LEITH WHEELER INVESTMENT OUTLOOK

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"Trust": Even The Name Implies Confidence

Here is a primer on income trusts which highlights our concerns over the potential for tax changes with negative implications for pricing.

Trusts pay no tax

How a trust works:
Trusts are a structure where the business pays out all its income so that the trust owners pay tax, not the trust itself. This differs from the corporate structure where the company pays tax and the shareholders are also taxed on the dividend payment. Trusts are owned by the unit holders who appoint trustees, much like a corporation that has a board of directors.

The trust itself usually owns shares in subsidiary operating companies or partnership units in operating limited partnerships. This structure is designed to limit the liability of the trust and to move cash from the subsidiaries that generate the cash up to the trust which distributes the cash to the unit holders. Tax paying companies can convert to a trust by several steps. For our readers that would like more details on how this works, see our web site at www.leithwheeler.com.

The tax advantage has created a huge appetite…

The trust market is big and growing fast with new issues. Over the past 10 years about $80 billion of new issues have been sold to the public. Over the past couple of years the growth in new issues has exploded. Last year just under $19 billion of new issues were sold. In addition, Trusts are growing through acquisitions paid for with new units. Today, the market capitalization of all outstanding trusts is in the order of $ 180 billion. In addition to these trust issues, over $30 billion of closed end mutual funds have been issued with a mandate to invest in unit trusts.

… and the contingent of trust cheerleaders grows

Together, over $100 billion of trust related paper has been sold to the public. At typical 5% to 6% commission rates, over $5 billion of revenues have been generated for the underwriting and sales people. Substantial revenues have also been generated for the lawyers and accountants that construct these somewhat complicated transactions, not to mention fees to investment managers that manage the new mutual funds. This fee gravy train has created a huge contingent of trust cheer leaders and not many people are in a position to offer an independent and critical voice.

We, however, are not waving pompoms

The most common response to our criticism of trusts is, "that's interesting but these trusts have been better performers than Canadian stocks over the past 5 years." Indeed they have been stellar performers, the trust index outperformed the overall stock market with a return of 24.1% vs 13.6% compounded for the TSX (to September 30, 2006). But this out-performance has also led to a receptive investor market and a proliferation of low quality trusts and, in some cases, suspect financial reporting and crazy deals for trust management. These issues, and the prospect of tax changes that could reduce the attractiveness of trusts, lead us to wave the yellow caution flag.

This Outlook looks at just the tax issue, and the potential for policy changes. First, we need to look at a few numbers. Because so many tax changes are in the works, we show the tax regime both for today and for 2010 when the proposed changes are intended to be in place.

The most recent Federal Government proposals call for a reduction of Federal and Provincial tax on dividends paid by corporations. These changes are intended to "level the playing field" so that the tax take from corporations and trusts would be the same. The Federal proposals also call for the Provinces to reduce their tax rate on dividends and our table incorporates this reduction in the BC rates. Quebec, however, has indicated it is not interested in reducing dividend tax rates.

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COMPARING TOTAL TAXES FOR A CANADIAN TAXABLE INVESTOR IN CORPORATION OR A TRUST

	Corporate Form		Trust Form
	Current	Proposed 2010	
Pre Tax Income	$100.00	$100.00	$100.00
Corporate Income Taxes	34.12	31.00	Nil
Dividend or Distribution Paid	$65.88	$69.00	100.00
Personal Income Taxes on dividend or trust distribution:			
Federal	$12.90	$10.01	$29.00
Provincial (BC)	7.91	2.70	14.70
	20.81	12.71	43.70
Total Income Tax Paid	54.93	43.71	43.70
Net After Tax Income	$45.07	$56.29	$56.30

** net federal rate on dividends 19.58% currently, going to 14.50% after proposed enhanced dividend tax credit.*

** net provincial rate on dividends 12.00% currently, going to 3.92% after proposed enhanced dividend tax credit.*

Recent tax changes reduce taxes on dividends ...

... and level the playing field for taxable Canadian investors

The first column shows the taxes paid today by both the company and the shareholders for a company earning $100 pre tax and then paying out the remaining after tax earnings to shareholders as a dividend. It shows that shareholders keep $45.07 for each pre tax $100 of revenue earned by the company. By 2010, this will rise to $56.29 due to the very large drop in the tax rate on dividends both federally and provincially if the combined corporate and enhanced dividend tax reductions are implemented. So, with these most recent proposals, the playing field is levelled for taxable **Canadian** investors if the changes are in fact implemented.

But taxable Canadian investors are just one factor in the market. What about registered accounts (RRSPs, RESPs, RRIFs) and pension plans?

Taxes are at least deferred, if not lost, when registered accounts own trusts

Pensions and RRSP's pay no tax. This means when a pension plan owns a stock the corporation itself pays tax (about $31.00 in 2010) but the dividend received by the pension plan is not taxed. When a pension plan owns a trust, no tax is paid. The trust itself does not pay tax so the earnings of the trust can be distributed to the pension plan without any tax being paid. The beneficiaries of pensions and RRSPs do pay tax when the funds are withdrawn. An argument can be made that tax isn't avoided when trusts are owned by pension plans but that it is just postponed. Ultimately, the argument goes, the tax is paid and, because the taxes deferred have been invested inside the pension plan to earn a return, the capital withdrawal is ultimately larger and the taxes will therefore be larger. (Financial people put it in terms of the present value of the tax is the same as though it were paid today.) Not so fast: Government services are being provided today but taxes on the pension withdrawal may or may not be collected until years from now. There is a mismatch between providing the services and collecting the taxes that will require other taxes to be collected today. In retirement, the individual is also likely to be at a lower tax rate than in his or her earning years. So, the pension tax argument has some validity and some issues. Why is it then that some of Canada's largest pension plans have fought so hard to keep the tax breaks for trusts? There are several reasons. The most obvious one is that there is simply more cash in the pension plan when distributions occur through trusts which don't pay tax than when they occur from corporations that do pay tax. This means they have more assets with which to meet their fixed liabilities and therefore their funded position improves. Another reason is that these pensions have large share holdings and when these companies convert to trusts, the value of those holdings goes up. This also improves the pension's current valuation.

Tax revenues will also be redistributed from the West to Central Canada

It may be of special interest to our Western readers to note the likely wealth transfer effect that trusts will cause. In both the case of trusts held by individual Canadian tax payers and by trusts held by pension plans, taxes will ultimately be paid to the province in which these taxpayers live. Given that there has been a disproportionately large shift by Western resource companies to the trust structure with a loss of provincial corporate tax, and because the population base resides disproportionately in central Canada, there will be a shift in tax revenues from the Western Provinces to Ontario and Quebec.

The big tax lost comes from foreign ownership of trusts

Another tax issue is the leakage coming from foreign investors. The table below compares the current taxes for a foreign investor owing a Canadian corporation and a trust. The bottom line on this table shows the tax paid to Canada on a $100 pre tax earnings. Instead of almost $44 of tax that is paid to Canada in the corporate form, only $15 of tax is collected in the trust form. U.S. investors gets a further tax break in that the trust distribution can be treated as a dividend for US Federal tax purposes. The 15% U.S. Federal tax on dividends is offset by the 15% withholding tax paid to Canada. So no U.S. Federal tax is paid on the distribution.

CANADA'S TAX TAKE ON FOREIGN INVESTMENT IN TRUSTS AND IN COMPANIES

	Corporate Form	Trust Form
Pre Tax Income	$100.00	$100.00
Corporate Income Tax	$34.12	*Nil*
Dividend Or Distribution Paid	$65.88	$100.00
Withholding Tax 15%	$9.88	$15.00
Total Tax Paid To Canada	$44.00	$15.00

This is a tilted playing field! U.S. investors pay only the 15% withholding tax while Canadians pay well into the mid 40% zone for both trust and corporate distributions.

This is not a minor problem. A recent paper on trusts by the C.G.A. Association[1] references a 1995 Department of Finance study that estimated that 22% of trusts were held by non residents (the balance is thought to be held 39% each by pensions/RRSPs and by tax paying Canadian investors). We suspect that foreign ownership is higher today but there is no data available. Not only does this result in a huge tax loss for Canada, it will lead to increased foreign ownership as U.S. investors, with their tax advantage, will continue to outbid Canadian buyers.

The pressure is on for companies to convert to trusts…

So, what do these tax issues mean and what policy reaction should be anticipated? Most importantly, it means that businesses are worth more as trusts than as corporations. Stated another way, the cost of capital is lower for trusts which means the corporate form is at a competitive disadvantage. It means that shareholders will continue to pressure managements to convert their companies to the trust form to eliminate tax and enjoy a higher valuation. It means that we will see a continuation of Telus and BCE type conversions. The floodgates have been opened and, unless the tax structure changes, only companies that pay no tax will remain in the corporate form. Corporate tax revenues will be a thing of the past.

… with implications for capital investment as well as for tax revenue lost

Tax loss is not the only consequence of converting the corporate sector to the trust model. There are legitimate concerns as to how the trust sector will grow when investors demand the distribution of cash and the tax rules mean that trusts must pay out their pretax earnings if they are to remain tax free. The answer we hear in our recent conversations with managements that have converted to trusts is that they will grow by issuing more units. This works in a receptive trust market and when things are going well for the enterprise. However, many opportunities for growth occur when enterprises and their competitors are under pressure. It remains to be seen whether these companies will be able to grow and prosper when they must continue to pay out distributions as trusts. For the country as a whole, the trust model may lead to businesses that are weak international competitors.

We think tax changes that are targeted to deal with these issues are inevitable. They are unlikely to be introduced by a minority government, but investors should expect changes when a majority government can deal with this tough issue.

[1] Demystifying Income Trusts", Certified General Accountants, January 2006

Here are some possible changes…

What changes could be made? The following are possible:

1. Provincial tax on trust distributions
2. A new tax treaty for foreign investors
3. Limits on pension ownership
4. Tax at the trust level

While these are the obvious options, not all are likely. A provincial tax would recapture lost provincial revenue but is difficult to believe that all provinces would coordinate their tax schemes. Trusts would move to lower taxed provinces if only a few provinces changed.

A new tax treaty for foreign investors is also a long shot. Experts in this area tell us that such negotiations take years and would make the softwood lumber deal look like a cake walk.

Limits on pension ownership remain a distinct possibility. This would limit the tax revenue that is arguably deferred. It does not, however, plug the taxes lost to foreign ownership.

We see a tax on trust distributions with an offsetting tax credit for taxable Canadian investors

A tax on trust distributions addresses all the issues and is the most obvious and likely change. This tax could be accompanied by a tax rebate for taxable Canadian investors that would equalize the tax between corporations and trusts. At the same time it would capture taxes today that pension plans do not now pay and it would capture the foreign tax hemorrhage.

Some of our readers may be surprised at what sounds like advocacy of higher taxes. We are not advocating higher taxes. Someone is going to pay the taxes to cover government services and it is only a question of where those taxes are collected. We see problems that must be dealt with if we are to retain a corporate sector in Canada and we see a most likely path that logic suggests the government follow. This path points to taxing the trust sector. In our view these tax changes we foresee are not fully factored into the pricing of trusts (of the 22% or more foreign investors, how many have spent a moments' thought on their tax advantage and its likely life span.)

We have been researching unit trusts since the late 1990's and Leith Wheeler clients own some trusts. Our list of trusts is short and the overall exposure in client accounts is relatively small. The short list of holdings reflects our return requirements and the expectation that trust multiples may compress as a result of tax changes. With enthusiastic market pricing, most trusts just don't give us a satisfactory return. Our short list also reflects the elimination of many trusts that don't meet our quality tests. Many new trusts are simply poor businesses; cyclical businesses that will be forced to cut distributions or businesses that are paying out too much cash and are not sustainable. A previous issue of the Outlook covered the problem of a declining asset base in conventional oil and gas royalty trusts (see "Ponzi Trusts" July 2004.) We own no oil or gas royalty trusts nor any commodity based trusts at this time. Our research has led us to trusts that have strong business models, trustworthy management and that trade at reasonable valuations…..the same fundamentals that we use to evaluate common stock.

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