Income Trusts: Just Another Special Interest Group?

We all know that every political, social or economic issue has a special interest group. It is worth asking the question of just how large is the special interest group for income trusts. Many Canadians will be surprised by the answer. Here are some interesting data points on the road to the answer.

Zero

This is the extent of the public disclosure of the analysis behind the Minister of Finance's assertion that income trusts give rise to "tax leakage" and which therefore must be eliminated to achieve "tax fairness". This assertion remains wholly unchallenged by our elected representatives who will be voting on this legislation in a matter of weeks. Meanwhile Canadian investors have experienced losses estimated at $35 billion.

Absent a reversal of Mr. Flaherty's tax proposal, these paper losses will be "crystallized", due to market events that are beyond the control of individual Canadian investors, at some point during the four year phase in of the proposed legislation. Simply extending the phase in to 10 years would only be of marginal help, since investors still would not control the destiny of their investments in the altered fiscal environment.

In its "tax fairness" analysis, zero is the amount of taxes that Finance assumes Canadians pay on RRSP and pension plan withdrawals. How can this be? Withdrawals from RRSPs and pension plans are the second largest source of taxable income for the Government next to income from employment. In 2004 Canadians paid taxes of $9 billion on $52 billion of such retirement income, which is subject to the highest level of personal taxation.

In so doing, the Minister of Finance's analysis has left out 31% of all taxes paid on income trusts, which is the proportion of income trusts held by Canadians in retirement savings accounts. It's no wonder he has reached the wrong conclusion in forming his policy.

Furthermore, Economics 101 teaches us that the returns earned across all RRSP and pension plan investments exceed the Government's cost of borrowing, by definition the lowest cost of capital in any economy. Therefore, to the extent that the Government has to "wait" to collect retirement taxes on trusts, it is being paid a "waiting premium". By properly including retirement taxes in the analysis, Mr. Flaherty would learn that income trusts are tax neutral, even without regard to the waiting premium.

Bad policy emanates from bad analysis.

This policy will only serve to eliminate choice -- an important investment choice many Canadians to date have made and a choice that many Canadians in the years to come will regret was taken away from them by Mr. Flaherty in 2006, as they too undertake the difficult task of providing for retirement income.

6

This is the number of Canadian bank owned dealers who were responsible for creating the market for this "Made in Canada" source of capital by underwriting 90% of all income trust financings during the past 10 years, amounting to $92.5 billion of investment capital for Canadian businesses and resource companies. It's interesting to note that we didn't need the services of foreign investment dealers to create this vibrant new market.

42

This is the number of companies that are members of the Coalition of Canadian Energy Trusts. In response to Mr. Flaherty's announcement they stated: "The announcement had a serious impact on the investments of hard working Canadians. We are focused on finding solutions to the problems created by the announcement."

111

This is the number of companies that are members of the Canadian Association of Income Funds. CAIFs position? "Income trusts are a vital form of savings for millions of people in this country. From young, working Canadians investing in RRSPs to fund their retirement, to pensioners relying on distribution payments from trusts, years of hard work and sacrifice have been undermined as a result of the government's announcement."

250

This is the number of publicly listed income trusts in Canada. With a market capitalization of $200 billion (pre-Flaherty), income trusts represent 10% of the value of the TSX and the 42 underlying royalty trusts are responsible for 20% of Canada's oil and gas production. Canadian income trusts employ 250,000 Canadians and generate significant economic growth, productivity and reinvestment across Canada.

This reinvestment is, however, subject to ongoing access to the Canadian capital markets, something which is in serious jeopardy in the post-Flaherty income trust world. Mr. Flaherty recently realized this himself and his remedial proposal is to enhance the tax efficiency to US investors of investing in the Canadian economy by reducing the taxes US investors pay to the Government.

The results of this remedial proposal would be in total contradiction to the explicitly stated goal behind Mr. Flaherty's income trust tax regime, which is to "ensure that taxes are not unfairly shifted onto the shoulders of Canadian taxpayers, especially families". Flaherty's proposed solution could be worse than the "problem" it is intended to fix, placing Canada in double financial jeopardy.

1000's

This is the number of members of the National Citizens Coalition. NCC has stated "we believe it is time for the federal government and Finance Minister, Jim Flaherty, to listen to what hard-working Canadians are saying about the proposed income trust legislation".

400,000

This is the number of members of the Canadian Association of Retired Persons, which represents the interests of the 11,000,000 Canadians over the age of fifty. CARP has stated that "the new income trust regime will be a blow to many seniors because of the high rate of returns that income trusts provide" and "seniors are actually enraged, frightened and panicked about potentially losing retirement savings that they count on for the essentials of daily living." Furthermore, "CARP urges the Government to exempt all current income trusts from its new tax regime as it has for REITs."

1,000,000

This is the estimated number of Canadians who have invested in income trusts due to their unique debt/equity hybrid nature. Given that income trusts are uniquely suited to retirement planning, it is not surprising that 31% of all outstanding income trusts (a proportion equal to $62 billion) are held in RRSPs and other pension plans. By eliminating income trusts as an investment alternative, investors are left with the two solitudes of debt and equity. Unlike in the U.S., Canadians saving for retirement do not have near-investment alternatives like the Tax Free Municipal Bond market and the enormous US High Yield market to fall back on.

2,500,000

This is the estimated number of Canadians who either directly, or indirectly through a mutual fund, own income trusts. Because portfolio diversity is an important way to reduce market risk, a large number of dedicated mutual funds have been created to assist Canadians who seek to invest in income trusts in a prudent way. All of these funds will have to be dismantled or seriously reorganized under Mr. Flaherty's proposed tax regime.

11,000,000

This is the estimated number of Canadians over the age of fifty, our country's fastest growing demographic group. The greatest single challenge this group faces is being adequately prepared financially for retirement.

Unlike the policy makers and MPs in Ottawa, who are members of fully indexed Government backed pension plans, and those in the employ of the federal public service, 70% of all Canadians are not participants in any defined benefit pension plan; many who are find that their plans are underfunded.

It should be no surprise that, given this enormous unfilled need and today's protracted low interest rate environment, many Canadians found great benefit in investing in income trusts. Prior to Mr. Flaherty's announcement, Canadians had taken the Conservative government at its word concerning income trusts -- that "trust" proved costly. Estimates range from $35 to $40 billion in lost value, equal to about 7.5 Softwood Lumber Disputes. Ironically, this was not the capricious act of a foreign government, but rather a capricious government, foreign to the needs and realities of Canadians saving for retirement

Even greater than the monetary loss inflicted by Mr. Flaherty is the loss of financial choice that Canadians will have, today and in the future, in providing for retirement. This leads us closer to our answer.

32,775,708

This is the current estimate of Canada's population at the time of writing. This is the "special interest group" which is affected by Mr. Flaherty's income trust policy proposal. Mr. Flaherty's proposal will kill the income trust market and in so doing eliminate an important and unique investment choice that many Canadians currently have and will, in future, wish they had as they prepare for retirement.

32,775,708 is very close to the final answer, however certain deductions have to made. It is not yet clear how many of the 308 elected members of Parliament belong to this special interest group. Their vote on the upcoming income trust legislation will determine whether they truly represent the interests of the other 32,775,400 Canadians they purport to represent.

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