

Income trust

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An **income trust** is an investment trust that holds income-producing assets. The term also designates a legal entity, capital structure and ownership vehicle for certain assets or businesses. Its shares or "trust units" are traded on securities exchanges just like stocks. The income is passed on to the investors, called "unitholders", through monthly or quarterly distributions. Distributions are typically higher than stock dividends, offering yields of up to 10% a year (up to 20% for riskier trusts).

The unitholders are the beneficiaries of the trust, and their units represent their right to participate in the income and capital of the trust. Income trusts generally invest funds in assets that provide a return to the trust and its beneficiaries based on the cash flows of an underlying business. This return is often achieved through the acquisition by the trust of equity and debt instruments, royalty interests or real properties. The trust can receive interest, royalty or lease payments from an operating entity carrying on a business, as well as dividends and a return of capital. (Source: Canadian Ministry of Finance (http://www.fin.gc.ca/activty/pubs/toirplf_1e.html).)

The main attraction of income trusts (in addition to tax advantages) is their ability to generate constant cash flows for investors, which is especially attractive when interest rates on bonds are low. They are especially useful for financial requirements of institutional investors such as pension funds. (*Investment Dictionary* (<http://www.investordictionary.com/definition/income+trust.aspx>))

The names *income trust* and *income fund* are sometimes used interchangeably, even though most trusts have a narrower scope than funds.

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Business law

Business organizations

Common law business forms:

Sole proprietorship
Partnership · Corporation
General partnership
Business trust

Statutory business forms:

Limited partnership
Proprietary limited company
Public limited company
Limited liability partnership
Limited liability company

Civil law corporate forms:

AB · AG · GmbH · K.K.
N.V. · OY · S.A. · A/S

Doctrines

Corporate governance
Limited liability · Ultra vires
Business judgment rule
De facto corporation and
corporation by estoppel
Piercing the corporate veil

Related areas of law

Contract · Civil procedure

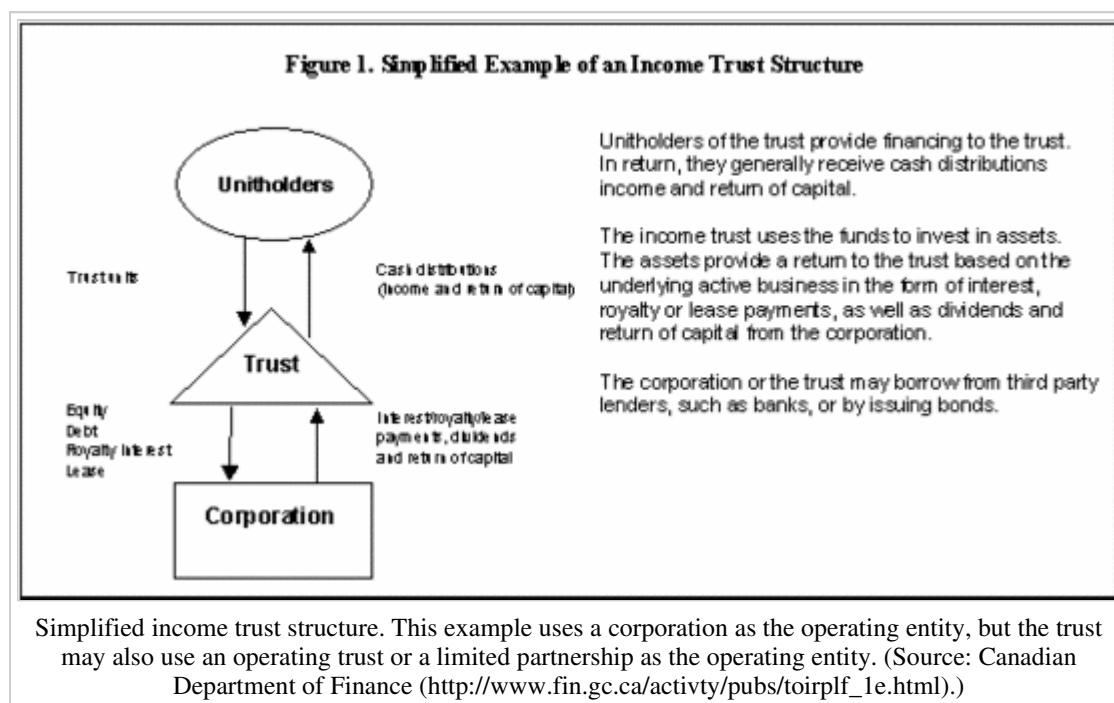
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Tax advantages

As a flow-through entity (FTE) whose income is redirected to unitholders, the trust structure avoids the double taxation that comes from combining corporate income tax with shareholders' dividend tax. If the tax regime allows it, a corporate subsidiary set up to run a trust's business pays a liability that reduces its tax bill, preferably to zero – making those payments to the trust unitholders ("pass-through taxation").

In a typical income trust structure, the income paid to an income trust by the operating entity may take the form of interest, royalty or lease payments, which are normally deductible in computing the operating entity's income for tax purposes. These deductions can reduce the operating entity's tax to nil. The trust in turn, "flows" all of its income received from the operating entity out to unitholders. The distributions paid or payable to unitholders reduces a trust's taxable income, so the net result is that a trust would also pay little to no income tax. The net effect is that the interest, royalty or lease payments are taxed at the unitholder level. (Source: Canadian Ministry of Finance (http://www.fin.gc.ca/activty/pubs/toirplf_1e.html).)

Types of income trusts



There are three primary types of income trusts:

Real estate investment trusts

Real estate investment trusts (REITs) invest in real estate: income-producing properties and/or mortgage-backed securities. The REIT structure was designed to provide a similar structure for investment in real estate as mutual funds provide for investment in stocks.

Royalty/energy trusts

Royalty trusts, "resource trusts" or "energy trusts" exploit natural resources such as oil wells. The amount of distributions paid will vary from time to time based on production levels, commodity prices, royalty rates, costs and expenses, and deductions. See Canadian Energy Trusts (<http://chinese-school.netfirms.com/Abacus-Canadian-energy-trusts.html>)

Business trusts

Business income trusts are individual companies that have converted some or all of their stock equity into an income trust capital structure for tax reasons. Business income trusts are used in many sectors, such as manufacturing, food distribution, and power generation and distribution. They are not investment trusts in the classic sense, since they represent a single company's assets and not a pool of investments.

Among business trusts, **utility trusts** that invest in or operate public utilities such as electricity distribution or telecommunications are sometimes put in a separate category as they are inherently less growth-focused. (*InvestCom* (<http://www.investcom.com/incometrust/whatis.htm>))

In the US, the business trust structure typically takes the form of publicly traded partnerships (PTPs) or master limited partnerships (MLPs), essentially limited liability partnerships (LLPs) with units that trade on public securities exchanges. [1] (<http://www.ptpcoalition.org/PTPFAQs.htm>) Those were very popular in the mid-1980s but are rare today. A more recent alternative called income depositary shares (IDS) has also failed to attract investor attention due to the trust activity being focused on the Canadian market.

The issue of economic efficiency of business trusts is controversial. On one hand, the distribution of income can force managers to exercise more discipline in investment decisions. On the other hand, the distribution can stunt the company's growth by preventing its expansion. If large numbers of growth-oriented businesses start converting to trusts purely for tax reasons, this could adversely impact the growth of the economy.

Investor risks

Income trusts are equity investments, not fixed income securities, and they share many of the risks inherent in stock ownership. Each trust has an operating risk based on its underlying business; the higher the yield, the higher the risk. They also have additional risk factors:

- Lack of diversification: unlike mutual funds, income trusts are generally single-sector or even single-enterprise, and their investments are sensitive to business cycles, especially for real estate and commodities.
- Potential sacrifice of growth: most revenue is passed on to unitholders, rather than reinvested in the business; in some cases a trust can become a wasting asset. Because many income trusts pay out more than their net income, the shareholder equity (capital) may decline over time. In such cases an investor is really receiving their own capital back through the distributions. For example according to one recent report, 75% of the 50 largest business trusts in Canada pay out more than they earn ("Who should you trust on trusts?" (<http://www.canada.com/national/nationalpost/financialpost/story.html?id=70faac90-a6c6-4315-a38f-b890b836838b>)," *Financial Post*, November 23, 2005.)

- Lack of income guarantees: income trusts do not guarantee minimum distributions or even return of capital. If the business starts to lose money, the trust can reduce or even eliminate distributions; this is usually accompanied by sharp losses in units' market value.
- Exposure to regulatory changes: while REITs and royalty trusts are generally well-established, single-company business trusts can cause significant losses in government tax revenue if they become too numerous. The government may decide to intervene and remove some of the tax benefits.
- Exposure to interest rate risk: since the yield is one of the main attractions of income trusts, there is the risk that trust units will decline in value if interest rates in the rest of the cash/treasury market increase. This risk is common to other dividend/income based investments such as bonds.
- Liability: depending on the local regulations, income trusts may be considered partnerships that do not provide the same limited liability protection as common stocks.

(Sources include: TD Waterhouse July 2005 paper
(<http://www.tdwaterhouse.ca/research/news/pdf/archive/072005.pdf>))

Income trust booms

The tax advantages offered to trusts in certain jurisdictions have fueled income trust booms and bubbles in the recent economic history of several countries. In each case, the growth was led by the multiplication of business income trusts. (Main source: "What we can learn from other markets (<http://www.globeinvestor.com/servlet/ArticleNews/trusts/GAM/20051013/RTRUSTCASE13>)," *Globe and Mail*, October 13, 2005.)

Australia

See also: Economic history of Australia, Taxation in Australia

Resource-rich Australia has had royalty trusts (and REITs) for a long time but in the early 1980s, a wider range of firms sought the same tax benefits and started converting into income trusts. Yield-hungry investors jumped on the bandwagon and rewarded the trusts with higher valuations. When Queensland Coal converted to a trust in 1984, its stock price tripled overnight.

The Australian government, seeing ever-increasing (but unquantified) losses of tax revenues, clamped down in 1985. All trusts except REITs and royalty trusts were given 3 years to find an exit strategy: to either keep the current structure at higher tax rates, or convert (back) to a public company. As unit prices started to collapse, the majority dropped the now-pointless trust structure.

United States

See also: Economic history of the United States, Taxation in the United States

In the US, the business trust structure appeared with publicly traded partnerships (PTPs) which were limited liability partnerships (LLPs) with units that trade on public securities exchanges, combining the tax advantages of partnerships with the liquidity of public companies. Starting from the early 1980s all sorts of business, from manufacturers to the Boston Celtics basketball team, converted to PTPs.

In 1987, conversions numbered more than 100 and Congress estimated that the trend was costing Washington \$245-million a year in lost revenue. All PTPs except those categorized as "slow-growth investments" (roughly a third of them) were therefore given 10 years before they would be taxed as

corporations. Just like in Australia, most of them converted back as unit prices fell, but the decade-long transition meant fewer sharp losses for investors. Others such as Cedar Fair received a special corporate tax rate on the condition that they would not be allowed to diversify outside of their core businesses. Few of the partnerships remain today as US income-focused investors favor high-yield bonds or debentures instead.

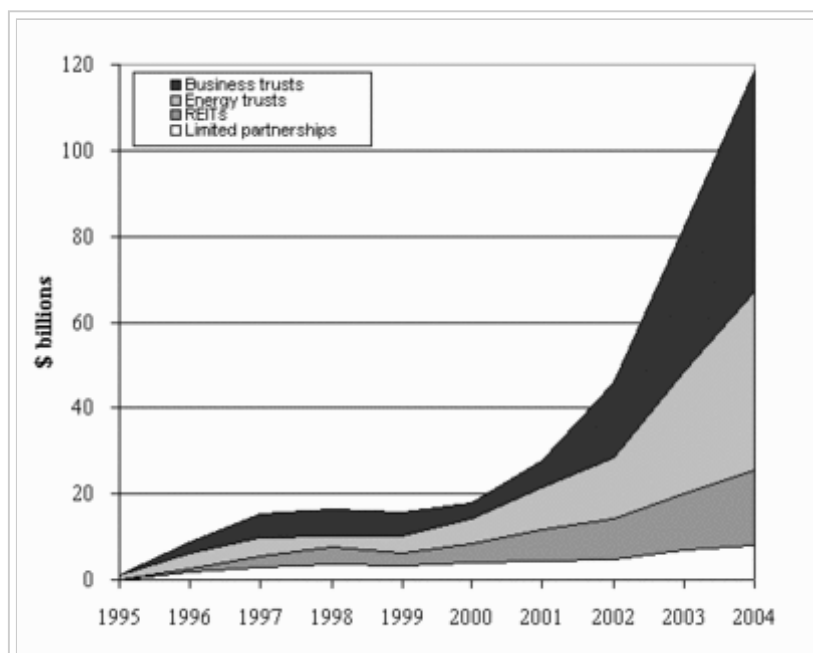
With the Canadian income trust market booming in the 2000s, American investment bankers have tried to import the Canadian model in a structure called income depositary shares (IDS). A handful of small IPOs have used this model since late 2003; but due to lack of investor demand, interested companies have preferred to go public directly in the hot Canadian market. ("Chasing Higher Yields Up North (http://www.businessweek.com/magazine/content/05_13/b3926130_mz070.htm)," *BusinessWeek*, March 28, 2005.)

Canada

See also: Economic history of Canada, Taxation in Canada

The first Canadian tax ruling enabling the income trust structure, inspired on the American PTPs, was awarded in December 1985 to the Enerplus Resources Fund royalty trust. The first corporate conversion into a proper business trust, using the 1985 ruling, was Enermark Income Fund in 1995. The move attracted little attention at the time as the vast majority of trusts were still REITs and royalty trusts (the so-called "CanRoys").

The trust structure was "rediscovered" after the dot-com crash of 2000, as investment banks were searching for new sources of fees after the IPO market had dried up. The first high-profile conversion was former BCE unit Yellow Pages Group (<http://www.ypg.com/>) becoming the Yellow Pages Income Fund and raising C\$1-billion in the process. By 2002, trusts accounted for 79% of all money raised through IPOs in Canada, with only 38% in the traditional sectors of petroleum and real estate. By 2005, the income trust sector was worth C\$160-billion (approx. US\$135-billion at October 2005 rates). The mere announcement by a company of its intention of converting could add 10-20% to its share price.



Growth in market capitalization of Canadian flow-through entities, 1995-2004 (source: Canadian Department of Finance (http://www.fin.gc.ca/activty/pubs/toirplf_1e.html))

Trusts received another boost in 2004-2005 as the provinces of Ontario, Alberta and Manitoba implemented limited liability legislation that shields trust investors from personal liability. (Such

legislation existed in Quebec since 1994).

Partly as a result of this ruling, Standard & Poor's then announced plans to add the largest income trusts to the S&P/TSX Composite Index (which it eventually did on December 19 [2] (<http://www.theglobeandmail.com/servlet/ArticleNews/TPStory/LAC/20051220/RMARKETS20/TPBus>) starting with a 50% weighting and gaining full representation on March 17, 2006. A new equity-only composite index would be created that will resemble the present structure without trusts. This move is seen as a strong gesture of support for the trusts, who would see increased demand from index fund managers and institutional investors replicating the index.

Business trusts have come to the attention of the government. In the March, 2004 federal budget, Finance Minister Ralph Goodale had tried to prohibit pension funds from investing more than 1% of their assets in business trusts or owning more than 5% of any one trust. Powerful funds led by the Ontario Teachers Pension Plan, which at the time had a significant stake in the Yellow Pages Income Fund, fought the proposed measure; the government backed off and suspended the restrictions.

Suspension of advance tax rulings

On September 8, 2005, the Canadian Department of Finance issued a white paper (http://www.fin.gc.ca/activty/pubs/toirplf_1e.html) suggesting that the trusts had cost it at least C\$300-million in taxes losses the preceeding year, with provincial governments possibly losing another \$300-million. The markets barely reacted and on September 13 Gordon Nixon, CEO of the Royal Bank of Canada, mentioned in passing that he was not opposed to Canada's largest bank converting into a trust. One week later on September 19, the Department of Finance announced that they were suspending advance tax rulings – essential for investor confidence – on future trusts. [3] (<http://www.globeinvestor.com/servlet/ArticleNews/trusts/GAM/20051011/RTRUSTMAIN11>)

The resulting uncertainty caused an immediate slump with the trust market losing approximately \$9-billion in market capitalization during the following week. This caused CanWest Global Communications to reduce its proposed \$700-million IPO spin-off [4] (http://www.editorandpublisher.com/eandp/departments/business/article_display.jsp?vnu_content_id=1001052001) to \$550-million. CI Fund Management also showed hesitation regarding its planned trust conversion. Previous plans by ACE Aviation Holdings to spin-off Air Canada Jazz into a trust were put on hold indefinitely. [5] (http://biz.yahoo.com/cnw/050930/e_ace_offeringjazzair.html?.v=1) "Traditional" Canadian REITs, once content to ride the trust boom, tried to distance themselves from the new business trusts, to avoid regulatory "collateral damage." [6] (<http://www.globeinvestor.com/servlet/ArticleNews/trusts/GAM/20050928/RREIT28>) ("Ottawa's move on income trusts throws sector into disarray (<http://www.globeinvestor.com/servlet/ArticleNews/story/GAM/20050928/RTRUST2828>)," *Globe and Mail*, September 28, 2005.)

According to RBC Dominion Securities, yearly trust cash distributions amounted to C\$16-billion in 2005, not including potential capital gains taxes on trust conversions. Of that amount, \$3.3-billion was collected in tax. RBC estimates that taxing trusts like regular companies could slash the market value of Canadian business trusts by as much as 30% [7] (<http://www.globeinvestor.com/servlet/ArticleNews/trusts/GAM/20051012/RRBC12>) – again, not counting the loss of the share price premium of companies that had announced their conversion and would then back off.

Following the announcement, Mr. Goodale and the Department of Finance declined to comment or answer questions on the future of income trusts. Intense lobbying efforts to "save the trusts" were undertaken by the business community and the Conservative Party of Canada. They demanded that if equal treatment is to be granted to trusts and traditional companies, it should be implemented by leaving the trusts alone and cutting corporate and/or dividend tax to match the trust advantage. That solution would cost the government an additional C\$1-billion, which the lobbyists claim would be a small price to pay for stabilizing the market and satisfying the public investors/voters.

Since any decision was to affect the finances of an unknown proportion of the government's voting base, the trust debate turned into an important issue in the 2006 election. Analysts were trying to estimate the political repercussions, mostly depending on how much retail investors, especially seniors saving for retirement, were involved in the market. Some analysts put this at 60-65% of the market, up to 80% when counting mutual funds. If this is the case, a pre-election decision unfavorable to income trusts would have proven hazardous to Prime Minister Paul Martin's minority Liberal government. [8] (<http://www.globeinvestor.com/servlet/ArticleNews/trusts/GAM/20051012/RTRUSTRETA12>)

Dividend tax cut announcement

The government found itself under increasing pressure throughout November as the opposition moved towards a vote of no confidence that meant the current administration might not remain in place by the time the trust consultation and review concluded on December 31. After the close of the markets on November 23, 2005, Mr. Goodale made a surprise announcement (<http://www.fin.gc.ca/news05/05-082e.html>) that the government would not tax the trusts, and would instead cut dividend taxes; the advance tax rulings were also resumed. The announcement described the proposed cut as such:

To accomplish this, the Government proposes to introduce an enhanced gross-up and dividend tax credit (DTC) for eligible dividends received by eligible shareholders. An eligible dividend will be grossed-up by 45%, meaning that the shareholder includes 145% of the dividend amount in income. The DTC in respect of eligible dividends will be 19%, based on the 2010 federal corporate tax rate as proposed in Budget 2005. The existing gross-up and tax credit will continue to apply to other dividends. (Canadian Department of Finance (http://www.fin.gc.ca/news05/data/05-082_1e.html))

The markets rallied in the hours leading to the announcement (the government denies (<http://www.bloomberg.com/apps/news?pid=10000082&sid=aC6K07C6tTxY&refer=canada>) any leaks, see below) and on the following days as well, sending the S&P/TSX Composite Index to a new five-year high. The day's biggest gainers were income trusts, income-trust candidates, high dividend-paying companies, and the TSX Group itself. Former trust candidates such as Air Canada Jazz announced that they were considering a trust conversion or spinoff once again.

The decision, while applauded by financial circles, was widely seen as confused and hurried (an earlier government statement on the same day had mistakenly suggested a slight tax on the trusts) and made for the sole purpose of buying votes for the January 2006 federal election. Since the Liberal government was defeated in that election, the proposed cuts may be short-lived; furthermore the government's calculations assume that the individual provinces will match the dividend tax credit with an equivalent one of their own, which is not certain to happen. [9] (<http://www.globeinvestor.com/servlet/ArticleNews/story/GAM/20051126/RTRUST26>)

Also, the Liberal government had come under fire for the very strong stock market rally that immediately preceded the announcement, suggesting leaks from government insiders to financial

circles. Opposition parties requested an official investigation on insider trading activity on that day. The Ontario Securities Commission has rejected the suggestion, saying it amounts to political interference; the Royal Canadian Mounted Police however, has lauched an inquiry on December 28. [10] (<http://www.theglobeandmail.com/servlet/story/RTGAM.20051229.wxtrusts1229/BNStory/National/>)

See also

- Flow-through entity
- Income fund
- Investment trust
- Royalty trust
- Real estate investment trust

External links

- Tax and Other Issues Related to Publicly Listed Flow-Through Entities (http://www.fin.gc.ca/activty/pubs/toirplf_1e.html) from the Canadian Department of Finance
- Distribution requirements (http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/rrn_part4_index.jsp) of the Ontario Securities Commission, including a section on income trusts and other indirect offerings
- Income Trust Centre (<http://www.globeinvestor.com/resources/trusts/>) from the *Globe and Mail*
- InvestCom section on Canadian income trusts (<http://www.investcom.com/incometrust/whatis.htm>)
- Canadian Income Trusts List (<http://www.investcom.com/cgi-bin/nameindustry/incometrust.cgi?ID=1&string=Income+Trust&exact=&ind=&cat=yes&sct=>)

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Categories: Corporate finance | Types of companies | Legal entities | Taxation in Canada | Economic history of Canada

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