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Changes to Income Trust Taxation in Canada: Investor Reaction and Dividend Clientele Theory

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Abstract

Abstract: This paper explores the relationship between tax-induced dividend clientele theory and the recent changes to the taxation of income trusts in Canada. On October 31, 2006, the Canadian government announced the Tax Fairness Plan (*TFP*) calling for the elimination of the considerable tax advantage enjoyed by income trusts. Generally, distributions from income trusts are now taxed at rates comparable to those imposed on corporate dividends. We examine market reaction to the *TFP* to address three issues: first, whether the valuation effect of a dividend tax increase is consistent with the traditional or the new view of dividend taxation; secondly, whether the market reaction to tax increases has a differential impact on firm value that is related to the tax preferences of taxable, tax-exempt, and foreign investor tax clienteles; and thirdly, whether firms change their dividend policies in response to the preference of institutional investors (tax-based dividend policy effect) or whether institutional investors are sorting themselves across firms based on their dividend policies (investor sorting effect). Our results provide strong evidence as follows. First, the valuation effect in reaction to the *TFP* announcement is consistent with the traditional view of dividend taxation – i.e. that taxes on dividends reduce the net return to investors, increase the firm's cost of capital and lower the firm's ability to access capital markets, thereby discouraging investment and savings. Secondly, we saw that trusts with a larger percentage of their units held by tax-exempt, low-tax, and foreign investors had a higher decline in value when compared with trusts held mostly by ordinary taxable investors. These results support dividend tax clientele theory. Finally, we observed changes in institutional investor clienteles consistent with the investor sorting effect.

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Citing Literature