Market Insight

TAL Global Asset Management Inc.

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The Government Takes a Stand On Income Trusts

Federal Finance Minister Ralph Goodale has asked the Canada Revenue Agency (CRA) to stop issuing advance tax rulings for companies considering a conversion to income trust status until the Finance Department completes its review of the entire income trust sector.

Income trusts are investment vehicles first used mainly by real estate companies and oil and gas producers as a tax-efficient way to pay dividends to investors. As the structure has become more popular, more than 200 companies, and not just oil, gas and real estate companies, have adopted it. Canada's income trust market has swollen ninefold to almost $170 billion in the past five years, which is equivalent to over 10% of the TSX.

The Finance Department announced about $300 million in missed tax revenue from income trusts last year and is examining changes to the rules to recover these lost revenues. It is seeking input on options, which could include changing laws so income trusts are taxed in the same way as corporations or integrating the corporate and personal taxation systems to distribute the tax burden more evenly. That process could take as much as a year.

This suspension of advance tax rulings could effectively freeze the income trust sector. Companies considering conversion to income trust status generally seek advance tax rulings to ensure the structure is acceptable for tax benefits. Nine companies currently considering the income trust structure were notified of the decision.

TAL Global Asset Management manages more than $1.5 billion worth of income trusts across all its portfolios. Gaelen Morphet, first vice president of equities for TAL and manager of the Renaissance Income Trust Funds, has been investing in income trusts for ten years, one of the longest income trust wealth management track records in Canada.

“It does have an impact right away,” she says. “There were a number of companies in the throes of converting. This makes them stand back and think because there is a possibility that they might be subject to tax.”

She says the ruling will likely affect companies that have yet to convert as opposed to those that are currently income trusts. It could in fact offer an advantage to existing trusts since the supply of trusts would become limited, making current ones more attractive.

On the other hand, there might be a flurry of income trust conversions before these changes are finalized. It is not clear when the new income trust tax policies will be implemented and some companies have already indicated their plans to continue the income trust conversion process. Gaelen Morphet believes that current income trusts could be exempt from the new regulations and income trusts set up between now and when the policy is implemented might be grandfathered.

“It would be a significant negative for business trusts if they did not grandfather the existing ones,” Gaelen Morphet says. “If they altered the rules going forward on all income trusts, Canadian capital markets would be affected adversely. But, in line with the government’s intentions, it would make income trusts less attractive and dampen the appetite for conversion.”

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The impact for investors is that it will most likely affect business trusts and less likely to severely penalize the entire income trusts market. “There has been an indication from the government that REITS (Real Estate Income Trusts) and royalty trusts are not their concern,” Morphet says. “Business trusts are where much of the growth has been and for many their structures have been created by financial engineering to avoid tax.”

The TAL approach to income trusts is towards investing in oil and gas royalty trusts and REITs, with less exposure to business trusts. Gaelen Morphet considers the new tax-related risks to be less significant than other considerations in selecting income trusts right now. The underlying fundamentals of the business behind the income trust supersede any other concerns. “If a company is not suited for a trust or is not well-managed, that will surpass anything the government imposes,” Morphet says. “We are planning to be even more cautious on business trusts.”

She says there have been four key question marks surrounding income trusts -- limited liability, inclusion in the TSX/S&P Composite Index, taxation, and interest rates. In the past 12 months limited liability and inclusion in the index have been resolved and interest rates will always fluctuate. “Within the next year the taxation issue will be resolved and that is the important one. The good part is that we will finally have a resolution and an end to uncertainty.”

“On a day-to-day basis there is no change in the way we manage our funds,” Morphet says. “The recent announcements from the government reinforce our views.”