

U.S. bill doubles trust tax to 35%

Would punish U.S. investors with Canadian dividend

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A proposed tweak to U.S. tax laws could more than double the amount of tax Americans pay on distributions from Canadian income trusts, a blow which would further damage investor interest in the sector.

Congressman Richard E. Neal, a Democrat from Massachusetts, recently filed a bill in the House of Representatives, which was then referred to the ways and means committee, that would revoke the existing special tax treatment on dividends from certain foreign entities such as income trusts and real estate investment trusts.

Distributions from these types of securities are now taxed at a rate of 15% in the hands of American investors -- a rate on par with taxes paid on dividends from U.S. corporations and Canadian corporations listed in the United States.

But Mr. Neal's bill could nix this special treatment for trusts and similarly structured investments, jacking up the tax rate on distributions to as high as 35%.

"If this was passed, there would be a disincentive for U.S. investors to purchase units in Canadian trusts, REITs and mutual funds," said Stephen Ruby, a senior tax partner at Davies Ward Phillips & Vineberg LLP. "You're going to lose all that buying power."

Currently, the U.S. taxman views distributions from income trusts and similar vehicles as "qualified dividend income" flowing from "certain foreign dividends," a status which grants these investments the favourable 15% tax treatment. But the bill, which is in the preliminary stages in the law-making process, would revoke this special status to investment vehicles that deduct their distributions to unitholders from their income, making it so the unitholders pay the tax rather than the investment entity.

That snares income trusts, REITs and even some mutual funds.

Peter Keenan, a New York-based tax specialist at Torys LLP, said this bill, which he estimates could raise the tax rate to as much as 35%, is in the "very preliminary" stages, making it subject to changes and delays.

Dividend-paying Canadian corporations -- such as the Big Five banks -- won't be affected by the bill because they qualify for the 15% tax treatment under different provisions. Companies listed on exchanges in the United States, for example, are awarded the lower tax rate.

This would be the second major threat to income trusts in five months. On the last day of October, Canadian Finance Minister Jim Flaherty announced plans to tax income trusts at a rate comparable to their corporate counterparts by 2011. That brought instant carnage to the income-trust market, and sparked intense backlash from



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John Dielwart, chief executive of ARC Energy Trust, was one of the most vocal critics of federal Finance Minister Jim Flaherty's income-trust tax reforms, arguing those changes could kill the oil and gas royalty companies.

investors and the business community.

Mr. Neal's bill has not been met with the same fury.

"Many, many bills get introduced -- and a small percentage of which pass. This could be one of them," said John Dielwart, the chief executive of ARC Energy Trust. Mr. Dielwart was one of the most vocal critics of Mr. Flaherty's reforms, arguing that the changes would kill the oil-and-gas royalty companies.

If Mr. Neal's bill does come to fruition, the oil and gas trusts could find themselves in great jeopardy. These assets have attracted huge interest from foreign investors, namely in the United States.

Canada's oil and gas trusts have a combined market capitalization of about \$85-billion, down from about \$100-billion in the days before Mr. Flaherty's announcement. Mr. Dielwart estimates that foreign investors control about 42% of the royalty trust market, or about \$35-billion. U.S. investors will quickly bail on these investments if their tax rate on the distributions suddenly doubles. But so far, the market has been mute.

"I would have more than a dollop of suspicion about whether a tax increase is likely to pass these days," said Peter Slan, an investment banker at Scotia Capital.

Income trust opponent Diane Urquhart -- the independent analyst who first noticed the effect Mr. Neal's bill could have on trusts -- said the proposed legislation takes away the tax advantage Canadian trusts have over American corporations, and allows the United States. to recoup lost tax revenue.

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