

ChazenInstitute

The Jerome A. Chazen Institute
of International Business



COLUMBIA
BUSINESS
SCHOOL

Chazen Society Fellow Interest Paper

Canadian Income Trusts Face Taxing Challenge

Scott Goodwin MBA '07

© 2007 by The Trustees of Columbia University in the City of New York. All rights reserved

As the days get longer and the annual tax-filing deadline approaches, Benjamin Franklin's famous quip about the certainty of death and taxes should serve as an important reminder to investors who have flocked to Canadian income trusts. This market, which largely centers on companies involved in natural gas and oil exploration and production, skyrocketed in recent years on the huge spike in energy prices. Because these companies are organized as trusts, they are able to distribute tax-free profits to their shareholders and bypass a layer of tax that companies with more traditional corporate structures must bear.

These trusts are essentially regular corporations except that they meet certain legal requirements that allow them to bypass a layer of taxation. A major requirement is that they must pass on a certain percentage of their profits to shareholders in the form of a dividend. But otherwise, they earn revenues and incur expenses in the normal course of business. Also, like more common corporate structures, these trusts are able to list their shares on major stock exchanges. And list they did: in 2003, 80 percent of initial public offerings on Canadian markets were by income trusts, according to Pennaluna & Company, a National Association of Securities Dealers-registered broker.

Consider this example that illustrates just how much of an effect income trusts can have on investors' returns. In the United States, a typical company organized as a C Corporation (as most companies are; the name comes from part of the tax code that governs it) pays corporate taxes on profits. And while one of the main principles of the U.S. tax code is that there is no double taxation, when those after-tax profits are distributed to investors, they too face a tax (technically, it is not double taxation because each entity is only taxed once). Assuming a corporation earns \$100 in a given year and faces a corporate tax rate of 35 percent, its after-tax profit is \$65. If it distributes this to shareholders via a dividend, shareholders are assessed a 15 percent tax on the distribution, reducing their after-tax take to just \$55.25. A Canadian trust structure, however, would guarantee 85 percent of that \$100 in after-tax profits to shareholders. It is therefore easy to see why this structure has become so attractive.*

The Canadian trust market has boomed, particularly with U.S. investors, mainly because of the surge in energy prices but also due to the attractive trust structure. Trusts were generating yields above 10 percent and were also appreciating at 20 percent per year, providing outsized returns for investors. A stunning exception was EnCana Corporation, headquartered in Calgary, which reached a share price of \$55.93 in late 2005, about 270 percent higher than when it went public in 2002.

As always with investing, if it sounds too good to be true, it probably is. And after years of white-hot performance, the Canadian income trust market was thoroughly spooked on Halloween. On October 31, 2006, Finance Minister Jim Flaherty proclaimed

* While it seems onerous in this example, the 15 percent dividend rate is a major decrease from previous dividend-tax rates and is a hallmark of Dean Glenn Hubbard's tenure as chairman of the President's Council of Economic Advisers.

the government intended to impose a layer of corporate taxes on the trusts, despite previous pledges that no such tax would be imposed. Although the plan is to begin taxing the companies in 2011, the trusts' valuations were immediately shaken by this proclamation. Penn West Petroleum, which trades on the Toronto Stock Exchange (TSX), lost almost 15 percent that day. And it was not just energy-related companies that suffered, as 9 of the 10 indices on the TSX declined on October 31. The only sector in the black at the end of the day was financials, as investors rotated money out of income trusts and into dividend-paying bank stocks, according to a *Wall Street Journal* report the next day. Equity valuations, which are based on the amount of future cash flow that can be distributed to shareholders, now reflect this stark reality of a second layer of taxes being imposed.

It is interesting to note the similarities between the Canadian income trusts and the U.S. real estate investment trusts, which have also done very well in recent years. Like the income trusts north of the border, REITs meet several restrictions that allow them to distribute pretax profits to shareholders. And while there have been no suggestions that this benefit may be under review, any implication that this might change could certainly have a negative impact on REIT share prices too.