CANADIAN INCOME FUNDS

Your Complete Guide to Income Trusts, Royalty Trusts, and Real Estate Investment Trusts

Peter Beck • Simon Romano

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To my father, on his 95th birthday.
—Peter Beck

I would also like to dedicate this book to Emma and Colin Romano.
—Simon Romano

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Introduction

Sitting outside on a shady patio on a warm day having a light lunch is one of summer's greatest joys. On the corner of Roxborough and Yonge street in Toronto, Café Doria has a beautiful patio, capable of seating 20 to 25 people under the natural shade of a large oak tree. On this particular July Saturday I was having lunch with my dad, who had come to visit us from Hungary. The fact that he's 93 years old certainly didn't prevent him from enjoying some of the simple luxuries of life, such as having a meal on a patio with his only son, whose latest book on hedge funds had been written up in the *National Post* that morning. William Hanley's article, *Hedge Funds for the Masses*, was on the main page of the business section of the paper. Dad was very proud to see my picture, and although his English is not as good as it used to be, he managed to read the whole article right after breakfast. By the time we arrived at the restaurant for lunch, he had read it three more times and could have recited paragraphs from it by heart.

Café Doria is mostly frequented by regulars who live in the neighbourhood. On weekends, they come in for a late morning coffee and croissant and a dose of the written news. At a quarter to twelve, when we sat down, many of the late risers were still reading their papers and sipping their lattes. I counted three *National Post*s, three *Globe and Mail*s, and one *Toronto Star*. I could hardly contain a big smile when I noticed that two people with the *Post* were reading my article. Though vanity has never been one of my weaknesses, I could not escape feeling just a bit smug.

A large bottle of cold San Pellegrino arrived immediately after we placed our orders. I poured some and turned to my right, spotting a smiling face at the table next to us looking at me.

"That's you in the paper," the man said, pointing at the business section of the *Post* that he had been reading a minute before. He promised he would buy the book and read it, although he said he was really not interested in investing in hedge funds. He explained that most of his investments were concentrated in his RRSP as, being young and single, he would rather invest the money in himself and continue to enjoy the finer things in life than put it into an investment vehicle that he knew nothing about.

"You know, what I really would like to learn about is income trusts. Almost every day I read or hear about them and I have no clue what they do." He said this as the waitress was approaching with the steaming plates. "My broker has been suggesting that I convert some of the mutual funds in my RRSP into income trusts, but even he couldn't tell me what they are or how they work." By this time the lasagna had landed in front of me and my concentration shifted towards satisfying a less conversational instinct. The man bade me goodbye, and folding his papers under his arm, walked inside to take care of his bill.

It was not until the middle of the next week, when I was talking to my friend and corporate counsel Simon Romano, that I suddenly remembered the conversation. “You have structured many income trusts, haven’t you?” I asked. I remembered that Simon was one of the foremost experts on the subject in the country. I told him about my encounter with the man in the café. “How many other people must be out there with the same questions?” he asked. “Tens of thousands, if not hundreds,” I answered. “You and I should write a book on the subject.”

We wasted no time discussing the validity of writing such a book and went straight to how we could find the time to do it along with all of our other commitments. After thinking about it for a few days, we decided to write a book about Canadian income trusts.

We approached John Wiley and Sons Ltd., who did such an excellent job of publishing and promoting my first book, *Hedge Funds for Canadians*, co-authored with Miklos Nagy. They loved the idea, and the rest is history. You are holding a copy of our labour in your hands.

Our goals in writing this book were simple: to make this complex and popular investment vehicle easy to understand, to take some of the legal and business mumbo-jumbo out of income trusts, and to explain them in a way that my friend in the café, and you, my dear reader, can easily understand. So jump right in—we promise it will be informative, enjoyable, and an invaluable tool for deciding if income trusts should become part of your investment portfolio.

Peter Beck

What Are Income Trusts Anyway?

TODAY'S INCOME TRUST LANDSCAPE

In late July of 2004, there was speculation that the Ontario government was considering an initial public offering for the Liquor Control Board of Ontario (LCBO), the world's largest wine and spirit buyer. The transaction, if it goes ahead, could value the business at several billion dollars.

For the Finance Minster, this could mean a serious reduction of the Ontario government debt without having to raise taxes. For investors in the proposed public offering, it could mean a steady, reliable investment that yields an average of 7–8 percent—more than three times as much as the best current savings account rates. This is a rather spectacular example of what this book is about. You see, the Ontario government may be considering turning one of its most profitable businesses—one that is reported to have put C$1.04 billion into the coffers for the year ending March 31, 2004—into an *income trust*.

With over 150 trusts currently trading on the Toronto Stock Exchange at a combined value of about C$91 billion, this relatively new vehicle, the income trust, is one of the hottest tickets on the Canadian investment landscape today. Indeed, of the C$4.6 billion generated from initial public offerings (IPOs are when a company sells shares to the public for the first time), C$3.8 billion was from income trusts last year in this country.

Between January, 2000, and December, 2003, the Canadian income trust market performed very well indeed, with total returns of over 150 percent, meaning that $100 invested in 2000 would be worth over $250 by December 2003, making income trusts one of the best-performing classes of investments over that period. Compare that to the under 10 percent return of the S&P TSX Composite Index over the same period! Note that we said *Canadian*. This is because income trusts, and the unique way in which they are structured, are a peculiarly Canadian animal. A number of attempts to export similar investment vehicles to the United States have been made, albeit with limited success to date.

So what is going on? How are these investments able to outperform other, more traditional ones? Is this some kind of loophole that is being exploited? Somebody must be on the losing end *somewhere*, right? Are they a fad? Can you invest in them? What are the risks? How much should you invest? How do they work? Where can you find information? So many questions. In this book we will examine the specifics of income trusts, and attempt to demystify some of the misconceptions and confusion surrounding them. But first, some of the basics.

THE BASICS: WHAT IS A TRUST?

In its simplest form, a trust means holding property for the benefit of others. Sound complicated? It's not. Imagine the following scene.

In a hospital, a healthy baby girl is delivered. Later on the immediate family gathers in the hospital room, and the paternal grandfather pulls out a ring that has been a family heirloom for centuries. Handing it to the little girl's father, he says, "Give this to her when she is old enough to wear it." By saying these words, and handing over the ring, a *trust* is created. The proud father is holding the ring for the benefit of his daughter or "holding property for the benefit of others." This is one of the simplest forms of trust, and it does not have to be in writing for it to be legally enforceable in a court of law, although having a legal document makes the enforcement of it considerably easier.

In a trust, property changes hands in exchange for a promise to hold it for a third person. This creates a separation between the ownership of property and the benefit of that ownership. This is different from a simple contract, such as buying a loaf of bread, where the benefit of ownership, in this case taking the bread home and eating it, is simply a matter of paying the specified price. If the little girl's father were to buy the ring in a jewelry store under such a contract, for instance, he would have the ownership and the benefit of that ownership as well. He could break it, sell it, melt it down—do whatever he wanted. But in our example of a trust, once he accepted the ring from the grandfather, he has the ownership but no benefit of that ownership. Those benefits belong to his daughter, to be received in the future.

Income trusts are based on this simple structure, and the concept of a trust has been around for quite some time—since the fall of the Roman Empire to be exact.

THE HISTORY OF TRUSTS

Rome at its height controlled the (then) known world, and its military legions were stationed all over Europe, the Mediterranean, and Asia, assuring complete compliance with the wishes of the capital. Unprecedented wealth was gathered in the Eternal City, and signs of it are still visible to this day. This wealth was not just represented by land, but also by minted coins that served as a universal representation of goods and services. The Romans also had a sophisticated legal system that to this day provides the basis for laws in a large number of European countries.

But things must come to an end, especially an empire whose basic economic engine was built on slavery. By the middle of the fifth century, the Western Roman Empire was no more, and many small kingdoms were created by people in territories it had once occupied in Europe. The Eastern Roman Empire survived for almost another thousand years, with Constantinople as its capital.

As no central government was in place in Europe, there was no longer any reliable minting of coins acceptable in the many kingdoms that sprang up after the Romans retreated. So the representation of wealth shifted toward the ownership of land. Land allowed people to produce food, one of the basic necessities of life. Rulers sought to enlarge their kingdoms by taking land from other kingdoms, since more land represented more food production and thus more wealth. However, these monarchs were not that keen on tending the land themselves—cultivating in those days with crude equipment was very hard work—and, in any case, they were too busy fighting for more land.

Consequently, the kings had to find others to cultivate their land. Since minted coins or paper money were not an acceptable representation of real value, they could not easily hire labourers to plow the land. Even if they could pay some kind of gold or silver coins for the work, there were no markets where peasants could buy food with coins. With land the main representation of wealth, it had to be the consideration for services. But how could land represent payment for services? This is where we bring a third party into the picture.

As you can imagine, these kings did not just brawl outside taverns to decide who was going to control a village. They gathered arms and soldiers, and fought large-scale battles. Those who joined them were not (contrary to Hollywood's many interpretations) just in it for the valour and victory of battle; once new lands were occupied, these soldiers expected to be paid for their services. So the ruler gave them some of the land they had just conquered. The deal was that the soldier would own the land as long as he was loyal to the king, and prepared to fight future battles for him.

The soldiers were no more eager to tackle the drudgery of cultivating the land than the kings. So they simply became landlords—the word itself originated at this time—and parcelled up the land among tenants, giving each a piece to work on. When the harvest was collected, the tenants, known as peasants, gave a certain percentage of it to the landlord and kept the rest. Thus the economic engine of the feudal system was created and the soldiers, known as vassals, accepted land in exchange for military service.

Being at war all the time is not exactly safe work, and as vassals died, the question of ownership of their land became an issue. People had many children in those days, and the question of how to divide the property amongst them was complicated. To keep the estate intact, the custom of the day was that the oldest son inherited everything, and the rest were out of luck. Girls had to get married to survive or become chambermaids, servants, etc., and the other boys sought the service of another king to obtain their share of land from the spoils of war.

Some forward-looking vassal fathers thought a little differently. They wanted not only to take care of their oldest sons, but others in the family as well. Dividing the estate into small pieces was not efficient—over generations, parcels would become minuscule—so these progressive fathers came up with the concept of trusts. This is how it worked: the father left the land to his eldest son, who promised to take the payments from the tenants (a percentage of produce collected each year after the harvest) and divide it among all of the brothers and sisters, including himself. Thus he held the property, for the most part, for the benefit of others. However, he was also a beneficiary in receiving part of the payments.

The system worked, and as similar structures became more popular, the concept of the trust found its way into the law books. Today, many countries have laws to accommodate the creation and existence of trusts to achieve any number of personal and business goals.

THE PLAYERS IN A TRUST: WHICH ONE IS THE INVESTOR?

One of the simplest trusts is the one described earlier, where the happy father accepts a ring for his newborn daughter to be held by him in trust until she gets old enough to wear it. To get an idea of where the modern investor fits into the picture, let's examine the players and their roles in a little more detail.

The grandfather pulled out the ring that had been a family heirloom for generations. At that point in time he owned the ring. It was his, and he had full title to it. This gave him the right to do whatever he wanted with it. He could pawn it, sell it, melt it down or frame it and hang it on the wall. But he chose to follow the family tradition, and seeing that his first grandchild was a girl, he found it appropriate to give it to her. However, the granddaughter could not even hold on to it yet, let alone put it on her little finger. So, the next best thing was to hand the ring to someone who would be there when the time came that she would be able to wear it. And in this case, the most logical person for the task was her father.

So by saying the words "Give this to her when she is old enough to wear it," the grandfather creates a trust, and becomes what is known as the settlor of that trust. The settlor is the individual (or other legal entity) that owns an asset and is willing to transfer it into a trust. So the pivotal moment in creating the trust is when the son agrees to the request and accepts the ring. At this point, the title of the ring transfers to the father—it is legally his. However, unlike the grandfather, he can't pawn it, sell it or melt it down. He can do only one thing; he must hold on to the ring until his daughter is old enough to wear it and then give it to her. Of course, he could frame it and put it on the wall until that day—that would not be a violation of the trust agreement. Thus, our happy dad has become the trustee, or the individual who keeps ownership of the trust property until the trust comes to its conclusion. In this case, that will be when the girl is old enough to wear the ring.

But hold on for a second; nobody asked the little girl if she wanted the ring in the first place—the decision was made without her. This is another important point; a trust can be set up without the agreement of the beneficiary, in this case the little girl. Only an agreement between the settlor and the trustee is needed to set up a trust for a beneficiary. This is very like the role of today's investor in an income trust. The investor is, much like the little girl, the beneficiary of the trust.

REASONS FOR SETTING UP A TRUST

A trust may be set up for personal reasons such as estate preservation or asset protection, or for business reasons. Income trusts are set up by corporations and businesses. But why? What are the advantages of setting them up and allowing the public to buy into them? One of the main reasons comes down to one of the two certainties in life—taxes.

Tax Mitigation

Under Canadian tax law, the general principle is that any profits a trust makes are not subject to taxation so long as those profits are distributed to the beneficiaries each year. The beneficiaries may well have to pay income tax on the moneys received based on their personal tax bracket, but the trust itself will not pay tax. This is in stark contrast to corporate taxation. A corporation has to pay income tax on any profit it makes before it can distribute the leftovers to its shareholders as dividends. These dividends are then taxed again at the personal level, though at a lower rate than regular income. The combined percentage of these two taxes is higher than the single income tax one would pay at the personal level as the beneficiary of a trust.

Let's look at a very simple example. Mr. Jones, a practising lawyer, lives in Ontario, and holds 100 percent of the shares of a public corporation that owns a number of apartment and office buildings. The company collects rent, and pays the expenses for running and maintaining the buildings. Mr. Jones' share of the profit is $800,000 a year. The company then pays about 36 percent of that $800,000 as combined federal and provincial taxes, or roughly $288,000. So when all is said and done, there is $512,000 profit left over to pay out to Mr. Jones as a dividend. Surprise, surprise—next April he has to pay about another 31 percent of tax on the dividend. Thus, another $158,720 is sent to Revenue Canada. From his initial share of the profit of $800,000, Mr. Jones is left with a measly $353,280.

Now let's see what would happen if those buildings were in a trust, with Mr. Jones as one of the beneficiaries. The rent will still be collected by the trust, and all expenses paid just as in the case of the corporation, so Mr. Jones' share of the profit is still $800,000 at the end of the year, and this entire amount is paid to him. As we discussed earlier, as long as the money is distributed to the beneficiary, no tax is payable by the trust.

However, our successful lawyer friend still has to pay income tax on the $800,000. Because he lives in Ontario, his combined federal and provincial tax rate is approximately 46.4 percent (his professional income already put him in the highest tax bracket), so he will send $371,200 to the government and end up with $428,800.

Let's compare this to our first example, where a corporation owned the buildings. The math is pretty simple. $428,000 – 353,000 = $75,520. That's a lot of money to give to the government if Mr. Jones doesn't have to. We firmly believe (and we are sure you will agree with us) that we could find better ways to spend our own money.

This tax advantage of trusts over corporations gave birth to the idea of income trusts, and we will examine these advantages in the next chapter. But for the moment, we need to understand one very important point: As long as a trust distributes all of its profits — after expenses—through the trust, it does not pay income tax on those profits. This is one of the fundamental reasons trusts are set up. Investors buy units in the trust, which act much like stocks (more on this later), and the investors in the units are paid distributions based on the cash flow from the company. As we will see later, there are a number of different ways in which this arrangement can work.

A Possible Downfall: Liability

As we discussed earlier, any type of asset or property can generally be placed into a trust. A business is an asset, for instance, as it is a going concern that hopefully creates a profit every year. With the preferential tax treatment for trusts, why do we still find most of the businesses operating under the corporate makeup? One issue is liability. Owners of corporations have limited liability while a trust beneficiary may not. Let's go back to Mr. Jones and see how this would affect his properties.

As Mr. Jones was a very successful individual, he and his family took five to six vacations a year; they avoided most of the popular holiday destinations and preferred unusual locations instead. During a particularly cold January, they decided to spend two weeks on the island of Mauritania, in a resort that catered to the rich and provided complete seclusion. There was no TV, radio, phone or Internet—just sunshine, the beach, great books, and unbelievable food.

Unbeknownst to Mr. Jones, two days into their vacation, Toronto, where his buildings were, was hit by one of the worst cold spells in history. The superintendent in one of his apartment buildings decided it was just too much for him and purchased a last-minute package to Cuba for a week at an all-inclusive resort. The next day he was gone. He tried to contact Mr. Jones to tell him of his decision—the vacation time was owed to him—but, of course, he could not get through. As a result, no one replaced him for that week.

The cold spell had been preceded by a stint of warm weather, and the resulting deep-freeze made the sidewalk in front of a particular building a skating rink. As there was no one to clear the ice of this busy area, over the next three days eight separate individuals fell and sustained numerous injuries. At the end of it all, the city had cleared the sidewalk, and sent a huge bill to Mr. Jones. As he could not be reached at his island paradise, Mr. Jones was surprised when he returned to find a class-action lawsuit filed on behalf of the eight victims by one of the sharpest litigators in town. The litigator was claiming damages in excess of $15,000,000, and should he succeed, that money would have to be paid.

Now, let's see what would happen to the $15 million in a case where the buildings were owned through a corporation, assuming that it has $1 million in insurance. A corporation is a legal entity that is created by a registration process, and, as such, is legally entitled to own property, run a business, etc. It can also be sued, as it would be in this case, and should the plaintiffs succeed, the company would have to pay the $15 million. The company would then sell all the buildings it owns along with any other assets for which it would receive, let's say, $9.5 million. This sum, plus the insurance proceeds of $1 million, would be paid out to the plaintiffs, and no more. The corporation would go bankrupt, and the remaining $4.5 million would never have to be paid, even though Mr. Jones, the sole shareholder, has lots of other assets. This is because the liability rests with the corporation, and does not include the shareholder. Once the corporation pays all it can, the story ends. True, Mr. Jones loses all of his buildings, but that is it—he pays no further damages, and keeps his own personal wealth.

Now let's see what would have happened if Mr. Jones had set up a trust to own his buildings, of which he was the sole beneficiary, and a third party, perhaps a friend, was the trustee. The sharp lawyer would have sued the trustee and the beneficiary as well, and *both* may have been held fully liable.

Let's assume that the trust was set up in such a way that the buildings can be sold, and the $9.5 million—plus the $1 million in insurance proceeds—paid out for the damages. That equals $10.5 million, the same as in the case of the corporate ownership. However, in this case, the remaining $4.5 million could still be owed by Mr. Jones personally. And because he owns all kinds of other assets—his big house, a large stock portfolio, a cottage up north, etc.—he would likely have had to liquidate some or all of these assets to pay the balance.

The big problem with the trust structure in this case is that the beneficiary may have *unlimited liability*. And as businesses can always run into unforeseen problems, and accidents can always happen, most business owners would rather take the less advantageous tax situation that comes with owning that business through a corporation, and enjoy the limited liability that a corporation provides, than set up a trust model.

The obvious question that comes to mind is, “Do I have unlimited liability as an investor in an income trust?” Don’t worry; as you will see in the following chapters, this issue has been thoroughly addressed by some of the best legal minds in the country.

THE BASIC STRUCTURE OF AN INCOME TRUST

Before we get into the specifics of taxation, types of trusts, and more complex issues, we will give you an example of how the whole trust structure is set up.

Setting up a Trust Structure

Let’s imagine that, through a wholly owned company (owned entirely by yourself), you own a rental property that is mortgage-free. Assume that it cost $250,000 to buy, and that municipal taxes are $2000 per year, and that utilities, maintenance, and other expenses are $8000 per year. Your company rents it out for $3000 per month, inclusive of utilities, for a total of $36,000 per year.

This means that the company’s profit before income taxes is:

$36,000 (rent) – $8000 (utilities, etc.) – $2000 (municipal taxes) = $26,000 per year

If we assume that the company pays combined federal and provincial income tax of 40 percent, it will pay $10,400 in income tax on this $26,000, and net $15,600 per year after tax. It will pay you this in dividends, on which you will pay tax.