

Extending the Grandfathering Period - Pump and Dump Shifting Who Loses

In my research report "Income Trusts: Heads I Win, Tails You Lose", I studied the fair value of income trusts versus corporations using an analysis of the present value of cash flows over a ten year period taking into account a fair terminal value for the business. In this report, I use the same present value of cash flows methodology to assess the impact of the grandfathering period in the recently adopted Income Trusts Tax Plan.

I have concluded that the Federal Government increasing the grandfathering period would be a mistake because such an adjustment would cause a short term rally of 6% or so in the income trusts market, that would enable the financial and income trust industries' marketing machines to entice seniors now owning these to potentially raise their stake in the asset class and to entice other seniors to enter the income trust market for the first time. The timing for seniors to enter the market could not be worse, given the widely acknowledged accounting mess in income trusts, where the cash yields upon which seniors are enticed to the market are inaccurate, inflated and misleading. **The short term rally of about 6% that an extension of the grandfathering period from 4 to 10 years would cause, will not spare seniors and other conservative investors from losing 24% to 35% of their investment in income trusts, as the overvaluation of income trusts relative to public corporations is wrung out of the market over time.**

My research report, Income Trusts: Heads I Win, Tails You Lose, dated October 18, 2006, concluded that the business income trust market was 39% to 53% overvalued relative to publicly traded corporations. At the end of the four year grandfathering period, there is no rationale for the premium pricing of income trusts relative to corporations to remain, in my opinion.

I attribute the significant overvaluation of income trusts mainly to (a) the inaccurate and deceptive high cash yield valuation methodology promoted by the financial and income trust industries; and, (b) to the mispricing of income trusts because virtually all equity research does not do pre tax equivalent valuation comparisons between income trusts and publicly traded corporations on the typically used financial valuation variables of P/E's, P/CF's, P/EBITDA's, P/S's, and P/BV.

The big problem with extending the grandfathering period in the Income Trusts Tax Plan would be that the "greater fools" would be enticed back into the market for the dumping of overvalued income trusts caused by the other reasons for the overvaluation of income trusts, the accounting mess and the inaccurate, inflated and misleading cash yields.

Chart 1 provides the summary of the damages or % capital losses in income trusts at different grandfathering periods for the Income Trusts Tax Plan applicable to Canadian tax deferred accounts, such as pension funds, RRSPs and RRIFs. For every grandfathering period of 0 to 10 years, the expected overall capital loss % is the same high case -35% as in my earlier research report, since I assume there is no rationale for the income trust pricing premium relative to corporations under the Income Trusts Tax Plan after the grandfathering period. The blue portion of the stacked bars in Chart 1 is the percentage decline that can be attributed to the loss of the tax deferral benefits from owning an income trust in a tax deferred pension fund, RRSP, or RRIF. The maximum degree of capital loss that can be ascribed to the tax deferral benefits decreases, as you would expect, as the grandfathering period is expanded. For example, the four year grandfathering period in the current Income Trusts Tax Plan suggests that the capital loss percentage from the loss of tax deferral benefits is -11%, while if there was no grandfathering period at all, the loss of tax deferral benefits would be cause a capital loss of -16%.

My starting point of analysis on the impact of the grandfathering period, is that the fair value of income trusts and corporations are the same for taxable individual accounts, since the Federal and four major Provincial governments have moved towards tax parity between income trusts and corporations. This fair value parity for taxable individual accounts is regardless of the grandfathering period. In my work, the terminal value of the business at the 10 year period reflects whether or not capital has been removed from the business and the need for future management to replace depreciating capital assets that have not been properly maintained or to repay debt that has been raised to fund distributions in excess of what the company earns, including the cash reserves necessary for capital asset replacement on a periodic basis.

Chart 2 shows that managers/owners of pension funds, RRSPs and RRIFs have an estimated capacity to pay 20% premium prices for income trusts over corporations, that have distribution to income payout ratios of 100% or more. This capacity amount is calculated to be the present value of the tax deferral benefit over a ten year period. Note that if the managers/owners of pension funds, RRSPs and RRIFs actually did bid up current income trust units to this capacity to pay a 20% premium, then they gave their tax advantage away to the current vendors of the income trusts and kept none of the relative tax benefits for themselves as beneficiaries of their tax deferred retirement savings plans. Pension funds, RRSPs and RRIFs should strive to pay the same price for income trusts as the taxable individual owners, so that the relative tax advantage of owning the income trusts remains wholly of benefit to them in the form of higher after tax returns relative to the individual taxable accounts.

In any case, the portion of the estimated total high case 53% premium of business income trusts over corporations on October 12, 2006 that can be ascribed to the pension funds, RRSPs and RRIFs would be much lower than their capacity to pay a 20% premium. The tax deferred Canadian owners are estimated to be only 40% of the total owners of income trusts. The contribution from the tax deferred Canadian owners would be a maximum of 8% (40% X 20%) out of the high case 53% premium I found in Income Trusts: Heads I Win, Tails You Lose.

Now, the American buyers of income trusts have had a much bigger tax advantage than the Canadian pension funds, RRSPs and RRIFs. My calculations would suggest the American owners of income trusts are harmed by the rise in total taxes under the new Income Trusts Tax Plan from say the range of (= 15% U.S. federal tax + 8% average U.S state tax + 15% Canadian withholding tax - 15% Canadian withholding tax credited against U.S. taxes + 60% X 15% Canadian withholding tax on return of capital portion of distributions that are not creditable against U.S. taxes?) to 48% (= 32% Canadian business taxes +.15% X 68% U.S. federal tax + 8% X 68% average U.S state tax + 15% X 68% Canadian withholding taxes - 15% X 68% Canadian withholding taxes credited against U.S. taxes). It is not clear to me how the U.S. IRS handles the 15% of the return of capital portion of distributions from Canadian income trusts, so perhaps this is an incremental withholding tax being paid that does not get a credit in the U.S.? **The strong tax advantage to American owners of Canadian income trusts would give the Americans a capacity to pay premiums for Canadian income trusts relative to Canadian corporations of 30% to 47%. On the basis of the estimated 20% of Canadian income trusts owned by Americans, the prorated contribution of the American buyers' capacity to pay premiums is 6% to 9%.**

Chart 3 shows that the weighted sum of the Canadian deferred tax accounts and Americans owning income trusts have contributed up to 17% of the high case 53% premium in the business income trusts market at October 12, 2006. The seniors enticed back into the income trusts market by extending the grandfathering period from 4 to 10 years in the Income Trusts Tax Plan would get a short term rally of about 6%. Chart 4 shows that there would likely be a subsequent decline of 24% to 35% after the short term rally, based on the overvaluation that has not yet been wrung out of the market. This is the overvaluation that has been caused by the inaccurate, inflated and misleading cash yields that has propped up unit prices above their fair value as businesses and relative to the same businesses in the corporation structure.

Chart 1: Damages in the Income Trust Market = % Capital Loss for Different Grandfathering Periods for Canadian Tax Deferred Accounts

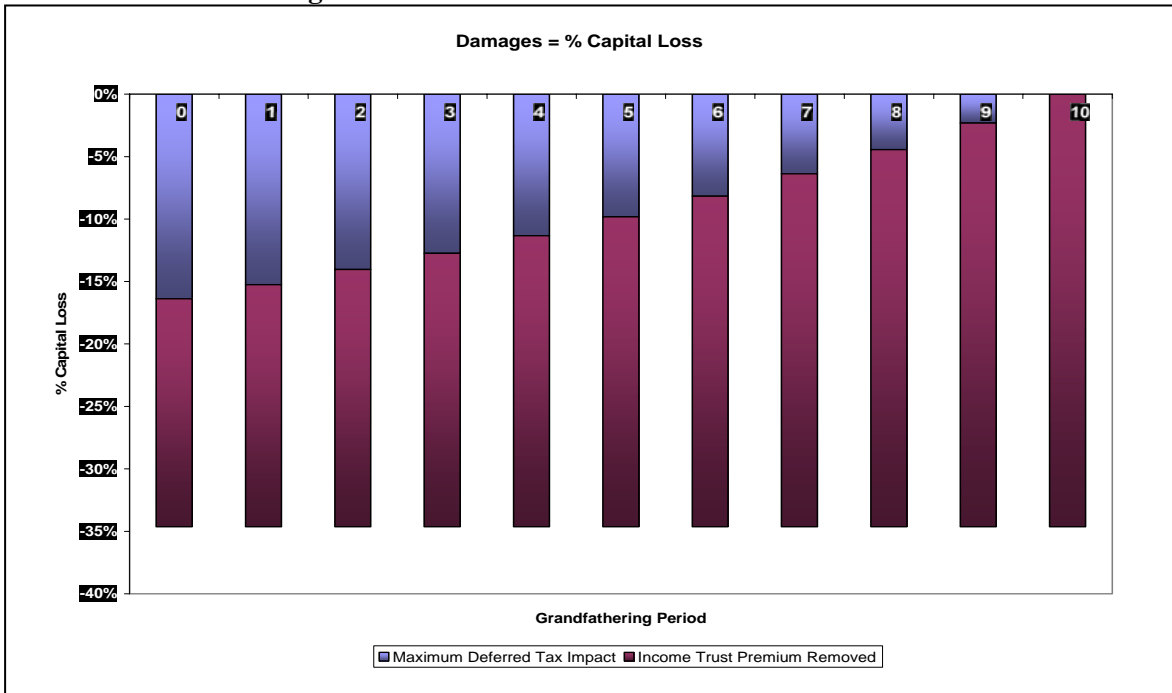


Chart 2: Valuation in the Income Trusts Market for Different Grandfathering Periods

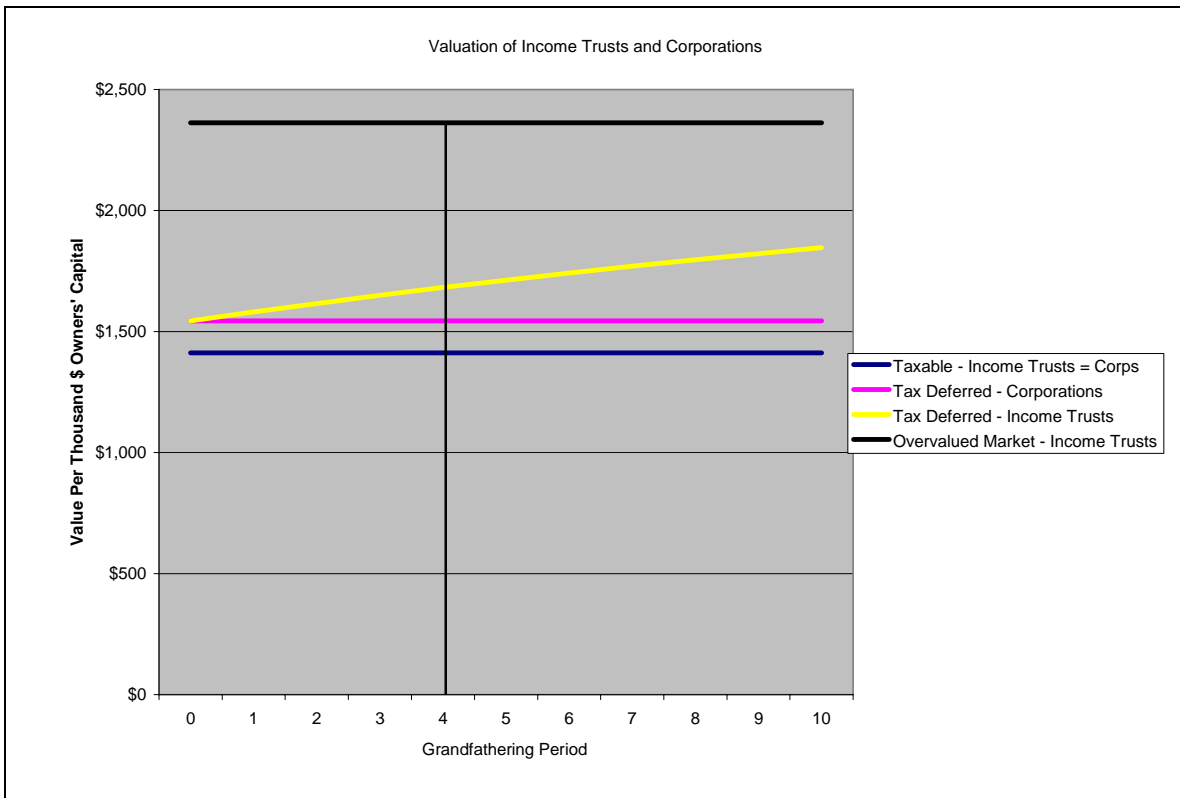


Chart 3: Combined Impact of Canadian Tax Deferrers & American Owners

	Canadian Tax Deferrers	Americans	Combined Impact
% of Income Trusts Owners	40%	20%	
Capacity to Pay Premium	20%	47% to 30%	17% to 14%
% Capital Loss Impact Maximum			
Immediate Implementation	-16%	- 32%	-13%
4 Year Grandfathering	-11%	- 27%	-10%
10 Year Grandfathering	0%	- 20%	- 4%

Chart 4: Illustration of % Capital Losses from Tax and Accounting Mess Factors

S & P/TSX Capped Income Trust Index	Index	% Change
October 12, 2006	156.9	- 5%
October 31, 2006 Income Trusts Plan Date	164.9	Base
November 13, 2006	137.3	-17%
November 21, 2006	145.3	+ 6%
Change Since October 31, 2006		- 12%
Move from 4 to 10 Years Grandfathering Period	154.0	+ 6%
After Short Term Rally from Grandfathering Change		- 7%
Heads I Win, Tails I Lose Call for Capital Loss		
Low Case	117.6	- 24%
High Case	101.9	- 35%

Diane Urquhart
 Independent Consulting Analyst
 Mississauga, Ontario
 Telephone: (905) 822-7618
 Cell: (416) 505-4832
 E-mail: urquhart@rogers.com