

Al Hudec
Davis & Company LLP

RESPONDING STRATEGICALLY TO THE NEW TRUST TAX

1

Responding Strategically to the New Trust Tax



2

Life is Now Fundamentally Different

<i>Pre-Hallowe'en '06</i>	<i>Post-Hallowe'en '06</i>
<p>"Tax advantaged" publicly traded business</p> <ul style="list-style-type: none">▪ no entity level tax▪ valued on a multiple of distributable cash▪ low cost of capital	<p>You are now a "SIFT"</p> <ul style="list-style-type: none">▪ taxed at corporate rates on Canadian-sourced 'non-portfolio earnings'▪ valued on an EBITDA multiple basis▪ punitive tax on retained earnings

4 Months Have Passed

- What are the strategic alternatives available?
- What questions should you be asking?

Annual MD&A Due April 2nd

- *CSA Staff Notice 41-304 -Income Trusts: Prospectus Disclosure of Distributable Cash*
- CSA Staff Notice 52-306 (revised) (*Non-GAAP Financial Measures*)
- CICA Draft Guidance on Distributable Cash Disclosure in MD&A – Published Nov 6/06

Immediate Responses

Normal Course Issuer Bids	Unitholder Rights Plans
<ul style="list-style-type: none"> • BFI Canada – Nov. 6/06 • Premium Brands Inc. Fund – Nov. 15/06 • Contrans Income Fund – Nov. 17/06 • Trilogy Energy Trust – Nov. 10/06 • Teranet Income Fund – Nov. 14/06 • Newport Partners – Dec. 8/06 • Amtelecom Income Fund – Dec. 8/06 • Phoenix Technology Income Fund – Dec. 15/06 • Clearwater Seafoods Fund – Jan. 19/07 • ATS Andlauer Income Fund – Jan. 15/07 	<ul style="list-style-type: none"> • Canadian Helicopters Income Fund • Tree Island Steel • Hardwoods Distribution • Stephenson's Rental • Armtec Infrastructure Fund • Norcast Income fund • Terravest Income Fund

Key Questions to Ask

1. How are your distributions impacted?
2. Can you opportunistically increase your payout ratio?
3. How much flexibility do you have in your capital structure?
4. Can you live within the “normal growth” guidelines?
5. What is your growth strategy?
6. Can you live with the restrictions on permitted financing activities?
7. Can you live with the uncertainty?

1. How are your distributions impacted?

- Canadian-sourced non-portfolio earnings taxed at 32%
- But what is your effective tax rate:
 - Investor composition
 - Foreign-sourced income
 - Returns of Capital
 - Available tax shield

2. Can you opportunistically increase your payout ratio?

- How discretionary is maintenance capex?
- Is there flexibility in the timing of funding of pension obligations/post-closure environmental liabilities?
- Are there opportunities for asset sales?
- Caveat re quality of distributable cash disclosure

9

Can you live within the “normal growth” guidelines?

- What is your growth plan during the transition period – does it qualify as “normal growth”?
- Is it realistic given your increased cost of capital and reduced capital market access?
- How flexible is your capital structure – do you have the capacity to issue additional debt to fund growth?
- If your business plan is predicated on acquisitions to sustain or growth cash flows, early conversion may be warranted

10

Guidance Re “Normal Growth”

- Large trusts (over \$250 market cap) can double size over 4 years under the cumulative 40/20/20/20 safe harbour limits
- Small trusts can more than double their size under the non-cumulative \$50 million/year limit

11

Limitations on Growth

- Rules assume incremental and linear growth – don’t work where growth episodic and lumpy
- Rules key off of units outstanding on October 31st – non-fully diluted

12

5. Can you live with the restrictions on permitted financing activities?

Restricted

- new issues of units
- convertible debt
- DRIPs
- issue of equity to fund foreign acquisitions (not logical)
- “newly developed” substitutes for equity

Non-Restricted

- non-convertible debt
- conversion of the exercise of exchangeables or convertible debt outstanding on Oct 31st
- equity to refinance debt outstanding on Oct 31st – it may be possible to reissue the debt to finance new acquisitions (does this include trade credit and operating lines?)
- mergers of existing SIFTs
- preferred shares of operating subsidiary

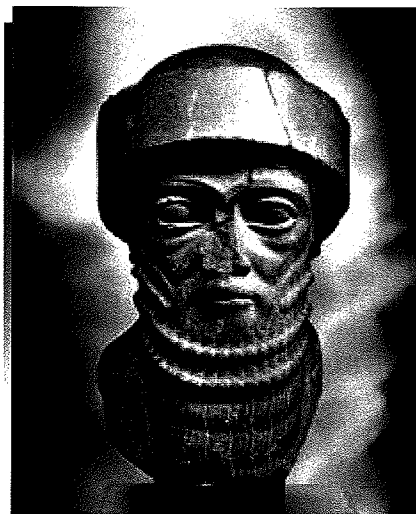
13

6. Can you live with the uncertainty?

- Political uncertainty – Will the new rules be enacted within the tenure of the incumbent government?
- No legislation forthcoming!!!
- How are the guidelines to be interpreted and applied? They are vague and devil is in the details
- Will Finance issue comfort letters? (Pengrowth precedent)
- How will Finance respond if the guidelines are *disrespected*?

14

What do Hammurabi and John Flaherty have in common?



15

Absolutely Nothing!

HAMMURABI	JOHN FLAHERTY
<ul style="list-style-type: none">• King of Babylonia, 1780 BC• Inscribed laws on stone for all to see• Called on all future kings to uphold the laws and not govern according to their impulses	<ul style="list-style-type: none">• Finance Minister, 2006• No written legislation• Vague policy guidance lacking in detail• Respect the policy intent or we will change the law retroactively

16

What are the Strategic Alternatives?

1. Stay the course
2. Reconvert to a corporate structure
3. Sale of the trust
4. Going private transaction
5. Trust-on-trust merger
6. Innovative structures

17

Stay the Course

- Optimize your distribution policy
- Vary your capital structure
- Grow within the rules
- Begin to explore eventual conversion, sale or privatization

18

Trusts Continue to Grow

- Algonquin Power – Clean Power
- Newport Partners – Quantum Environmental Group
- CanWel – five lumber pressure treating plants
- Altus – EZRA Consulting
- Connors Bros – Sea Value Company Ltd.
- GeniVar – GLD Experts-Conseils, Kazmar Associates, Martoni, Cyr & Associates, Cochrane Design Group
- Ag Growth – Hansen Manufacturing Corp.
- ProVenture – John Deere properties
- Consumers' Waterheater – PowerStream Inc.
- Parkland – Neufeld Companies
- TransForce – Westfreight
- Amtelecom – Gore Bay Cable TV
- Eveready – Rodrigues Directional Drilling
- Premium Brands – Creekside Custom Foods
- Bell Alliant – Bell Nordiq
- Liquor Barn – 4 stores
- PDM Royalties – Baton Rouge Restaurants
- Contrans – Trifar Transportation
- SFK Pulp – 2 recycled bleached kraft mills

19

Trust Financings Continue

- \$3.9 billion of income trust financings since October 31st (O&G - \$2.4B, REITS - \$1.2B, business trusts - \$0.3B)
- Examples
 - Algonquin - \$60 million convertible debentures
 - Westshore Terminals - \$40 million
 - Arctic Glacier - \$80 million
 - SFK Pulp - \$75 million
 - Newalta - \$78 million
 - Parkland - \$50 million
 - Colabor - \$50 million
 - PDM Royalties - \$25 million

20

2. Convert Back to a Corporation

There are some significant legal differences between corporations and trusts

Corporations	Trusts
<ul style="list-style-type: none">▪ Ability to retain earnings▪ Dividends subject to financial tests▪ Return of capital permitted only in liquidation/substantial reorg or share repurchase	<ul style="list-style-type: none">▪ Retained earnings taxed at highest personal rates▪ No restrictions on distributions▪ Unrestricted ability to return capital

21

Other Significant Differences

- Corporations are growth vehicles, incentivized by tax laws to retain and recycle earnings
- Income trusts are vehicles without the ability to retain earnings, with high payout ratios that appeal to yield-seeking investors

22

Reconversion Reality Check

- 53 business trusts < \$100 million
- 100 business trusts < \$200 million
- Often have no tax pools
- Orphaned by analysts?
- Loss of shareholder constituency
- Access to capital?
- Public company compliance costs

23

The Auction Has Begun!!!

- Halterm - \$172 million sale to Macquarie Infrastructure Partners
- Calpine Power - \$830 million sale to Harbinger Capital
- Lakeport Brewing - \$200 million sale to Labatts
- Norcast - \$87 million sale to Pala Investments
- Entertainment One - \$120 million sale to Marwyn Investments Management
- Great Lakes Carbon - \$437 million sale to Rain Commodities
- SCI – sale of Simmons Canada Inc.
- CanWest – suggested Canwest Income Fund

24

Are you for sale?

Strategic Reviews	Catalyst Toeholds
<ul style="list-style-type: none">▪ Custom Direct▪ Boralex Power▪ Grenow Windows & Doors▪ Movie Distribution Income Fund▪ Cinram International Income Fund▪ Specialty Foods Income Fund▪ ED Smith Income Fund▪ KCP Income Fund▪ Stephenson's Rental Services Income Fund▪ FMF Capital Group▪ Boralex Power Income Fund▪ Hartco Income Fund▪ Entertainment One Income Fund	<ul style="list-style-type: none">▪ George Armoyan – Versacold, Hardwoods, Entertainment One▪ Jerry Zucker – Coast Wholesale Appliances▪ Futura – Tree Island, Hardwoods▪ Harbinger – Calpine▪ Iqbal Kassam (Zynick Capital Corporation) – Stephenson's Rental Services▪ Brookfield – Arcadian Timber Fund▪ Jimmy Pattison - Westshore

25

Alternative Sale Processes

- Public auction
- Private sale

26

Structuring Alternatives

1. Cash take-over bid
2. Shares for units exchange
3. Cash bid for assets
4. Trust-on-trust merger
5. Private equity or management buy-out
6. Creative alternatives

27

1. Cash Bid

Canadian residents

- Unit holders indifferent between bid for units and bid for the fund's underlying assets (ie. securities of sub-trust, corp or L/P)
- Disposition of units triggers capital gain

Non-residents

- Bid for units preferred – no capital gains tax if not Cdn taxable property
- Bid for underlying assets followed by distribution of cash – subject to withholding

28

2. Shares for Units Exchange

- The purchaser corporation acquires trust units on a tax rollover basis – s.85(1) election (or if the purchaser is foreign, use an exchangeable share transaction)
- As a critical second step, the purchased trust must be terminated by year end when it ceases to be a 'mutual fund trust'

29

3. Purchase of Assets/Redemption

- Cash purchase of securities of underlying operating entity
- Cash redemption of units
- Distribute cash proceeds – gain allocated to unit holders, non-taxable portion of gain retains its characterization (Non-residents – withholding)
- Termination of trust is deemed disposition of units, but proceeds don't include income allocated from redemption
- One step transaction
- Bump in the tax cost of the trust's interest in its subsidiaries to fair market value
- Acquisition of control rules don't apply to trust mergers

30

4. Trust-on-trust mergers – s.132.2

- The purchasing trust acquires the assets of the target trust in return for units of the acquiring trust and the assumption of the target's debt
- Since there are no loss carry forward provisions available to merging trusts, the target trust must trigger any available gains to absorb its available tax losses
- Within 60 days of the asset transfer, the target acquires its units for cancellation, in exchange for units of the purchasing trust
- The two trusts jointly elect to have section 132.2 of the *Income Tax Act* apply

31

5. Are you a candidate for a management buy-out?

- Management team partners with private equity to go private
- Preserves the tax benefits (non-listed partnerships are not SIFTs)
- Avoids the regulatory burden of a public listing
- Energetic management team
- Significant retained interests
- Valuation and Minority Approval requirements
- Conflicts - Who will lead the process?

32

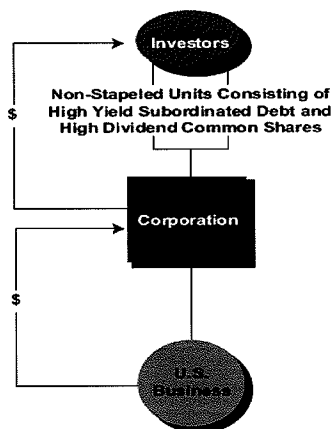
6. Creative Alternatives

- Feed the demand for yield
- Discipline management with a high payout ratio
- Resolve the “lack of integration” problem for tax-exempt and non-resident investors

33

Paper-Clipped Units

IDS Structure



34

"Hungry for Yields, Investors Branch Out"

Stingy Payouts on Traditional Investments Prompt Funds to Seek Income Through Foreign REITs and Other Exotic, Riskier Fare

By ELEANOR LAISE

FOR SOME investors, it's all about the yield—especially with the stock market's wobbly performance in recent days. With everything from long-term Treasury bonds to dividend-paying stocks offering relatively low payouts, a growing number of people are pursuing aggressive new strategies to generate income.

Among the strategies gaining favor with income-hungry investors are publicly traded energy partnerships, foreign real-estate securities and more-rapid trading of dividend-paying stocks. Mutual funds and closed-end funds—which have a fixed number of shares that usually trade on an exchange—are quickly adopting these strategies as they aim to attract baby-boomer investors who are on the brink of retirement and eager to generate a steady stream of income.

The new strategies give investors a relatively high and rising stream of income—and the potential for investment gains—at a time when many traditional income-oriented investments offer lackluster yields. But they also come with potential pitfalls that investors in money-market funds and Treasury bonds don't have to think about, and greater levels of risk.

Beyond Bonds

Income-oriented investors are finding new ways to generate yield—while taking on new risks:

- Some new funds move money among **dividend-paying stocks**, aiming to collect as many payouts as possible.
- Other new funds are investing in a fast-growing group of **foreign real-estate securities**.
- Publicly traded partnerships with attractive distributions are raising record amounts from investors.

Alpine Total Dynamic Dividend fund and Eaton Vance Tax-Managed Global Diversified Equity Income fund, both launched in recent weeks, employ a trading-oriented dividend-hunting approach and raised record amounts for U.S. closed-end fund initial public offerings. A number of funds, including Diamond Hill Strategic Income, are increasingly investing in publicly traded partnerships as part of their strategy to produce income. And fund companies like Franklin Templeton Investments, Cohen & Steers Inc. and ING Group NV's ING Funds have recently rolled out new funds investing in foreign real estate.

Though dividends generally have become more attractive thanks to the 2003 tax-law changes, which lowered the top tax rate on qualified dividend income to 15%, much of the income produced by the new strategies doesn't qualify for this lower rate. Foreign investments can be pummeled by currency fluctuations or political upheaval. Rapid trading can lead to hefty tax bills and increased trading costs, which take a bite out of returns.

Yet unconventional income-producing strategies are gaining prominence as traditional sources of income look less and less attractive. A 10-year Treasury note currently yields just 4.5%, after yes-

Please turn to page D3

The Wall Street Journal, Feb. 28, 2007

Continued from page D1

terday's sharp rise in Treasury prices. That's less than many shorter-term certificates of deposit and money-market accounts. And the yields on junk bonds, which are issued by companies with lower credit ratings—and traditionally offer investors substantially higher yields in exchange for taking on greater risk—are very low relative to Treasury bonds.

While many income-seeking stock investors turn to utilities and real estate investment trusts, or REITs, those sectors are now highly valued and offer relatively low yields, many advisers say. And dividend-paying companies are increasingly reluctant to boost their payouts. The number of Standard & Poor's 500 companies raising their dividends so far this year is down about 1% from the same period last year.

Here's how some funds are pursuing bigger payouts:

■ **Dividend capture.** A number of new funds are aiming to boost their dividend income by rapidly moving money among dividend-paying stocks. In this "dividend capture" strategy, a fund typically buys a dividend-paying stock, holds it long enough to qualify for the next dividend payment, then sells it and uses the proceeds to purchase another stock expected to pay a dividend in the near future. The strategy

Raising the Yield Bar

Funds are finding new ways to generate income at a time when many traditional investments offer disappointing yields. Below, some offerings that use more-exotic—if riskier—income strategies.

Fund (Ticker)	Type of Fund	Strategy
Alpine Total Dynamic Dividend (AOD)	Closed-end fund	Aims to invest in foreign and domestic companies with the potential to increase dividends. Uses a "dividend capture" strategy that involves moving money relatively quickly among dividend-paying stocks.
Claymore/Zacks Yield Hog (CVY)	Exchange-traded fund	Aims to track the Zacks Yield Hog Index, which includes REITs, preferred stock, master limited partnerships and other securities.
Cohen & Steers Asia Pacific Realty Shares A (APFAX)	Mutual fund	Invests in real estate securities in the Asia Pacific region.
Diamond Hill Strategic Income A (DSIAK)	Mutual fund	Invests in income-producing securities like corporate bonds, preferred securities and REITs. Devotes about 10% or 11% of assets to master limited partnerships.

Source: See companies.

allows a fund to collect more dividends per dollar of assets than it could if it simply followed a buy-and-hold approach.

The Henderson Global Equity Income fund, launched in November, uses a dividend-capture strategy, as do a handful of new closed-end funds.

While the strategy boosts dividend income, it also increases trading costs, which cut into investors' returns and can potentially result in higher tax bills for investors.

Since these funds often hold stocks for short periods, they may generate short-term capital gains, which are taxed at higher rates than longer-term gains. And unless the funds meet certain holding-period requirements, the dividends they

generate won't qualify for the lower tax rates. Certain funds, such as the new Eaton Vance offering, are managed to minimize tax consequences.

■ **Foreign real estate.** Investors who have enjoyed the steady income and strong returns of domestic REITs in recent years are now venturing further afield. Many countries are now adopting structures similar to REITs, which give companies tax breaks as long as they distribute a substantial portion of their income to shareholders.

In portfolios it manages for clients, investment-advisory firm WBI Investments in Little Silver, N.J., recently introduced a 6% allocation to foreign real estate. New mutual funds that invest in

foreign real estate include DWS REEF Global Real Estate Securities fund and Cohen & Steers Asia Pacific Realty Shares.

While U.S. REITs typically offer yields below 4%, some foreign markets offer typical real-estate security yields above 5%. But investors seeking income overseas must consider how currency fluctuations and political changes could impact their holdings. Real-estate securities in many markets have already had a strong run and "they have to be approached very cautiously," says Thomas J. Herzfeld, president of Thomas J. Herzfeld Advisors in Miami.

■ **Master limited partnerships.** These fast-growing investments are attracting income-oriented investors with yields

of roughly 5% to 8%. MLPs, which are publicly traded partnerships that are typically in energy and natural-resource-related businesses, don't pay corporate taxes but pass most of their earnings on to investors. Last year, MLPs raised a record \$9.4 billion in new equity, up from \$5.6 billion in 2005.

Funds are increasingly investing in the partnerships. The Alpine Total Dynamic Dividend fund will invest about 5% to 10% of its assets in MLPs, says Kevin Shalchinsky, the fund's co-manager. In the new Claymore/Zacks Yield Hog ETF, MLPs can constitute up to 25% of the portfolio.

While MLP payouts don't qualify for the lower dividend tax rate, much of their distributions are considered a tax-deferred return of capital. "Yet investors must consider the slight but significant risk that new legislation could reduce MLPs' tax advantages, experts say. Late last year, Canada announced plans to change the rules governing its MLP-like income trusts, causing sharp price declines.

Though many MLPs, such as energy pipelines, have traditionally been insulated from commodity price fluctuations, many new offerings are more susceptible to these swings. "As the number of MLPs grows, there's an increasing amount of commodity-price risk," says Yves Siegel, an analyst at Wachovia Securities.

The Wall Street Journal, Feb. 28, 2007

The US “Junk Bond” Analogy

- Corps capitalized with high-yield debt – siphon 90% or more of the free cash flow
- Couple with warrants to provide equity component

31

When should I act?

- Periodically reassess the benefits of preserving the ‘transition period’ tax window
- Weigh against the tax and administrative costs of dismantling your trust
- Be alert to the opportunities – avoid the “valuation headwinds”
- Early conversion may be accretive

32

Factors Impacting Timing

- Transition period growth plans
- Capital expenditure requirements
- Cost of capital
- Mix of foreign and domestic income
- Unit holder composition
- Available tax pools/attributes
- Tax/administrative costs of conversion
- Accretive/dilutive impact
- Opportunities – What are your alternatives?

34

Predictions

- Restructuring of the trust sector will occur sooner rather than later
- Shift of ownership from retail to provide market
- Shift to US ownership
- Less investment in low risk/ low return opportunities
- Less liquidity and fewer exit opportunities
- High dividend paying corporations and perpetual preferred share alternatives (\$2.5 billion issued since October 31, 2006)
- Canadian “junk” debt market
- “Paper-clipped” unit

41

The Davis/Sheinin Team



Doug Buchanan
Vancouver Office
2800 Park Place
666 Burrard Street
Vancouver, BC
Canada V6C 2Z7
Tel 604.643.2907
Fax 604.605.3526
E-mail dbuchanan@davis.ca



Saunder Sheinin
Vancouver Office
2800 Park Place
666 Burrard Street
Vancouver, BC
Canada V6C 2Z7
Tel 604.647.4777
Fax 604.605.3742
E-mail: equities@sheininco.com



Albert Hudec
Vancouver Office
2800 Park Place
666 Burrard Street
Vancouver, BC
Canada V6C 2Z7
Tel 604.643.6463
Fax 604.605.3546
E-mail ajhudec@davis.ca



Brian Hiebert
Vancouver Office
2800 Park Place
666 Burrard Street
Vancouver, BC
Canada V6C 2Z7
Tel 604.643.6463
Fax 604.605.3546
E-mail brian_hiebert@davis.ca

Questions and Comments

