"Tax Fairness Plan"

By Diane L.M. Cook

Last Halloween, the federal government of Canada put quite a scare into the oil and gas industry. On October 31, 2006, the Honourable Jim Flaherty, Minister of Finance, announced a new Tax Fairness Plan. According to the Department of Finance's press release, the TFP is designed to "restore balance and fairness to the federal tax systems by creating a level playing field between income trusts and corporations".

The proposed legislation will include a distribution tax on distributions from publicly traded income trusts and limited partnerships and a reduction in the general corporate income tax rate of one-half percentage point as of January 1, 2011.

For income trusts that began trading on November 1, 2006, the new legislation will apply beginning with their 2007 taxation year. For existing income trusts and limited partnerships there will be a four year transition period from 2007 until 2011 and the new legislation will not apply until their 2011 taxation year.

Analysts believe the federal government announced the TFP in light of recent announcements by major corporations such as Bell Canada, Telus, EnCana, and major banks of their intention to convert from corporations to income trusts. The federal government believed if these companies completed their conversions, they and the provincial governments would lose billions of dollars in revenue due to tax leakage.

In its effort to level the playing field, the federal government inadvertently targeted energy trusts, or publicly-traded flow-through share entities (FTEs), of which there are many of these types of trusts in the oil and gas industry. Unlike corporations, FTEs don't pay corporate income tax on revenue 'passed through' to their investors. Rather, the investors pay personal tax on that income.

Michael R. Smith, leader of Deloitte & Touche, Calgary's Energy Tax Practice, says "In Alberta, 12 per cent of the 256 total trusts, which amounts to 46 energy trusts and related trusts, represent almost 45 percent of the $200 billion in market capitalization for the trust sector."

Deloitte & Touche, a member of a committee struck by the Canadian Institute of Chartered Accountants "to make recommendations around the disclosure and treatment of distributed cash that can be applied in the income trust industry", believes there will be broad economic impacts the TFP will have on the oil and gas industry.

"The major effect of the TFP is that it effectively taxes the income generated and distributed by these trusts as if it was income earned by a corporation. From an investor's perspective, a distribution from an income trust will be treated in the same way as a taxable dividend from a Canadian corporation," says Smith.

Deloitte & Touche believes the impact on industry from the TFP will create a downward spiral for energy trusts. "The new taxation legislation could result in a consolidation of trusts to protect against predatory purchasers and to allow for these entities to be sizable corporations upon being forced to convert to corporate structures in 2011. As well, smaller trusts will likely be the most susceptible to being merged into the larger trusts or being subject to takeovers by corporations as their market values may be depressed," says Smith.

The controversy with the TFP lies in the federal government's rationalization for implementing the TFP and not consulting the energy industry first. The federal government asserts that current legislation allows companies organized under the trust structure to avoid paying their fair share of tax which results in tax leakage for both the country and all provinces and that income trusts threaten Canada's long-term economic growth.

According to its report titled Canadian Energy Trusts: An Integral Component of the Canadian Oil and Gas Industry dated December 2006, the Coalition of Canadian Energy Trusts argues that, not only do energy trusts pay their fair share of provincial and federal taxes; the energy trust structure actually enhances provincial and federal revenues. "During the past five years, CCET member trusts have generated greater taxes both provincially and federally than would have occurred had they been structured as corporations," says Sue Riddell Rose, president and CEO of Paramount Energy Trust and co-chair of the Coalition of Canadian Energy Trusts.

In response to the federal government's claim that income trusts threaten the country's long-term economic growth, Riddell says, "On the contrary, energy trusts are the ideal model for Canada's mature hydrocarbon basins. Since their introduction in 1986, they have played a unique role in maximizing oil and gas production and reserve recovery and providing essential capital to Canada's energy industry."

Most of the CCET's member companies were shocked at the Minister of Finance's announcement to implement new tax legislation which they believe hits energy trusts hard.

Baytex Energy Trust was one such company. "Baytex is disturbed by and concerned with the unilateral approach taken by our federal government. We also disagree with the mischaracterization of the business model of energy trusts and its alleged undesirable impact on the Canadian economy. We are working with the CAIF and the CCET to hopefully influence the government in their implementation process," says Raymond Chan, president and CEO of Baytex Energy Trust.

Enerplus Resources Fund, an energy trust which celebrated its 20th anniversary in 2006, is currently evaluating various strategies to deal with the proposed tax should it become law. "Until we have reviewed all of our options, we are continuing to manage our business as we have in the past. The growth guidelines that were put forward by the federal government prior to Christmas provide us with the clarity needed to continue with our business over the next four years. However, beyond 2011, the increased tax burden is generally expected to negatively impact the economics of Canadian development and acquisition opportunities. It's difficult to comment on post 2011 operations as one of our options could be to convert to a corporation and this would change our business strategies," says Jo-Anne Caza, vice president, Investor Relations, of Enerplus Resources Fund.

John Dielwart, chief executive officer of ARC Energy Trust, says the TFP's future impact on energy trusts will depend on the type of assets the trusts own and the type of employees that the trusts employ. "We view ourselves as being an oil and gas entity that happens to be structured as a trust. We believe the oil and gas industry is fundamentally sound and that the companies or trusts that have the best assets and the best people will continue to outperform. Our focus will continue to be on developing and acquiring high quality assets. What has changed is our cost of capital has gone up and our access to capital has gone down. Therefore we will have to carefully review any project that is particularly capital intensive and/or has a lower rate of return to ensure that they are still economic under the new regime."

Once the new tax fairness plan has been implemented, Caza believes the trust environment will look dramatically different after 2011. "Should the proposal be passed, we think the trust environment will be smaller as a result of mergers and takeovers, as well as the conversion of trusts to corporations."

On December 21, 2006, the Minister of Finance released draft legislative proposals to implement the new tax legislation. The Minister has invited interested parties to comment on the draft legislative proposals until January 31, 2007 and some time after that date the federal government will formally introduce the new legislation.

Until then, the oil and gas industry will wait with baited breath to see if the federal government will take into consideration how energy trusts do not result in tax leakage or impair the future economy of the country. But rather, work with industry to find a "made in the west" solution that will allow energy trusts to continue to maximize production from the Western Canadian Sedimentary Basin and not only provide income for its investors but provide its fair share of taxes to all levels of government. OGN