TAXATION OF INCOME TRUSTS IN CANADA:
EFFECTS ON STRUCTURE, CONDUCT AND PERFORMANCE

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Abstract:
Income trust as a business structure became increasingly popular in Canada since 2003. Income trust structure gave companies advantage of shifting their tax burden on to the investor. The investor, on the other hand, received steady and higher than the market rate of return on invested capital and also received capital gains in the form of ‘return of capital’. When large Canadian corporations were in the process of changing their structure from public corporations to income trusts, the government of Canada in a sudden shift of policy announced that it would remove the tax advantage of income trusts and put them on equal footing with Canadian corporations. This announcement in October 2006 had implications on the structure, conduct and performance of Canadian industry. The purpose of this paper is to analyze reasons for change in the government policy and the effect of the new tax policy on the structure, conduct and performance of Canadian industry.

Introduction:

Businesses which have achieved high profits and maturity, with moderate growth prospects, have adopted income trust structure to become tax efficient. Under this structure, the income trust, which has a business, sells units in the stock market to raise its capital. The unit holders receive two types of payments; (a) return on their units and, (b) return of capital. Return on units is treated as interest income for tax purposes and depending on income of persons, the marginal tax rate may be around 45%. The return of capital part is treated differently. The investor is to deduct this amount from the cost of units he had bought. This becomes a taxable capital gain at the time of sale of the units. Normally capital gain tax works out to be around 25%.

The income trust units retain some of the earnings for further growth and, after deducting expenses, pay out most of their income (high pay-out ratio) to the unit holders. The pay-out ratio of income trusts varies between 50 to 80%. That is why income trusts are also called flow-through entities. Income of businesses flows through a trust to investors.

The income trusts units are held by two types of investors: (a) those who are old and drawing pensions and (b) those who want regular monthly income rather than buy and sell shares and face market fluctuations. The average rate of return on income trust units before October 2006 was in excess of 10%. Some foreign investors got attracted by the rate of return and started buying Canadian income
trust units.

In 2006 the banks were giving low rate of interest. On saving deposits it was less than 1% and on GIC’s it was about 2%. Bonds were also giving low interest. Most Canadian corporation gave zero to very low dividends to investors. The corporate philosophy is that they give growth, i.e., when share price rises the investor sells and gets capital gains.

Some provinces (Ontario, Alberta and Manitoba) passed law to make investment in income trusts safer. Prior to 2004 investment advisors advised investors to stay away from income trusts as they were deemed risky because of liability issues. The passage of law in 2004-2005 to make liability restricted to the value of the shares made investment in them attractive.

Canadian investors were increasingly becoming attracted to the high rate of return on income trusts units and tax deferral aspect of return of capital amount. The money started pouring into income trusts and out of the corporate structure.

The First Shock:

The perception of tax leakage was on the mind of Ralph Goodale, the Finance Minister at the time of the budget 2005, when he wanted to introduce a bill to tax flow-through entities. However, the Government of Canada, at that time, wanted to consult stakeholders before making a shift in policy and taxing income trusts. It brought out a White Paper titled: “Tax and Other Issues Related to Public listed Flow-Through Entities (Income Trusts and Limited Partnerships)”¹. The public consultation process had persons believing that the government was going to change its policy and would start taxing income trusts. The share price of income trusts fell sharply. It is believed that Canadian investors lost $9 billion in capital. The government’s attempt to tax income trusts and its consequence on seniors who had invested money in them became the subject of severe criticism by the then leader of opposition Stephen Harper. Mr. Harper at that time promised the Canadian people that he would not change the tax structure of the income trusts.²

Mr. Ralph Goodale felt pressured and announced that he has decided not to tax flow through entities. This announcement coupled with Mr. Harper’s promise, gave energy to the investors of income trusts and money started pouring in from the Canadian and foreign investors into income trusts. According to the White Paper, “Total market capitalization was $118.7 billion at the end of 2004, up from $18 billions at the end of 2000. Business and energy trusts have grown the most rapidly over that period.”³

The Shock of 2006:

After Mr. Stephen Harper became Prime Minister of Canada, there was more aggressive investment in income trusts. Some of the large corporations were also
considering converting into income trust structure. Prominent among them were BCE Inc., EnCana Corp. and Suncore Energy Inc. The Royal Bank, the largest Canadian bank also gave impression that it was leaning toward becoming an income trust. The capital was being transferred from corporations into income trust in the amount which became alarming to the corporate executives. Both Prime Minister Stephen Harper and Finance Minister Jim Flaherty felt pressure from corporations. Mr. Flaherty on October 31, 2006 announced the shift in policy under which specified flow through entities would become subject to income tax beginning 2011. He said that he wanted to create a level playing field for both corporations and specified flow-through entities (SIFTS). Mr. Flaherty, in a press release of December 15, 2006 gave the details of his proposed tax.

a) The public traded SIFTS would continue to be tax free till 2011 unless they show expansion in excess of normal growth. The companies having excess of normal growth would be taxed immediately.

b) The normal growth is defined as the annual growth which is less than $50 million. These $50 million includes issuance of new units and debt which is convertible into units. However, converting debt that was outstanding on 31st October 2006 into units would not be considered growth.

c) Any mergers of two SIFTS, or reorganization thereof, would not be considered growth as long as they do not issue new equity.

These details were followed by a draft legislation on December 21, 2006. According to this legislation:

1. Publicly traded SIFTS will be subject to a new distribution tax from 2011. However, if there are new publicly traded SIFTS they would have to pay distribution taxes from 2007.

2. The tax rate will be equal to the combined federal and provincial tax paid by Canadian corporations.

3. The distribution made by publicly traded SIFTS to the shareholders will be treated as dividend, same as Canadian corporations, instead of income as is the current treatment.

4. The federal corporation tax rate will be cut by one-half percent from 2011.

Effects of New Tax Measures:

The change in tax policy had immediate effects on stock markets. The stock market plummeted with this announcement. There was the nervousness among investors. Here are is the price of some of the prominent stocks of October 2006:
<table>
<thead>
<tr>
<th>Name</th>
<th>Price in Canadian Dollars</th>
<th>% Change in 2 months</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>31 Oct.06</td>
<td>30 Nov.06</td>
</tr>
<tr>
<td>Arc Energy T/U</td>
<td>27.56</td>
<td>23.10</td>
</tr>
<tr>
<td>Advantage Energy I T/U</td>
<td>15.28</td>
<td>14.48</td>
</tr>
<tr>
<td>Bonavista Energy T/U</td>
<td>33.50</td>
<td>28.83</td>
</tr>
<tr>
<td>Bonterra Energy I T/U</td>
<td>37.50</td>
<td>28.93</td>
</tr>
<tr>
<td>Canetic resources T/U</td>
<td>20.00</td>
<td>16.83</td>
</tr>
<tr>
<td>Fording Coal T/U</td>
<td>28.68</td>
<td>24.38</td>
</tr>
<tr>
<td>Harvest Energy T/U</td>
<td>32.95</td>
<td>26.90</td>
</tr>
<tr>
<td>Nal Oil&amp;Gas T/U</td>
<td>18.35</td>
<td>13.83</td>
</tr>
<tr>
<td>Paramount Energy T/U</td>
<td>16.77</td>
<td>14.97</td>
</tr>
<tr>
<td>Penn West Energy T/U</td>
<td>42.21</td>
<td>36.50</td>
</tr>
<tr>
<td>Royal Host Real Est T/U</td>
<td>6.19</td>
<td>6.28</td>
</tr>
<tr>
<td>Shiningbank Ener T/U</td>
<td>19.69</td>
<td>16.25</td>
</tr>
</tbody>
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In the above table fractions are avoided by rounding them to the next nearest percentage, higher or lower. Data in the above table is taken from the actual monthly statements sent to clients by TD Waterhouse.

Considering the value of all energy trusts, they lost about 25% of the value in two months. The lost value amounts to 35 billion dollars. Money flowed from SIFTS to corporations and non-SIFTS trusts.

The effect of proposed tax on SIFTS deterred BCE and other businesses from adopting the income trust structure. It no longer made business sense to adopt income trust structure.

The baffled SIFTS asked their clients to write letters to the Finance Minister to change the policy. Letters were drafted and sent to the finance minister but of no avail. The U.S. investors have launched an action in court against the Finance Minister for violation of NAFTA agreement.

Since the income trust companies distributed 100% of their distributable cash, they sold more debt and more units for replenishing the depleted reserves and for further expansion. The new law has put severe restriction on the ability of income trusts to do that. They are now being forced out of their business in the long run. In the short run the trust companies have lowered the cash distribution to investors in an attempt to increase the cash reserve for tax purposes. Lowering of distribution affected their unit price further. Carfinco Income Fund adopted an alternative strategy. Instead of giving cash distribution it started giving “in-kind” distribution. This was done to increase its cash reserves. As prices of income trust units fell, some SIFTS found it hard to continue operating in current structure and started moving toward corporate structure.
Since limit is put on the growth of SIFTS by law, their performance has been seriously affected. This gave to SIFTS additional reason to convert to corporations. For instance, TransForce Income Fund (TIF-UN-TSX) announced that it is converting into corporation as soon as possible. The company’s board of directors felt that they could not raise equity any more to meet its growth requirements as they already have lots of debt and have to distribute a large percentage of cash under present structure.\(^5\)

The decision of the government coupled with falling prices of natural gas meant doom for trusts involved in production and distribution of natural gas. The drop in their prices was substantial. They became cheaper than their asset value and hence were easy target of takeover. Prime West Energy Trust took over Shiningbank Income Fund. Shiningbank Trust units were priced 0.62 of Prime West Energy Trust. Penn West Energy Trust took over Canetic Resources Trust. Cannetic units were exchanged for 0.515 of Penn West. Canetic previously took over Tristar. And Harvest Energy Trust took over Viking. The list goes on.

Another aspect of the market structure is buyback by the launcher of the trust. For example, Canwest Media Income Fund, launched in 2005 by Canwest Global Communications Corporation, was bought back by Canwest Global.\(^6\) The issue price of the unit was $10 and the purchase price was $9. So Canwest Global paid approximately $55 million less for the units. The price had fallen after the tax announcement by the Finance Minister.

The takeover of income trusts was not restricted to Canadian private equity and corporations. The decline in price of income trusts attracted foreign suitors as well. For instance, E.D. Smith Income Fund was sold to TreeHouse Foods (a U.S. company) for $217 million in cash.\(^7\)

In nutshell, the announcement of tax on income trusts led to the structural changes in Canadian industry. Corporation grew while SIFTS shrunk in value. There is now less number of Canadian income trusts than at the time of announcement of the tax. Some income trusts merged or taken over by other income trusts, foreign buyers, corporations and private equity. All income trusts reduced the pay out ratio to increase their cash reserves. All SIFTS faced decline in the unit price. They also resisted the new measures which according to them were discriminatory as real estate investment (basically, income) trusts and private income trusts were not being taxed. Protests were made to the Finance Minister but he stayed firm. The growth rate of income trusts was restricted by law. The new tax measures affected the structure, conduct and performance of SIFTS.

Reasons for Taxing SIFTS:

1. **Foreign Ownership of Energy Trust:** In a speech to Canadian Parliament, Mr. Flaherty, the Finance Minister, stated that more than half of the energy trusts were owed by Americans and they pay 15% tax. He considered putting the tax on
energy trusts was to create a level playing field for all Canadians.\(^8\) (See video clip of the speech, given to Parliament on 23\(^{rd}\) November 2007, on YouTube linked by Naftatrustclaims.com). The Department of Finance (White Paper, 2005, p. 20) puts foreign ownership of energy trusts at 37.5%. After the promise of the Leader of Opposition, Mr. Stephen Harper, who later on became the Prime Minister, of not changing the tax structure of the Canadian income trusts, many foreign investors got interested in the income trusts. Taking Mr. Flaherty’s data to be correct, it means that more than 15% foreign ownership in energy trusts increased during one year. Mr. Harper’s election promise opened the floodgate of foreign investment in energy trusts.

Canadian income trusts are listed both in Canadian and U.S. stock exchanges. Under the provisions of NAFTA Canadians and U.S. investors are to be treated equally. If U.S. citizens pay 15% tax to government of Canada on incomes earned in Canada, Canadians do the same on incomes earned in U.S. And Canadians do invest in U.S. and earn income from that country paying 15% tax. According to the White Paper on p.8:

“In the case of non-resident unitholders, income distributions from income trusts are subject to a 25% withholding tax under the ITA. This withholding tax is generally reduced under Canadian bilateral tax treaties. For example, the withholding tax rate on trust distributions under the Canada-US tax treaty is reduced to 15%. The withholding tax insures that some tax is paid on income by non-residents through an income trust.”

The level playing field already exists for Canadians and putting tax on income trusts did not create any additional level playing field.

2. Tax Fairness: Another reason for putting tax on SIFTS is making them pay taxes which are equal to the those paid by corporations. In Ralph Goodale plan all the income trusts, irrespective of the business they are in, were being considered for tax purposes. In Flaherty plan several trusts are left out of tax jurisdiction. These left out trusts are real estate income trusts and private trusts. The main reason as to why trusts enjoyed tax free status till 2006 was that they earn money for the stakeholders and the stakeholders when they get money pay taxes according to the income they received. By putting tax on some specified income trusts (e.g. resource based income trusts, business income trusts and limited partnerships) and leaving others untouched is certainly not fair tax plan.

Under the new tax law, the older the older individuals, who have income trusts in their retirement portfolio, will pay tax twice. They will pay tax when the income is earned by SIFTS before distribution and also pay tax at the time they start receiving income after retirement, same as if they would have corporate shares in their portfolio. But if they had invested their retirement funds in REITS, they would pay tax only once when they start receiving income after retirement,
because they REITS income is tax free.

3. Revenue Loss: According to the White Paper (p.14) the federal tax revenue loss due to the tax free status of income trusts in 2004 was $300 million. Of this amount the business income trusts amounted to $120 million, energy trusts accounted for $55 million, REITS accounted for $80 million and limited partnerships accounted for $45 million. Since Flaherty plan excludes REITS, the loss would have been $220 million instead of $300 million.

Was the government really losing tax revenue? Was the loss amount realistic? Let us assume corporate profit tax 34%, dividend tax 30% and capital gains tax 25%. These figures correspond to a normal business investor having income about $100,000. Figures could be different for different investors. There were two types of income received from income trusts: monthly distributed income (interest income) and return of capital (capital gain). Marginal tax rate on interest income for a person earning $100,000 was 46% in 2006 (and 45% in 2007), the capital gains tax is similar to the persons investing in corporations.

The payout ratio of income trusts varies between 50 to 80%. It means that the major portion of profit earned by income trusts is distributed to unit holders. The executives of the income trusts get only a fraction of the salary as compared to the executives of corporations. The cost of running an income trust is less than the cost of running a corporation. The rate of return on investment in income trusts is in excess of 10%. The dividend paid by corporations varies between zero and 3 percent. As a consequence, an equal amount of capital would have generated higher income and higher amount of taxes for the government than a corporation would have. A higher pay out ratio generates larger tax base, and considering marginal tax of 45-46%, would result in higher tax revenue than a corporation. This tax disadvantage of income trusts investors sufficiently covers any tax leakage from pension funds. In conclusion, if a fair comparison of equal sized income trust and corporation is made, and all aspects of taxable income and tax rates are taken into account, one would find that the income trusts did not cause tax leakage.

If we assume that the government position to be correct and there is a tax leakage which the government wanted to plug, then there is a question of leaving out real estate investment trusts and private trusts out of tax jurisdiction. Certainly the government could have increased its tax revenue if it had taxed all trusts.

There is an additional problem. The government’s own White Paper in 2005 suggested that there was a tax revenue loss which could be recovered by taxing all trusts which sell shares in the market. At that time Mr. Harper made statement that he, if elected Prime Minister, would leave the income trusts untaxed. When Mr. Harper made this statement he was aware of the White Paper and made no mention of the tax leakage. Tax revenue loss could not have become reason overnight for the government to have changed its position to cause the demise of a
booming sector.

4. Conversion of corporations into trusts: The Canadian Broadcasting Corporation on November 1, 2006 reported the following on its web site:

“In a hastily called news conference on Tuesday afternoon, Flaherty said $70 billion of new trust conversions have been announced so far this year-Something he said is hurting the economy.

“He called trust conversion “a growing trend to corporate tax avoidance.”

The BCE Inc. is being bought by 3 private equity groups, the Ontario Teachers’ Pension Plan through its investment arm Teachers’ Private Capital, Providence Equity Partners (U.S.), Madison Dearborn Partners LLC. (U.S.) and some Canadian investors. The teachers will hold 52%, U.S. partners will hold 41% and Canadian investors 9% thus satisfying government regulation of less than 46.7% foreign asset ownership in a company. Barring the outcome of a few legal cases against this deal, the BCE Inc. is all set to fall in private hands. Its shares will no longer be offered in the stock markets.

It means that the government has been successful in stopping BCE’s conversion into an income trust. But it is not successful in preventing it from avoiding taxes. The private trusts continue to enjoy tax free status under the new law as did income trusts prior to 2006. The government, if it was serious to prevent tax leakage, would have not left the private equity door open for corporate conversions.

5. Pressure from corporate executives: The corporate conversion into trust worried corporate executives. These executives get bonuses based on the growth of their companies. And when income trusts were sucking in their growth money, their concern was natural. The Finance Minister Jim Flaherty and the Prime Minister Stephen Harper were made aware of the situation. A story in the Globe and Mail, November 2, 2006, was titled: “Income-trust crackdown: The inside story”. In this story the authors Sinclair Stewart and Andrew Willis state the following:

“High-profile directors and CEOs, meanwhile had approached Mr. Flaherty personally to express their concerns: Many felt they were being pressed into trusts because of their duty to maximize shareholder value, despite their misgivings about the structure. Paul Desmarais Jr., the well connected chairman of Power Corp. of Canada, even railed against trusts in a conversation with Prime Minister Stephen Harper during a trip to Mexico, and told him that he should act quickly to stop the raft of conversions, according to sources.”
Could the pressure from corporate executive be the real reason for tax on income trusts? The Power Corporation of Canada is a diversified management and holding company with interests in financial services industry in North America and Europe. It has also industrial interests in Europe and China. It is a large corporation. Its operating earnings in 2008 increased 25.3% over 2006. Its quoted market value was about $14 billion and it had 407 million outstanding shares. (Figures taken from its web site on May 8, 2008). Its share price rose from about $30 in 2006 to about $45 in 2007. Other corporations had similar experience. After the announcement of tax on income trusts the share of corporations jumped upwards and the price of shares of income trusts nosedived. Corporate executives were the beneficiary of the government’s income trust tax decision.

This paper has examined the possible reasons behind the government decision to tax SIFTS. In the United States of America and Australia steps were taken to curb the growth of flow-through entities in the mid 1980s. Limited partnerships involved in venture capital and resource industries remained as flow-through entities in these countries. Real estate income trusts continue to enjoy tax benefits in U.S. However, the flow-through entities were introduced in Canada in mid 1980s. When the government of Canada allowed the formation of REITS and other income trusts, it had the benefit of experience of Australia and U.S. In both those countries, the government took action when the rapid growth of flow-though entities threatened the investment in corporations. If the government of Canada had gained from the experience of those countries, the painful capital loss suffered by income trust unit holders could have been avoided by laying down stricter conditions for the areas and the growth of income trusts right at the time of their inception.
End Notes:


2. See the video clip of the speech given by Mr. Harper on YouTube linked by naftatrustclaims.com.

3. White Paper, p. 5


5. “Watch TransForce for insight into the end of an era” by Fabrice Taylor, Globe and mail, April 02, 2008.


8. video clip of the speech, given to Parliament on 23rd November 2007, on YouTube linked by Naftatrustclaims.com.