Diane Francis
Financial Post

Trusts proposal must be recanted

Diane Francis
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The word is that the Tories are scrambling to find a face-saving compromise after their $30-billion income trust mess.

But the facts are, there can be no compromise. The only sensible strategy is to recant the entire tax proposal and study the issue properly.

As constituted, it is indefensible. Finance Minister Jim Flaherty's policy contains a giant inconsistency. He said he would leave REITs, or real estate income trusts, untouched. A REIT is an income trust for real estate.

REITs were presumably exempted because they are accepted structure and because they exist in most major economies.

And the reason they are accepted is because they make economic, stock market and business sense. Real estate is a commodity that is capital-intensive to acquire and exploit and that is also subject to the perils of price cycles, interest rate volatility and fickle equity markets.

So the flow-through, hybrid nature of an income trust meets most needs.

But Mr. Flaherty's glaring inconsistency is that the same arguments apply to energy and infrastructure income trusts, yet he did not exempt them.

Oil and infrastructure income trusts exist in most major economies because they make economic and business sense, as do REITs. So if REITs should be exempt, why shouldn't energy and infrastructure income trusts?

This topic was tackled by Ned Goodman, of Dynamic Funds and Dundee Financial, in a recent letter to the Prime Minister and Finance Minister:

"In the same way you have chosen to exempt REITs from this tax policy initiative, energy trusts should have been accorded the same treatment on similar grounds. Energy trusts are not a new phenomenon and operate on a somewhat similar basis to REITs. They are largely passive investments where a trust is structured to either: (i) acquire and hold royalty interests in conventional oil and gas, synthetic crude oil or mining properties, or

(ii) acquire and hold shares and/or debentures of a Canadian corporation that carries on a resource business," he wrote.

"Under either scenario, it is a passive investment not unlike the passive role of REITs. Similarly, infrastructure trusts which are clearly passive investments should be accorded like treatment. Therefore, on the same principle that was chosen to exempt REITs, we respectfully suggest that energy trusts and infrastructure trusts should be accorded the same treatment where their primary investment is in Canadian assets," he wrote.

In 1987, the Americans were not inconsistent and they exempted both REITs and their equivalent energy/infrastructure income trusts, which they call Master Limited Partnerships (MLPs).

"The U.S. public MLP market is a significant US$90-billion industry that supports energy and infrastructure businesses involved in exploration, development, mining, refining, transportation and marketing of natural resources," Tom Buchanan wrote to me. He is CEO of Provident Energy Trust, a $3.6-billion Calgary-based trust with assets in U.S. and Canada.

Washington recalibrated the MLPs in 1987 only after a careful review following conversion by some taxpaying business to flow-through vehicles like the MLPs. It was the same issue as here but the Americans were surgical in their reform.

"The existing MLP business trusts were given a 10-year transition period to revert back to corporations and the IRS [Internal Revenue Service] chose to exempt REITs and energy-based MLPs. This has created a very active, growth industry since 1987," he wrote.

In Canada, Flaherty's folly will sandbag the Canadian energy trusts vis a vis the MLPs and result in foreign takeovers of Canadian assets, Mr. Buchanan said.

My current fear is that the Tories will grab the Bloc Quebecois' suggestion for a 10-year delay in an attempt to save face, but this simply won't work. It's also not appropriate.

What should happen is very simple: Energy and infrastructure trusts should be exempt from any new tax, just as REITs are. They should be allowed to grow and flourish and new ones should be created.

The business income trust should be left alone pending an intensive study by people who really understand business and taxes. This may lead to action or not.

As for the energy sector, the damage will be permanent and long-lasting unless the Tories completely recant their intention as quickly as possible.

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Trusts decision damage continues: Was pledge broken to pay for next 1% cut to GST?
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Some government apologists are speculating I have broken ranks with the Conservatives over the income trust debacle because I lost money on them.

That is absolutely untrue.

Here are the facts: For the record, my stock market portfolio increased on the announcement of the policy change. That's because I'm diversified in my holdings and because my dividend-paying stocks advanced to compensate for the immediate losses on my income trusts, which were overweighted in REITs and underweighted in energy trusts.

And it is thought I have broken ranks with Prime Minister Stephen Harper and Finance Minister Jim Flaherty even though I know and like both men.

But the the two are simply wrong on this issue. They are obviously out of their depth when it comes to capital markets and too willing to break promises made to people even if it causes financial harm.

The Prime Minister reneged on his promise to leave income trusts alone. There was no compelling reason for the change, witness the remarks weeks before by the head of the Bank of Canada that income trusts were good for the economy.

Consider the following:

They were told, and believed, the policy would stop tax leakage among Canadians, which didn't exist. Then Flaherty speculated about lowering foreign withholding taxes, exacerbating the only tax leakage that did exist.

On top of it all, they refused to exempt existing income trusts from the tax change planned for 2010 and stopped new trust conversions because of whining about an unlevel playing field by a handful of CEOs who hadn't had time to convert to income trusts.

The Tory about-face also ignored legislation that enshrined income trusts in the four major investment provinces.

It ignored the ascension of the asset class to an S&P/TSX index. And worst of all, it ignored the damage that everyone knew would happen to income trust holders because it had happened in 2005 when the Liberals talked of changing the policy.

Where was the Prime Minister's morality? Where was the Finance Minister's duty of care?

I speculate the promise to income trust holders was broken to keep the promise of cutting GST by another 1%.

Damages are mounting. Besides the $30-billion loss in income trust values, the Tories have left a $200-billion asset class in limbo, harmed the oilpatch and bruised Canada's reputation as a country that won't retroactively change laws.

Now the Bloc Quebecois has broken ranks with the Tories by suggesting a compromise of phasing out income trusts over 10 instead of four years.

I have two problems with this.

I worry that the embattled Tories may cut a backroom deal with the separatists, which is harmful to Canadians. Second, I worry that they don't understand that extending the policy change date to 10 years from four does nothing.

Here's the question: If income trusts face a four- or even a 10-year demise, will they be able to issue debt and securities to fund acquisitions and payment of distributions?

If rules stipulate income trusts cannot issue debt and equity to fund acquisitions and pay distributions they will collapse further in price.

If they are allowed to issue debt and equity and make acquisitions for four or even 10 years, it only postpones the inevitable and will create a riskier investment for those buying their units. In fact, it would be like a ponzi scheme of the last unit investor paying for the existing unitholders' distribution.

Once realized, the units will collapse in price. In other words, a four-year or even 10-year extension with restrictions is a disaster and a four- or 10-year extension without restrictions would be the same.

This is how the real world works. The government has ruined the asset class no matter what it proposes to do unless it promises to reverse its announcement and leave existing ones alone.

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Diane Francis
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Senate, Bloc key to trust policy: Harper's $30B blunder may yet be corrected

Diane Francis
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My least-favourite institutions -- the Bloc Quebecois and the Senate -- appear to be the only means of preventing Prime Minister Stephen Harper's $30-billion income trust policy blunder.

The Bloc Quebecois is calling for the proposed tax on income trusts to occur 10 years hence, not four years as announced by Finance Minister Jim Flaherty.

This means the issue, in a final vote before the House of Commons, could end up in a dead heat: Tories and NDP add up to 153 votes versus the Liberals and Bloc 151 votes plus two independents.

But I think it's in trouble. Several Tory and NDP MPs have said, in correspondence sent to me, they will vote against the proposal.

Then there's the Senate.

If the proposal is packaged as an amendment to the Income Tax Act, which it surely is, then it must be approved by the Senate.

"If it's just a budget issue, the Senate won't deal with it. But if he changes the law on the tax side, that's an issue we can deal with," said Senator Jerry Grafstein, a savvy businessman who understands capital markets. "Facts must come before policy. We want to know the facts. Was there a rationale or was it a loop-de-loop, which can happen in Ottawa?"

At the moment, he gives the government the benefit of the doubt and says there must be compelling facts somewhere. But my sources and research say the government didn't do its homework.

Senator Grafstein wants to see their facts and figures to justify the proposal and then wants to see their plans as to how to transition the income trust sector and minimize impact to individuals. He also wants a factual rationale for the four-year transition period.

"This decision was so profound on our economy that we must be damn sure about what's going to happen in future. And that's why I believe the government must fully explain and there should be a public inquiry to study this," he said.

But the future is not being explained, according to several income trust CEOs who told me their phone calls remain unanswered and the Tories and their civil servants have given no guidance as to what they should be doing, now or ever.

"It's a joke, it's retroactive, it's banana republic time," said one from B.C.

The Bloc's recommendation for a 10-year delay on changing the income trusts may be music to investor ears because it will likely kill the proposal, but Senator Grafstein is not impressed.

"The Bloc doesn't understand these issues," he said. "Where did they get 10 years? Where did Ottawa get four years?"

Ottawa has to explain the facts behind its unknown transitional plans.

And how, having shaved $30-billion off the value of the income trust sector, it is going to prevent the wholesale takeover of these assets by private equity, pensions or corporations that pay little or no tax. Or how will it prevent the confiscation of these assets from ordinary Canadian families to bargain-hunting, leveraged foreign takeover artists?

There are other interesting angles in all of this.

There's the role played by the country's pension funds -- Ontario Teachers, Canada Pension and the Caisse de Depot. They screamed blue murder last year when the Liberals suggested similar changes. But not this year. Perhaps it's because each has earmarked huge amounts for private equity investments. This means the Tory blunder will result in even more tax leakage as small taxpaying investors, looking after their own old-age needs, are replaced by a handful of gigantic pension funds.

And where are the nation's other big players, the Canadian banks? They objected last year but are mute this time around even though they collectively made an estimated $6-billion in brokerage fees creating the income trust sector.

Why haven't they waded into the fray in the name of defending their investor/clients?

Perhaps they are playing politics with the Finance Minister to get some bank mergers approved or perhaps their brokerage outlets will be happy to make billions more in fees helping income trusts restructure or sell out to foreigners or buyout artists who will borrow billions and never pay tax.

Finally, there are politics involved here.

Why would Prime Minister Harper break a firm pledge? Why would he select a Finance Minister without policy experience?

Here's what might have happened: Harper made three important tax pledges to get elected seven months ago: 1. To leave income trusts alone; 2. To cut the GST by 1% immediately; and 3. To cut the GST by another 1% before he left office.

Cutting the GST by 1% cost government coffers $6-billion a year, or nearly half of the entire surplus. The only way to cut the GST by 1% more was to find new taxes and this half-baked proposal was pitched vigorously by a finance official who used to work for a Wall Street firm.

Finally, in this strange situation, I will give the last word to a separatist:

"We want to stop the conversion of companies into income trusts, but we think the transition for existing ones should be for 10 years, not four like the U.S. did and in order to help the individual investors," said Pierre Paquet, Bloc Finance critic in a phone interview. "People bought these in good faith and we believe this is the right thing to do."

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Black & White Photo: National Post, File / Senator Jerry Grafstein.

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Diane Francis
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Tory income trust policy is flawed: Taxing trusts will not lead to tax fairness
Diane Francis
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It's obvious that Prime Minister Stephen Harper, Finance Minister Jim Flaherty and the civil service simply did not do their homework before wreaking $30-billion worth of havoc on the income trust sector.

Even worse than the immorality of breaking a promise people made financial bets on, the Prime Minister et al are absolutely incorrect in assuming their proposal will enhance tax fairness, eliminate tax leakage and increase productivity. It will do the opposite.

The policy is so naive that there should be a full-blown hearing by the Senate into the matter before it's approved. To rush it through, without sufficient examination, would be to exacerbate what can only be described as a massive policy blunder by politicians that clearly don't understand capital markets.

The root of the problem is that the decision was based on analysis by federal officials who regard RRSPs and pensions as tax "exempts" even though they are merely deferral mechanisms. So the numbers were improperly counted when it comes to taxes paid by Canadian income trust unitholders.

Second, the officials apparently missed the real source of leakage -- U.S. income trust owners, who pay only a 15% withholding tax. Not only was this ignored, but Mr. Flaherty even mused aloud that the 15% withholding tax should be even lower than it already is.

It gets worse.

New proposed taxes on income trusts will force them to restructure back into traditional corporations. This will increase the tax leakage.

A Post reader analyzed taxes paid by a corporation, Manulife Financial, and an income trust, CI Financial Trust. Manulife is a $40-billion market capitalization giant and CI Trust, $7.7-billion.

In 2005, Manulife's pre-tax earnings were $4.3-billion and the cash taxes paid were about 7% of earnings. It paid dividends of $926-million to shareholders, who were taxed at 18% rates. So the combined corporations' and investors' tax rates were equivalent to 25%.

By contrast, CI Financial Trust forecasted a 2006 distribution of $570-million and its unitholders would have tax rates of 35%.

Why wouldn't the Department of Finance, the Minister and Prime Minister understand this?

Because Ottawa's analysis dealt with posted tax rates, not with the actual tax rates paid after all the accounting tricks are used.

Corporations duck taxes while income trusts are tax-generating machines because they are constitutionally set up to distribute a majority of their money to unitholders who pay full taxes, except for foreigners.

(If Ottawa finally realizes that leakage is about the foreigners, then it should grandfather existing trusts and require future ones to have foreign ownership restrictions.)

On the issue of productivity, Mr. Flaherty and his Finance Department "pencils" get failing grades again.

The theory of corporate taxation is that by imposing taxes on corporations, they will be encouraged to avoid them by keeping their cash flow then productively redeploying it.

But here's how the real world works:

Corporate managements usually deploy their cash surpluses to overpay themselves. Then they often get involved in unproductive, but tax-efficient, endeavours such as buying back stock, which, not coincidentally, also enhances the value of their own wallets.

In addition, corporations use surplus cash to make sometimes foolish diversifications, acquisitions or sub-optimal investments in their own businesses. The examples are plentiful of such misadventures by cash-rich managements.

Finally, there's the governance issue.

Many of us invested in the trust sector because we were sick and tired of lousy managements getting their sticky fingers on owners' funds. Besides, income trusts have more managerial discipline because they must make regular payments, which imposes on their managements a rigour that is otherwise non-existent.

As one reader summarized: "It is a simple truth that nothing Enron was doing, in terms of reporting as current earnings future questionable returns and concealing liabilities with dubious off-balance sheet debt parking, could have taken place if it was an income or royalty trust and forced to let investors know each and every month how much cash they were going to be getting."

Finally, the biggest blunder of all is that this policy announcement has discounted the income trust sector by $30-billion which represents a huge whack of the economic base of Canada.

This confiscation of value will pave the way for traditional corporations and private equity outfits to pick them off cheaply.

These potential buyers, often foreign, will turn around and borrow huge sums to buy them -- money which will be written off against profits for tax purposes. The resulting leveraged buyout of the income trust sector will cost Ottawa dearly, thus putting more pressure on taxes from ordinary Canadian families.

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Black & White Photo: Dave Chan, Reuters File Photo / Harper and Flaherty two thumbs up: While they may be congratulating themselves for plugging the income trust tax leakage, Prime Minister Stephen Harper and Finance Minister Jim Flaherty get a thumbs down from columnist Diane Francis.; Black & White Photo:

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Diane Francis
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Harper's mistake needs correcting: PM's credibility on the line over income trust rules

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Stephen Harper and his Finance Minister, Jim Flaherty, have destroyed their credibility and unethically sideswiped investors because of a lack of policy imagination in dealing with some of the underlying problems concerning income trusts.

I don't disagree that problems exist and that, obviously now, Stephen Harper's pledge to leave them alone was foolish.

But their approach has been even more foolish and they have, in essence, attacked Bay Street's excesses and unnecessarily harmed Main Street.

While I'm sympathetic with the need for change -- see the underlying hidden problem described below -- I'm totally unsympathetic toward a Prime Minister who breaches his contract with voters. It's even more egregious considering that he could have met challenges and also his commitment by grandfathering existing income trusts and preventing future ones.

Instead he chose to destroy his reputation and tens of billions in value.

This is a blunder that the government must recant and revise soon. One lifeline is going to be extended next week, according to sources, by tax expert Jack Mintz ,who is recommending that the income trusts be restructured over the next decade, not the next four years. This would help a bit.

The real underlying problem regarding income trusts is their popularity among U.S., and foreign, investors who had snapped up some 40% of the total.

At the same time, Main Street was doing the same and some 40% was held in RRSPs.

Herein lies the rub.

RRSPs eventually pay taxes on income trust distributions, so the corporate taxes that trusts don't pay are taxed eventually. RRSPs are a tax deferral system set up by a predecessor Tory regime so that ordinary Canadians could look after their old age themselves.

But the foreign and offshore owners pay only 5% tax.

When distributions cross the border, Ottawa gets a 15% withholding tax according to negotiated tax treaties. In the United States and Britain, this 15% Canadian tax is deductible against their own taxes (already lower than Canadian taxes), thus making income trusts hugely attractive.

In other words, Ottawa eventually got its pound of flesh from Canadian RRSP and non-RRSP holders but could not tax the foreigners beyond 15%.

So the foreigners flooded in and Bay Street obliged by convincing companies to convert to trusts.

Unchecked, this spelled disaster. It would have encouraged foreign ownership and continued to put upward pressure on the Canadian dollar, thus hurting Canadian exporters.

But that was no reason for Harper to do what he has done.

His other choices included reducing taxes on all corporations to level the playing field or renegotiating tax treaties.

The best and most honourable solution was for the Prime Minister to keep his promise by grandfathering the sector already in existence so that people were not financially damaged, further reduce corporate taxes and ask for voters to understand why he had to change his mind.

So why wasn't this done?

I don't know, but there are several likely explanations: Ignorance of options or consequences; a lack of integrity in terms of the importance of keeping promises; or, most likely, an inability to stand up to the Canadian corporate leaders who argued, behind closed doors, that grandfathering was unfair to those who hadn't had time to become income trusts.

None of these are acceptable excuses.

Governments have a right to change future policy direction but not to retroactively tamper with past policies and damage people. And politicians have a right to change their minds, but not to break promises made only months before even if they obviously did not understand the consequences of their pledges.

The whole matter is doubly disappointing because the Tories, unlike the party alternatives, are supposed to understand free enterprise and business. They are supposed to value and enhance the principle of individuals taking responsibility for their lives whenever possible.

Instead, we have a king-sized policy train wreck that had better be cleaned up soon.

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Retroactive trust policy is confiscatory
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Just what was the Prime Minister, and his Tory cabinet, thinking last month when they decided to clamp down on income trusts? Did they honestly believe that the campaign footage of Stephen Harper clearly articulating his pledge not to touch income trusts a few months ago would be forgotten or not be rewound on "YouTube" and every blog around?

While governments have the prerogative to change direction, the retroactivity of this policy is confiscatory. All existing income trusts should have been grandfathered and the door shut on future entries. Instead, the Tories are proposing the stock-market equivalent of the 1981 National Energy Policy, which will end up serving three ends: to limit foreign ownership, impose higher taxes and adversely affect markets without justification.

The near-hysteria over the issue is over-the-top, in as much as it is important to note that income trusts, on average over a period of time since their collective IPOs, have mostly outperformed other asset classes, despite the recent drop in value.

That aside, the Tories have made a monstrous misstep. A promise is a promise and retroactive changes are unjust and are simply shameful business practice.

On the issue of broken promises, it's arguable that Mr. Harper has caused direct damage to investors since his pledge because if he had equivocated people or entities might have otherwise sold or diversified. The broken promises have also damaged corporations who, in good faith, have spent millions restructuring themselves into trusts, only to find that they have four years to spend more in order to try and make their investors whole.

As if all that's not bad enough, the policy is flawed: The jury's still out on the issue of "tax leakage" or whether the income trust phenomena harmed markets or productivity.

Frankly, BCE shareholders would have been significantly better served if the cash flow from the phone company had been distributed to them rather than squandered on dozens of multi-billion-dollar investment boondoggles.

But I digress.

Another insulting aspect of this issue is the spin the Tories have given it, which has, not coincidentally, attracted the support of the New Democrats and the Bloc Quebecois. They are using the corporate-welfare-bum excuse and saying that their measures restore fairness to the little guy in the tax system.

That's just plain bunk.

The "leakage" they took aim at is not corporate income tax avoidance, but at the RRSP deferral policy brought in by the Tories during the 1980s to help the middle class save money for their old age.

Here are the facts: Roughly 40% of income trust distributions flowed tax-free into RRSPs and now the Tory measures will, in four years' time, attack the deferral by taxing 31.5% of the income trust's cash flow headed toward RRSPs.

For those of us who own income trusts outside our RRSP, the measures are tax neutral because the lower distributions will cost us less income tax.

So the Tories are undermining the principle of the RRSP deferral -- a broken promise/tax grab that only a bunch of politicians and civil servants on indexed pensions would conceive of, then implement.

Then there are the other issues of foreign investment mistreatment, as well as claims that trusts damage the economy or markets.

"David Dodge just a week before this was announced said the Bank of Canada had studied income trusts and found them to be efficient for markets," said Garth Jestley, president of Middlefield Capital Corp., in an interview yesterday.

Middlefield manages $4-billion and has been investing in trusts for 20 years. Significantly, it has put tens of thousands of British investors into Canadian income trusts recently, mostly real estate and oil.

"The British investors were offended," he said. "The point is that they were uninterested in this asset class until 2005."

That's when key Canadian provinces extended the same statutory protection to income trusts as corporations enjoyed in terms of limiting liability, he said.

Put another way, this was another signal to investors that income trusts were safe because lower levels of government were also happy to enable their creation through special statutes.

"This encouraged British investors, who had been cautious because of the Lloyd's of London experience with unlimited liability," he said.

So the Tories have not only transgressed the RRSP deferral principle, but have bruised and alienated some foreign investors.

The influential U.S. magazine Barron's put it well when its editorial opined about the fact that Canadians, like Americans, cannot trust governments to maintain stable or sensible tax policies.

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Black & White Photo: Kaz Ehara, National Post, File / British investors introduced to trusts by Middlefield Capital were "offended" by Ottawa's move, chief executive Garth Jestley says.

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