Presentation to the House of Commons Finance Committee
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I support the Income Trusts Tax Plan, with no increase in the grandfathering period beyond 4 years. I strongly urge that the Income Trust Tax Plan be enhanced by the addition of prescribed conditions to the Income Tax Act to stop income trusts from reporting deceptive non-GAAP financial measures. Cash distributions must be defined as income distributions and return of capital distributions. The cash yield calculation should be restricted, unless there is an equally prominent income yield calculation.

The Federal Government should not be giving tax incentives for an investment targeted to seniors, where the product is an unsuitable investment based on their investment objectives of secure retirement income and preservation of retirement capital. The high risk design of income trusts and their deficient investor protection legal framework are unsuitable for seniors.

Making matters worse, the tax incentive promotes the purchase of an investment, where there is malfeasance in the financial reporting and marketing materials. These materials provide cash yield and other non-GAAP financial measures that are inaccurate and misleading. Seniors have been encouraged by their advisors to pay excessive prices relative to corporations and junk bonds. Not only have seniors given away their tax advantage to the vendors of these businesses, they have paid much more than this. So now there are billions of capital losses only partly explained by the new income trusts tax.

Just before the Income Trusts Tax Plan was announced, business income trusts were trading at a premium of about 55% relative to the TSX/S&P60 and a sample of Canada's non-cyclical public corporations on the basis of their price to earnings ratio. This premium was about 40% using the measure of price to cash flow from operations.

My research concludes that the income trust tax advantages are responsible for about 16% of the 55% premium. I conclude that the Income Trust Tax Plan with 4 year grandfathering has a 10% negative impact on prices. The business and energy income trusts have declined 13% or $23 billion since October 31, 2006. The new tax caused about $17 billion of this decline. This damage is a necessary consequence of the government closing a tax loophole, that is not achieving benefits for the economy and even seniors. For a properly diversified portfolio with less than 20% invested in income trusts, the new tax damage would be about 2%.

The income trust and financial industry say the high cash yields are due to the income trusts not paying any business taxes. But, the cash yield goes beyond the lift from no business taxes and provides a return of capital. The cash distributions are higher than the income of the underlying businesses in 2 out of 3 business income trusts. In business income trusts, distributions are on average 60% above income. The sources of extra distributions are borrowed money, reserves from prior financings and not retaining cash to replace plant, machinery, equipment and software. This financial engineering without proper transparency is causing the return of capital to being capitalized as if it is income. This causes the excessive pricing in the market.

The May 3, 2006 Canadian Accounting Standards Board Decision says:

"the AcSB is concerned that the failure to distinguish clearly between returns on capital and returns of capital is inaccurate and potentially misleading, particularly when terms such as yield are used to describe the amount distributed."

Paul Hayward, OSC Senior Legal Counsel says in the 2002
Canadian Tax Journal article called, "Yield debate continues 4 years later":

“Some investors may not grasp that part of the apparent "yield" represents a return of capital as opposed to a return on capital. If investors are being misled about the fundamental nature of their investments, then it may be argued that the [Income Tax] Act is complicit in the deception."

The 1994 Deferred Criminal Prosecution Agreement between the U.S. Justice Department and Prudential Securities Inc. says:

"17. In oral presentations and in marketing literature, PSI routinely used the term "yield," "return on investment," and "income' to describe the quarterly cash distributions received by investors in the Energy Income Funds. PSI routinely used such terms in its marketing materials even though PSI knew as evidenced by its disclosure in a footnote in the partnership prospectus, that the cash distributions did not constitute pure profit or interest, but instead also contained a return of original investment capital, which from my review of partnership financial records was substantial."

"14. PSI frequently used the terms "tax free," "tax sheltered," and "tax advantaged" to describe the quarterly cash distributions made to investors. The use of these terms implied that there was profit from the operation of the partnerships which was not to be taxed to investors, when in fact, that portion of the distributions received by investors for which PSI claimed a tax advantage, was not profit , but a return of investor capital."

The U.S. Justice Department found this criminal conduct in sales materials for limited partnerships sold to seniors during the 1980's and early 1990's. The U.S. Justice, the SEC, NASD and a consortium of 27 States reached settlements for fines of $41 million and the largest restitution settlement in American history of $2 billion.

The RCMP, provincial and municipal police forces have the jurisdiction to investigate the deceptive cash yields in income trusts under Section 380 of the Criminal Code:

Every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this Act, with intent to defraud, affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public is guilty of an indictable offence and liable to imprisonment for a term not exceeding fourteen years.

(1) Without limiting the generality of section 718.2, where a court imposes a sentence for an offence referred to in sections 380, 382, 382.1 and 400, it shall consider the following as aggravating circumstances:

(*a*) the value of the fraud committed exceeded one million dollars;

(*b*) the offence adversely affected, or had the potential to adversely affect, the stability of the Canadian economy or financial system or any financial market in Canada or investor confidence in such a financial market;

(*c*) the offence involved a large number of victims; and

(*d*) in committing the offence, the offender took advantage of the high regard in which the offender was held in the community.

My conclusion on income trusts having flawed design and execution are not theoretical. The business income trust offerings market has very poor performance during 2001 to now, despite a period of strong Canadian economic growth. This poor performance was clear before the Income Trusts Tax Plan was announced.

Business Income Trust Offerings Between January 1, 2001 and December 31, 2006
Performance As of
January 25, 2007

	IPOs		
	All	**In Capital Loss**	**In Capital Loss > -20%**
# Offerings	138	81	45
Offerings $ Millions	$19,484	$11,176	$6,291
% of All Offerings	100%	59%	33%
Offerings Gain (Loss) Average %	-1%	-31%	-47%
Offerings Gain (Loss) $ Millions	-$141	-$3,454	-$2,984
Market Cap Gain (Loss) * $ Mil	$3,403	-$4,750	-$4,017
Investment Banking Fees $ Mil	$1,095	$633	$360
Other Offering Expenses $ Mil	$451	$273	$145
Total Offering Fees $ Mil	$1,546	$906	$505

	All Offerings		
	All	**In Capital Loss**	**In Capital Loss > -20%**
# Offerings	286	169	88
Offerings $ Millions	$34,971	$19,085	$10,246
% of All Offerings	100%	59%	31%
Offerings Gain (Loss) Average %	0%	-28%	-44%
Offerings Gain (Loss) $ Millions	$8	-$5,338	-$4,502
Market Cap Gain (Loss) * $ Mil	$2,734	-$10,923	-$10,081
Investment Banking Fees $ Mil	$1,847	$1,024	$558
Other Offering Expenses $ Mil	$591	$346	$189
Total Offering Fees $ Mil	$2,439	$1,370	$746

* Market Cap Gain/Loss
= Estimate based on % gain/loss relative to first offering price in period X current market cap.

Investment banks, securities lawyers and accountants have made $2.4 billion of fees on $35 billion of IPO and secondary offerings of business income trusts since January 1, 2001. The size of the offerings market was one third of the total market capitalization of business income trusts today. Yet investors in these business income trust offerings have capital losses overall.

There is still a 30% premium in the business income trust market compared to the TSX/S&P60 and my sample of 20 non-cyclical public corporations. Income trust income yields are too low at 7% compared to U.S. junk bonds at 8.6% I am expecting another $10 to $20 billion in capital losses in business income trusts alone. Energy income trust will have more capital losses as more cut their distributions and their premiums relative to energy corporations are wrung out.

I do not support extending the grandfathering period because sophisticated owners will take the 6% rally from an announced extension to dump their positions onto new seniors and other unsophisticated retail investors.

The % damages from the Income Trust Tax Plan is only 10% because 40% of the owners are in taxable accounts where there is no change in combined business and personal taxes.

Distribution of Income Trusts Ownership				
% of Income Trusts Owners	40%	40%	20%	
Capacity to Pay Premium Due to Tax Advantage				
Urquhart	0%	20%	39%= 47% to 30%	16% = 17% to 14%
% Capital Loss Impact Maximum				
Immediate Implementation	0%	-16%	- 32%	-13%
4 Year Grandfathering	0%	-11%	- 27%	-10%
10 Year Grandfathering	0%	0%	- 20%	- 4%

40% of the owners are in tax deferred accounts, where the maximum damage is 11% for the 4 year grandfathering period. The weighted average contribution of tax deferred accounts to overall damage is about 5%.

There is no double taxation of either corporate dividends or post 2011 trust distributions when one takes into account the generous tax benefits already contained within RRSPs and pension funds. The upfront contribution deduction and not paying taxes on investment income within the plans more than compensate for the post 2011 trust distributions not receiving the preferential treatment of dividends.

Over a 10 year period, the present value of a $1,000 investment in income trusts within an RRSP is worth 24% more than a taxable account owning the same income trusts. The present value of a portfolio owning corporations, with the same pre tax earnings and 100% payout ratio as the income trusts, would be worth 6% more than a taxable account owning the same corporations.

(The incremental difference between income trusts and corporations is 18%, which I rounded up to 20% for the capacity to pay a premium for income trusts by pension funds in Heads I Win, Tails You Lose)

There is both a short term and permanent loss of government revenues from the ownership of income trusts in RRSPs and pension funds, relative to corporations. For every $1000 invested in income trusts within an RRSP achieving an .investment return of 8.5% pre tax, there is $836 of present value of government revenues collected over 10 years at the top personal tax rate. This is 16% less than the $969 of present value of government revenues that would be collected on the same amount invested in corporations within an RRSP achieving the same pretax investment return. There is permanent government revenue loss after only one year. The permanent government revenue loss increases the longer income trusts are owned within the RRSP.

20% of the income trust owners are foreign, primarily American. The estimated damages from the new tax on Americans is -27% for the 4 year grandfathering period. The weighted contribution of the foreigners to overall damage is about 5%.

Owners of income trusts need to recognize that the US IRS could at any time close its own tax loophole of Americans having their distributions from Canadian trusts treated as "qualified dividends" with a 15% preferential federal tax rate Canadians pay full income tax rates on the same distributions and Americans pay full income tax rates on distributions from U.S. REITS.

The U.S. IRS is foregoing about US $364 million per annum by treating Canadian income trusts distributions as "qualified dividends" rather than income. Closing the tax loophole reduces the U.S. federal deficit and provide greater fairness in the American income tax system. Further, it is unusual for the American Government to be providing such an incentive for American investment in Canadian income trusts, which effectively subsidizes these Canadian businesses.

American Capacity to Pay Premium Due to Tax Advantage

	Corporation	Income Trust - A	Income Trust -B
Profit	100	100	100
Business Tax	(32)	0	0
After Business Tax Profit	68	100	100
Distribution	68	100	160
Withholding Tax	10.20	15.00	24.00
American Dividend Tax Rate	23%	23%	23%
American Personal Tax	15.64	23.00	23.00
Foreign Tax Credit	(10.20)	(15.00)	(15.00)
Net American Personal Tax	5.44	8.00	8.00
Combined Business & Personal Tax	47.64	23.00	32.00
Profit After All Taxes	52.36	77.00	68.00
Capacity to Pay Premium		47%	30%
% Capital Loss		-32%	-23%

CONCLUSION

The winners of income trusts are the vendors cashing out and the investment banks, securities lawyers, accountants and investment managers making billions of dollars in fees. These sophisticated players win, while seniors lose in poor investment returns? The Income Trust Tax Plan limits the exposure of seniors to more billions of capital losses from new income trust conversions at excessive prices. Adding the new prescribed conditions for the reporting of income distributions and special return of capital distributions will increase the transparency of current income trusts. Seniors must never again have an investment product marketed to them on non-GAAP financial measures that are deceptive and considered criminal in the U.S.