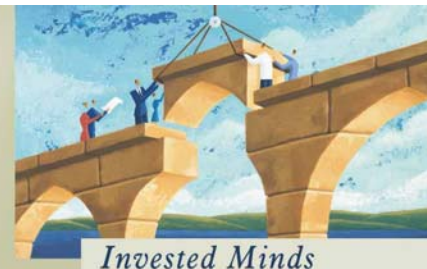




Global Asset Management Inc.

# Market Insight



Invested Minds

APRIL 2, 2004

## Federal budget's curve ball won't strike out income trusts

As far as retail investors are concerned, the federal budget's proposals on income trusts were a home run, having no impact on the near \$80 billion they have invested in this asset class so far -- no tax hikes, no limitations, no changes.

"It's status quo for mutual funds and retail investors," says Gaelen Morphet, TAL Global Asset Management's leading income trust manager. "The budget proposals have absolutely no impact in that playing field, since these investments are ultimately taxed."

What limited attention income trusts did receive was targeted at pension funds. The budget proposal does not change the structure of income trusts, as many feared, and it allows participation in income trust markets by all parties. However, it did restrict investment in business income trusts by pension funds, leaving unfettered access to REIT's, resource and royalty trusts. A pension fund may invest no more than 1% of the book value of its assets in a business income trust, nor may it hold more than 5% of any single business trust.

With all the debate and confusion on what these rules mean and how they will be implemented, TAL went straight to the source for clarification from the Government of Canada's Department of Finance.

### Interpreting the Rules

- All pension pools that held business income trusts on March 22, 2004 will have the full five-year transition period (ten years for directly held investments) to reduce their positions to within restricted limits without penalty.
- Any additional positions purchased after March 22, 2004 that exceed the new restrictions will be subject to a tax penalty of 1% per month if still owned on December 31, 2004 and beyond. This prevents pension fund managers from "stock-piling" their business income trust holdings between now and the effective date of the legislation.
- The spirit of this legislation is to prevent the government from losing tax revenues from business income trusts in the future, not to penalize funds already invested. This is one reason the transition period is so long (five to ten years).

### Key dates include:

- **March 22, 2004:** the day before the budget announcement, this represents the benchmark date for measuring violations
- **January 1, 2005:** the effective date of the proposed legislation
- **December 31, 2009:** the end of the five-year transition period, after which the 1% per month penalty applies to all violations made by pooled or indirect investments.
- **December 31, 2014:** the end of the ten-year transition period, after which the 1% per month penalty applies to all violations made by direct investments.

### Examples may help explain how these restrictions and subsequent penalty taxes will be implemented for pension funds.

#### Example A:

On March 22<sup>nd</sup>, Pension Fund A held 3% of the book value of its assets in a restricted business trust. It does not add to this, nor to any other business income trust position, after March 22<sup>nd</sup>.

Pension Fund A will have the full five-year transition period -- until December 31, 2009 to reduce its business trust position to 1% of the book value of its assets before it is subject to any penalty tax.

Not only the book value, but also the composition of the investments must be identical to the March 22<sup>nd</sup> portfolio in order to be exempt from penalty during the transition period. That is, Fund A could not change which business trusts its 3% is invested in and still avoid penalty.

#### Example B:

On March 22<sup>nd</sup>, Pension Fund B held 1% of the book value of its assets in a restricted business trust. Before the effective date of January 1, 2005, Fund B purchases an additional 1% in another restricted business trust.

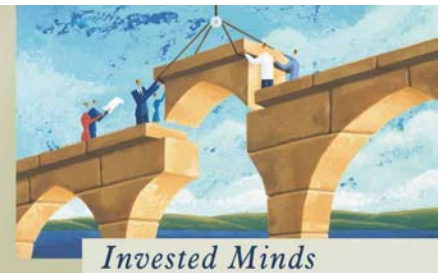
Effective January 1, 2005, Pension Fund B will be subject to a 1% per month penalty tax on the investment made in the restricted trust after March 22<sup>nd</sup>. It must continue to pay this tax until the book value of its total investment in restricted business trusts is 1% or below.

*These rules apply in the same way to the restriction preventing pension funds from holding more than 5% of any single business trust.*



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## Loud Bark, No Bite

“Cutting through all the noise, we doubt this will materially change the landscape in the income trust market, since pension funds often find more suitable investment opportunities in those income trust sectors that have been excluded from any restrictions,” says Morphet. “With a few notable exceptions, such as many of the power companies, we believe the newer business income trusts generally do not have proven track records, are very small, and are often unsuitable for the conservative risk profile of a pension fund anyway.”

The proposed changes specifically target business income trusts and not the other income trust sectors where TAL’s pension investments in income trusts are more heavily weighted.

After speaking with the Department of Finance official, it appears that the spirit behind the legislation means the new rules will not restrict investment into any trust if the pension fund could directly invest in the underlying asset, such as real estate, or mines. This is why REITs, resource and oil & gas royalty trusts are specifically excluded from any restrictions.

“They are incorporating our feedback, and the feedback of other industry professionals in determining which income trusts will be classified as business trusts for these purposes,” says Morphet. “At this point, we do not believe that a limited appetite from pension funds in the business trust sector will have a material impact on the overall income trust market, nor do we believe that limited access to the business trust sector for pension funds will eliminate credible opportunities for them in the income trust market.”

The Department of Finance has also indicated that endowments and foundations, which are defined separately from pension funds in the Tax Act, were not the intended target of this legislation.

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## Watch for Index Inclusion Implications

This development is likely to have the greatest impact on the issue of S&P/TSX Index inclusion. Until now, the unlimited liability characteristic of income trusts was the largest roadblock keeping income trusts out of the index. We expect proposed provincial legislation addressing this issue to pass, eliminating the unlimited liability roadblock in Ontario and pushing income trust inclusion to the forefront of the TSX agenda as early as 2005.

Given recent developments, we expect there will now be some debate as to whether to include business trusts in the Index at all. According to a report published by TD Newcrest, if the S&P/TSX were to include royalty trusts and REIT’s, the impact on the Index would still be very significant, with 29 trusts qualifying for inclusion – an estimated index weighting of 4.56%. This compares to 45 trusts and a 6.36% weighting if all trusts that qualify, including business trusts, are added.

“At the end of the day, this intervention is more than most of us believe was necessary, but it’s one of the least intrusive actions the government could have taken aside from doing nothing,” says Morphet. “We will be following these issues closely, actively working to ensure that pension fund opportunities in the income trust market continue to be positive.”



**Gaelen Morphet and her team at TAL Global Asset Management are responsible for more than \$1.0 billion in income trust investments, in both retail and pension investment plans. She has been following this market for more than eight years, making her one of the most experienced income trust investment managers in Canada.**