



Changes In The Taxation of Income Trusts

Dealing With The Unknowable!

Executive Summary

How did we manage through this period?

In the last five years, income trusts have grown to a point where they collectively account for a market cap of \$200 billion. When you add TELUS and BCE Inc. to the mix, that total market cap would have eclipse \$250 billion. So much growth over a short period tells us that something important was happening in this market.

When TELUS and BCE Inc. announced that they were transitioning their businesses to income trusts their share values surged. Perhaps given the twin announcements from these telecommunication giants, we should have expected a reaction from the Federal government. But given the conservative's initial position that they would leave income trusts alone, Finance Minister Jim Flaherty's Halloween announcement caught everybody by surprise. But the fact is, he did react. And when he did, the shares of all income trusts fell sharply, wiping a collective \$25 billion from Canadian's net worth over a period of two days.

The point here is that individual companies, as well as the broader stock market, are always vulnerable to surprises. Such is reality: surprises happen, markets react. For investors who purchased 3 million-odd shares of TELUS & BCE on October 31st, it was no doubt very difficult to wake up the next day to double-digit losses. Especially when it was the result of an event that could not have been predicted.

We find that situations like we have experienced with income trusts are more the norm than the exception. And I am not talking about government pronouncements per se. But rather about how events that have the most short term impact on investments, can never be predicted.

Because we know that, we prefer to focus on the things we know, and can manage. For example, owning shares of companies with investment grade credit ratings, consistent earnings growth and consistent dividend growth. Owning a diversified portfolio so that a surprise in any one sector does not destroy the portfolio's value.

This approach works! Notice that during the income trust crisis, our Managed Global Mandate fund actually went up in value. Our pools because of significant ownership in the Canadian banks, either held their ground or rose in value. Because of course, investors sought out quality dividend paying companies when the bottom was falling out of income trusts.

A Halloween Tax Grab Disguised as Tax Fairness

Cutting through a field of government cow pies...

Having said that, it is important that we understand the legislation, because we need to manage through it going forward. Our goal with this report is to cut through the government rhetoric to get to the heart of the matter. That is, how will these changes affect our portfolios longer term?

If timing is everything, then the Government of Canada's decision to issue a "tax fairness" plan on Halloween after the stock market closed, is appropriate. According to the government, there is

a growing trend toward corporate tax avoidance. According to the government, “top Canadian companies, operating within the current rules, have been converting to trusts in order to seek a more favorable tax treatment by capitalizing on an available tax rule.” As if that were the only reason that income trusts exist.

The government’s official press release (<http://www.fin.gc.ca/news06/06-061e.html>) noted that the current tax environment, offers corporations short-term tax benefits if they switch to an income trust structure, but in doing so, it is creating an economic distortion that is threatening Canada’s long-term economic growth. More importantly, it is shifting any future tax burden onto hardworking individuals and families. If left unchecked, these corporate decisions would result in billions of dollars of lost revenue for the federal government “to invest in the priorities of Canadians, including more personal income tax relief. These decisions would also mean less revenue for the provinces and territories.”

Well Mr. Flaherty, I have news for you; corporations DO NOT pay tax... individuals do! If a corporation with a higher tax threshold wants to maintain its profit margin, it has to raise prices in order to pay the extra tax. These embedded costs are nothing more than hidden taxes, ultimately paid by the consumer... read individual!

If the company feels it cannot recover the cost of higher taxation through price increases, then it will cut costs through a change in the materials (read lower quality material) used to build the end product or through layoffs driven by productivity increases. Again, putting the tax onus squarely on the individual. Sounding off on a faceless corporation may be politically appealing, but in the real world, it is a baseless argument.

Leveling the Playing Field

One reason investors thought the income trust issue was a non-starter, was the fact that the government took steps to level the playing field by increasing the dividend tax credit in its 2006 budget. Apparently, what was not addressed, was the impact of distributions versus dividends in tax exempt accounts.

According to the government, “a major reason for the proliferation of these [income trusts] entities – and a major reason for the concern they have generated – is the unbalanced income tax treatment that applies to them and their investors. In short, tax rules that were designed essentially for non-commercial and portfolio investment trusts (and for owner-operated partnership businesses) are being used by large-scale business entities that are widely held and publicly-traded, and the results are not appropriate.”

Publicly-traded Flow Through Entities (FTEs), which is how the government intends to categorize exchange traded income trusts for purposes of this legislation, are not very different from business corporations, even though their tax treatment can be radically different.

The government believes that the combination of FTEs paying distributions to tax exempt investors, have substantially lower combined income tax rates than is the case for large corporations paying dividends to tax exempt shareholders.

The government also believes that non-residents (represented by say taxable US investors) and tax-exempt entities can obtain a sizable tax advantage if they invest in FTEs rather than a corporation.

For some perspective, we need to look at how a corporation is taxed versus FTEs. Effectively, when a corporation pays a dividend to its shareholders, it does so with after tax dollars. The dividend is subject to tax in the hands of the shareholder, but for shareholders who are resident in Canada, the income tax system relieves the potential double taxation through the dividend gross-up and dividend tax credit mechanism.

In contrast to corporations, FTEs flow 85% to 90% of their income to the shareholder using pre-tax dollars. The tax is paid by the end unitholder, so that when the cycle is complete, the tax paid and benefits received should net out. In fact, that is exactly what happens for Canadian investors who hold FTEs in a taxable account. Because, the 2006 Federal Budget effectively equalized the tax treatment for taxable Canadian investors' receiving income from FTEs versus income from corporations.

However, there remains a bias in favor of investments in FTEs for two important categories of investors – tax-exempt investors and non-residents. Canadian tax-exempt investors, such as Canadian pensions and RRSPs, pay no tax on FTE income nor do they pay tax on dividend income.

However, because dividends are paid out of corporate income that has been taxed, the dividend income received by these tax-exempt investors has in effect borne tax, at a combined federal-provincial tax rate that will be somewhere between 31% and 34%. Because earnings are not taxed before the distribution takes place, the cash flow is higher and that benefits tax exempt investors.

Again more rhetoric. RRSPs and pensions are not tax exempt mechanisms, they are tax deferral mechanisms. At some point the individual will be required to take income from the RRSP or the pension and will pay tax as ordinary income at that point. So once again, the tax is paid, the circle is complete, and by the way, it all comes back to the individual.

The government also points out that non-resident investors benefit from a lower rate of tax on income received from Canadian FTEs compared with the dividends of taxable Canadian corporations. "For example, U.S. investors are subject to total Canadian tax of 15% on income received from Canadian publicly listed income trusts, compared with a combined tax rate of around 42% on dividends from large Canadian corporations."

In this sense, there would seem to be a disparity, and the government would be correct in its intention to protect the interests of Canadians. Something that I suspect the government will play up in the coming weeks. But having said that, don't think for a moment that Canadian corporations decided to switch to income trusts because they thought it would be attractive to non-resident investors. The real market for these securities comes from yield hungry Canadian investors.

The New Tax Fairness Rules

To address these perceived “disparities,” the proposed legislation, which we believe will pass, proposes the following changes;

- Levy a distribution tax on FTEs. In other words, tax the distribution before it is paid out, just as a corporation must pay tax on its earnings before a dividend is declared. The tax levy will be at the combined federal-provincial tax rate, which will be around 34% in 2007, falling to approximately 31% by 2011.
- The government has decided to exclude Real Estate Investment Trusts (REITs) from this tax grab, because it views real estate as a passive investment. Why that is different from a utility or oil company paying distributions based on the cash flow from passive power generating equipment or oil rigs is a mystery to me.
- Distributions received from FTEs will be taxed as though they were dividends and any payments – read distributions – that reflect a return of capital will be exempt.
- And finally, this legislation will not affect existing FTEs until 2011.

To understand how the impact, we have to look at it from a couple of perspectives; the taxable investor and the tax-exempt (i.e. tax deferred) investor. In both cases, the amount of the distributions will decrease, probably by 30% to 35%. Also, the value of the investor’s portfolio will decrease as the market adjusts FTE market prices to reflect the reduced distributions.

On the other hand, a taxable investor will benefit from lower taxation on the distributions, which means that on an after tax basis, the payout should be the about the same. Tax exempt investors end up with a lower distribution but no offsetting tax treatment. So they lose on both fronts; lower distributions and lower market value.

Some Gems In The Mix

As you might expect, the government was not all about taking away. Being a savvy political machine, they did add some gems for taxpayers.

In an effort to reduce the impact on potential after tax distributions, the government will reduce federal corporate tax by an additional 0.5% by 2011. It also opened the door for pension income splitting (beginning in 2007), which effectively allows retirees to split their pension income. That is a big move and will go a long ways towards dampening the bite from progressively painful tax brackets.

The government also intends to raise the age credit from \$4,066 to \$5,066 effective with the 2006 tax year. This measure will affect low to middle income seniors. The age credit begins to be phased out once net income reaches \$30,270 and is fully clawed back when income reaches \$57,377.

How Did These Changes Affect Your Portfolio

Investors were affected – to the tune of about \$25 billion in market capitalization – as the market collectively re-valued FTEs on the basis of the new rules. The change in market values is based on how the market values the discounted cash flow coming from the FTE.

That's no different than how the market values any stock. A stock's value is just the present value of a series of perpetual payments. Whether those future payments come in the form of dividends or distributions is irrelevant.

By 2011, the cash flow from existing FTEs will be lower, and if we discount that back to present value, the value the market places on that cash flow will be reduced. That was the bloodbath we saw on November 1st and the follow through on November 2nd.

From our perspective, one of the benefits of holding a diversified portfolio is to mitigate the fall out from events such as this. As you know, we have used income trusts (read FTEs) in our portfolios for many years. Where we have used income trusts, we tend to buy exchange traded funds (ETFs) that hold a diversified basket of trusts – including REITs that were not affected by this change - and because of that diversification, the ETFs did not fall nearly as much as the individual FTEs.

But more importantly, we also use dividend paying common stocks (including the Canadian banks that actually went up in value over this period), preferred shares and bonds in our income portfolio, not to mention inside our core income pool, covered call writing where the income from option premium is taxed as capital gains.

So while the market may have taken a pound of flesh from the income trust sector, it did not get its pound of flesh from our clients.

