



NOVEMBER 2, 2006

## The Landscape Changes For Income Trusts

### Overview

The federal government has announced proposed changes to the way income trusts and listed limited partnerships are taxed, with the measures phased in over a four-year period for existing trusts and partnerships.

In his announcement, the federal finance minister specifically said that the tax on distribution measures would apply in 2007 to income trusts created starting November 1, 2006, including "recent large trust announcements". There have been \$70 billion worth of corporate conversions to income trusts announced in 2006 alone, including Telus Corp. and BCE Inc., which announced its plans on October 11.

The tax rate on trust distributions will start at 34 per cent in 2007 — to mirror federal and provincial taxes on companies — and will drop to 31.5 per cent by 2011. This effectively ends any tax advantages for investors in trusts over corporations.

At the same time, the minister also announced that the general corporate income tax rate will be cut by 1/2 point as of January 2011, and he also will allow income splitting for pensioners. Government estimates show that the combined measures will cost the federal government \$1 billion per year, coincidentally very close to widespread estimates of revenue losses from income trusts.

Canadian taxable investors are expected to be unaffected by the proposed changes from a tax perspective. Tax-deferred accounts and non-resident unit holders will be negatively affected by up to 31.5%.

The income trust announcement came with little warning on Tuesday evening after the markets closed. However, at the stock market open on Wednesday morning the TSX's capped income-trust sub-index fell 11.5 per cent with the income trust sector losing about \$18-billion of its value. Prospective trust conversion BCE Inc. was off 12 per cent at opening and Telus was off 16 per cent. Among major trusts Penn West was off 12 per cent and Yellow Pages 21 per cent.

In addition to income trusts, there was pressure on the Canadian dollar due to the popularity of trusts among non-residents. The Canadian dollar weakened to 88.09 cents on Wednesday morning after Tuesday's Bank of Canada close of 89.04 cents.

### The CIBC Asset Management Outlook

- BCE and Telus are negatively affected since the stocks rose earlier in anticipation of their conversion. It is unlikely now, that either company will convert to an income trust. If the stock momentum pushes the prices down too much, we would consider buying these two high quality companies.
- Strong dividend-paying sectors of the equity markets such as the banks and the insurance companies should perform well as investors seek traditional income sources.
- It is likely that the most negatively affected type of income trust will be in the Canadian oil and gas royalty trust sector. These trusts have significant foreign ownership and foreign owners will not be able to take advantage of the dividend tax credit. Individual recipients of distributions from these trusts or partnerships will treat the distribution as a dividend eligible for the enhanced dividend gross-up and tax credit.
- Real Estate Income Trusts (REITs) will be tax exempt and therefore not as negatively affected in the marketplace as income trusts in general.
- A number of income trusts could possibly consider unwinding their trust status in the coming weeks.



## Comments by Gaelen Morphet, first vice president of Canadian equities for CIBC Asset Management and portfolio manager of the CIBC Asset Management managed income trust funds

- The tax rules do not change until January 2011. Income trusts are now like corporations with a four year tax holiday, carrying on business as usual and paying out their distributable income to investors as they have in the past. Investors will continue to benefit from high yields and will receive distribution income as they have in the past.
- In the meantime, the investment landscape has changed. Effective November 1, 2006, if a company converts to a trust, it becomes immediately taxable. Therefore, there is no fiscal advantage to converting to a trust anymore. Both BCE and Telus had plans to convert to a trust, but with this new proposed legislation, they will likely abandon the plan.
- There is little doubt that in four years, most existing income trusts will have to cut their distributions in order to pay tax.
- When a corporation converts to an income trust, there is a standard valuation premium of about 30% over an equity stock. With the optimism of the market, some income trusts have been trading in excess of this 30% premium. We are beginning to see the collapse of the premium. The question that remains is how quickly the premium will disappear and by how much. We expect each income trust will react differently.
- Income trusts with the best business models and the best management teams will continue to thrive. The market will be most harsh on companies that were never suitable for the income trust structure – those that have typically grown through acquisition, with high payout ratios and too much debt.
- The Canadian equity market as a whole has been a beneficiary of the income trust phenomenon. Income trusts, in particular the oil and gas royalty trusts, have benefited from using their valuation premiums as takeover currency to grow in size and distribution.
- Many stocks that have been rumoured to be converting to the trust structure and which have premiums built in to their valuations are seeing these premiums vanish. The most notable are BCE and Telus, but the list also includes AGF, Suncor, IGM Financial, TransAlta, Fortis, Alliance Atlantis, Corus, and others.

## Comments by Stephen Gerring, vice president of equities for CIBC Asset Management and portfolio manager of the CIBC Monthly Income Fund

- The proposed changes will be neutral for taxable Canadian investors. While investors will receive a smaller distribution (reduced by the amount of the tax paid by the income trust), the investor will pay less tax on that smaller distribution because this distribution will be taxed as an eligible dividend, resulting in the same amount of after-tax income. However, the tax changes will hurt non-resident investors and investors holding their investments in tax-sheltered plans. Thus, demand for trusts from these two groups will be affected.
- The impact on the CIBC Monthly Income Fund will be constrained because the exposure to trusts is limited and because the Fund holds a high quality portfolio of dividend paying stocks with relatively low price to earnings multiples.