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Keep your faith in income trusts

Rollover in 2011 may pay off in dividends

As we approach 2011, many investors are thinking about the Federal Government's Tax Fairness plan announced in October 2006 and are concerned about how their income trust holdings will fare when faced with pending changes. Income-oriented investors worry about having a shortfall in retirement funding.

Effective January 1, 2011, income trusts that are classified as Specified Investment Flow-Through Trusts (SIFTs) will become liable to pay distribution taxes, known as the SIFT tax. All sectors of the income trust realm are subject to the SIFT tax, but the level to which they will be affected depends on the type of trust.

According to Canaccord Adams analyst Kyle Preston (March 11, 2010), energy trusts appear to be the best positioned of all sectors for a successful conversion to dividend-paying corporations. Several have already converted and have held their distributions/dividends flat. Crescent Point Energy Corp. (TSX: CPG) is a good example. On conversion, the company's monthly dividend per share was equal to its monthly distribution per unit. The company has since maintained the $2.76 dividend, indicating consistency for income-oriented investors.

Engineering and construction income trusts are largely expected to cut distributions on conversion. Since October 2007, 29 have completed conversions, but only four have been able to maintain distributions without having to purchase tax assets. Decisions to cut distributions appear to be based on the relative health of the balance sheet. Since engineering and construction firms tend to be acquisitive by nature, they need to be able to finance acquisitions, and large dividends may not be sustainable post-conversion.

Power and pipeline income trusts are a bit more varied. While most have stated plans to convert by 2011, those that are classified as limited partnerships (LPs) can hold off and convert at a later date with no tax consequences. Delaying conversion gives LPs the ability to maintain a higher distribution, and thus the potential to be rewarded by the markets as income-investors hunt for yield.

Business trusts are expected to have the most difficulties when making the conversion to corporations because most do not have any significant tax shelters to offset the rollover. As they become taxable, the majority of business trusts are expected to reduce distributions by as much as 20-30%.

Regardless of the income trust sector, most individual taxable investors should not experience a significant decrease in the income stream they earn from these investments. The Canadian source portion of the distribution will be taxed as a dividend and thus will be eligible for the dividend tax credit.

For example, a taxable individual investor remains in the same position on an after-tax basis when receiving a $1.00 dividend from a corporation instead of a $1.22 - $1.43 cash distribution from an income trust. This is beneficial as investors in most provinces can earn up to $30,000 to $40,000 in dividends without paying any material taxes, assuming no other income is earned, and investors in the lowest tax bracket often realize more than the dividend due to the tax credit mechanism.

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Even when factoring in a distribution cut it's estimated that, due to the benefits associated with the dividend tax credit, taxable individual investors can withstand up to a 29% cut before being negatively affected.

In assessing the impact of SIFT taxation, investors need to pay close attention to their individual tax situation and should consult with their tax advisors as there is a wide discrepancy between provinces and at different levels of income.

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