

# 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, Ministry of Finance, suddenly announced on October 31, 2006 a new tax to be imposed on income trusts beginning in 2011. The effect will be to tax income trusts and their distributions in the same manner as corporations and the dividends paid by them in four years time. The statutory rate will be 31.5%, but similar to all companies, the effective rate may be lower depending on their ability to shelter tax. 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. *In effect, the proposal levels the taxation playing field between income trusts and corporations, discouraging income trust conversions.*

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. The capital markets will be wary and that caution 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 are 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 trusts 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 from a valuation perspective. However, since the announcement, the market has been quick to recognize the differential impact on each trust and trust valuations have gravitated toward the valuation of peer group companies operating as corporations.

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.

*For more information contact:*  
*Barrantagh Investment Management Inc.*  
*(416) 868-6295*  
[\*info@barrantagh.com\*](mailto:info@barrantagh.com)

*Copyright 2006 Barrantagh Investment Management Inc. All rights reserved. Reproduction of portions of this Commentary is permitted provided the source is noted. Please notify us at [info@barrantagh.com](mailto:info@barrantagh.com) of any reproductions.*