A Welcome Tax Reform Response to the Income Trust Issue

Finance Minister Goodale today tabled a Ways and Means motion reducing the personal income tax (PIT) on dividends. By substantially trimming the double taxation of dividend income, the tax treatment of dividends, income trust distributions and capital gains is now more equal and tax considerations should no longer loom as such a large factor affecting decisions on corporate organization. The Finance Minister opted to end current investor uncertainty on the future of income trusts by shortening the consultation period from the original December 31st deadline and providing an immediate policy announcement in advance of Parliament potentially dissolving early next week, Specifically the Minister proposes:

- To create "eligible dividends" as those dividends paid after 2005 by public corporations (and other corporations that are not Canadian-controlled private corporations) from income that is subject to the general corporate income tax (CIT) rate, while ordinary dividends after 2005 will be those paid by a firm subject to the small business income tax rate;
- To increase the gross-up factor from 25% to 45%; and
- To enhance the combined federal/provincial dividend tax credit from 20% to 32%.

With this formal policy announcement, the deferment of advance tax rulings by Revenue Canada on potential trust conversions is ended.

Finance estimates that the revenue cost of this measure will be $300 million annually, beginning in 2006. This impact, however, will vary with corporate decisions on the distribution of their earnings.

The Finance Minister reported that submissions to date had indicated widespread support for eliminating the double taxation of dividends. This reform, though only partial in the near term, goes a long way to remedying a longstanding tax inequity, encourages saving and investment and makes our tax system more competitive with the U.S. It reduces the disincentive to distribute corporate earnings, making dividends a more viable option relative to capital gains.

The market for income trusts will be dampened to the extent that the demand for trusts versus dividend-paying equities eases, causing an adjustment in the relative prices of each instrument. A number of the other options to curtail income trusts that have been discussed this fall would have been more damaging, notably a direct tax on distributions, a cap on income trust holdings for tax deferred plans or restricted interest deductibility. Tonight's announcement offers some reassurance to individuals such as retirees relying on income trusts' large cash distributions, and offers the prospect of higher regular income from preferred and common equities.

In the near-term, the "playing field" becomes more level, but the tilt, albeit much gentler, will still favour income trusts. The enhanced dividend tax credit only fully eliminates the double taxation of dividends after the corporate surtax is eliminated in 2008 (equivalent to a 1.12 percentage point general CIT rate reduction) and the general CIT rate, at 21%

through 2007, falls to 19% by 2010. (The CIT rate is slated to fall to 20.5% in 2008, 20% in 2009 and then 19% in 2010). The federal government assumes that the provincial governments proceed with their proposed CIT changes and adjust their dividend taxation to match Ottawa's more generous treatment. However, the remaining bias towards income trusts may fade sooner than anticipated. In Ottawa's November update, the proposed advance in eliminating the capital tax for Canada's larger non-financial corporations from 2008 to 2006 will expose more businesses to the CIT surtax until it is removed in 2008. Thus, removing the surtax may be accelerated if funds permit.

Not addressed is Alberta's concern over the generous tax treatment accorded to non-residents holding resource trusts during a period of very buoyant commodity prices. Currently non-residents pay only a 15% withholding tax, significantly less than the average taxable Canadian investor on non-renewable resource income.

Is tonight's tax reform sufficient to dampen income trusts, particularly business income trusts whose spread across most industries has caused Ottawa so much concern? Probably not. The uncertainty that has shadowed the income trust sector this fall is now largely removed. It is unlikely that the legislation covering the PIT reduction on dividends will be passed, but Revenue Canada will act on the directive. Moreover, the Conservatives are on record as supporting this tax reform.

Canada's New Dividend Taxation Arithmetic

	Larger Corporations Current	**Larger Corporations Proposed**	**Income Trusts**
	$ except where noted		
Income	100	100	100
CIT*	32	32	0
Distribution to Investor	68	68	100
Canadian Taxable Investor			
Dividend Gross-Up, %	25	45	n.a.
Grossed-up Dividend	85	99	n.a.
Top PIT rate (avg fed/prov),%	46	46	46
PIT	39	45	46
Divdend Tax Credit, %**	20	32	n.a.
Dividend Tax Credit	17	32	n.a.
Net PIT	22	14	46
Total CIT and PIT	**54**	**46**	**46**

* *Combined federal/provincial corporate tax rate by 2010 given proposed federal and provincial tax changes.*
** *Average federal/provincial rate.*
Source: Finance Canada.

Mary E. Webb
Scotia Economics
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