Ontario Farmer
January 10, 2006

BY JOHN PARSONS
The writer is a certified general accountant and farmer near Cache Bay

If the yields look too attractive, it could be that some of your dividend is your own money

Ask hard questions before trusting income trusts

With income trusts back in the spotlight due to the recently announced criminal investigation by the RCMP, it seems an appropriate time to discuss whether they make a good investment for retiring farmers.

Readers may recall that the bottom fell out of the market for these investments in September when Ralph Goodale first announced that the Ministry of Finance would be reviewing the tax implications.

The department was worried that their tax revenues were taking a beating, particularly given the suggestion that some of the major Canadian banks were thinking of converting their structure to a trust format.

Following that announcement, small investors scrambled for the exits in a panic which resulted in nearly $23 billion being shaved off the collective value of all income trusts in Canada. Financial institutions, pension funds, and the Canadian Association of Retired Persons (CARP) hit the roof.

In a blind haste, just before the election call, Goodale reversed himself and stopped the review mid-stream. At the same time, he enhanced the dividend tax credit in order to appeal to those very pensioners he'd terrified a few months earlier.

First things first, though. Just what are we talking about? Income trusts, which are some times known as income funds, are trusts which usually own debt and equity of an underlying entity carrying on an active business.

The income trust structure was developed to facilitate distributions to investors through payment of interest, dividends, and a return of capital. An income trust can generally avoid paying ordinary income tax by paying all of its taxable income (including net realizes! capital gains} to the holders of the trust, thus avoiding the usual corporate taxes.

Earnings from the business are distributed to investors each month or quarter, with yields that usually appear to be well in excess of what you could earn elsewhere.

For a relevant comparison, we could think in terms of farm co-operatives where patronage dividends are paid to members once a year. These special dividends are deducted from net income which, in turn, will reduce the co-operative's taxable income and its liability for in-

come tax.

A co-operative which deals only with its members has an opportunity to reduce or eliminate its taxable income in a given year. The same thing holds for income trusts, however they are an entirely different animal than our local farm co-operatives.

It should also be pointed out that there are trusts and then there are trusts. The original income trusts were set up a couple of decades ago as oil and gas royalty trusts and these were followed by real estate investment trusts. Many of these have been excellent investments and still are today. The problems seem to be stemming from business income trusts.

At face value, the opportunity to earn a high yield seems fabulous. Retirees and income -seeking investors have had a very-hard time in the past few years when faced with returns of two, three, or four per cent on Canada Savings Bonds or bank GICs,

The cost of living didn't get any lower, but their investment earnings shrank drastically with the low interest climate and created a great deal of hardship for those on fixed incomes.

The income trust sector seemed to provide that one golden opportunity to keep up their needed cash inflow.

"Just hold on a minute," says Mark Rosen of Accountability Research Corporation. In a technical analysis produced by this organization just last November, the title alone grabs your attention: 'The Worst is Yet to Come'.

Quite apart from the taxation boondoggle, this report suggests that business income trusts could be overvalued by 28 per cent on average. This translates into-some $20 billion across the entire business trust market.

The problem is that investors did not realize that these trusts have been paying out cash distributions well in excess of net income and thus are not sustainable over the long term.

Obviously, if you take out more cash from your farming operation each year than you actually make from sales perhaps by ever-increasing operating loan balances – eventually the farm will be facing a financial crunch.

That is exactly what Rosen's group has discovered. This is backed up by information from. other sources which confirm that as of last November some 21 income trusts had suspended or cut their distributions.

To quote Rosen further, "we believe that the primary motivation for the conversion of many corporations Into business trusts has not been related to Income tax advantages. Rather, it has been the opportunity for selling owners to receive inflated prices well above what strategic industry buyers and professional investors alone would be willing to pay."

To me, that sound very much like those famous Ponzi schemes - the first guys in the game hope to make their money off the next suckers jumping into the fray who, in turn, need someone else to put even more money into the pot so that they can get their money out with a nice fat profit. Somewhere along the line the masses are left holding the worthless pot.

This may sound like a bit of extremism, but Rosen analyzed the 50 largest business trusts in Canada and found that 75 per cent of them were making those cash distributions in excess of their income.

Any corporation, any farm for that matter, needs to retain some capital to reinvest in the business on a regular basis. Equipment wears out, expansion opportunities come up, major technological advances cry for your surplus earnings.

Yet if all the funds have been siphoned out, how can you even keep going, never mind expand in the future?

The final nail in the coffin is those distributions themselves. Part of the cash disbursements are called a return of capital. Clients are delighted to find this portion is not

taxable but don't realize that all the trust has done is give them a portion of their own money back.

Think of it this way. You put $1,000 in a bank GIC paying four per cent interest. At the end of the year the bank pays you that $40 interest and decides to make it look better by including a return of capital of $50.

At first it looks like you made a heckuva lot better a return with your $90 income. But it's hardly cricket to call that a nine per cent return when all you really earned was four per cent of interest.

You don't make anything on your own money being flipped from one hand to the other and given back to you.

Unfortunately, those "higher than actual" yields show up to much in the trust business.

It seems a bit simplistic to finish off with a weak suggestion to get some solid investment advice from a trusted professional. There are good trusts out there particularly in oil and gas and the real estate sectors.

If the quoted returns seem to good to be true, ask question until you're blue in the fact. Just maybe you'll be better off staying out of income trusts an going for solid investments in our big banks or major corporations now that the dividend tax credit is scheduled to it increase substantially at the beginning of this year.