

"INCOME TRUSTS AND OTTAWA: *DEJA VU* ALL OVER AGAIN?"

by *Patrick Kim*

Vice President, Investments, KBSH Capital Management Inc.

Will the income trust market become a victim of its own success? With the recent and rapid succession of very large income trust conversions (i.e. Telus Corp. and BCE Inc.) the too familiar question arises yet again: What should the federal government do about income trusts?

Rather than negatively viewing the recent developments as causes for national concern, such high-profile conversions may actually be the catalysts that lead to reduced corporate taxes, more efficient capital and investment decisions, and a more competitive Canadian corporate sector.

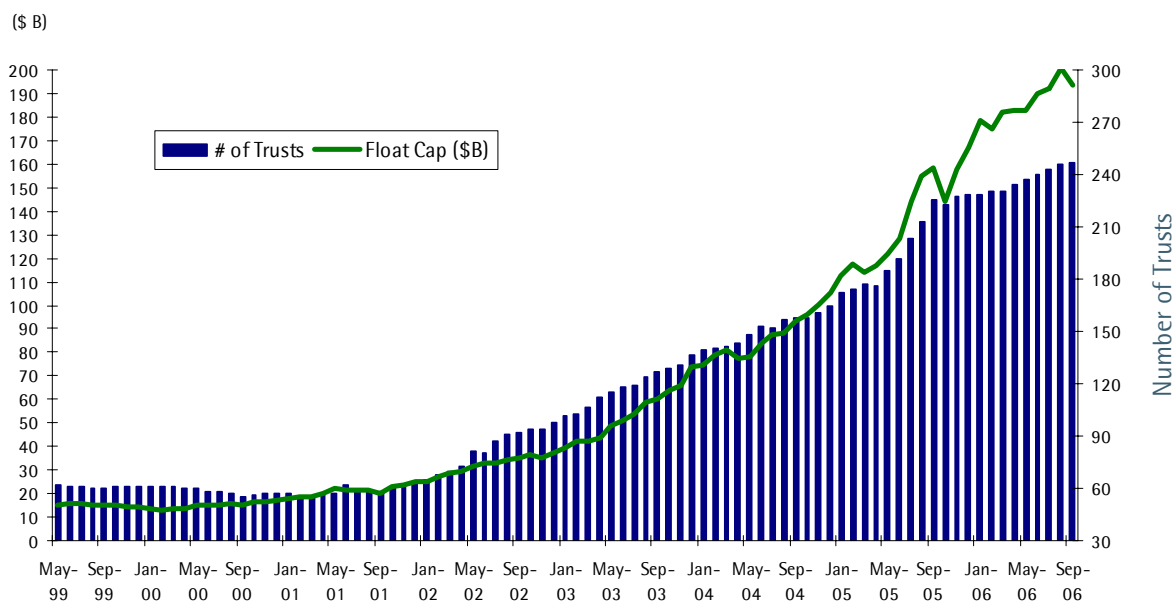
- *Income trusts are inherently more tax efficient versus corporations,*
- *Any short-term tax revenue losses at the income trust level should be viewed in the context of higher tax revenues from investors as well as the greater wealth created by conversions,*
- *There is no evidence that income trusts have harmed productivity or innovations in corporate Canada; lower costs-of-capital have strengthened Canadian businesses.*



CAPITAL
MANAGEMENT

We are reiterating our view that, on balance, income trusts have had a strong positive impact, not only for the Canadian capital markets, but also for the broader Canadian economy. The federal government should consider the full scope of benefits this sector of our economy has provided. In many ways, the income trust structure represents a success in efforts to eliminate the inefficiencies of double taxation that we still witness today with many Canadian corporations. Why would the government want to discourage a structure that is inherently more efficient? We concede that income trusts may continue to enjoy a cost-of-capital advantage against traditional corporations due to the avoidance of double taxation. However, it would make more sense to address the unfairness and inefficiencies of double taxation in order to "level the playing field".

EXHIBIT 1: THE GROWING INCOME TRUST MARKET



Source: Scotia Capital

TAXES

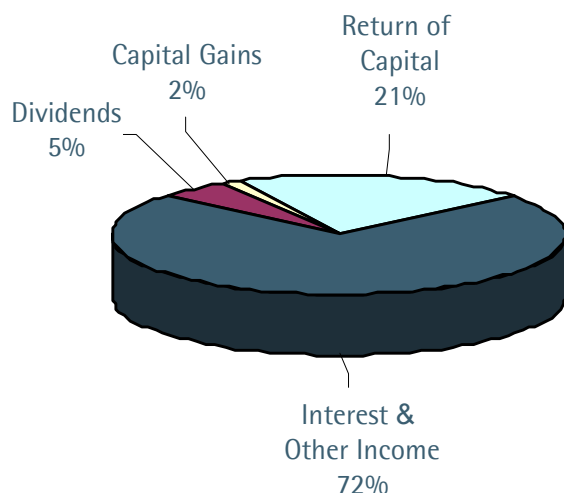
There continues to be characterization of income trusts and their investors as tax "avoiders". This understates the large contributions by the millions of Canadians who, directly or indirectly, invest in income trusts. Investors certainly do pay income taxes on their income trust holdings, not only on cash distributions received, but also on significant capital gains. For instance, the conversion of BCE and Telus will trigger tremendous capital gains liabilities by long-time shareholders even though there will be no economic disposition.

Several economists have estimated the annual "tax loss" to Ottawa due to income trusts in the \$500 million range. Proforma for BCE and Telus, this figure could rise as high as \$2 billion. When trying to gauge political appetite for another confrontation on income trusts, it is important to keep in perspective that this hypothetical \$2 billion represents only 6% of the annual corporate income taxes

collected by the federal government. Also recall that the Minister of Finance recently announced a \$13 billion federal surplus.

We believe that these estimates of "tax losses" could be significantly overstated, given that much of this analysis is one-sided, focusing on the taxes sheltered at the income trust level. The majority of the cash distributions payable to unitholders are taxable, usually in the form of interest income, dividend income, business income or capital gains. In fact, for many Canadian investors, a dollar of income trust distribution will attract a HIGHER effective tax rate versus the same dollar received as a traditional corporate dividend. We estimate that the income trust market will distribute over \$19 billion in cash distributions to its public unitholders in the following year.

**EXHIBIT 2: 2005 AVERAGE DISTRIBUTION COMPOSITION FOR TAX PURPOSES
DIVERSIFIED BUSINESS INCOME TRUSTS**



Source: CIBC World Markets

PRODUCTIVITY AND GROWTH

The income trust market includes some of the best-managed businesses, highly respected not just at home, but across the world. For example, income trusts such as Yellow Pages Income Fund, RioCan REIT and Enerplus Resources Fund have established very long operating histories and prominent positions on a global market scale. Individual Canadians use products and services from these businesses on a daily basis, from the electricity in our homes, to the office buildings in which we work, to the pizza we'll pick up tonight. Income trusts represent a broad cross-section of the Canadian economy.

The idea that income trusts cannot reinvest is a false generalization. There are almost 250 current income trusts listed on the TSX, in a multitude of industries. Many income trusts have maintained market leadership positions for decades in competitive markets. The Canadian capital markets have shown a willingness to support income trusts that either: i) seek external financing or ii) retain a

significant portion of operating cash flows for growth initiatives. As examples, we put forward Energy Savings Income Fund and Sleep Country Canada Income Fund, income trusts which have grown their businesses many times over with no evidence of having been restricted because of their structure.

Due to growing demand from investors for sustainable and regular income, many income trusts enjoy a relatively lower cost-of-capital, which may actually encourage growth initiatives. Certain income trusts, such as Vermilion Energy Royalty Trust, BFI Canada Income Trust and Trinidad Energy Services Income Trust have made significant acquisitions outside of Canada, making Canadian unitholders the owners of growing businesses across the world.

We believe income trusts are compatible with innovation, entrepreneurship, increasing productivity and growth because these qualities are present in Canadian investors, the ultimate owners of income trusts. The income trust sector has brought about a more leveled balance of investment decision-making abilities between investors and corporate managers.

CONCLUSION

We believe the current Conservative federal government will take a more positive view on the income trust market compared to the decidedly hostile tone adopted by the previous Liberal government. We do acknowledge that the income trust structure continues to offer a cost-of-capital advantage versus the traditional corporation and concur that there should be greater equalization. However, the current federal government (and even the former Liberal government) has indicated that the most efficient way to handle this imbalance is to reduce the tax burden on corporations and their shareholders as opposed to introducing additional taxes on income trusts and their unitholders.

We expect the future will include more income trusts in Canada – and that may not be such a bad thing.

KBSH Capital Management Inc. operates as an independent, wholly owned subsidiary of Rockwater Capital Corporation. This report was prepared by KBSH Capital Management Inc. with information obtained from public sources believed to be reliable, but KBSH makes no representation as to the accuracy or completeness of such information. Opinions expressed constitute the current judgment of the author as of the date of this report. They do not necessarily reflect the opinions of KBSH and are subject to change without notice. KBSH has no obligation to update or amend this report or to otherwise notify a reader thereof in the event that any matter, opinion or forecast set forth herein, changes or subsequently becomes inaccurate. This report is provided for informational purposes only. It is not to be construed as an offer to buy or sell or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular investment strategy in any jurisdiction. Copyright ©2006 KBSH Capital Management Inc.



CAPITAL
MANAGEMENT

TORONTO
(416) 863-1433

MONTREAL
(514) 499-5274

HALIFAX
(902) 421-1564