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THE TRUTH ABOUT INCOME TRUSTS: TRUSTS HELP RETIREMENT SAVINGS, PUT CASH INTO CANADIAN ECONOMY

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Finance Minister Ralph Goodale announced last week the government is putting the brakes on tax rulings for income trusts while it holds consultations on the federal income tax treatment of such vehicles. Reaction to the possibility the popular investments could face new taxes was swift, knocking some $9-billion off the approximately $170-billion market value of existing income trusts.

Mr. Goodale said there is concern the large number of income trusts could prove harmful to the infrastructure of the Canadian economy because trusts pay out all excess cash to investors, and don't retain much to reinvest in their businesses.

But on closer inspection, you can see most of the issuers that came to market as income trusts over the past few years would not have been growing their businesses rapidly as private companies anyway. Their excess cash would merely have gone to a few people—their owners—rather than to a broader group of investors. That's because the type of business suitable for trusts is generally in a mature industry and has low capital-expenditure requirements.

So the trust structure doesn't damage the financial infrastructure—and the broader distribution of excess cash allows more investors to receive a share of the profits. Whether that money is spent or saved for retirement, it will still be taxed at some point. And putting money into people's pockets helps the economy, while cash saved for retirement plans offsets potential government costs in the future—a big concern given the aging Canadian population.

But some people will also argue the income trust structure restricts companies from growing by acquisition because they have no excess cash to do so.

The truth is, many businesses grow without paying cash for acquisitions out of their earnings. BFI, Connors and KCP are examples of income trusts that have done acquisitions that have more than doubled their size. They have done them by using their securities as currency, by drawing on their bank lines and by going back to equity markets to help fund these acquisitions. This is like all other businesses with one exception.

Having to go back to the capital markets for approval to do a significant acquisition every time means a discipline is imposed on the management and boards of income trusts that makes them stand out from a corporate governance perspective. Much has been written about the tendencies of some non-trust management to spend cash on acquisitions that are unproductive, very expensive and ultimately unsuccessful.

The irony in all of this focus on income trusts is that they are an innovative Canadian solution to a Canadian problem: how to successfully operate, grow and finance mid-market companies that would otherwise have a difficult time finding financing for themselves. In fact, income trusts are the most innovative and successful financial product in Canadian financial history.

Presumably Mr. Goodale doesn't want to wipe them out, and will come up with a solution that addresses the legitimate needs of Canadian businesses and investors as well as the federal government. In an environment where equity investments with attractive yields are not widely available elsewhere to assist Canadians planning for their retirement, it would be damaging to do otherwise.

The situation calls for a surgical approach to taxation rather than a complete realignment of the whole tax system or a significant tax imposed on income trusts.

Mr. Goodale has several possibilities. He can maintain the status quo, adjust the dividend rate or dividend tax credit, impose a minimum tax on income funds or eliminate the duplication of corporate and personal taxes or some combination of these alternatives. And not all would be disastrous for the fund sector, as the market seems to fear.

For example, a minimum tax on income funds could be used to reduce the government's loss of tax revenue, pegged at $300-million a year. That would not have a significant impact on the viability of income trusts so long as returns to investors compare favourably with dividend yields.

It's difficult to imagine whatever changes the government brings in, it won't treat the 140 or so publicly traded trusts and the $170-billion in investors' money they represent with great care.

There is some speculation existing income trusts would be grandfathered by any new legislation—perhaps making them even more valuable—although the market seems to be betting otherwise based on its initial reaction last week.

The Minister says he wants to engage in a broad consultation process and you can be sure lobby groups representing pensioners, baby boomers, yield-hungry investors and the ever-increasing number of businesses in Canada that are attracted to income trusts will accommodate his request. Here's hoping it doesn't turn into a long and drawn out process. The uncertainty is costly.

Last week's announcement suspending further advance tax rulings has left management and boards considering forming an income trust unsure as to the government's intentions. There is great pressure to make the right decision, especially on conversions. About 99 percent of trust IPOs don't require such a ruling, and most conversions don't either. What may slow things down is the lack of clarity surrounding the government's plans.

So speed is of the essence. Canadians can only hope the Minister doesn't do anything that significantly damages the income trust sector under the guise of trying to fix it.