



TD Economics

Special Report

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FEDERAL GOVERNMENT TAKES ACTION ON INCOME TRUSTS

Finance Minister Flaherty gave investors a Halloween fright last night, with the unexpected announcement that the government intends to tax the distributions of income trusts. And, the market reaction today was to be expected, with the S&P/TSX Composite Index plunging by almost 300 points or 2.4%. To offset the potential impact on the investment income of older Canadians, the government also announced some tax relief. It also announced a half point reduction in the general corporate income tax rate as of 2011. However, these latter initiatives were overshadowed by the decision regarding income trusts. So, let's review the various announcements and assess the implications.

Why has the government acted?

The Department of Finance provided a clear explanation for the government's actions in a background report that can be found at <http://www.fin.gc.ca>. Specifically, the proliferation of income trusts was a major concern. The tax rules that allowed income trusts (which the government refers to as 'flow-through entities') to pay no taxes

on distributions was originally intended for small- or medium-scale businesses that were generally owner-operated businesses and trusts. However, due to the preferential tax treatment, there was rapid growth in the number of large-scale and publicly-listed companies adopting the trust structure.

To address the implications of lost provincial and federal tax revenues, as well as some of the potential economic fallout (including the possibility that the trust structure could be detrimental to productivity), the Liberal government attempted to stem the trend by making a commitment to lower the taxation of corporate dividends -- a promise that was embraced by a newly elected Conservative government. But, as we warned in a research report in late 2005, the changes would not truly level the playing field between trusts and tax-paying corporations, because foreign investors and Canadians investing through tax shelters (i.e. pension funds and RSP accounts) would still have a significant incentive to hold trusts. That risk has played out, with the Department of Finance stating that, "it can be concluded that the tax advantage still enjoyed by non-

COMPARISON OF INVESTOR TAX RATES IN 2011				
Investor	Current System		New System	
	FTE (Income)	Large Corporation (Dividend)	FTE (Non-Portfolio Earnings)	Large Corporation (Dividend)
Taxable Canadian (*)	46%	46%	45.5%	45.5%
Canadian tax-exempt	0%	32%	31.5%	31.5%
Taxable U.S. investor (**)	15%	42%	41.5%	41.5%

(*) All rates in the table are as of 2011, include both entity- and investor-level tax (as applicable) and reflect already-announced rate reductions and the additional .5% corporate rate reduction described below. Rates for "taxable Canadian" assumes that top personal income tax rates apply and that provincial governments increase their dividend tax credit for dividends of large corporations.

(**) Canadian taxes only. U.S. tax will in most cases also apply.

Source: Department of Finance

resident and tax-exempt investors in FTEs [income trusts] are now a driving force behind these conversions.”

Income trusts lose their tax advantage

To address the above mentioned concerns, the government has announced the following:

- A distribution tax will be levied on income trusts (excluding REITs – real estate income trusts) at the combined federal-provincial tax rate, the average of which will be close to 34% in 2007 but will fall to 31.5% by 2011.
- The tax will not kick in for existing trusts until 2011. For any future conversions the tax will commence with the 2007 taxation year.
- Investors in trusts will be taxed as though the distributions from trusts were dividends. Payments that reflect return of capital will be exempt.
- The Government estimates that in 2011 the distribution tax will raise \$400 million in federal revenues. Many have expressed surprise that the figure would be so low. It is important to understand that the estimate is not gross collections from the tax, but the net difference between the new revenue and lower personal income taxes. Just as the estimates of government revenue loss to income trusts represent a loss of corporate income tax revenues partially offset by higher personal income tax collections, the actions announced October 31st will raise a substantial amount of revenue from the distribution tax, but there will be less personal income tax revenue because distributions will be taxed as dividend income in the hands of investors rather than attracting the full personal income tax rate.

Implications for trusts

This effectively neutralizes the tax advance of shifting from a corporate structure to a trust. Some companies, such as TELUS and BCE, that were in the process of making the conversion may choose not to proceed. And, it is possible that some business trusts could consider returning to a corporate structure. In other words, the government’s stated objectives should be fulfilled.

To understand the direct tax consequences it is helpful to divide the tax-paying universe into three segments. “Taxable Canadians” (individuals holding investments outside a registered savings plan) will not see a large change in their after-tax income position under the pro-

posed regime. The distributions they receive from an income trust will be lower (presumably directly lowered by the 31.5% distribution tax levied as of 2011) but the flow will be taxed as dividends and hence eligible for the lower tax rate provided by the combination of the dividend gross-up and dividend tax credit instead of being taxed at the full personal income tax rate. As a result, the overall tax rate should be unchanged under the new regime at 45.5%.

Canadian “tax-deferreds” (or as sometimes referred to as “tax-exempts”) will receive lower distributions without an offsetting tax break. This largely refers to holdings in RSP accounts and pension funds. Prior to the announcement there was no taxation, but with the announced changes the distributions from the income trusts will be lower by 31.5% in 2011.

Similarly, foreign investors will receive lower distributions without an offset. The taxation faced by foreigners will rise from 15% to 41.5%.

In addition to the tax effects, investors will be affected to the extent that the proposed changes lower the market values of the income trusts. Since the valuation of any stock is a reflection of the discounted present value of the future revenue stream, the imposition of the distribution taxes will lower the market assessment of valuations. And, while the tax changes will only be imposed on existing trusts in 2011, markets will be forward looking and will factor in the changes immediately. This is why prices for many income trusts corrected after markets opened on November 1st. However, this should be a one-time adjustment, as the new information is fully priced into the value of the stocks.

As investors mull the consequences of Minister Flaherty’s proposed actions on income trusts there will likely be heightened attention to the proposals before the federal and most provincial legislatures to reduce the tax rate on dividend income. On average across the country, the combined federal-provincial tax rate on dividend income will be cut from around 32% to 20% once the legislation is passed. The change will be retroactive to the 2006 taxation year.

Other tax changes

In addition to the announcements related to income trusts, the government also outlined three major tax changes, which are generally designed to soften the blow.

In order to offset any revenue gain that the government

might receive from the imposition of the distribution tax, the federal corporate income tax rate will be lowered. In addition to the already announced decline from 21% in 2007 to 19% in 2010, there will be a further half point reduction to 18.5% in 2011.

There were also two policies aimed at limiting the fall-out from the income trust changes on older Canadians.

The Government is raising the age credit (for people 65 years of age and older) from \$4,066 to \$5,066 effective with the 2006 tax year. The measure will affect low and modest income seniors as the age credit begins to be phased out once net income reaches \$30,270 and is fully “clawed back” at a net income of \$57,377. For some seniors the benefit of the increase in the age credit will be offset by the change in income trusts because the distributions from trusts will be treated as dividends and will therefore be subject to the dividend gross-up, raising their net income.

More importantly, the Government will allow pension income-splitting effective with the 2007 taxation year. This will save many couples considerable money because it dampens the bite from Canada’s progressive income tax rate structure.

An example will help make this clear. Consider a family of two living on a single pension that amounts to \$50,000 above and beyond any credits (basic credit, age credit, pension exemption et cetera). The first federal income tax bracket is 15.5% and for 2006 it goes up to \$36,378, with the remaining part of the \$50,000 facing a tax rate of 22%. So that’s \$5638.59 of taxes on the first \$36,378 and then \$2,996.84 on the remaining \$13,622. So the total tax bill would be \$8635.43. Now if the same \$50,000 is evenly split at \$25,000 both spouses would pay \$3,875 (15.5% of \$25,000) for a total of \$7,750. So the savings to the couple who has \$50,000 in one name and nothing in the other is a significant \$885.43.

The provincial tax savings are also substantial, as shown in the accompanying table.

The tax relief for older Canadians adds up to a significant saving, with the Federal tax forgone amounting to \$350 million per year for the tax credit and \$700 million for the pension splitting.

It is natural to ask why seniors are being insulated from

FEDERAL CORPORATE INCOME TAX RATE					
	2007	2008	2009	2010	2011
Federal Corporate Income Tax Rate	21.0%	20.5%	20.0%	19.0%	18.5%
Source: Department of Finance					

PROVINCIAL TAX SAVINGS FROM SPLITTING A \$50,000 PENSION	
Provinces	\$ Amount
British Columbia	503.59
Alberta *	0.00
Saskatchewan	248.42
Manitoba	505.86
Ontario	472.50
Quebec **	851.56
New Brunswick	850.67
Nova Scotia	1257.26
Prince Edward Island	769.84
Newfoundland & Labrador	1140.92
* No savings in Alberta because they have a flat 10% rate	
** This is only if Quebec adopts the change. They don't have to as they are not in the PIT Tax Collection Agreement	
Source: Department of Finance & TD Economics	

the potential impact of the changes on income trusts. The answer is quite simple. Most seniors are relying on their investment income to finance their lifestyle, while younger Canadians are still saving for retirement.

Will the proposed actions be passed into law?

A minority government situation always creates uncertainty as to whether proposals will ultimately be enacted. The Government intends to proceed quickly. Draft legislation may be available before the end of this calendar year and legislation could be introduced into the House in early 2007, perhaps around the time of the 2007 Budget. It is likely that all the proposed measures will be introduced in one bill. So voting against the income trust actions would likely also entail voting against the increase in the age credit and pension income-splitting. Turning thumbs down on the measures affecting seniors might be difficult for the opposition. It is expected that Canada Revenue Agency will implement the proposed actions prior to Royal Assent. That means, for example, that the increase in the age credit would have to be printed on the tax forms to be mailed out for the 2006 taxation year. The Liberals will no doubt focus upon the apparent contradiction between the proposed actions and previous pledges by Conservatives to not take action against trusts. On the other hand, the Liberals may be glad to see another party take the lead on a thorny problem that bedeviled them for years. Meanwhile, the NDP and the Bloc have given early, but informal, indications of support for the suite of actions. So, the odds favour the government proposals being enacted. The key risk would be if the government was brought down by a vote of non-confidence on the 2007 Budget.

In terms of other political developments, vigorous denunciations and lobbying against the proposed actions can be anticipated. Indeed, the Conservative government must have fully anticipated this before making the announcement. As such, it can be expected that they will demonstrate considerable resolve in defending not only the general nature of the policies, but also their specifics. The attacks on the government will come in a general form -- accusations of renegeing on previous commitments, destroying shareholder value -- and in the specifics -- why only protect REITs when other forms of trusts such as public utilities have been in existence for a long time, why make the grace period before the imposition of the tax only 4 years et cetera. Many technical questions will also likely arise. Such as, what types of entities will be exempt from the distribution tax. The bottom line is that there will be a very narrow window for people to comment on these terribly important points of detail between when the draft legislation is made available and when the legislation is tabled in the House of Commons. For example, that window might only be January 2007.

Conclusions

In our opinion, unless the government falls on the 2007 Budget, the announced tax changes will be passed into legislation and this will draw to a close the conversions to the trust structure by large publicly-listed companies. In

fact, it is not evident why businesses would necessarily want to retain a trust structure. At the moment, trusts face less restrictive disclosure requirements, but this will likely change in the years ahead. Meanwhile, there are a number of restrictions on trusts, such as limits to what can be done with profits. If companies want to simply pass along all of their retained earnings as dividends, it can be accomplished within the corporate structure. So, we are not sure whether the income trust sector will still be present in 10 years time.

In terms of more immediate implications, there will be an adjustment in income trust valuations, but markets will do this quite quickly. Canadians holding income trusts outside of tax shelters will be impacted by the valuation adjustment, but their tax burden will not increase. However, the attraction of holding income trusts in RSPs or by pension funds and foreign investors has been significantly diminished.

Finally, the cut in the corporate tax rate is meagre, but it is welcome news. Seniors should be happy with the announced tax changes, particularly the income splitting. By introducing income splitting for senior Canadians, the federal government has opened the door to public pressure for a similar treatment of all Canadians, after all the same tax distortion is felt by seniors living off one pension as a young family that has a stay-at-home parent.

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