A Cure for the Annual Income Trust Headache

Kathy Hill

The income trust and closed-end fund sector of the market with a market capitalization of approximately $200 billion offers some excellent investment opportunities, often providing attractive tax-advantaged cash flow and total returns. However, calculating capital gains for tax purposes on these asset classes can be quite complicated. Canada Revenue Agency (CRA) requires investors to accurately calculate an adjusted cost base (ACB) when these investments are sold. A very large percentage of these trusts and funds pay monthly distributions that include an amount that is a tax-deferred return of capital (ROC). Each of these ROC amounts reduces the ACB of the investment and must be accumulated to arrive at the accurate ACB used to calculate the capital gain or loss upon disposition.

How do you know if the distributions you received have an ROC component? Check your T3 slips to see if there is an amount reported in Box 42, defined as "Amount resulting in cost base adjustment". This new box was added by CRA to address the concern that investors were receiving these tax-deferred distributions and failing to adjust for them correctly. Unfortunately, seeing a number in Box 42 is only a starting point. Investment dealers report the numbers in batches and thus the amount you see on the T3 may represent the ROC for multiple trusts and funds you may hold. In addition, you likely did not sell all the securities held. Lastly, the accompanying report provided with the T3 is only for the current year. This is of limited use if you held the investment for several years before selling.

Where do you go to get the information you need? Most of the information you require can be mined from public sources. Some company websites are excellent at providing current and historical breakdowns of their distributions with complete tax information. However, many websites are difficult to navigate, and others do not provide the necessary information at all.

Some full-service investment advisors will provide help in arriving at the ACBs. One such advisor was Mike Wooding, an advisor for nearly thirty years with CIBC Wood Gundy in Victoria, B.C. Always interested in this market sector, he was an early investor when the first trust was issued in 1986 and by the time he retired he had 15% of his assets under administration in these securities. Wooding found that during tax season his support staff was devoting a tremendous amount of time and resources to providing clients and their accountants with ACBs for all the income trusts, closed-end funds, split-share corporations and exchange-traded funds (ETFs) they had sold during the year. Believing there had to be a better way than chasing down all the information manually and building spreadsheets, upon retirement in 2006 he took on the project in earnest. Partnering with me, the development of the ACB Tracking Inc. website commenced.

The company launched in February 2007 with a simple, user-friendly website, www.acbtracking.ca. Now in its second year, the service has been warmly received by many accountants, investment advisors, and individuals across Canada.

Well aware of the fact that a service such as this is only as good as the integrity of the database from which it draws its information, considerable time and effort was spent researching, entering and validating the record dates of the distributions, the amounts of the distributions, and the portions that were categorized as return of capital. The database contains over 700 issues and is constantly being updated.

Another of the elements ACB Tracking focused on was capturing all "phantom" distributions. These are fairly widely used, yet are often not well understood by investors or tax preparers. In order for trusts to remain non-taxable, they must distribute earned income by yearend. While most trusts pay their distributions in cash, a trust may elect to declare a distribution in additional units, and then complete a concurrent unit consolidation such that the number of units outstanding after the consolidation is identical to the number outstanding before the unit distribution was paid. Thus, there is no impact on the net asset value of the fund or trust, there is no dilution, and the trust remains non-taxable. The investor has a tax liability to the extent of the unit distribution paid, but receives no cash with which to pay this liability, nor does he receive additional units, hence the term "phantom" distribution. However, the good news is that the ACB of the position is increased by the amount of the unit distribution, thereby reducing the capital gain liability (or increasing the loss) upon ultimate disposition of the position.

Phantom distributions are often difficult to recognize, and sometimes not even reported. The key element to look for is a unit distribution with a concurrent unit consolidation. Phantoms are very common in ETFs. ACB Tracking Inc. has gone to great lengths to identify all phantom distributions paid by trusts and funds in the database to ensure users' tax liabilities are not overstated.

Since Finance Minister Jim Flaherty's announcement of October 31, 2006, the trust market has seen unprecedented activity. There was a high volume of sales, as well as numerous reorganizations within the sector. When funds merge, change their names, and announce splits and consolidations, finding the complete details to calculate an accurate ACB can become even more tedious.

Detailed Report

Prepared for: Joe Investor
Prepared by: Professional Accounting LLP
Created: 13-Feb-2008 14:17:24 (Eastern)

ACB Tracking Inc.

RioCan Real Estate Investment Trust

Settlement or Record Date	Activity	Number of Units	Total Units Held	Purchase Settlement Amount	Disposition Settlement Proceeds	Adjusted Cost Base	Capital Gain (Loss)	Dist'n per Unit	ROC Per Unit	ROC Amount Received	ACB Balance
03-Oct-2000	Buy	1,000	1,000	$9,050.00					0.00000		$9,050.00
31-Oct-2000	Distribution		1,000					0.089	0.04962	$49.62	$9,000.38
30-Nov-2000	Distribution		1,000					0.089	0.05238	$52.38	$8,948.00
29-Dec-2000	Distribution		1,000					0.095	0.05605	$56.05	$8,891.95
31-Jan-2001	Distribution		1,000					0.089	0.02745	$27.45	$8,864.50
continued with monthly distributions											
31-Jul-2007	Distribution		1,000					0.110	0.05221	$52.21	$5,535.33
31-Aug-2007	Distribution		1,000					0.110	0.05221	$52.21	$5,483.12
30-Sep-2007	Distribution		1,000					0.110	0.05221	$52.21	$5,430.91
31-Oct-2007	Distribution		1,000					0.113	0.05340	$53.40	$5,377.51
30-Nov-2007	Distribution		1,000					0.113	0.05340	$53.40	$5,324.11
21-Dec-2007	Sell	600	400		$12,574.50	$3,194.47	$9,380.03		0.00000		$2,129.64

Summary of Adjusted Cost Base and Capital Gains (Loss) Calculation

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RioCan Real Estate Investment Trust

Purchases

Settlement Date	Units	Settlement Amount
03-Oct-2000	1,000	$9,050.00

Dispositions

Settlement Date	Units	Settlement Amount
21-Dec-2007	600	$12,574.50

Adjusted Cost Base and Resulting Capital Gain or Loss Calculations

Settlement Date	Units	Fund/Trust	Proceeds of Disposition	Adjusted Cost Base	Capital Gain (Capital Loss)
21-Dec-2007	600	RioCan Real Estate Investment Trust	$12,574.50	$3,194.47	$9,380.03

Unsold Position

If all positions for this investment have not been sold, adjusted cost base details of the unsold portion will appear below. This information will be required for future calculations, at which time the following information should be entered as a purchase in the ACB calculator as of the date indicated for the number of units remaining and for the amount shown. For this information to be valid, please ensure that you have entered all of the buy and sell transactions that have occurred to date.

Settlement Date	Units	Fund/Trust	Settlement Amount	ACB per Unit
21-Dec-2007	400	RioCan Real Estate Investment Trust	$2,129.64	**$5.32**

The 2007 taxation year was very unique for income trusts due to the number of takeovers that did not provide the election of a tax-deferred rollover. Nearly 50 income trusts were bought out for cash, with the result that each one will require ACB calculations. Some of the more widely held issues affected are TransAlta Power LP, Legacy Hotels, Bell Nordiq, Oceanex, Shiningbank, CHIP REIT and Retirement REIT. If January 2008 is any indication, we will see more of the same this year.

The ACB Tracking Inc. site is a web-based calculator that enables you to perform these calculations in just a few minutes, automatically taking into account mergers, splits and consolidations, name changes, and phantom distributions. These calculations come complete with PDF reports detailing all of the activity in the trust or fund during the investor's holding period, as well as a summary of the capital gain or loss on the sale and the adjusted cost base of any remaining position – easy and complete records to keep in your tax file! Even complex calculations involving multiple predecessor funds can be performed in a few minutes, instead of hours.

As a website application, there is no software purchase or installation required. The cost of using the system ranges from $2.99 to $8.50 per calculation report, depending on the number of calculations purchased. Calculations do not expire and can be carried forward for use during future tax seasons.

Good quality income trusts, closed-end funds and ETFs still deserve representation in diversified investment portfolios. Now, thanks to ACB Tracking Inc. the annual headache of calculating the adjusted cost bases of liquidated positions finally has a cure.

A portion of a sample (and relatively simple) report for RioCan is presented for your understanding.

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Dale's note: We receive numerous inquiries on how to complete ACB calculations for various securities. Here is an affordable service which can meet most of these requests. I did invite Kathy to prepare this special report for you.