

From The Desk

Observations, thoughts and theories from
the world of global portfolio management

Are Income Trusts Dead?

February 2010

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The new rules surrounding taxation of income trusts take effect on January 1st, 2011, with trusts expected to be subject to the same rates of taxation as corporations. With taxes consuming a considerable portion of the earned income, the most compelling reason to favour trusts over common stock disappears. While the segment that was the income trust market will look drastically different come January, the constituents remain open for business, and remain viable investments despite the pending changes. The strike of midnight December 31st this year does not close the books on the businesses. Income trusts will be alive.

An income trust is simply a specialized form of corporation, designed to take the vast majority of money earned by the operating concern and pay out that money as income, to be taxed in the hands of the shareholders. Loved by retirees and pension plans alike, the trusts tended to pay out significantly greater cash flows than bonds, utility and bank stocks, and helped to supplement income and grow pension plan assets. In the fall of 2006, the taxman turned the lights out on the party shortly after Bell Canada began exploring conversion to a trust. The revenueurs were loathe to forgo their percentage of corporate earnings, sweeping changes were introduced, and a shiver ran through the trust market. The announcement of the taxation of trusts effectively reduced the value of their distributable income by roughly a third, and the trust market sold off appreciably as a result. Many of the weakest hands were taken private. Many chose to convert to corporations, removing their tax advantage. Many still exist as trusts; despite a deadline that many would think was looming large. Each business, indeed the industry segments of the trust 'universe', will address their relative need to convert from trust to corporation in their own time.

Real Estate Investment Trusts, or REITs, will continue to exist and operate with relatively little change. REITs represent one of the oldest forms of trusts, and have been largely exempted from the new rules. Changes to the REIT sector dictate that only income earned from longer term rents are expected to remain free from tax, leaving the hotel and lodging REITs subject to the new rules. Additionally, any gains made from flipping - the purchase, refurbishment, and sale of properties - will likely be subject to taxes. While flipping does not represent the core business of typical real estate trusts, many engage in the practice, and use the proceeds to help carry them through troughs in the very cyclical business of property management.

Business trusts will lose practically all of the benefits associated with the trust structure, and many have already undergone conversion from trusts to dividend paying corporations. With most conversions has been an associated cut in payouts, which both reflects the change in taxation between corporation and trust and the change in direction most newly converted trusts have articulated. In their previous tax-exempt form, growing a business added risk and consumed capital, rather than paying of the majority of their post-tax earnings many conversions have chosen to reduce their payouts but pursue strategies to grow their businesses. Where before a business trust might contentedly earn eight percent and pay that out entirely, shareholders rarely reward small businesses that do not pursue growth. Those that have not converted are highly likely to do so in advance of the deadline.



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Resource trusts represent the vast majority of the remainder of the universe, and in the shorter term are the least likely to undertake changes in operation. Due to the nature of their business, it is entirely possible that many resource trusts will remain in their current form well beyond the January 1st 2011 rollover. Resource seeking businesses benefit from tax credits derived from their costs of exploration and acquisition, and may be able to use those credits to offset taxes due. This may permit some resource trusts to maintain their current level of distributions and pass through favourable tax treatments to unit holders. While these tax pools sound like the perfect tonic for what will ail resource trusts, they are not infinitely deep, the application of tax credits is subject to acceptance by the taxman, and they may not be withdrawable in a linear fashion, which could lead to lumpiness in tax treatments year over year.

Trusts will continue on, though clearly income trusts will continue to undergo considerable change. We should not view this change with a negative eye; with each conversion a trust is lost, but a new company emerges, typically one with a smaller dividend and a mandate to grow. Management in this new group of conversions may find that free from the constraints of having to pay high monthly distributions, opportunities to grow their businesses and increase dividends will present themselves. The income trust is not dead; the conversions increase the investable universe available to those who seek dividends, growth, or both, and this is a change that most should find welcome.

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The number zero has always been important to the branch of mathematics. The time for zero in economics has probably run its course, but never have so many owed so much to quite literally nothing. As counter-intuitive as wanting higher borrowing costs might seem, both investors and savers should welcome the coming central bank actions.

ZERO

Guardian Capital Advisors Investment Committee



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