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e-brief

Unfinished Business: Achieving Neutral Taxation of Corporations and Income Trusts

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The recent increase in the dividend tax credit was focused on creating a level playing field between corporations and income trusts. By lowering the tax paid on corporate dividends, the minister of finance aimed to add a little lustre to dividend-paying stocks, compared to income trusts, which pay little or no corporate tax. This would eliminate the tax distortions affecting the efficiency of capital markets.

Has the minister really achieved his aims? Only partly. This e-brief concludes that the policy has largely failed to eliminate tax distortions. The reason: businesses can increase their value by more than a third by converting corporate assets into income trusts. Further tax policy actions will be required if tax neutrality is to be established.

A Partially Level Playing Field…

But first, what has the minister achieved? By increasing the dividend tax credit, the minister has partially reduced the discriminatory taxation of dividends. To illustrate, here are examples of the tax treatment before and after the change.

Before the announcement, dividends could be subject to higher tax than other forms of income, including income trust distributions. For example, a corporation earning \$100 in profits could pay corporate tax of \$35, leaving \$65 to be distributed as a dividend. The shareholder would pay personal taxes on the dividends calculated as follows. The dividends would be grossed-up by a factor of 125 percent to \$81.25. For the high-income earner, personal taxes levied at a 46 percent rate would be applied to the grossed-up value of dividends, resulting in \$37.37 in tax. However, the taxpayer could reduce personal taxes by a federal-provincial dividend tax credit equal to 20 percent of grossed-up dividends, or

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$16.25, resulting in a net personal tax payment of $21.12 ($37.37 minus $16.25). The total corporate and personal tax levied on dividends would therefore be $56.25.

In contrast, income trust distributions are taxed at a much lower rate. Income trusts surged in popularity because they provided an opportunity for business to bypass the corporate tax by capitalizing the company with debt. After conversion, most of the income paid through trusts to investors would only be subject to personal tax. For high-income investors, facing a 46 percent rate, $100 in corporate profits distributed through income trusts would only be subject to personal taxes of $46. Thus, by converting corporations into trusts, the high-income investor could save $10 in tax for each $100 in corporate profits.

After the minister's announcement, the effective tax rate on dividends is reduced. The federal dividend tax credit is increased from roughly 13 percent to 19 percent on dividends paid by companies with high-taxed profits. Dividends are grossed-up by a factor of 145 percent instead of 125 percent. If the provinces follow along, their dividend tax credit would increase on average from 7 percent to 13 percent of grossed-up dividends. In the case of the high-income earner, dividends will bear $35 in corporate tax and personal tax of $13.20, for a total tax of $48.20, somewhat more than the tax on income trust distributions. The reason for this small difference is that the minister assumes that corporate tax rates will be cut a further 3 points by 2010, assuming no further NDP-brokered budget deals.

…But 60 percent of Investors Still Prefer Income Trusts

So far, so good. The dividend tax credit can be used to reduce personal income taxes on dividends paid to individuals. But investors who pay little or no personal tax on investment income remain unimpressed, because they obviously can't take advantage of the tax break. This includes owners of pension funds, RRSPs and non-resident investors in Canadian equities. The tax distortion remains. These investors, who comprise over 60 percent of the equity market, prefer companies to convert business assets into income trusts since they can avoid paying corporate taxes at a 35 percent rate. As well, they pay no tax on income trust distributions, in the case of RRSP and pension plan owners, or a 15 percent tax in the case of non-residents.

Getting lost in all this debate is another tax distortion that has not been addressed by the minister. While income trusts have achieved a lower cost of capital for business investments and better returns to investments by avoiding the discriminatory dividend taxes, there is one catch. The tax system encourages excessive distributions since trusts that retain taxable profits are subject to onerous taxation. Undistributed income is subject to the top personal income tax rate where the trust resides (such as 39 percent in Alberta and over 46 percent in Ontario) and distributions from income earned in prior years is further taxed as capital gains in the hands of the unit holders. Thus, trusts have little choice but to make large distributions for tax reasons, which can be attractive to investors looking for high-yield investments but reduce the ability of businesses to fund investments with cheaper internal sources of capital.

Because Conversion Produces Tax Efficiency — and a Valuation Premium

On the whole, however, when a corporation is converted into an income trust, investors will get a premium from the higher valuation of assets arising from reductions in tax, or so-called tax efficiency. Market value increases when the overall tax bill decreases. In this analysis, I estimate the valuation premium arising from tax efficiency using several assumptions. The first is that the corporation distributes all of its profits as dividends, thus providing a high cash yield on corporate assets just like income trusts. The second is that the corporate profits are taxed at the average federal-provincial tax rate of 35 percent. The third is that investors only distinguish between income trusts and dividend-paying corporations in terms of their tax savings.

As is shown in Table 1, the conversion premium from a corporation shifting to income trust status virtually disappears for taxable investors (only 4.4 percent under the new regime in contrast to 36 percent under the old regime). However, for the majority of the market, the conversion premium remains at 54 percent, since pension plans, RRSP owners and non-residents can benefit from large tax efficiency gains with conversions to income trusts.

It is difficult to tell which type of investor is particularly important in determining the valuation of income trusts but both pension plans and non-residents — now protected under new provincial limited liability rules applied to trusts — will likely be significant sources of finance for the trust market. If one just takes the average of tax rates faced by each category of investment, the new dividend tax policy continues to provide significant tax benefits with conversions — the premium in valuation from conversion to income trusts drops from 48 percent to 35 percent.

Not all corporations would wish to convert into income trusts, at least from the average investor's point of view. Those companies that pay corporate tax as a share of profits below 15 percent (rather than at the statutory tax rate assumed in the calculations) would prefer to be corporations than income trusts.

Without question, significant gains remain for a large share of the market when corporations are converted into income trusts. If the minister wishes to create a truly level playing field between corporations and trusts, he needs to carry out several other tax policies:

- Make the dividend tax credit refundable to pension plans and RRSP owners so that they would be indifferent between corporation and trust assets.
- Levy a corporate distribution tax to ensure that the refundable dividend tax is covered by corporate tax payments.
- Increase the level of tax on non-residents receiving income trust distributions so that they pay a similar tax on corporate dividends and income trust distributions.
- Reduce the tax penalty on income trusts so that they are indifferent with respect to paying out distributions or retaining income for tax reasons.

None of these policies can be implemented overnight since they require a fundamental reform of the tax system. However, it is better to take time to get things right than to rush into a decision. If income trust conversions remain unabated, hopefully the minister will politely create a truly level playing field next time when he needs to make sure the capital markets are operating efficiently.

Table 1: *Implied Conversion Premium Due to Tax Savings*

		Conversion Premium	
Marginal Investor	**Portion of Securities**	**Old Dividend Tax Regime**	**New Dividend Tax Regime**
High Personal Tax Bracket	n/a	22.2%	4.2%
Average Personal Tax Bracket	39.5%	35.7%	4.4%
Pensions & RRSPs	39.1%	53.8%	53.8%
Non-Residents	21.4%	53.8%	53.8%
Average Shareholders	100.0%	48.1%	35.1%

Notes: Calculations are based on the following assumptions:

(1) An effective corporate tax rate of 35 percent prior to conversion;

(2) Marginal tax rate on income trust distributions is 46 percent for high-income investors, 40 percent for average taxable investors receiving dividends, 0 percent for pension plan and RRSP owners and 15 percent for non-resident owners.

(3) Marginal tax rate on dividends is 32 percent for high-income investors, 25 percent (old regime) and 11.7 percent (new regime) for average investors, 0 percent for pension plans and RRSP owners and 15 percent for non-resident owners.

(4) A 100 percent dividend payout policy prior to conversion.

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