RBC Dominion Securities Inc.

Dirk Lever, CA (Analyst)
(416) 842-7908; dirk.lever@rbccm.com

Fergal Kelly, CA (Analyst)
(403) 299-6576; fergal.kelly@rbccm.com

Walter Spracklin, CFA (Analyst)
(416) 842-7877; walter.spracklin@rbccm.com

Tal Woolley (Analyst)
(416) 842 7857; tal.woolley@rbccm.com

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INDUSTRY | COMMENT

MARCH 5, 2008

Income and Royalty Trusts

Writing One Wrong...More to Go

In the Federal Government's Budget of February 26, 2008, changes were proposed to the provincial tax rate embedded in the Trust Tax, which takes effect for year-ends after December 31, 2010.

- The original legislation called for a notional provincial income tax rate of 13%; a rate that did not mimic the provincial corporate income tax rates in most provinces. (Some were higher, and some were lower.)
- **What the Federal Government proposed is similar to current corporate income tax legislation**; a trust's taxable income will be allocated to provinces and the applicable provincial corporate income tax rate will be utilized. Taxable income is allocated based on the weighted average of revenues and salaries applicable to each province. If there are amounts not allocable to a province a rate of 10% will be utilized (squaring off with the Federal Government's push to reduce provincial income tax rates to 10%.)
- **There remains some very interesting differences between trusts and corporations**. The Trust Tax is applied against the taxable portion of cash distributions paid for year ends after December 31, 2010. To the extent that a portion of a cash distribution is not made from taxable income (a "return of capital"), the Trust Tax does not apply. In addition, to the extent that taxable income of the trust is not paid out in the form of a distribution, the trust is taxed at the top marginal income tax rate of an individual.
- **We are not debating the Trust Tax, but point out three areas where we believe the Trust Tax has highlighted issues in the Canadian income tax system:**

1. **Trust Rollover Provisions** - Trust rollover provisions are to be provided eventually, but are needed immediately.
2. **Double Taxation** - Dividends (and soon trust distributions) earned in a Canadian pension fund are effectively double taxed; pension income is taxed in full when paid to retirees, without the benefit of the dividend tax credit. Canadian pension funds should be provided the dividend tax credit. At a minimum, RRIFs and other retirement annuities should be allowed to participate in the same tax credits extended to taxable Canadians.
3. **Forced Collapse of RRSPs** - The lifespan of an RRSP (currently forced to be collapsed at age 71) should be revised such that it may be coterminous with the life of the beneficiary, allowing the beneficiary to determine how to drawdown their plan portfolio to best suit their financial needs.

Writing One Wrong…More to Go

Provincial Thinking

In the Federal Government's Budget of February 26, 2008, changes were proposed to the provincial tax rate of the Trust Tax, which takes effect for year-ends after December 31, 2010. As we pointed out numerous times, the original legislation called for a notional provincial income tax rate of 13%; a rate that did not mimic the provincial corporate income tax rates in virtually any province. Particularly out West, the actual proposed provincial income tax rates for 2011 were lower than the notional 13% income tax rate embedded in the Trust Tax legislation. Even the Federal Government's proposed corporate income tax rate reductions encouraged the provinces to reduce their corporate income tax rates to 10% by 2011, yet the notional trust tax rate was held at 13% (hardly setting a good example). In many provinces, the provincial income tax rate discrepancy was significant enough that trusts would be penalized for their structure; in order to save income taxes, managers would be forced to convert to corporate form once tax pools were depleted.

What the Federal Government has proposed is effectively taking a page right out of corporate income tax legislation; allocating a trust's taxable income to the provinces and applying the applicable provincial corporate income tax rate. Provincial allocation is determined by taking the weighted average of the trust's revenue and salaries in each Province. If revenue and salaries are allocable to a location outside of a Canadian province, then a notional income tax rate of 10% will be used. In Exhibit 1, we provide an example of the proposal; anyone who has prepared corporate income tax returns will be familiar with the computations.

Exhibit 1: Provincial Taxable Income Allocation (example for 2012)

Assumed Taxable Income: ($MM)	$132.6 Revenue	Salaries	Pro-Rated	Taxable Income	Provincial Tax Rate	Tax Thereon
British Columbia	165.5	2.4	10.7%	16.2	11.0%	1.8
Alberta	953.4	21.0	74.7%	95.1	10.0%	9.5
Saskatchewan	172.3	3.2	12.4%	16.5	12.0%	2.0
Manitoba	30.1	0.3	1.7%	3.1	14.0%	0.4
Ontario	14.0	0.0	0.5%	1.7	14.0%	0.2
Total Provincial	**1,335.3**	**26.9**	**100.0%**	**132.6**	**10.5%**	**13.9**
Federal				**132.6**	**15.0%**	**19.9**
Combined				**132.6**	**25.5%**	**33.8**

Source: RBC Capital Markets Research

Exhibit 2: Federal and Provincial Corporate and Trust Income Tax Rates

Corporate and Trust Tax Rates	2008E	2009E	2010E	2011E	2012E+
Federal	19.5%	19.0%	18.0%	16.5%	15.0%
Provincial					
B.C.	11.5%	11.0%	11.0%	11.0%	11.0%
Alberta	10.0%	10.0%	10.0%	10.0%	10.0%
Saskatchewan	12.5%	12.0%	12.0%	12.0%	12.0%
Manitoba	14.0%	14.0%	14.0%	14.0%	14.0%
Ontario	14.0%	14.0%	14.0%	14.0%	14.0%
Quebec	11.4%	11.9%	11.9%	11.9%	11.9%
New Brunswick	12.0%	12.0%	12.0%	12.0%	12.0%
Nova Scotia	16.0%	16.0%	16.0%	16.0%	16.0%
Newfoundland	14.0%	14.0%	14.0%	14.0%	14.0%
Trusts that retain taxable income (approx.)				46.0%	46.0%

Source: Department of Finance and RBC Capital Markets estimates

Fraternal Twins

One might think that with this latest proposal there is now little difference between trusts and corporations, but this is not so, there remain some very interesting differences. First, the trust tax is applied against the taxable portion of trust (and public limited partnerships) distributions for year ends after December 31, 2010. To the extent that a portion of a cash distribution is not made from

taxable income (commonly referred to as the "return of capital portion") the Trust Tax will not apply. This is an interesting difference from corporations from an income tax perspective; it is extremely difficult for a corporation to make regular return of capital cash distributions. Almost all corporate dividends are taxable dividends, whether the corporation had taxable income or not. Taxable Canadian investors prefer returns of capital from an income tax perspective; such payments are typically not taxed immediately, but are potentially taxed as capital gains when the security is eventually sold (returns of capital are deducted from the tax cost basis of the investment.) In addition, to the extent that taxable income of the trust is not paid out in the form of a distribution, the trust is not taxed at the Trust Tax rate, but rather at the top marginal income tax rate of an individual, an approximate 15% to 20% of incremental income tax; a tax to be avoided, likely by conversion to corporate form. After 2010, when income tax pools run out, expect corporate conversions.

The Fed's IOU: Time to Deliver, Now

On December 20, 2007, the Federal Government reiterated its intention to allow a tax deferred transformation from trust to corporation, both for investors and the business itself. Effectively, no person or business should incur a federal income tax liability on the simple conversion from trust to corporation. But here is the problem, there is less than three years to go now, and the Federal Government has not produced the needed rollover provisions. In order for trusts to be able to plan their affairs, clear regulations are required. Unfortunately for those trusts that intend to convert to corporate form, they are hindered, as there is no legislation on which to act. Nearly a year and a half after the Trust Tax was proposed (Halloween, 2006) there is still no legislation. Trust managers are likely tired of being asked what they will do, and how they will do it. Politicians that believe they "have dealt with the trust issue" should realize they are not finished. In their wake they appear to have left a trail of confusion and animosity for an important part of the Canadian capital markets.

Trust rollover provisions are needed, and needed now. Trusts will require unitholder approval in order to convert to corporate form, and unitholder approval will require clear plans for the conversion, an information circular prepared, and sufficient time for a meeting to be called – all of which require significant time. The Federal Government is pushing up against time limits for trusts to reasonably deal with the issue. Even if one assumed that the rollover provisions were released in the summer of 2008, it would be too late to tie-in the approval process with 2008 Annual General Meetings. It may not be until 2009 that a clear plan can be drafted, information circulars prepared, and special meetings legally constituted. This cannot happen overnight; lead time is needed. One cannot assume that unitholder approval will even be provided for those looking to convert to corporate form.

Trustees' Dilemma

Consider the dilemma faced by some Trustees; convert now to corporate form, assuming rollover provisions existed, or wait and see if a change of government occurs before 2011 (a change that could reduce the financial burden of the Trust Tax, allowing the trusts to continue much like they had in the past). What Trustees are weighing is the value of a political "call option". Some businesses are ready to convert as soon as the route is cleared, and they should be provided with rollover legislation immediately (is this not what in fact the Feds want?), while others will ponder the political landscape.

Double Taxing Canadian Pensioners?

How is it, as a country, we think it right to double tax Canadian Pensioners? Though not all countries attempt to integrate income tax legislation in order to eliminate double taxation, Canada does. But, there still exists a form of double taxation in the Canadian economy, and sadly it is against a group that can hardly afford to foot the bill; Canadian Pensioners. From recent comments made by senior politicians, it is now apparent that the notion that pension funds (including RRSPs) are "tax-exempt" has been abandoned, and they now concur with the general populace that pension funds are "tax-deferred" entities. (Pension plans themselves are private trusts that do not consume the income generated; rather, the income is retained until it is distributed to the pensioner, with the pensioner taxed on the entire distribution as income.) Pension income is not eligible for tax credits on any taxes paid on income earned by the pension plan, nor is the pension plan itself eligible for a tax credit. Thus, a portion of pension income is subject to double taxation; most pensioners are sadly unaware.

Trusts Avoided the Double Tax Trap

Many taxable Canadian investors were aware that the trusts did not "avoid income taxes" at all, as the underlying taxable income of the trust was taxed in the hands of the unitholders, either immediately, or when the funds were paid out of the pension fund. Investors voluntarily assumed the liability for tax; it was part of owning a trust, and nobody was forced into it. The Federal Government's notion that individuals were being saddled with higher income taxes because the business itself did not pay income taxes ignored the point that investors voluntarily assumed the underlying income tax liability. Within Canada, there still exists a misunderstanding of the facts surrounding the taxation of Trusts and Limited Partnerships. The structures helped investors avoid double taxation, which may be why many Canadian investors owned trusts. So obvious was the financial benefit of the trust structure that effective 2006, the Federal Government finally amended the obvious flaw in the dividend tax credit system for publicly traded corporations, a flaw that

existed for years. Even if an investor never "liked" the trust model, they have to admit that the trusts were very good at highlighting the obvious flaws in the corporate income tax system. But flaws in the tax system still exist.

Canadian Pensions Should be Eligible for Tax Credits

Quite simply, tax credits available to taxable Canadian investors (on the payment of corporate dividends and trust distributions in 2011) should be provided to Canadian pension plans in order to eliminate double taxation. Interest income, for which a corporation or trust received an income tax deduction, avoids the issue of double taxation altogether. Some businesses just cannot reinvest all the income they generate, and excess capital is often distributed to investors in the form of dividends. Distributions that themselves have been subject to income tax should not again be taxed when distributed to pension beneficiaries; pension plans should be provided the same tax credit provided to taxable Canadians.

At a Minimum, Full Tax Credits for RRIF's

Many RRSP (Registered Retirement Savings Plan) owners opt for conversion into a RRIF (Registered Retirement Income Fund) at age 71, a form of annuity, as a way to spread out over time the underlying income taxes of the RRSP. Unfortunately, double taxation of corporate dividends (and trust distributions in 2011) also occurs at the RRIF level. At a minimum, those retirees that created RRIFs with trusts and dividend paying corporations as part of their RRIF portfolio, should be eligible for dividend and distribution tax credits, as the financial burden of double taxation is virtually immediate.

Eliminate the Forced Collapse of an RRSP Prior to Death

Most anyone that has an RRSP knows that when they turn 71, they must collapse their RRSP; some annuity options are available to help spread the income tax costs over time. There are reasons floated as to the why and magic of age 71, but it is becoming apparent to many that the forced collapse of an RRSP should be reviewed, especially since the economy has employees past age 71. The irony of an employee unable to contribute to a retirement plan because they are too old is not lost on us. Why have mandatory collapse dates at all? Why not allow the RRSP continue for the life of the plan owner? This way a pensioner can determine his or her own best course on retirement; all income withdrawn from the plan will be taxed in full. On death of the planholder, either a spousal rollover is permitted or the full amount remaining in the RRSP is subject to income tax.

Political Reminders

We are not writing to debate the Trust Tax, as those currently in power have made up their minds; however, we are pointing out three key areas where the Trust Tax has (to use the Province of Alberta's terminology) highlighted "unintended consequences". First, rollover provisions are needed immediately in order that management teams can plan for their future, and can outline these plans to their investors. Consider that corporate conversions will require unitholder approval, requiring planning and lead-time. Provisions cannot wait until 2010; they are needed immediately. Second, double taxation of pension income needs to be addressed, and the proposal on which most agree is to provide tax credits to pension plans. Remember that interest income is not subject to the same double taxation. We can appreciate that such a revision may take some time to study and implement, but even the announcement of such a review would be a step in the right direction. At a minimum, and as a stopgap, RRIFs (and other forms of retirement annuities) should be provided with the same tax credits extended to taxable Canadians. Third, the life of an RRSP should be revised such that it is permitted to be coterminous with the life of the beneficiary (mitigating the need for RRIFs or other forms of annuities), allowing the beneficiary to determine their own financial future. (Most RRIFs last 10 years, at which point the RRSP is completed drained; then what for the pensioner? This can be a terrible predicament for a pensioner, as effectively they are pre-paying income taxes for post age 81 benefits. We believe the RRSP system in general is tremendous, but it does have two key flaws: a fixed collapse date and the double taxation of dividends, and soon, double taxation of trust distributions as well.)

Quick Summary of Proposals

1. **Trust Rollover Provisions are Needed Immediately.**
2. **Eliminate Double Taxation of Income Earned in a Canadian Pension Fund, and at a Minimum, Allow RRIFs and Other Retirement Annuities to Participate in the same Tax Credits Extended to Taxable Canadians.**
3. **Revise the Lifespan of an RRSP Such That it May be Coterminous with the Life of the Beneficiary, Allowing the Beneficiary to Determine How to Drawdown their Plan Portfolio to Best Suit their Financial Needs.**

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