Presentation to the House of Commons Finance Committee on Income Trusts
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There is no need to alter the income trust tax amendment in Bill C-52 based on developments since the October 31, 2006 announcement of the new income trusts tax. The only action now required is for the Canada Revenue Agency to announce its plans to use the General Anti-Avoidance Rule and the Thin Capitalization Rules in the Income Tax Act to ensure that acquirers of income trusts will be paying Canadian business taxes. This must be done so that individual investors are treated fairly compared to pension funds, private equity funds, corporations, and U.S. master limited partnerships. If GAAR and the Thin Capitalization Rules are enforced, foreign acquirers do not have a Canadian tax incentive to take-over Canadian income trusts.

(a) The income trust tax damage was relatively small upon announcement and income trust losses are considerably lower now.

The average capital loss in the first fourteen days was -14% or about $24 billion (or -2.5% of total Canadian individual investment assets).

The capital loss as of May 28, 2007 is now reduced to -3% or about $5 billion.

While income trusts have rallied from their worst prices, they have underperformed the common stock market, which has rallied 15% since October 31, 2006.

Energy trusts have fared slightly worse at -7% since October 31, 2006, while energy corporations are up 11%.

(b) On April 26, 2007, the National Pensioners and Senior Citizens Federation, United Senior Citizens of Ontario and the Small Investor Protection Association made a joint call for a criminal investigation by the RCMP and OPP on the deceptive cash yields in the marketing materials used by the investment banks to sell income trusts to seniors.

This call for a criminal investigation was supported by a professional opinion letter prepared by Rosen & Associates. Dr. Al Rosen and I approached the RCMP and the U.S. securities regulatory authorities with the evidence on widespread criminal conduct in the income trust industry, shortly after our February 3, 2007 appearance before this Committee.

The RCMP should do this criminal investigation. The current probes of corruption in senior management at the RCMP and at the Justice Department may delay the investigation somewhat. But, there is no limitation period on

criminal fraud charges and the marketing documents cannot be discarded, as this would be obstruction of justice.

(c) The business income trusts that had stumbled badly before the Flaherty income trusts tax announcement have not recovered.

There are still 50 business income trusts down more than 20% from their latest public offering price during the past 6 and one half years. The average capital loss in this group is close to 50% with aggregate capital losses of $8 billion. The income trust tax was responsible for at most 10% of these price declines. These price declines occurred due to the deceptive cash yields, which proved not to be sustainable.

51 business income trusts have had distribution suspensions and significant cuts. This is 26% of all business income trusts in Canada.

28-May-07	Number	Distribution Suspensions	Distribution Cuts	Combined	%
Business Trusts, Excluding Utilities & Energy Service	156	12	32	44	28%
Utilities Trusts	21	0	2	2	10%
Energy Services Trusts	19	1	4	5	26%
Total Business Trusts	196	13	38	51	26%

(d) There have been 25 acquisitions of business income trusts, but this was anticipated since the new income trust tax would result in the phase-out of most income trusts by 2011.

The two ways to phase out are acquisition or conversion back into a corporation. 196 business income trusts and 48 energy trusts will not likely exist after 2011.

The Canadian Association of Income Trust Investors, the Federal Liberal Party, and several tax lawyers and financial analysts are saying the acquired income trusts will not be paying any Canadian tax. U.S. Master Limited Partnerships are said to be the most promising acquirers of Canadian energy trusts, with the intent to pay no Canadian taxes. The objective of the vocal income trusters is rescission of the new income trusts tax, so that individual Canadians get back the same tax advantages the current institutional and corporate buyers are alleged to be getting.

But the answer for fair treatment is not to rescind the income trusts tax, but for the Canada Revenue Agency (CRA) to enforce the Generally Anti-Avoidance Rule ("GAAR") in Section 245 and the "Thin Capitalization Rule" in Section 18(4) of the Canadian Income Tax Act. The fair tax policy is that Canadian businesses not be permitted to operate with artificially high debt-to-equity ratios and interest

rates for the purpose of stripping profits and paying no business income taxes. Similarly, energy trusts should not be permitted to use artificially structured royalty agreements for the purpose of stripping profits and paying no business income taxes. Canadian businesses should pay Canadian business income taxes regardless of who owns them _public investors, pension funds, private equity funds, corporations, master limited partnerships, foreign or domestic.

I hope that the Canadian government is not taking the short-term view of turning a blind eye to acquirers of income trusts intending to pay no Canadian business income taxes in order to foster more take-outs at higher prices to mitigate senior's losses caused by the new income trusts tax. It is not appropriate to allow current acquirers to think that the Canadian government has no intention to enforce its GAAR and "Thin Capitalization Rule", when fairness dictates that it must do so. The acquirers are paying take-over prices today on the possible misunderstanding that they will be paying minimal to no Canadian business income taxes.

Simple Illustration of GAAR and "Thin Capitalization Rule"

	Capital Mix	Balance Sheet	Rates	Income
Effort to Avoid Business Income Taxes				
Earnings Before Interest and Tax				$120
Capital	100%	$1,000	12%	$120
Debt	95%	$950	14%	-$133
Equity	5%	$50	-26%	-$13
Business Income Taxes @ Average Rate			26%	$0
Canadian GAAR & Thin Capitalization Rule - Rule Calculation				
Earnings Before Interest and Tax				$120
Capital	100%	$1,000	12%	$120
Debt	10%	$100	8.25%	-$8
Equity	90%	$900	12%	$112
Business Income Taxes @ Average Rate			26%	$29
Canadian GAAR & Thin Capitalization Rule - Optimal Capital Structure				
Earnings Before Interest and Tax				$120
Capital	100%	$1,000	12%	$120
Debt	67%	$667	8.25%	-$55
Equity	33%	$333	20%	$65
Business Income Taxes @ Average Rate			26%	$17

The U.S. IRS has used anti-avoidance measures on the U.S. business subsidiaries of several Canadian income trusts. So there is no reciprocity argument for the Canadian CRA to turn a blind eye to the Canadian business subsidiaries of U.S. corporations or Master Limited Partnerships. For example,

on August 4, 2005, Sun Gro Horticultural Income Fund, a peat moss producer with operations in the United States and Canada, revealed in financial statement notes that the IRS had challenged the 13 percent interest rate that Sun Gro's U.S. subsidiary pays on debt owed to the Canadian-based income-trust parent. As part of its audit, the IRS has asserted that only a 7 percent interest rate would be acceptable as being at arm's length and anything above would not be tax deductible for U.S. tax purposes. Three other funds—including KCP Income Fund, which has a 14 percent interest rate on intercompany debt, BFI Canada Income Fund (12 percent), and Associated Brands (10 percent) — were said by BDO Dunwoody to be subject to similar tax avoidance challenges.

(e) On March 23, 2007, the U.S. Congress Ways and Means Committee received a Tax Bill that will take away the tax incentive for Americans to invest in Canadian income trusts.

Under the new U.S. Tax Bill, the distributions from Canadian income trusts will no longer be treated as "qualified foreign dividends" taxed at the preferential rate of 15%. Instead, these distributions will be treated as income taxed at the full personal income tax rate, where the top U.S. federal income tax rate is 35%.

Americans own an estimated US$ 34 billion of Canadian income trusts and the U.S. IRS is foregoing about US $364 million per annum by treating Canadian income trusts distributions as "qualified foreign dividends" rather than income.

The U.S. Tax Bill achieves the same policy objectives for the U.S. as the Canadian income trust tax plan achieves for Canada:

(1) Stops government revenue leakage; and,

(2) Creates tax fairness, by leveling the playing field between Canadian income trusts and American corporations, Master Limited Partnerships and REITs.

The U.S. Tax Bill has no grandfathering period, so it potentially could remove the tax advantage for Americans to own Canadian income trusts well before the 2011 date, when Canada's new income trust tax would achieve the same end.

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