



Demystifying Income Trusts

By the Certified General Accountants
Association of Canada



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Acknowledgements

CGA-Canada takes this opportunity to thank Rock Lefebvre, P.AdM, MBA, FCIS, CGA and Amar Goomar, M.Sc., CGA of our Research and Standards Department.

Appreciation is extended also to Association members, and to internal and external team contributors who provided support and expertise and to Ron Harvey, B.Comm., CFP, CGA who provided peer review to this paper.

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Certified General
Accountants Association
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Table of Contents

Foreword..... 7

Introduction..... 9

1. Executive Summary 11

2. Basics of Income Trusts 15

 An Overview 15

 Return of Capital 18

 The Research and Development Dilemma 19

 Structure 19

 Impetus for Experienced Growth 21

 Canadian Uniqueness of Income Trusts 24

3. Comparison of Tax Implications 27

 Tax Proposition of a Corporation 27

 Tax Proposition of an Income Trust 28

 Tax Implications of the November 2005
 Federal Government Declaration 31

 Tax Proposition of Mutual Funds 33

4. Comparison with Other Forms of Investment 37

 Income Trusts and Bonds 37

 Income Trusts and Equity Holdings 37

 Income Trusts and Mutual Funds 38

5. A Thorough Comparison of Investment Options/Forms 41

6. Types of Income Trusts 61

 Business Income Trusts 61

 Real Estate Investment Trusts (REITs)..... 61

 Royalty Trusts 63

7. Comparison of Income Trust Types 65

8. Rating Practices 71

9. Speaking to Government Policy..... 75

10. Closing Comments	81
11. Appendix A – Tax Comparison of Proposed Dividend Rules and Income Trusts	87
12. Appendix B – Taxes Paid and Proceeds Retained	91
14. References and Related Sources	97

List of Figures

Figure 1: Simplified Example of a Corporate Structure	20
Figure 2: Simplified Example of an Income Trust Structure.....	20
Figure 3: Sophisticated Income Trust Structure.....	21
Figure 4: Simplified Example of Taxes Paid Under a Traditional Income Trust Structure	31

List of Tables

Table 1: Income Trust Market Capitalization (\$ billions).....	22
Table 2: Alternative Means of Generating Cash Income from Retirement Nest Egg.....	23
Table 3: Comparison of the Treatment of Publicly Listed Entities in Several Countries.....	25
Table 4: Summary of Total Tax Paid and Total Cash Retained	33
Table 5: Total Tax Paid on \$100 of Entity Earnings Assuming Full Distribution	75
Table 6: Total Tax Paid on \$100 of Entity Earnings Assuming 40% Dividend.....	76
Table 7: Total Tax Paid on \$100 of Entity Earnings (Dividend Proposal).....	77
Table 8: Total Tax Paid on \$100 of Entity Earnings Assuming 40% (Dividend Proposal)	78
Table 9: Alternative Means of Generating Cash Income from Retirement Nest Egg.....	82
Table 10: Federal 2004-2005 Income Tax Revenues	85

Foreword

Very recently, the debate on income trusts has illustrated that the world of finance can be most interesting and thought provoking. Interested or not in commercial activity, those following current affairs have witnessed significant media coverage revealing a passionate debate on the attributes of income trusts and their place in the Canadian investment landscape.

Interestingly, income trusts have existed for a couple of decades although the trust sector has only gained steeped popularity in the last 10 years with the sharpest increase occurring since 2000. Clearly motivated by increased popularity with investors, key developments associated with their positioning within the financial market fabric coincide with the current interest in the subject matter. These developments include the full impending inclusion of income trusts in the S&P/TSX index, the growing number of corporations and major financial institutions considering trust conversion and the consultation paper released in September 2005 by the Department of Finance on flow through entities (FTEs) discussing the current tax structure of trusts.

The recent release of this consultation paper accentuates the government's reaction to concerns regarding the capacity of income trusts to flow through income to investors without attracting taxation at the entity level. Although the monies flowed through the trust construct are fully taxed in the hands of unitholders, the government of Canada estimates that this business form has resulted in the forfeit of federal tax revenue to the tune of \$300 million. Potential strategies identified by the government to rectify this concern include, but are not limited to, limiting the deduction of interest expense by operating entities, taxing FTEs in a manner similar to corporations, generating supplemental incentives to ward off the accelerated shift to trust investment, or better integrating the personal and corporate income tax systems. Although it is not quite clear how a change in government in February 2006 might affect the current income trust structure, it can reasonably be surmised that changes may be sought in the relatively near future.

Having now witnessed public reaction to some of these proposals, we can be assured that the debate will ensue and that resistance to the elimination of existing income trust incentives will mount. The current popularity of income trusts as effective investment instruments will not be easily waned and the options available to offset the movement may well introduce other complications in a shroud of marginal correction.

In response to widespread interest and increasing relevance to Canada's financial markets, the Certified General Accountants Association of Canada (CGA-Canada) has seen it timely to release this paper. Intent upon debating the merits and pitfalls of income trusts, the main purpose of this paper is to reveal the nature of income trusts and how they compare to other investment vehicles.

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Introduction

Although the trust sector has only gained steeped popularity in the last 10 years with the sharpest increase occurring since 2000¹, income trusts have existed for a couple of decades. They have become a major investment vehicle for Canadians with an estimated 2004 market capitalization of \$118.7 billion. Recent developments such as inclusion of income trusts in the S&P/TSX index, the growing number of corporations and major financial institutions considering trust conversion and the consultation paper² released by the Department of Finance on flow through entities (FTEs) discussing the current tax structure of trusts have fuelled the ongoing debate.

The consultation paper makes specific reference to tabled concerns regarding the capacity of income trusts to flow through income to investors without attracting tax liability at the entity level. Although the monies flowed through the trust construct are fully taxed in the hands of unitholders, the government of Canada estimates that the prevalence of income trusts in the Canadian marketplace has resulted in the forfeit of federal tax revenue in the amount of 300 million dollars³. Potential strategies identified to rectify this concern include such mechanisms as “limiting the deduction of interest expenses by operating entities, taxing FTEs in a manner similar to corporations, or better integrating the personal and corporate income tax systems”⁴. Of the various options available to the federal government, the minister of finance on November 23, 2005 announced that if the current government returned to power in January 2006, it would increase the dividend tax credit to placate the corporate securities investor. Although it is not clear how the newly elected government will approach the subject matter or how far the government’s considerations will affect the current income trust structure, it can reasonably be surmised that changes may be sought in the relatively near future.

There is little doubt that the increasing popularity of income trusts is directly related to a shift in Canadian capital markets that have sought to accommodate the needs of companies and investors⁵. From the investor’s perspective, the needs that are accommodated most by an income trust structure are those characterized by retirees. The “over 50” attraction to income trusts stems from monthly trust distributions that are typically greater than the proceeds

1 Department of Finance, Government of Canada. “Tax and other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)”, Consultation Paper, September 2005.

2 Ibid.

3 According to the Department of Finance, Government of Canada, business income trusts accounted for \$120 million, whereas energy trusts, REITs and limited partnerships accounted for \$55 million, \$80 million, and \$45 million, respectively (Department of Finance, September 2005, 5).

4 Department of Finance, Government of Canada. September 2005.

5 Michael R. King. “Income Trusts-Understanding the Issues”, Bank of Canada Working Paper, September 2003, 2003-25.

Investors decide how best to reinvest cash flows as opposed to leaving them in the hands of the management of the income trust

or yields of other investment devices. Often times, the optimization of investment returns is crucial in preserving quality of life and meeting basic necessities. A recent report by the Certified General Accountants Association of Canada (CGA-Canada) titled *The Social and Economic Implications of an Aging Population* clearly details the challenges and fears that accompany retirement and the modesty of government-administered benefits⁶. One of the recommendations put forward in the paper is that Canadians should assume fuller responsibility for their prospects. Canadians doing just that, in large part, may explain the current attraction of the retired to income trusts⁷. Moreover, since income trusts return 70% to 95% of their cash flows in the form of cash distributions and return of capital to unitholders, they allow investors to decide how best to reinvest those funds, as opposed to leaving them in the hands of management of the income trust.

From a corporate perspective, trusts have been quite beneficial as well, since many corporations have been able to successfully sell a wide variety of assets by transferring them into an income trust structure. This activity has led to an increasing flow of investment capital to projects that show solid as well as high yielding rates of return.

And although income trusts seem to benefit both companies and investors, it is clear that there are some difficulties associated with them. It has become evident that trusts will likely not be corporate Canada's new panacea, as the government's discussion of tax considerations is currently highlighting⁸.

In response to the increasing relevance of income trusts within Canada's investment market, CGA-Canada sees it pertinent to release this paper with the intent of accurately outlining the nature of income trusts and the standing of trusts in the current financial environment. CGA-Canada's purpose and goal is to advance understanding and to promote transparency and objectivity. With that goal in mind, the paper will offer an overview and establish a general understanding of income trusts, including what an income trust is and how an income trust is established. Furthermore, the paper will discuss tax implications in a corporate, income trust and mutual fund structure while reflecting also on the federal government's announcement of November 23, 2005 in which it proposed to increase the dividend tax credit from 13.33% to 19.00%. In addition, the paper will look at other types of investments such as bonds and mutual funds and thoroughly compare trusts to mutual funds and corporation securities. Discussions of the variety of trusts and the rating methodologies used by some current major rating agencies are also included. The paper will offer some concluding thoughts and will apply the knowledge gained to further highlight the current issues surrounding income trusts.

6 Certified General Accountants Association of Canada. *Growing Up: The Social and Economic Implications of an Aging Population*, 2005.

7 Ibid.

8 Andrew Willis. "Corporate Canada's New Panacea", *The Globe and Mail*, September 10, 2005, B4.

Executive Summary

1

In light of the rapidly changing and highly complex income trust market, CGA-Canada deems it crucial to publish this report in order to review key characteristics of income trusts and to outline a number of issues related to the structure of trusts, including the management, valuation and taxation of income trusts. CGA-Canada believes that income trusts resonate well with Canadian investors as legitimate investment vehicles but caution the investor to be reasonably knowledgeable and prudent when venturing into this relatively unknown phenomenon. In order to successfully demonstrate the unique position of income trusts in the financial market, this paper aims to educate the less sophisticated investor about income trusts by outlining what income trusts are, how they are structured and how they compare to other investments.

In its basic form, an income trust raises funds by issuing units of securities to the public through what is commonly known as an Initial Public Offering (IPO). With those acquired funds, the income trust purchases most of the equity and debt of an operating business and thereby becomes entitled to receive all cash flows of that business.

Generally, the establishment of a trust is characterized as a designed activity wherein the price paid for the equity and debt of the operating business, the absolute and relative amounts of equity and debt, and the rate of the interest charged on the debt are calculated with a view to designing a construct which satisfies an expected yield on investment to unitholders which all the while results in a negligible taxable income at the entity level. In that respect, the main task of the income trust is to focus on the operating business' ownership, operation, and management of assets in order to achieve the main goal: the generation of consistent and rewarding cash distributions for the trust's unitholders.

The term income trust generically embodies the spectrum of trusts which include business trusts, real estate investment trusts (REITs) and royalty trusts. While REITs and royalty trusts have existed since the 1980s, business income trusts are a more recent development in Canada. Business income trusts usually acquire substantially all of the issued equity and debt of a successful operating business. Under a common business income trust structure, the trust earns income primarily from the sale of products of the operating business and from the interest payments received on the debt of the operating entity. The business income trust sector has been the fastest growing trust sector over the past four years. An explanation for the growth may be that

The main goal of the income trust is to generate consistent and rewarding cash distributions

business income trusts cover many sectors including manufacturing, food distribution and power generation.

REITs generally acquire income-producing real property and earn income leasing the property to an operating entity and earn interest income through the holding of debt of an operating entity. REITs are moreover established like business trusts except that the underlying properties are real estate properties. Royalty trusts usually earn royalty income from resource generating properties and earn interest income through the holding of debt of an operating entity. The establishment of royalty trusts is similar to the establishment of business trusts, except that the underlying properties are resources such as oil and gas.

One of the features that make income trusts unique is their tax treatment. Under the current income trust regime, almost all of the cash flow is distributed to unitholders. This renders the remaining net income that is subject to entity income tax insignificant.

The uniqueness of income trusts stems from their unique tax treatment and the high yield cash distributions

There is some debate as to the sustainability of these cash flows. However, a simple way to determine the sustainability of a trust is to pay attention to the payout ratio, which is the amount of cash distributed in comparison to the amount of cash generated from normal operations. As with any kind of business, the investor has to be fully aware of the intricacies of the structure, as well as the risks and benefits associated with it. In addition, when it comes to income trusts, it is important to invest in a business that aligns its interests closely with those of its unitholders.

Since most of the cash in an income trust structure is distributed to unitholders, little resources are earmarked for research, innovation or other expenses that are directed at limiting obsolescence. Therefore, the types of businesses that are deemed suitable for an income trust structure are those that normally have mature assets that require little ongoing capital expenditure to enhance product characteristics, face little or no competition, provide a sustained level of cash distribution, have several revenue streams, have low interest rates on a limited amount of debt and lastly, a management team that is fully focused on cost control.

In order to highlight income trusts' unique position in the market place, it is beneficial to compare income trusts to other types of investment, including bonds and mutual funds. A comparison highlights that the uniqueness of income trusts stems from their unique tax treatment as well as the high yield cash distributions. A comparison with mutual funds furthermore highlights the benefits and drawbacks of trusts and their proclivity to specialize.

From a corporate perspective, income trusts have aided corporations to successfully sell a wide variety of assets by converting to, and effectively transferring ownership interest to an income trust structure. This has facilitated the flow of investment capital to projects having solid expected rates of return. In this respect, arguments have been made that the tax treatment of income trusts has led to greater economic efficiency. Others have argued, on the other hand, that tax treatments of various entity constructs are deemed to distort investment decisions and consequently lead to reduced economic efficiency.

A comparison of the tax treatment of publicly traded investment vehicles and business structures of Australia, the UK and the US that may be similar to income trust structures in Canada shows that the Canadian treatment of income trusts is quite unique. For example, publicly listed investment vehicles appear to be generally taxed as corporations in Australia, the UK and the US and listing requirements in the UK may limit the development of the type of income trusts publicly traded in Canada.

Of the various options available to the federal government, the minister of finance announced on November 23, 2005 that if the government returned to power in the January 2006 federal election, it would increase the dividend tax credit to placate the corporate investor or shareholder. If the government were to adopt this proposal and assuming that the provincial government(s) would match proportionally the announced increase in the dividend tax credit, the top earner investor would pay tax on dividend income at rates of about 23.20% as opposed to the current 31.34% in Ontario, of about 25.27% as opposed to the current 31.58% in British Columbia and of about 15.77% as opposed to the current 24.08% in Alberta.

The proposal, if passed by parliament and proportionally matched by the province(s), would reduce the tax on dividends for a top earner in Ontario to 23.20% and bring it into line with the current effective capital gains tax of 23.21%. Concurrently, in British Columbia, the proposal would have the effect of taxing dividends and capital gains of the top earner at 25.27% and 21.85% respectively. In Alberta, the tax paid on cash dividends from the proposed dividend tax credits would be 15.77% compared to 19.50% on capital gains.

From the tax perspective alone, an Ontario investor would be inclined to be indifferent to any preference of receiving dividends or capital gains while a British Columbia investor would continue to favour investments that offer capital gains prospect while an Alberta investor would prefer investments which optimize dividend payments. Thus, from this tax perspective taken in isolation of other considerations, a distortion of investment decisions would take place as different parts of the country react differently to different types

of investment opportunities. Not surprisingly, our overall analysis affirms that Alberta has become Canada's tax sanctuary for top income earning individuals.

In summary, our calculations as presented in later sections show that at an average 40% dividend declaration by corporate entities, income trusts would generate superior government revenues for the provinces considered but only for the top income earner groups when taking into account the proposed increased dividend tax credit put forward by the federal government on November 23, 2005 and assuming furthermore that the provinces would proportionally match increased dividend tax credits. Therefore for these top income earner groups, the corporate form would be more favourable. Considering the government's likely desire to dissuade top earners from investing in income trusts, this policy, if accepted, would reasonably achieve some level of success in dawdling migration to income trusts by top income earners from investing in income trusts.

An Overview

Over the past five years, investment in income trusts by the retail investor community has been quite popular. In order to understand this current attraction, we are well served to fundamentally outline what an income trust is, and by extension, what it is not.

In short, an income trust is a subset of the mutual fund trust. Because mutual fund trusts are established pursuant to subsection 132(6) of the Income Tax Act, this same section of the Act also provides for, and applies to, income trusts. Similar to a mutual fund trust, an income trust is observed by the provincial securities commissions. Unless specifically mentioned to the contrary, the term “income trust” herein is used interchangeably when discussing a business trust and other variants of trusts¹⁰. The variants of trusts shall be discussed in a later section of this paper (“Types of Income Trusts”).

In its basic form, an income trust raises funds by issuing units of securities to the public through what is commonly known as an Initial Public Offering (IPO). With those acquired funds, the income trust purchases most of the equity and debt of a successful operating business and thereby becomes entitled to receive cash flows or proceeds of that business. The operating business essentially acts as a subsidiary of the income trust. Generally, an income trust owns one operating business but it may own more than one business.

Through the establishment of an income trust, the parent trust has the opportunity to raise funds for the purpose of purchasing the equity of the business. In that way, an income trust offers a way by which to tap the capital markets and to liberate much needed capital — an innovative Canadian solution to a Canadian problem of how to successfully operate, grow and finance mid-market companies that would otherwise have a more difficult time to secure financing.¹¹

The cash flow of an income trust may consist of earnings from various streams of revenues including earnings from operations, interest income earned on the purchase of any debt, and dividends and capital gains arising from any investment activity. The cash flowing to the income trust from the operating

⁹ In this paper, we have assumed that an income trust is presently operational therefore it does not address conversion of a business into an income trust and any disclosure mandated by provincial securities regulators.

¹⁰ Business trusts can also be referred to as hybrid trusts or business income trusts and other variants of trusts include Real Estate Investment Trusts (REITs) and Royalty Trusts.

¹¹ Philip Brown. “The Truth About Income Trusts: Trusts Help Retirement Savings, Put Cash into Canadian Economy”, *Financial Post*, September 28, 2005, FP8.

The investor must be aware of the intricacies, the risks and benefits of income trusts

company, as a result of having purchased most of the equity and debt of that business, is then distributed to the unitholders. A unitholder does not directly own a share of the operating business, such as is the case with a corporation, but instead has an indirect relationship with the operating business. Moreover, unitholders are final beneficiaries of the trust, and their units represent a right to participate in the income and capital of the trust and not of the operating company per se. Since income trusts return 70% to 95% of cash flows in the form of cash distributions, they allow investors to decide how best to reinvest those funds as opposed to leaving them in the hands of management of the income trust.

Seemingly attractive on its face, cash distributions do however come with a certain degree of risk and investors should be made aware of the anticipated breakdown of these cash distributions. In particular, and most importantly, investors should be aware of the relative proportions of income distributions and the return of capital. Only then, can the investor appreciate the true magnitude of the yield which in turn leads to optimum decision making. Furthermore, distributions containing returns of capital cannot indefinitely persist without some form of capital replenishment¹².

Should an income trust need to raise new capital, it may do so via the issue of a debenture and/or by selling additional units to the public via an IPO. This fresh capital can be used to purchase new assets or to replenish depleted cash reserves resulting from returns of capital by the income trust to its unitholders.

In sum, a simple way to determine the sustainability of a trust is to pay attention to the payout ratio, which is the amount of cash distributed in comparison to the amount of cash generated from normal operations: “the lower the ratio, the less likely the trust will run into problems during a cyclical downturn”¹³. As with any kind of monetary undertaking, it can be concluded that the investor must be fully aware of the intricacies and the risks and benefits so associated. In addition, in the case of income trusts, the discussion above clearly illustrates the importance of investing in a business that aligns its interests closely with those of its unitholders.

Finally, investors should be aware of the fact that a higher potential yield can only arise from a higher level of risk and variability in cash distributions.

Participants

Under the trust, the trustee(s) hold legal ownership of the business for the benefit of the unitholders or beneficiaries. And within the establishment and operation of an income trust, there are several parties that derive financial

¹² Al Rosen. “Too Good to Trust”, *Canadian Business*, May 20, 2004, Vol 77, Issue 10, 37.

¹³ David Berman. “Trusts’ Growth Prospects New Wrinkle for Investors”, *National Post*, September 26, 2005, SR7.

benefits such as the board of trustees, the legal counsel of the trustees, the underwriter, legal counsel of the underwriter, the management company, the unitholders, etc.¹⁴

The main task of the income trust is to focus on the ownership, management, and operation of the assets of the operating business and its main purpose is to distribute cash generated by that business. Generally, the management of the business is contracted out, to the vendor of the operating business in the case of a private company, or to a professional management team in the case of a widely held public company.

Although an investment in an income trust is often referred to as a win/win strategy, not all participants benefit from this opportunity in equal fashion. The main beneficiaries of an income trust arrangement are normally the owners or vendors of the corporation, followed by the investment bankers who are able to demand fees in a low performing market environment, and lastly the investors, who typically expect to receive a higher distribution when compared to a corporate structure or an investment in fixed income securities.

Constitution of Trust

Generally, the establishment of the trust may be a designed activity, e.g. the price paid for the equity and debt, the amount of equity and the amount of debt and the rate of the interest charged on the debt is calculated and established such that the trust provides an expected yield on investment to the unitholders and results in almost nil income after distribution of its income to unitholders.

We can take for example, an owner of a private business who wishes to sell the business at terminal value. Terminal value in this sense is not taken in an accounting sense but should be taken rather in the sense that the owner is disposing of ownership interest as a final or terminating act. In fact, the business will typically attract maximal value as a legitimate going concern. Towards that end, the owner may be best served to establish an income trust. The income trust would simultaneously raise funds to purchase the equity and the debt of the business. Thus the establishment of an income trust is a means by which to access the capital markets for the purpose of raising capital to accomplish the transaction. Under this circumstance, the vendor and the income trust are not acting at arm's length. Invariably, the vendor might also buy units of the income trust or alternatively not sell 100% of the interest in the operating business so as to continue to maintain a relationship. Subsequently, the vendor, being the expert manager, may enter into a management agreement to continue to manage the operating business. Consequently, the vendor's interests become congruent with those of trust investors.

¹⁴ The roles and responsibilities of various parties involved are detailed in the trust indenture documents, including the methodology of the cash flow computation and the frequency and percentage of the cash flow distribution, which normally resides at a rate of approximately 80% monthly.

Types of businesses most suitable for conversion to an income trust are those businesses that have mature assets that require little ongoing capital expenditure to enhance the products, face relatively little or no competition, provide a sustained level of cash distribution with little or no variability at a higher level of yield, have more than one revenue stream containing some degree of diversification, have low interest rates on limited debt with a long maturity date to minimize fluctuation on the cash flow caused by interest rate resets, and have a management commitment that is predominantly focused on cost control.

Interestingly, the foreign market has evolved and in 2002 to 2003, some Canadian income trusts were established by purchasing US businesses. One such example is Heating Oil Partners LP. The interest in Canadian income trusts by US companies is that under US law, no comparable security is available. Thus, the vendors of American businesses are now taking advantage of the higher valuations offered by the Canadian income trust model as an attractive alternative to divestment of interest by way of the conventional business model. That is, rather than disposing of the shares or of the assets or otherwise through liquidation.

From the discussion above, it can be concluded that the principal preoccupation of an income trust is to focus on the operating business' ownership and management of assets in order to achieve the main goal of generating consistent, constant and rewarding cash distributions for the trust's unitholders.

Under the structure, the magnitude of cash distributions are not fixed nor guaranteed and nor is the principal. Thus, the conservative investor seeking Guaranteed Investment Certificate (GIC) type guaranteed returns and recovery of principal are typically not the best candidates for income trust investment.

Return of Capital

Sometimes an income trust may return a part of capital to unitholders. This is simply known as a 'return of capital'. The return of capital can normally arise from the cash flow made available through tax savings resulting from depreciation and sale of capital assets.

Investors prefer receiving a return of their capital since the capital outlay which is exposed to risk is in effect reduced. Immediate and assured return enhances confidence, while also offering to the investor the opportunity to decide how best to redirect resources or investment wealth. This can be a powerful incentive for those who wish to exercise greater control over the manner in which capital is utilized or reinvested as this would normally not be the case in alternative investment models. Moreover, the return of capital

reduces the adjusted cost base and therefore the gain resulting from a sale activity is a capital gain that is taxed at the lowest personal rate¹⁵.

The Research and Development Dilemma

Since most of the cash in an income trust structure is distributed to unitholders, little resources are available for research, innovation or other activities directed at limiting obsolescence.

Investors are well served to compare the research, development and innovation activities of various competing entities in order to identify the potential advantages and risks of not doing so. More pertinent yet, it is interesting to contrast the research and development (R&D) behaviour of income trusts with that of competing counterparts in the same industry or sector. While the relevance of R&D will vary amongst types of product offerings, examples may be found from within the product spectrum. For instance, a fast food retailer having invested in R&D with a view to improving its service and the development of a new menu that boasts a healthier line of fast food items in order to conform to new diet trends can be expected to fare better than its counterpart who may have maintained its menu for several years. Given the proclivity of income trusts to invest less in R&D, we can envision how a corporate form which accentuates the pursuit of improvements can confer a competitive advantage. Had the long distance telephone business been structured as an income trust, it is conceivable that it would not have been as adaptable to available technological improvements as it has been.

Investors are well served to compare the research and development behaviour of income trusts

Structure

Figure 1 provides a simplified example of a corporate structure while Figures 2 and 3 respectively present examples of a simplified income trust structure and a more sophisticated income trust structure. It should be noted that an income trust may also use an operating trust or a limited partnership as the operating entity¹⁶ and may furthermore own more than one business.

¹⁵ Should the adjusted cost base become negative at any time, the absolute amount of the variance is recognized as a capital gain in the year of receipt of such return and is accordingly taxed because the adjusted cost base cannot be negative.

¹⁶ Department of Finance, Government of Canada, September 2005.

Figure 1: Simplified Example of a Corporate Structure

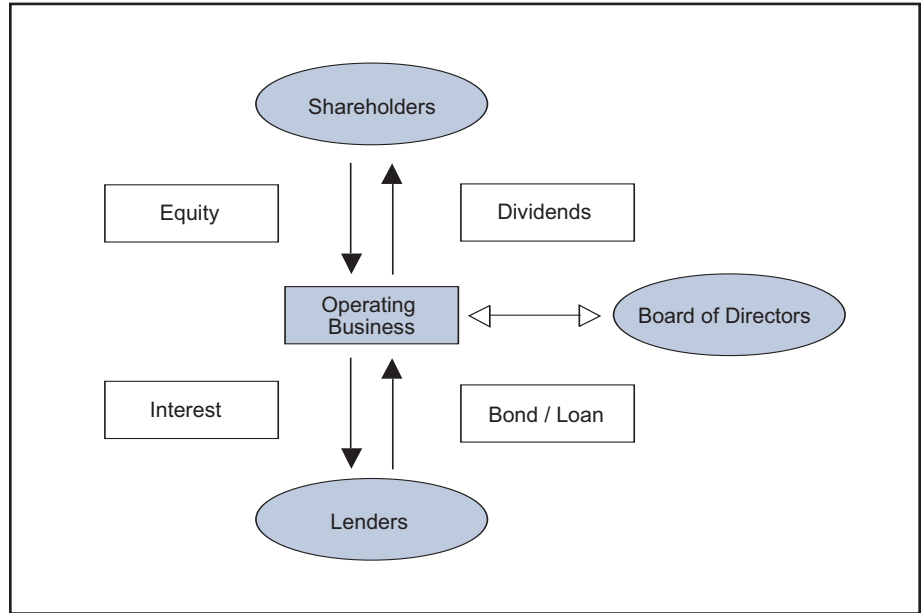
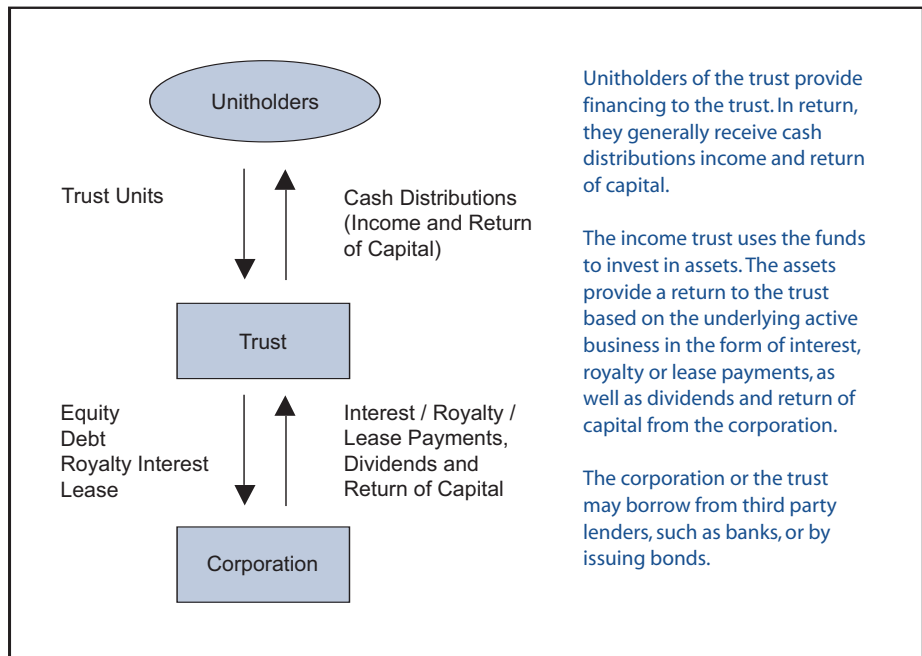
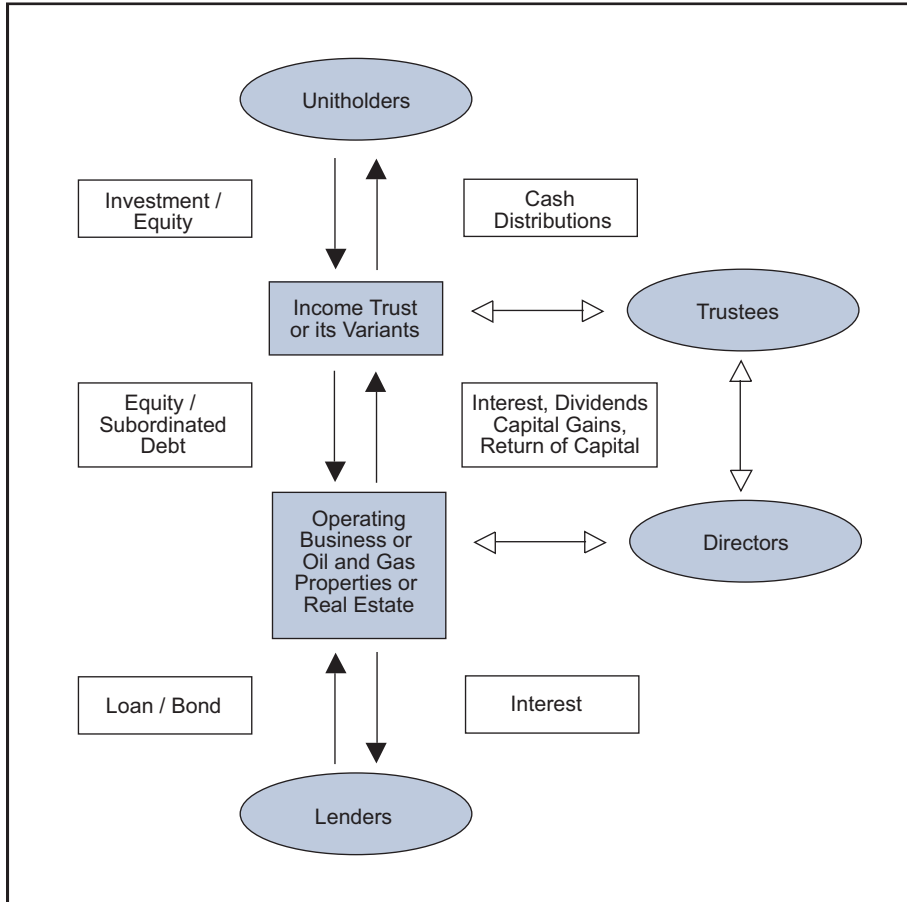


Figure 2: Simplified Example of an Income Trust Structure



Source: Adapted from Department of Finance, Government of Canada, Consultation Paper, September 2005.

Figure 3: Sophisticated Income Trust Structure



Income trusts have become a reasonable vehicle by which investors can secure a constant income

As portrayed in Figure 3, a trust structure usually entails the undertaking of two boards; one for the trust itself and one for the operating business that is owned by the trust. Each board has different roles and responsibilities, which can sometimes be a complicating feature. Generally, the trust is the public entity which has the reporting issuer responsibilities and it is the operating company’s board that oversees actual operation of the business.

Impetus for Experienced Growth

A recently published report by the CGA-Canada outlines the social and economic implications of an aging population and outlines how current government-administered benefits will only provide for a minimum standard of living¹⁷. The paper recommends that Canadians assume greater responsibility in planning for their retirement by articulating a well coordinated financial plan¹⁸. In this respect, it seems that income trusts have become a reasonable vehicle by which mature investors can secure a constant income that promotes independence and a wholesome lifestyle.

¹⁷ Certified General Accountants Association of Canada. "Growing Up: The Social and Economic Implications of an Aging Population", 2005.

¹⁸ Ibid.

Thus, as the recent government consultation paper outlines, income trusts' market capitalization is steadily increasing and was estimated to be \$118.7 billion at the end of 2004 which is up from \$18.0 billion at the end of 2000¹⁹ (see Table 1).

Table 1: Income Trust Market Capitalization (\$ billions)

	Business	Income Trusts Energy	REITs	Limited Partnerships	Total
Dec. 2004	51.4	41.9	17.4	8.0	118.7
Dec. 2000	3.7	5.8	4.6	3.9	18.0
Dec. 1995	-	1.3	-	-	1.3

Source: Department of Finance, Government of Canada, September 2005, Consultation Paper

Furthermore, there are approximately 200 income trusts in Canada. The Canadian Association of Income Funds suggests that approximately 1 million Canadians own income trusts directly while many others have interests in income trusts through mutual funds or other indirect holdings²⁰.

A Canaccord report published in April 2005 outlines that over \$1.3 billion of trust financing was transacted in March 2005²¹. In April 2005, trust financings totalled \$5.9 billion, including unit offerings, corporate conversions and convertible debenture issuances²². What is more, there are “approximately \$2 billion in announced trust financings yet to be completed and a further \$2 billion of corporate conversions to occur later this year.”²³ All this is to say that income trusts have become a powerful investment vehicle that has already established substantial staying power.

Moreover, when compared to other retirement investment options, income trusts have offered the highest yields as can be seen in Table 2²⁴. In this respect, income trusts seem to represent one of the highest sources of sustainable recurring cash yield in equity and fixed income markets and therefore are the preferred structure for many retirees²⁵.

19 Government of Canada. Consultation Paper.

20 Garry Norris. “Income Trusts left in Limbo”, *London Free Press*, October 8, 2005, URL: <http://lfpres.ca/newsstand/Business/2005/10/08/pf-1253511.html> (accessed October 8, 2005).

21 Bruce McDonald and others. “Income Trust Review: Better Value, But Not Out of the Woods Yet ...” Canaccord Capital Corporation, April 2005, 2005-053.

22 *Ibid.*, 60.

23 *Ibid.*, 60.

24 Chris Rankin et al. “Income Trusts: Trust Reform Hurts Canadians: Contact your MP and Express Your Concerns”, Canaccord Capital Corporation, October 26, 2005, 2005-147, 2.

25 *Ibid.*

Table 2: Alternative Means of Generating Cash Income from Retirement Nest Egg

Type of security	Typical Pre-tax Yield
Income Trusts	9%
Corporate Bonds	5%
Government of Canada 10 Year Bonds	4%
Dividend Paying Stocks	2.5%
Canada Savings Bonds	2%

Source: Extracted from *Canaccord Capital, Chris Rankin et al.*

As the above discussion has highlighted, income trusts have substantiated themselves as a viable alternative to other types of investments including, bonds, mutual funds and stocks.

Begun on September 16th, 2005 with the introduction of the provisional index²⁶, it is intended that income trusts will be fully folded into the S&P/TSX composite index by March 2006. As of December 16th, 2005, half of the float weights of the trusts that are going into the composite index have been included; and finally on March 17th 2006, the other half will be added. Analysts are calling the inclusion of income trusts into the S&P/TSX index one of the greatest changes to the index since it evolved from the old TSE 300 in 2002²⁷. The decision to include income trusts will move the value of the index to be more representative of the value of the market, since income trusts already represent 8% of the total volume traded on the exchange.

Income trusts are a viable alternative to other types of investments

What is more, including income trusts into the index will furthermore substantiate its existence as a legitimate investment vehicle.

In a corporation, a shareholder has limited liability, meaning that in an adverse circumstance, the shareholder is generally not liable for the activity or the financial liability of the corporation beyond that invested. This protection was not available to unitholders of an income trust until 2003. In 2004, Alberta, Manitoba, and Ontario implemented limited liability legislations. Thus, the unitholders in those provinces have comparable protection to shareholders of a corporate structure. Quebec has had such legislation since 1994. Taken with some of the other features of income trusts, we can expect that the introduction of such protection has also contributed to the increased consideration by investors of income trusts as a viable investment option.

26 Sonia Horvitch. "Trust Near the 'Big Event'", *National Post's Financial Post & FP Investing*, September 12, 2005, FP3.

27 Theresa Ebden. "Paving the Way for a Fair Exchange", *The Globe and Mail*, June 29, 2005, E1.

Canada seems to be grappling with a Canadian problem that may need more than just a revision of income trust structures

Canadian Uniqueness of Income Trusts

A comparison of the tax treatment of publicly traded investment vehicles and business structures in Australia, the UK and the US that may be similar to Canadian income trust structures reveals that the Canadian treatment of income trusts is quite unique. For example, publicly listed investment vehicles appear to be generally taxed as corporations in Australia, the UK and the US and listing requirements in the UK may limit the development of the type of income trusts publicly traded in Canada²⁸. As well, in Australia corporate and personal income tax systems are fully integrated, which may be another factor contributing to the absence of distinct preference and growth for comparable income trust structures²⁹. Therefore, Canada seems to be grappling with a Canadian problem that may need more than just a revision of income trust structures. According to a recent report by Canaccord, Canada's current double taxation structure (taxing corporate income, and then taxing the dividends from these corporations) and comparatively favouring capital gains treatment strongly biases a corporation to either retain its earnings or simply buy back its own stock³⁰. In Canaccord's view, this substantial tax disincentive for corporations to boost dividend payouts results from Canada's current tax system that actually encourages cash cow corporations to do the wrong thing by retaining excess capital³¹. When one combines the existing flaws in our tax system with the growth of investor demand for a regular stream of recurring cash flow as opposed to capital gains, it is no surprise that income trusts are now viewed by many as superior investments and that cash cow corporations have become dinosaurs.³² Table 3 compares the treatment of publicly listed entities in several countries.

28 *Department of Finance, Government of Canada*, September 2005.

29 *Ibid.*

30 Rankin. "Income Trust Reform Hurts Canadians: Contact Your MP and Express Your Concerns", Canaccord Capital Corporation, October 26, 2005.

31 *Ibid.*

32 *Ibid.*, 3.

Table 3: Comparison of the Treatment of Publicly Listed Entities in Several Countries

	Canada	Australia	UK	US
Integration	Partial	Full	Partial	Partial
General tax treatment of publicly traded FTEs	Flow-through tax treatment	Taxed as corporations	Publically traded FTEs are generally taxed as corporations	Generally taxed as corporations
Exceptions (to the general tax treatment)				
-REITs	None	None	Consultations ongoing on possible REIT structure	REITs permitted flow-through tax treatment
-Limited partnerships (LPs)	None	LPs investing in venture capital permitted flow-through tax treatment		PTPs permitted flow-through tax treatment for passive income

Source: Department of Finance, Government of Canada, September 2005, Consultation Paper.

In 2002 and 2003, some Canadian income trusts were established through the purchase of US businesses such as Heating Oil Partners LP. In addition to the Heating Oil Partners Income Fund, by 2004 six additional cross-border (US/Canadian) income fund IPOs had been completed for aggregate proceeds of more than C\$1 billion. The latest trend is for established Canadian income funds to make acquisitions of US-based businesses typically funded through an offering of trust units.³³

³³ Richard Willoughby and others. "The Evolution of Income Trusts", *International Tax Review*, September 2004, Vol. 15, Issue 8, 45-48.

Comparison of Tax Implications

In Canada, interest income is taxed in such a way as to have the effect of being taxed as salary income (i.e. ordinary income); only 50% of the capital gains are subject to taxation while the remaining 50% typically does not attract any tax; and dividend income attracts dividend tax credits.

The *Personal Tax Planning 2005/2006* guide³⁴ published by the Certified General Accountants of Ontario provides calculations for an amount of tax payable related to ordinary income, capital gains and dividend income. The combined marginal tax rate (federal and provincial tax rate) for a top earner (i.e. an individual earning greater than \$115,739), for a resident of Ontario on salary or ordinary income is 46.41%, on dividend income is 31.34%, on capital gains is 23.21%; and for a resident of British Columbia on salary or ordinary income is 43.70%, on dividend income is 31.58%, on capital gains is 21.85%; and for a resident of Alberta³⁵ on salary or ordinary income is 39%, on dividend income is 24.08%, on capital gains is 19.50%. For other provinces or territories, the reader is encouraged to consult the *Personal Tax Planning* guide.

Tax Proposition of a Corporation

Corporations pay federal and provincial corporate taxes. The provincial corporate tax liability arises from the residency of its permanent establishment. Both taxes are payable on net income before payment of dividends to its shareholders. Canadian corporations can generally be said to pay earnings out to their shareholders in the form of dividends to the tune of about 40% of earnings.

Thus, the recipients of taxed amounts are federal and provincial governments at the corporation's marginal tax rate and federal and provincial governments at the dividend level at the individual's or recipient's marginal tax rate.

Shareholders pay tax on those dividends received to the province of their residency based on respective marginal tax rates. For example, a top earner resident of Ontario would pay tax on dividends at a rate of 31.34%, of British Columbia at a rate of 31.58%, and of Alberta at a rate of 24.08%.

³⁴ This and comparable guides of other provinces may be obtained by making contact with the Certified General Accountants Association of the province or territory of interest.

³⁵ We arbitrarily selected three provinces in order to present sample calculations.

Additionally, upon disposal of shares, any experienced capital gains will likewise be taxed by federal and provincial authorities in the year of disposal. In purely technical terms, the amount of capital gain will end up being the proceeds of the sale, less the adjusted cost base and any redemption charges, such as sales commissions. For example, a top earner resident of Ontario would pay tax on capital gains at a rate of 23.21%, of British Columbia at a rate of 21.85% and of Alberta at a rate of 19.50%.

It should be noted that when earnings and capital gains accrue in a registered plan such as a Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF) or Registered Education Savings Plan (RESP), the tax payable is deferred until such time as the funds are withdrawn from those plans.

Tax Proposition of an Income Trust

Under the current income trust structure, almost all of the cash flow (70% to 95%) is distributed to unitholders. Unlike the corporate structure discussed above, entity level tax is calculated on the post distribution income. This renders the remaining entity level net income and resulting tax liability relatively insignificant. Consequently, the trust itself attracts and pays little tax. Naturally, this small amount of net income retained at the trust level is nevertheless subject to tax at the applicable federal and provincial tax rates.

Also, under the income trust structure, the distributions are paid to unitholders in the same form as originally received or earned by the income trust. Therefore, the unitholders assume responsibility for paying applicable taxes on distributions, returns of capital and capital gains in the proportional manner earned by the trust. The taxes are paid at their respective marginal rates which will generally be lower than the marginal tax rate of the income trust, rendering an income trust entity quite tax efficient. It should be noted that the make-up of distributions may oscillate such that the net after tax return to the investor would not necessarily be constant.

Since most of the earnings are of the ordinary income type, the province of residency of the unitholders would receive the applicable tax on the earnings at the recipient's marginal tax rate. For a top earner, an Ontario resident would pay tax on ordinary income at the rate of 46.41% while a British Columbia or Alberta resident would pay tax at the rate of 43.70% and 39.00% respectively. Had these earnings come in the form of dividends such as those received from a corporation, the tax payable would have been at the respective rates of 31.34%, 31.58% and 24.08% for Ontario, British Columbia and Alberta. In keeping with our discussions above, it should also become apparent as to how the amount of ordinary income arising from a trust structure would generally

be more than that arising from corporate dividends. Thus, provincial personal taxes would be higher both in absolute and in aggregate terms.

Not so unlike the conditions of the corporate structure previously discussed, capital gains tax, if applicable, will be payable when realized upon disposal or divestment. In purely technical terms, the amount of capital gains will again be represented as the proceeds of the sale, less the adjusted cost base and less any redemption charges and commissions.

As previously explained, the income trust would normally pay nil or insignificant tax at the entity level. Everything else being equal, distributable net earnings are consequently greater in an income trust structure than in a corporate structure. Inherent to financial market valuation, the amount, frequency and reliability of past and expected future earnings determine the value of an operating business. Taken together, these factors shape the value of the operating business as a going concern and by extension, the value when placed on the market. Accordingly, an operating business when converted to an income trust will tend to fetch higher public valuation. As such, the vendor of the operating business will tend to receive higher monetary value or reward upon conversion to, and issuance of, trust units to the public.

As described in earlier sections of this paper, the one concept unique to an income trust is the concept of the return of capital. At times, when trusts are short of earnings and aspire to nevertheless meet expected yield commitments, they may return some of the capital/cash retained by the trust.

Investors typically prefer to receive a return of capital rather than leave the capital with the entity since their at-risk capital is diminished. It effectively avails the investors the opportunity to decide, for themselves, how the capital is utilized or reinvested. Importantly, the return of the capital reduces the adjusted cost base but does not immediately trigger a tax event. Rather, the tax effect will be deferred, and congruent with any eventually recognized capital gain upon sale of the units. It is however conceivable that after several years, the investor's adjusted cost base may become zero or even below zero. When this transpires, any return of capital exceeding a zero cost base will be recognized as a taxable capital gain in the year of actualization. In the case of investments which are housed in registered savings plans such as RRSPs, RRIFs and RESPs, tax liability is deferred until funds are withdrawn from the registered plan.

The shifting of entity tax base from the corporation form of business to the trust form has not gone unnoticed by the federal government. According to the federal government consultation paper on income trusts issued in September 2005, the taxes foregone in 2004 due to the advent of income trust structures

is estimated to have reached \$300 million³⁶. The paper espouses that “business income trusts accounted for \$120 million, while energy trusts, REITs and limited partnerships accounted for \$55 million, \$80 million, and \$45 million, respectively”³⁷.

Figure 4 illustrates the tax structure under an income trust³⁸. In the provided example, an operating entity earns \$100 of business income but does not pay corporate income tax because the interest, royalty or lease payments it makes to the trust are deductible in computing its income for tax purposes. The trust does not pay income tax on the \$100 of income received from the operating entity since it distributes all of its income to unitholders. Based on the assumptions made by the department of finance, government receives only \$14.82 from Canadian residents and \$3.30 from non-residents for an aggregate of \$18.12³⁹ on the \$100 distribution. As the figure depicts, these calculations are based on the premise that unitholders are comprised of Canadian taxpayers (39%), non-residents (22%) and tax exempt individuals (39%). From this perspective, we can acknowledge the government’s concern. We would caution the reader however to not deduce from this discussion that the Canadian taxpayer pays only \$14.82 on receipt of a \$100 distribution. This is what the government receives on average from the collective unitholders for every \$100 of distributions and should not be confused as the effective tax rate applicable to a Canadian resident who is subject to the aforementioned tax rates. More appropriately, an individual top earner Canadian taxpayer should be recognized as being liable on average for an amount of tax which is more in the area of \$38 on a \$100 distribution.

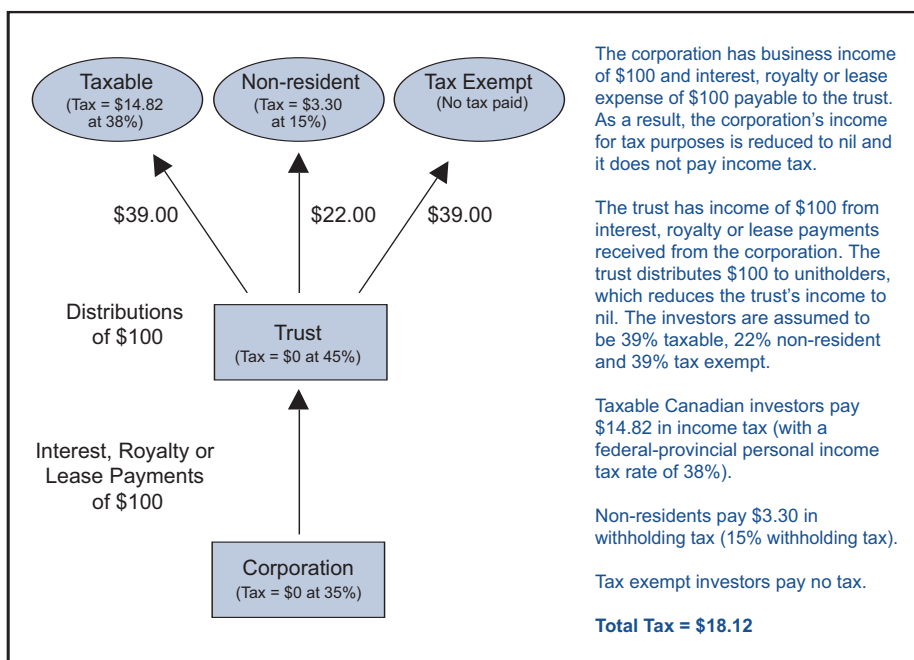
36 Department of Finance, Government of Canada, September 2005.

37 Department of Finance, Government of Canada, 7.

38 Ibid., 16.

39 Ibid., 16.

Figure 4: Simplified Example of Taxes Paid Under a Traditional Income Trust Structure



Source: Adapted from Department of Finance, Government of Canada, September 2005, Consultation Paper.

The nebulous question that remains at this point is how long this favourable tax structure will survive given the recent pressures on income trusts by the government. While the government has put forward passive strategies aimed at rendering other investment vehicles more attractive, namely dividends, there has been little suggestion that the treatment of income trusts will be substantially altered. We can expect that a negatively received government intervention which imputes heightened tax exposure on income trusts will be contested as the recent responses by investors as well as investment companies have exemplified.

Tax Implications of the November 2005 Federal Government Declaration

Of the various options available to the federal government, the minister of finance on November 23, 2005 announced that if the government returned to power in January 2006, it would increase the dividend tax credit to placate the investors in a corporation. Presumably, this would level the playing field and mitigate the mass migration of investors and investment capital to income trusts. While we now know the results of the federal election, it is reasonable to expect that the Conservative government will likewise pursue this initiative based on earlier comments of Mr. Solberg. So while the following analysis is contingent upon the certain proposals of the previous government, it should not be ignored on the premise that it will now falter. The fact of the matter is

that, as reported by *The Globe and Mail* on January 12th, 2006, the federal finance critic Mr. Monte Solberg said “when the Liberals made their announcement, that’s what we had been proposing.” And he further added “so we’re very supportive of that approach and we’ll be explicit about it when we release our platform.” All this is to say that there is significant likelihood that the proposal or a similar alternative will continue to resonate with the government of the day.

Assuming that the provincial governments would match proportionally the suggested increase in the dividend tax credit, a top earner investor in Ontario would pay tax on dividend income of about 23.20% as opposed to the current 31.34%, in British Columbia of about 25.27% as opposed to the current 31.58%, and in Alberta of about 15.77% as opposed to the current 24.08%.

Please note that the proposal, if eventually passed by parliament and proportionally matched by the province(s), for a top earner, would reduce the tax on dividends in Ontario to 23.20% and bring it in line with the current effective capital gains tax of 23.21%. In Alberta, the tax paid on cash dividends from the proposed dividend tax credits would be 15.77% compared to 19.50% on capital gains — providing a significant tilt towards dividend paying investments. Concurrently, in British Columbia, the proposal would have the effect of taxing dividends and capital gains of the top earner at 25.27% and 21.85% respectively.

In summary, from the tax perspective alone, an Ontario investor would be inclined to be indifferent to any preference of receiving dividends or capital gains while a British Columbia investor would continue to favour investments that offer capital gains prospect while an Alberta investor would prefer investments which optimize dividend payments. Thus, from this tax perspective taken in isolation of other considerations, a distortion of investment decisions would take place as different parts of the country react differently to different types of investment opportunities.

The reader is encouraged to consult Appendix A of this paper should greater understanding of the underlying calculations supporting these conclusions be desirable. Examination of Appendix A will also reveal the total tax take from the current corporate structure in comparison to that proposed by the past minister of finance. More germane to our discussion of income trusts, the appendix also provides comparable tax consequences onto top earner income trust unitholders of Ontario, British Columbia and Alberta.

In the spirit of brevity, Table 4 below summarizes for each \$100 of trust distribution or dividend declaration to Ontario, British Columbia and Alberta taxpayers, the results of the calculations of Appendix A.

Table 4: Summary of Total Tax Paid and Total Cash Retained for Top Earners

	Total Tax Paid			Total Cash Retained		
	Corporate		Income Trusts	Corporate		Income Trusts
	Current	Proposed		Current	Proposed	
Ontario	\$56.14	\$50.94	\$46.41	\$43.86	\$49.06	\$53.59
British Columbia	\$55.95	\$51.89	\$43.70	\$44.05	\$48.11	\$56.30
Alberta	\$49.61	\$44.09	\$39.00	\$50.39	\$55.91	\$61.00

Table 4 shows that the proposed increase in dividend tax credits reduces the total tax paid in a corporate structure from \$56.14 to \$50.94 for a resident of Ontario, from \$55.95 to \$51.89 for a resident of British Columbia, and from \$49.61 to \$44.09 for a resident of Alberta. Thus, in a corporate structure, the least amount of total taxes collected from the corporation and individual top earner combined will occur in the province of Alberta.

Also, from Table 4, it is evident that under an income trust structure, the governments (federal and provincial) would collect a lesser amount of taxes than under the corporate structure even after taking into account the proposed increase in the dividend tax credits. The amount of taxes received in an income trust structure from a top earner in Ontario, British Columbia and Alberta are \$46.41, \$43.70 and \$39.00 respectively. Thus, in an income trust structure, the least amount of taxes collected from a top earner likewise occurs in the province of Alberta. Without belabouring the point, the province of Alberta is consistently the best Canadian tax environment for the top earner investor.

Tax Proposition of Mutual Funds

Under a mutual fund structure, all of the earnings are distributed to the unitholders. Should the mutual fund company keep those earnings in totality or in part, it would simply be taxed at the marginal tax rate of the entity.

When an individual invests in a mutual fund, taxes emanate based upon the type of earnings (interest income, dividends, capital gains, etc.). Quite typically, the unitholders pay applicable tax on those earnings at their marginal tax rates in the year of recognition and upon disposition of units.

Quarterly, semi-annually or otherwise, unitholders are apprised of fund performance by way of prescribed communication. During the beginning of each calendar year, unitholders can also expect to receive a T3 information slip which must be filed with the Canada Revenue Agency and diligently reported in the previous year's tax filing. Contrary to income trusts though, the unitholders do not actually receive the earnings in the form of cash proceeds. Rather, the agent typically reinvests earnings on behalf of the unitholders.

Consistent with the tax treatment afforded to corporate and income trust entities, earnings and gains experienced through mutual fund investments in registered plans (RRSP, RRIF, and RESP) are shielded from tax liability until such time as they are withdrawn.

The units are subject to a capital gain or loss when sold as is the case when stocks are sold. The corresponding tax liability is triggered only when realized upon sale or disposition of the units. The proceeds of the sale net of any redemption charges and commissions less the adjusted cost base represent the value of any capital gains.

One unique feature of a mutual fund is that mutual funds might periodically issue additional units to existing unitholders. For example, in an up-turn market, the unit price might become too high such as to psychologically discourage an investor from buying the mutual fund. In short, the units can become unaffordable to an average investor. As such, mutual funds might pay distributions in the form of additional units in order to lower the unit price. Under these circumstances, the adjusted cost base of the units is lowered, as the amount of money invested is now divided by the sum of the number of previously held and additional new units. On a conceptual level, the provision of additional unit distributions may be viewed as being correspondent to the return of capital notion embedded in income trusts.

The receipt of additional units is not taxable as it simply reduces the adjusted cost base of the investment. Thus it has the effect of increasing the potential capital gains at the time the units are sold. It is conceivable that after several years the investor's adjusted cost base may become zero, but unlike income trusts, cannot become negative.

It is imperative to note that the timing of unit purchases can make a difference with regards to the investment earnings. This means that a unitholder owning units before the earnings allocation date (usually around the end of December) receives those earnings for the whole year regardless of when the units were purchased. This means that two investors having the same marginal tax rate, investing in the same number of units, regardless if they are late year or early year subscribers, would pay the same amount of tax on those earnings. In other words, the late year investor would be proportionally penalized because of taxation of reported earnings that have not yet been earned. Consequently, the late year investor will have to make a long term commitment to the fund in order to mitigate the amount of tax paid on any unearned earnings. However, staying invested for a long term carries with it the inherent risk of losing money while also offering the advantage of possibly receiving superior earnings. Had the late year investor received those earnings in cash, the payment of income tax might probably be less offensive.

On the other hand, had the fund company distributed additional units, the late year investor would have an advantage over the early year investor in that they would likewise qualify to receive additional units at the same time without the corresponding vesting period.

Comparison With Other Forms of Investment

One of the easiest ways to highlight income trusts' unique position in the market-place is to compare them to other sources of investment income. In this section, we provide a high level comparison of investing in income trusts with investment in bonds, equity and in mutual funds. The next section "A Thorough Comparison" provides a thorough comparison of corporations, income trusts and mutual funds to highlight some of the differences and similarities.

Income Trusts and Bonds

One explanation for the popularity of income trusts is that investors rather fallaciously compare the return from income trusts to the return received from investing in bonds. That comparison is flawed because:

- Cash distributions received from an income trust are neither guaranteed nor fixed since they are dependent on cash generated by the operating business and, as such, can be quite inconsistent. By comparison, an investment in bonds guarantees interest income as long as the bond issuer is solvent.
- The recovery of an investment in an income trust is not guaranteed whereas the principal in a bond investment is guaranteed as long as the bond issuer is solvent.

Thus, an investment in an income trust is hardly comparable to an investment in bonds.

Income Trusts and Equity Holdings

Income trusts can reasonably be compared to investments in equity security as the only material difference is that an investment in equities commands a return on an investment in the form of dividends. An investment in an income trust, however, entitles the investor to cash distributions that are usually greater than the average amount of dividends and are also distributed more frequently than the dividends payout.

Also, an income trust may return a part of capital to the unitholder whereas the concept of return of capital is nonexistent in the corporate structure.

As is the case with equity, the income trusts units are traded on a stock exchange and their price depends upon the supply and demand of the units and is impacted by prevailing market conditions.

Income Trusts and Mutual Funds

Most frequently, income trusts are compared to the most commonly known investment option available to average Canadians: mutual funds⁴⁰.

Mutual funds are pooled funds aggregated from numerous investors. This makes mutual funds easier and more convenient to purchase than shares and offers diversified portfolios that are professionally managed. Capital is invested in stocks, bonds and money market instruments. In addition to the generic funds, there are specialized funds that are invested in specific areas, such as bond funds, fixed income funds, index funds, small cap funds and Canadian equity funds to name a few. The units may be purchased directly from a mutual fund company or through brokerage houses that are licensed to trade on the stock exchange⁴¹.

One reason why mutual funds are so popular with the average investor is the fact that they do not require any financial expertise on the part of the unitholder, such as analyzing stocks or following market trends since they usually are offered in managed portfolios. Therefore, since 1988, the mutual fund industry has grown from just over \$25 billion in assets under management to more than \$391 billion by the end of 2002⁴².

However, owning such a managed portfolio comes at a price, namely the management fee, which is charged by the manager of the mutual fund and is charged as a percentage of the asset values. This management fee or Management Expense Ratio (MER) can be as high as about 3% for some type of funds and is not dependent on performance, which means that it is levied against the holding even if market performance is modest or even poor.

The brokerage fee that the buyer is charged when buying the units is referred to as the 'load'. Thus, when no fees are charged, the fund is referred to as a "no load" fund. Within load funds however, two different fee methods are used to charge the client: front-load and backend load. In the case of front-loads, the brokers deduct the fees up front to sell those funds; thus the amount of money invested is reduced by the amount of applicable fees paid. For backend load funds, fees gradually decline as a function of the length of time that the investor stays invested within the same family of funds. In other words, if an investor sells the units in the first year, the redemption fee might be 3.5%. However, since the redemption fee in this case is reduced by 0.5% every year, the investor would avoid paying any backend load fees if funds are held for seven years or more. This has the effect of discouraging frequent trading.

40 Similar to income trusts, the mutual fund trusts (i.e. companies) are established pursuant to subsection 132(6) of the Income Tax Act at the federal level and at the same time are supervised by the provincial securities commissions.

41 For a list of major companies that offer mutual funds, the reader is referred to the business section of a national daily newspaper.

42 Kathleen C. Young, "Mutual Fund and Segregated Fund Flowthrough Tax Rules; Resolving the Inconsistencies", *Canadian Tax Journal*, Toronto: 2004, Vol. 52, Iss. 3, 884.

As mentioned earlier, mutual funds are moreover set up as flow through entities, which means that any income earned is flowed through to the unitholders. After paying for expenses, such as the MER, it passes on different types of income to unitholders to avoid a tax liability at the entity level that might be at the highest marginal tax rate.

The different types of incomes passed on to the unitholders arise from:

- Interest income arising from investments in bonds or money market instruments;
- Dividend income arising from dividend paying securities;
- Capital gains arising from a sale of security;
- Foreign incomes arising from investment in foreign securities and instruments; and
- Occasional distribution of additional units to existing unitholders. The provision of additional distribution of units may be viewed as being akin to the return of capital concept in income trusts as discussed in the previous section.

The unitholders receive this distribution in the same form as originally received by the mutual fund company which means that interest income earned by the mutual fund company is flowed through as interest income and capital gains as capital gains and so on.

The net capital gains after offsetting capital losses, if any, are generated through the trading activity of mutual funds and are flowed through to the unit holder as capital gains. However, any net capital loss is kept within the mutual fund to offset future capital gains.

Generally, to avoid fluctuations in invested capital, the mutual funds may discourage frequent trading by charging investors about 2% early redemption fees if they sell their units as early as within 90 to 180 days of investing.

In the case of an index mutual fund, the fund company aims to match the returns of an index as opposed to beating it. This results in less buying and selling, which reduces the commissions paid to make these transactions and thereby benefits the investor, since more of the investment dollar is working for the investor. However, whether the MER of 0.5% to 1% charged by an index fund is justified because of minimal active trading is an open question.

Generally, the stocks owned by a mutual fund are valued daily at the market closing price, e.g. 4:00 P.M. for the TSX in Toronto. Sometimes, the mutual funds value their securities at a fair price. The fair price reflects the impact of events transpiring after close of the markets including impacts of major

political announcements, or announcements of departing key individuals responsible for, or influential to, the company. Such an adjustment to reflect the estimated fair price is usually reviewed and finalised by a committee overseeing the operation of a mutual fund.

Recently, mutual funds of income trusts have surfaced in the marketplace wherein mutual funds acquire units of income trusts. This is both legitimate and rather interesting, to say the least.

A Thorough Comparison of Investment Options/Forms

In the following pages we will outline various factors, presented in no particular order of importance, that impact a corporate structure, an income trust and a mutual fund respectively and compare the advantages and shortcomings.

Purpose, Complexity and Suitability of Structures

Purpose and Focus of the Established Entity

- **Corporations**

Corporations are established to attract public capital and as such seek to enhance the long term value of shares. The focus of a corporation is therefore directed at the company's long term growth, while at the same time, specific actions are taken in order to appreciate the price of the shares of the company within a quarterly reporting time frame.

- **Income Trusts**

For income trusts, the purpose is to provide cash distributions without negative surprises and without much variability in cash distributions. It is important to note that a negative variability would lower the unit values, whereas any positive movement would invariably increase the unit value. It is therefore management's objective to avoid such negative revelations. In this respect, the income trust's focus is mainly on providing a consistent and sustained level of cash distributions within a specified frequency such as monthly or quarterly.

- **Mutual Funds**

For mutual funds, the purpose is to consistently enhance the value of the units held by selling poor performers and adding shares of corporations that are expected to perform well in the long term. Therefore, the focus of a mutual fund is on the long term growth of the investments by undertaking actions aimed at appreciating unit price.

Complexities of the Alternative Structures

- **Corporations**

Since corporate structures have been in existence for some time, investors and shareholders are relatively familiar with the risks and rewards associated with investment in a corporate structure. It is generally assumed that a retail investor understands the various conditions affecting the

success or failure of an operating business. These include such elements as supply and demand, the risks of non-acceptance of its products by the market place, competition, product quality and obsolescence, among other considerations.

- **Income Trusts**

As income trusts are, relatively speaking, a new phenomenon, the risks and rewards of investing in these structures are not well known. The retail investor might not fully understand the variables associated with investing in income trusts, which makes it imperative that the retail investor understand the products of the operating business, such as the demand of its products in the market place, risks of non-acceptance of its products by the market place, competition, product quality and obsolescence, among other things. While sharing similar risks and rewards of corporate structures, trusts also possess the added complexity of requiring investors to deal through an intermediary in the form of the trust. As such, the investor is required to gain appreciation of both the operating company and of the trust construct.

- **Mutual Funds**

Since mutual funds have been available for some time, unitholders are generally quite knowledgeable about the risks and rewards associated with an investment in mutual funds. Again though, if so inclined, the investor must grasp with gaining the knowledge or confidence of the mutual fund construct, while perhaps understanding a multitude of underlying operations portfolios.

Suitability to Particular Structures

- **Corporations**

Corporations run varied business lines that require the reinvestment of funds into projects aimed at yielding augmented returns. Therefore, corporations may engage in one or several types of businesses that specialize in the manufacturing, wholesale or retail of particular products or services. These products and services can include almost any conceivable products or product bundles. Anchored in entrepreneurialship and commercial enterprise theory, corporations offer everything from traditional manufacturing activity to more recent innovations in communications, broadband and pharmaceuticals. Technological and scientific advancements are expected to continue to prompt and to renew the offerings of the corporate form of business.

- **Income Trusts**

Businesses that are deemed suitable for conversion to an income trust are commonly regarded as mature operating businesses that generate reliable

cash flows, are not dependent upon major capital expenditures, and have only limited reinvestment needs. Moreover, an income trust is usually formed to oversee the operation of only one business. Therefore, the business of an income trust specializes in overseeing the manufacturing or sale of a particular product or service. For example, the Brick, being a recent trust conversion, specializes in the sale of home furnishings and appliances.

- **Mutual Funds**

Mutual funds invest in shares of corporations. More recently, mutual funds have diversified to include investment in income trust units. In general, mutual funds invest in all types of businesses.

Closed-ended or Open-ended

- **Corporations**

Corporations are regarded as being closed-ended meaning that the number of shares issued to shareholders is limited and one has to buy or sell those shares through a stock exchange such as the S&P/TSX.

- **Income Trusts**

Income trusts are likewise closed-ended since the number of units issued to unitholders is limited and one has to buy or sell units through a stock exchange such as the S&P/TSX.

- **Mutual Funds**

Conversely, mutual funds may be open-ended or closed-ended. Open-ended funds simply impart that the numbers of units issued are not fixed. In other words, if investors buy more units, the mutual fund company would simply issue more of them and, accordingly, invest more money into the market. As well, if the performance of the mutual fund is favourable, more investors would be inclined to buy its units. Inherently, as the unit price increases or as more funds are invested, the aggregate magnitude of management fees will too increase.

In contrast, closed-ended mutual funds transact a fixed number of units. Therefore, if one wishes to buy any units in a closed-ended mutual fund framework, the units must be acquired from current unitholders willing to sell them. Accordingly, these units are traded on the stock exchange and their unit prices are dependent upon demand and supply, current net asset value and speculation of the investor population. Identical to open-ended funds, management fees can be expected to increase in corollary fashion with unit price increases and increased activity.

Leadership, Ownership and Management

Boards of Directors/Trustees, Executive Compensation and Administrative Contracts

- **Corporations**

A corporation's Board of Directors is independent and elected by the corporation's shareholders. While external expertise is oftentimes consulted, the management and administration of the operation is typically left to organization personnel. Information with respect to executive compensation is disclosed in the annual report and may be supplemented by other stipulated reporting practices of the board or delegated committee of the board.

- **Income Trusts**

Generally, the Board of Trustees is appointed and in some cases, a predetermined number of trustees may be elected. An external professional or founding manager performs the management and administration of the operating company for a fee which is subject to goods and services tax. Depending upon the type of business of the income trust, the related input tax credit, in rare cases, might not be available. This naturally equates to an additional cost of doing business, which inevitably diminishes cash available for distribution. Generally, the manager should hold a significant number of units so that manager interests will be congruent with those of investors. A standard business practice is to also have the manager sign a "non competition" agreement.

- **Mutual Funds**

The Board of Trustees may be either elected or appointed. Professional managers perform the management and administration of the mutual funds externally within a fully disclosed management expense ratio. Management fees are subject to goods and services tax (GST) and a mutual fund being a financial service, may not be able to obtain offsetting input tax credits. Therefore, the GST could again be an additional cost item having the effect of reducing the net asset value.

Audit Committee

- **Corporations**

In corporations, a member of the Board of Directors responsible for and knowledgeable of internal controls typically chairs the audit committee.

- **Income Trusts**

Generally, within income trusts, a member of the Board of Trustees is responsible for and knowledgeable of internal controls and chairs the audit committee.

- **Mutual Funds**

In a mutual fund, a member of the Board of Trustees is responsible for and knowledgeable of internal controls and chairs the audit committee.

Prevention and Management of Risks

Downturn in Economy

- **Corporations**

During economic downturns, most companies experience foregone profits or losses. Correspondingly, share prices decline. While most corporations' profits suffer, there are some corporations less dramatically affected than others due to conditions of inelasticity. Grocery retailers and others providing basic necessities are typically better insulated from these negative economic events.

- **Income Trusts**

Similar to corporations, some income trusts such as those associated with fast foods, oil and gas royalty trusts and residential rental real estate investment trust units (both discussed in the "Types of Income Trusts" section of this paper) perform better than others during economic downturn, The simple reason being that these income trusts represent activities that satisfy people's basic needs, such as food, shelter and transportation.

- **Mutual Funds**

The conditions applying to corporations extend to mutual funds simply by virtue of ownership of those same or similar corporation shares. Given a mutual fund's ability to diversify and to switch, the exposure to risk can nevertheless be better mitigated or hedged.

Risk Management

- **Corporations**

In order to ensure a competitive advantage in the market place, the management team must identify and perform risk mitigating activity. Corporations manage risks by mitigating the impacts of factors such as business performance, market growth, single business risk, reinvestment risk, seasonality, barriers to entry in the business, diversification of customers, consumer profile, obsolescence of product and plant, currency hedging activity, interest rate changes, the amount and terms of short term debt versus long term debt, to name a few.

- **Income Trusts**

Although income trusts have to manage the same factors as corporations, they face an additional risk; the inability to respond to product obsolescence. Since most of the cash earned in an income trust goes directly to the unitholder, not enough capital remains within the company for the purpose of researching and developing new and improved products or product lines.

- **Mutual Funds**

Since mutual fund companies invest their funds in corporations, they deliberately rely on corporations to manage risks. The mutual fund company is mainly responsible for diversifying its portfolio and therefore the most pervasive risk management strategies comprise of including corporations that follow good risk management practices in their portfolio and that offset each other's exposure.

Research and Development Activity

- **Corporations**

Through research activity, corporations continually seek to improve existing products and to introduce new products and brand identities. For example, Kodak, a film company before, is now a digital camera company. AgfaPhoto GmbH, a film company, did not innovate and therefore does not find itself to be as financially secure as Kodak. By extension, we find an abundance of Kodak product on retail shelves.

- **Income Trusts**

Since most of the cash is distributed to unitholders, very little resources are allocated to explore research and innovation. Therefore, those businesses not needing to innovate on a regular or ongoing basis are best suited for income trust structure. As only the future will reveal, there are presently several vulnerable income trusts that may not endure in the absence of this modernization; especially where competitors more effectively respond to societal demand.

- **Mutual Funds**

Since mutual funds do not own, operate or directly influence the commercial business activity of the companies they hold, less can be said of research and development. It would nevertheless be remiss to presume that fund portfolio managers ignore corporate research behaviour in speculation or portfolio design.

Interest Rate Shifts

- **Corporations**

An interest rate increase raises debt servicing costs, thereby decreasing earnings of the corporation, ultimately resulting in decreased share value. Since interest rate increases include an inflation component, the corporations that are able to pass on inflationary costs to their customer such as real estate, power and pipe, oil and gas properties, to name a few would fare better than those that cannot. A decrease in interest rates would naturally have a converse effect.

- **Income Trusts**

An interest rate increase raises the cost of debt and therefore decreases the amount available for cash distributions and in turn, the unit price. Thus, the investors would demand increased distributions in order to compensate for the effect of an interest rate increase. Whether the income trust has the ability to do so remains an open question. In order to compensate for the loss of earnings, income trusts generally distribute a part of the accumulated cash (see discussion under “Distributions”). Since interest rate increases include an inflation component, the trusts that are able to pass on inflation costs to their customers would fare better than the ones that cannot. Again, a decrease in interest rates would naturally have the opposite effect.

- **Mutual Fund**

Since mutual funds invest in corporations, as with corporations an increase in interest rates decreases unit values and prices. Again, a decrease in interest rates would naturally have the opposite effect.

Cost Control

- **Corporations**

Although cost control is important, this objective is often balanced against the long term growth of the price of shares.

- **Income Trusts**

Disciplined cost control must be exercised in order to generate sustained cash distributions. Therefore, the management team is more likely fixated on cost control.

- **Mutual Funds**

Cost control, relatively speaking, is not as significant a factor.

An income trust generally pays out 70% to 95% of cash earnings to unitholders

Merger and Acquisition Activity

- **Corporations**
Generally, corporations pursue mergers and acquisitions in order to increase their market share and to pursue economies of scale or synergies and, in some cases, to survive.
- **Income Trusts**
Income trusts pursue mergers and acquisitions in order to survive market upheavals, to provide consistent distributions and in some cases, to increase market share.
- **Mutual Funds**
Mutual funds pursue mergers and acquisitions in order to increase their market share.

Distributions

- **Corporations**
Corporations generally pay out about 40% of their earnings in dividends. Depending on the earnings and the economic climate, the dividends pay out may increase or decrease, such as happened with Bell Canada Enterprise (BCE) that increased the dividend payout by 10% in 2004. The balance of these earnings is invested in or directed to corporate projects intent on securing greater return on those funds for the benefit of shareholders.
- **Income Trusts**
Compared to corporation shareholders, trust unitholders can normally expect to receive higher pay outs. An income trust generally pays out 70% to 95% of cash earnings to the unitholders, giving the unitholders greater control over their future investments. The retained funds are kept in reserve in order to be used for future distribution should the operating business generate a cash amount that is less than the committed yield to the investors, for very limited research and development activity and to finance capital projects or to subsidize acquisitions.
- **Mutual Funds**
Mutual funds allocate almost 100% of the earnings to their unitholders in the form of interest income, dividends and capital gains. They do not distribute proceeds to investors but rather reinvest in additional corporate shares on behalf of investors.

Reductions and Increases in Earnings or Distributions

- **Corporations**

A reduction in earnings punishes the share value; although not to the same extent as income trusts, due to the fact that under the corporate model, the focus is on long term potential. An increase in earnings signals prosperity and increases the value of shares.

- **Income Trusts**

A reduction in distribution severely lowers the unit price due to the fact that unitholder focus is directed at cash flow from investment. Income trusts tend to increase distributions at a slower pace than the actual increase in distributable income so as to build a reserve to offset any future distributions volatility. If those funds are not needed to manage the volatility, they may be used to finance capital projects or to subsidize acquisitions.

- **Mutual Funds**

Due to the diversified nature of investments within mutual fund portfolios, the effect of an increase of earnings is less pronounced. Thus, relatively speaking, a reduction in the earnings does not affect unit prices to the same extent.

Purchasing of Shares/Units by the Entity and Valuation of Businesses

Purchase or Redemption of Shares or Units

- **Corporations**

Corporations may purchase their shares either through a full service broker or a discount brokerage house, if they have the extra cash reserves. In so doing, the number of shares outstanding is reduced and the earnings per share are correspondingly accentuated. It is normal that a reported increase in earning per share results in an increased share price. The prevailing market price is paid at the time of the execution of the order. Similarly, an external or independent investor purchases shares through a full service or a discount brokerage house.

- **Income Trusts**

Income trusts may purchase units either through a full service broker or from a discount brokerage house, if they have excess cash. This way, they would reduce units outstanding and thereby increase the percent yield per unit. This action has to be weighed against increasing the percent yield versus consistency of yield at present levels versus return of capital to the unitholders. The prevailing market price is paid at the time of the execution of the order. Similarly, an investor purchases units through a full service broker or a discount brokerage house.

- **Mutual Funds**

Mutual funds do not purchase their own units. An investor may purchase mutual fund units either through a full service broker or from a discount brokerage house, or directly from the mutual fund company. The purchase/sell order is executed at the close of day prices.

Valuation of Businesses

- **Corporations**

Corporations generally pay the fair market value established by independent valuers when buying other businesses.

- **Income Trusts**

The vendor of an operating business will often attain a higher valuation due to tax savings accruing to the trust structure. Generally speaking, when a vendor sells its business to an income trust, an independent valuator may not be retained and the price charged by the vendor may be slightly higher than the value attributed had it been otherwise computed by an independent valuator.

- **Mutual Funds**

Mutual funds buy other mutual funds at their fair market values.

The Shareholder/Unitholder

Demography of Investors

- **Corporations**

Mainly, young and middle-aged investors are most attracted to the features afforded by share ownership.

- **Income Trusts**

Retirees and citizens over 50 years of age favour income trust investment since they prefer immediate cash distributions as opposed to investing in the prospect of long term growth.

- **Mutual Funds**

The population investing in mutual funds more ambiguously spans all ages.

Types of Shareholders and/or Unitholders

- **Corporations**

Corporations commonly have several classes of shareholders such as class A common voting, class B non-voting, and preferred shares.

- **Income Trusts**

Similar to corporations, income trusts may have several classes of units. The Brick Group Income Fund for instance has class A and class B units.

- **Mutual Funds**

Mutual funds may have more than one class of unitholders. Scotia Mutual Funds for example, have Class A and Class F units.

Liability of Shareholders and/or Unitholders

- **Corporations**

The liability of the individual shareholder in a corporation is limited.

- **Income Trusts**

In some provinces, the beneficiaries of a trust are not protected from the liability of the trust which means that the unitholder's liability is unlimited. The unlimited liability infers that the unitholder might be liable for more than the value of the investment. On July 1st, 2004, the province of Alberta enacted the *Income Trust Liability Act* under which beneficiaries are not liable for the liabilities of the trust arising after July 1, 2004. This provision applies to an Alberta trust only. The *Ontario Trust Beneficiaries Liability Act* was enacted in December 2004 and resembles the provisions afforded by Alberta law. Manitoba and Quebec likewise have similar acts.

Although the liability issue has not been resolved fully in other provinces, it is believed that, should a need arise, unitholders of a widely held and publicly traded income trust would not be held liable since it would be too difficult and expensive to instruct and honour an unlimited liability proceeding.

- **Mutual Funds**

It is assumed that liability issues applying to income trusts likewise apply to mutual fund companies since mutual funds are effectively trusts. But since the mutual funds invest in shares of corporations that invoke limited liability proviso, the liability considerations of unitholders are not likely to be as pronounced as those of an income trust.

Shareholders'/Unitholders' Interests

- **Corporations**

A share offering to potential shareholders by a corporation is considered a direct offering and as such shareholders receive and enjoy a direct interest in the corporation.

- **Income Trusts**

The unitholders' investments are considered to result from an indirect offering because the unitholders receive only an indirect interest in the operating business through a trust intermediary. The vendor after the sale of the business, if obtaining units of the trust, has also indirect interest in the operating company but direct interest in the trust like any other unitholder.

- **Mutual Funds**

A mutual fund offering is a direct offering because unitholders have interests directly in the mutual fund company.

Terminal Value versus Current Value

- **Corporations**

Through the acquisition of shares, shareholders directly own a part of the corporation but receive only a portion of the earnings, e.g. about 40%, in the form of dividends. Therefore shareholders do not receive the full value of their share in the corporation until the corporation is terminated via a sale to another corporation. In other words, the shareholders receive termination value at dissolution. Any shareholder selling shares before the dissolution of the company does receive the market value of the shares but does not receive their share of the full value of the enterprise. This phenomenon is evident when a merger takes place; the company being merged usually receives a premium on the trading price of the shares.

- **Income Trusts**

The vendor of the operating business receives the terminal value, whereas the unitholder receives the projected yield on investment. The unitholders receive terminal value when the trust is merged with another trust through merger or acquisition.

- **Mutual Funds**

Mutual fund units are always valued at the fair market value. The discussion mirrors the corporation discussion above because the mutual fund actually functions like an ordinary investor, i.e. as a shareholder of each of the corporations held. Therefore, any mutual fund company selling its holding of shares before the dissolution of the company does receive the market value of the shares but do not receive their share of the full terminal values of the enterprises.

Earning per share (EPS), Trust Yield and Mutual Fund Unit Price

- **Corporations**

EPS equates to annual earnings, as computed in compliance with Generally Accepted Accounting Principles (GAAP), divided by the number of outstanding shares.

- **Income Trusts**

Yield, as a percentage, equals cash distribution, excluding return of capital, divided by the offering price per investment unit. In some trusts, yield calculation may include the return of capital which produces a higher, yet more ambiguous, reported yield.

- **Mutual Funds**

Net value of holdings is calculated as total value of assets minus expenses such as the MER. The unit price of a mutual fund or Net Asset Value (NAV) equates to the net value of holdings divided by number of issued units.

Market Exposure

S&P/TSX Index

- **Corporation**

The S&P/TSX index includes the trading activity of select corporations. For instance, the transportation index includes a select number of corporations engaged in the transportation industry, whereas the S&P/TSX 60 index reports the trading activity of the top 60 corporations listed on the Toronto Stock Exchange (TSE).

- **Income Trusts**

Revered by analysts as one of the greatest changes to the index since it evolved from the old TSE 300 in 2002⁴³, income trusts will be folded into the S&P/TSX composite index by March 2006. The decision to include income trusts will move the index closer to the market since income trusts already represent 8 per cent of total volume traded on the exchange⁴⁴.

43 Theresa Ebdon. "Paving the Way for a Fair Exchange", *The Globe and Mail*, June 29, 2005, Section E, front page.

Gordon Pape. "Rebottling the Genie", *Globeinvestor Gold*, *The Globe and Mail*, October 16, 2005, URL: <http://gold.globeinvestor.com>

44 Theresa Ebdon.

- **Mutual Funds**

The stocks owned by a mutual fund are valued each day at the market closing price (4:00 P.M. for the S&P/TSX in Toronto). It may occur, however, that mutual fund's securities are valued at a fair price. The fair price reflects the influence of political and economic events on the value of the fund as determined by a committee duly designated to oversee and manage the impacts of such emerging conditions.

Financial Analysts

- **Corporations**

The larger the market cap as a function of share price multiplied by the number of outstanding shares, the greater the liquidity and the more widely held the shares of a corporation. The greater too will be the interest of financial analysts in the activities and performance of the corporation.

- **Income Trusts**

Relatively speaking, an income trust will usually be of lesser market cap, lower liquidity and not as widely held as corporations and will therefore not attract the same generic interest of financial analysts.

- **Mutual Funds**

The analysts of several brokerage houses track the performance of mutual funds and provide mutual fund investment advice to their particular clients.

Accounting, Controls and Certification

Accounting and GAAP

- **Corporations**

Corporations follow GAAP. While conforming to GAAP and within the spirit of GAAP, aggressive accounting is permitted that might result in maximal reported period earnings which naturally puts upward pressure on share price value. Corporations are required to provide comparative financial statements which reveal current financial performance against that of the prior year.

- **Income Trusts**

Income trusts likewise follow GAAP. While conforming to GAAP and within the spirit of GAAP, aggressive accounting, although permitted, is not helpful as it lowers the amount of cash distribution putting downward pressure on the unit price. Income trusts usually report earnings before interest, taxes, depreciation and amortization (EBITDA).

Importantly, we must concede that “distributable cash” is a non-GAAP financial measure and that the investor community is well served to induce a mechanism which reasonably reconciles distributable cash to GAAP reporting.

CGA-Canada contends that even in the first year of formation of the income trust, it should also provide comparative financial statements and not invoke the argument that the legal entity or construct has changed. One should always keep in mind the fact that only the legal construct and its constituency have changed and not the line of business.

- **Mutual Funds**

Mutual funds also follow GAAP. While conforming to GAAP and within the spirit of GAAP, aggressive accounting is permitted that might result in increased net value of holdings. The increased net value of holdings increases unit values, resulting in higher and more attractive unit prices for unitholders.

Errors and Misstatements

- **Corporations**

Should there be any errors in the financial statements, they may be corrected in the subsequent financial statements. The discovery of errors is not considered to bode well for management and therefore the accrual and cut-off procedures and the analysis of preliminary account balances must be performed accurately if the confidence of financial statement users is to be maintained.

- **Income Trusts**

After having distributed cash and discovering an error, there is no immediate mechanism available by which to recover cash distributions from unitholders. Therefore, the accrual and cut-off procedures and the analysis must be performed accurately so as to avoid future volatility of distributions and post-event unitholder exit from the trust.

- **Mutual Funds**

After having reported T3 earnings as previously discussed, and having discovered an error, a revised T3 may be issued by the fund. Similar to other forms of investment vehicles, the restatement of financial information and issuance of revised T3 does not bode well for the management and therefore the accrual and cut-off procedures must be performed accurately.

It should become apparent that errors and financial misstatements can be damaging, sometimes devastating, to the management teams, the audit committees and the boards of any of the three structures discussed.

Disclosure

- **Corporations**

The Canadian Institute of Chartered Accountants' (CICA) Handbook and securities regulators provide disclosure guidelines for corporations while products and guidelines issued by the Certified General Accountants Association(s) and the Institute(s) will provide guidance and instruction to preparers of financial statements.

- **Income Trusts**

Provincial securities regulators provide instruction and guidance with respect to disclosure.

- **Mutual Funds**

Provincial securities regulators provide instruction and guidance with respect to disclosure.

Debt/Equity Ratio Analysis and Rating

- **Corporations**

The debt/equity ratio is an important indicator of the financial vitality of a corporation. In a public corporation, the debt is rated.

- **Income Trusts**

The debt/equity ratio does not have the same significance for income trusts as it has for corporate structures since this ratio results from a designed activity. In an income trust, only the sustainability and variability of cash distributions are rated (see discussion in "Rating Practices" section of this paper).

- **Mutual Funds**

Mutual funds do not operate with reliance on debt financing.

Materiality

- **Corporations**

Relatively speaking, corporations exercise the highest threshold.

- **Income Trusts**

Relatively speaking, income trusts exercise the lowest threshold.

- **Mutual Funds**

Relative to an income trust, mutual funds exercise a higher threshold but relative to a corporation, exercise a lower threshold.

Taxation

Taxation at the Corporate Level

- **Corporations**

A corporation's net income is taxed at the corporation's marginal tax rate.

- **Income Trusts**

Effectively, the after distribution net income is taxed at the trust's marginal tax rate. Most earnings are distributed in the form of cash to the unitholders and consequently, the amount of tax payable is normally insignificant.

- **Mutual Funds**

Since all earnings are distributed, there is no tax liability within mutual funds.

Taxation of Income to Shareholders and/or Unitholders

- **Corporations**

Shareholders receive dividends. The dividends are taxed at a lower rate than interest or ordinary income as the result of dividend tax credits.

- **Income Trusts**

Unitholders receive income in the same form as earned by the trust, e.g. regular income, interest income, dividends, and capital gains. Typically, the payout is as regular income. Under the *Income Tax Act*, the regular income is taxed at the full personal marginal tax rate of the recipient, the dividend income at a lower rate due to the dividend tax credit, and the capital gains at the lowest tax rate due to available capital gains exemption. A net capital loss is retained in the income trust and as such is not flowed through to the unitholders.

- **Mutual Funds**

Unitholders receive income in the same form as earned by the mutual fund trust, e.g. interest income, dividends, and capital gains. Under the *Income Tax Act*, the regular income is taxed at the full personal marginal tax rate of the recipient, the dividend income at a lower rate due to the dividend tax credit, and the capital gains at the lowest tax rate due to available capital gains exemption. A net capital loss is retained by the fund and as such is not flowed through to the unitholders. Under this structure, unlike an

income trust, the taxpayer does not receive any cash but is nevertheless required to pay applicable tax on reported income.

Return of Capital

- **Corporations**

Not applicable.

- **Income Trusts**

Sometimes, a unitholder receives return of capital. Investors enjoy receiving a return of capital since the capital at risk is reduced thereby offering the opportunity to decide how the capital is utilized or reinvested. Moreover, the return of capital reduces the adjusted cost base of the asset and therefore the gain resulting from a sale activity is a capital gain that is taxed in the hands of the investor at the lowest rate.

- **Mutual Funds**

Sometimes, a unitholder receives distribution of units, a concept that has similar consequences to the return of capital in an income trust. Such a distribution lowers the adjusted cost base of the holdings and the gain resulting from a sale activity is a capital gain that is taxed at the lowest rate.

Taxation of Shareholder Gains

- **Corporations**

The sale of shares of a corporation is subject to capital gain or loss. While most taxpayers are eligible for partial capital gains exemption, tax is payable on experienced gains. Capital losses can be applied against capital gains to reduce taxes otherwise payable.

- **Income Trusts**

The sale of units of an income trust is likewise subject to capital gain or loss and the enjoined tax treatment.

- **Mutual Funds**

The sale of units of a mutual fund is likewise subject to capital gain or loss and the enjoined tax treatment.

Registered Plans Eligibility

- **Corporations**

Shares of Canadian corporations are eligible investments under RRSPs, RRIFs, and RESPs. Contributions to RRSPs are deductible and contributions to RESPs attract a 20% federal endowment of up to \$400 per child per year. The dividends received on a regular basis and capital gains received through sale of shares are not taxed while they reside in the registered plans. However, the total value, including the earnings and the principal, are taxed at the shareholder's marginal tax rate upon withdrawal from these plans. The preferential tax treatment of dividends and capital gains is typically lost when housed in a registered plan.

- **Income Trusts**

Units of Canadian income trusts, REITs and royalty trusts (both discussed in the "Types of Income Trusts" section of this paper) are likewise eligible for RRSP, RRIF, and RESP investment. Contributions to RRSPs are deductible and contributions to RESPs attract a 20% federal endowment of up to \$400 per child per year in the same fashion as shares. The interest income, dividends, and capital gains received on a regular basis and capital gains generated through sale of units are not taxed while invested in the registered plans. Like shares however, the total value including the earnings, principal and the return of capital are taxed at the unitholder's marginal tax rate upon withdrawal from these plans. Accordingly, the return of capital that is normally not taxable becomes taxable. The lower taxes, normally payable on dividends and capital gains, would also be lost. Consequently, from the perspective of return of capital only, it is more advantageous to hold income trust units outside of registered plans.

- **Mutual Funds**

Units of Canadian mutual funds are also eligible RRSP, RRIF, and RESP investments. Contributions to RRSPs are deductible and contributions to RESPs attract a 20% federal endowment of up to \$400 per child per year in the same fashion as shares and trust units. In a mutual fund structure, the distributions are received directly by these plans, whereas the unitholders of a mutual fund at this point only receive performance reports. The notional interest income, dividends, and capital gains generated through sale of units are not taxed while the investment is in the registered plans. However, the total value is taxed at the unitholder's marginal tax rate as soon as the funds are withdrawn from these plans. Also, additional capital gains resulting from the additional distribution of units would also be lost. Consequently, from the perspective of the receipt of additional distribution of units only, the mutual funds yield the best net return to investors when held outside of those registered plans.

Types of Income Trusts

There are three main groupings of income trusts. The most commonly known are business trusts which are also known as business income trusts or hybrid trusts, followed by real estate investment trusts (REITs) and royalty/energy trusts. While REITs and royalty/energy trusts have existed since the 1980s, business income trusts are a more recent development in Canada. In this section, we provide a high level discussion on these three types of trusts and include a comparison between investing in a traditional rental property and a REIT.

Business Income Trusts

Business trusts, or business income trusts, usually acquire substantially all of the issued equity and debt of a pre-existent entity or operation. Under a common business trust structure, the trust earns income primarily from the operation of the operating company including interest payments received on the debt of the entity. The business trust sector has been the fastest growing trust sector in the last four years. An explanation for the growth may be that business trusts cover many sectors, including manufacturing, food distribution, and power generation and distribution. Some of the types of businesses that currently fall under the business trust category include:

- Fast food chains;
- Mattress manufacturers;
- Natural gas distribution companies;
- Electrical power generation establishments; and
- Vending machine companies.

From this limited list, it can be deduced that a great range of businesses are, or could qualify to be, part of the income trust sector. It is therefore imperative that investors comprehend the nature of trusts and that they be further informed of the business risks and rewards of the individual or underlying operating businesses.

Real Estate Investment Trusts (REITs)

Although REITs existed prior to 1994, changes to the Income Tax Act (ITA) in 1994 facilitated their growth by expanding the circumstances under which REITs could qualify as mutual fund trusts under the ITA⁴⁵.

⁴⁵ Department of Finance, Government of Canada, 9.

REITs are established in much the same way as business trusts except that the underlying property is comprised of real estate property which may be characterized as commercial retail, commercial office, commercial industrial, residential and retirement properties.

REITs generally acquire income-producing real property and primarily earn income from leasing or operating the property and/or earn interest income through the holding of debt of an operating entity.

Each type of REIT property has its unique risks with regards to returns to the unitholders, with the most obvious risk being the effect of market downturns on realty properties. Notably, the change in value of basic apartments and retirement properties which offer to meet basic residential needs will be less sensitive or less pronounced than those, say, of luxury buildings and high-end housing.

With a view to mitigate the potential risk of declining or vulnerable revenue streams, a REIT usually combines a variety of properties in its portfolio. In addition, REITs usually continue to add assets valued by professional valuers to the portfolio. Moreover, REITs do not undertake property development activities, since the pay-off of this type of activity is subject to elevated risk and may cause variation in the distributions to investors commanding a constant and reliable cash flow.

Investment Considerations:

Real Estate Rental Properties vs. REITs

An investor investing in real estate rental property has ownership of the property, may obtain a mortgage in order to finance the property, normally pays land transfer taxes, where applicable, and is taxed on rental income flowing from this property. Net rental income is taxed at the investor's marginal tax rate and is included in the earned income calculations in computing the RRSP contribution limit. An investor may self-manage property or pay management fees to a property manager. Upon sale of the property, any experienced appreciation is recognized and treated as a capital gain.

On the other hand, an investor buying REIT units has ownership of the trust units rather than the property and receives distributions in the form of interest, dividends and capital gains. The cash distributions, which may be less than the rental income, is included in computing the investor's earned income for the purpose of determining RRSP contribution limits. In addition, a unitholder assumes the responsibility to pay taxes at the respective marginal tax rate, which is generally lower than that of the REIT. However, it should be noted that the allotment of each type of distribution changes over time, which means that the 'after tax return' to the investor would not necessarily be consistent from one year to the next. Additionally, the amount of tax payable would not

always be the same as taxes payable are heavily dependent upon the type or nature of the earnings. The properties are professionally managed and the investor receives only the price appreciation of the trust units, not that of the underlying property.

In assessing which investment route to pursue, an investor should evaluate respective personal circumstances and their ability and inclination to assume responsibility for property and market risks. Given the multitude of considerations, CGA-Canada encourages investors to discuss their personal circumstances with specialists and/or financial advisors to determine suitability of rental property and REIT alternatives. Either or both options may be attractive under varying circumstances.

Royalty Trusts

Although the first energy trust in Canada was established in the mid 1980s, the growth of the sector did not take place until mid 1990, when the market cap of this sector increased significantly. In the late 1990s the popularity of energy trusts began to decline, partially as the result of lower commodity prices and higher interest rates; however, in recent years their popularity has rebounded due, in part, to a reversal in these two factors.

Royalty trusts usually earn royalty income from resource properties through a royalty interest and/or earn interest income through the holding of debt of an operating resource property. The establishment of royalty trusts is similar to the establishment of business trusts, except that the underlying properties are oil and gas assets.

The major point to note regarding royalty trusts is the fact that finite oil and gas reserves will eventually be depleted. Therefore, in order to maintain distribution of income to unitholders, the royalty trust would have to continually purchase new assets in order to sustain the life of the trust. However, since there are only a limited number of assets available for sale, the acquisition price of available assets tends to increase via bidding wars since all royalty trusts face the same challenge. Accordingly, the bidder with deep pockets tends to get the available asset at inflated prices. The ability of a royalty/energy trust to provide a steady flow of cash distribution to investors depends largely on the market price of energy, the size of reserves, the cost of adding reserves, the cost and pace of production, and the debt load of the trust.

Furthermore, royalty trusts do not undertake any exploration activities since the pay off may be subject to risk which causes a greater variation in the distribution, which would upset the investors who naturally demand a reliable and steady stream of income.

As energy prices have been high for quite some time, it is reasonably natural for investors to feel confident that the energy prices might continue to be high for the foreseeable future. While the current market gives much reason for optimism, some prudence may nevertheless be in order. Although we do acknowledge the high returns that might be reaped from royalty trusts, we do highlight that values are highly dependent on political, economic and environmental factors.

Comparison of Income Trust Types

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The discussion in the preceding section should illustrate that each trust type has different strengths and weaknesses, and that it is incumbent upon the investor to ultimately choose the trust type(s) best suited to portfolio preferences. Whereas business trusts offer great variety, their performance is relatively difficult to predict and require careful analysis. Seemingly, REITs are on the other hand more stable although we must be cognizant that unit prices are nevertheless still coupled to fluctuations in interest rates. Royalty trusts, on the other hand, may offer great yields, but their payouts are dependent on the price of oil, which is often tied to economic, political and environmental events.

Knowing the various benefits as well as the potential shortcomings of each type of trust is crucial to the investor since it will aid the investor in aligning speculative prediction with desired outcomes. Oftentimes influenced by multiple objectives, it is relatively common to see diversification within individuals' portfolios aimed at harnessing complementary strategies. These strategies will naturally be influenced by the investor's long and/or short term objectives and expectations.

What follows is a comparison of more salient factors relating to business trusts, REITs, and royalty trusts. Expectantly, the comparison will make it easier for an investor to evaluate the appropriateness of income trusts as an investment vehicle and to ultimately identify type(s) of trusts that best suit particular needs.

Valuation of Assets

Valuation of assets refers to the price paid by the trust for the operating business or the assets held by the operating business.

- **Business Trusts**

Generally, the establishment of the trust may be a designed activity. This means that the valuation of the trust assets and the consequential amount of equity and debt and the rate of interest charged on the debt are calculated and established such that the trust results in almost nil income after distribution of its income to unitholders. Intentionally, the trust designs its financial configuration to respond to anticipated return expectations of unitholders.

- **REITs**

REITs pay the fair market value of the properties as determined by prevailing market conditions with the assistance of independent valuers who perform the valuation of assets.

- **Royalty Trusts**

Since assets available for purchase are limited, the acquisition price of existing assets tends to escalate due to competition between various royalty trusts having prominent interest in the same properties; sometimes even resulting in bidding wars. Here, the economic principle of supply and demand determines the shape of the market and the behaviour of participants. Consequentially, the bidder with deeper pockets and inclination normally secures the available assets, but at inflated prices.

Boards of Trustees

- **Business Trusts**

In a business trust, members are generally appointed. In order to gain trust of the public, it would be prudent to appoint the independent members to key committees such as the audit or the compensation committees. This is especially true in cases where the sponsor retains significant control over the board.

- **REITs**

Generally, members are appointed. However, a few independent members may be elected. Similar to business trusts, it would be prudent to assign independent members to the key committees in order to gain public trust where the sponsor retains a significant control over the board.

- **Royalty Trusts**

Same comments as REITs are applicable to royalty trusts.

Economies of Scale

Typically, an entity that achieves economies of scale, efficiencies or synergies lowers the average cost per unit of production such that the profitability of the venture is favourably impacted.

- **Business Trusts**

Since business trusts usually only consist of one operating business, they rarely achieve significant economies of scale in the absence of mergers and acquisitions.

- **REITs**

Through mergers and acquisitions, REITs attain sufficient size to achieve economies of scale.

- **Royalty Trusts**

Through mergers and acquisitions, royalty trusts may achieve a sufficient size to achieve economies of scale. Moreover, since the oil and gas industry depends on finite resources, sustainable royalty trusts are required to engage in merger and acquisition activity to endure.

Diversification

Diversification refers to the acquisition of additional assets outside of the existing sector of activity or complementary assets within the entity's current sector. In the latter case, diversification is pursued with a view to broadening supply chain opportunities. It is normally prompted by the motivation to minimize exposure to risk or to secure additional revenue streams for the benefit of beneficiaries.

- **Business Trusts**

The vendor of the operating business is generally retained on a contract basis in order to manage the business. Under this strategy, should the income trust acquire other businesses that are similar in type, it would receive more income from similar revenue streams, but without much diversification. An acquisition in the same line of business would be complicated by the fact that another vendor would want to manage the new acquisition. However, should the trust pursue other lines of business or diversify, the existing manager would not necessarily be proficient to manage a new line of business.

- **REITs**

The existing management normally has the experience to manage more properties that are similar in nature. Should a REIT, whose principal business is rental apartments, acquire a hotel property, it may have to acquire staff skilled in managing hotel properties. Under this strategy, REITs may diversify revenue streams and mitigate the risk of revenue disruption and or variation through diversification albeit in the same market sector.

- **Royalty Trusts**

Royalty trusts face the same challenges as REITs. However, a new acquisition may be integrated fully with the existing properties without much difficulty or friction. Under this strategy, royalty trusts would receive more income from several streams in the same market sector.

Innovations and Research Activity

The primary purpose of pursuing innovation and research is to mitigate the risk of obsolescence and to enhance favourable product characteristics intent on maintaining and growing market share.

- **Business Trusts**

Since distribution is accentuated, almost all of the cash flow is paid out to unitholders. Consequently, sufficient funds are often not retained by the income trust to ward off the effects of product obsolescence or to keep up with a competitive market environment.

- **REITs**

Due to modest level of funding retained in the trust, funds are normally retained only to the extent of meeting required maintenance activities related to the real estate property in the portfolio. Given the nature of the underlying assets of an REIT though, additional research activity is perhaps not germane.

- **Royalty Trusts**

Presently, the risk of oil and gas use becoming obsolete is remote. However, due to lack of cash dedicated to research activity, potential new uses of oil and gas or prospective refinement efficiencies are normally not explored by a royalty trust.

Business Risk

Business risk relates to all of the risks inherent to a business line or business activity including both internal and external factors.

- **Business Trusts**

Although the types of business trusts vary, they generally invest in only one business, which can lead to a high business risk concentration. However, each type of income trust attempts to mitigate that risk and to make the most of its particular circumstances. For example, electric power generation trusts usually seek to secure sign-up long term sales and fuel supply contracts in order to offer sustained and predictable cash distributions.

- **REITs**

REIT investments are usually in one sector of the market, but the risk is usually mitigated through a diverse portfolio of real estate property that includes multiple properties and may even indulge in a spectrum of property types.

- **Royalty Trusts**

Although investments are in one sector of the market, they are spread over

fewer properties or assets than REITs, which increases the business risk to a certain extent.

Interest Rates

The interest rate generally refers to the rate of interest charged on debt or the general prevailing interest rate.

- **Business Trusts**

A high prevailing interest rate tends to lower the unit price because an investor has other alternative investments such as GICs that become relatively more attractive. Moreover, in a high interest rate environment, the debt financing costs increase resulting in the decrease of available cash distributions which in turn lead to lower unit prices. In addition, interest rates are linked to inflation and accordingly the business trusts that are satisfying basic needs of the population would be more apt to pass on the associated increased costs. Those in a position to pass on the effects of such pressures to consumers are thereby more successful in mitigating the impact of increased interest rates. Conversely, a reduction in interest rates has the opposite effect.

- **REITs**

Similar to the case of business trusts, high interest rates tend to lower the unit price because an investor has other investments to choose from, such as GICs. Moreover, in a high interest rate environment, the debt financing cost would increase, resulting in the decrease of available cash distributions, which would lead to lower unit prices. Contrary to business trusts, interest rates, while linked to inflation, lead to an increase in the value of commercial real estate properties. Thus, real estate is considered a hedge against inflation. The increase in the price of properties may be leveraged to purchase other investments. REITs specializing in residential apartment buildings generally have the ability to pass on additional inflation costs to tenants. Naturally, a low interest rate would have the opposite effect.

- **Royalty Trusts**

Similar to the case of business trusts and REITs, high interest rates tend to lower the unit price because an investor has other alternative investments to choose from such as GICs. Moreover, in a high interest rate environment, the debt financing cost would increase, resulting in the decrease of available cash distributions, which would lead to lower unit prices. In addition, interest rates are linked to inflation, which in turn leads to an increase in commodity prices. Thus, investing in commodity is considered a hedge against inflation. Royalty trusts generally have the ability to pass on additional/inflation costs to consumers. Again, a low interest rate would have the opposite effect.

Economic Downturns

- **Business Trusts**

Some income trusts such as manufacturers and vendors of basic necessities inclusive of food, shelter and basic amenities can be expected to perform better or more consistently than others. The longer that a consumer can delay a particular acquisition or avoid it entirely; the more vulnerable will be the product offering to economic conditions.

- **REITs**

During an economic downturn, REITs may offer inducements such as a period of free rent or rebates in order to attract new tenants. During free rent periods, a REIT would be required to pay out distributions in excess of its cash flows from undistributed cash earnings. However, the REIT would seek to replenish its undistributed earnings at earliest opportunity.

- **Royalty Trusts**

Oil and gas royalty trusts perform better during economic downturns since they are dealing with a basic commodity on which consumers depend for their basic continued subsistence.

Due to the nature and relative novelty of income trusts, it becomes crucial for investors to be fully aware of the risks associated with anticipated distributions from their respective unitholdings. One current shortcoming inherent to the rating system is the fact that submission to the scrutiny of a rating agency is strictly voluntary. Most income trusts therefore do not expose themselves to the rating process since they often fret over the expense associated with the thorough rating by an independent agency. Many income trusts are of the opinion that they serve their investors better by transferring the avoided expense in the form of cash distributions to the unitholders. Given the complexity of the market however, CGA-Canada strongly supports the rating agency process since rating agencies provide the rare independent opinion of a professional body on the sustainability of income trust distributions. We argue that in the long run, investors would value the intellectual resources and rigorous analysis these agencies provide, since very few investors can afford the time or resources to assess each possible income trust independently. Thus, investors are strongly encouraged to access the resources provided by these agencies in order to assess the prospect of their potential investments.

Income trusts are rated by these agencies with respect to their variability and sustainability. Variability herein referring to the degree of change in cash distributions and sustainability herein referring to the length of time the cash distribution can be sustained.

Currently, there are four very active rating agencies in Canada:

- Dominion Bond Rating Service;
- Standard and Poors;
- Moody's Investors Service; and
- Fitch Inc.

Each rating agency follows its unique process, but all utilize the expertise of professional staff and, after thorough analysis of a variety of factors, arrive at a rating score.

In order to exemplify the process used by these agencies, we offer the following discussion which highlights the methodology used by the Dominion Bond Rating Service and the Standard and Poors rating agency in assessing the sustainability of cash distributions from prospective income trusts.

The ratings of the Dominion Bond Rating Service (DBRS) income rating scale can be summarized as follows:

- STA-1: Highest stability and sustainability of distributions per unit.
- STA-2: Very good stability and sustainability of distributions per unit.
- STA-3: Good stability and sustainability of distributions per unit.
- STA-4: Adequate stability and sustainability of distributions per unit.
- STA-5: Weak stability and sustainability of distributions per unit.
- STA-6: Very weak stability and sustainability of distributions per unit.
- STA-7: Poor stability and sustainability of distributions per unit.

Moreover, each of the above rating scales is further subdivided into three categories:

- High (e.g. STA-3 high)
- Middle (e.g. STA-3 middle)
- Low (e.g. STA-3 low)

Thus, the Dominion Bond Rating scheme provides a score from within a total of 21 potential classifications when ranking income funds of the following five industry categories:

- Power
- Pipelines
- Real Estate Investment Trusts
- Oil and Gas
- Business and Specialty Trusts

In addition, DBRS relies on the combined effect of the following seven factors to arrive at a rating:

- Asset quality;
- Operating and industry characteristics;
- Financial flexibility;
- Diversification;
- Size and market position;
- Sponsorship & governance; and
- Growth.

DBRS also considers the intrinsic components of each of these factors outlined above. For example, components to be considered when evaluating asset quality may include:

-
- Remaining life of asset;
 - Asset age;
 - Condition & location;
 - Product differentiation;
 - Risk of obsolescence; and
 - Inherent value of tangible and intangible assets.

On the other hand, the Standard and Poors uses a seven-scale stability rating system ranging from high to low sustainability of distributions:

- SR-1: Highest level of cash distribution stability.
- SR-2: Very high level of cash distribution stability.
- SR-3: High level of cash distribution stability.
- SR-4: Moderate level of cash distribution stability.
- SR-5: Marginal level of cash distribution stability.
- SR-6: Low level of cash distribution stability.
- SR-7: Very low level of cash distribution stability.

Rating agency findings should be a component of the conscious investor's investigation

In order to arrive at a stability rating, Standard and Poors conducts a four-phase analysis:

- First Phase: Structure and governance
- Second Phase: Business profile
- Third Phase: Financial profile
- Fourth Phase: Distribution

As can be inferred from the examples above, all rating agencies take similar factors into consideration before arriving at a stability rating.

With respect to income trusts, ratings are a measure of sustainability and variability of future cash distributions per unit. However, unlike a corporation where rating agencies include the debt of the organization into their analysis in order to address default risk, the debt of an income trust is not rated.

Because they provide an independent third party opinion on rated income trusts, rating agency findings should be a major component of the conscious investor's investigation. However, although rating agencies are a very good source of information with regards to income trusts and provide a thorough and transparent method of analysis, they should not be used as a sole source for making crucial investment decisions.

The analysis above offers only a glimpse into the rating schemes utilized by Dominion Bond Rating Service and Standard and Poors. In order to arrive at a sound investment decision, we strongly urge the reader to consult the detailed outline of the rating scheme methodology and the complementary research offered on the websites of these and other rating agencies. For additional information, the reader is encouraged to consult the websites of the rating agencies discussed above. The Dominion Bond Rating Service can be found at www.DBRS.com while Standard and Poors can be found at www.standardandpoors.com.

Speaking to Government Policy

Of the various options available to the federal government, the minister of finance on November 23, 2005 announced that if the government returned to power in January 2006, it would increase the dividend tax credit to placate the investors in a corporation. Presumably, this would level the playing field and mitigate the mass migration of investors and investment capital to income trusts.

The Basic Premise

Table 5 below has been produced relying on the contents of Appendices A and B and presents the scenario for each of the provinces of Ontario, British Columbia and Alberta for three income earning groups (i.e. top earner of \$115,739, \$75,000 earner, and \$50,000 earner). It is assumed that many retirees and senior citizens would reside in the \$50,000 earner group. We can see that, based on a full distribution (of dividends and distributions) with the entity retaining none of the entity earnings, government intake on every \$100 of entity earnings is superior for three earner groups under the corporate form of business, and correspondingly the net proceeds retained by the entity and individual taken collectively are inferior for any of the provinces considered. As a result, investment in trust activity is favourable to all income groups.

While we have seen several renditions of this manifestation through the works and propositions of others, we can reasonably concede that this scenario is, in practice, flawed.

Table 5: Total Tax Paid on \$100 of Entity Earnings Assuming Full Distribution

		Corporate Entity			Income Trust Entity		
		Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings		\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate		36.12%	35.62%	33.62%	-	-	-
Balance Paid to Investors		\$63.88	\$64.38	\$66.38	\$100.00	\$100.00	\$100.00
Top Earner	Personal Tax Rate	31.34%	31.58%	24.08%	46.41%	43.70%	39.00%
	Personal Tax Amount	\$20.02	\$20.33	\$15.98	\$46.41	\$43.70	\$39.00
	Total Tax Paid	\$56.14	\$55.95	\$49.60	\$46.41	\$43.70	\$39.00
	Net Proceeds Retained	\$43.86	\$44.05	\$50.40	\$53.59	\$56.30	\$61.00
\$75,000 Earner	Personal Tax Rate	27.59%	24.08%	20.33%	43.41%	37.70%	36.00%
	Personal Tax Amount	\$17.62	\$15.50	\$13.50	\$43.41	\$37.70	\$36.00
	Total Tax Paid	\$53.74	\$51.12	\$47.12	\$43.41	\$37.70	\$36.00
	Net Proceeds Retained	\$46.26	\$48.88	\$52.88	\$56.59	\$62.30	\$64.00
\$50,000 Earner	Personal Tax Rate	15.86%	15.90%	15.33%	31.15%	31.15%	32.00%
	Personal Tax Amount	\$10.13	\$10.24	\$10.18	\$31.15	\$31.15	\$32.00
	Total Tax Paid	\$46.25	\$45.86	\$43.80	\$31.15	\$31.15	\$32.00
	Net Proceeds Retained	\$53.75	\$54.14	\$56.20	\$68.85	\$68.85	\$68.00

A Variation to the Basic Premise

Table 6 attempts to depict a more realistic scenario which recognizes that corporations do not typically pay out in dividends the full after tax earnings of the entity. Rather, they justifiably retain a portion of earnings. Assuming that corporations pay on average 40% of after tax earnings in the form of dividends, Table 6 has likewise been produced relying on the contents of Appendices A and B. It presents the scenario for each of the provinces of Ontario, British Columbia and Alberta for the three earner groups with the 40% stipulation in mind. We can see that, based on a partial distribution of dividends with the corporate entity retaining 60% of the after tax entity earning and full distribution of trust entity earning, the above premise can now be challenged. Based on this scenario, government intake on every \$100 of entity earnings is now inferior under the corporate form of business for top and \$75,000 earners of Ontario, and only marginally superior for top earners of British Columbia and Alberta. Table 6 also presents that the government intake in corporate form is superior for \$75,000 earner groups of British Columbia and Alberta and \$50,000 earner groups of the three provinces, and accordingly, investment in trust activity is favourable to these three earner groups. Correspondingly, the net proceeds retained by the entity and individual taken collectively are directly inversed.

CGA-Canada believes this scenario to be more reflective than the immediately preceding one. Consequentially, the claim can be made that some of the current public debate can be rendered partially and unintentionally misleading.

Table 6: Total Tax Paid on \$100 of Entity Earnings Assuming 40% Dividend

		Corporate Entity			Income Trust Entity		
		Ontario	BC	Alberta	Ontario	BC	Alberta
	Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
	Corporate Tax Rate	36.12%	35.62%	33.62%	-	-	-
	Dividend payout rate	40.00%	40.00%	40.00%	-	-	-
	Balance Paid to Investors	\$25.55	\$25.75	\$26.55	\$100.00	\$100.00	\$100.00
Top Earner	Personal Tax Rate	31.34%	31.58%	24.08%	46.41%	43.70%	39.00%
	Personal Tax Amount	\$8.01	\$8.13	\$6.39	\$46.41	\$43.70	\$39.00
	Total Tax Paid	\$44.13	\$43.75	\$40.01	\$46.41	\$43.70	\$39.00
	Net Proceeds Retained	\$55.87	\$56.25	\$59.99	\$53.59	\$56.30	\$61.00
\$75,000 Earner	Personal Tax Rate	27.59%	24.08%	20.33%	43.41%	37.70%	36.00%
	Personal Tax Amount	\$7.05	\$6.20	\$5.40	\$43.41	\$37.70	\$36.00
	Total Tax Paid	\$43.17	\$41.82	\$39.02	\$43.41	\$37.70	\$36.00
	Net Proceeds Retained	\$56.83	\$58.18	\$60.98	\$56.59	\$62.30	\$64.00
\$50,000 Earner	Personal Tax Rate	15.86%	15.90%	15.33%	31.15%	31.15%	32.00%
	Personal Tax Amount	\$4.05	\$4.09	\$4.07	\$31.15	\$31.15	\$32.00
	Total Tax Paid	\$40.17	\$39.71	\$37.69	\$31.15	\$31.15	\$32.00
	Net Proceeds Retained	\$59.83	\$60.29	\$62.31	\$68.85	\$68.85	\$68.00

Introduction of Dividend Tax Relief Proposal

Expanding on these scenarios to include the effect of the federal government's proposal to increase the dividend tax credit from 13.33% to 19.00% as discussed earlier in this paper, we can replicate the above analysis. Table 7 has been produced relying on the contents of Appendices A and B and presents the scenario for each of the provinces of Ontario, British Columbia and Alberta for the three earner groups. We can see that, based on a full distribution (of dividends and distributions) with the entity retaining none of the entity earning, the original premise (refer to Table 5) is again confirmed, albeit less pronounced. Government' intake on every \$100 of entity earnings is superior under the corporate form of business, and correspondingly, the net proceeds retained by the entity and individual taken collectively are inferior for any of the provinces considered. This is rather interesting considering that the intent of the proposal is to bring about greater parity between dividends of corporations and distributions of trusts. So while it does level the playing field somewhat, it does not entirely remedy the disparity.

Table 7: Total Tax Paid on \$100 of Entity Earnings (Dividend Proposal)

		Corporate Entity			Income Trust Entity		
		Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings		\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate		36.12%	35.62%	33.62%	-	-	-
Balance Paid to Investors		\$63.88	\$64.38	\$66.38	\$100.00	\$100.00	\$100.00
Top Earner	Personal Tax Rate	23.20%	25.27%	15.77%	46.41%	43.70%	39.00%
	Personal Tax Amount	\$14.82	\$16.27	\$10.47	\$46.41	\$43.70	\$39.00
	Total Tax Paid	\$50.94	\$51.89	\$44.09	\$46.41	\$43.70	\$39.00
	Net Proceeds Retained	\$49.06	\$48.11	\$55.91	\$53.59	\$56.30	\$61.00
\$75,000 Earner	Personal Tax Rate	18.86%	16.57%	11.43%	43.41%	37.70%	36.00%
	Personal Tax Amount	\$12.05	\$10.67	\$7.58	\$43.41	\$37.70	\$36.00
	Total Tax Paid	\$48.17	\$46.29	\$41.20	\$43.41	\$37.70	\$36.00
	Net Proceeds Retained	\$51.83	\$53.71	\$58.80	\$56.59	\$62.30	\$64.00
\$50,000 Earner	Personal Tax Rate	7.02%	7.08%	5.63%	31.15%	31.15%	32.00%
	Personal Tax Amount	\$4.48	\$4.56	\$3.73	\$31.15	\$31.15	\$32.00
	Total Tax Paid	\$40.60	\$40.18	\$37.35	\$31.15	\$31.15	\$32.00
	Net Proceeds Retained	\$59.40	\$59.82	\$62.65	\$68.85	\$68.85	\$68.00

Adaptation of Dividend Tax Relief Proposal

In keeping with the logic advanced through the provision of Table 6 above, Table 8 likewise attempts to depict a more realistic scenario which recognizes that corporations do not typically pay out in dividends the full after tax earnings of the entity. Again assuming that corporations pay on average 40% of after tax earnings in the form of dividends, Table 8 which has likewise been produced relying on the contents of Appendices A and B presents the scenario for each of the provinces under comparison. We can see that, based on a partial distribution of dividends with the corporate entity retaining 60% of the after tax entity earning and full distribution of trust entity earning, the original premise has now been eradicated for the top earners only. Government intake

The government could effectively dissuade top income earners from investing in income trusts through its dividend proposal

on every \$100 of entity earnings is now inferior under the corporate form of business for top earners of all provinces and the \$75,000 earners of Ontario. Resultantly, for these earner groups investment in corporate form is more favourable than a comparable investment in trust activity. Table 8 also presents that the government intake in corporate form continues to be superior, as shown in Table 6, for \$75,000 earner groups of British Columbia and Alberta and \$50,000 earner groups of the three provinces, and accordingly, investment in trust activity is favourable to these earner groups. Correspondingly the net proceeds retained by the entity and individual taken collectively are directly inversed.

Table 8: Total Tax Paid on \$100 of Entity Earnings Assuming 40% (Dividend Proposal)

		Corporate Entity			Income Trust Entity		
		Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings		\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate		36.12%	35.62%	33.62%	-	-	-
Dividend Payout Rate		40.00%	40.00%	40.00%	-	-	-
Balance Paid to Investors		\$25.55	\$25.75	\$26.55	\$100.00	\$100.00	\$100.00
Top Earner	Personal Tax Rate	23.20%	25.27%	15.77%	46.41%	43.70%	39.00%
	Personal Tax	\$5.93	\$6.51	\$4.19	\$46.41	\$43.70	\$39.00
	Total Tax Paid Amount	\$42.05	\$42.13	\$37.81	\$46.41	\$43.70	\$39.00
	Net Proceeds Retained	\$57.95	\$57.87	\$62.19	\$53.59	\$56.30	\$61.00
\$75,000 Earner	Personal Tax Rate	18.86%	16.57%	11.43%	43.41%	37.70%	36.00%
	Personal Tax	\$4.82	\$4.27	\$3.03	\$43.41	\$37.70	\$36.00
	Total Tax Paid Amount	\$40.94	\$39.89	\$36.65	\$43.41	\$37.70	\$36.00
	Net Proceeds Retained	\$59.06	\$60.11	\$63.35	\$56.59	\$62.30	\$64.00
\$50,000 Earner	Personal Tax Rate	7.02%	7.08%	5.63%	31.15%	31.15%	32.00%
	Personal Tax	\$1.79	\$1.82	\$1.49	\$31.15	\$31.15	\$32.00
	Total Tax Paid Amount	\$37.91	\$37.44	\$35.11	\$31.15	\$31.15	\$32.00
	Net Proceeds Retained	\$62.09	\$62.56	\$64.89	\$68.85	\$68.85	\$68.00

Having now manoeuvred through this rigour, we have learned that the proposal does provide relief to corporate shareholders. (Table 6 versus Table 8.) It is nevertheless most pronounced as increasingly less net corporate after tax earnings are distributed to shareholders and benefits most the higher income earners. At the 40% dividend threshold, income trusts in fact generate superior government revenues but only for the top earner groups of Ontario, British Columbia, and Alberta and the \$75,000 earners of Ontario. Conversely, for these groups, the corporate form is more favourable to the investor. Through its proposed dividend proposal, the government could effectively dissuade top income earners from investing in income trusts. For the balance of other groups considered within our analysis, the corporate form continues to generate superior government revenues. In short, investment in income trusts would continue to be most favourable for the \$50,000 income earner groups.

It should be noted that several assumptions have been made in arriving at the above conclusions. For example, calculations are based on payment of dividends and distributions to income earners at their calculated marginal tax rates as per the government's proposal, and investments are deemed to not be sheltered within registered plans. Defective as this may well be, assumptions have been applied consistently and uniformly.

Closing Comments

As our discussion has highlighted, income trusts have substantiated themselves as a viable alternative to other types of investments such as bonds, mutual funds and stocks. Income trusts' market capitalization is steadily increasing and was estimated to be \$ 118.7 billion at the end of 2004. With approximately 200 Canadian income trusts in Canada, the Canadian Association of Income Funds suggests that some 1 million Canadians own income trusts directly, while many others have interests in income trusts through mutual funds or other indirect holdings⁴⁶. A Canaccord report published in April 2005 outlines that over \$1.3 billion of trust financings were completed in March 2005⁴⁷. In April 2005, trust financings totalled \$5.9 billion, including unit offerings, corporate conversions and convertible debenture issuances⁴⁸. There are "approximately \$2 billion in announced trust financings yet to be completed and a further \$2 billion of corporate conversions to occur later this year."⁴⁹ In light of this activity, it is fair to say that income trusts have become a popular investment vehicle having established considerable staying power.

It is estimated that 30% of investors hold their units in pension plans, RRSPs or other tax-deferred assets, which infers the demography of the income trust clientele⁵⁰. According to Statistics Canada estimates, pension funds are now the largest investment class in Canada with the market value of assets approximating \$626 billion at the end of 2003⁵¹. This represented approximately one half of the Toronto Stock Exchange's market capitalization of \$1.3 trillion in 2003. As pension fund population has grown, both individually and as a group of investors, so too has their ownership of the shares of Canadian companies and their overall influence in capital markets⁵². This means that distributions from income trusts have become an essential supplementary income — predominantly but not exclusively for seniors. Moreover, when compared to other active or retirement investment options, income trusts offer the highest yields as can be seen from Table 9. In this respect, income trusts seem to represent one of the highest sources of sustainable recurring cash yield in equity and fixed income markets and are therefore the preferred structure for many retirees⁵³.

46 Garry Norris. "Income Trusts Left in Limbo", *London Free Press*, October 8, 2005, URL: <http://lfpres.ca/newsstand/Business/2005/10/08/pf-1253511.html> (accessed October 8, 2005).

47 Bruce McDonald and others. "Income Trusts: Income Trust Review: Better Value, But Not Out of the Woods Yet ...", Canaccord Capital Corporation, April 2005, 2005-053.

48 *Ibid.*, 60.

49 *Ibid.*, 60.

50 Garry Norris. "Income Trusts Left in Limbo", *London Free Press*, October 8, 2005, URL: <http://lfpres.ca/newsstand/Business/2005/10/08/pf-1253511.html> (accessed October 8, 2005).

51 Department of Finance, Government of Canada, "Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)", 34. This total does not include registered pension plan assets held in government consolidated revenue funds, insurance companies, or Government of Canada annuities.

52 *Ibid.*, 34.

53 Chris Rankin et al. "Income Trusts: Trust Reform Hurts Canadians: Contact Your MP and Express Your Concerns", 2005-147, 2.

Table 9: Alternative Means of Generating Cash Income from Retirement Nest Egg

Type of security	Typical Pre-Tax Yield
Income Trusts	9%
Corporate Bonds	5%
Government of Canada 10 Year Bonds	4%
Dividend Paying Stocks	2.5%
Canada Savings Bonds	2%

Source: Extracted from *Canaccord Capital, Chris Rankin et al.*

While our discussion has concentrated on investors, it would be remiss to not identify the attractiveness of income trust conversion to business owners. Since an income trust is an investment vehicle that pays out substantially all of the cash flows generated from relatively mature, revenue producing assets in a tax efficient manner, the structure allows the owners of a business to sell off assets at a higher valuation than when the assets are held in a corporate structure⁵⁴. In other words, through the income trust structure, many corporations have been able to successfully sell a wide variety of assets by transferring them into an income trust structure. In and of itself, this enticement has contributed considerably to the spike in income trust activity.

Financial analysts predict that whatever tax measures will be introduced, they will not destroy the appeal of trusts entirely

Although the federal government's announcements in its white paper have caused fear among investors and temporarily caused the market capitalization of trusts to decline by \$23 billion in September 2005, financial analysts predict that whatever tax measures will be introduced, they will not destroy the appeal of trusts entirely. Trusts could conceivably face new taxes that pare down the amount of cash distribution to unitholders, a development that could easily depress trust unit prices. Some argue that the best trusts will surmount any new tax structure due to their financial flexibility, which is why some money managers are looking to buying opportunities ahead⁵⁵. Many have criticized that the underlying problem of the corporate form of business is double taxation (taxing corporate income, and then taxing investors receiving the dividends from these corporations)⁵⁶. This assertion has been around for years and the emergence of income trusts is argued to be the market's direct response to the iniquitous tax system.

From our discussion of the preceding section, we see that based on a full distribution (of dividends and distributions) with the entity retaining none of the entity earnings, government intake on every \$100 of entity earnings is superior under the corporate form of business and correspondingly the net proceeds retained by the entity and individual taken collectively, are inferior for any of the provinces considered. Conversely, investment in trust activity is favourable to all income groups.

54 Michael R. King. "Income Trusts-Understanding the Issues", September 2003.

55 Rob Carrick. "You Have to be Quick", *The Globe and Mail*, October 18, 2005, <http://www.globeinvestor.com>.

56 Chris Rankin and others. "Income Trusts: Trust Reform Hurts Canadians: Contact Your MP and Express Your Concerns", *Canaccord Capital Corporation*, October 26, 2005, 2005-147.

Conceding that this approach is, in practice, flawed, an alternative computation was presented depicting a more realistic scenario which recognizes that corporations do not typically pay out in dividends the full after tax earnings of the entity. Assuming that corporations pay on average 40% of after tax earnings in the form of dividends, we learned that, based on a partial distribution of dividends with the corporate entity retaining 60% of the after tax entity earning and full distribution of trust entity earning, the original assertion can now be challenged. Government intake on every \$100 of entity earnings is now inferior (see Table 6) under the corporate form of business for top and \$75,000 earners in the province of Ontario, and only marginally superior for top earners in the provinces of British Columbia and Alberta. CGA-Canada believes this scenario to be more reflective than the immediately preceding one. Consequentially, the claim can be made that some of the current public debate can be rendered partially and unintentionally misleading.

Expanding on these scenarios to include the effect of the federal government's proposal to increase the dividend tax credit from 13.33% to 19.00% as discussed earlier, we replicated the above analysis. We learned that, based on a full distribution (of dividends and distributions) with the entity retaining none of the entity earning (see Table 7), the original assertion (see Table 5) is again confirmed, albeit less pronounced. Government intake on every \$100 of entity earnings continues to be superior under the corporate form of business for any of the provinces considered. This is rather interesting considering that the intent of the proposal is to bring about greater parity between dividends of corporations and distributions of trusts. So while it does level the playing field somewhat, it does not entirely remedy the disparity.

In keeping with the logic advanced that corporations pay on average 40% of after tax earnings in the form of dividends, and to be fair, we depicted what was considered to be a more realistic scenario. We can see that, based on a partial distribution of dividends with the corporate entity retaining 60% of the after tax entity earning and full distribution of trust entity earning, the original assertion has now been eradicated for top earners (see Table 8). Government intake on every \$100 of entity earnings is now inferior under the corporate form of business for the top income earners of all provinces and the \$75,000 earners of Ontario. Resultantly, for these earner groups, investment in corporate form is more favourable than investment in trust activity.

Our purpose for providing this examination has been to show that there is merit in assessing the tax implications of different provinces and that there is need also to contrast the effects onto different income earner levels; under both the current regime and under one which might seek to mitigate the attractiveness of income trusts stemming from an encouraging tax treatment.

Moreover, we hope to have revealed that, in considering any assertion or proposal, it is imperative to base the analysis on the actual flow of proceeds and not on conceptual or all encompassing convention which might inadvertently camouflage or distort required elements of the hypothesis. To do otherwise could lead to unexpected investor behaviours and results. So while our analysis has confirmed that the proposal does provide relief to corporate shareholders, at least in Ontario, British Columbia and Alberta, that relief is nevertheless most pronounced as increasingly less net corporate after tax earnings are distributed to shareholders and most advantageous to high income earners. At the 40% dividend threshold, income trusts in fact generate superior government revenues but only for the top earner groups of Ontario, British Columbia and Alberta and \$75,000 earners of Ontario. Conversely, for these groups the corporate form is more favourable. Through the dividend proposal therefore, we can see that the federal government can effectively dissuade top earners from investing in income trusts and, as such, at least partially meet its objective.

Federal income tax revenue forfeit of \$300 million is not considerable when taken into context

To what extent the government has, and will, analyse all of the various permutations remains unspecified but we can expect that various imperfections would surface in the implementation of the proposed design and perhaps with unforeseen costs. Moreover the strategy is passive, encouraging investor proclivity for share holdings over trust holdings, but does little to proactively ensure government intake. While unpredictable, taken with an unaltered income trust treatment, there is a risk that the current forfeit of tax revenues could swell as the result of the proposed dividend tax relief.

And even if we are to accept the federal government's assumptions and the ensuing assertion (federal income tax revenue forfeit of \$300 million) as being precise, CGA-Canada is tempted to further contextualize the perceived impairment. There is no argument that \$300 million represents a considerable amount of money to the average Canadian, but when taken as a function of federal income tax revenue, we can quickly concede that the amount is relatively immaterial. Relying on the information available in the 2005 Public Accounts of Canada, Table 10 helps us to reveal the magnitude or *absence thereof* of the federal government's perceived problem. As a function of income tax revenues for the fiscal year ending March 31, 2005, \$300 million constitutes only 0.2 percent. While well beyond the scope of this paper, it is interesting to note that actual federal income tax revenues for the fiscal year ending March 31st, 2005 exceed March 2004 forecasts by \$6.8 billion. So, in absolute terms, the asserted forfeit of \$300 million should not be disquieting given its limited order of magnitude; a reflection that is made all the more superfluous in the face of the budget windfall.

Table 10: Federal 2004-2005 Income Tax Revenues

Income Tax revenues	Actual (in millions of dollars)
Personal Income Tax	\$98,521
Corporate Income Tax	29,956
Other Income Tax Revenues	3,560
Total Income Tax Revenues	\$132,037

Source: Extracted from Government of Canada, September 27, 2005, Public Accounts of Canada 2005 Summary Report and Financial Statement.

Naturally, government pursues multiple initiatives of varying degrees of magnitude and is encouraged to do so by its stakeholders. Given the nature of income trusts, the offsetting economic and tax revenue implications of tax composition considerations, and the suggestions discussed herein however, CGA-Canada would support restraint of this debate in favour of pursuing other pressing issues relating to health care, income protection, economic and social prosperity and productivity amongst others.

It is hoped that our analysis has served to inform and to empower the average investor and that our discussion has shed light on some of the issues besieging the income trust debate. Our goal has been to impart consciousness and confidence to investors and their representatives and, as such, to empower individuals in making important financial decisions. While it need likely not be articulated, any investment alternative should be evaluated against the objectives of the investor, whether that investment be in the form of an income trust or otherwise. Understandably, investment predictability, performance and risk tolerance will help guide the investor while individual experience will help to shape personal investment behaviour.

Tax Comparison of Proposed Dividend Rules and Income Trusts

ONTARIO

Assumptions:

Corporation earns \$100. Pays federal and provincial tax on \$100 and pays out the remaining amount as cash dividends.

Income Trust earns \$100. It pays out the \$100 as cash distributions.

Per Department of Finance, Government of Canada, the Dividend Tax Credit in respect of eligible dividends will be 19 percent, based on the 2010 federal corporate tax rate as proposed in Budget 2005. For simplicity, in this paper, 19.00% has been used in all calculations.

Foot Note Reference	Corporation										Income Trust					
	Current					Proposed										
Federal Personal Top Tax Rate	1	29.00%					29.00%					29.00%				
Provincial Personal Top Tax Rate	1						11.16%					11.16%				
Sur Tax Factor - Top Rate - Ontario	1					1.56	17.41%			1.56	17.41%					
Personal Top Marginal Tax Rate	1						46.41%				46.41%		46.41%			
Federal Top Marginal Tax Rate - Gross-up	1					46.41%	1.25	58.01%		46.41%	1.45	67.29%				
Federal Dividend Tax Credit - Gross-up	2					13.33%	1.25	16.67%		19.00%	1.45	27.55%				
Provincial Dividend Tax Credit - Gross-up	2					5.13%	1.25	6.41%	1.56	10.00%	7.31%	1.45	10.60%	1.56	16.54%	Federal Dividend Tax Credit to be increased from 13.33% to 19%, i.e. an increase by a factor of 1.4254. If the province were to increase the DTC by the same factor, it would equal to 5.13% x 1.4254 = 7.31%
Tax Rate on Cash Dividends	1						31.34%				23.20%					
Total Income							\$100.00				\$100.00		\$100.00			
Corporate Tax Rate - Federal and Provincial	3	36.12%					\$36.12				\$36.12					
Cash Dividend						\$63.88	\$63.88			\$63.88	\$63.88					
Fed Top Marginal Tax Amount						58.01%	\$37.06	58.01%	\$37.06	67.29%	\$42.99	67.29%	\$42.99	\$46.41		
Less Federal Dividend Tax Credit						16.67%	\$10.65	16.67%	\$10.65	27.55%	\$17.60	27.55%	\$17.60			
Less Provincial Dividend Tax Credit						6.41%	\$4.10	10.00%	\$6.39	10.60%	\$6.77	16.54%	\$10.57			
Net Personal Tax							31.34%				23.20%					
Total Tax Paid - Personal and Corporate							\$22.32	\$20.02	\$20.02		\$18.62	\$14.82	\$14.82			
Cash Retained							\$56.14				\$50.94		\$46.41			
							\$43.86				\$49.06		\$53.59			

Foot Note 1 Personal Tax Planning, Certified General Accountants of Ontario, 2005/2006, Appendix III and IV.

Foot Note 2 Personal Tax Planning, Certified General Accountants Association of Canada, 2004/2005, Investment Income and Expenses, Dividends, page 55.

Foot Note 3 Canadian Income Tax Act with Regulations, 80th Edition, Reference Table XVI, General (Non-Manufacturing) Corporate Income Tax Rates by Province - 2005, CCH Canadian Limited.

BRITISH COLUMBIA

Assumptions:

Corporation earns \$100. Pays federal and provincial tax on \$100 and pays out the remaining amount as cash dividends.

Income Trust earns \$100. It pays out the \$100 as cash distributions.

Per Department of Finance, Government of Canada, the Dividend Tax Credit in respect of eligible dividends will be 19 percent, based on the 2010 federal corporate tax rate as proposed in Budget 2005. For simplicity, in this paper, 19.00% has been used in all calculations.

	Foot Note Reference	Corporation						Income Trust	
		Current			Proposed				
Federal Personal Top Tax Rate	1	29.00%			29.00%			29.00%	
Provincial Personal Top Tax Rate	1				14.70%			14.70%	
Personal Top Marginal Tax Rate	1				43.70%			43.70%	43.70%
Federal Top Marginal Tax Rate - Gross-up	1		43.70%	1.25	54.63%		43.70%	1.45	63.37%
Federal Dividend Tax Credit - Gross-up	2		13.33%	1.25	16.67%		19.00%	1.45	27.55%
Provincial Dividend Tax Credit - Gross-up	2		5.10%	1.25	6.38%		7.27%	1.45	10.54%
							Federal Dividend Tax Credit to be increased from 13.33% to 19%, i.e. an increase by a factor of 1.4254 If the province were to increase the DTC by the same factor, it would equal to 5.10% x 1.4254 = 7.27%		
Tax Rate on Cash Dividends	1				31.58%				25.27%
Total Income					\$100.00				\$100.00
Corporate Tax Rate - Federal and Provincial	3	35.62%			\$36.62				\$35.62
Cash Dividend					\$64.38				\$64.38
Fed Top Marginal Tax Amount			54.63%	\$35.17		63.37%	\$40.79		\$43.70
Less Federal Dividend Tax Credit			16.67%	\$10.73		27.55%	\$17.74		
Less Provincial Dividend Tax Credit			6.38%	\$4.10		10.54%	\$6.79		
			31.58%			25.27%			
Net Personal Tax				\$20.33	\$20.33		\$16.27	\$16.27	
Total Tax Paid - Personal and Corporate				\$55.95			\$51.89		\$43.70
Cash Retained				\$44.05			\$48.11		\$56.30

Foot Note 1 Personal Tax Planning, Certified General Accountants of Ontario, 2005/2006, Appendix III and IV.

Foot Note 2 Personal Tax Planning, Certified General Accountants Association of Canada, 2004/2005, Investment Income and Expenses, Dividends, page 55.

Foot Note 3 Canadian Income Tax Act with Regulations, 80th Edition, Reference Table XVI, General (Non-Manufacturing) Corporate Income Tax Rates by Province - 2005, CCH Canadian Limited.

ALBERTA

Assumptions:

Corporation earns \$100. Pays federal and provincial tax on \$100 and pays out the remaining amount as cash dividends.

Income Trust earns \$100. It pays out the \$100 as cash distributions.

Per Department of Finance, Government of Canada, the Dividend Tax Credit in respect of eligible dividends will be 19 percent, based on the 2010 federal corporate tax rate as proposed in Budget 2005. For simplicity, in this paper, 19.00% has been used in all calculations.

	Foot Note Reference	Corporation						Income Trust	
		Current			Proposed				
Federal Personal Top Tax Rate	1	29.00%			29.00%			29.00%	29.00%
Provincial Personal Top Tax Rate	1			10.00%			10.00%		10.00%
Personal Top Marginal Tax Rate	1			39.00%			39.00%		39.00%
Federal Top Marginal Tax Rate - Gross-up	1		39.00%	1.25	48.75%		39.00%	1.45	56.55%
Federal Dividend Tax Credit - Gross-up	2		13.33%	1.25	16.67%		19.00%	1.45	27.55%
Provincial Dividend Tax Credit - Gross-up	2		6.40%	1.25	8.00%		9.12%	1.45	13.23%
							Federal Dividend Tax Credit to be increased from 13.33% to 19%, i.e. an increase by a factor of 1.4254		
							If the province were to increase the DTC by the same factor, it would equal to 6.40% x 1.4254 =		9.12%
Tax Rate on Cash Dividends	1			24.08%					15.77%
Total Income				\$100.00					\$100.00
Corporate Tax Rate - Federal and Provincial	3	33.62%		\$33.62					\$33.62
Cash Dividend				\$66.38					\$66.38
Fed Top Marginal Tax Amount			48.75%	\$32.36			56.53%	\$37.54	\$39.00
Less Federal Dividend Tax Credit			16.67%	\$11.06			27.55%	\$18.29	
Less Provincial Dividend Tax Credit			8.00%	\$5.31			13.23%	\$8.78	
			24.08%				15.77%		
Net Personal Tax			\$15.99	\$15.99			\$10.47	\$10.47	
Total Tax Paid - Personal and Corporate			\$49.61				\$44.09		\$39.00
Cash Retained in System			\$50.39				\$55.91		\$61.00

Foot Note 1 Personal Tax Planning, Certified General Accountants of Ontario, 2005/2006, Appendix III and IV.

Foot Note 2 Personal Tax Planning, Certified General Accountants Association of Canada, 2004/2005, Investment Income and Expenses, Dividends, page 55.

Foot Note 3 Canadian Income Tax Act with Regulations, 80th Edition, Reference Table XVI, General (Non-Manufacturing) Corporate Income Tax Rates by Province - 2005, CCH Canadian Limited.

Appendix B

12

Taxes Paid and Proceeds Retained — Ontario, B.C. and Alberta Top Income Earner, \$75,000 Earner and \$50,000 Earner

Relying on Appendix A marginal tax rates and Appendix V of the 2005/2006 Personal Tax Planning guide of the Certified General Accountants Association of Canada

Top Income Earner

Total Tax Paid on \$100 of Entity Earnings Assuming Full Distribution

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Balance Paid to Investors	\$63.88	\$64.38	\$66.38	\$100.00	\$100.00	\$100.00
Personal Tax Rate	31.34%	31.58%	24.08%	46.41%	43.70%	39.00%
Personal Tax Amount	\$20.02	\$20.33	\$15.98	\$46.41	\$43.70	\$39.00
Total Tax Paid	\$56.14	\$55.95	\$49.60	\$46.41	\$43.70	\$39.00
Net Proceeds Retained	\$43.86	\$44.05	\$50.40	\$53.59	\$56.30	\$61.00

Total Tax Paid on \$100 of Entity Earnings Assuming 40% Dividend

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Remaining Corporate Earnings	\$63.88	\$64.38	\$66.38	0	0	0
Dividend payout rate	40.00%	40.00%	40.00%	0	0	0
Balance Paid to Investors	\$25.55	\$25.75	\$26.55	\$100.00	\$100.00	\$100.00
Personal Tax Rate	31.34%	31.58%	24.08%	46.41%	43.70%	39.00%
Personal Tax Amount	\$8.01	\$8.13	\$6.39	\$46.41	\$43.70	\$39.00
Total Tax Paid	\$44.13	\$43.75	\$40.01	\$46.41	\$43.70	\$39.00
Net Proceeds Retained	\$55.87	\$56.25	\$59.99	\$53.59	\$56.30	\$61.00

Total Tax Paid on \$100 of Entity Earnings (Dividend Proposal)

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Balance Paid to Investors	\$63.88	\$64.38	\$66.38	\$100.00	\$100.00	\$100.00
Personal Tax Rate	23.20%	25.27%	15.77%	46.41%	43.70%	39.00%
Personal Tax Amount	\$14.82	\$16.27	\$10.47	\$46.41	\$43.70	\$39.00
Total Tax Paid	\$50.94	\$51.89	\$44.09	\$46.41	\$43.70	\$39.00
Net Proceeds Retained	\$49.06	\$48.11	\$55.91	\$53.59	\$56.30	\$61.00

Total Tax Paid on \$100 of Entity Earnings Assuming 40% Dividend (Dividend Proposal)

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Remaining Corporate Earnings	\$63.88	\$64.38	\$66.38	0	0	0
Dividend Payout Rate	40.00%	40.00%	40.00%	0	0	0
Balance Paid to Investors	\$25.55	\$25.75	\$26.55	\$100.00	\$100.00	\$100.00
Personal Tax Rate	23.20%	25.27%	15.77%	46.41%	43.70%	39.00%
Personal Tax	\$5.93	\$6.51	\$4.19	\$46.41	\$43.70	\$39.00
Total Tax Paid Amount	\$42.05	\$42.13	\$37.81	\$46.41	\$43.70	\$39.00
Net Proceeds Retained	\$57.95	\$57.87	\$62.19	\$53.59	\$56.30	\$61.00

\$75,000 Income Earner

Total Tax Paid on \$100 of Entity Earnings Assuming Full Distribution

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Balance Paid to Investors	\$63.88	\$64.38	\$66.38	\$100.00	\$100.00	\$100.00
Personal Tax Rate	27.59%	24.08%	20.33%	43.41%	37.70%	36.00%
Personal Tax Amount	\$17.62	\$15.50	\$13.50	\$43.41	\$37.70	\$36.00
Total Tax Paid	\$53.74	\$51.12	\$47.12	\$43.41	\$37.70	\$36.00
Net Proceeds Retained	\$46.26	\$48.88	\$52.88	\$56.59	\$62.30	\$64.00

Total Tax Paid on \$100 of Entity Earnings Assuming 40% Dividend

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Remaining Corporate Earnings	\$63.88	\$64.38	\$66.38	0	0	0
Dividend payout rate	40.00%	40.00%	40.00%	0	0	0
Balance Paid to Investors	\$25.55	\$25.75	\$26.55	\$100.00	\$100.00	\$100.00
Personal Tax Rate	27.59%	24.08%	20.33%	43.41%	37.70%	36.00%
Personal Tax Amount	\$7.05	\$6.20	\$5.40	\$43.41	\$37.70	\$36.00
Total Tax Paid	\$43.17	\$41.82	\$39.02	\$43.41	\$37.70	\$36.00
Net Proceeds Retained	\$56.83	\$58.18	\$60.98	\$56.59	\$62.30	\$64.00

Total Tax Paid on \$100 of Entity Earnings (Dividend Proposal)

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Balance Paid to Investors	\$63.88	\$64.38	\$66.38	\$100.00	\$100.00	\$100.00
Personal Tax Rate	18.86%	16.57%	11.43%	43.41%	37.70%	36.00%
Personal Tax Amount	\$12.05	\$10.67	\$7.58	\$43.41	\$37.70	\$36.00
Total Tax Paid	\$48.17	\$46.29	\$41.20	\$43.41	\$37.70	\$36.00
Net Proceeds Retained	\$51.83	\$53.71	\$58.80	\$56.59	\$62.30	\$64.00

Total Tax Paid on \$100 of Entity Earnings Assuming 40% Dividend (Dividend Proposal)

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Remaining Corporate Earnings	\$63.88	\$64.38	\$66.38	0	0	0
Dividend Payout Rate	40.00%	40.00%	40.00%	0	0	0
Balance Paid to Investors	\$25.55	\$25.75	\$26.55	\$100.00	\$100.00	\$100.00
Personal Tax Rate	18.86%	16.57%	11.43%	43.41%	37.70%	36.00%
Personal Tax	\$4.82	\$4.27	\$3.03	\$43.41	\$37.70	\$36.00
Total Tax Paid Amount	\$40.94	\$39.89	\$36.65	\$43.41	\$37.70	\$36.00
Net Proceeds Retained	\$59.06	\$60.11	\$63.35	\$56.59	\$62.30	\$64.00

\$50,000 Income Earner

Total Tax Paid on \$100 of Entity Earnings Assuming Full Distribution

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Balance Paid to Investors	\$63.88	\$64.38	\$66.38	\$100.00	\$100.00	\$100.00
Personal Tax Rate	15.86%	15.90%	15.33%	31.15%	31.15%	32.00%
Personal Tax Amount	\$10.13	\$10.24	\$10.18	\$31.15	\$31.15	\$32.00
Total Tax Paid	\$46.25	\$45.86	\$43.80	\$31.15	\$31.15	\$32.00
Net Proceeds Retained	\$53.75	\$54.14	\$56.20	\$68.85	\$68.85	\$68.00

Total Tax Paid on \$100 of Entity Earnings Assuming 40% Dividend

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Remaining Corporate Earnings	\$63.88	\$64.38	\$66.38	0	0	0
Dividend payout rate	40.00%	40.00%	40.00%	0	0	0
Balance Paid to Investors	\$25.55	\$25.75	\$26.55	\$100.00	\$100.00	\$100.00
Personal Tax Rate	15.86%	15.90%	15.33%	31.15%	31.15%	32.00%
Personal Tax Amount	\$4.05	\$4.09	\$4.07	\$31.15	\$31.15	\$32.00
Total Tax Paid	\$40.17	\$39.71	\$37.69	\$31.15	\$31.15	\$32.00
Net Proceeds Retained	\$59.83	\$60.29	\$62.31	\$68.85	\$68.85	\$68.00

Total Tax Paid on \$100 of Entity Earnings (Dividend Proposal)

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Balance Paid to Investors	\$63.88	\$64.38	\$66.38	\$100.00	\$100.00	\$100.00
Personal Tax Rate	7.02%	7.08%	5.63%	31.15%	31.15%	32.00%
Personal Tax Amount	\$4.48	\$4.56	\$3.73	\$31.15	\$31.15	\$32.00
Total Tax Paid	\$40.60	\$40.18	\$37.35	\$31.15	\$31.15	\$32.00
Net Proceeds Retained	\$59.40	\$59.82	\$62.65	\$68.85	\$68.85	\$68.00

**Total Tax Paid on \$100 of Entity Earnings Assuming 40% Dividend
(Dividend Proposal)**

	Corporate Entity			Income Trust Entity		
	Ontario	BC	Alberta	Ontario	BC	Alberta
Corporate Earnings	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00
Corporate Tax Rate	36.12%	35.62%	33.62%	0	0	0
Corporate Tax	\$36.12	\$35.62	\$33.62	0	0	0
Remaining Corporate Earnings	\$63.88	\$64.38	\$66.38	0	0	0
Dividend Payout Rate	40.00%	40.00%	40.00%	0	0	0
Balance Paid to Investors	\$25.55	\$25.75	\$26.55	\$100.00	\$100.00	\$100.00
Personal Tax Rate	7.02%	7.08%	5.63%	31.15%	31.15%	32.00%
Personal Tax	\$1.79	\$1.82	\$1.49	\$31.15	\$31.15	\$32.00
Total Tax Paid Amount	\$37.91	\$37.44	\$35.11	\$31.15	\$31.15	\$32.00
Net Proceeds Retained	\$62.09	\$62.56	\$64.89	\$68.85	\$68.85	\$68.00

**Tax Rate Calculation Relating to Proposed Dividend Tax Credit
Ontario, B.C. and Alberta — Income Earners of \$75,000 and \$50,000**

Relying on Appendix A marginal tax rates and Appendix V of the 2005/2006 Personal Tax Planning guide of the Certified General Accountants Association of Canada

Note: Tax rate calculation of top income earner is provided in Appendix A.

Ontario

Constituent	Dividend	Gross-up	Gross-up Amount	\$50,000 Earner		\$75,000 Earner		
				Tax Rate	Tax Amount	Tax Rate	Surtax Factor	Tax Amount
Federal Tax	\$100.00	1.45	\$145.00	22.00%	\$31.90	26.00%	-	\$37.70
Provincial Tax	\$100.00	1.45	\$145.00	9.15%	\$13.27	17.41%	-	\$25.24
Total Tax	-	-	-	-	\$45.17	-	-	\$62.94
Federal Dividend Tax Credit	\$100.00	1.45	\$145.00	19.00%	\$27.55	19.00%	-	\$27.55
Provincial Dividend Tax Credit	\$100.00	1.45	\$145.00	7.31%	\$10.60	7.31%	1.56	\$16.54
Total Dividend Tax Credit	-	-	-	-	\$38.15	-	-	\$44.09
Net Tax Amount	-	-	-	-	\$7.02	-	-	\$18.86
Net Tax Rate	-	-	-	-	7.02%	-	-	18.86%

British Columbia

Constituent	Dividend	Gross-up	Gross-up Amount	\$50,000 Earner		\$75,000 Earner	
				Tax Rate	Tax Amount	Tax Rate	Tax Amount
Federal Tax	\$100.00	1.45	\$145.00	22.00%	\$31.90	26.00%	\$37.70
Provincial Tax	\$100.00	1.45	\$145.00	9.15%	\$13.27	11.70%	\$16.97
Total Tax	-	-	-	-	\$45.17	-	\$54.67
Federal Dividend Tax Credit	\$100.00	1.45	\$145.00	19.00%	\$27.55	19.00%	\$27.55
Provincial Dividend Tax Credit	\$100.00	1.45	\$145.00	7.27%	\$10.54	7.27%	\$10.54
Total Dividend Tax Credit	-	-	-	-	\$38.09	-	\$38.09
Net Tax Amount	-	-	-	-	\$7.08	-	\$16.57
Net Tax Rate	-	-	-	-	7.08%	-	16.57%

Alberta

Constituent	Dividend	Gross-up	Gross-up Amount	\$50,000 Earner		\$75,000 Earner	
				Tax Rate	Tax Amount	Tax Rate	Tax Amount
Federal Tax	\$100.00	1.45	\$145.00	22.00%	\$31.90	26.00%	\$37.70
Provincial Tax	\$100.00	1.45	\$145.00	10.00%	\$14.50	10.00%	\$14.50
Total Tax	-	-	-	-	\$46.40	-	\$52.20
Federal Dividend Tax Credit	\$100.00	1.45	\$145.00	19.00%	\$27.55	19.00%	\$27.55
Provincial Dividend Tax Credit	\$100.00	1.45	\$145.00	9.12%	\$13.22	9.12%	\$13.22
Total Dividend Tax Credit	-	-	-	-	\$40.77	-	\$40.77
Net Tax Amount	-	-	-	-	\$5.63	-	\$11.43
Net Tax Rate	-	-	-	-	5.63%	-	11.43%

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