The pros and cons of income trusts

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Income trusts are all the rage. Do you feel tempted to join the crowd and buy some? If you already have bought, do you wonder if you made the right decision? If the answer is yes to either of these questions, then read on.

The growing popularity of income trusts is highlighted by the flood of initial public offerings (IPOs) in 2002. They amounted to $4.8 billion, or 86% of all new issues. In the three years prior, only $1.7-billion worth of income trusts came to market.

Whereas there were 52 listed on the TSX in 1998, there are now more than 220 income trusts, with market capitalization exceeding $60 billion. The group is now big enough to have its own indexes: the S&P/TSX Canadian Income Trust Index and the Nesbitt Burns Trust Index.

As many investors know, the attraction is the high yields ranging from 7% and to over 20%. With interest rates on GICs, bonds, and money market funds at historic lows, income trusts have become more enticing places for retirees to earn income and investors to park money.

They are able to offer such high yields because they are legal entities formed to hold cash-generating assets for which no re-investment is planned, allowing all of the net income to be distributed to unitholders. And because earnings are so distributed, they are exempt from corporate tax.

Also, unitholders do not pay any tax in the period received on the portion of the yield representing depreciation/depletion, i.e. return of capital. It is deferred and taken as a capital gain/loss whenever the units are sold at cost bases adjusted downward by the amount of capital returned.

Corporations and partnerships hold assets too, but for the purpose of developing them – which requires retaining and re-investing earnings. They are furthermore taxed on their earnings, so dividends, the double-taxed residual left over after re-investments, are consequently much lower than the yields offered by income trusts.

Income trusts are mainly created by companies and private-capital firms to raise money. They can spin off assets with high and steady free-cash flows to the public, promising unit buyers a share in the future streams in exchange for their money upfront.

This is called securitizing – the conversion of illiquid assets into tradable securities. In the bear market and economic slowdown of the last three years, it has been one of the few avenues for businesses to raise funds.

The three basic types of income trusts are defined by the nature of their underlying assets: i) oil and gas, ii) real estate (REITS), and a iii) catch-all category containing utilities and other businesses.

The third category, about one-quarter of the total, is expanding and becoming quite diverse due to the surge in IPOs. Income trusts have been set up for companies in fast food, sardine packing, cold storage, retirement homes, film production, pet food, mattresses, and long-distance trucking.

Financial advisor Tom Delaney recommends income trusts as "the only game in town" for income investors. He advises spreading risk by buying mutual funds having portfolios of income trusts. His favorite is Diversified Income Trust, which has no deferred sales charges and management expenses of only 2% a year.

Another well-known advisor, Gordon Pape, is also firmly on the buy side. Moreover, he disagrees with the notion that income trusts are a bubble about to burst just like the technology boom did.

He and others see the dilutive wave of IPOs being brought under control by mutual funds threatening buyer strikes. They also see institutional investors, such as pension funds, becoming interested in income trusts as impending changes in regulatory rules are effected.

One likely change coming is the removal of restrictions preventing brokers from lending income trusts, which should enhance liquidity. Second, governments are moving to clear up unlimited liability concerns. Third, if income trusts are ever allowed into the S&P/TSX Composite Index, index funds will need to buy them.

Yet, there is an imposing line-up of critics arrayed against the proponents. Their adamant rejections are just as deeply-felt as the enthusiastic acceptance by the likes of Delaney and Pape.

The trend toward income trusts is raising concerns within the pages of the Canadian Tax Journal about a "substantial erosion of the corporate tax base." Tax experts Paul Hayward and David Perry believe a legislative response is needed to curtail the drain, estimated to be as high as $1 billion.

The higher estimates of lost tax revenues are doubted by some, including the Ministry of Finance. In their view, trusts simply shift the tax burden to unitholders; they may have RRSPs to shelter the payments, but the tax is only deferred (albeit at lower rates).

What may be overlooked, however, is the potential for a growing misallocation of capital. In providing an incentive to lock up cash-rich assets inside no-growth trusts, Canadian tax law may be causing companies to unduly sacrifice long-term growth for short-term palliatives.

Legislative responses thus seem likely. A further tip-off is the fact that few other countries are as accommodating. Indeed, many of the Canadian IPOs have been originated by cash-staved U.S. firms unable to set up trusts in their home country.

Beside the policy risk, it must be kept in mind that income trusts are more like equities than bonds. Their claim on assets have a lower ranking, and their yields are not based on a legal commitment but on management projections for the underlying assets.

Given that free cash flow is subject to interpretation, there is a potential for distributions to be cut back just like stock dividends are subject to rollbacks. In short, inherent subjectivity provides fertile grounds for accounting and governance flexibility, which can lead to investor disappointment.

As for cuts in distributions, consider the recent experience of Halterm Income Fund, an operator of a cargo-transfer facility. One of its largest customers decided to stop using its port; the price of its trust units plunged 20% on the news.

Or take the income trust recently created by trucking firm Contrans Corp. It lost money for three years during the early 1990s and was "a flat tire away from bankruptcy." Is this the kind of business with stable enough cash flows to ensure high monthly payments to unitholders?

Similarly for restaurant income trusts such as those recently created by A&W and The Keg. They may need at some point to refurbish equipment and outlets, which could result in depriving unitholders of the payout they sought by in a trust.

Clearly, the avalanche of IPOs is putting more lower-quality income trusts onto the market. Analysts at Standard & Poor's Corp. recently warned that investors should avoid trusts with yields in the low teens "... because the levels of distributions being promised are clearly unsustainable."

But even the higher quality trusts, mostly identifiable by yields below 10%, pose risks in the environment of today. Income trusts as a group are presently "at the top of its game," thanks to the downward trend in interest rates over the last two years. But can that continue?

With governments around the world striving to reflate their economies, interest rates would seem to be ready to trend up again. Indeed, they already are on an upward course in Canada due to the policies of the Bank of Canada.

Income trusts are not bonds, but their prices vary inversely, like bonds, with interest rate changes. So, investors who buy income trusts now could be buying at a secular low in interest rates, resulting in a running capital loss for years to come (although cyclical trusts could have an offset).

In addition, the oil and gas trusts have been pushed up recently by strong oil prices. Now that the end of the Iraqi situation is on the horizon, there could be a letdown in energy prices, and in turn, energy trust prices.

REITs are normally thought to be the more solid of income trusts. But even here, apartment-building vacancy rates are on the rise as tenants move into new homes with the encouragement of low mortgage rates.