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# FineAnswers

Answers to questions on tax, finance and Investment

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## INCOME TRUSTS – HAVE THEY DROPPED TOO MUCH?

**Is it true that Income Trusts paid no tax before the creation of the Distribution Tax on 31<sup>st</sup> October 2006?**

*Yes! But they had to distribute nearly all of their earnings and therefore the recipients would bear the tax.*

**Under the old tax regime would the overall tax be less in the year 2011?**

*Yes! But only about two percentage points if received by an individual paying tax at the top marginal rate of tax in Ontario. However, this percentage point increases for lower income investors. At an income level of around \$60,000 the overall increase in taxation will be close to five percentage points. So you can say the lower income groups who probably hold more of this type investments are hit harder. Compare the two tables below.*

**What if the recipient of distributions was tax exempt such as a RRSP or a Pension Plan?**

*Then, there would be no tax to pay at all. For now! But, remember the tax would have only been deferred. When the investments in the plan are ultimately paid out to the recipient, tax would be payable. All such payments would be taxed as income regardless of whether some were capital gains. Not a fair result for plans with a short life as capital gains are taxed at half the rate of other income.*

**In comparing publicly traded corporations to Income Trusts before the new distribution tax, would the government's tax loss be limited to the deferral of the tax otherwise payable on the income and gains in RRSP's and Pension Plans?**

*No. It would probably be more. Because, some individuals would be in a lower tax bracket when receiving payment from their registered plans than the current corporate tax rate of approximately 36% in Ontario.*

**Since the Minister of Finance's announcement, the price of Income Trusts on the TSX has dropped anywhere between 10% and 20%. Why have the prices of ALL Income Trusts not dropped by the same amount?**

*Aside from the usual market factors, there might be one other MAIN reason. Income Trusts have a different mix of taxable and non-taxable (often referred to as Return of Capital) amounts in their distributions.*

**What is the nature of Return of Capital?**

*Return of Capital is really the difference between the earnings after the deduction of amortization (Capital Cost Allowance; a term used by the tax department for allowable amortization) and earnings before deduction of amortization. In other words it is more or less equal to the amount of amortization that is being returned as capital.*

**If Income Trusts are continuously paying out amounts equal to the amortization and not retaining it, how are they going to get the funds to replace their amortized or depleted assets?**

*Good question! For now they are issuing more units and using them to replace the amortized or depleted assets.*

**So in other words Income Trusts are getting back from new investors what they paid out earlier as Return of Capital. If so, their units are increasing while their income would probably stay the same.**

*That is correct in most cases. And therefore, resulting in a possible drop in the per unit distribution.*

**Why does the Return of Capital have an effect on the price of Income Trusts?**

*This may be because there is a perception of more income, but in fact it is more like a mix of principal and interest, similar to an investment in mortgages or annuities.*

**Is it true to say the more amortization write off, the less the effect of the new tax on the drop in the share price?**

*Yes, this may be true in some cases!*

**Given the effect of the new tax in four years is it possible to calculate the expected drop today in the price of Income Trusts?**

*I have an example (EnerVest Diversified Income Trust) of such a calculation on the next two pages. This income trust holds other Income Trusts as investments, like a mutual fund. You will find two tables. One assumes ownership of trusts by individuals in the middle marginal tax rate and the other by Individuals in the top marginal tax rate.*

**What are your assumptions?**

*The assumptions are as follows:*

- 1)  *Holders of EnerVest Diversified Income Trust will value their investment with reference to both distributions and earnings.*
- 2)  *The earnings and distributions per unit are going to stay the same (at 7.08% per annum) over the next four years.*
- 3)  *The tax rate on Income Trusts, which is almost the same as the rate for public corporations, will be 31.5% in 2012.*
- 4)  *Tax on individuals at the \$55,000-67,000 tax bracket will be 33% (in Table 1) and the top marginal rate will be 46.4% (in Table 2)*
- 5)  *Marginal tax rate for individuals (at \$55,000-67,000) on the taxable portion of distributions from Income Trusts will be 15%, (in Table 1) and 25% (in Table 2) which is the same as tax on eligible dividends from public corporations.*
- 6)  *Two thirds of issued units are held by individuals and one third by non-taxable entities.*
- 7)  *Return of Capital is assumed to be 40% of distribution.*

**Based on the calculations in the tables below, is the Specified Investment Flow-Through (SWIFT) as referred to by the department of finance, which includes Income Trusts, overvalued or undervalued?**

*Based on the one calculated below and on the assumptions made they seem to be fairly valued. EnerVest Diversified Income Trust, as at 13<sup>th</sup> November 2006 was trading about 16.67% below its net asset value per unit, which comprise of several other income trusts. EnerVest closed at \$5.45 while its net asset value per unit was reported on its website (<http://www.enervest.com/DiversifiedIncomeTrust.asp>) to be \$6.54. One would assume that the market value of EnerVest would be closer to its net asset value per unit and it is difficult to explain the reason for such a big difference. In fact EnerVest announced on the 14<sup>th</sup> of November that it would repurchase a number of its units.*

**So do think EnerVest must be a good buy?**

*It definitely is a good arbitrage.*

**NOTICE TO READER**

***THE AUTHOR OWNS SHARES OF ENERVEST DIVERSIFIED INCOME TRUST***

***FOR INVESTMENTS IN THIS SECURITY MAKE SURE TO CONSULT WITH YOUR INVESTMENT ADVISOR***

TABLE 1

**ENERVEST DIVERSIFIED INCOME TRUST -At 13<sup>th</sup> November 2006**  
**Using a Midrange Marginal Tax Rate**

	Distribution to an Individual			Tax Sheltered Distribution				
	Tax Rate	Earning	Capital	Total	Tax Rate	Earning	Capital	Total
Distribution in 2006		\$ 0.50	\$ 0.34	\$ 0.84		\$ 0.50	\$ 0.34	\$ 0.84
Tax at the trust level	0.00%	0.00		0.00	0.00	0.00		0.00
Net available for distribution		0.50	0.34	0.84		0.50	0.34	0.84
Tax rate on income - \$55,000 to \$67,000	33.00%	(0.17)		(0.17)	0.00			0.00
		0.34	0.34	0.67		0.50	0.34	0.84
Distribution in 2012		\$ 0.50	\$ 0.34	\$ 0.84		\$ 0.50	\$ 0.34	\$ 0.84
Tax at the trust level	31.50%	(0.16)		(0.16)	31.50	(0.16)		(0.16)
Net available for distribution		0.35	0.34	0.68		0.35	0.34	0.68
Tax for dividends - \$55,000 to 67,000	15.00%	(0.05)		(0.05)	0.00	0.00		0.00
		\$ 0.29	\$ 0.34	\$ 0.63		\$ 0.35	\$ 0.34	\$ 0.68
Percentage drop based on earning & distribution		<b>13.10%</b>		6.56%		<b>31.50%</b>		18.90%
Average Percentage drop based on distribution I				<b>9.83%</b>				<b>25.20%</b>
Market price 31st October 2006				<b>\$ 7.12</b>				<b>\$ 7.12</b>

**Estimated Unit Price of EnerVest Diversified Income Trust - Based on drop in earnings only**

	Unit Price	Earning %	Future Value
Future value based on current earning rate	\$ 7.12	7.08%	\$ 9.36
Weighted average (2:1) % drop in unit price as result of the new tax kicking in 2011			19.23%
Future value of price after the tax effect			\$ 7.56
Present value of estimated future price of units discounted at 4.20%	<b>\$ 6.41</b>	4.20%	

**Estimated Unit Price of EnerVest Diversified Income Trust - Based on drop in distribution**

	Unit Price	Earning %	Future Value
Future value based on current earning rate	\$ 7.12	7.08%	\$ 9.36
Weighted average (2:1) % drop in unit price as result of the new tax kicking in 2011			14.95%
Future value of price after the tax effect			\$ 7.96
Present value of estimated future price of units discounted at 4.20%	<b>\$ 6.75</b>	4.20%	

**TABLE 2**  
**ENERVEST DIVERSIFIED INCOME TRUST -At 13<sup>th</sup> November 2006**  
**Using the Top Marginal Tax Rate**

	Distribution to an Individual			Tax Sheltered Distribution				
	Tax Rate	Earning	Capital	Total	Tax Rate	Earning	Capital	Total
Distribution in 2006		\$ 0.50	\$ 0.34	\$ 0.84		\$ 0.50	\$ 0.34	\$ 0.84
Tax at the trust level	0.00%	0.00		0.00	0.00	0.00		0.00
Net available for distribution		0.50	0.34	0.84		0.50	0.34	0.84
Tax rate on income \$119,000+	46.41%	(0.23)		(0.23)	0.00			0.00
		0.27	0.34	0.61		0.50	0.34	0.84
Distribution in 2012		\$ 0.50	\$ 0.34	\$ 0.84		\$ 0.50	\$ 0.34	\$ 0.84
Tax at the trust level	31.50%	(0.16)		(0.16)	31.50%	(0.16)		(0.16)
Net available for distribution		0.35	0.34	0.68		0.35	0.34	0.68
Tax for dividends \$119,000 +	25.04%	(0.09)		(0.09)	0.00	0.00		0.00
		\$ 0.26	\$ 0.34	\$ 0.59		\$ 0.35	\$ 0.34	\$ 0.68
Percentage drop based on earning & distribution		<b>4.18%</b>		1.86%	<b>31.50%</b>			18.90%
Average Percentage drop based on distribution				<b>3.02%</b>				<b>25.20%</b>
Market price 31stst October 2006				<b>\$ 7.12</b>				<b>\$ 7.12</b>

Estimated Unit Price of EnerVest Diversified Income Trust - Based on drop in earning only			
	Unit Price	Earning %	Future Value
Future value (year 2011) based on current earning rate	\$ 7.12	7.08%	\$ 9.36
Weighted average (2:1) % drop in unit price as result of the new tax kicking in 2011			13.29%
Future value of price after the tax effect			\$ 8.12
Present value of estimated future price of units discounted at 4.20%	<b>\$ 6.89</b>	4.20%	

Estimated Unit Price of EnerVest Diversified Income Trust - Based on drop in distribution			
	Unit Price	Earning %	Future Value
Future value (year 2011) based on current earning rate	\$ 7.12	7.08%	\$ 9.36
Weighted average (2:1) % drop in unit price as result of the new tax kicking in 2011			10.42%
Future value of price after the tax effect			\$ 8.39
Present value of estimated future price of units discounted at 4.20%	<b>\$ 7.11</b>	4.20%	

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<http://www.tavana.ca/newsletter/newsletter.asp?iddetail=7>

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