

# BREACH OF TRUST

The federal government's surprise decision to tax income trusts spells major changes to this unique structure and investment vehicle. The short-term effect is clear — a sharp drop in trust valuations across the board, a massive hit to the TSX and the wiping out of significant savings for many Canadian investors. But **LESLIE HAYMAN** argues that the long-term evolution of income trusts is far more uncertain. Will they continue to be a viable part of the Canadian economy — and the portfolio of retail investors?

**M**uch has changed in the 20-year history of income trusts and 2006 is certainly no exception. Finance Minister Jim Flaherty's abrupt announcement after markets closed October 31 that the federal government will move to tax income trusts created after November 1 caused a shockwave in not just the trust sector, but throughout the investment community.

Previously announced decisions from Telus Corp. and BCE Inc. that they would convert common equity into trust units, with a combined market value of \$50 billion, are

now up for reconsideration. These two issues promised to bring known managers of widely held firms into the trust ownership structure. They would have enlarged the trust market by roughly one-quarter, pushing income trusts up to \$250 billion in value from \$20 billion six years ago. Six years from now, it is anyone's guess as to what that number will be.

Beyond the specific short-term effects of the Conservative government's decision to tax income trusts, there are several issues that will play out in the long run. Will Canadian corporations still see value in converting to an income trust structure, despite the new tax regime? How will existing income trusts, which have a grandfathered

provision of tax-relief until 2011, change their business plans? Will there be creative strategies to revise the structures of flow-through entities? What are the long-term prospects for value- and income-seekers in the Canadian market? At this stage, there are more questions than answers.

However, some things are known. Investors who weren't previously looking at income trusts are surely now more compelled to follow the sector. Those who did not even know their mutual funds or pension plans held income trusts are paying more attention. Many retail investors are certainly looking to their advisors for guidance in the current market.



With a view towards helping to inform advisors about income trusts, market risks and dynamics, this article reviews the evolving nature of income trusts, key benchmark measures of return and risk and the pros and cons of investing in this asset class.

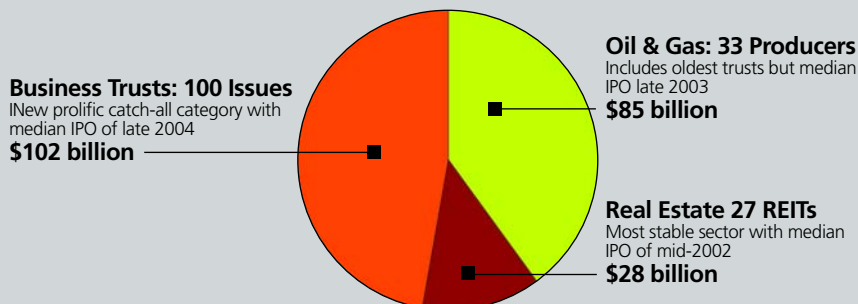
We look at income trusts in their own right, on the day prior to the proposed new tax rules. Market values have changed since then, but a significant element of policy risk has also been removed.

### MATURING MARKET

From their roots in the oil patch and real estate sectors, Canadian income trusts have grown to include 250 issues on the Toronto Stock Exchange (TSX). Half of these issues are new in the last few years, expanding the market to \$210-billion in value or about 10 per cent of the overall TSX equities market by late 2006.

### INCOME TRUST MARKET VALUE

TSX Q3 2006 – \$210 BILLION



The median market capitalization for trusts remains relatively small at \$300 million. But this is changing. The market has matured since participants were threatened by a new tax regime in late 2005. That caused the single-most significant sell-off in more than a decade. Retail investors sold trusts and prices fell 17 per cent on average.

The market recovered with added strength from the decision (at that time) of the Department of Finance not to tax trusts. Other factors aided in the recovery of trusts:

- large fund managers bought in to acquire the majority of trust units;
- Standard and Poors (S&P) included trusts in its TSX composite indices;
- new players like hedge funds added liquidity;

- large public firms like CI Financial, Precision Drilling and, now, BCE and Telus decided on trust conversion;
- the Canadian Association of Income Funds explored enhancements in corporate governance and reporting standards;

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- private and public companies moved from being just sellers to buyers of trusts as well, confirming trusts as valued entities in traditional capital markets; and
- trust price volatility generally realigned with other equities in related sectors.

Overall, trust units were priced up during 2006 so that relative cash yields fell from a median of more than 10 per cent to

But many past assumptions have proved wrong. Some people assumed income trusts lose value when interest rates rise, as if dividend-paying equities are really fixed income products. Some assumed that income trusts in Canada are like trusts in the U.S., where

assets cannot be renewed or utilized alongside an active business. And some people characterized trusts solely as tax avoidance vehicles.

As a unique form of ownership, trusts were often misconstrued as an entirely homogeneous asset class with a single risk and return profile. Like equities, every enterprise offered as a trust needs to be distinguished on its own business merits.

Many are still learning about the nature of trusts. As top trust executives discussed in a financial forum in October, a key reason for conversion into an income trust is to finance growth. That growth can be seen in rising unit prices and growing cash flows that can translate into rising rates of distribution. Companies held in public trust can focus on efficient cash management and generate profits that are taxable in the hands of their owners.

It's a fallacy to generalize, however, that if one company in a sector converts into a trust, then all companies have similar ability or intent to operate that way.

Finance professionals are gaining experience to reduce potential trust risks. Past practices launched trusts with 100 per cent payout of cash flow and hope that business growth could cover the cost of asset maintenance. Today, new issues are structured to prioritize cash flow for distributions to owners but leave margin for operations.

Companies with trust issues and payout commitments can work to ensure cash is available for covering costs of doing business, interest, operations and growth. Fund managers argue that trust agreements give company owners the control they deserve. And flow-through entities focus public company managers on the most profitable, less speculative uses for cash while ensuring owners are paid returns.

## ASSETS WITH TAX IMPLICATIONS

No doubt, trusts transfer the burden of tax for a particular business to those who choose to own it. This fact will continue even with the decision of the Conservative government. Diversified trust holdings can minimize business and sector-specific risks for owners with each then being responsible and equipped to plan finances in the context of their personal tax situation.

As income trust structures provide business the legal means to transfer at least some of the tax burden to owners, a liability is taken from assets in the market so market prices naturally rise. Trust conversions may still remain popular among business owners, including professional and hedge fund managers seeking a strategy to “enhance shareholder value.”

In fact, we may see more unique strategies to use income trusts structures under the new rules. Limited partnerships, closed-end and open-end trusts have provided a flexible framework for private and public companies to structure their affairs to attract outside capital at a relatively low cost. Companies commit to pay cash as tangible and frequent returns. Owners are given right and means to govern the way returns and free cash flow is managed or used, in- or outside the company, for reinvestment.

Companies with tangible assets, particularly those with low maintenance and operating costs, provide owners with down-

side protection against unit price volatility. Otherwise, trust prices vary somewhat with owner expectations about business cash flows, some of which is paid out through distributions to owners.

As advisors know, distributions from some trusts may be treated for tax purposes as return of capital; owners may find tax deferral opportunities on cash income.

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Distributions are used to reduce the capital cost base rather than add to taxable income. But tax deferrals need to be determined each year as return of capital diminishes over time with the aging of assets and shrinking cost allowances. Ordinary business income tends to increase in relative terms.

Advisors can help investors defer taxes by holding income trusts in registered retirement accounts. Trusts may well be held outside of a registered account when return of capital or capital gains are significant.

More importantly, advisors can think about the tax implications for income trusts in terms of equities, not bonds or debt issues. In contrast to fixed income products, income trusts can reward owners with unit price appreciation. Whereas the government provides a tax credit on capital gains for assets held outside a registered account, capital gains made on growing trusts are deemed fully taxable income when cashed

out of a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF).

One of the common misunderstandings about income trusts is that what Revenue Canada misses in corporate income tax on trusts, it may more than make up for on personal income tax now and fully taxable retirement account withdrawals a bit later.

Clearly, that argument did not dissuade the finance minister from his decision to tax income trusts similar to corporations. While much has been made of the supposedly negative impact of trusts on research and development and company reinvestment, there is little if any hard evidence that trusts diminish productivity or hinder innovation in the Canadian economy.

Unit price fluctuations triggered by perceived risk do not diminish business fundamentals that drive cash flow and returns for investors, the economy and, ultimately, tax revenues.

## RETURNS AND RISK

Some general principles have emerged to suggest that total returns from trusts remain highly attractive relative to other investments. This is despite reports about S&P indices showing income trust prices lagging those of equities from time to time.

Our iTrustIndex of Total Returns shows that an equal weight purchase of every income trust in September 2000, or on the day it was first issued since then, provided trust investors an average annualized return of approximately 18 per cent. Half of that was provided through frequent cash returns that give investors the flexibility to spend income, reinvest or diversify. A matched weight and similarly timed purchase of an equities and bond-based exchange-traded index fund provided a total return of less than one half and one quarter that of trusts, respectively.

Returns can also be measured against risk. Studies by BMO Nesbitt Burns in the last year calculated that the return relative to market risk was significantly better for trusts than for equities, as measured by the Sharpe Ratio. One factor in risk reduction

## BUSINESS TRUSTS SERVE AS A CATCH-ALL CATEGORY REPRESENTING A VARIETY OF SUB-SECTORS:

### Energy-related (48 trusts worth \$39 billion):

- down-stream utilities with solid assets;
- mid-stream processors; and
- up-stream service firms with business cycle tied to tight energy supply.

### Food-related (28 trusts or 11 per cent of issues but only three per cent of market value):

- restaurant royalty funds;
- retailers with steady business but narrow margins; and

- producers and distributors that often seek growth in the American market but risk suffering from its shrinking dollar relative to Canadian payout commitments.

### Other business (27 trusts worth \$54 billion):

- resource-related trusts (9) depend on global economy and trade;
- commercial service firms; and
- consumer-based businesses.

## FAIR OR FOUL?

Finance Minister Jim Flaherty revealed his "Tax Fairness Plan" October 31. The measures "are necessary to ensure our economy continues to grow and prosper" and "to bring Canada in line with other jurisdictions around the world," according to Flaherty. The Conservative government outlined four key measures:

- A tax on distributions from publicly traded income trusts that begin trading November 1, beginning with the 2007 taxation year. Existing income trusts have a four-year transition period and will be subject

to the tax in the 2011 taxation year. Real estate investment trusts (REITs) are exempt from the distribution tax if they meet certain rules related to income and assets.

- A reduction in the general corporate income tax rate of one-half percentage point as of January 1, 2011.
- An increase in the Age Credit Amount by \$1,000 from \$4,066 to \$5,066 effective January 1, 2006, targeted to low- and middle-income seniors.
- Permission of income splitting for pensioners beginning in 2007.

and return boost may well be frequency of cash returns.

Studies for the iTrust Report show that income trust unit price gains roughly reflect increases in company cash flows. Some of that leads to increases in rates of cash dis-

tributions. In fact, three trusts announced distribution increases for every one of the 30 that announced a cutback during 2006. The net change in distributions delivered an average five per cent boost in the rate of cash returns to owners.

### GLOBAL APPEAL

Even with the new tax rules, Canadian trusts remain unique in world markets because they allow flow-through ownership without restricting business or asset growth, or the nature of an operating enterprise. As a result, there is persistent investment in trusts by pension funds and institutional investors at home and abroad. Income trusts provide investors an instrument to buy into Canada and growing assets at the core of our economy, particularly oil and gas producers, real estate investment trusts (REITs), business trusts, limited liability partnerships and restaurant royalty funds. How the Conservative government's recent decision to tax trusts will affect this foreign investment remains to be seen.

In all cases and sectors, business-specific risk needs to be assessed. High yields can reflect perceived risk but equity-oriented metrics remain useful.

There are strong signs that the unique Canadian income trust and its market matured in 2006. The once local demand for structured equities by individuals, long-term owners and income seekers has extended to professional investors and active traders at

home and abroad. Income trusts are now recognized as both a call on the Canadian economy and a unique vehicle for owning productive assets. Those assets not only generate substantial returns; they can pay owners frequent and growing returns in cash.

With reward comes risk. Like common shares, trust units rise and fall in value and cash returns are never fixed. As much as managers have the discretion to increase distributions, they may also reduce or suspend payouts. Risk relates to the health of underlying assets and the operating business.

Of course, the finance minister's announcement manifested another form of "political risk." This will clearly stunt the growth of the income trust market in the short-term. It will take months and years to determine how buyers and sellers will respond to a new tax regime.

As the range and variety of businesses financed through trust structures evolve, advisors will be increasingly responsible for the due diligence required to differentiate the quality of assets underlying an income trust investment. Individual businesses, including their related market, economic and other risks, warrant fundamental research and financial knowledge.

The returns to investors from application of that expertise can be significant. **■**

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*LESLIE HAYMAN, an Advocis associate member, is president of the iTrust Institute, a non-partisan research and education organization, and publisher of iTrustInvestor.com and the iTrustReport. She can be reached at [leslie.hayman@itrustinstitute.org](mailto:leslie.hayman@itrustinstitute.org).*