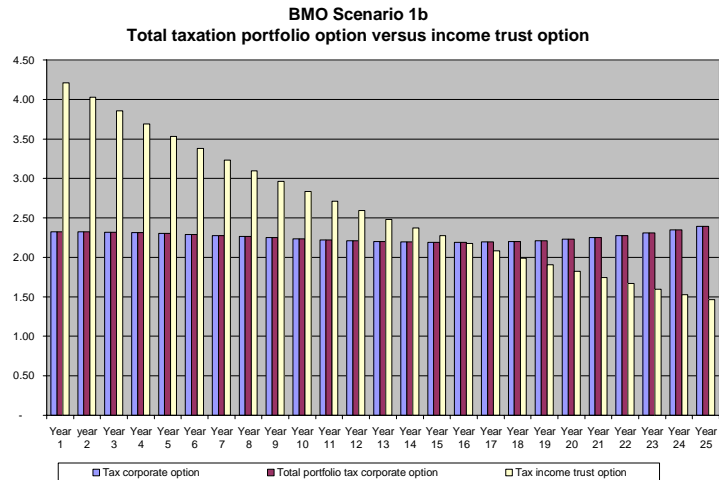


Chart 42 – Tax, valuation premium 40%



5.2.3 BMO Scenario 2 – taxable accounts, return of capital not taxable

The following analysis shows the return and tax profile that an income trust should have if return of capital was not taxable but distributions in excess of earnings were still made. Chart 44 shows the total return scenario for a valuation premium of 40%.

Chart 43 – 40% valuation premium, cash distributions 160% of earnings, return of capital tax free

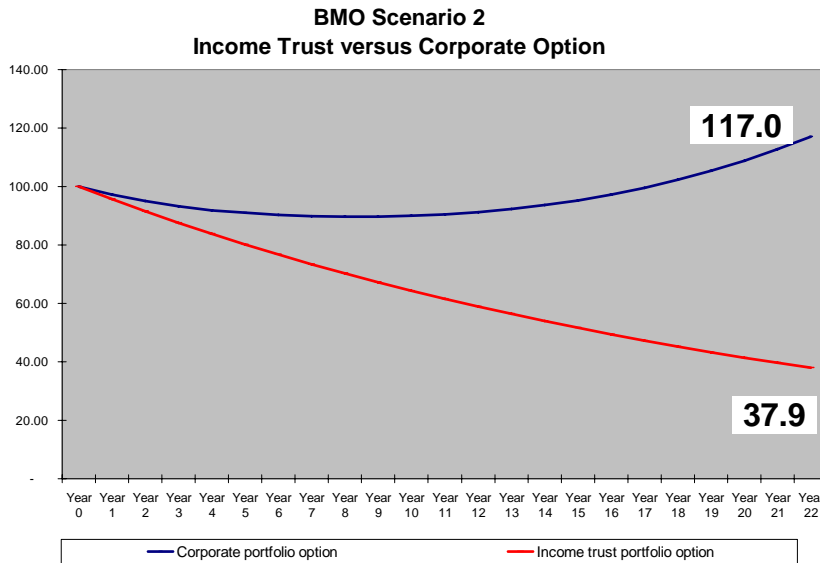


Chart 45 shows the tax on two portfolio options assuming no taxation of return of capital. Note the tax rising in year 6. This is due to capital gains tax being paid on share realizations to fund the equivalent withdrawal following the depletion of the low risk portfolio.

Chart 44 – Tax based on distributions of 160% of earnings and 40% valuation premium

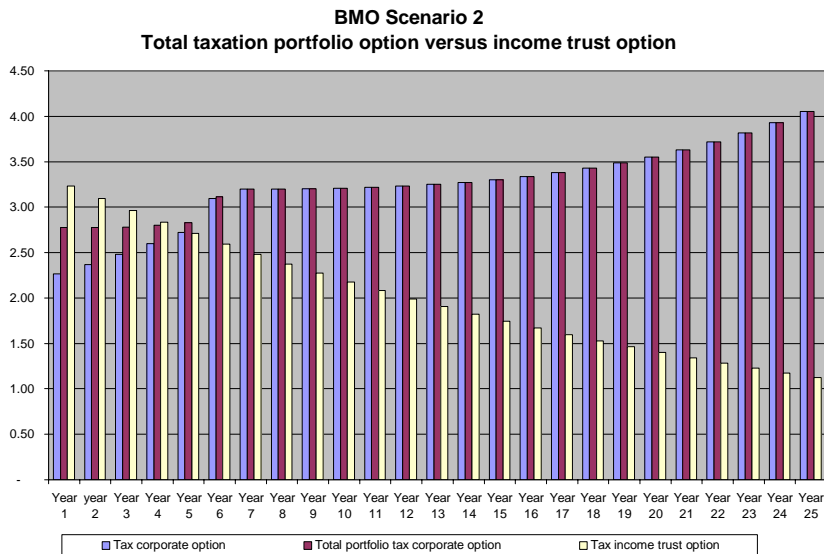


Table 8 is the summary table for the data range associated with distributions at 160% of earnings.

Table 8

160% distributable cash - return of capital non taxable								
Premium	Income Trust end value	Tax paid		Portfolio option end value	Tax paid		Portfolio option asset allocation	
		10 year	22 year		10 year	22 year	Cash & Bonds	Shares
56%	42	24	44	132	29	72	36%	64%
40%	38	27	47	117	30	71	29%	71%
15%	31	31	52	80	30	64	13%	87%
0%	25	35	56	49	31	58	0%	100%
Required rate of return - Income Trust								
Premium	Cash distribution rate	Required rate of return on equity		Original return on equity	% Increase			
56%	16.9%	10.6%		6.45%	164%			
40%	17.3%	10.8%		7.19%	150%			
15%	17.8%	11.1%		8.75%	127%			
0%	18.0%	11.2%		10.06%	112%			

The above basically shows that the impact of the valuation premium alone is significant. The income trust has to work that much harder to break even in terms of total return. Chart 46 shows the relative performance of the two portfolio options where distributions are only 100% of earnings and chart 47 the associated tax position over time.

Chart 45 – Distributions 100% of earnings, 40% valuation premium

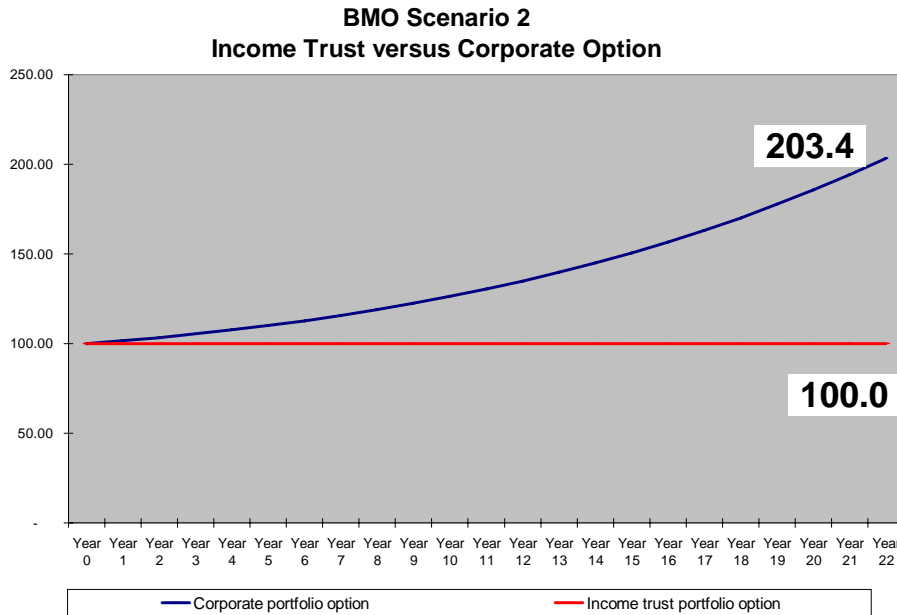


Chart 46 – Tax based on distributions of 100% of earnings, 40% valuation premium

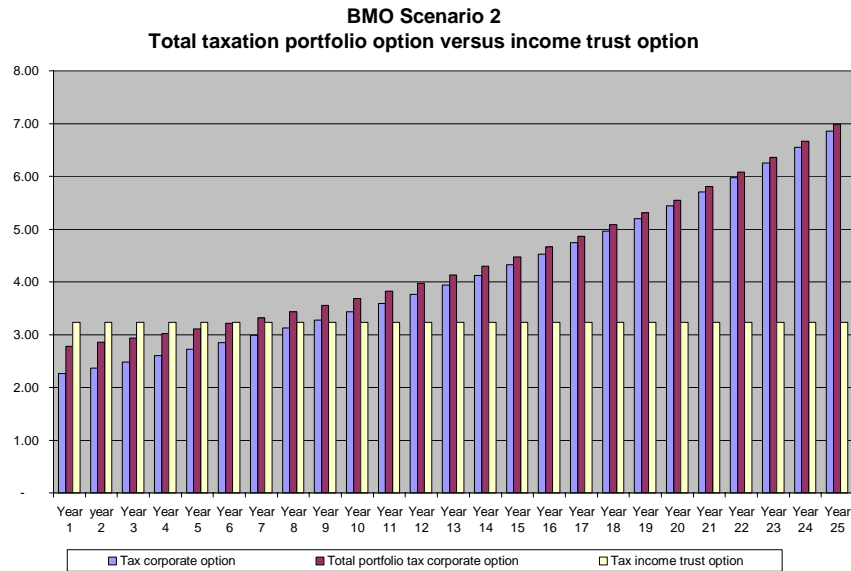


Table 9 is an abbreviated summary table for cash distributions of 100% of earnings. Note the lower end figure for the 56% valuation premium. This is due to the increased low risk asset allocation.

Table 9

100% distributable cash - return of capital non taxable								
Premium	Income Trust end value	Tax paid		Portfolio option end value	Tax paid		Portfolio option asset allocation	
		10 year	22 year		10 year	22 year	Cash & Bonds	Shares
56%	100	29	64	199	31	86	36%	64%
40%	100	32	71	203	32	90	29%	71%
15%	100	40	87	185	35	95	13%	87%
0%	100	45	100	149	36	92	0%	100%

5.2.4 BMO Scenario 2B – return of capital tax free

As with scenario 1b the following analysis relates to the performance and taxation of the two options where the income trust holder is assumed to hold the share prior to conversion and the income trust post conversion. This time return of capital is not taxed.

Chart 48 shows the returns on the two options assuming a 40% income trust valuation differential and distributions of 160% of earnings. Chart 49 shows the outcome with only 100% of earnings distributed as cash. Chart 50 illustrates the tax situation for chart 48 and shows a marginally higher tax take (note that in this analysis non statutory rates of corporation tax are used). Chart 51 shows the tax situation for chart 49, which shows that in this scenario the tax take is higher over time for the corporate option; it is a result which stands for higher and lower valuation premiums. Chart 52 shows the accumulated tax liability for this relationship (chart 49). Income trusts start off with higher taxation but end with lower relative taxation and this is shown in the rise and fall of the curve.

Chart 47 – 40% valuation premium

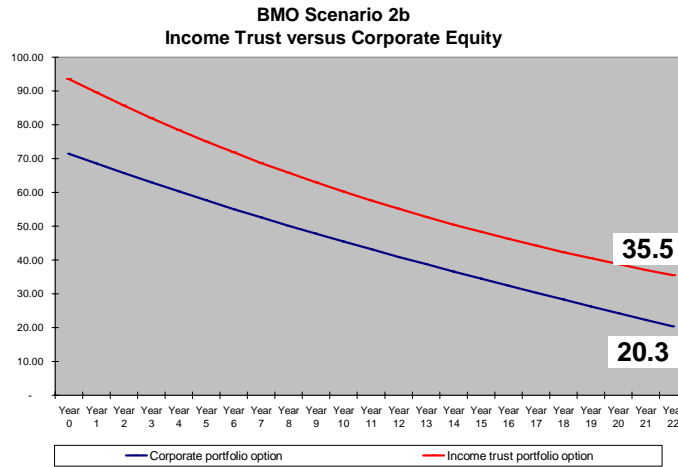


Chart 48 – 40% valuation premium, distributions 100% of earnings

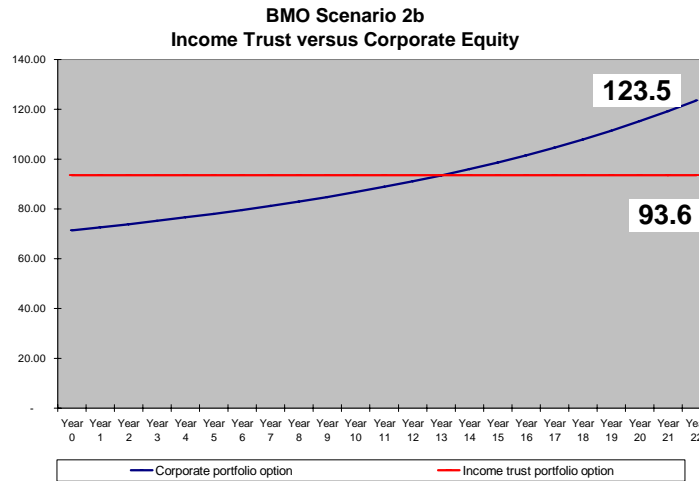


Chart 49 – tax for chart 48

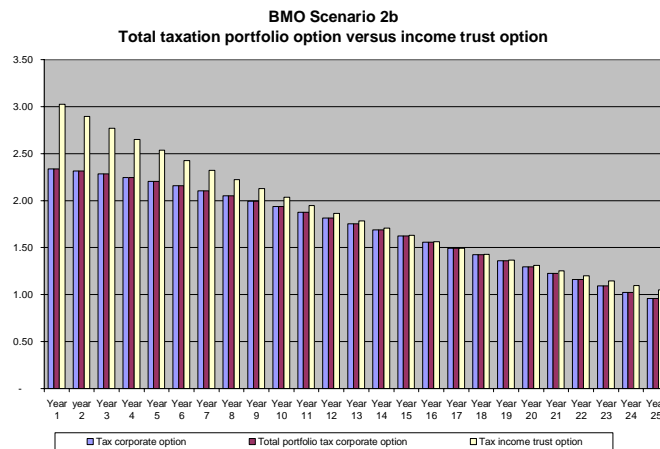


Chart 50 – tax for chart 49

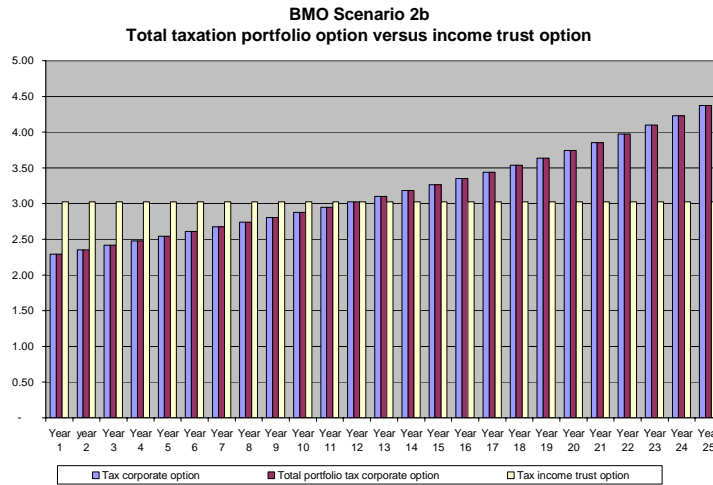
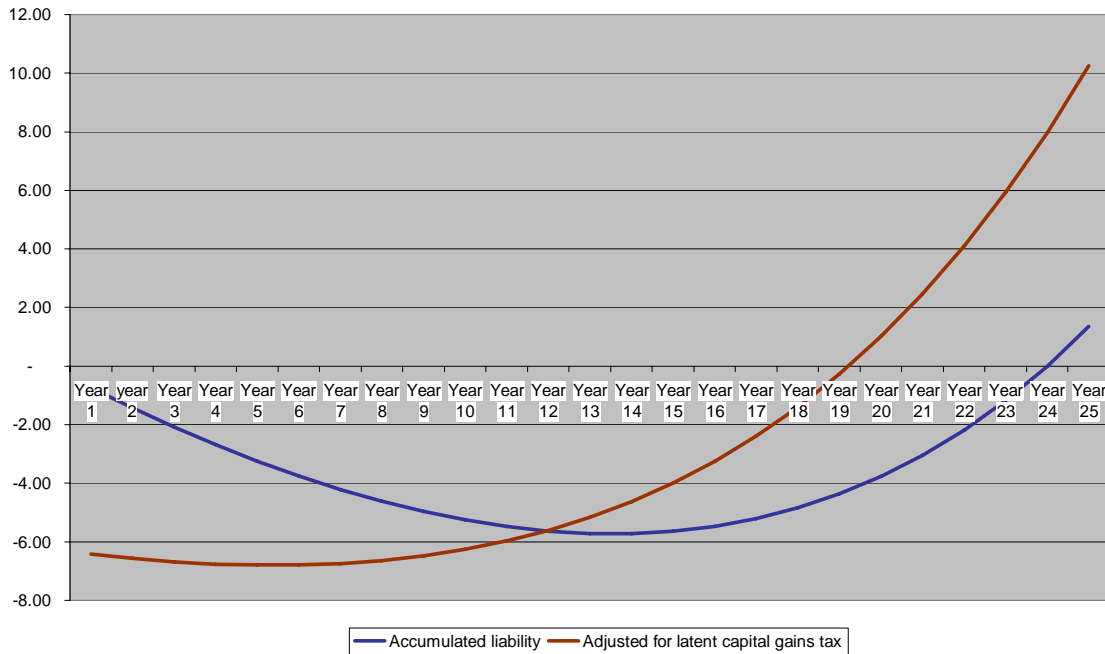


Chart 51

BMO
Accumulated tax liability at 2.79% net annual interest



5.2.5 BMO Scenario 3 – lower rate taxpayers

The following analysis was conducted at an average income tax rate of 31% and a dividend tax rate of 7%. The following two charts (53 and 54) show the return and tax payable relative to an income trust assuming 65% of the return of capital is taxable with a valuation premium of 40%. Charts 55 and 56 show the same scenario but this time with return of capital not being taxed.

Chart 52

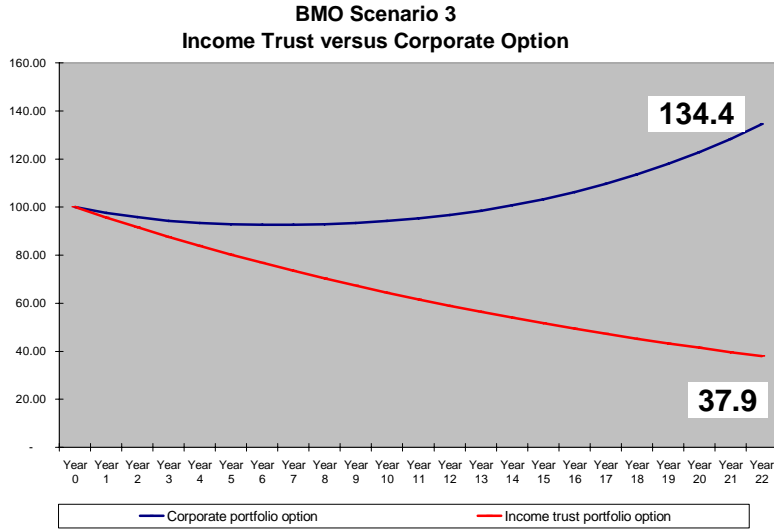


Chart 53

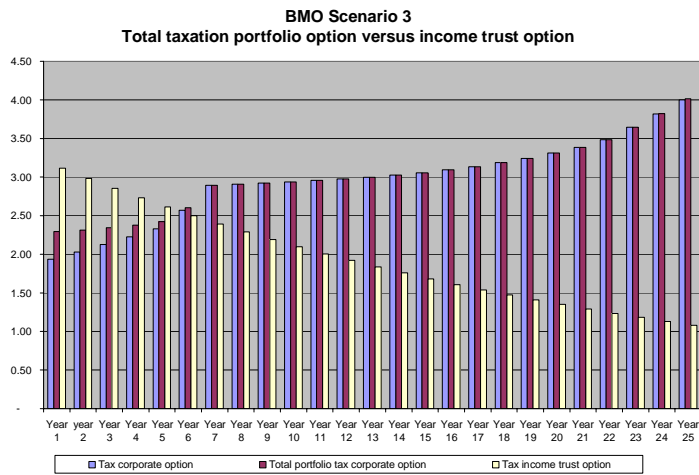


Chart 54

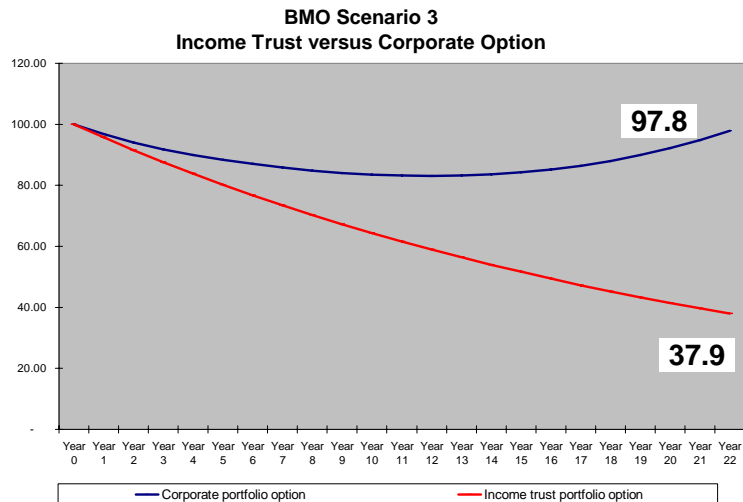
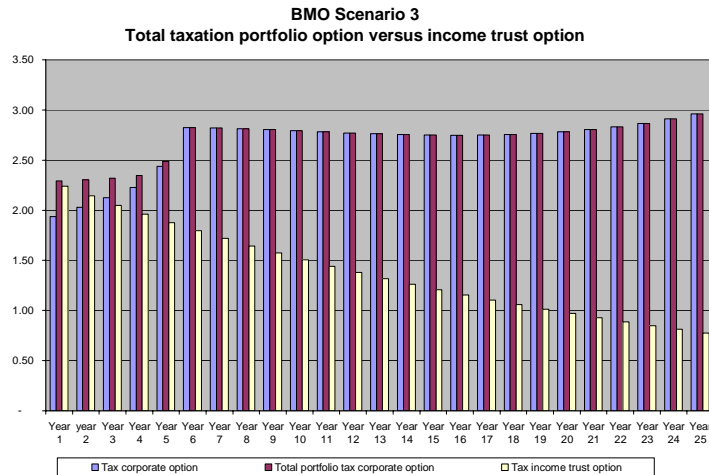


Chart 55



The conclusion from the above charts is that income trusts should be of greatest benefit to those with lower rates of income tax. Unfortunately taxation of return of capital and valuation premiums more than compensate for any benefit.

5.2.6 BMO Scenario 4 – RRSP

In chart 57 corporate and income trust returns accumulate until year 10, after which the 11.5% distributable cash yield (160% of earnings at 40% valuation premium) is distributed from the income trusts. Chart 58 shows the associated tax profile. Further charts show the same information with valuation premiums of 56%, 40% and 20%. The primary reason for the performance differential of income trusts at lower valuation premiums is due to the higher tax paid by the corporate portfolio option.

Chart 56 – 56% valuation premium

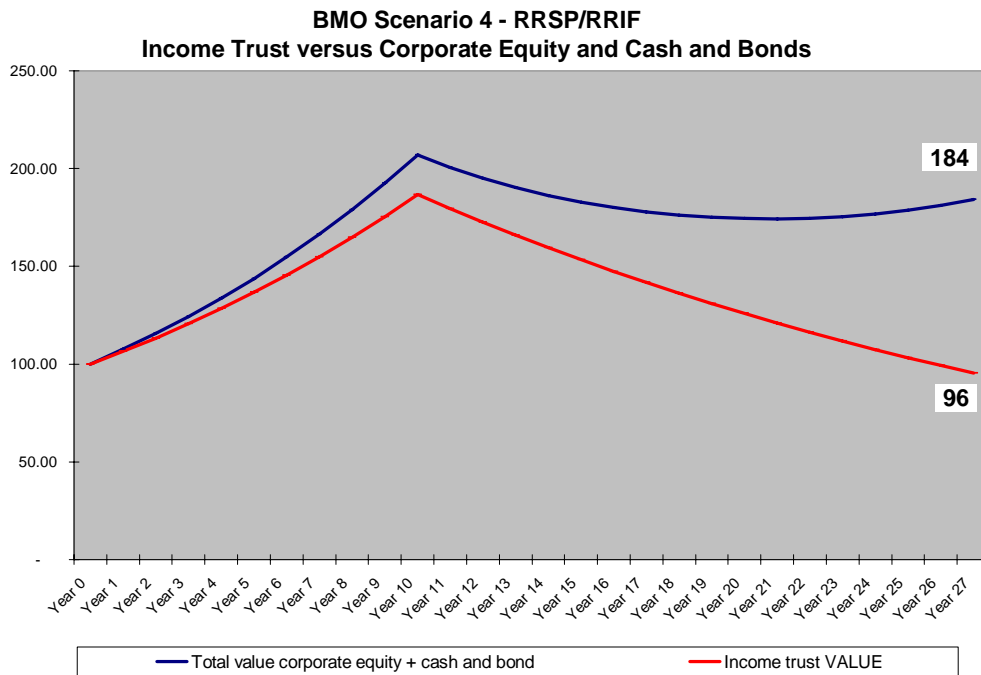


Chart 57 – Tax - 56% valuation premium

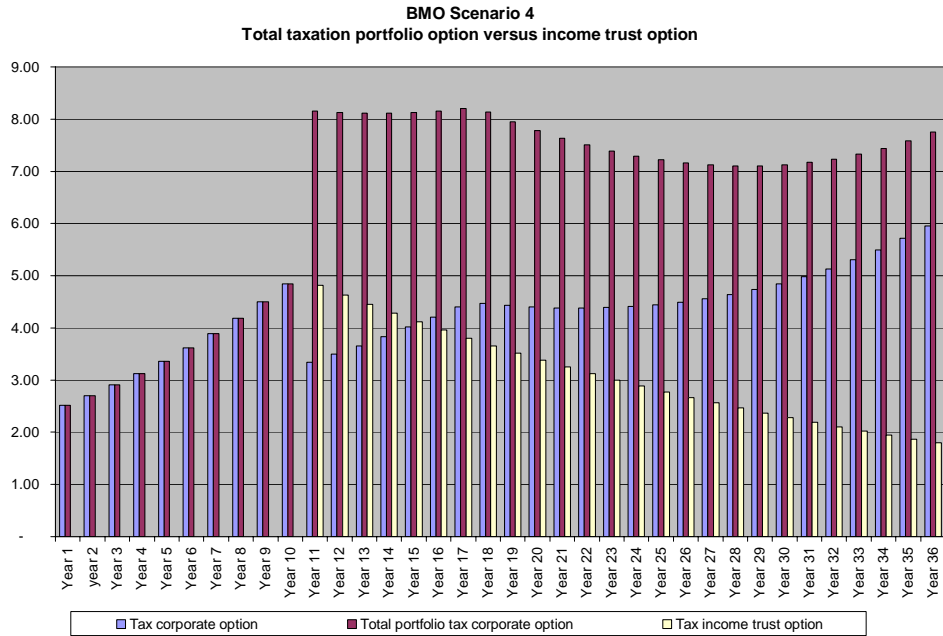


Chart 58 – 40% valuation premium

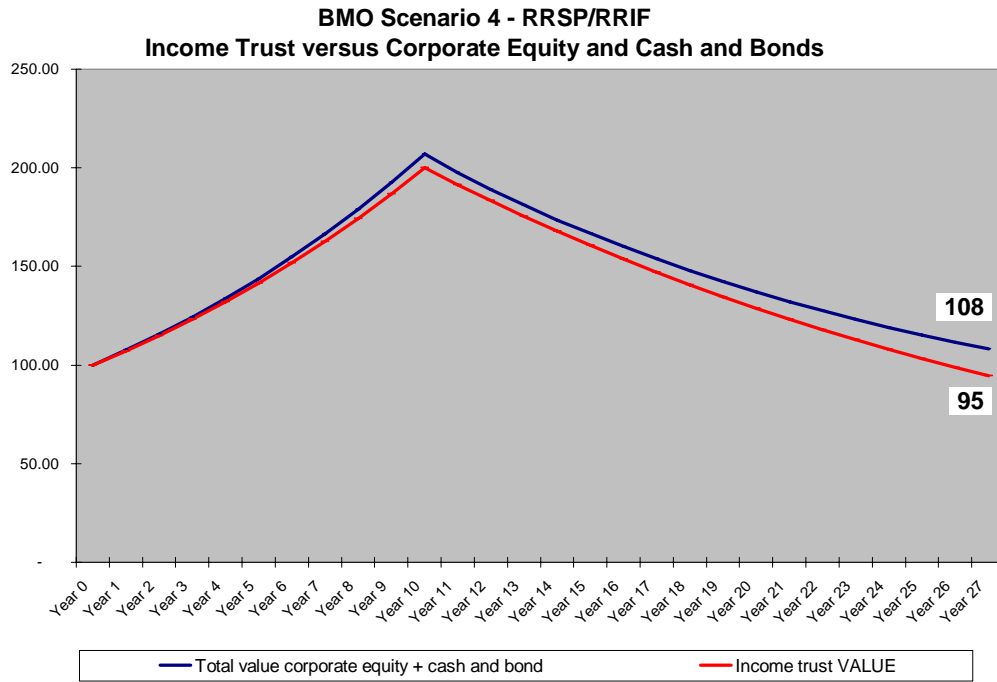


Chart 59 – 40% valuation premium

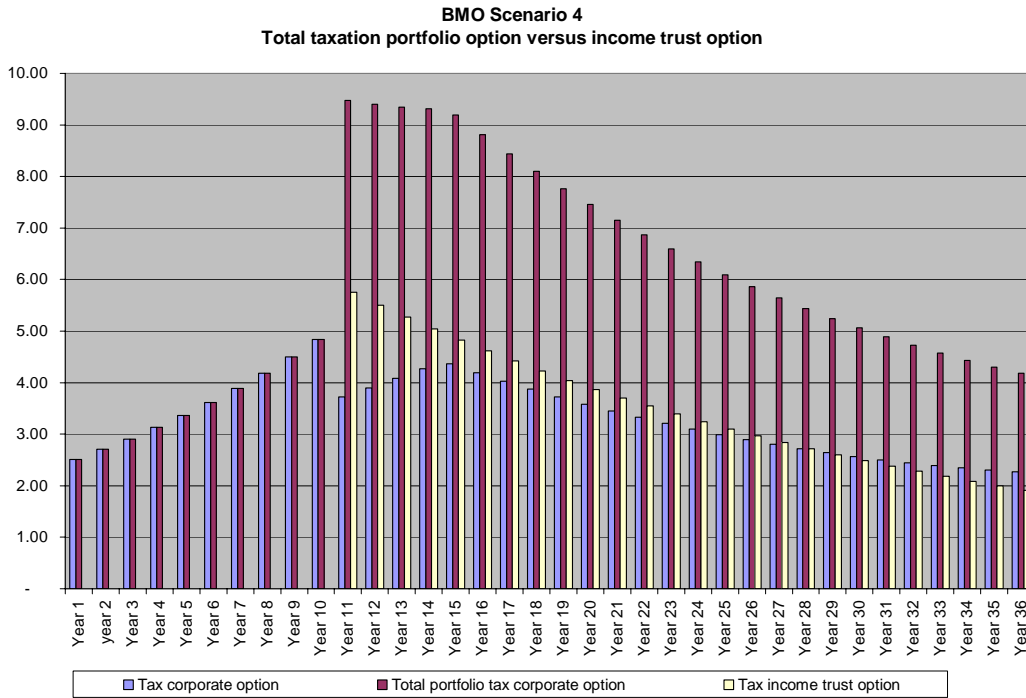


Chart 60 – 20% valuation premium

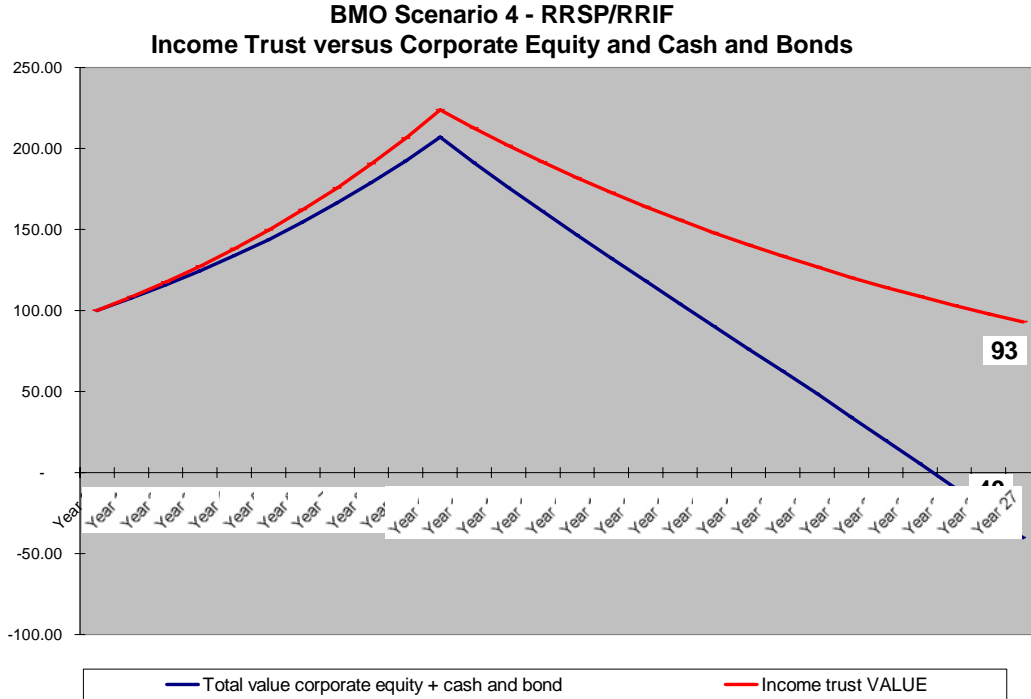
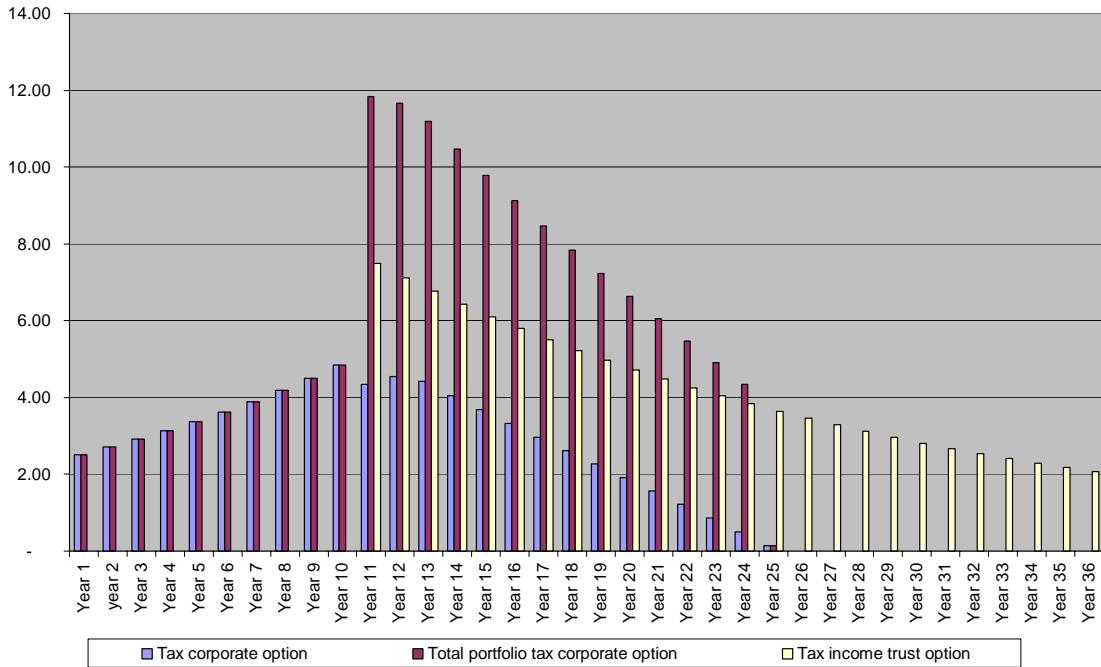


Chart 61 – 20% valuation premium

BMO Scenario 4
Total taxation portfolio option versus income trust option



While investors will deplete their investment holdings corporate structures and business entities that reinvest in their business are likely to continue in one form or another. The previous charts show that the only time the income trust option provides a higher level of taxation per investor within an RRSP structure is when the capital allocated to the corporate option is fully depleted due to paying a higher level of taxation. The following charts show the accumulated tax liability (the opportunity cost of corporate tax foregone) for two different valuation premiums and a 3.55% equity risk premium. The red dotted line shows the latent tax on remaining capital held in the income trust, the solid blue line the accumulated tax surplus of deficit from selecting the corporate portfolio option.

Chart 62 – 40% valuation premium

BMO Scenario 4
Accumulated tax liability

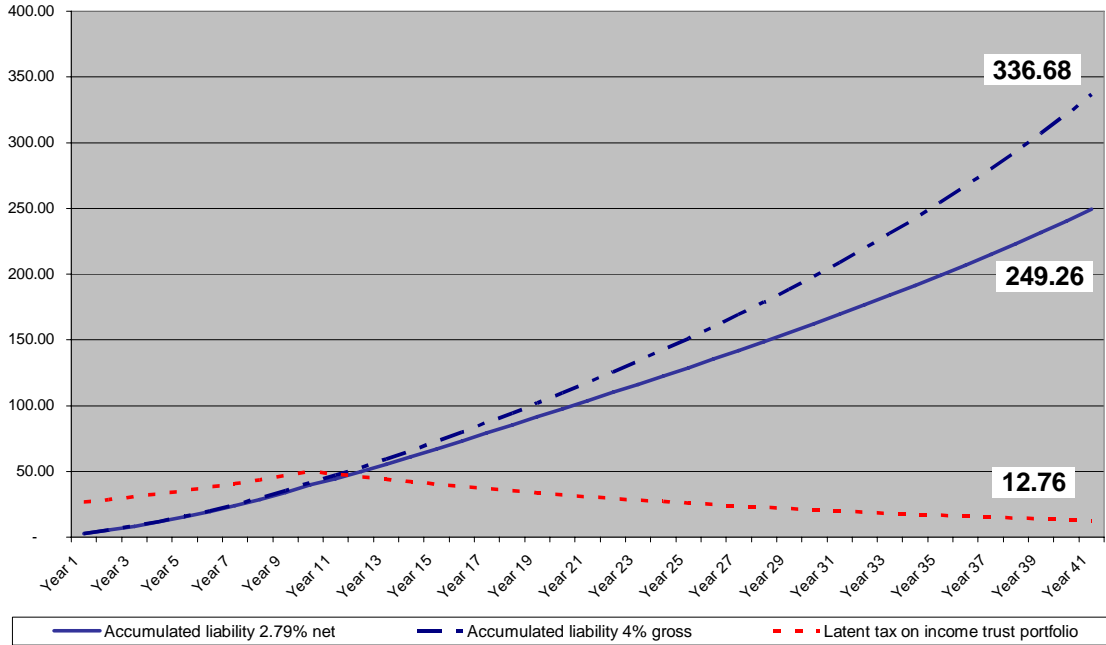
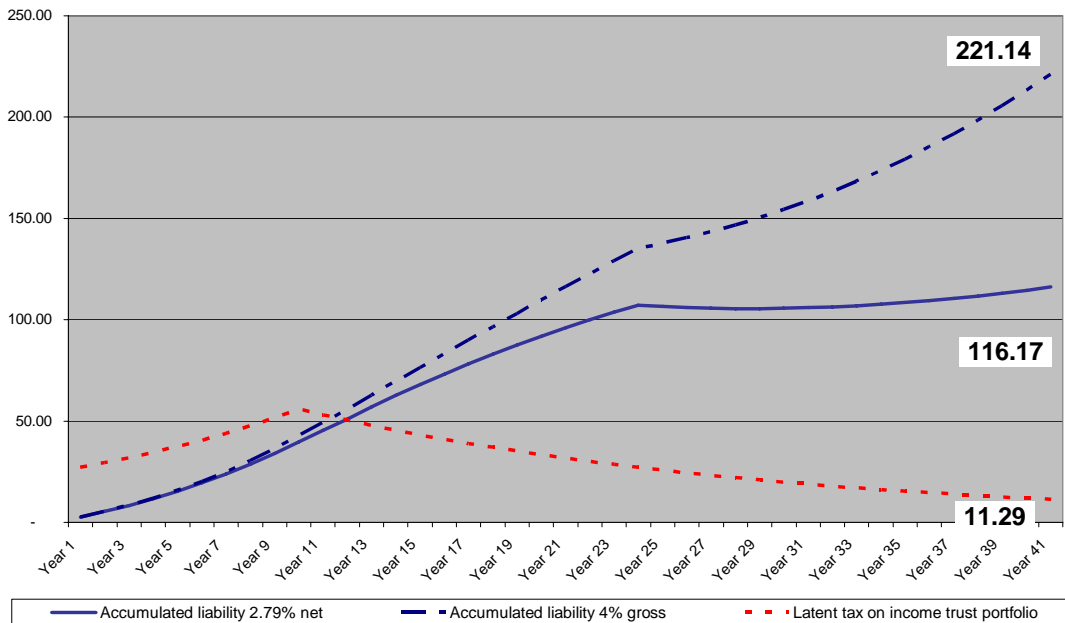


Chart 63 – 20% valuation premium

BMO Scenario 4b
Accumulated tax liability



5.2.7 BMO Scenario 4B - RRSP

This analysis assesses the tax take for tax exempt/deferred accounts where the income trust holder was also the share holder and has hence benefited from the conversion/IPO uplift.

Chart 65 shows the total return within a tax exempt/deferred account for a valuation premium of 40% and chart 66 the associated tax profile. Chart 67 shows the accumulated surplus/deficit tax liability associated with the opportunity cost of the tax differential between the corporation and the income trust. This differential is due to corporation tax paid on the corporate portfolio option. The implicit equity risk premium in this analysis (Chart 67) is 3.55%. The outstanding tax liability in this scenario is larger than the latent tax (red dotted line) that would be due on the remaining income trust capital within the pension fund.

Chart 64

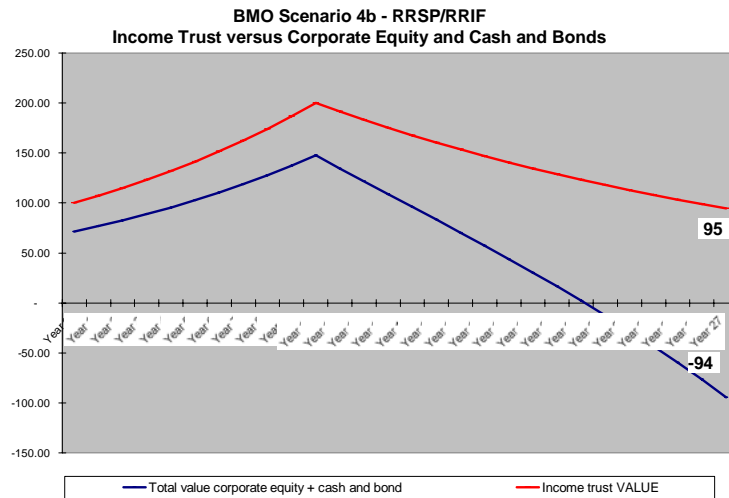


Chart 65

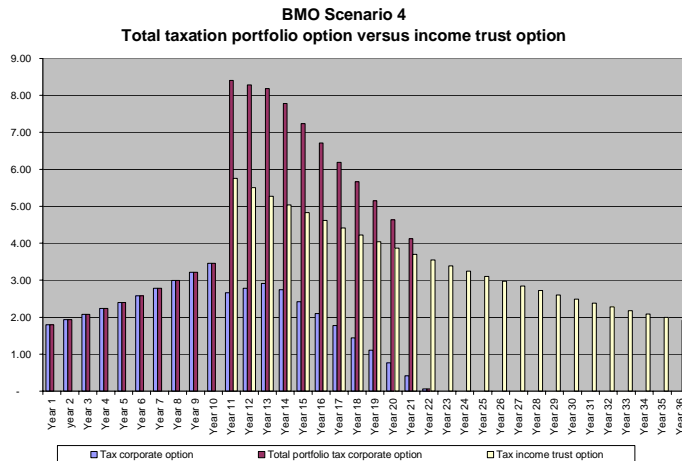
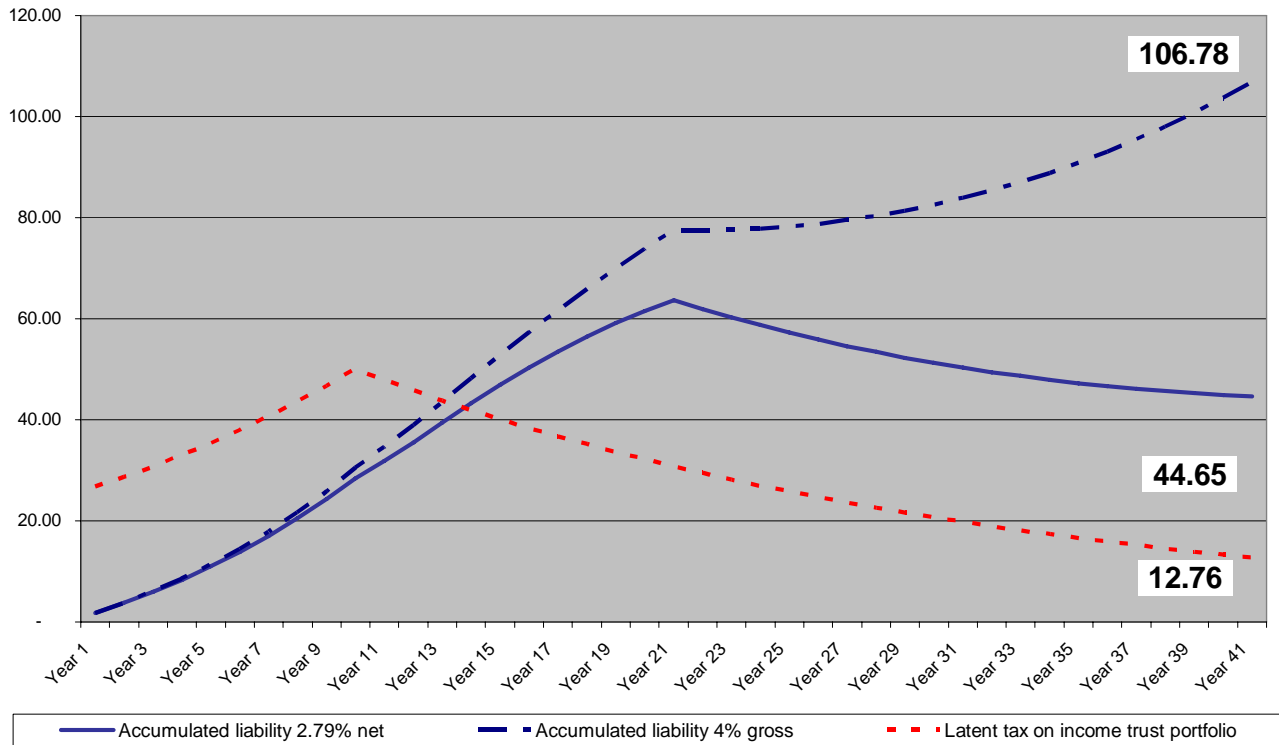


Chart 66

BMO Scenario 4b Accumulated tax liability



5.2.8 BMO Scenario 5 – Post 2011

The analysis is virtually the same for the BMO data as for the Fortin data and therefore readers should refer to section 5.1.4 for further information.

5.3 Certified General Accountants

It is worthwhile at this point to look at the above analysis through an alternative independent report prepared by the Certified General Accountants titled “Demystifying Income Trusts”. This report provided an assessment of income trust and corporate taxation and the following analysis uses the high income earner and the low income earner data as reference points.

However it is important to note that the CGA analysis did not include the impact of capital gains tax on retained earnings nor did it assess the implications of a valuation premium on the total risk/return relationship between income trusts and portfolios with corporate structure investments (shares). This analysis as shown in this report is material to a proper assessment of total taxation and total return with regard to the private investor. THE CGA also excluded tax exempt accounts and focused only on taxable accounts, as will this comparative analysis.

The following analysis looks at the CGA analysis assuming a) no valuation premium (charts 68 and 69) and b) a 40% valuation premium (charts 70 and 71). In keeping with the CGA analysis no return of capital is assumed to be distributed or taxed, which again is at odds with the facts and unrealistic. The first two charts look at a higher rate taxpayer and the second two charts a lower rate taxpayer.

Chart 67²⁵

No valuation premium, 46% income tax, 23% dividend tax rate, 36.16% corporate tax

**CGA Taxation Analysis
Higher rate taxpayer**

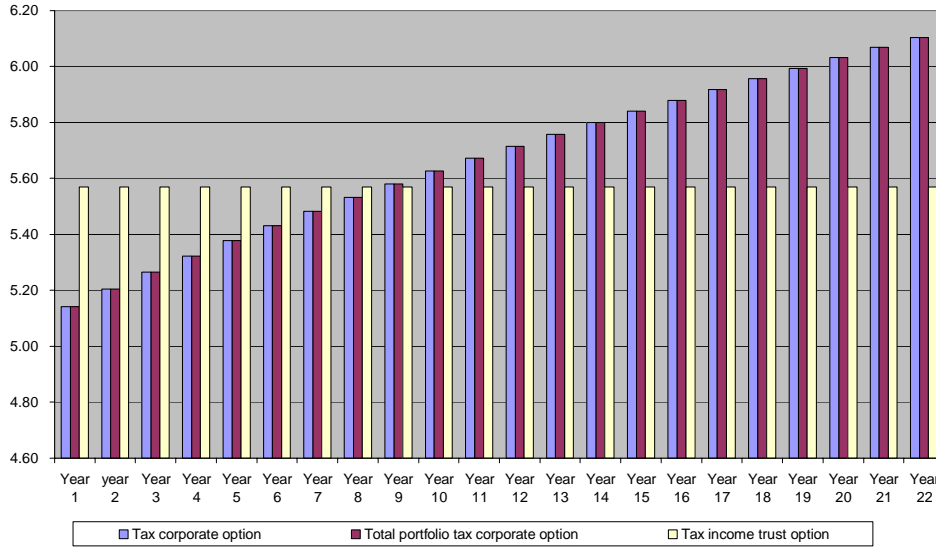
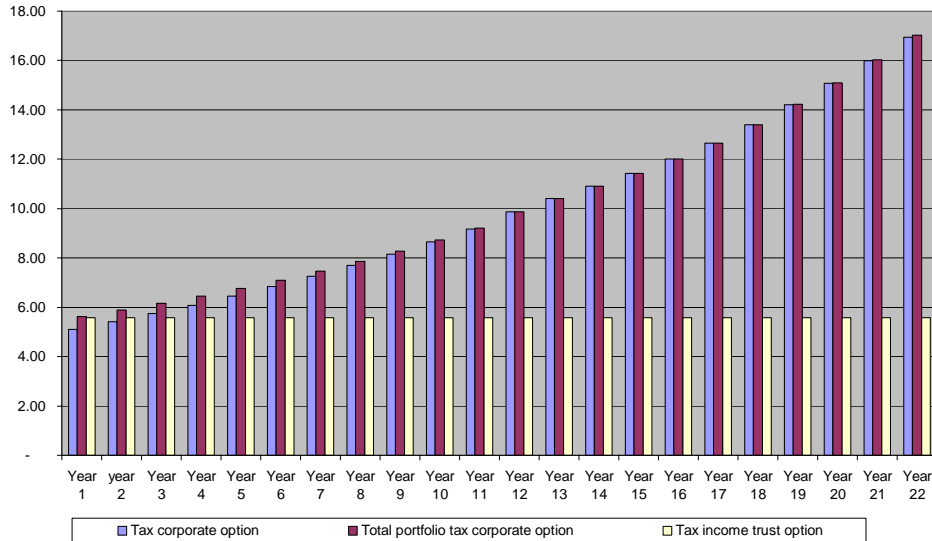


Chart 68 – Valuation premium of 40%, 46% income tax, 23% dividend tax rate, 36.16% corporate tax

**CGA Taxation Analysis
Higher rate taxpayer**



²⁵ Note that there is no cash and bond allocation in the model for the corporate option portfolio with no valuation premium.

Chart 69

No valuation premium, 31.15% personal tax rate, 7% dividend tax rate, 36.16% corporate tax rate

**CGA Taxation Analysis
Lower rate taxpayer**

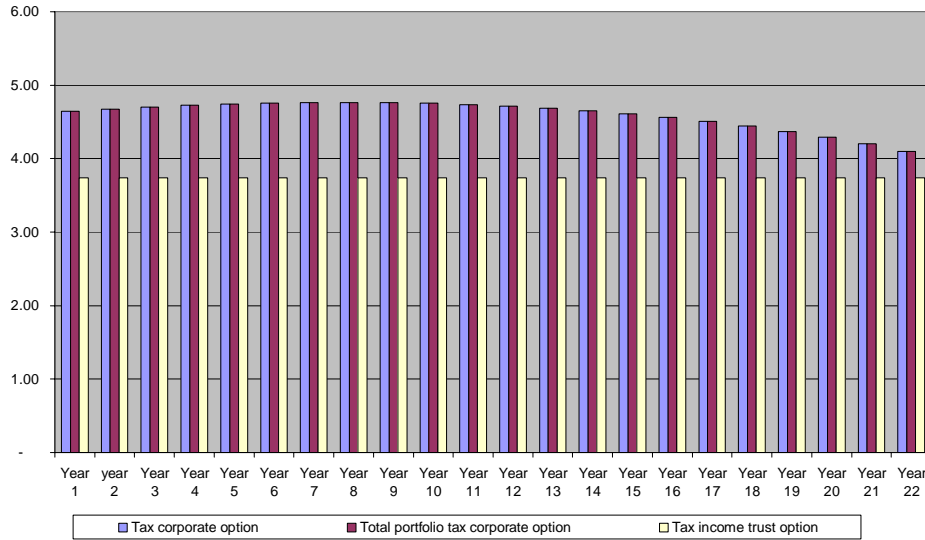
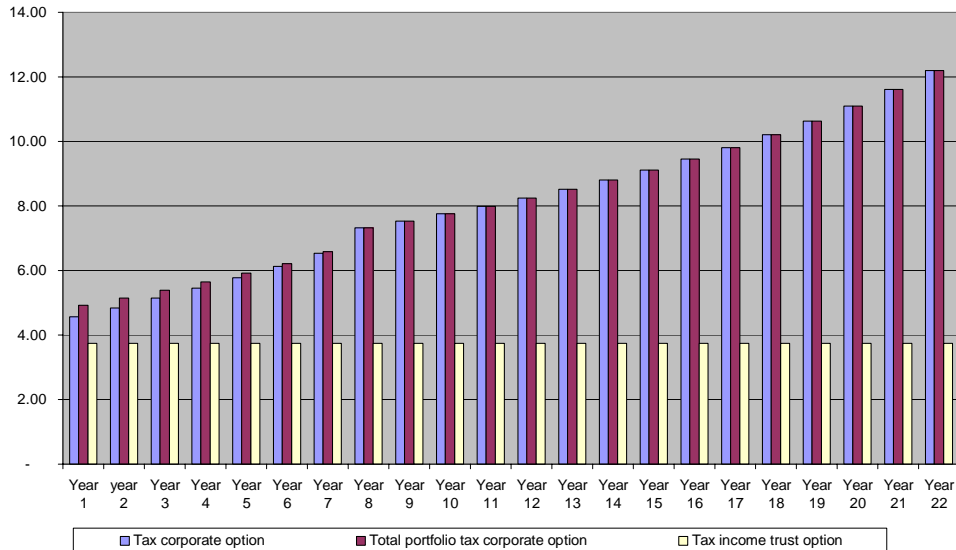


Chart 70 – Valuation Premium 40%

**CGA Taxation Analysis
Lower rate taxpayer**



Modeling Conclusions

Within the confines of a simple model designed to assess the impact of valuation premiums and taxation of return on capital, it is clear, within a portfolio context that income trusts do not yield a higher level of taxation than the corporate structure for those investors buying income trust post conversion and at IPO.

Income trusts yield a higher level of taxation for those portfolios that held the share prior to conversion and hold it beyond conversion but only when distributions exceed taxable earnings.

Surprisingly, as far as tax exempt/deferred accounts are concerned, at the portfolio level, the corporate structure yields the highest level of taxation, even when holders are assumed to have held the corporate structure prior to conversion and continue to hold post conversion.

In virtually every scenario the total return profile of an income trust was inferior to that of the corporate structure under the modelling assumptions. .

For those who bought an income trust post conversion or at the IPO stage, in order for the income trust proponents' arguments to hold good over time, the return on equity (earnings) would have to be raised significantly above the level produced by the corporate structure and maintained throughout the market and economic cycle to compensate for the valuation premium.

It would appear that pro income trust arguments have ignored the impact of valuation premiums and taxation of return of capital on taxation, risk and return over time.

6.1 Taxable accounts

6.1.1.1 No valuation premium no return of capital

If we ignore the valuation premium and if we ignore the taxation of return of return of capital, income trusts yield an initial higher level of taxation for higher rate taxpayers (46% tax rate) than the corporate structure but this is reversed over time resulting in an overall higher level of taxation from the corporate structure before inclusion of latent capital gains tax and capital gains tax on conversion. For lower rate taxpayers the corporate structure yields the higher level of tax (31% income tax rate). But this assumes neither a valuation premium nor taxation of return of capital, which is unreasonable.

6.1.1.2 Valuation premium, return of capital taxed

If return of capital is taxed and, it does appear that a significant element (albeit a varying amount on a trust by trust basis) is taxed, income trusts yield a higher **initial** level of taxation for those who purchase post conversion or at IPO. The impact of this taxation of return of capital is compounded by income trust valuation premiums. As a result the total tax take from income trusts declines relative to the tax take from a portfolio option. A corporate structure portfolio option ultimately yields a higher tax take per unit of initial capital invested in a given portfolio.

For those investors who held the corporate structure prior to conversion (the B analysis in each section) the tax take is higher for the income trust but total returns suffer.

To base an argument for rather than against an investment vehicle which taxes a more highly valued return of capital is both spurious and odd, as if the laws of the universe no longer apply. Individuals should not be paying for a return of capital in the pricing of income trusts and this is something which has already been discussed in the Accountability Research Corporations November 2005 report. However the fact that capital is being returned to investors and treated as income (and taxed) not only inflates the value of

the asset in the eyes of the investor but misrepresents the true risk and return relationship.

The taxation of return of capital also effectively increases the taxation of return. In the BMO analysis, return of capital that was being taxed was some 65% (cash distributions of 160% of earnings of which 87% are taxable). For a tax rate of 45% the equivalent effective tax rate was 62.6%.

6.1.1.3 Valuation premium, no taxation of return of capital – purchase post conversion or at IPO

When we assume the existence of a valuation premium and, when return of capital is not taxable, income trusts yield a marginal initial higher level of taxation than the corporate option for the highest rate taxpayers, but yield a lower tax take for average and lower rate taxpayers. If income trust return of capital was properly taxed, this should be the true tax scenario.

In this context the portfolio option is one which provides room for an allocation to lower risk cash and bonds based on the valuation premium; indeed at valuation premiums of 35% and above there is significant room within a corporate structure for even higher allocations to lower yielding lower risk asset classes than shown in the modelling. As discussed throughout this report the higher the valuation premium the higher the price paid for a unit of income trust earnings²⁶.

In a non taxable account an investor is able to purchase the same after tax return via a corporate investment for less and still have money left to purchase a lower risk asset allocation, thereby enhancing total long term return (but not necessarily the immediate cash distribution) and reducing overall long term risk²⁷. This additional purchasing power at the taxable portfolio level allows an individual to buy investments which yield additional tax revenue, something which many have omitted when calculating the relevant tax take between the two competing portfolio structures.

If we ignored the impact of valuation and did not likewise adjust the earnings streams from both the income trust and the corporate investment structures the income trust option would clearly and incorrectly yield a higher level of tax.

Alternatively, instead of allocating capital to lower risk assets we could merely purchase more of the corporate entity. That is with the same amount of money needed to purchase an income trust (\$100) at a valuation premium of 40% we could buy 140% of a comparable share. In other words 140% of corporate earnings is going to yield a higher level of tax than 100% of income trust earnings²⁸.

In reality, as far as the investor is concerned, the long term impact of the valuation premium and the depreciation of the mature business asset results in a declining tax take on a per unit of initial capital invested²⁹. While there is nothing wrong in a company distributing cash flow or even returning capital if justified, the valuation premium accorded by the tax treatment of income trusts should invalidate their inclusion within a taxable environment. Capital allocated to a corporate structure would yield both higher levels of corporate tax per taxable investor over time and higher return per unit of initial capital invested.

Yet, according to the 2005 HDR/HLB study some 60% of business and oil and gas income trusts held by

²⁶ In fact what would appear to significant yields at 40% valuation premiums would be even larger at neutral or closer to neutral valuations.

²⁷ Please note that discussion of “short term” income trust performance and risks from cyclical market and economic lows/peaks and during periods of compression/expansion of high yield credit spreads will be discussed in later reports. The focus of this report is on long term structural and physical relationships.

²⁸ Please also note that the corporate tax calculations in these scenarios use those rates provided by the pro income trust lobby group and are not the higher statutory rates which would yield an even higher tax take.

²⁹ This report does not go into detail into the efficacy of the income trust as a business structure. This is assessed in a later report in the Income Trust series. While a mature company with limited growth potential can distribute all its earnings and possibly be returning capital, it would be insane for a company in a competitive or a growth segment of the economy to be doing the same.

Canadian investors were held in taxable accounts (2004 data). While income trusts do appear to have a significant portion of return of capital taxed this should not be a reason to invest in them.

6.1.1.4 Valuation premium, no taxation of return of capital – purchase pre conversion

Here the tax argument is more ambiguous. Where the long term risk premium between equities and bonds is low (circa 1.5%) the tax take will favour the corporate structure when capital is being returned but not taxed. Where risk premiums are higher the tax take and return will favour the income trust structure but where cash distributions are equal to taxable earnings, the tax and return structure favours the corporate entity.

6.1.2 Tax exempt accounts – purchase post conversion or at IPO

Within the tax exempt/tax deferred environment, the income trust was spared the taxation of return of capital while the impact of tax relief at the corporate tax level mitigated the valuation risk.

As the analysis shows, the tax raised from a tax exempt tax deferred account is higher for corporate investment structures than for income trusts. Those who would argue otherwise have either totally ignored the corporate tax flows or have forgotten to adjust for valuation premiums when valuing the discounted cash flows.

An investor who wanted to buy a corporate investment within a tax deferred/tax exempt environment could still benefit from the valuation premium but to a much lesser extent than they could in taxable accounts. While in a taxable account an investor could acquire an equivalent net after tax return for a lower capital investment than the purchase of an income trust, within a tax exempt environment they can buy the same value for an equivalent purchase amount. That is in a taxable account an investor only needs to spend 71.4 dollars on a corporate investment for every 100 dollars on an income trust at a valuation premium of 40%. In a tax exempt account an investor needs to spend 100 dollars to receive the equivalent value. In other words in a tax exempt account there is effectively no difference between an income trust and a corporate vehicle for valuation premiums of 40%.

6.1.3 Tax exempt/deferred accounts – purchase pre conversion

The income trust portfolio option provides the better long term return for those who held the trusts prior to conversion in their corporate form. The tax argument however is more difficult. The benefit to the government of receiving corporate tax on pension capital has a significant opportunity cost which the income trust structure finds it hard to beat. Under the analysis of varying but constrained equity risk premiums³⁰ the corporate structure yields the higher tax take despite investors running down corporate portfolios well before the income trust. Also note that corporate tax from a corporation is not falling and that all that is happening is that ownership of shares have been sold in the market place for cash for consumption.

6.1.4 Post 2011

Assuming statutory rates of tax and no taxation of return of capital the post 2011 environment essentially equalises the tax take between income trusts and corporations for individual investors. The situation is punitive for investors where return of capital is being unnecessarily taxed and where corporate tax rates are as suggested by the BMO and CAIF reports. The issue of the taxation of return of capital is an issue that concerns the TAMRIS Consultancy and it is one which will be addressed in later reports in the “Insanity of Income Trusts” series. As stated the potential tax disadvantage of income trusts (which is dependent on assumptions) should be no excuse to re-establish the income trusts into the financial services market place

³⁰ These are meant to be mature low growth companies.

Conclusion

This report has focussed on the tax arguments surrounding the income trust debate. Since the taxation debate is related at one level to the valuation of income trusts this report also focussed on taxation and the valuation premium. Since valuation premiums are related to portfolio issues, issues associated with portfolio construction were also touched at a basic level.

At a fundamental level income trusts pay a higher level of tax than they should (taxation of return of capital) and their valuations expose investors to significant long term portfolio risks. Taken together these two factors increase risk and reduce return relative to a lower priced corporate structure. These flaws should not be used to support income trusts, yet, somehow they have been used to promote an argument that has been championed by some as a cause worth fighting for. This is clearly insane. What is worth fighting for are accountability, transparency, better regulation and policing, lower costs, better financial advice and the development of a financial services profession that puts its clients' interests first.

Investors should be concerned about the overall combination of tax paid and total long term return at the portfolio level and not short term tax and portfolio returns during cyclical upswings and commodity price booms. There are a large number of issues that have not been addressed in the narrow focus of this report. These issues will be dealt with in future reports on the income trust phenomenon.

Not all income trusts were distributing all their cash flow or causing return of capital to be taxed. In fact a few operated more like corporations and incurred sizeable annual corporate tax bills, reinvested heavily and kept sensible debt allocations. This analysis is not intended to decry well managed businesses focused on the long term but to dispel the arguments that tax advantaged and inappropriately priced income trusts were both good for taxation and portfolio return.