



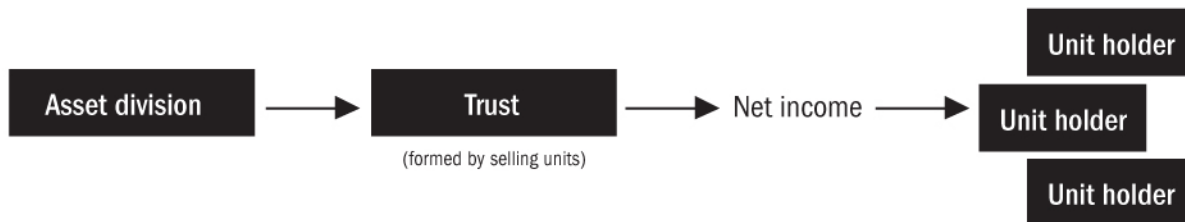
# Income trusts – hot or not?

Income trusts continue to be popular with investors. Understanding what they are, how they work and issues associated with them is important to know.

What are income trusts? Are they really that great? How do I understand how they fit with a client's portfolio? What are their risks?

## What are income trusts?

Income trusts themselves are securities offered on the TSX. They are alternative vehicles for corporations to raise capital without doing a stock or bond offering.



A trust is formed by selling units and the trust uses the money raised to directly or indirectly acquire all or a portion of the corporation or a cash flow generating asset. The trust receives the income from the business or property, pays expenses and flows out the net income in the form of distributions to unit holders. The trust promises the investor regular cash distributions from this income. The distributions are advertised as a percentage.

The most common or traditional trusts in the past involved oil and gas, natural resources and real estate. However many corporations have jumped into the market recently and are offering **business income** trusts.

The business income paid to the trust is treated as an expense to the corporation. The trust then distributes the net income to the unit holders of the trust. The income trust generally targets but does not guarantee a fixed percentage payment or fixed dollar per unit amount.





People assume this is the yield when in fact may be a combination of income and return of capital. The part of a distribution that is return of capital is not taxable when it is received but it reduces the adjusted cost base of the recipient's units so a larger capital gain will arise when the units are sold.

**It is important to note that each income trust is different, and each offering must be looked at closely to understand how the investor earns their income.** Due diligence associated with buying a stock in a company is the same when considering investing in a business income trust.

## Are they really all that great?

The way income trust issuers market these is two-fold.

Claim to be tax efficient

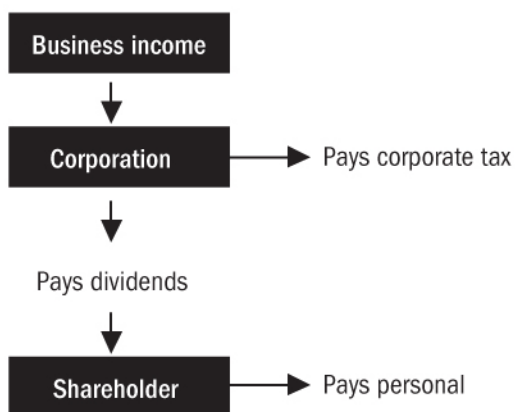
Claim to pay a particular yield

The tax efficiency claim based on the argument that they reduce “double taxation”.

Instead of buying the actual shares of the company where investors receive after-corporate-tax earnings such as dividends and then have to pay individual tax on it (double taxation), the before-tax earnings are passed on to the investors of the income trust to pay individual tax on.

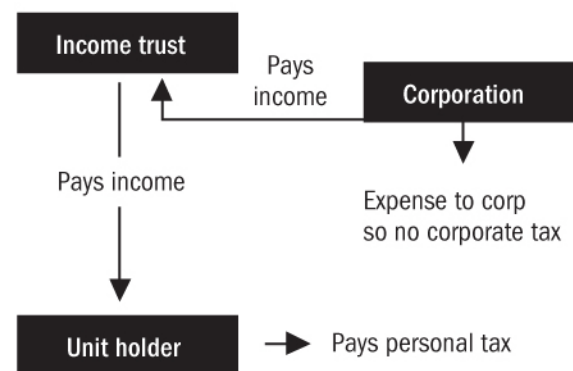
However, the income passed to investors may not be the most tax effective – it could be business income, which is 100 per cent taxable.

### Purchase equities



Tax x 2 = Corporate + Personal

### Purchase income trust



Taxed only to unit holder

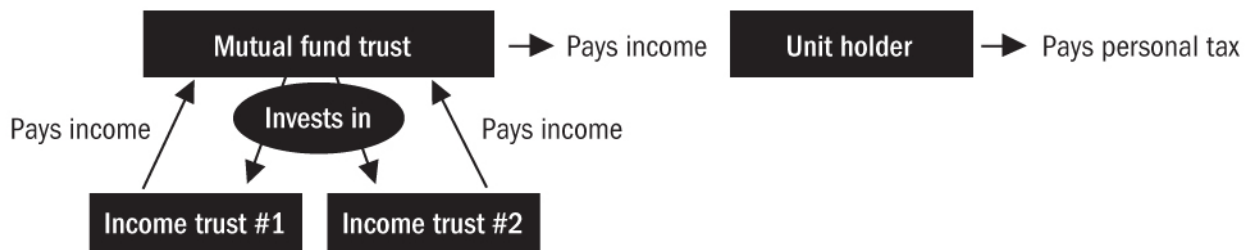
Obviously, if the Corporation does not have sufficient income or if the asset does not earn sufficient income the trust will not be able to pay the advertised distribution.

Critics believe this ‘flow through’ of corporate earnings to unit holders of the income trust ‘exploits’ tax laws and they think these could be at risk if Canadian tax laws change to prevent this leakage of corporate taxes. The first indication of this was in the last federal budget where it was proposed to restrict the amount pension plans can invest in income trusts to 10 per cent.



There also are mutual fund trusts whose mandate is to invest in the income trusts just described.

### Purchase mutual fund income trust



### So – how do they fit into clients’ portfolio?

Many income trusts require the investor to retain their units for a fixed period of time (a holding period). This creates problems for clients who may be interested in transferring assets.

While they are looked at for what they think is reliable income, they really are just like equities. They contain the same risk as investing in the business through purchasing common stock. Be careful of older, more conservative clients purchasing these thinking they are a fixed income product.

There is also no guarantee the distributions will continue. If the income trust pays out all of the specified income to the unit holders, it will not have any funds for future expansion etc. The distributions are not endless.

### How do you know when a client holds one?

The ticker has **un** on the end and the fund name usually includes the term “income trust”. While they sound conservative, they are equitized income products: “high-yield equities”.

As with other prudent practices, total exposure to this asset class should be limited to 10 per cent.

### So what are the risks?

As mentioned above, there is a risk that the trust will not earn enough to make the promised distributions. Also there is the risk of the applicable tax laws changing. In addition, there may be unlimited liability for trust unit holders for any liabilities of the corporation. Trust units fall behind bondholders and common shareholders as creditors. These risks are somewhat less than the biggest risk of misunderstanding and improper structuring.

For example, using them as a fixed income component of a portfolio when really they are more like an equity component could seriously imbalance a client’s portfolio.



**Here is a summary of advantages and disadvantages:**

Advantage	Disadvantages
	*MISUNDERSTOOD – perceived fixed income
have enjoyed good returns in past	question about unit holder liability for company debts
They do actually pay out the income rather than reinvesting	capital is not guaranteed
Distribution may depend on the performance of a single asset rather than that of the entire corporation	"yield" may include a return of capital
Reduces double taxation associated with corporate dividends	income tax risk if laws change
Some liquidity as they are traded on stock exchange	trust unit holders have fewer protective rights than common shareholders or bondholders
	higher costs than traditional equities
	income is not predictable because distributions are directly tied to the performance of the corporation or underlying asset
	as all net income is paid out to investors – no cash for reinvestment back into business – growth potential stunted

There are many types of income trusts on the market with many different spins to them. These are not easily understood, nor do they always live up to the promises and qualities they are sold on. If a client is looking for a reliable, safe, fixed income product, income trusts will not fit the bill. It is important to understand what it is a client is looking for and match their needs with a properly diversified portfolio.

***The information provided is accurate to the best of our knowledge as of the date of publication, but rules and interpretations may change. This information is general in nature, and is intended for educational purposes only. For specific situation you should consult the appropriate legal, accounting or tax expert.***

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