

Barrantagh

Investment Management

Income Trusts – The New Taxation Era November 1, 2006

The Announcement – Leveling the playing field

In the stated interest of, “fair taxation”, the Federal government suddenly announced on October 31st a new tax to be imposed on income trusts. At a rate of 31.5%, the effect is to tax income trusts and their distributions in the same manner as corporations and the dividends paid by them. The announcement reflects a fundamental shift in the tax system and a departure from the government’s earlier commitment to leave the tax rules for income trusts unchanged. Existing trusts will benefit from a four-year transition period, but trusts in progress that were not publicly trading at the date of the announcement (notably BCE and Telus) will not receive transitional status and will be subject to the tax immediately. *In effect, the proposal levels the taxation playing field between income trusts and corporations, discouraging income trust conversions.*

It should be recognized that the proposals are merely rough guidelines without much detail. Certainly there will be market-wide trust value swings, on legislative interpretations and statements made by various affected groups, on the impact of the proposals. While the eventual enactment of the income trust proposals is highly probable given the expressed support of the NDP and BQ, there will likely remain a high degree of uncertainty as to the full impact of the proposals even after passage by parliament. Obviously the capital markets will be volatile and that volatility will be compounded by speculation around what steps the trusts might take to regain stability and access to capital markets. Already discussions are under way in trust circles as to the merits of converting back to the corporate model.

The Affect – Not all trusts equal

Some trusts will be more affected than others; for example, the new tax does not apply to the return of capital portion of the distribution. Trusts in the power and pipeline group should be less affected because of the high percentage of capital return in their distributions. Furthermore, the new tax does not apply to the foreign income taxed in another jurisdiction. Several trusts derive income from non-Canadian sources and therefore will face a lower overall tax rate than trusts with purely Canadian businesses. As well, trusts with existing tax shelter from depreciation, interest expense and tax loss carry forwards, have a tax advantage. In general, those trusts considered to be growth vehicles with low payout ratios should do better in the market place. Since the rules will be instituted in the trusts’ 2011 taxation year, generally four years away, some trusts may be able to partially mitigate the tax burden through acquisitions, industry consolidations, and deferring the return of capital part of distributions until after 2011. Two sectors within the overall trust sector deserve special mention, namely real estate investment trusts (REIT’s) and oil and gas royalty trusts. Under a narrow definition

REITS that earn passive income will not be subject to the new rules, presumably on the basis that income producing real estate should be allowed flow-through treatment. Unfortunately, oil and gas royalty trusts have not been grandfathered, although the original trust conversions go back more than a decade. Oil and gas trust executives are advocating relief from the rules on the basis that the trust structure is a legitimate mechanism to create value where it would have never occurred or be deferred far into the future.

Future Status – Selective trust remain appropriate investment vehicles

While the proposed tax change was certainly a “drop the bomb” shock to investors, we believe income trusts will continue to play a role in the investment programs of most Canadians. Investors, particularly retirees, who continue to want or need income, will continue to find trusts attractive, provided they meet the criteria of a sound investment and the after tax return competes favourably with dividends and interest.

In the past, trusts have traded at a premium to corporate comparables and many still do. Over time trust valuation models will likely gravitate toward the valuation of peer group companies operating as corporations. Since the announcement, we have already seen and may see more narrowing of the valuation premiums between trusts and corporations. At this stage, we are attempting to differentiate those trusts that will survive and may be good investments versus those that are permanently crippled by the tax proposals.

Barrantagh has always looked at trust vehicles as “high paying dividend stocks” using valuation metrics that compare their overall appreciation potential to conventional corporations. However, until the legislation becomes more transparent, we will be very cautious when committing money to income trust vehicles; in fact we have trimmed some trust holdings from our portfolios in favour of dividend paying corporations and traditional bonds. *Over time, the better trusts with solid, stable businesses and good management will adjust to the new reality and will be recognized as sensible investment alternatives.*

Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners. We are dedicated to preserving our clients’ capital while generating growth through consistent application of our value-based fundamental investment philosophy. We manage portfolios on a segregated basis to meet our clients’ investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

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