

## BRIEF TO THE FINANCE COMMITTEE IN STUDY OF TRUSTS

### Summary of Findings

The following Brief provides a range of data and meaningful factual context to provide clear evidence on the merits and risks of the taxes and rules for Canadian flow-through entities. Using comprehensive current and historic market data, a systematic and persistent form of analysis, we focus on questions about income trust taxation and rules of enormous consequence for all Canadians.

This document offers facts and statistics showing that:

1. **New taxes on trust distributions and equity-restricting rules do not abolish unfair tax loopholes but exacerbate problems** the rules were supposed to address while blinding policy makers to root concerns;
2. **Income trusts offer fundamental value and demonstrative growth of significant potential value to all Canadians;**
3. **The Tax Fairness Plan is unworkable due to lack of standard practice so is deemed neither fair nor a plan.** There are such inconsistencies in related equity rules that their administration is case-by-case, rendering the Tax with supplementary rules no Plan, but unconstitutional.

**There is no merit in considering secondary questions about whether a 4-year tax grace period is long enough** for trust managers or owners:

- ✓ **Further delay of new taxes from 4 to 10 years, on distributions from existing trusts, will boost unit prices but create policy uncertainty that destroys social capital** (*see Appendix 1 on implications of broken trust or dishonest policy makers*) yet ignores need for public policy to address real problems in Canadian financial markets.
- ✓ **News about taxes certain to diminish investor returns, shocks any kind of equity market including, in this case, the trust market** as investors re-price the net present value of cash returns from securities:
  - **The single most statistically significant event in the 20-year history of the \$160 billion income trust market occurred in 2005** on the day after Finance Minister Ralph Goodale undermined his own public Consultation process and unilaterally changed working policy by demanding a stop in advance tax rulings (*Volatility Study by L. Hayman using the RiskMetrics<sup>tm</sup> services and an equal-weight and comprehensive dataset to index the entire trust market*).

- **The median drop in unit price across the entire income trust and income fund (of funds) market was -17%** (*from TrustInvestor.com comprehensive iTrust Index*).
- **Small investors who held a vast majority of income trust units in the highly participatory flow-through exchange in 2005 were scared out of their holdings.** Ownership effectively concentrated in the hands of large domestic and foreign fund managers who bought up assets at a discount during that time (*reported to finance pros by the business development manager(s) of the Toronto Stock Exchange, in Q3 2006*).
- **There was an entire and immediate recovery in unit price when a clear and fair decision was made** by the Liberal Government with Conservative Opposition support;
- **Thoughtful decision: Protect trust investors from new taxation but increase dividend tax credits**, explained as an appropriate reaction to public and expert consideration of the Department of Finance theoretical and narrowly defined calculations of "tax leakage".
- **The second most significant negative shock to the \$200 billion income trust market occurred in November 2006** following the announcement by Finance Minister Jim Flaherty that income trust distributions will be taxed beginning in 2011 (*Volatility Study by L.Hayman using the same methodology as in 2005*).
- **The median drop in unit price across the entire income trust and income fund of funds market was -13%** (*per iTrust Index including nearly 250 trusts*).
- **Many more Canadian and now foreign investors fled the income trust market**, further concentrating ownership among fewer people and making individual investors more dependent on the services of large fund managers (*per reports to L. Hayman from investors, domestic and foreign fund managers*).
- **Reinforced policy shock, so further destroyed social capital on a global scale as evidenced by the instant price-down of the Canadian dollar in foreign exchange markets** (*Reuters*).

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## **Assumed Terms of Reference**

Tax on cash distributions from Canadian income trusts, excluding passive REITs with Canadian holdings, and rules to inhibit a doubling in equity of trusts were brought to life in a “Tax Fairness Plan” based on clearly stated and implied objectives:

1. Abolish unfair tax status for income trust equities;
  - a. Reduce tax leakage;
  - b. Eliminate tax-only incentives for existing public equities and private companies from going public as an income trust;
  - c. Preventing growth in and eliminating the public market to protect investors from a “bad”, illegal or fraudulent from of security issue;
2. Support or strengthen Canadian Financial markets;
3. Focus investment on and retain Canadian ownership in productive and growing enterprise, in particular Canadian enterprise.
4. Enact a corporate tax rather than adding a tax burden carried by individual Canadians.

## **Objective Data with Unique Capacity to Inform Committee**

### **Public Witness**

The Institute is a non-partisan research and education organization that has studied income trusts and their market in a broad context as a non-partisan organization for more than a year now, including both collection of research published by a full range of experts and through our own original studies (*refer to Background, below*).

During 2006, the Institute activated its web site as a system to gather information related to the income trust market and securities, including views on tax considerations from income trust executives directly as well as through review of the results from the 2005 Consultation published by the Department of Finance. Findings of that Consultation were not published.

Towards its research efforts, the voluntary President, Ms. Leslie Hayman both lent financing towards set-up of the organization and provided access to a comprehensive database of fundamental business measures as well as market pricing data that she had established for use in reporting to subscribers to her research and information services.

## **Comprehensive and Consistent Data with Systematic Analysis**

The database provided by Leslie Hayman tracks every one of the approximately 250 trusts and REITs as well as the income- funds listed on the Toronto Stock Exchange. Comprehensive dataset includes:

- ✓ **Trust Market Guide and Index** of total annual returns including distributions and price data, details on the break-down of distributions, business-specific data and unit prices on an equal weight basis by trust and sector (*iTrust Index as of December 1, 2006*):
  1. **Oil and gas producers – 30 Issues - \$69 billion;**
    - a. Oil oriented;
    - b. Gas-focused;
    - c. Output mix
  2. **Energy-related trusts – 50 Issues - \$35 billion;**
    - a. Upstream energy services;
    - b. Mid-stream pipelines & processors;
    - c. Down-stream distributors and retailers;
  3. **Food-related Business Trusts – 27 Issues - \$5 billion:**
    - a. Producers;
    - b. Distributors
    - c. Retailers and Restaurants;
  4. **Real Estate Investment Trusts – 29 Issues - \$29 billion:**
    - a. Residential REITS including Seniors Facilities;
    - b. Office Property REITS;
    - c. Commercial Property REITs
    - d. Hotel and Temporary Lodging Providers;
  5. **Business trusts – 206 Issues - \$45 billion:**
    - a. Resource Producers
    - b. Service Providers
    - c. Product Manufacturers;
  6. **Managed funds of funds – 150+ Issues - \$19 billion:**
- ✓ **Comprehensive Independent Analytical System** reveals underlying values on an objective and consistent basis for a broad range of securities including trusts and other flow-through entities along with equities.

## RESEARCH FINDINGS AND OBSERVATIONS

### Abolishing Unfair Tax Status for Income Trust Equities?

- ✓ **FACT: The addition of taxes to trust distributions creates an unfair situation. It distorts the decidedly fair prior tax decisions.** With some benefit of Finance Department expertise and public Consultation, the Minister of Finance made a decision in late 2005 to ensure a “level playing field” between trusts and other equities:
  - By way of reducing the tax on dividends from common equities;
  - Including informed support for the decision by the Liberal Minister, from previously oppositional public representatives including the Conservative Finance Critic and Party Leader;
  - Included explicit confirmation in the form of restated election promises to support the decision by leaders of the governing party and the Opposition, leading up to the early 2006 federal election.
- ✓ **FACT: Department of Finance personnel did NOT demonstrate expert support or clear calculations from which they can conclude trusts constitute a “Tax Loophole”.** Department officials could not provide specific or explicit measures with balance and confidence (*first day of Finance Committee Trust Study, January 30, 2007*):
  - The Department received more than a 1000 submissions on tax fairness including positive and negative perspective;
  - Only approximately “100 submissions by experts” to the Department included concerns about income trust tax loop holes;
  - No comparative measure was provided, however, on the most important number of submissions that offered calculation of tax gains from trusts or the sense that income trusts are not built around a tax loophole (*calculate that 90% of submissions or (1000-100)/1000 received may provide evidence of trust benefits to Canadians*);
- ✓ **FACT: The Department of Finance has not published detailed data to support its contention that Consultation findings and recent tax estimates change or differ from the basis on which a fair tax decision was made by the Minister of Finance, Ralph Goodale in 2005:**
  - Consultation findings published in alphabetical order on the Department of Finance web site remain incomplete (*per review by iTrust Institute of all data that was published*);
  - Department of Finance personnel continued in 2006 to use the narrowly defined methodology and statistical assumptions reported in 2005 (*Per testimony to the Finance Committee January 30, 2007*);

- Note that requests for information by BMO Nesbitt Burns analyst Gordon Tait were not fully satisfied with readable documents (Per testimony to the Finance Committee January 30, 2007);

### **Tax Leakage or Loss?**

- ✓ **FACT: Tax on distributions destroyed \$20+ billion from the tax base with 2006 news that owners will be taxed through capture of cash from distributions (immediate loss by millions of investors). Another \$200 billion disappears if the government eliminates trusts (per iTrust Index).**
- ✓ **FACT: Data from the Department of Finance Annual Reports to the Federal Government shows that, despite talk about losses, actual Canadian income tax revenues grew over 5-years, up more than 34% during the time that income trusts became popular and corporate taxes increased as well (see Appendix 3);**
- ✓ **FACT: During growth of the trust market there was no evidence of tax losses as both the number of reporting tax filers and the tax receipts increased in favor of the government** due to both an aging population and the general long term upward valuation trend of investment portfolios (*according to study by iTrust Institute contributor of recent 5-year data published on the CCRA web site and included in Appendices 3 and 4*):
  - **Statistic:** In 2004 there were 2.696 million taxpayers and they reported taxable income of \$44.4 billion, up significantly from 2000 when 2.432 million individual taxpayers reported pension or other superannuation taxable income of \$34.5 billion.
  - **Statistic:** RSP income tax revenue increased from 2000 when there were 1.230 million tax filers and total of \$6.6 billion up to 1.632 million tax filers with a total of \$8.1 billion in taxes paid in 2004.
- ✓ **FACT: Considering taxes deferred through Registered Retirement contributions, over a recent 5-year period there was a swing between pension related taxable income net of RPP and RSPP taxable deductions in the government's favor** between 2000 and 2004 inclusive (*according to study by iTrust Institute contributor of data published by Department of Finance, included in Appendix 4*):
  - **Statistic:** Combined deductions of registered pension plan and registered retirement pension plan contributions by individual Canadians during the 5-year period rose from \$34.9 billion in 2000 to \$38.2 in 2004.
  - **Statistic:** Pension-related taxable income net of RPP and RSPP taxable deductions moved from a net \$6.2 billion in the government's favor in 2000 to a net \$14.3 billion, even more, in its favor in 2004.

- ✓ **FACT: Regardless of whether income trusts are part of the equity market or not, improved and coordinated tax and regulatory policy is required from the Government of Canada to limit massive tax “losses” from existing rules that prefer foreigner. Rules can ensure that the Provinces regain access to tax revenues and that Canada attracts tax-paying residents and investors into its market:**
  - The trust market may, in fact, provide motivation, useful information and effective insight that helps focus attention on returns in an overhaul of the tax system, as called for by many experts in recent years.
  - Regardless of trusts or equity holdings, wealthy foreign investors and wealthy Canadians who have structured legal off-shore entities obtain cash returns from Canadian companies without paying fair tax whereas tax-paying Canadians bear the full brunt of tax on returns from those same investments;
  - The Minister of Finance has proposed reducing with-holding tax, so allowing greater tax “loss” to foreign investors as a way to attract capital to Canadian markets, yet discriminates against the owners of those businesses structured as trusts and that pay returns to investors;
  - Canadian Banks are pivotal in structuring internal schemes to enable international swaps of value that eliminate tax on Canadian investments by foreign investors.
- ✓ **FACT: Department of Finance confirmed for the Finance Committee that calculations of taxes losses from income trusts in 2006 are like those in 2005 and entirely limited in their scope of calculation of changes to show theoretical tax losses per year considering only corporate income and capital gains taxes while excluding of other key tax measures (January 30, 2007):**
  - Excludes individual income and other tax increases (see below);
  - Excludes economic multiplier effects and tax revenue gains due to the velocity of cash returns, reinvestment and follow-on spending.

How much do major swap and off-balance sheet transactions (within divisions of major Canadian banks) really cost Canadian tax payers compared to supposed losses of tax revenues on the Canadian income trust market?  
Why can a person in Frankfurt or Geneva with a lot of money get cash yield from Canadian income trusts and dividend-paying companies without tax whereas Moms and Dads who are struggling to save for or who are living in retirement in Canada have to pay the tax added to distributions by the policy of the Minister of Finance?

- ✓ **FACT: Income trusts and flow-through entities are organizations of standardized high quality sufficient to constitute a financial security based on legal practices that necessarily respect Canadian laws. Trusts have a 20-year history of exchange on the TSX, as one or more of a diverse range of structured financial securities based on trust laws** (*numerous reports by finance and tax experts from various Canadian law firms found in the professional expert archive of reports offered by Mondeq.com*):
  - Public mutual funds;
  - Exchange traded index funds (ETFs);
  - Private trusts, usually set up by wealthy people to minimize tax;
  - American-style MLPs;
- ✓ **FACT: Income trusts are created generically from lawful contracts that structure cash flow for flow-through to taxable owners based on legally sound but flexible structures. These attract growing investment demand by sophisticated and other investors around the world:** Because investors, generally place money where it generates total greatest return which is reasonably measured in rough or specific terms of net present value of net cash returns over a period of time:
  - Australian flow-through entities remain popular as both REITs and as trusts (*Studies by MBA students at Carleton University show that the Australian Parliament was considering ways to address the growing number of trusts in Australia at the end of 2006, despite government rules to eliminate trusts in 1985*);
  - American trusts continue to trade in growing numbers in the form of Master Limited Partnerships (MLPs) in the United States (*Reports verified by BMO analyst during Finance Committee study Jan. 30'07*);
  - Global stock exchanges compete with one another by adding flow-through classes of securities as a means for investors to obtain cash returns from their investments, starting with easily structured real estate trusts which have, for example, just been introduced in to Asian and South African markets in 2006 (*NY Times Report Q4 2006 provides meaningful broad context relevant to the Minister of Finance's specific acknowledgement of MLPs and REITs on January 30, 2007*);
  - At about the time Canada announced a punitive 36% tax on new income trust issues to block conversion of large widely-held entities BCE and Telus into an income trust, the British government approved flow-through entities being listed on public exchanges in the UK for the first time (again in the easily understood REIT form), but on the basis that public issues of flow-through securities be allowed only for those good companies of a minimum large size and widely-held nature. The aim in the U.K. is to protect the interests of domestic small investors (*NYTimes.com*);

## Eliminating Tax-related Conversion Incentives?

- ✓ **FACT: For business managers and owners determined merely to avoid tax, there are far more compelling and less expensive strategies than converting a public equity into an income trust, particularly if the company is not viable from a cash-flow or operational perspective:**
  - Standard accrual accounting practices have and will continue to provide managers control over earnings numbers on which taxation is focused for traditional common equities;
  - Off-shore corporate structures are not only possible but used by sophisticated Canadian business managers to avoid tax even while income trusts grew in number and following restrictions on trusts;
  - Evidence of non-trust preferences may be seen when observing the TSX. To grow income potential from company conversions and new issues, the TSX established a relationship with the less regulated London Stock Exchange (LSE) which is rapidly growing its number of offshore listings/issues;
- ✓ **FACT: Tax conversion decisions by owners and managers are decisions that do not rely entirely on tax avoidance factors. Nor do they exclude other basic business considerations.** Public issue and trust conversion decisions can, regardless of tax rules, result from executives' and owners' desires and preferences:
  - Decisions to adapt the legal structure of the company over time reflects financing needs and/or other desires:
    - To pay tangible returns to owners and/or to attract new financial investments;
    - To lay a private or traditional public equity bare to consideration by, or to make a company transparent for, informed investors where distributions constitute significant informative value for business observers in and outside the enterprise
  - It is a fallacy to say that all companies convert into a trust in any particular sector merely because one competitor does so:
    - E.g. BCE and Telus proposed a trust conversion after Manitoba Telecom executives and owners considered one. But MBT rejected a trust conversion in a way BCD and Telus did not.
    - E.g. Trust structure adoption can be closely correlated with decisions by directors, insiders and managers to pay owners cash returns as the BCE decision to convert and then to not convert demonstrates in late 2006. In both situations, there was a common proposal to increase cash payments to investors;

- It is a fallacy to say that the “banks will have to convert” into income trusts because other widely-held companies considered the merit:
  - Vertical integration of banks working with a financial services oligopoly in Canada provides massive net earnings to these companies, so provides little motivation or need for them to consider paying fair returns to owners, particularly when the trust tax eliminates more profitable investment alternatives for Canadians;
  - Banking regulation effectively limits the financial structure of these institutions to disallow full-fledge preference to pay returns to investors. Some fund managers note banks are inefficient entities that work as cash-hoarding enterprises as a result;
  - The brokerage arms of Canadian banks have been significantly responsible for the poor pricing of the majority of income trust issues that failed soon after IPO. Banks may be most responsible, by implication, for the types of losses identified in Ms. Urquhart’s “Tails You Win...” Study (refer to Appendix 2), especially given that these same banks are most rewarded for selling the IPO issues of companies to less informed Canadian investors.
- In many, but not all cases, the high legal cost of corporate restructuring is undertaken by existing owners to liquidate ownership. This happens regardless of the stage in the public-private process and regardless of entity status as trust or traditional equity (*per interview of equity issuers and financial services professionals by L. Hayman during 2005-2007*).
- ✓ **FACT: Cash dividends or distributions are of significant economic value purely as information, so much so that:**
  - Professional fund managers are regularly surveyed by Merrill Lynch to determine the extent to which fund managers desire fundamental returns as cash (i.e. certain returns versus potential returns with risk);
  - An increasing proportion of investors around the world are seeking frequent cash returns from their investments (Dow Jones reported that a survey of fund managers released by Merrill Lynch & Co. found that, “The proportion of fund managers wanting to see cash returned to shareholders reached a record high of 53% this month, up from 44% in December 2006.” The Implication: Equities structured for frequent returns, like those from Canadian Income Trusts, meet the needs and demands of global investors). The Merrill Lynch Survey for January 2007 found that
    - Investors increasingly want corporations to prioritize their cash flow to return cash to shareholders;
    - Returns to shareholders can come in the form of share buybacks, dividends or cash acquisitions;

- A majority of investors believe cash returns should take priority over capital spending, debt repayment and topping up pensions.
- Less experienced investors including seniors naturally seek regular and frequent distributions and pay a premium for units of ownership to do so. Some might feel more closely connected to their business when knowing that the distribution is regular and provides some fundamental measure of business performance outside of accrual accounting practices that can be more easily manipulated by executives;

## Protecting Investors from Bad Security Issues?

- ✓ **FACT: 88% of Canadian income trusts and REITS had earnings and public issues traded at a price within a reasonable range of risk as of the end of 2006** (per periodic review of Price to Earning ratios as part of the iTrust Index and Ratings system by L. Hayman):
  - 88% of issues had a P/E ratio based on trailing twelve month basis of greater than 1 (it had earnings);
  - 88% of issues had a reasonable P/E ratio of less than the risk-related tolerance level at that time of 24 (calculated as 100 divided by the yield on the 3-month Canadian Treasury Bill);
- ✓ **FACT: For every reduction in cash distribution rate by income trusts during 2006, there were increases by three other issuers** (per on-going collection of changes in distributions by L. Hayman at *TrustInvestor.com* for purposes of reporting useful investor news and as a fundamental input factor in determining investment quality ratings);
- ✓ **FACT: Approximately 3 of 4 income trusts and REITs was of good quality in terms of cash flow for purposes of distribution, at the end of 2006** (per periodic review of fundamental financial reports by all issuers as part of the iTrust Index and Ratings system by L. Hayman):
  - None of this majority of flow-through entities had cut back on its distribution in the prior two years;
  - All of this majority of income trusts paid cash distributions less than the amount of net cash they generated from continuing operations;
- ✓ **FACT: Elimination of Income Trusts distracts and delays much needed attention to the real underlying risks and problems in the Canadian public market** with more than 1300 issues due potential concern in addition to flow-through equities (per interviews with professional fund managers and private equity investors by L. Hayman, and as confirmed in conclusions drawn in narrowly defined reports such as Diane Urquhart's "Heads I Win, Tails You Lose" report but also in broad authoritative reports from the Bank of Canada):
  - Trust operations are so transparent in terms of cash in relation to operating considerations that even a relatively few trusts among the 250 issues that have troubles can be so clearly identified as if sole culprits of bad management at public equities, that those few failures remain memorable;
  - Professionals recognize that regardless of trust structure, there can be lack of due diligence, on purpose or by accident, among investment bankers responsible for pricing and marketing new issues to Canadians in return for substantial transaction fees;
  - Lax or non-existing enforcement of existing securities rules, could be fixed to ensure appropriately informative sales processes by brokerage firms<sup>13</sup>

- and commissioned sales or advisory agents promoting new issuers of high risk businesses to ill-informed investors in Canada as it is deemed a self-regulating industry;
- ✓ **FACT: All new issues are riskier to investors than securities with a year or more in track record regardless of the issue being a trust or traditional equity** because real operating and performance information is not offered to the public until the company is required to provide investors with at least a fiscal year of financial reports.
  - ✓ **FACT: Conversion of common equity to trust provides far less risk and far more information to investors than any kind of IPO, equity or trust, because the company already has the experience and track record of operating as a public company.**
  - ✓ **FACT: Numerous income trusts offer high quality assets priced at such a discount to fair valuations that the issues have been and, particularly now, continue to be bought-out of public investors' hands by professional investors including** private equity managers, pension fund managers, foreign investors and other traditional equity owners. This is evidenced by the number of trust listings bought out of the market (known via on-going reporting at TrustInvestor.com in process of maintaining its Guide to trusts). For example:
    - The price of Halterm Income Fund units (business trust HAL.UN) leapt up 22% with an offer to buy out the company by a foreign investors, while other trust unit prices fell on November 1, 2006;
    - Blue-chip REITs that include revenue from business service operations akin to a business trust operation, such as those once trading as Olympia and York REIT (OYR.UN), were bought out by pension fund and other investors in recent years;
  - ✓ **FACT: Traditional analysts are often blind to quality assets even from the oil and gas producers with the largest reserves in Canada. They can ignore companies with the best reserves when offered as assets along with monthly net cash returns on profitable operations in the form of a trust.** Their research mandate is to follow only those securities in which their banking or service firm takes an investment or broker interest. Research is limited by aims to earn investment banking fees and sales commissions from secondary equity issues, services not needed by good quality companies with internal growth. All trusts are included in the iTrust Universe: It is independent comprehensive research. This is done with third-party data but also by directly gathering raw data in order to see measures beyond those from traditional professional information sources. Such *research supports equity Ratings by L. Hayman considering business financial reports in the context of equity markets and the Canadian economy, including all income trusts:*

- Canadian Oil Sands Income Fund (COS.UN) is covered by analysts with its oil equivalent reserve life index of more than 40 years. It has seen its unit prices bid up by foreign investors despite faltering prices for crude and despite its relatively high cost of production. Buyers look for a good net present value of future cash flow generated from its large asset base;
- Peyto Energy Trust (PEY.UN) is not often covered despite its gas reserve life index of closer to 20 years, more than any other gas producer trust or not. It has seen its units trade within a stable price range despite faltering prices for gas, particularly because its cost of production is relatively low. This trust has grown its assets;
- ✓ **FACT: Most trusts that fail to maintain cash distributions fail to do so because of a cash squeeze often faced during the first year of public issue (fast-following an initial public offering). The payout cut communicates risk of which investors deserve knowledge, something owners would not have known had the issue been made through one and/or almost any other traditional form of equity** (research by L. Hayman as part of the comprehensive tracking and reporting process for TrustInvestor and its subscribers' Report):
  - Had these companies not been paying cash distributions and providing it as a measure of company health through a trust structure, managers could have delayed exposure of internal problems for as much as a year or more, during which time, Ponzi-type secondary financial issues could have been made to obtain more working capital without signifying enterprise risk or problems for investors;
  - It is not clear how many or when traditional equities and particularly low or no cash-flow "growth" equities will be exposed – if ever -- as poorly managed and, "bad", investments:
    - Accrual accounting can be manipulated in favor of positive appearances as easily, or more, easily than cash accounting practices;
    - Failed securities issues other than income trusts can be taken private or have, in the case of exchange-traded funds, units redeemed without publicizing business problems to investors. Few announce that a business has failed (certain respected fund managers provide egregious examples of potentially deceptive communications about their funds that fail: They merge but don't fail)

## Strengthening Canadian Financial Markets?

- ✓ **FACT: By focusing responsibility on paying cash returns to investors, for use at their discretion, cash distribution features unique to flow-through entities enhance the quality of Canadian markets for buyers:**
  - Returns attract participation in Canadian markets on the buyer side so also attracts sellers;
  - Cash returns maximize the efficiency of investments relative to potential allocations of cash towards newly identified and valued opportunities
- ✓ **FACT: When income trusts were seen as investments upon which policy risk would not be imposed, new issues of these high-velocity cash engines outpaced issues of traditional equities** (per PriceWaterhouse Coopers and TrustInvestor research and reports);
- ✓ **FACT: Public or private, net cash returns like those returned to owners by Canadian income trusts are the focus of demand by sophisticated investors because there is a measurable increase in returns relative to market-related risk in such securities compared to securities that offer slower or no dividend payments:**
  - Income trusts have a significantly higher return relative to risk than traditional equities in Canada (per sector studies by L. Hayman as part of her Report research and per index-based Sharpe Ratio studies by Gordon Tait, analyst of BMO Nesbitt Burns for which results were published in the firm's first "Book" on Income Trusts mid-2005);
  - The average rate of distribution for income trusts in Canada has always been higher than traditional equities. But American common stocks offer higher dividends on average than Canadian common equities, some say due to a more diverse & competitive offering of securities in the United States compared to Canada (Study by L. Hayman in 2005);
- ✓ **FACT: The greatest risk and damaging effect in the Canadian income trust market results from discriminatory and punitive government tax policy. Policy clouds reflection on the diverse set of positive qualities for the range of securities in the trust market:**
  - News of pending tax directly caused a discounting of trust unit prices (*as above*);
  - Higher than fair (36% versus a little more than 31%) taxes on new trust issues was the direct cause for a change in business decision by business managers and owners at BCE and Telus so that high quality companies decided NOT to structure in a way that gives owners discretion over allocation of cash flows from the business;
- ✓ **FACT: Despite now allowing for 200% growth in trust equity over the next 4 years, but because the Department of Finance is taking such an explicit role in financial decision-making for 250** <sup>16</sup>

**businesses structured as flow-through-through entities, the tax and rules can only be deemed unfair as they weaken the quality of the Canadian market:**

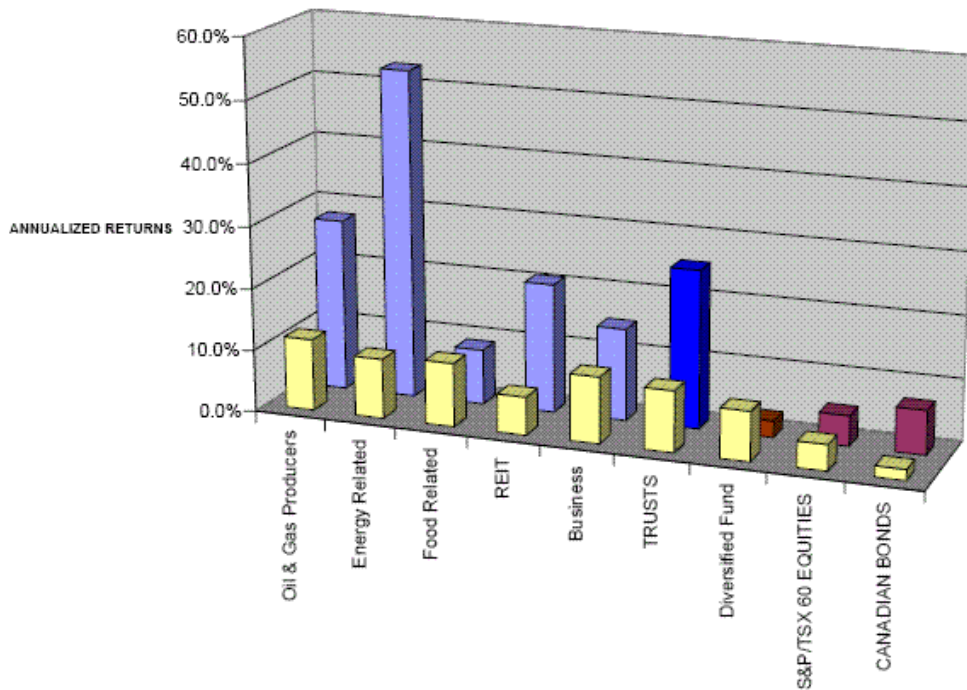
- The Department of Finance tax and equity policy is so onerous for managers of these relatively few companies that tax policy administrators are now forced to accept special submissions on a case-by-case basis to consider allowance of equity, literally, in regard to special interests;
- The tax and equity rules impose conditions in which debt must be preferred by managers over equity issues so government policy reshapes a growing market into a highly levered high-risk market;
- In a small relative market where growth in net cash flow and returns to investors was a driving force, government policy has effectively limited access to commercial benefits and growth in those equities;

### **Canadian Ownership in Productive and Growing Enterprise**

- ✓ **FACT: Dividends and cash distributions are, over the entire history of stock exchanges in North America, highly correlated with internal business growth** (*per studies report to the society of Certified Financial Analysts in an Editor's Corner note in 2006 by the editor of the CFA Journal, Rob Arnott*)
- ✓ **FACT: More than three dozen companies with flow-through issues in December 2006 offered investors Return on Capital in excess of 15% per annum** (not to be confused with return of capital), according to the TrustInvestor.com Report.
- ✓ **FACT: For 6+ years between Sept. 1 2000 and Nov 30 2006, the Total Annualized Return for all income trust issues considered on an equal weight basis was more than 36% per annum including annualized rates of price gain plus annual rates of cash distribution relative to price (i.e. yield). This total return is many times more than the returns for investors from managed income funds and for the S&P/TSX equities index**, despite the market price-down and value reduction following the 2006 tax news announcement (*per Ratings research by L. Hayman and shown in the following chart*):
  - Average trust yield rose with a price down of units starting November 1, so yield went from 8.8% per annum up to 9.9%;
  - 25% per annum was the average price gain on units held on an equal weight basis since inception of the Index (September 1, 2000) or since inclusion of a company in the income trust universe on the date of conversion of new issue.

DEC 2006

**AVERAGE TOTAL ANNUALIZED RETURNS BY SECTOR**  
 \$1000 Equal Weight Investment in Trusts & Funds Upon New Issue  
 September 1, 2000 - November 30, 2006 iTrustReport



	Oil & Gas Producers	Energy Related	Food Related	REIT	Business	TRUSTS	Diversified Fund	S&P/TSX 60 EQUITIES	CANADIAN BONDS
■ AVG CASH YIELD	11.6%	9.7%	10.3%	6.2%	10.7%	9.9%	6.0%	4.2%	1.7%
■ TOTAL ANNUALIZED RETURN	27.6%	53.1%	8.9%	20.8%	14.6%	25.5%	2.7%	4.9%	7.1%

TOTAL ANNUAL RETURNS = ISSUE PERFORMANCE FOR INVESTORS:  
 Annualized rate of price gain + yield or annual rate of cash distribution.

- ✓ **FACT: Not all businesses manage to deliver internal net gains in assets, earnings or cash flows regardless of their structure as common stock or income trust:**
  - **Statistic:** Since 2003, there have been between 18-24 income trusts that have provided consistent growth in assets, without issuing new equity, by growing their cash flow from continuing operations, retaining cash flow for maintenance and growth activities, but returning less than 60% of cash flow back to owners. These companies have:
    - Tangible assets on their books and growing owner equity;
    - Received a premium pricing in the market evidenced by a low relative yield (distribution/price);
    - Not been the focus of income trust sellers and brokers who are responsible to get good investments into the hands of their clients but find it easier to provide good issues in short supply to a few large and influential investors;
  - **Statistic:** Only one equity on the Canadian stock exchange demonstrated the same high degree of fundamentally good qualities to warrant investment offered like the 18+ trusts noted above (as of Dec. 31, 2006 in report by L. Hayman using iTrust Ratings system):
    - A consistent methodology was systematically applied to Rate the fundamental qualities of potential investments in terms of demonstrative growth from a business with due consideration of informative quality, positive earnings, cash flow, total annualized returns including capital gains from price gains, with preference for companies showing no negative indicators for cash flow;
    - That one top-rate common equity showed, however, negative cash flows as concerns not shown by the companies operating as trusts.
    - A few financial services firms including the banks and Manulife offered many positive returns than many stocks, but without offering the same quality of total annualized returns to investors.

## Enacted Corporate Tax Rather than Individual Canadian Tax?

- ✓ **Fact: The tax on distributions makes use of corporations as a mechanism for tax collection, but does not affect the operations of the corporation** (*according to direct comment on impact of new taxes made in discussion or correspondence with Institute directors during survey of income trust executives in December 2006 and January 2005*);
- ✓ **Fact: The pending tax on distributions from income trusts directly reduces the income of tax-paying Canadians who own income trust securities.**

## CONCLUSIONS

By looking at a comprehensive set of facts, the Institute found that:

- ✓ **Income trusts are like common public equities and not generically good or bad investments.** If they were, then financial services firms and their allies who joined with members of various other trade lobby groups to fund the recent upstart lobby group, CAITI, would not have opportunity to sell quality-differentiating services to investors.
- ✓ **Many, not all, company managers with investors and lenders in and outside the income trust market are honest people and work in the interest of owners.** Canadians need to improve the quality of the investment environment (*not kill the proverbial canary as if protecting others from seeing that air in the mine of public equity is bad aside from trusts*)
- ✓ **An overly narrow focus on cash yield as a unique feature of income trusts, by analysts and now the government in order to impose new taxes, fails to address the full risk, returns and growth potential available to Canadian investors.** Such a focus on relative yield is not only misleading in the process of selling new issues of securities and fund products to Canadian investors and seniors, but it cripples Canadian policy makers to the extent that it misinforms policy with limited, relative numbers.
- ✓ **An overhaul of the tax system, banking and market regulations and a commitment to enforcement is required to ensure that Canadians can compete in the global markets of the 21<sup>st</sup> century.** With courage of commitment to change for the shared good, Canadians might better understand the high value of holding global leadership on trusts, and refining them rather than cutting back to the “me-to” REIT-only stance. Trusts offer returns sought by us and a world of potential lenders, owners and investors.

## **BACKGROUND**

### **Contact**

Leslie Hayman  
President, iTrust Institute  
850-36 Toronto St., Toronto ON M5C 3C5

[leslie@itrustinstitute.org](mailto:leslie@itrustinstitute.org) Telephone 416-822-4388

### **About the Institute**

#### **Objective and Inclusive**

The iTrust Institute is an independent, non-partisan organization that provides research and education services to members and others.

The Institute was born in early 2006 from the interests of members in TrustInvestor, a leading independent information resource for more than 3993 members including investors, advisors, brokers, bankers, traders, financial professionals, market makers & issuers. That number now approaches 5000 as Liberal tax policy and Conservative election promises helped popularize income trusts in early 2005.

The iTrust Institute was incorporated as a federal not-for-profit organization as a means to address the information needs of a public and government divided during the Department of Finance Consultation of 2005. At that time, we assembled a Round Table to address questions still unanswered today. Many sensed growing need for specialized education and objective information in regard to the securities and their market.

Specifically, the Institute was formed to ask the question and explore the extent to which "Equities managed and structured like income trusts to flow net gains through to owners by way of frequent and regular distributions of cash can offer superior rates of overall return, support market growth, enhance economic productivity and contribute to growth of the tax base with less risk than other equities given honest managers and a fully competitive market supported by open communications."

## **Founding Directors and Advisors**

Three founding directors included a retired executive and senior citizen, a semi-retired lawyer and the President, Ms. Leslie Hayman.

Ms. Hayman was elected President to bring the Institute her expertise as the creator, publisher and editor of the long-running TrustInvstor.com as well as the subscription service all the iTrustReport. These services are both free and paid subscription services, respectively, geared to helping do-it-yourself investors and financial service professionals with useful information about income trusts and funds, their risks, returns and investment strategies in the context of the Canadian market.

Ms. Hayman has a business degree from the Ivey School of Business at Western University in London Ontario. Leslie is an active associate member of both of the CFA Society of Toronto as well as Advocis, the Financial Advisors' Association of Canada, for whom she had the privilege of writing the December 2006 review of the trust market, coinciding with the announcement of new taxes by the Minister of Finance (copy attached).

In addition to the two other directors, Ms. Hayman calls upon and responds to a range of advisors who offer diverse and significant perspective on trust related issues, the markets and broader considerations on a formal and periodic informal basis. Advisors have included government administrators, government policy advisors, senior executives with income trusts, professional fund managers, company executives, corporate and commercial lawyers, accountants and, as important, individual investors with good questions and ideas.

## **Canadian Tax Orientation**

As Canadians and investors of all political stripes, Institute members and advisors see need to understand how business returns to public investors align with the productive capabilities and operating practices of the enterprises they own, and if those enterprises are structured and managed in such a way that growth is possible and pays returns aligned with surrounding interests in growing the Canadian economy.

The Institute makes no assumption about the need for or appropriate use of tax revenues, only that taxes relate to the rights and freedoms of citizens and play a role in economic and social growth including rules with constitutional implications so must be applied in a decisive manner for clear purposes and applied on a consistent -- i.e. fair -- basis.

## **In the Name of Trust**

The Institute obtained the name iTrust from Ms. Hayman for use by the Institute, not to advocate or lobby for income trusts. A company of hers has a trademark on the iTrust name.

Rather than promoting income trusts per se, founding members saw need and potential to test the real benefits and risks for investors and Canadians to place their trust in public financial securities in general. We saw further opportunity to obtain great insight by focusing on legal structures and working realities and performance of flow-through securities and trust structures in particular.

With surprise imposition of new taxes and rules on flow-through entities in 2006, the Canadian government increased the urgency for good information in order to ensure policy has positive impact on Canadians and our economy, today and tomorrow. With reversal of election promises, the Conservative government also provided a fertile environment for the Institute to consider broader notions, requirements, practices as well as consequences of trust in regard to social and economic development.

## **APPENDIX 1 - TRUST OF PUBLIC POLICY KEY TO MARKETS**

### **Participatory Exchange Relies on Social Capital Built on Trust**

As presented from a formal Thesis Paper on Trust by Kate Korycki from McGill University at the annual conference of the APPSA (Atlantic Provinces Political Science Association) for 2006.

Ms. Korycki now works for the Federal Government.

### **Introduction**

On a normative level, a world populated by broadly trusting, engaged and connected individuals, acting together to further their aims, seems more desirable than one inhabited by atomized, isolated and mistrustful ones<sup>1</sup>. Intuitively, the former holds the promise of cooperation and progress while the latter sets the stage for conflict, passivity and decay. On an equally prescriptive level, the quality of democracy depends in large measure on the participation and oversight of the citizenry. There seems to be a clear, if again intuitive, connection between highly civic-minded societies and well functioning democracies.

Robert Putnam, the precursor of the wave of scholars exploring the connection between trust and democracy, explains that the presence of social capital, which he understands as the interplay of trust, norms of generalized reciprocity and networks of engagement, facilitates the resolution of collective action dilemmas (Putnam 1993, 167).

He imbues social capital with a formidable force. Its existence improves children's welfare and education (Putnam 2000, 297); creates healthy and safe neighbourhoods (308); fosters economic prosperity (319); contributes to health and happiness of societies (326); and, most importantly for the purpose of this work, it strengthens democracy (337).

...

### **Findings**

Institute findings: Markets and financial exchanges are no less reliant on trust and social capital than democratic process. Common elements include consistent and publicly accessible decisions regarding policies that ensure general risk of participation in an exchange is reduced sufficiently with such "democratic" processes to enable participants' at least minimal confidence for willingness to face the risks inherent in the market itself without undue additional risk of changing standards of practice perceived, in particular, in regard to punitive, discriminatory or otherwise unfair and untrustworthy policies.

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## APPENDIX 2 – REVIEW OF INDEPENDENT STUDY

### Misleading Due to Generic Conclusions from Partial Data Set

#### The Study

A respected financial expert, Diane Urquhart, took the press podium in October 2006 beside the NDP finance critic, Judy Wasylycia-Leis, to present an “independent” study “*Income Trusts: Heads I Win, Tails You Lose*”.

The study concludes reductions in income trust distributions reflect a problematic structure inherent in trust securities. The author attempts to build a case to suggest that a key concern for investors about trusts is that they fail to report the difference in source of cash for distribution in terms of return of capital or net operating gains.

The study also carries the assumption and general observation of need to protect Canadians from false claims and incomplete attention to risk during promotional efforts by financial product and broker sales personnel.

#### Deficient Methodology

The Urquhart study fails to observe a full data set for the income trust market. The expert uses limited information in so far as it is the only information available from Bloomberg Media Services.

While the source is credible for what it does offer and appears to have been convenient for use by the author, it clearly does not provide a comprehensive view of the Income Trust market let a full historic depth of perspective.

Furthermore, the study fails to measure the extent to which the relatively few securities cited for study reflect the way flow-through entities generate net earnings or growth.

#### Alternative Findings from Meaningful Data

Through use of comprehensive market-tracking data, the iTrust Institute can show that:

- ✓ During 2006, there were more than three times as many distribution increases as decreases by income trusts. There is little difference in statistics when REITs are excluded;
- ✓ Approximately three quarters of income trusts and flow-through entities have not had a reduction in distribution in the past two years and, furthermore, pay cash returns to investors that are less than operating cash from continuing operations;

- ✓ The high frequency of cash distributions unique to Canadian income trusts generally increases returns relative to market-related risk for investors. This kind of cash return to investors offers such informative and economic value to investors seeking transparency in managerial practice that there is increasing demand by sophisticated foreign investors to own Canadian flow-through securities. There is demand to own Canadian income trusts despite the economic dampening impact of new taxes on recipients of distributions from income trusts.

### **Remedial Considerations**

Comprehensive factual studies show very different findings with significant implications compared to those presented in the expert independent study that was publicized as if part of the NDP Finance Critic's position on income trusts and the Party's stated reason to support Conservative tax policies.

Institute findings can support some of the conclusions of that same study by Ms. Urquhart in so far as there is common recognition of the need to protect Canadians from false claims and incomplete attention to risk during the sales process by financial services, product and broker sales personnel.

The Urquhart study gives the public, including Finance Committee members and politicians, the misimpression that such distribution and structure problems are significant and generic among trusts.

### **Conclusion**

The study findings and public comments are irresponsible and misleading when presented as fact, particularly when published without comparative measure and out of context.

The distribution-oriented propositions are as offensive to good Canadian managers as the statements are inappropriately generic.

There is clear evidence of need to improve the accuracy of information provided to investors by sellers when they advise or promote purchase of units or shares, particularly for initial public offerings. This perspective is not new or isolated to income trusts, however, and has been featured as a conclusion of reports commissioned by authorities like the Bank of Canada.

## APPENDIX 3 – RECENT 5 YEARS CCRA STATISTICS

### Other Pensions or Superannuation Taxable Income

From the CCRA Web site reports for five recent years:

- ✓ # of filers increased 10.9%
- ✓ \$ reported increased 28.7%
- ✓ Average \$ reported by filer increased from \$14,209 in 2000 to \$16,486 in 2004 which is a 16% increase

Tax Year	Number of Filers	\$ Millions Reported
2000	2,431,590	34,549.9
2001	2,502,500	37,063.8
2002	2,546,880	39,188.3
2003	2,615,330	40,798.9
2004	2,696,250	44,450.0

### Investment Taxable Income

From the CCRA Web site reports for five recent years:

- ✓ # of filers decreased 8.9%
- ✓ \$ reported decreased by 19.8%
- ✓ Average \$ reported by filer decreased from \$2,689 in 2000 to \$2,369 in 2004 which is a 11.9% decrease

Tax Year	Number of Filers	\$ Millions Reported
2000	7,404,690	19,913.4
2001	7,318,200	20,389.5
2002	6,579,590	15,968.0
2003	6,515,660	16,036.4
2004	6,742,200	15,970.9

## RRSP Taxable Income

From the CCRA Web site reports for five recent years:

- ✓ # of filers increased by 32.6%
- ✓ \$ reported increased by 21.6%
- ✓ Average \$ reported by filer decreased from \$5,390 in 2000 to \$4,944 in 2004 which is a 8.3% decrease

Tax Year	Number of Filers	\$ Millions Reported
2000	1,230,270	6,631.6
2001	1,343,960	7,049.6
2002	1,444,000	7,159.3
2003	1,555,670	7,781.8
2004	1,631,550	8,066.1

## Taxable Amount of Dividends

From the CCRA Web site reports for five recent years:

- ✓ # of filers decreased by 13.6%
- ✓ \$ reported increased by 29.6%
- ✓ Average \$ reported by filer increased from \$4,248 in 2000 to \$6,378 in 2004 which is a 50.1% increase

Tax Year	Number of Filers	\$ Millions Reported
2000	3,736,280	15,873.0
2001	3,029,700	16,833.8
2002	3,026,680	17,468.6
2003	2,947,650	17,728.8
2004	3,226,420	20,579.2

### RPP Contributions Taxable Deductions

From the CCRA Web site reports for five recent years:

- ✓ # of filers increased by 12.8%
- ✓ \$ reported increased by 44.7%
- ✓ Average \$ reported by filer increased from \$1,845 in 2000 to \$2,366 in 2004 which is a 28.2% increase

Tax Year	Number of Filers	\$ Millions Reported
2000	3,644,430	6,722.5
2001	3,673,320	6,968.3
2002	3,749,020	7,595.8
2003	3,991,150	8,408.0
2004	4,110,640	9,727.0

### RRSP Contributions Taxable Deductions

From the CCRA Web site reports for five recent years:

- ✓ # of filers decreased by 4.7%
- ✓ \$ reported increased by 0.9%
- ✓ Average \$ reported by filer increased from \$4,398 in 2000 to \$4,657 in 2004 which is a 5.9% increase

Tax Year	Number of Filers	\$ Millions Reported
2000	6,415,210	28,215.7
2001	6,314,650	27,255.5
2002	6,037,280	25,856.6
2003	5,908,520	26,076.5
2004	6,113,200	28,467.1

## APPENDIX 4 –LAST 9 YEARS CCRA STATISTICS

### Dept. of Finance Annual Report to the Federal Government

*Reported as Federal government's income tax revenues with fiscal years for 12 months ending March 31<sup>st</sup>. Amounts in \$ billions reflecting income taxes*

Fiscal Yr	97/98	98/99	99/00	00/01	01/02	02/03	03/04	04/05	05/06
Personal	70.8	72.5	79.4	83.3	79.5	81.7	84.9	98.5	103.7
Corporate	22.5	21.6	23.2	28.2	24.2	22.2	27.4	30.0	31.7
Other	3.0	2.9	3.5	4.3	2.9	3.3	3.1	3.6	4.5
<b>Total IT</b>	<b>96.3</b>	<b>97.0</b>	<b>106.1</b>	<b>115.8</b>	<b>106.6</b>	<b>107.2</b>	<b>115.4</b>	<b>132.1</b>	<b>139.9</b>

Over an entire 9 year period, total income tax revenues increased by 45.3%:

- ✓ Personal income tax revenues increased by 46.5%
- ✓ Corporate income tax revenues increased by 40.9%
- ✓ Other income tax revenues increased by 50.0%

For the last 5 years commencing fiscal 2001/02, total income tax revenues increased by 31.2%:

- ✓ Corporate income tax revenues increased by 31.0%
- ✓ Personal income tax revenues increased by 30.4%
- ✓ However, Other income tax revenues increased by 55.2%

Categories' % of total income tax revenues tracked as follows:

Fiscal Year	97/98	98/99	99/00	00/01	01/02	02/03	03/04	04/05	05/06
Personal	73.5	74.7	74.8	71.9	74.6	76.2	73.6	74.6	74.1
Corporate	23.4	22.3	21.9	24.4	22.7	20.7	23.7	22.7	22.7
Other	3.1	3.0	3.3	3.7	2.7	3.1	2.7	2.7	3.2
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Over the last 5 years, personal income revenues decreased from 74.6% to 74.1% of the total while corporate income tax revenues were steady. Personal plus Other increased most significantly from 76.6% to 77.3%.