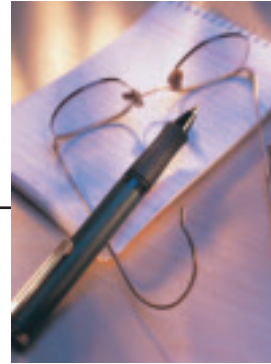


The Future of Income Trusts

The Feds have made a decision—now what?



FIELD NOTES

BY SEAN CLEARY AND
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The growth of the income trust market in Canada over the last several years has been dramatic. As of September 30, 2005, there were 227 income trusts listed on the Toronto Stock Exchange (TSX), up from 73 in 2001, and only a handful in the mid-1990s. For the first three quarters of 2005, income trusts raised a total of \$35.5 billion in equity financing on the TSX, representing 39% of all new equity capital. Income trusts now represent approximately 10% of the quoted market value of the TSX.¹ The rise of income trusts has been driven at least in part by investors' (especially retail) search for "yield." Lacking the well-developed high yield fixed income market that exists in the U.S., Canadian investors have moved into trusts in their search for income-producing securities. Current estimates suggest that these vehicles generate more than \$500 million in monthly distributions to unitholders, which suggests that trusts are putting a significant amount of cash flow into Canadian investors' hands.

The main advantage of the income trust structure lies in their tax treatment. In general, an income trust is set up as an entity that holds both the debt and equity securities of an underlying operating company. The capital structure of the operating company is set up so as to (nearly) eliminate taxes at the corporate level. This means that all free cash to the firm flows from the operating company to the trust, which then distributes the cash flow to unitholders. Since the cash is not taxed at the trust level, this means the cash flow of the operating company is taxed only once, at the personal level, when distributed to unitholders. The income trust structure thus allows avoidance of double taxation. The benefits of this are reflected in the growth of the

trust market. It is also this characteristic, along with the rise of the business trust paradigm allowing virtually any company to convert to a trust structure, that has led to government concerns about the effect of trusts on the tax base.

THE DEPARTMENT OF FINANCE ANNOUNCEMENTS

On September 19, 2005 the government announced unexpectedly that it would not issue advance tax rulings on trust conversions and would be reviewing the status of trusts. This announcement threw a new variable into the mix and increased the risk premium for investors in the days that followed. Indeed, from September 19 to November 22, the S&P/TSX Income Trust Index had a total return of -9.2%; while the S&P/TSX Composite Index was down only 1.6% over this period.

In another surprise announcement on November 23, 2005, the government put a premature end to the consultation process on income trusts in the wake of complaints from angry investors, and in light of a pending election. The solution adopted at this time was to effectively drop personal tax rates on dividends to around 21% (for the highest marginal rate) from their current 32% by increasing the dividend "gross-up" to 45%, and increasing the dividend tax credit to 19% from 13%. This result means that the total personal and corporate income tax paid on dividend income should be similar to the total taxes paid if that income were earned by a trust.

Not surprisingly, market reaction to the November 23 announcement was fast and dramatic. As rumours of the dividend tax reduction spread through the markets on the afternoon of November 23, the prices of several stocks moved significantly. As one

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would expect, those benefiting from the rumours included: (1) those with high dividend yields such as BCE Inc. (up 4.9% on the day); (2) companies that had been expected to convert to the trust structure prior to the September announcement such as CI Fund Management (up 4.1%); and (3) income trusts hit hard by the September announcement such as the Yellow Pages Income Fund (up 6.6%). This trend continued throughout trading on November 24th, with the S&P/TSX Composite Index increasing 1.5% on the day. The gains were driven primarily by high dividend yielding stocks such as Financials and Telecoms, and also by companies that are income trust “candidates” (e.g., TSX Group Inc., up 12.1% and CI Funds, up 8.2%). As one would expect, income trusts fared well with the S&P/TSX Capped Income Trust Index increasing 5.9% over the two days.

THE FUTURE FOR INCOME TRUSTS

While the November 23 decision has put an end to speculation (for now) as to how the government will deal with income trusts, it leaves several issues unresolved. Certainly, it has done little to deal with the forgone tax revenues associated with the income trust structure, which was supposedly part of the motivation for the September announcement. While it should slow down the number of businesses converting to trusts, present estimates suggest the government will lose another \$300 million in taxes as a result of the new dividend tax treatment. While the long-run effect on the tax base is difficult to predict, it is unlikely to increase the tax base substantially and it may in fact have the opposite effect. However, \$300 million is a relatively small amount (approximately 0.2% of the tax base) and we are of the belief that reducing the amount of double taxation in our system is a positive step.

A more critical issue that remains unresolved is that

a large portion of trust income will avoid taxation at any level. While the “after-tax” returns may now be comparable for trusts and high dividend-paying stocks, the trusts still provide higher “before-tax” payout rates. As a result, we should see a movement to high quality dividend-paying stocks by taxable investors. However, non-taxable investors such as pension funds, RRSPs, and foreign investors will continue to prefer the higher “before-tax” yielding income trusts. This suggests that the income trust structure will still be an attractive alternative for corporations. In other words, this issue remains unresolved and will have to be dealt with in the future.

At the end of the two-month period, trusts had recovered most of the value lost, and some stocks are clear winners. However, the whole manner in which this issue has been dealt with leaves much to be desired, and has created a significant amount of unnecessary excess market volatility. This always creates winners and losers, and this rarely occurs in a fair and equitable manner. In fact, market activity on November 23 (and, in all likelihood, during previous trading days) suggests many people had certain “advantages” over others.

CONCLUSION

The long-term effect of the government’s November 23 decision remains unclear. However, the short-term reaction has been favourable, and there is good reason to believe it is a positive decision for our capital markets. The positive market reaction speaks volumes about Canadian investors’ appetite for high-payout, tax-efficient securities. This type of reaction is consistent with our research on income trusts, which shows the value provided by trusts in expanding the investment opportunity set, to say nothing of their ability to attract foreign capital. ■

1. This and the previous numbers are taken from the 2005 TSX report “Income Trusts on the Toronto Stock Exchange (TSX).”