# Issues With Income Trusts

More Canadians than ever are investing in them—but this wary investor hasn't followed the herd.

FIELD NOTES

BY ROB HEINKEL

Income Trusts (ITs) have become the majority of Canada's new equity issues. In 2000, the number of new IT issues was just under $1 billion, but in 2002 the number exceeded $8 billion. Their capitalization on the Toronto Stock Exchange (TSX) is now approximately $45 billion. ITs have become a significant economic entity.

Some of my friends hold ITs in their personal investments. They talk about the high "yields" (nine per cent or more) compared to money market yields which are crawling along at three per cent or less. But I don't personally own any. Moreover, none of the institutional funds I am involved with are participating in the IT market at this time. Why? Because I like to invest in things that I understand—and there are still some unanswered questions about ITs. Here are some of the main ones:

### How do ITs affect investor tax bills?

Unlike corporations whose earnings are taxed, IT distributions avoid corporate taxes. That leaves more money for investors, who then pay personal income taxes on the IT distribution. But, is the savings from eliminated corporate taxes enough to offset the increase in personal tax paid? IT proponents say yes, claiming that, through the elimination of corporate taxes, ITs reduce the total amount of tax paid—both corporate and personal. Thus, they argue that after-tax distributions are maximized using the IT structure rather than the corporate structure.

However, while IT unitholders pay tax on trust distributions at the personal rate, shareholders in corporations receive a personal tax credit on IT dividends. Thus, the net difference between the corporate and IT forms seems to lie in the dividend tax credit versus the personal rate on IT distributions. I am not clear about how significant the net advantage is for ITs, and how it might vary from investor to investor.

Even if there is a major tax advantage with ITs, I would hope that it isn't the only advantage to this financing vehicle. One proponent of ITs claims he had no reason to believe anyone is opposed to changing the trust law to make these investments more attractive. However, if the tax advantage is the only value increase that comes from ITs, then I would be surprised if the federal government did not put an end to them. For a given amount of government spending, any reduction in tax revenues brought about by ITs must be offset by a tax increase elsewhere. That can't make us collectively better off and may, in fact, make things worse.

### Is liability limited or not?

Even the biggest proponents of ITs admit there is a small chance unitholders will be exposed to major liabilities. In what circumstances would the collapse of an IT affect the unitholders' personal assets?

The assets of the IT would first have to disappear, and any insurance covering catastrophic contingencies fail or be unavailable. Even then, lawyers seem unsure whether the personal wealth of unitholders would be at risk in such a situation. While it sounds like the probability of such a situation is almost zero, it's the "almost" that scares institutional trustees. After all, who wants to be the initial test case in a catastrophic IT failure? Not my pension plan, please.

The limited liability issue may become irrelevant if legislatures change their trust laws to ensure limited liability—something which is now underway in Alberta and Ontario (the home of most ITs).

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### Is IT management more attentive to unitholders?

IT proponents claim that forcing management to pay out free cash flow eliminates things like “empire building” and non-economic acquisitions. This might be true. Research has shown, for example, that operating performance improves following leveraged buyouts, where management has obliged itself to large debt payments under the threat of default. Perhaps IT managers obligated to full payout also perform better.

IT proponents say that forcing the payout of all free cash flow doesn’t mean that management can’t take advantage of profitable new opportunities (what we academics call “positive net present value initiatives”). However, to fund those new opportunities, management must go to unitholders to raise new funds. This forces management to get the unitholders’ “approval” before expanding. Revealing how new money is to be spent before it’s acquired is a good thing. Corporations, some would argue, accumulate free cash flow which management can spend without getting prior shareholder approval. It is certainly true that corporate management favours “internal financing” of new initiatives.

However, there also seems to be a dark side to raising new money for financing investment. Research has clearly shown that the value of existing shares falls by around three per cent on the day that a company announces it needs new money. The result is that companies are reluctant to issue shares to finance new investments. Studies have shown that corporations often act as if equity markets don’t exist, waiting until they have sufficient internal funds for investment. With ITs, however, management won’t be able to accumulate internal funds and that could mean they won’t take advantage of investment opportunities as needed.

### Does the shift from corporations to ITs matter?

Yes, it does matter. If institutional investors concerned about the unlimited liability of ITs restrict their managers from investing in them, then they lose the opportunity of new IT issues. Since the overwhelming majority of new investment opportunities coming to the market have been ITs, Canadian managers, particularly small cap managers, are seeing significant opportunities taken away from them.

Understanding ITs is also an issue. They seem to be “priced” in terms of their “yield,” which is usually taken to mean the last year’s cash payout divided by the current value of the IT. For ITs with very stable payouts, this might be meaningful. However, investors may misunderstand and interpret the yield as what will be paid in the future. ITs are not bonds—they are equities, with no assurance of future cash flow. Does an IT based on manufacturing industrial products assure future cash flow? I don’t know. Of course, the same is true of bonds or shares in a corporation, but most investors do seem to understand the inherent uncertainty in those investments.

Finally, if the IT is a way to eliminate corporate taxes and pay out free cash flow, why don’t shareholders in corporations demand very high levels of leverage, and then own both the debt (with interest payments wiping out any corporate tax) and the shares? This seems to be tax-equivalent to ITs. And perhaps management incentives could be dealt with in the corporate form almost as well as in the IT form.

### Conclusion

ITs have become a significant presence in Canadian capital markets. The issue of limited liability is important to institutional investors, although that hurdle may soon be overcome by legislative changes. If limited liability is achieved, institutional use of ITs will likely increase, perhaps raising tax policy issues. At the same time, the question of whether IT management incentives are better than those provided by incorporation awaits a full answer. ∎