Business Trust &

REITs Bulletin

October 2003

The Rise and Fall of the Cross-Border Income Trust and What Lies Beyond...

Recent US tax-related concerns expressed by several major accounting firms have significantly chilled the market for cross-border income trusts. However, alternative investment structures replicating many of the economic, investment and tax attributes of the income trust model may be emerging.

The Rise...

Over the past several years, the size of the income trust market in Canada has increased exponentially. In the first half of 2003, income trust offerings represented 80% of the total value of all initial public offerings in Canada. Currently, Canadian publicly-traded income trusts have a market capitalization of approximately $57 billion, representing 7% of the aggregate capitalization of the Toronto Stock Exchange.

The dramatic rise in the popularity of business income trusts can be attributed to the desire of investors to earn healthy returns in the face of low interest rates and declining traditional equity markets and to the significant tax benefits that flow from using an income trust rather than a more conventional investment vehicle. A recent study by the Capital Markets Institute of the University of Toronto estimated that the use of income trusts costs the federal and provincial governments more than $500 million a year in lost tax revenues.

Not surprisingly, as the Canadian income trust market has matured, income trust offerings have expanded to include businesses from a wide cross-section of industries. Until early 2002, the business operations of most income trusts were confined to Canada. This changed over the past 18 months, however, and several offerings were brought to market featuring income trusts which invested in enterprises based principally in the United States.

The cross-border income trusts share many structural traits with their Canadian counterparts. In the typical cross-border income trust offering, a Canadian trust acquires common shares and subordinated debt ("**Trust Debt**") of a US operating corporation. The Trust Debt generates enough interest expense to offset (or substantially offset) the corporation's taxable income in the United States.

The Fall...

Although the tax opinions contained in the prospectuses of most of the cross-border income trust offerings were significantly qualified with respect to, among other things, the classification of the Trust Debt as debt (and not equity) for US tax purposes (such that interest payments would be deductible), many large-dollar offerings (aimed primarily at retail investors) were successfully completed at prices relatively comparable to those realized in domestic offerings.

Recently, a number of the major accounting firms have expressed concerns about the US tax exposure of cross-border income trusts. On September 15, 2003, the Specialty Foods Group Income Fund ("**Specialty Foods**") announced that PricewaterhouseCoopers had chosen not to serve as the fund's auditor over concerns it had with the deductibility of the interest paid on the Trust Debt. Other firms quickly followed suit, with KPMG, Deloitte & Touche, and BDO Dunwoody each announcing that they too would be reviewing the US tax risks inherent in the cross-border income trust structures in which they are involved.

We understand that the US tax concerns associated with most cross-border trust structures are actually two-fold. The primary concern is the debt/equity classification issue. Unlike the more formalistic approach in Canada, US tax law adopts a fact-driven "substance over form", analysis in determining whether a particular instrument constitutes debt or equity. The US courts have identified a number of factors that must be considered in making this determination, including the intention of the parties, the debt to equity ratio of the issuer, and the commonality of creditors and shareholders. We understand that based on these factors and, in particular, the fact that the income trust holds both the Trust Debt and the equity, many US tax experts are concerned that the Internal Revenue Service (the "**IRS**") may take the position that the Trust Debt should be classified equity for US tax purposes. It has also been suggested that the interest rates charged on the Trust Debt in most cross-border income trusts are unreasonable and that a portion of the resulting interest expenses could be disallowed.

Many cross-border income trusts expected that these concerns would be quickly resolved, but this hasn't happened. On the contrary, the risk that the IRS may challenge the US tax position of many cross-border income trusts has introduced a "chill" into the market which, absent clarification from the IRS, could be permanent.

What Lies Beyond...

In light of these recent developments, alternative structures, such as "income deposit securities" offerings ("**IDSs**"), may take on increasing prominence. In the typical IDS offering, the use of an income trust as an intermediary is completely avoided. Instead, investors purchase IDSs, consisting of shares and notes, in the US operating company. While initially bound together, the shares and notes are severable after a certain period of time (responding to the unity of debt and shareholder concern and thus addressing, to a certain extent at least, the debt/equity characterization issues noted above in the cross-border income trust structure).

In addition to IDSs, other innovative structures are being developed that may replicate the tax benefits thought to have been offered by cross-border income trusts. Ultimately, the emergence of alternative investment structures may allow Canadians to continue to enjoy the tax benefits associated with an income trust while investing in ventures located outside of Canada.

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McMillan Binch has developed an innovative and dynamic public markets practice. Drawing on our strengths in securities law, structured products, corporate restructuring and tax, McMillan Binch has assembled an integrated team with a wealth of experience capable of delivering on a wide range of income trust-related briefs.

We would be pleased to discuss how the use of an income trust or an alternative tax-preferred structure may be of interest to you or your client. For further information, please contact your McMillan Binch lawyer or one of the lawyers listed below:

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