

Federal Government to Implement New Tax Fairness Plan

Tax on distributions is key measure impacting income trust market

On October 31, 2006, Federal Finance Minister Jim Flaherty announced a new Tax Fairness Plan (the Plan), designed to restore balance and fairness to the federal tax system by creating a level playing field between Income Trusts and corporations.

The following is a synopsis of the details of the Tax Fairness Plan, the reasons for its implementation, the key factors affecting the Income Trust market, and the expected impact on markets.

In brief:

- The federal government has announced changes to the tax system that proposes to tax income trusts in the same manner as corporations.
- Trust will be taxed at corporate tax rates before distributions; distributions will subsequently be treated as dividends.
- These changes take effect in the 2011 tax year for trusts that are currently publicly traded. It is expected therefore that the existing trust market will likely shrink considerably by 2011.
- New trusts that begin trading after October 2006, are impacted immediately, and as such, there will likely be no further conversions, including BCE and TELUS.
- Real Estate Investment Trusts (REITS) appear to be mostly exempt, and will not be impacted.
- Preliminary work by Scotia Capital suggests that this will have an immediate negative impact on market valuations – Scotia Capital expects unit prices may decline by 10% to 15%.

Specific details of the plan are as follows.

The New Tax Fairness Plan

What does the Plan entail?

The measures in this new Tax Fairness Plan include:

- A Distribution Tax on distributions from publicly traded income trusts and limited partnerships.
- A reduction in the general corporate income tax rate of one-half percentage point as of January 1, 2011.
- An increase in the Age Credit Amount by \$1,000 from \$4,066 to \$5,066 effective January 1, 2006 (this will benefit low and middle-income seniors).
- The permission of income splitting for pensioners beginning in 2007.

Why is the federal government implementing this new plan?

This new Tax Fairness Plan follows change to the tax regime implemented in the 2006 Budget, which reduced the rate of federal tax on dividends from large Canadian corporations in an attempt to level the playing field between income trusts and corporations.



According to the announcement from the Minister of Finance, despite these previous changes to the tax regime, a tax on distributions is being implemented due to the following:

- 1) A significant increase in the number and size of businesses and corporations converting to an Income Trust structure. In the federal government's view, this is a result of the tax advantages still enjoyed by non-resident and tax-exempt investors.
- 2) The ongoing depletion of provincial tax revenues (due to the inability of the provinces to tax distributions to non-residents).
- 3) The shift in tax revenues between provinces (which in turn has caused concerns over lost revenue for the provincial governments).
- 4) Similar actions have taken previously by both the U.S. and Australian governments to address corporate tax avoidance.

Therefore, the federal government is now implementing what they consider to be a more appropriate tax regime for Income Trusts (referred to as Flow Through Entities (FTEs)). Essentially, this tax treatment will be similar to that of corporations. Further, unit holders will now be treated essentially like shareholders.

The federal government believes this will eliminate an economic distortion that in their view threatens both future economic growth, and a potential shift of the future tax burden on individuals from entities.

What are the key facts affecting the Income Trust Market?

There are a number of key factors in the Plan affecting FTEs (Flow Through Entities):

- 1) FTEs income will be subject to tax at corporate tax rates. According to the announcement, all publicly traded income trusts, with the exception of certain Real Estate Investment Trusts (REITS), will be subject to this taxation. This includes all Business and Royalty Trusts.
- 2) Investors in an FTE will be taxed on distributions as though they were dividends.
- 3) These changes will take effect beginning in the 2007 taxation year for FTEs that begin to be publicly traded after October 31, 2006. FTEs that were already publicly traded before that date will not see the tax changes implemented until the 2011 taxation year.
- 4) The announcement included a clause for anti-avoidance – the proposal is subject to change to address any new structures that may subsequently emerge that run counter to the policy objective of the Tax Fairness Plan – the leveling of the playing field.

However, there are several cases that remain uncertain, and will require further clarity from the federal government:

- a) Given the ambiguity of over the classification of income versus rent, under the text of the Plan, Seniors Housing and Lodging REITs may not qualify for exemption.
- b) Also due to the text of the Plan, U.S. based REITs may also not qualify for exemption.
- c) In the case of Stapled units (such as Timberwest Forest) and Income Participating Securities (such as Student Transportation of America Ltd.), a debt instrument is attached to an equity security and traded together as a unit. Since the debt interest payments are the primary source of cash distribution, they may not be impacted by this announcement. However, this may be voided by the anti-avoidance clause.



The Department of Finance also provided the following comparison of tax rates at the federal level as of 2011.

Simplified Comparison of Investor Tax Rates in 2011

Investor	Current System		New System	
	FTE (Income)	Large Corporation (Dividend)	FTE (Non-Portfolio Earnings)	Large Corporation (Dividend)
Taxable Canadian (*)	46%	46%	45.50%	45.50%
Canadian tax-exempt	0%	32%	31.50%	31.50%
Taxable U.S. investor (**)	15%	42%	41.50%	41.50%

(*) All rates in the table are as of 2011, include both entity- and investor-level tax (as applicable) and reflect already-announced rate reductions and the additional .5% corporate rate reduction described below. Rates for "taxable Canadian" assume that top personal income tax rates apply and that provincial governments increase their dividend tax credit for dividends of large corporations.

(**) Canadian taxes only. U.S. tax will in most cases also apply.

Source: Department of Finance Canada

What are the implications for the Income Trust Market?

The key implications are as follows:

- There is no immediate impact on taxable investors from an after-tax distribution standpoint, all else held equal. Distributions to investors will eventually be lowered due to the introduction of tax at the FTE level, but these distributions will then be treated more advantageously as dividends, resulting in no net after-tax impact. In fact, the planned further reduction in corporate taxes beginning in 2011 is a net benefit to taxable investors.
- The implementation of a tax on distributions will effectively reduce the attractiveness to non-resident and tax-exempt accounts. **Therefore, we expect significant selling pressure in the Income Trust market today, with the exception of the REIT sector, which as noted is mostly exempt from these changes.**
- These measures will be effective in rebalancing the income tax treatment of corporations and FTEs, and as a result, the legal form a business takes will going forward depend less on tax legislation. **Therefore, we expect TELUS Corp. and BCE Inc. will not proceed with their**



planned conversion. We expect this will place pressure on the shares of TELUS and BCE, as well as those debt and preferred share issues of BCE that were slated to be called as a result of trust conversion. This is consistent with market commentary and comments from the Minister of Finance.

- These measures will likely result in little to no new issues or conversions going forward, outside of the REIT sector.
- There remains a four-year grandfathering period – FTEs currently publicly traded are not subject to these changes until the 2011 tax year. Therefore, no change in current structures is expected in the near term, as FTEs will remain an attractive tax structure over that period. Beginning in 2011, however, we expect many FTEs will re-visit their structure, to determine what will be in the best interest of unit-holders. We believe FTEs will have to reconsider market valuations and liquidity, net returns to unit-holders, as well as potentially re-examining the liability perspective (noting the superior limited liability legislation afforded to corporations in Canada).
- Beginning in 2011, it will become disadvantageous to hold FTEs in non-taxable accounts, due to the inability to realize the beneficial tax treatment of dividend income. In 2011, it will be much more advantageous to hold FTEs in taxable accounts, similar to high yielding common equity and preferred shares.

Due to these factors, should the Tax Fairness Plan be implemented, we believe the Income Trust Market will eventually become a much less significant portion of the Canadian financial market landscape. We refer to the experience in both the U.S. and Australia where similar legislation was enacted, and a decrease in relative market capitalization of FTEs subsequently occurred.

Furthermore, given the current composition of Parliament, it is expected the Plan will indeed be implemented. The opposition Liberal Party is in the midst of a leadership campaign, the New Democrats have previously voiced their opposition to further trust conversions and the current treatment of FTEs under the Tax Act, and finally, the Bloc Quebecois we expect will be supportive of initiatives to protect provincial tax revenues.

Finally, although there will be downward pressure on Income Trust market valuations today, we note that the near term outlook remains unchanged, and private market transactions may also provide support. Scotia Capital is forecasting a contraction in unit valuations, expecting EV/EBITDA multiples may contract and as a result unit prices may decline by 10% to 15%. However, we do believe the Power and Infrastructure Trusts may be insulated, as they currently are trading at valuations in-line with common equity valuations.

We also note that at this juncture Scotia Capital is making no changes to target prices or investment ratings in the Income Trust space.

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