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Who will benefit from the Conservatives taxing income trusts?

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Tory supporters howled over the plan to tax trusts, but in the long run they'll be better off

It used to be that a loudmouthed Conservative MP could always count on income trusts when he needed a biting comeback in Parliament. In mid-October when Ralph Goodale, the former Liberal finance minister, waxed on about truth and broken promises, Treasury Board President John Baird pounced. "When I hear [Goodale's] name and trust, it makes me think of the income trust scandal," the Tory pit bull barked, referring to how Goodale fumbled the issue during the last election. The Liberals' bungling cost pensioners "literally millions of dollars," Baird liked to remind people. But that's peanuts compared to the $20-billion hit investors took last week after the Harper government broke its promise not to tax income trusts. Now the Conservatives are on the defensive. But observers are coming around to the idea that the tax move won't hurt the party or its business-minded supporters nearly as much as initially predicted.

On the face of it, Finance Minister Jim Flaherty's decision to tax income trust distributions comes as a body blow to the government's biggest fans -- Bay Street, the oil patch and seniors. The bankers and lawyers who fed the market with a steady diet of income trusts look set to lose out on millions in advisory fees. Canaccord Adams, a Toronto-based investment bank, promptly blasted the proposal. Its analysts urged concerned Canadians to "call their MPs and tell them to put the brakes on the legislation." In Calgary, aggrieved energy trust executives formed a coalition to oppose the tax change. "I hold our politicians to a higher standard on this file," said John Dielwart, head of ARC Energy Trust this week. "I will, as an individual . . . do everything I can to make sure voters are informed." And seniors found a voice in Seymour Schulich, the 66-year-old mining entrepreneur and philanthropist who happens to be a major energy trust investor. "I think it will cost them the next election," he warned. "Don't mess around with seniors."

Tough words. But others insist that the Tories essentially had no choice but to act, given the threat to the federal tax base, and that the fundamental logic behind the move will eventually calm even the angriest critics.

The debate flared up this fall when Canada's two largest phone companies, Telus and BCE, planned to restructure as income trusts -- essentially promising to pay out most of their profits, or cash flow, to unitholders as dividends. Less profit means less corporate taxes, and according to Jack Mintz, a professor at the University of Toronto's Rotman School of Management, income trust conversions were on track to leave a gaping, $1-billion hole in government coffers. Meanwhile there were worries the trust structure discouraged businesses from reinvesting in their growth. But even Mintz thought there was only a 10 per cent chance Ottawa would plug the loophole before the next federal election. Days later, Flaherty dropped the bombshell, triggering the uproar and days of angry recriminations in the media.

Despite the ensuing hue and cry, there are strong arguments to be made that voters across the board will be better off for it. Of all those affected, the Bay Street crowd will bounce back the fastest. The phones are already ringing at trust-structured companies across the country, as lawyers and accountants offer to help CEOs revert back to corporate status -- for a fee, of course. And whenever billions of dollars are in play, as they are now, bankers will find a way to grab a slice. As investors lose their appetite for income trusts, you can count on the brokerages to devise new products to pitch.

Meanwhile, the newly formed Coalition of Canadian Energy Trusts has pleaded with Ottawa to slow down and meet with energy trusts before acting. Earlier this week, the group warned of dire consequences to the oil and gas sector, such as lost foreign investment and a reduction in energy production in Canada. But a lengthy consultation process involving executives, lawyers, bankers, civil servants and politicians would be a recipe for leaks and abusive insider trading. That's what happened when the Liberals broached the subject last year. At the same time, it's difficult to see why foreign investors would withhold their capital from Canada's booming energy sector simply because the income trust tap was shut off. Surging global demand for Canada's oil and gas isn't about to end.

It's hard not to feel for those seniors who loaded up their portfolios with income trusts, only to see them hammered overnight. There are already stories of retirees with as much as 90 per cent of their savings parked in trusts. But chances are, those investors were headed for disaster anyway. Diane Urquhart, an independent analyst who works with the National Pensioners & Senior Citizens Federation, has been warning seniors for months that trusts are too risky. Her viewpoint didn't win her many friends. Last month, she appeared on TV to say trusts had no place in a retiree's portfolio because of their poor disclosure and frothy valuations. Her email box filled with angry missives. "I would recommend you take up something that women are better at, such as knitting or baking or having babies," wrote one trust fanatic.

But if anything, her analysis showed that trusts were headed for a major correction, regardless of what Ottawa did. For one thing, too many trusts pay out more in distributions than they take in. In those cases, the trusts end up handing unitholders back their own capital. So far this year, more than two dozen trusts have cut their payouts, triggering a collapse in their unit prices. If Canada were to enter a recession, many trusts would be hit hard. On that basis, trusts were hardly an ideal investment for seniors looking for stability, she says. In an October report, she compared business income trusts to large Canadian public corporations on the basis of pre-tax income. The results showed trusts traded at a 53 per cent premium to corporations. Even after the post-Halloween carnage, she says trusts have further to fall. "I'd figure another 13 to 20 per cent more," she says.

There is good news in all this. Ottawa introduced tax measures for seniors that probably wouldn't have been put in place otherwise. Both income splitting and an increase in the age credit will offer seniors $1 billion in tax savings next year, and $6 billion over the next six years. That should ease the pain for some trust-laden retirees. Already this week trusts have clawed back somewhat. For those investors who have had their money in trusts for several years, they're still way ahead even after the recent drop. As for the large number of seniors who didn't buy into the trust mania at all, they just received a retirement gift from the Tories, one they might remember come election time.
