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## Stapled Securities—“The Next Big Thing” for Income Trusts? Useful Lessons from the US Experience with Stapled Shares

Reuven Avi-Yonah, Tim Edgar, and Fadi Shaheen\*

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### PRÉCIS

Le ministère des Finances (« le ministère ») a présenté deux séries distinctes de mesures législatives qui, ensemble, visent à étouffer la demande sur le marché des fiducies de revenu (mais avec des conséquences différentes au chapitre du revenu). Cependant, ni la législation proposée ni l'actuelle Loi de l'impôt sur le revenu ne contiennent de règle visant la nouvelle qualification des capitaux propres. Par conséquent, les résultats fiscaux associés aux structures standards des fiducies de revenu et des fiducies de redevances peuvent encore se matérialiser avec des structures de participation directe où l'utilisation d'une fiducie comme mécanisme de mise en commun est éliminée et où les investisseurs détiennent directement une obligation spéculative à rendement élevé combinée à un nombre déterminé d'actions de l'émetteur. Jusqu'à maintenant, ces structures d'obligation spéculative étaient principalement utilisées à des fins de placement transfrontalier aux États-Unis pour éviter l'impôt sur le revenu des sociétés américain sans perte significative des attributs autres que fiscaux. Mais l'élimination des restrictions sur la détention de biens étrangers dans le cadre de régimes de report du revenu exonéré d'impôt, comme les régimes de pension agréés et les régimes enregistrée d'épargne-retraite, signifie qu'il y a très peu de contrainte dans la législation fiscale à l'acquisition de substituts à ces obligations spéculatives par cette catégorie d'investisseurs dans le contexte canadien.

L'article met en lumière l'utilisation de titres combinés (de participation et d'emprunt) comme structure de participation directe pour éviter l'application du traitement fiscal des dividendes à des structures de fiducie de revenu ciblées, comme le prévoit la dernière proposition législative du ministère. Les auteurs laissent entendre que le ministère devra probablement modifier la législation proposée pour tenir compte précisément de ces structures de propriété combinée. Ils montrent comment l'expérience américaine avec des actions combinées, en particulier la réponse législative du Congrès fournit un modèle

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\* Reuven Avi-Yonah is the Irwin I. Cohn Professor of Law at The University of Michigan Law School, Ann Arbor. Tim Edgar is of the Faculty of Law, The University of Western Ontario, London, and a senior fellow, Taxation Law and Policy Research Institute, Monash University, Melbourne. Fadi Shaheen is an SJD candidate at The University of Michigan Law School. The authors would like to thank two anonymous referees for valuable comments on an earlier draft of this article.

pratique viable pour les modifications à apporter. Cependant, ce modèle législatif ne porterait que sur les titres combinés dans le cadre de structures intermédiaires. On a aussi besoin d'une certaine forme de règle de nouvelle qualification des capitaux propres pour tenir compte de l'utilisation de participations combinées dans des structures autres qu'intermédiaires pour assurer l'efficacité de la législation proposée.

## ABSTRACT

The Department of Finance (“the department”) has introduced two separate sets of legislation that together attempt to limit demand in the income trust market (though with very different revenue consequences). However, neither the proposed legislation nor the existing Income Tax Act contains an equity recharacterization rule. Consequently, the tax results associated with the standard income trust and royalty trust structures can still be realized with direct holding structures, in which the use of a trust as a pooling mechanism is eliminated and investors hold directly a combination of high-yield junk debt and a specified number of shares of the issuer. Until now, these junk bond structures have been used primarily for cross-border investment into the United States, to avoid the US corporate income tax without any significant loss of non-tax attributes. But the elimination of the foreign property holding restrictions for tax-exempt deferred income plans, such as registered pension plans and registered retirement savings plans, means that there is very little in the way of any tax-law constraint on the acquisition of direct junk bond substitutes by this class of investors in a domestic context.

This article highlights the use of stapled securities as a particular direct holding structure that could be used to avoid the application of the department’s latest legislative proposal, which applies dividend tax treatment to targeted income trust structures. The authors suggest that the department will most likely have to modify this draft legislation to specifically address stapled security structures. They illustrate how the US experience with stapled shares, and particularly the congressional legislative response, provides a workable template for the necessary modifications. However, this legislative template would only address the use of stapled securities in intermediated structures. Some form of equity recharacterization rule to address the use of stapled securities in disintermediated structures is also needed to ensure the target effectiveness of the draft legislation.

**KEYWORDS:** INCOME TRUSTS ■ SHARES ■ SECURITIES ■ TRANSACTIONAL SUBSTITUTION ■ SPECIFIED INVESTMENT FLOWTHROUGH ■ NON-PORTFOLIO PROPERTIES

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## INTRODUCTION

On October 31, 2006, the Department of Finance (“the department”) issued a press release<sup>1</sup> and an accompanying set of legislative proposals intended to shut down demand in the income trust market from the remaining tax clientele for this structure—namely, non-resident and tax-exempt investors, including deferred income plans such as registered pension plans (RPPs) and registered retirement savings plans (RRSPs). These proposals, which have been carried forward and modified in draft legislation released on December 21, 2006<sup>2</sup> and again on March 27, 2007,<sup>3</sup> attempt to realize this result by applying dividend treatment to distributions from certain publicly traded trusts and partnerships. The resulting entity-level tax is intended to supplement the enhancement of the dividend tax credit for resident individuals, which was the immediately previous legislative response focused on the demand side of the income trust market.<sup>4</sup> Budgetary constraints apparently prevented the extension of the credit on a refundable basis to tax-exempt and non-resident investors,<sup>5</sup> necessitating a further response to address continued demand from these investors.

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- 1 Canada, Department of Finance, *News Release 2006-061*, October 31, 2006 (herein referred to as “the October 2006 proposals”).
  - 2 Canada, Department of Finance, *News Release 2006-086*, December 21, 2006 and the accompanying draft legislation and explanatory notes (herein referred to as “the December draft legislation”).
  - 3 Canada, Department of Finance, *News Release 2007-026*, March 27, 2007 and the accompanying Notice of Ways and Means Motion To Implement Certain Provisions of the Budget Tabled in Parliament March 19, 2007—Budget Implementation 2007, March 27, 2007 (herein referred to as “the March 2007 notice of ways and means motion”). The March 2007 notice of ways and means motion has since been enacted by Bill C-52, Budget Implementation Act, 2007; SC 2007, c. 29. Legislative references herein have not been updated to reflect the passage of Bill C-52, which followed the writing of this article and its preparation for publication.
  - 4 Canada, Department of Finance, *News Release 2005-082*, November 23, 2005 (herein referred to as “the November 2005 proposal”). The proposal was implemented in legislation effective for dividends paid after 2005. See SC 2007, c. 2, sections 44(1) and 48; and Canada, Department of Finance, *News Release 2006-028*, June 29, 2006 and the accompanying draft legislation and explanatory notes. The November 2005 proposal was brought forward by the new Conservative government in its post-election budget. Canada, Department of Finance, 2006 Budget, Budget Plan, May 2, 2006, 231-32 and the accompanying Notice of Ways and Means Motion To Amend the Income Tax Act, resolution (20).
  - 5 For a discussion of a system of full integration as a systemic response intended to eliminate the income trust market, see Jack M. Mintz and Stephen R. Richardson, “Income Trusts and Integration of Business Investor Taxes: A Policy Analysis and Proposal” (2006) vol. 54, no. 2 *Canadian Tax Journal* 359-406; and Lalit Aggarwal and Jack Mintz, “Income Trusts and

This latest volley from the department may signal a merciful end to the income trust saga. One can only hope that it does, after months of arguments in defence of income trusts, diligently reported by an often sympathetic popular press.<sup>6</sup> Yet the draft legislation leaves some gaping holes.<sup>7</sup> Instead of closing those holes with specific legislation, the department issued a warning in the press release accompanying the October 2006 proposals: “[I]f there should emerge structures or transactions that are clearly devised to frustrate those policy objectives [the death of the income trust structure], any aspect of these measures may be changed accordingly and with immediate effect.” It remains to be seen whether this statement constitutes a sufficient market chill to kill the demand for income trusts. If there is no such effect, the income trust saga could move into a new stapled securities and/or junk bond phase.<sup>8</sup>

Given the underinclusiveness of the draft legislation, we believe that it is unlikely to be successful in ultimately eliminating the income trust market. This latest response is entirely characteristic of the department’s approach throughout the income trust saga, which has been marked by two defining features. One feature is a hesitancy to do anything ahead of developments in the financial markets. This hesitancy has left the department continually on the back foot. The other feature is a preference for

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Shareholder Taxation: Getting It Right” (2004) vol. 52, no. 3 *Canadian Tax Journal* 792-818.

Budgetary considerations may also be a factor in recent legislative proposals in the United States to deny the low rate of personal tax on dividends for income trust distributions received by US investors. See Carrie Tait, “US Bill Doubles Trust Tax to 35%,” *Financial Post*, March 28, 2007.

- 6 For a refreshingly independent view, see Eric Reguly, “Trust Lobbyists, That’s Enough of Your Fury,” *Globe and Mail*, December 19, 2006. (“Someone should encase income trust lobbyists in concrete and fling them off a bridge into deep water. On second thought, forget it; even that wouldn’t stop the misguided creatures. Houdini-like, they would somehow break free and call for Jim Flaherty’s [the Finance Minister’s] head the moment their lips broke the surface. They are unstoppable and insatiable.”)
- 7 The draft legislation has already been the subject of an extensive descriptive literature. For a good review of the draft legislation, including analyses of various legislative pressure points, see Corrado Cardarelli, “Income Trust and Mutual Fund Trust Developments,” in *Report of Proceedings of the Fifty-Eighth Tax Conference*, 2006 Conference Report (Toronto: Canadian Tax Foundation, 2007), 10:1-19.
- 8 The imperative to find tax-effective substitutes for income trust structures that are subject to the draft legislation may be muted somewhat by the generous transitional relief. In particular, application of the proposed distributions tax is deferred until 2011 for targeted entities that were publicly traded as of October 31, 2006. Moreover, the department has expanded the scope of the four-year sunset clause to accommodate the “normal growth” of grandfathered entities. The department has proposed a definition of such growth as new equity issues equal to the greater of (1) \$50 million and (2) 100 percent of the market capitalization of an entity at the end of trading on October 31, 2006. The 100 percent safe harbour is to be spread on a 40/20/20/20 basis for 2007 through to 2010. See Canada, Department of Finance, *News Release* 2006-082, December 15, 2006. These proposals were carried forward in the March 2007 notice of ways and means motion. Curiously, they were not brought forward in legislative form. Instead, the general wording of the guidelines in the press release is incorporated by reference.

incremental responses that target particular taxpayers on the demand side of the income trust market in the hope that doing so will take sufficient air out of the market.<sup>9</sup> These responses have invariably been underinclusive and have allowed the income trust market to continue to grow at the expense of the corporate income tax base. Underlying both of these features is a substantial political dimension, reflected partly by the representations of vocal and persistent “paper entrepreneurs” (investment bankers, accountants, and lawyers) and “the grey power set.”<sup>10</sup> The former have enjoyed a presumably profitable role in creating and marketing the income trust structure as what has been perceived to be a necessary element in the investment portfolios of the latter, whether held directly or through RPPs or RRSPs.

This article highlights the possible use of stapled security structures as a technique to avoid the application of the draft legislation. The first part of the discussion describes the development of the general features of the income trust structure as an example of tax-driven financial innovation involving the substitution of a lower-taxed transactional form for a higher-taxed transactional form. The second part reviews the draft legislation as an attempt to equate the tax on income trust structures and conventional corporate structures by raising the tax on the former. The failure of the legislation to apply to the full range of potential transactional substitutes is emphasized; in particular, the draft legislation leaves the door open to the use of stapled securities as a tax-effective substitute for an income trust structure. Stapled securities are securities of two or more formally separate entities that are contractually stapled together so that they may not be owned, held, sold, or purchased separately.

The third part of the article describes the US experience with stapled shares including, in particular, the legislation introduced by Congress to prevent their use as tax-effective transactional substitutes in both the domestic and international contexts. The fourth part considers how the US legislative response to stapled share structures might be incorporated in the draft legislation in an effort to improve its target effectiveness. We note that extension of the draft legislation to stapled securities

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9 The income trust saga is not the first time that the department’s policy-making efforts in response to tax-driven financial innovation have been marked by these two features. A past example with all too many parallels is the preferred share saga, which unfolded from 1974 to 1987. This period saw a series of underinclusive, incremental responses to the use of preferred shares as tax-effective debt substitutes. Demand was not shut down until 1987, with the introduction of a comprehensive distributions tax applicable to dividends paid on taxable preferred shares (broadly defined as any share other than a fully participating common share). See Tim Edgar, “The Classification of Corporate Securities for Income Tax Purposes” (1990) vol. 38, no. 5 *Canadian Tax Journal* 1141-88, at 1149-57.

10 Much of the organized representation effort has been spearheaded by the Canadian Association of Income Funds. However, there has been no shortage of commentary generated by individuals acting independently of this loose coalition (though also apparently motivated by self-interest). The lobbyists found a welcoming audience among politicians during parliamentary hearings on the December draft legislation. The hearings culminated in an analytically thin report: Canada, House of Commons, *Taxing Income Trusts: Reconcilable or Irreconcilable Differences?* Report of the Standing Committee on Finance, 39th Parl., 1st sess., February 2007.

would still leave the direct holding of high-yield junk debt as a possible tax-effective substitute. In the absence of any significant non-tax constraints on the use of such debt, a further legislative response may be required. But this response would have to be much different, both conceptually and in its design features, from the draft legislation, even if the legislation were supplemented with additional provisions addressing the use of stapled securities. In particular, an extension of the draft legislation to stapled securities would somehow have to be supplemented with a further extension to securities that are held proportionally by investors, but are not formally stapled together.

The fourth part of the article also includes a brief discussion of the exception in the draft legislation for real estate investment trusts (REITs),<sup>11</sup> which the suggested modifications to address the use of stapled security structures would leave in place. These modifications would be limited to a denial of the availability of exempt REIT status in the context of stapled securities used to avoid dividend tax treatment.

### **INCOME TRUST STRUCTURES AS AN EXAMPLE OF TAX-DRIVEN TRANSACTIONAL SUBSTITUTION**

The common feature of income trust structures is the elimination (or substantial reduction) of the unintegrated portion of the corporate income tax by substituting high-yield, subordinated junk debt for a direct share investment in an operating corporation. In addition, the vast majority of income trust structures include a pooled investment trust to hold the debt and any remaining equity. The substitution is that of a lower-taxed transaction for a higher-taxed transaction along two different boundaries, on either side of which is a different tax treatment under the Income Tax Act.<sup>12</sup>

The substitution of high-yield acquisition indebtedness for shares of an operating corporation focuses on a discontinuity along the debt-equity boundary. In particular, the pattern of cash flows associated with the relevant shares is altered by substituting a fixed payment in the form of interest on the acquisition indebtedness. With businesses that require little or no retention of earnings for capital expenditures, the sacrifice in the desired pattern of cash flows is small, yet the debt-for-equity substitution results in a significant and disproportionate change in tax treatment (deductible interest expense at the corporate level versus non-deductible dividend payments). The substitution of a trust for a holding corporation as a vehicle to pool the capital of investors acquiring the shares of the operating corporation focuses on an inconsistency in the tax treatment of the cash flows distributed from these two organizational forms. Without any sacrifice in the desired pattern of cash flows, distributions from the

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11 The changes to the draft legislation proposed in the March 2007 notice of ways and means motion primarily address the scope of this exception. See *infra* notes 41 and 42 and 110 to 119 and the accompanying text; and Alan Bowman, Jon Northup, and Jarrett Freeman, "Government Releases Revised Income Trust/REIT Rules" (2007) vol. 46, no. 2 *Tax Notes International* 143-45.

12 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

trust are deductible and are not subject to any entity-level tax, while distributions from a corporation are non-deductible and subject to the corporate income tax.

At a broad conceptual level, the income trust structure is an example of a particular type of behavioural adjustment to taxes that is sometimes referred to in the literature as “transactional substitution.”<sup>13</sup> As one particular category of such an adjustment, transactional substitution involves the substitution of a lower-taxed transactional form for a higher-taxed form in instances of perfect (or near-perfect) substitutability or instances of imperfect substitutability.<sup>14</sup> The principal difference between these two types of substitution lies in the sacrifice of desirable non-tax attributes associated with a higher-taxed transaction that must be made in order to access the tax saving associated with a lower-taxed substitute. This difference in non-tax attributes represents the efficiency loss (referred to in the economics literature as “excess burden” or “deadweight loss”) associated with the behavioural adjustment to the particular difference in tax treatment. In both instances, the substitution of a lower-taxed transaction results in revenue loss equal to the total of the explicit taxes saved. Because the substitutable transactions have different non-tax features in instances of imperfect substitutability, efficiency losses arise directly from the substitution.<sup>15</sup>

The development of the income trust structure is, in large part, the story of the attempt to refine these structures to more closely replicate the non-tax attributes of the higher-taxed holding of shares of a corporation in both intermediated and dis-intermediated forms. The income trust saga began innocently enough with a tax ruling in 1986 that blessed a royalty trust structure created in Calgary for the acquisition of oil and gas assets in Alberta.<sup>16</sup> The structure stripped the profits from the

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13 See, for example, Tim Edgar, “Designing and Implementing a Target-Effective General Anti-Avoidance Rule,” in David G. Duff and Harry Erlichman, eds., *Tax Avoidance in Canada After Canada Trustco and Mathew* (Toronto: Irwin Law, 2007), 221-58 (categorizing tax-avoidance transactions as tax-attribute creation transactions, tax-attribute trading transactions, and transactional substitutions); and Michael Brooks and John Head, “Tax Avoidance: In Economics, Law and Public Choice,” in Graeme S. Cooper, ed., *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD Publications BV, 1997), 53-91 (cataloguing the different types of tax-avoidance behaviour that are the focus of economics and law).

14 See Brooks and Head, *supra* note 13 (describing similar consequential attributes shared by the different types of tax-avoidance behaviour).

15 The most obvious consequential attribute of instances of perfect (or near-perfect) substitutability is the revenue loss attributable to the substitution of the lower-taxed for the higher-taxed asset, item, or transactional form with equivalent non-tax features. Because the alternatives have equivalent non-tax features, no efficiency effects result directly from the substitution. But there may be indirect efficiency effects where the government operates under a budget constraint. Under those circumstances, the revenue loss caused by the substitution may have to be made up with other taxes that can have efficiency effects associated with the behavioural adjustments to such taxes. Alternatively, the revenue loss can result in expenditure cuts, with income and wealth distribution effects (and even efficiency losses where the relevant spending programs address market failures). See James M. Buchanan, “Externality in Tax Responses” (1966) vol. 33, no. 1 *Southern Economic Journal* 35-42.

16 Jacquie McNish and Beppi Crosariol, “A Taxing Week,” *Globe and Mail*, November 8, 2006.

properties by paying tax-deductible royalties to a mutual fund trust, which distributed the royalties to the unitholders on a tax-deductible basis. The combination of the tax-deduction for the royalty payments and the flowthrough treatment of the income distributed by the trust avoided the unintegrated portion of the corporate-level tax, which would have been payable if the assets had been acquired by the investors in corporate form. For several years, erosion of the corporate-level tax through the use of the royalty trust structure remained confined to the oil and gas sector; however, in the early to mid-1990s, this structure was modified to substitute high-yield, subordinated junk debt for a royalty agreement in what came to be called an “income trust” structure.

Development of the income trust structure as a modification of the royalty trust is marked by three general phases or types of structures.<sup>17</sup> The first stage of development produced the standard income trust structure (see figure 1), which was initially used in share acquisitions and debt-for-equity recapitalizations of corporations carrying on mature businesses with stable cash flows and little in the way of capital investment requirements. The common feature of this first generation of income trust structures was the elimination (or substantial reduction) of the unintegrated portion of the corporate income tax by substituting junk debt for a share investment in an operating corporation.<sup>18</sup> In addition, this basic structure included a pooled investment trust to hold the debt and any remaining shares.

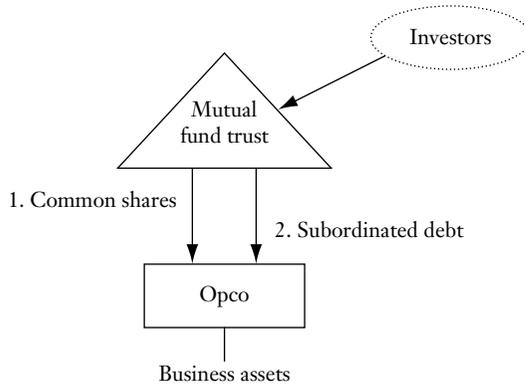
The second generation of income trust structures (see figure 2) combined the tax-deductible preferred share feature of the junk debt in the standard structure with the use of a partnership to realize a similarly tax-efficient structuring of the distribution of that portion of the earnings of a business that represent the riskier

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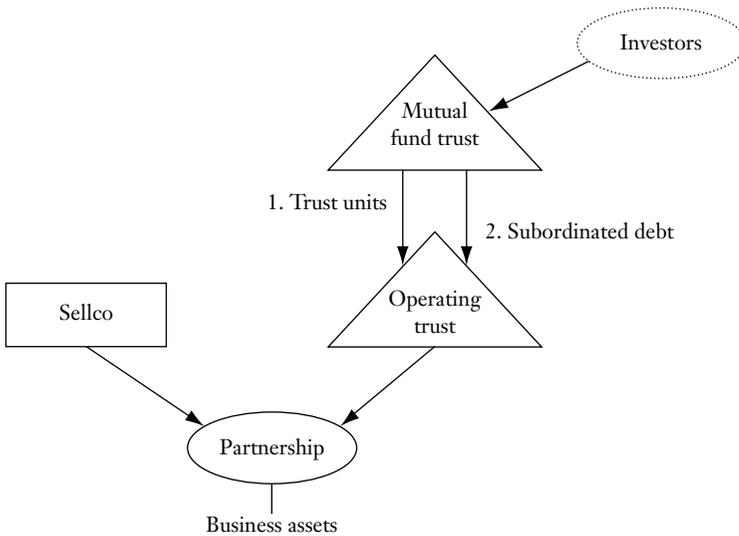
17 This taxonomy of income trust structures is an admitted oversimplification of the transactional details. There is a wide range of structures differing in certain respects. For example, in the US context (discussed later in this article) different structural details are involved with US limited liability companies and US C corporation structures used in the acquisition of a US business in an asset sale or a share sale. Another variation involves the use of a royalty trust structure to acquire certain operating businesses, rather than resource properties. These structures can nonetheless be classified within one of the three general categories described here (as well as the royalty trust structure) for the purposes of illustrating the targeting issues they present. See, in this respect, Simon Romano and Jeffrey Singer, “Canadian Income Trusts Come of Age” [March 2005] *International Financial Law Review* 53-56 (characterizing income trust structures as variations on one of two themes: (1) the use of a corporation to own the underlying business assets; and (2) the use of a limited partnership to hold the underlying business assets).

18 In some early advance income tax rulings, there were questions centred on the reasonableness of the amount of the interest expense for deduction purposes under paragraph 20(1)(c). For a review of the formalistic characterization approach of junk debt in the context of income trust structures, see Douglas A. Cannon, “Income Trusts: The Interest (Deduction) Continues—A Review of Westshore Terminals Income Fund and Superior Propane Income Fund,” in *Current Issues in Corporate Finance*, 1997 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 4:1-28, at 4:8-13. See also Paul D. Hayward, “Income Trusts: A ‘Tax-Efficient’ Product or the Product of Tax Inefficiency?” (2002) vol. 50, no. 5 *Canadian Tax Journal* 1529-69, at 1551-53.

**FIGURE 1 Standard Income Trust Structure**



**FIGURE 2 Income Trust with a Partnership Structure**



growth element and/or the associated retention of earnings for capital expenditures. More particularly, these “income trust with a partnership” structures continued to involve the issuance of high-yield junk debt to strip out the expected return on assets held indirectly in a partnership through an operating trust and an upper-tier mutual fund trust. In the standard partnership structure, the high-yield debt is issued at the level of the operating trust, while the unexpected return is passed on by distributing the return on the partnership interest held by the operating trust to the upper-tier

mutual fund trust and on to the holders of interests in that trust.<sup>19</sup> Thus, through the combination of an income trust and a partnership structure, the market developed a means to strip out from the corporate income tax base both the competitive return and any economic rents of a business, as well as the return on the assumption of risk. In short, the whole of the unintegrated portion of the corporate income tax on either of these returns could be eliminated.

The third generation of income trust structures eliminated the use of a trust as a pooling mechanism, with investors holding directly a combination of high-yield junk debt and a specified number of shares of the issuer, referred to as “income deposit securities” (IDS)<sup>20</sup> (see figure 3) or “income participating securities” (IPS)<sup>21</sup> (see figure 4). Until the elimination of the tax-law constraint provided by the foreign property rules (discussed below), these junk bond structures were used primarily in a cross-border context for investment into the United States in order to avoid the US corporate income tax.<sup>22</sup> These transactions realized the same tax benefit associated with the standard income trust structure by substituting for the intermediary trust a direct holding by investors of a combination of the high-yield junk debt and the shares of the operating corporation, which would otherwise be held proportionally by the trust.

As mentioned above, the 2005 budget proposal to repeal the foreign property holding restrictions for deferred income plans<sup>23</sup> opened up the range of substitutable

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19 The operating trust was interposed between the partnership and the mutual fund trust in order to ensure that the trust units acquired by RPPs and RRSPs were not foreign property for the purposes of the limitations on the amount of such property that these deferred income plans could hold. See *infra* note 23 and the accompanying text.

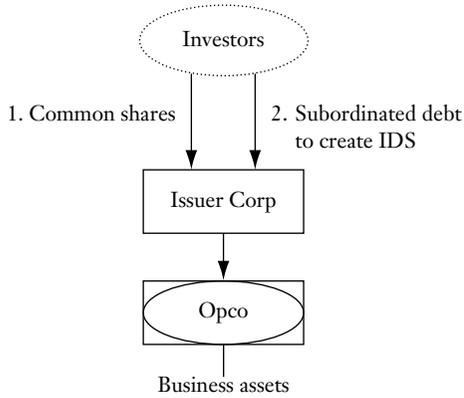
20 See, for example, Jack Bernstein and Barbara J. Worndl, “Cross-Border Acquisitions: The Evolution from Canadian Income Trusts to Income Deposit Securities” (2003) vol. 31, no. 2 *Tax Notes International* 143-45; Ken Snider, “The Evolving Market of Canadian Income Trusts and Income Deposit Securities” (2004) vol. 17, no. 6 *Journal of Taxation and Regulation of Financial Institutions* 5-12; Christopher J. Steeves, “Income Deposit Securities—A New Hybrid” (2003) vol. 8, no. 4 *Corporate Structures and Groups* 450-53; and Ian Karleff, “Canadian-Style Trusts Head South,” *National Post*, July 23, 2003.

21 IPSs are similar to IDSs and have been used as a substitute for the standard IDS structure. See Jack Bernstein and Barbara Worndl, “Canadian-U.S. Cross-Border Income Trusts: New Variations” (2004) vol. 34, no. 3 *Tax Notes International* 281-84; and Sandra Rubin, “Income Trusts’ Next Big Thing,” *National Post*, May 5, 2004.

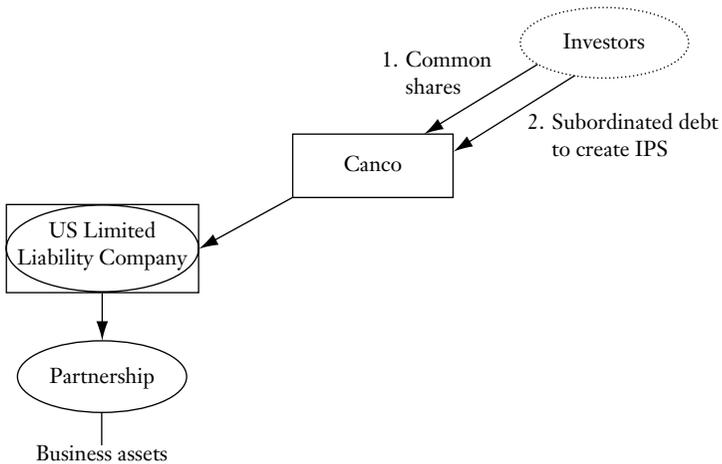
22 A version of the IDS/IPS structure was used in a domestic context by TimberWest Forest Corp. See Sinclair Stewart and Andrew Willis, “Bay Street Eyes Plan B,” *Globe and Mail*, November 8, 2006.

23 Canada, Department of Finance, 2005 Budget, Budget Plan, Notice of Ways and Means Motion To Amend the Income Tax Act, resolution (5), February 23, 2005, effective January 2005. RPPs remain subject to investment restrictions under the relevant non-tax regulatory regime. RRSPs and other deferred income plans remain subject to a tax-law requirement that their investments be “qualified investments.” Most importantly, shares or debt of a non-resident corporate issuer are qualified investments only if listed on a prescribed exchange. Interests in non-resident partnerships and trusts are not generally qualified investments.

**FIGURE 3 IDS Structure**



**FIGURE 4 IPS Structure**



structures by making available to these investors direct holding structures like IDS and IPS. In fact, the elimination of the foreign property holding restrictions also opened up the possibility of the direct substitution of the limited partnership form for the corporate form, exposing yet another boundary in the tax law. In effect, a direct substitution of a flowthrough entity for the corporate form could be used for a broad range of investors to realize the result otherwise available with the use of either high-yield junk debt in a standard income trust structure or the combination of debt and a partnership interest in the income trust with a partnership structure.

Each of these iterations of the income trust structure is accurately characterized as tax-driven; each involves the development of redundant securities or organizational

forms that are used predominantly for the tax saving that they access.<sup>24</sup> Indeed, the development of the income trust structure follows a common pattern of tax-driven financial innovation, whereby a latent inconsistency or discontinuity in the tax law becomes the focus of structured finance transactions designed to capitalize on the particular inconsistency or discontinuity. The impetus for the innovation is often found in a particular market development or environment; for example, a low-yield or low-interest environment is said to have been the impetus for the growth of income trusts (and their older royalty trust cousins). Nonetheless, the focus of these redundant securities (or organizational forms) remains the tax benefit that they are designed to access.<sup>25</sup>

In terms of the broad design features of a legislative response that is target-effective, income trusts present a classic case of the problem of line drawing in the tax law—that is, the difficulty of drawing a boundary between two different tax treatments where the precise details of the boundary at any given point lack much in the way of normative content. Given the lack of such content, the precise dimensions of the boundary will necessarily be somewhat arbitrary. On the assumption, however, that these kinds of boundaries are not to be eliminated in the short to the medium term, certain of the literature draws on the insights of optimal tax theory as the basis for an approach to line drawing that enhances efficiency.<sup>26</sup> Very generally, this literature

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24 At a general level, however, some of the literature suggests that income trusts can be characterized as efficiency-enhancing because of the elimination of the unintegrated portion of the corporate income tax; in effect, they are seen as a form of “self-help,” or “homemade” integration of the corporate and shareholder-level taxes. They are characterized as efficiency-enhancing because they eliminate welfare losses conventionally attributed to three standard biases associated with an unintegrated corporate income tax: (1) a bias in favour of the unincorporated sector; (2) a bias in favour of debt over equity investment; and (3) a bias in favour of the retention of earnings rather than their current distribution to shareholders. Welfare losses arise to the extent that investors would prefer the corporate form, equity investment, or current distribution of earnings, but the tax system alters that choice because of a preference for the unincorporated sector, debt investment, and the retention of earnings. As with the use of high-yield junk debt in leveraged buyouts (LBOs) and debt-for-equity recapitalizations, the more particularized (and more prominent) version of this efficiency case for income trusts is the argument that they reduce agency costs by imposing on corporate management the discipline of required cash flow distributions. In short, management is prevented from wasting or “burning” excess cash flows, which must instead be distributed to investors. See, for example, Paul Halpern and Oyvind Norli, “Canadian Business Trusts: A New Organizational Structure” (2006) vol. 18, no. 3 *Journal of Applied Corporate Finance* 66-75, at 71.

25 An excellent account of this development process in the United States may be found in Mark P. Gergen and Paula Schmitz, “The Influence of Tax Law on Securities Innovation in the United States: 1981-1997” (1997) vol. 52, no. 2 *Tax Law Review* 119-97. Other past examples of this pattern of development of tax-driven financial innovation in Canada are (1) the use of preferred shares as a substitute for loan transactions and (2) the use of finance leases as a substitute for leveraged asset purchases.

26 See, for example, David A. Weisbach, “Line Drawing, Doctrine, and Efficiency in the Tax Law” (1999) vol. 84, no. 6 *Cornell Law Review* 1627-81; and David A. Weisbach, “An Efficiency Analysis of Line Drawing in the Tax Law” (2000) vol. 29, no. 1 *Journal of Legal Studies* 71-97.

suggests that deadweight losses associated with the maintenance of boundaries in the tax law can be minimized by taxing close substitutes consistently in an effort to realize a level of “transactional neutrality.” This general approach addresses the revenue loss attributable to the substitution of lower-taxed for higher-taxed forms of transactions, while eliminating the transaction costs of such substitutions. Moreover, to the extent that the substitution involves sacrifices in non-tax factors, increasing the tax on the lower-taxed substitute eliminates the efficiency losses associated with these sacrifices.

For tax policy makers, drawing the tax-law boundary lines for substitutable transactions is especially problematic if there is a range of alternative transactions that includes both close and imperfect substitutes. Where such transactions exist, increasing the tax on a lower-taxed substitute to equal that on a higher-taxed form may only induce the substitution of alternative transactions that are lightly taxed but have associated efficiency losses attributable to their imperfect substitutability from a non-tax perspective. Tax policy makers must therefore first identify the range of close substitutes that can defensibly be taxed similarly. In addition, tax policy makers must identify the range of alternative transactions that provide imperfect substitutes. These transactions should be taxed differently only if the sacrifice in non-tax factors is significant enough to constrain the substitutability of such transactions. In short, tax-law boundaries should be drawn where tax policy makers can have some confidence that identified non-tax factors serve as a robust constraint on substitutability.<sup>27</sup> Otherwise, the legislative response executing the line-drawing exercise will be underinclusive.

Although there may be some costs associated with the undesirability of the private-law attributes of income trust structures, it is clear that they have not operated as an especially robust constraint on the tax-driven adoption of such structures.<sup>28</sup> During

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27 For a discussion of the significance of non-tax constraints or “frictions” generally for tax-planning purposes, see Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Edward L. Maydew, and Terry Shevlin, *Taxes and Business Strategy: A Planning Approach*, 3d ed. (Upper Saddle River, NJ: Prentice Hall, 2003), chapter 6. For a discussion of the significance of such constraints from a policy perspective, see David M. Schizer, “Frictions as a Constraint on Tax Planning” (2001) vol. 101, no. 6 *Columbia Law Review* 1312-1409.

28 Much of the non-tax legal literature emphasizes the differences in governance structures, including the liability issue for beneficiaries in an income trust structure. In this respect, one of the more significant developments for the income trust market was the adoption by the Alberta and Ontario governments of legislation providing limited liability protection for income trust unitholders. See the Income Trusts Liability Act, 2004, tabled in the Alberta legislature on May 6, 2004; and the Trust Beneficiaries Act 2003, tabled by the Ontario government with the March 27, 2003 budget. The liability issue apparently served as a barrier for the acquisition of trust units by certain registered pension funds and prevented listing of trust units in stock indexes. This latter barrier may have exacerbated liquidity risk associated with thin secondary markets for trust units, which may have served to constrain, to some extent, the use of income trusts. By clarifying the liability issue and opening the way to stock index listing, this type of private-law legislation apparently deepened the tax-clientele demand for income trust structures, with an increase in supply and associated revenue loss.

the first generation of the income trust structure, the most significant non-tax constraint on their adoption was an apparent market perception that the cash distribution requirements limited their use to those businesses that have relatively stable cash flows, face limited competition, and have very little in the way of capital expenditures that require the retention of a portion of the cash flows of the business. In the absence of any appreciable tax-law uncertainty and any significant costs attributable to the private-law attributes of the income trust structure, a number of these businesses effectively “checked the box” to eliminate the unintegrated portion of the corporate income tax. This effective election was made by adopting the income trust structure, with the cost being the associated transaction costs and any efficiency losses attributable to the private-law attributes of the structure.

The initial perception that the income trust structure was suitable only for businesses with stable cash flows was based on the premise that the return on the acquisition indebtedness could be used to strip out the competitive or normal return on the underlying assets (that is, the stable cash flow). As noted above, the second generation of income trust structures combined the tax-deductible preferred share feature of the standard structure with a similarly tax-efficient structuring of the distribution of that portion of the earnings of a business that represented the riskier growth element and the associated retention of earnings for capital expenditures. The development of these partnership structures underlay the spread of the income trust structure to businesses with growth potential. The precise parameters of any market constraint on this form of the income trust structure were exceedingly unclear. Indeed, the subsequent deepening of the income trust market was entirely consistent with a pattern of incremental development of tax-driven financial innovation generally, suggesting that, in the absence of the introduction of any tax-law constraint, markets will continue to massage available tax-effective structures in an effort to extend their adoption.

As described in the next section, the draft legislation, as an example of an efficiency-based exercise in line drawing, is flawed in its failure to apply to stapled security structures. In particular, the failure of the draft legislation to extend to stapled securities leaves open their use as tax-effective substitutes for income trust structures subject to the legislation. Given that there appear to be no obvious non-tax constraints on such substitution, this underinclusiveness is potentially fatal, and the department could be forced to legislate retroactively, unless the threat in the October 2006 proposals to do just that serves its ostensible purpose.

## **USING STAPLED SECURITIES TO AVOID THE APPLICATION OF THE DRAFT LEGISLATION**

As a response intended to shut down demand from tax-exempt and non-resident investors, the draft legislation attempts to raise the tax on a range of income trust structures consistent with the tax on dividend distributions in a corporate context. In contrast, the November 2005 proposal attempted to restore a measure of consistency in the tax treatment of corporate structures and income trust structures by

reducing the dividend tax on the former. In addition to the different revenue consequences, the draft legislation and the November 2005 proposal differ importantly in their respective targeting dimensions. Enhancing the tax credit for dividend distributions involves some targeting issues associated with the need to ensure that underlying corporate income is subject to a statutory tax rate consistent with the gross-up and credit rate at the shareholder level.<sup>29</sup> Much more problematic targeting issues arguably arise with the attempt to ensure that the tax on income trust structures for tax-exempt and non-resident investors is increased to a level consistent with dividend distributions. Most importantly, any such legislative response must ensure that it applies to the full range of possible substitutes. In this respect, the availability of a wide range of close substitutes for the standard income trust structure means that a target-effective response will inevitably be somewhat inelegant. But given an acceptance of a revenue constraint that precludes a lower tax on dividend distributions for tax-exempt and non-resident investors, the need for such legislation is unavoidable.

Indeed, in the presence of a high degree of substitutability of the income trust structure for the public corporation, the November 2005 proposal to enhance the dividend tax credit was a false step: it sacrificed revenue without stopping further bleeding from a growing income trust market. With a significant portion of the corporate revenue base remaining at risk, the draft legislation proposes to raise the tax on income trust structures used as substitutes for the corporate form in a publicly traded context. This result is realized by applying dividend treatment to distributions of income of a “specified investment flow-through” (SIFT) trust or partnership from its “non-portfolio properties.”<sup>30</sup>

As its principal targeting mechanism, the draft legislation defines a SIFT trust or partnership as a resident entity that holds any non-portfolio property where investments in the entity are listed for trade on a stock exchange or other public market.<sup>31</sup> “Non-portfolio property” is defined<sup>32</sup> as

- the holding by a single investor of more than 10 percent of the relative fair market value of all issued securities of a subject entity;
- the holding of securities of a subject entity (and affiliated entities) where the securities constitute more than 50 percent of the equity value of the investor itself;

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29 This result is realized through the definitions in subsection 89(1) of the “general rate income pool” of a Canadian-controlled private corporation (CCPC) and the “low rate income pool” of a non-CCPC, added (with related amendments) by SC 2007, c. 2, section 47(1).

30 Distributions of income from non-portfolio properties are treated as non-deductible dividends, subjecting the underlying income to tax at the entity level at a rate of 31.5 percent. This rate is intended to approximate the combined federal-provincial tax on the taxable income of a public corporation.

31 Draft legislation, proposed section 122.1, definition of “specified investment flow-through trust,” and proposed subsection 197(1), definition of “specified investment flow-through partnership.”

32 *Ibid.*, proposed section 122.1, definition of “non-portfolio property.”

- Canadian immovable or resource property where such property constitutes more than 50 percent of the equity value of the entity; and
- property used in the course of carrying on a business in Canada.

An “investment” includes a “security” of the trust or partnership,<sup>33</sup> which is defined to include (1) an income or capital interest in a trust, (2) a partnership interest, (3) a right to acquire such an interest, or (4) a liability of a trust or partnership.<sup>34</sup> The concept of an investment is also extended to include a right that may reasonably be considered to replicate a return on, or the value of, a security of a trust or partnership.<sup>35</sup> Investments are considered to be listed on a public market if they are listed on a stock exchange or an over-the-counter market, defined as a trading system or other organized facility through which securities that are qualified for distribution may be exchanged.<sup>36</sup>

With these concepts of a SIFT trust and a SIFT partnership, the department essentially chose to use an entity-level “dividend trap” rather than an equity recharacterization rule<sup>37</sup> for the junk debt held proportionally with shares of an issuer in an income trust structure. As executed in the draft legislation, this different conceptual approach addresses the use of both royalty trust substitutes and direct entity plays in which a publicly traded trust or partnership is substituted for a publicly traded corporation. The draft legislation also manages to address the use of high-yield junk debt held in an intermediary SIFT trust or the use of a partnership interest that is similarly held. More specifically, the concept of a SIFT trust or a SIFT partnership accurately targets both the standard income trust structure and the income trust with a partnership structure. Under the proposed provisions, for both structures, the return on high-yield junk debt will be treated as a dividend as it passes through a publicly traded trust before being distributed to investors. The return on partnership interests will also be subject to the same treatment, usually as it passes through a publicly traded trust holding the interest. Where interests in the partnership are themselves publicly traded, the return will be subject to dividend treatment as it is earned and distributed by the partnership. In fact, the return on businesses carried on directly by publicly traded trusts and partnerships will be subject to dividend treatment to ensure that these entities cannot be substituted directly for the publicly traded corporate form.

The draft legislation does not, however, obviously extend to stapled security structures, which could potentially be used to stream off business income of an entity directly to the investors. Provided that the income stream is deductible to the

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33 Ibid., paragraph (a) of the definition of “investment.”

34 Ibid., definition of “security.”

35 Ibid., paragraph (b) of the definition of “investment.”

36 Draft legislation, proposed section 122.1, definition of “public market.”

37 The design features of an equity recharacterization rule are explored in Tim Edgar, “The Trouble with Income Trusts” (2004) vol. 52, no. 3 *Canadian Tax Journal* 819-52, at 843-52.

operating entity, a stapled security structure would avoid the dividend distributions tax for an intermediary SIFT trust or partnership but would maintain the non-tax attributes of an intermediated investment by stapling securities held by investors directly with their interests in the trust or partnership. Stapling the interests would ensure proportional holdings without the use of an intermediary pooling entity (which would create the intended dividend trap under the draft legislation). Securities held directly by investors would normally have to be debt securities that give rise to an interest deduction for the operating entity. Substitute structures could also use rental payments where the lessor is an intermediary REIT. Dividend treatment at the level of the operating entity could be avoided provided that the issuer is a corporation. In that case, it does not matter that its securities are publicly traded, since the draft legislation applies SIFT status to publicly traded trusts or partnerships. Moreover, dividend treatment is limited to income from non-portfolio properties of these entities. Where the operating entity is itself a trust or partnership, interests or liabilities of the entity could not be publicly traded without attracting SIFT status.

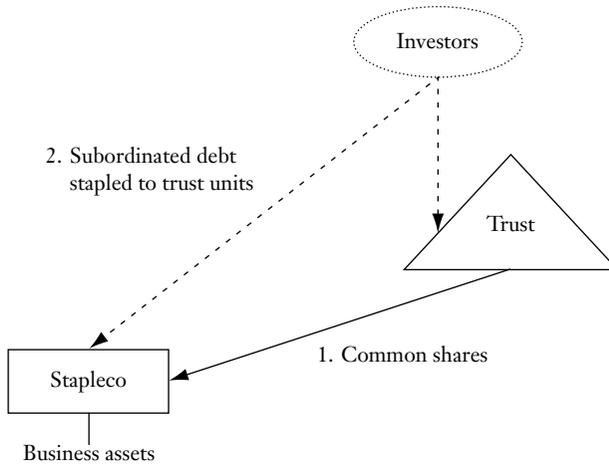
As one illustrative example of a tax-effective stapled security structure, the standard income trust structure could be modified using an IDS or IPS structure (figures 3 and 4), as shown in figure 5.<sup>38</sup> The modification would involve the issuance of high-yield junk debt by a corporation directly to investors, who would otherwise acquire the debt of the corporate issuer indirectly through interests in an intermediary trust. Income from the business could be stripped out of the corporation as deductible interest expense payable to the investors. The debt would be stapled to units of the trust acquired by the investors, with the amount advanced for these units being used by the trust to acquire shares of the operating corporation. The stapling of the high-yield junk debt and the trust units would ensure that the cash flows, as well as most of the other non-tax attributes, of the stapled structure would replicate those associated with a standard income trust structure. Because interest on the junk debt would be paid directly to the investors, and not through the intermediary trust, the draft legislation would not apply to treat the income stream as a dividend distribution from the trust.

Much the same result could be realized by modifying the income trust with a partnership structure. For example, high-yield junk debt could be issued by a partnership directly to investors rather than through an intermediary trust.<sup>39</sup> As with the above-described modification of the standard income trust structure, the debt could be stapled to trust units acquired by the investors. This structure, however, would replicate the income trust with a partnership structure only to the extent of the expected return on the junk debt. A more tax-effective substitute, shown in figure 6, would distribute economic rents and/or unexpected returns associated with the

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38 Stewart and Willis, *supra* note 22. See also Andrew Willis, “Will Bay Street Outfox Goodale? Don’t Bet on It,” *Globe and Mail*, October 26, 2005.

39 However, the debt would have to be unlisted. If it was listed for trade, the issuer would be considered a SIFT partnership, and income from the business assets, distributed as interest on the debt, would be treated as non-deductible dividend payments.

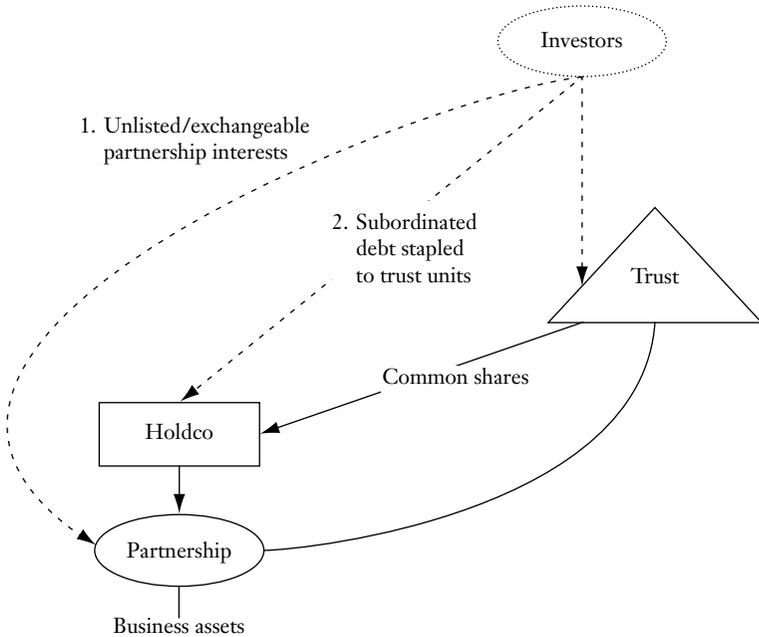
**FIGURE 5 Stapled Version of a Standard Income Trust Structure**

growth element of the underlying business through partnership interests that are issued directly to the investors. These interests could not be stapled to publicly traded junk debt of the partnership and/or trust units in an intermediary structure; in that instance, the partnership interests themselves would be considered publicly traded and the partnership would be accorded SIFT status, with dividend treatment applying to income on its business assets. Instead, a holding corporation could be interposed between the investors and business assets held in a partnership. Investors could acquire partnership interests that are not listed for trade, along with publicly traded debt of the holding corporation, which would be stapled to units in a trust. The same effect as listing for trade could be achieved by providing that the partnership interests of investors could be exchanged for further trust units or a combination of trust units and junk debt of the corporate issuer. Provided that the exchange feature would not lead to a characterization of the partnership interests as publicly traded,<sup>40</sup> the draft legislation would not apply to the return on the partnership interests acquired directly by the investors, or any junk debt issued by the intermediary corporation. Only the return that is distributed through the intermediary SIFT trust would be subject to dividend treatment.

A third illustrative avoidance technique using stapled securities would involve an asset sale with a leaseback structure using an intermediary REIT, shown in figure 7. More particularly, the real estate assets used in carrying on a business could be sold

40 Paragraph (e) of the definition of a security, supra note 34, includes a right to acquire any of the interests that are within the definition. It is unclear whether this element of the definition would extend to a right that is embedded in a security. Moreover, there is nothing in the definition of a public market, supra note 36, that would extend a publicly traded characterization to a right to acquire a security where the right is not itself publicly traded but the security that can be acquired is publicly traded.

**FIGURE 6 Stapled Version of an Income Trust with Partnership Structure**



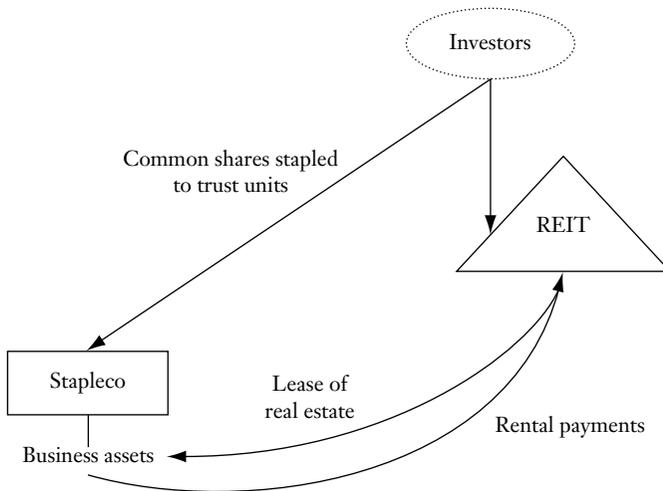
to a REIT and leased back, with deductible rental payments made by the publicly traded operating corporation to the REIT. The draft legislation would not apply to treat the rental payments received by the REIT as dividend distributions to investors holding units in the REIT, since the legislation specifically excludes these entities from SIFT status. For the purpose of this exception, a REIT is defined<sup>41</sup> as a publicly traded resident trust that

- holds only “qualified REIT property”<sup>42</sup> throughout a taxation year;
- earns 95 percent or more of its revenue from interest, royalties, and rent from real property, as well as gains from the disposition of such property;

41 Draft legislation, proposed section 122.1, definition of “real estate investment trust.”

42 “Qualified REIT property” is defined in proposed section 122.1 as (1) Canadian real property; (2) securities of an entity that performs a property management function in respect of property of the trust or itself satisfies the conditions for REIT status; and (3) property that is ancillary to the earning of rent from immovables and capital gains on the disposition of immovables. For this purpose, “rent from real or immovable properties” is defined in proposed section 122.1 to include payments for services ancillary to the rental function and to exclude property management fees, hotel service fees, and rents based on profits. These definitions were introduced in the March 2007 notice of ways and means. The December draft legislation limited qualified REIT property to Canadian real property. The exempt status of REITs, as well as the extension of qualifying REIT activities to include a property management function and services ancillary to property rental, is discussed infra notes 110-119 and the accompanying text.

FIGURE 7 Stapled REIT



- earns 75 percent or more of its revenue from rents from, mortgages on, or gains from the disposition of Canadian real property; and
- derives 75 percent or more of its equity value from Canadian real property, cash, and Canadian government debt throughout a taxation year.

Nothing in these qualifying conditions would prevent an asset sale and leaseback structure using an intermediary REIT to stream off much of the expected return that would otherwise be paid out under a standard income trust structure as interest on high-yield junk debt.

The three structural alternatives discussed above are refinements of either the standard income trust structure or the income trust with a partnership structure; they attempt to more closely replicate the non-tax attributes of the publicly traded corporate form in instances of perfect (or near-perfect) substitutability. Each presents much the same revenue and efficiency effects as existing income trust structures. Since the draft legislation is intended to eliminate those effects, by taxing all investors in such structures consistently with investors in publicly traded corporations, a target-effective legislative response should extend the same tax treatment to stapled security structures.

In this respect, as stated above, the definition of an investment in a trust or partnership extends to a right that may reasonably be considered to replicate a return on, or the value of, a security in the trust or partnership. This extension appears to contemplate publicly traded derivative financial instruments, such as structured notes, swaps, or other synthetic instruments, which replicate the return on a unit in a trust or an interest in a partnership that is not otherwise publicly traded. The derivative instrument may be issued by the trust or partnership itself or by a third party,

whether related or unrelated to the trust or partnership. Extending the definition of an investment to publicly traded derivatives would result in SIFT status for the relevant trust or partnership; however, it is unclear whether the extension would apply to stapled security structures. Moreover, extension to derivative financial instruments issued by unrelated third parties could well be overinclusive where such instruments are issued, not for the tax-avoidance purpose targeted by the draft legislation, but for legitimate non-tax purposes, such as hedging the risk associated with an investment.<sup>43</sup>

In fact, it is unclear whether the department has stapled security structures in mind with the extension of the definition of an investment in a trust or partnership to include derivative financial instruments. It is more likely that the product label warning in the October 2006 proposals regarding substitute structures contemplates stapled security structures, in which case the department has made it clear that it is willing to legislate retroactively to address their use. In our view, the US legislative response to stapled shares is an obvious model that could be used to target stapled security structures as tax-effective substitutes for income trust structures subject to the draft legislation. In other words, extension of the draft legislation based on the US legislative model could improve the target effectiveness of the proposed measures by ensuring that they will apply, explicitly and more precisely, to stapled security structures.

## US EXPERIENCE WITH STAPLED SHARES

Until the mid-1980s, stapled shares were used in the United States for various planning purposes in both the domestic and international contexts. Congress, however, effectively shut down this type of tax-driven, transactional substitution in 1984 with the introduction of section 269B of the Internal Revenue Code.<sup>44</sup> This legislative response should serve as a cautionary tale for any Canadian tax planners who perceive stapled securities as an opportunity to avoid the application of the draft legislation. Indeed, IRC section 269B provides a ready-made template for the kind of retroactive legislative response threatened by the department in the October 2006 proposals.

### Stapled REIT Structures

Until recently, the corporate income tax in the United States was a classical system. Even now, the corporate income tax is only partially integrated through a reduced personal income tax rate on dividends. Generally, a domestic corporation (referred

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43 A problem of overinclusiveness also seems to arise because of the broad bundle of rights described in the definition of a security and the specific inclusion of liabilities of an entity (supra note 34 and the accompanying text). The definition appears to include derivative financial instruments acquired by a trust or partnership for hedging purposes. Where these instruments are acquired through an exchange or an over-the-counter market, they would be investments in the trust or partnership listed on a public market and would make the trust or partnership a SIFT trust or SIFT partnership even where units in the trust or interests in the partnership are not listed for trade.

44 Now contained in the Internal Revenue Code of 1986, as amended (herein referred to as “IRC”).

to as a “US C corporation”) is subject, as a separate legal entity, to tax on its income at a maximum graduated rate of 35 percent. Unlike salary and interest expense, dividends paid by the corporation out of its earnings and profits are not deductible in computing taxable income and are also considered taxable income to the shareholders. Corporate income is thereby taxed twice, first at the corporate level and then at the shareholder level. However, corporate shareholders are afforded a dividends-received deduction (DRD) in respect of dividends received from a US corporation. The rate of the DRD varies depending on the shareholding percentage in the distributing corporation.<sup>45</sup>

Some entities, such as “S corporations,”<sup>46</sup> partnerships,<sup>47</sup> and certain trusts,<sup>48</sup> are treated as flowthrough entities, with income taxed only to the shareholders, partners or beneficiaries as allocated or distributed to them. Other corporations, such as regulated investment companies (RICs) investing in securities (that is, mutual funds) are relieved from corporate tax on dividends and capital gains distributed to their shareholders.<sup>49</sup> Similar treatment is provided for REITs<sup>50</sup> and real estate mortgage investment conduits (REMICs).<sup>51</sup>

Like RICs and REMICs, the REIT is a creature of the IRC. There are three basic types of REITs: “(1) equity REITs, which own real estate, and derive income from property rentals; (2) mortgage REITs, which invest in real estate mortgages and derive income from fees and interest on loans; and (3) hybrid REITs, which hold both mortgage and real estate assets.”<sup>52</sup> The REIT was created in 1960 with two apparent rationales.<sup>53</sup> The principal rationale was the extension to real estate investors of the flowthrough treatment afforded to RICs, to allow them to similarly pool their resources without the imposition of corporate or entity-level taxation. In effect, REITs are intended to provide for small real estate investors the same advantages usually available for institutional and wealthy investors.<sup>54</sup> According to Congress,

[t]hese advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to secure benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.<sup>55</sup>

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45 IRC section 243.

46 IRC sections 1361 to 1379.

47 IRC sections 701 to 761.

48 IRC sections 641 to 679.

49 IRC sections 851 to 855.

50 IRC sections 856 to 859.

51 IRC sections 860A to 860G.

52 Russell J. Singer, “Understanding REITs, UPREITs, and Down-REITs, and the Tax and Business Decisions Surrounding Them” (1996) vol. 16, no. 2 *Virginia Tax Review* 329-45, at 330-31.

53 Charles E. Wern III, “The Stapled REIT on Ice: Congress’ 1998 Freeze of the Grandfather Exception for Stapled Stock” (2000) vol. 28, no. 3 *Capital University Law Review* 717-44, at 719.

54 See *ibid.*

55 HR rep. no. 86-2020, (1960), 3-4, cited in Wern, *supra* note 53, at 719-20.

A secondary rationale was the provision of investor protection from the business risks associated with real estate investments. This goal is realized by limiting REITs to passive investment in real estate.<sup>56</sup> In prohibiting REITs from engaging in active businesses, Congress intended to prevent their use as a tax-effective substitute for the corporate form.<sup>57</sup> In this respect, Congress stated:

This bill [that is, the legislation creating the REIT] restricts this “pass through” of the income for tax purposes to what is clearly passive income from real estate investments, as contrasted to income from active operation of business involving real estate. . . . [A]ny real estate trust engaging in active business operations should continue to be subject to the corporate tax in the same manner as is true in the case of similar operations carried on by other comparable enterprises.<sup>58</sup>

A REIT is taxed as a corporation, but is afforded a deduction for dividends paid in a taxable year.<sup>59</sup> The deduction ensures that distributed income is subject only to investor-level taxation. REITs are subject to entity-level taxation, as regular C corporations, on undistributed income. To qualify for REIT status, a corporation, trust, or association must elect to do so and must meet the following conditions, among others:<sup>60</sup>

- at least 95 percent of gross income must be derived from dividends, interest, rents from real property, gain from the sale or other disposition of shares, securities, and real property not held as inventory, and gain from the sale or other disposition of a non-prohibited real estate asset;<sup>61</sup>
- at least 75 percent of gross income must be derived from “real property rentals, loans, gains from the sale or other disposition of real property or real estate

56 See Wern, *supra* note 53, at 720.

57 *Ibid.*

58 HR rep. no. 86-2020 (1960), 3-4, cited in Wern, *supra* note 53, at 720. The Tax Reform Act of 1986, Pub. L. no. 99-514, enacted on October 22, 1986, allowed REITs to directly furnish “services customarily furnished or rendered in connection with the rental of real property, whether or not . . . charges [for such services] are separately stated” (IRC section 856(d)(1)(B)). REITs were thus able to provide such services to their tenants without violating the eligibility conditions, thus eliminating the need to use independent contractors. See Wern, *supra* note 53, at 721. The March 2007 notice of ways and means motion similarly expanded the range of permissible services for the purposes of the REIT exemption under the draft legislation. See *supra* note 42 and the accompanying text.

59 IRC section 857.

60 IRC section 856. In addition, the entity must (1) be managed by one or more trustees or directors (IRC section 856(a)(1)); (2) have fully transferable shares or certificates (IRC section 856(a)(2)); (3) not be a financial institution or an insurance corporation (IRC section 856(a)(4)); (4) have 100 or more shareholders (IRC section 856(a)(5)); and (5) not be closely held (IRC section 856(a)(6)).

61 IRC section 856(c)(2).

assets, abatements and refunds on taxes, and income and gain derived from foreclosure property;<sup>62</sup>

- at least 75 percent of the assets must be real estate assets, cash and cash items (including receivables), and government securities;<sup>63</sup>
- not more than 20 percent of the value of the total assets may be securities of one or more taxable REIT subsidiaries (TRSS);<sup>64</sup> and
- except for securities of TRSS and government securities, not more than 5 percent of assets may be securities of any one issuer, and the entity cannot hold securities with more than 10 percent of the total voting power or value of the outstanding securities of any one issuer.<sup>65</sup>

(These conditions are similar to those set out for REIT status under the draft legislation.)<sup>66</sup>

In the early 1980s, stapled share structures were developed to allow REITs to carry on an active business while complying with the prohibition on such activity, thereby maintaining their status as REITs with the associated flowthrough treatment.<sup>67</sup> As illustrated in figure 7, a REIT would form a stapled entity—that is, a formally separate corporation the shares of which were held by the shareholders of the REIT and were contractually stapled to the shares of the REIT so that the interests in each entity could not be traded separately. The REIT and the stapled corporation were considered two separate entities in form, but with the same shareholders and management. The REIT would own and hold only real estate assets, which would be leased to the stapled entity carrying on a particular business. By paying all, or most, of its income to the REIT as rent, the stapled corporation would generate a deduction that eliminated, or substantially reduced, its taxable income. The active business income on the underlying assets of the stapled corporation would arguably be converted into qualifying passive income (rent) through this structure, thereby avoiding corporate-level taxation on the business income distributed by the REIT to the investors.

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62 IRC section 856(c)(3), and see Singer, *supra* note 52, at 331.

63 IRC section 856(c)(4)(A).

64 IRC section 856(c)(4)(B)(ii). The concept of a TRS is discussed *infra* at notes 110 to 119 and the accompanying text.

65 IRC section 856(c)(4)(B)(iii).

66 See *supra* note 41 and the accompanying text. Additional conditions similar to those listed in note 60, *supra*, in respect of US REITs must be met by Canadian REITs in order to qualify for closed-end mutual fund trust status under the Act. See the definition of “mutual fund trust” in subsection 132(6) and regulation 4801.

67 See Wern, *supra* note 53, at 725-26.

## Stapled Foreign Corporation Structures

### *Avoiding Subpart F*

US citizens, residents, and domestic corporations (“US taxpayers”) are subject to US tax on their worldwide income,<sup>68</sup> with a credit for taxes paid to the source country.<sup>69</sup> Foreign-source income earned by a foreign corporation is generally not subject to US tax until repatriated to a US taxpayer.<sup>70</sup> Since 1913, six anti-deferral regimes have been enacted to limit the availability of this deferral (though some of these provisions no longer apply).<sup>71</sup> Of relevance to the discussion here is subpart F of the IRC (sections 951 to 964), enacted in 1962 to eliminate the benefit of deferral for certain offshore structures that Congress considered to be artificial “tax haven” devices designed to exploit low foreign taxes. Subpart F applies to “controlled foreign corporations” (CFCs) earning “Subpart F income.” Each “United States shareholder” of a CFC is generally allocated a pro rata share of the CFC’s subpart F income, whether or not a corresponding distribution is made by the CFC, and must include this

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68 IRC sections 1, 11, and 61.

69 IRC section 901. The foreign tax credit is subject to two limitations: the general limitation and the “baskets” limitation. The general limitation limits the foreign tax credit to the US tax rate on the relevant income (IRC section 904(a)). The baskets limitation applies the general limitation separately to each category of income (basket) (IRC section 904(d)). Starting January 2007, there are two baskets, the passive income basket and the general basket.

70 A domestic corporation is a corporation formed, organized, and registered in the United States, regardless of the location of its management and control, place of business, etc. A foreign corporation is any corporation that is not a domestic corporation (IRC sections 7701(a)(4) and (5)). Thus, the determination of whether a corporation is domestic or foreign depends on a formal rule: a domestic corporation is one that was incorporated in the United States. As to the classification of foreign entities, the check-the-box regulations under the IRC generally allow the shareholders of such entities to choose whether the entity is treated for US tax purposes as a foreign corporation or as a foreign partnership (Treas. reg. sections 301.7701-1, 2, and 3). However, certain specific foreign business entities are not subject to the check-the-box regulations; instead, they are always treated as foreign corporations for US tax purposes. These formal rules make deferral of US taxation a relatively easy task, subject to the anti-deferral rules discussed or mentioned below. US taxpayers carrying on business outside the United States may incorporate a corporation in a foreign jurisdiction and defer US taxation of the income from the business until repatriation as dividends or liquidation distributions. Similarly, a US corporation conducting business through a branch in a foreign country may check the box to have the branch treated as a foreign corporation for US tax purposes, providing the same deferral benefit otherwise available to the parent-subsidiary form of organization.

71 The accumulated earnings tax (AET), which was enacted in 1913 (IRC sections 531 to 537) and is rarely applied; the personal holding corporation (PHC) regime of 1937 (IRC sections 541 to 547), which, since 2001, no longer applies to foreign corporations; the foreign personal holding corporation (FPHC) regime of 1937 (IRC sections 551 to 558), which was abolished; the foreign investment company (FIC) regime of 1962 (IRC sections 1246 and 1247), which was abolished as well; the subpart F regime, which was enacted in 1962 (IRC sections 951 to 964); and the passive foreign investment company (PFIC) regime, which was enacted in 1986 (IRC sections 1291 to 1298).

amount as ordinary income.<sup>72</sup> Subpart F income consists primarily of passive income<sup>73</sup> and sales or services income from certain related-party transactions where the location of the underlying business activity (that is, where services are performed, or where products are manufactured or sold for use) is outside the CFC's country of incorporation.<sup>74</sup>

A CFC is defined as any foreign corporation more than 50 percent of the total combined voting power, or the total value, of which is owned, or is considered to be owned, by US shareholders on any day during the taxable year of the foreign corporation.<sup>75</sup> A US shareholder is a US person who owns, or is considered to own, 10 percent or more of the total combined voting power of a foreign corporation.<sup>76</sup> Thus, the subpart F rules apply to the US shareholder of a foreign corporation only if more than 50 percent of the total combined voting power or value of the corporation's shares is owned, directly or indirectly, by US shareholders, each of whom owns at least 10 percent of the shares of the foreign corporation.

Stapled share structures were sometimes used to avoid the application of subpart F by avoiding CFC status for a foreign corporation controlled by a widely held US corporation. Instead of forming a foreign subsidiary earning subpart F income, a widely held US corporation would form a foreign corporation the shares of which would be stapled to the shares of the US corporation (figure 8). Subpart F would arguably be avoided, provided that no 10 percent US shareholders together owned more than 50 percent of the total combined voting power of the foreign corporation, which would be widely held in form.

### ***Avoiding Withholding Tax and Retaining the Benefit of the DRD***

A foreign person's "fixed or determinable, annual or periodic" income from a US source that is not connected with the foreign person's US business is subject to

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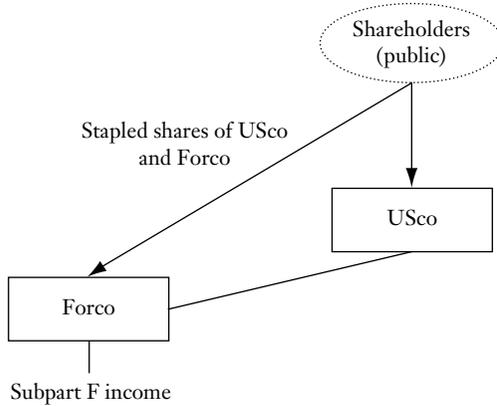
72 IRC section 951(a).

73 IRC sections 952(a) and 954(c). Subpart F income does not include royalties and rents from active business (IRC section 954(c)(2)(A)) and certain dividends and interest from corporations within the same country as the CFC (IRC section 954(c)(3)(A)(i)). For taxable years beginning in 2006, 2007, and 2008, dividends, interest, rents, and royalties received or accrued from a related CFC are not treated as subpart F income to the extent that they are attributable to income of the related CFC that is neither subpart F income nor income effectively connected with a US business (IRC section 954(c)(6)). Subpart F does not apply (1) if the subpart F income does not exceed the lesser of US\$1 million or 5 percent of the CFC's income (IRC section 954(b)(3)(A)); (2) if the taxpayer can establish that the income was subject to an effective foreign tax rate that is 90 percent or more of the US tax rate (IRC section 954(b)(4)); or (3) with respect to active income from a banking, finance, or insurance business (IRC sections 954(h) and (i)).

74 IRC sections 952(a) and 954(d) and (e).

75 IRC section 957(a).

76 IRC section 951(b).

**FIGURE 8 Stapled Structure To Avoid Subpart F**

US taxation on a gross basis at a relatively high withholding rate of 30 percent.<sup>77</sup> However, “a combination of source rules, statutory exemptions, and tax treaties results in [interest] income being generally taxed only when earned by foreign businesses as part of their active business operations—such income generally is not taxed when earned by portfolio investors.”<sup>78</sup>

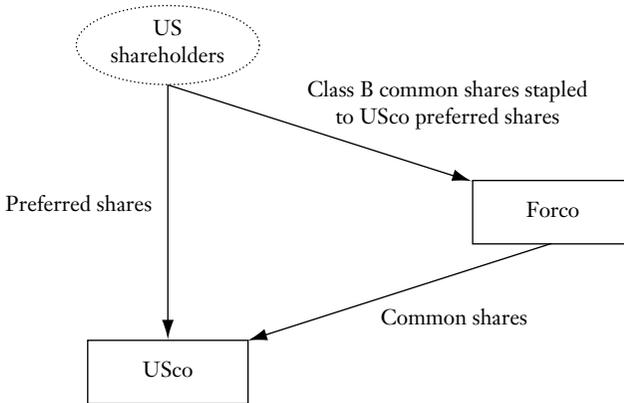
For foreign direct investors, stapled stock structures could be used to avoid the application of this non-resident withholding tax and retain the benefit of the DRD for US corporate shareholders. For example, assume that a foreign corporation (Forco) and a US corporation (USco) have agreed to merge on a share-for-share basis. If Forco were to acquire USco in exchange for its shares, dividends or interest paid by USco to Forco (the new foreign parent), and probably such payments by Forco to its new US shareholders, would be subject to withholding taxes. Moreover, the US corporate shareholders of USco receiving shares of Forco would lose the benefit of the DRD.

To avoid withholding tax and retain the benefit of the DRD, the transaction could be structured as shown in figure 9. USco would first issue to its shareholders, on a pro rata basis, preferred shares with voting power representing less than 20 percent of the voting power in USco.<sup>79</sup> Forco would then acquire the common shares of

77 IRC sections 871(a) and 881(a).

78 Reuven S. Avi-Yonah, “The Structure of International Taxation: A Proposal for Simplification” (1996) vol. 74, no. 6 *Texas Law Review* 1301-59, at 1318. See IRC sections 871(h) and 881(c).

79 The less than 20 percent voting power limitation is needed in order to qualify for a US tax-free reorganization under IRC section 368(a)(1)(B), which requires that the acquiring corporation have control of the acquired corporation immediately after the acquisition. “Control” for this purpose means “the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation” (IRC section 368(c)). However, a number of other US tax issues could arise. See, for example, IRC sections 306 and 367(a).

**FIGURE 9 Stapled Structure To Avoid Withholding Tax and Retain the DRD**

USco in exchange for class B common shares of Forco, and the USco preferred shares would be stapled to the Forco class B common shares. The stapled share arrangement would provide the terms and amounts of the distributions on each class of shares. In a merger between equals, the objective would be to require Forco and USco to make equal distributions through the Forco common shares and the USco preferred shares, respectively. There might also be a need for an equalization agreement between the two corporations that would control the required degree of identity or diversity of interest between the two types of shares.<sup>80</sup> This structure would allow the US corporate shareholders to continue to receive dividends through USco and the foreign shareholders to continue to receive dividends through Forco. Withholding tax on dividends would be avoided, and the US corporate shareholders would retain the benefit of the DRD.<sup>81</sup>

## US Congressional Reaction to Stapled Share Structures

### *Case Law Preceding the Enactment of IRC Section 269B*

Before the enactment of IRC section 269B, some case law considered the characterization of stapled share arrangements. The issue in these few cases was whether the formally separate nature of the shares should be respected, and the shares treated as interests in each of the relevant entities, or whether the shares should be considered a single interest in a single entity. Although the decisions did not address the issue

80 See Peter C. Canellos, "Combining United States and United Kingdom Corporations" (1988) vol. 42, no. 4 *The Tax Lawyer* 935-60, at 956-60.

81 There is some suggestion in the literature (see Canellos, *ibid.*, at 958-59) that the Internal Revenue Service could have challenged this structure. It is suggested that the structure might be subject to recharacterization, with distributions from USco to its US preferred shareholders being deemed to be distributed first to Forco, and then from Forco to the US shareholders. (The stapled stock issues of this structure related to IRC section 269B are discussed below.)

in a tax-avoidance context, the approach taken to the characterization issue was relevant to the use of stapled share structures for planning purposes. In this respect, the case law appeared to articulate the same general principle: that is, there is no substantive difference between a parent-subsidiary structure and a stapled share structure that would suggest that they should be treated inconsistently. Accordingly, a stapled share structure should be considered a single interest in a single entity.

Two cases, in particular, articulated this proposition, albeit not in a structured finance context. In *De Coppet v. Helvering*,<sup>82</sup> since it was unlawful for a bank to engage in certain dealings with securities, the directors of the bank held, as trustees for the bank shareholders, the outstanding shares of an investment company that dealt with such securities. The shares of the investment company were stapled to the shares of the bank. The investment company was wound up without assets, and the taxpayer attempted to deduct losses on the shares. The court disallowed the deduction, holding that

it would certainly have made a great difference how the investment shares were held, if they were not locked to the bank shares. But they were; it was impossible to sell them without selling the bank shares, or to sell the bank shares without selling them. We do not say that no differences can be conjured up between the legal form chosen and the usual share holding of a subsidiary; but they are immaterial to the subject at hand. The beneficial interest was as much an appurtenance of the bank shares as an easement is of the servient tenements; it merely gave them an added value, precisely as it would have done, had the Bank been the shareholder. Collectively the same persons must always be equitable owners of the investment shares and shareholders of the Bank, and in the same proportion; there never could be one group holding bank shares, and another holding investment shares. So far as a corporation is the aggregate of its shareholders in respect of their collective rights and obligations, there was but one corporation. . . .

The important matter is not what formal legal differences there were between the model adopted and the ordinary case of a corporate subsidiary; but whether the investment was single. It was if the investor could not have dealt with the parts separately; and these investors could not. When we speak of an investment, we do not think of the various ventures in which the company may be engaged, or of the various properties it may hold. We think of the unity which we must deal with as such, regardless of the particular legal paraphernalia in which it is clad.<sup>83</sup>

In 1954, relying on the fact that the subsidiary shares were stapled to the bank shares in *De Coppet v. Helvering* and were not subject to the bank's creditors, depositors, and other third parties, the Internal Revenue Service (IRS) issued the following ruling:

82 108 F. 2d 787 (2d Cir. 1940); aff'g. 38 BTA 1381 (1938): cert. denied, 310 US 646 (1940); reh'g. denied, 311 US 725 (1940).

83 *Ibid.*, at 788-89 (2d Cir.). See also *Moore v. Hoey*, 31 F. Supp. 478 (NY Dist. Ct. 1940); and *Commissioner of Internal Revenue v. Hagerman*, 102 F. 2d 281 (3d Cir. 1939); aff'g. 34 BTA 1158 (1936).

The distribution by a national bank of the stock of a wholly-owned subsidiary corporation to a trust created for the purpose of holding the stock for the pro rata benefit of shareholders of the bank with control vested in the majority of such shareholders constitutes a taxable dividend . . . to the extent of earnings and profits of the bank available for dividends even though the disposition of the stock is tied to existing stock ownership in the bank.<sup>84</sup>

But in 1957, the Tax Court in *Earl R. Wilkinson*<sup>85</sup> held that the transfer by a bank of the shares of its subsidiary to trustees, with the beneficial interests of the shareholders of the bank being stapled to the bank shares, did not constitute a taxable dividend paid to the shareholders. The court reasoned as follows:

The plan in the instant case was adopted to meet the requirements of the Comptroller of the Currency. It was a plan whereby the Bank would rid itself of Securities, its wholly owned subsidiary, and still retain for its stockholders the benefits that had resulted from its being a Bank subsidiary. Evidently such a transfer satisfied the requirements of the Comptroller but a realistic look at the transaction shows that to all intents and purposes Securities was retained by the Bank as an available medium to perform the same auxiliary business functions as were performed by it before the transfer.

From the Bank stockholders' position, it is difficult to see how any change resulted from the transfer that gave rise to the realization of gain. Petitioner's investment was, in substance, exactly the same after the transaction as before. Before the transaction, petitioner's investment and the investment of all the Bank shareholders might be said to be direct ownership of the stock of the Bank and solely by reason of such ownership, indirect ownership of the stock of Securities. After the transfer, petitioner and the other Bank shareholders had the same investment, namely, direct ownership of the Bank stock and solely by reason of such ownership, indirect or beneficial ownership of the stock of Securities. While in form there was a severance of Securities stock from the Bank assets, the petitioner and the other stockholders in the Bank received nothing they did not have before, as a result of the transaction. The beneficial ownership of the stock of Securities, after the transaction, was still locked into ownership of the Bank stock. It was still a pro rata interest depending upon ownership of the Bank stock. That beneficial interest could not be transferred without transfer of the Bank stock. If, the day after the transfer, petitioner had sold his Bank stock, he would have transferred substantially the same investment as to Securities stock as if the transfer had been made the day before.<sup>86</sup>

### ***IRC Section 269B***

IRC section 269B contains three separate rules, each of which addresses the use of a stapled share structure in a particular context.<sup>87</sup> The rules apply in respect of a "stapled entity" and "stapled interests" in an entity. "Stapled entities" are defined as

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84 Rev. rul. 54-140, 1954-1 CB 116.

85 29 TC 421 (1957).

86 *Ibid.*, at 425-26.

87 The text of the provision is reproduced as an appendix to this article.

any group of two or more entities if more than 50 percent in value of the beneficial ownership in each consists of “stapled interests.” An “entity” means any corporation, partnership, trust, association, estate, or other form of carrying on a business.

Stapled REIT (and RIC) structures are addressed by treating the REIT and the stapled entity as a single entity. The activities of the stapled entity are thus imputed to the REIT, disqualifying it from REIT status where the stapled entity engages in business activities producing active income.

The use of stapled share structures to avoid the application of the subpart F regime is addressed by providing that, in such structures, a stapled foreign corporation is treated as a domestic corporation, thereby subjecting the corporation to US income tax on its worldwide income. However, IRC section 269B(e) excludes from this rule those situations in which the domestic and foreign stapled corporations are both foreign owned. For this purpose, a corporation is “foreign owned” if less than 50 percent of its voting power and value is owned (or treated as owned) by US persons. The rationale for this exception is that subpart F would not apply in any event, because neither corporation would be a CFC.

A third rule addresses the use of stapled shares in the context of the definition in IRC section 1563 of a “controlled group of corporations,” which is relevant to various provisions. In general, IRC section 1563 defines a “controlled group of corporations” as either a parent-subsidiary controlled group of corporations, a brother-sister controlled group, or a combination thereof (combined group), all subject to the conditions set out in the provision. For the purposes of IRC section 1563, a stapled corporation is considered a subsidiary of the other corporation to which it is stapled. This deeming rule codifies the case law preceding the enactment of IRC section 269B described above.

Because a foreign corporation that is stapled to a domestic corporation will be treated as a domestic corporation under IRC section 269B(a)(1), the foreign corporation will be deemed to convert to a domestic corporation in a tax-free reorganization under IRC section 368(a)(1)(F).<sup>88</sup> This treatment could allow the use of a stapled foreign corporation’s losses to offset income of other members of the US affiliated group.<sup>89</sup> To prevent such a result, the IRS announced in 1989 that regulations would

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88 See Rev. rul. 89-103, 1989-2 CB 65; see also Treas. reg. section 1.269B-1(c). Under US law, corporate reorganizations generally are tax-free to the corporation and its shareholders, but where the reorganization has cross-border aspects, IRC section 367 may require the corporation and/or its shareholders to include certain amounts in gross income or to make certain other adjustments. See Treas. reg. sections 1.269B-1(c), 1.367(a)-1T(e) and (f), and 1.367(b)-2(f).

89 In general, IRC section 1504 defines an “affiliated group” as one or more chains of “includible corporations” connected through 80 percent stock ownership in voting power and value with a common parent corporation that is an includible corporation (defined in IRC section 1504(b)). Affiliated groups are afforded special income tax treatment by filing one consolidated income tax return (IRC section 1501), with all the implications thereof. A loss of one includible corporation, for example, may be used to offset losses of other includible corporations in the affiliated group.

be issued under IRC section 269B with respect to stapled domestic and foreign corporations.<sup>90</sup> Under these regulations, a stapled foreign corporation (which would otherwise be treated as a domestic corporation according to IRC section 269B(a)(1)) is treated as a foreign corporation for purposes of the definition of an includible corporation under IRC section 1504(b). Thus, unless a special election is made under IRC section 1504(d), losses of a stapled foreign corporation that are deemed to be losses of a domestic corporation under IRC section 269B(a)(1) will not be allowed to offset income of any member of an affiliated group.<sup>91</sup>

However, this provision facilitated a planning structure whereby a US corporation could gain a tax advantage by forming a stapled foreign corporation to hold the shares of its foreign subsidiaries and/or its other foreign assets. Since the stapled foreign holding corporation was not an includible corporation, it was not considered to be part of the consolidated group, and thus no consolidated interest expenses would be allocated to it. The result was an increase in the foreign-source income of the stapled foreign holding corporation and thus in the amount of its foreign tax credit limitation.<sup>92</sup> In 2003, Treas. reg. section 1.269B-1(d)(2) was added to address this planning technique. The regulation provides that “a foreign corporation that is stapled to a domestic corporation will be treated as a domestic corporation for the purposes of the definition of an includible corporation under section 1504(b) when applying §§ 1.904(i)-1 and 1.861-11T(d)(6).”<sup>93</sup> That is, for the limited purpose of determining the foreign tax credit limitation of a consolidated group, the stapled corporation is treated as an includible corporation.

Under Treas. reg. section 1.269B-1(b)(2), the commissioner may treat an interest that would otherwise be a stapled interest as not being stapled if the principal purpose of the stapling is the avoidance of US income taxation. The IRS had previously suggested in FSA 200233016<sup>94</sup> that it may be able to disregard a reorganization involving stapled interests under the general sham transaction doctrine (also known as the economic substance doctrine), according to which a transaction will be disregarded for tax purposes when it has no significant economic effects other than the creation of tax benefits. It was also suggested that the IRS may challenge a stapled structure in other ways: first, by the application of IRC section 482<sup>95</sup> to allow the reallocation of income and expenses between a US corporate group and a stapled foreign

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90 Notice 89-94, 1989-2 CB 416.

91 Ibid. See also Treas. reg. section 1.269B-1(d)(1).

92 See supra note 69.

93 See Notice 2003-50, 2003-2 CB 295.

94 Internal Revenue Service, Field Service Advice (FSA) 200233016, May 9, 2002.

95 Under IRC section 482, the IRS may exercise its authority to reallocate income, expenses, deductions, credits, or allowances between two or more trades, businesses, or organizations that are owned or controlled by the same interests if such allocation is necessary to prevent tax evasion or to reflect the true economic allocation of income.

entity; second, by the application of IRC section 269<sup>96</sup> to disallow deductions, credits, or other allowances if the principal purpose of the stapled structure is to secure tax benefits; and third, through the disqualification of a transaction as a tax-free reorganization where assets are transferred to a stapled entity.

## **EXTENDING THE DRAFT LEGISLATION TO ADDRESS THE USE OF STAPLED SECURITIES**

### **Addressing Stapled Securities in Intermediated and Disintermediated Structures**

With IRC section 269B available as a template, it should be relatively easy to develop legislative provisions that will block the use of stapled security structures to avoid the application of the draft legislation. For example, stapled REIT structures could be addressed by deeming stapled entities to be a single entity for the purposes of the eligibility conditions for REIT status. A provision similar to IRC section 269B(a)(3) would attribute the business activities of a stapled entity to the stapled REIT, disqualifying it from REIT status. Other stapled security structures, such as those illustrated in figures 5 and 6, could be addressed using IRC section 269B(a)(2) as a model. In particular, modifications of income trust structures that use stapled securities to bypass a SIFT trust or partnership and stream income directly to investors could be subject to a rule that deems the stapled securities to be owned by the trust or partnership. Income earned on indebtedness or through a partnership interest held outside a SIFT entity would thus be channelled through that entity, ensuring deemed dividend treatment.<sup>97</sup>

For the purposes of the draft legislation, the definitions of “stapled entities” and “stapled interests” set out in IRC section 269B(c) could be used. Some further consideration might be given, however, to the articulation of a bright line that would result in the application of the relevant deeming rules. As described above, IRC section 269B uses a 50 percent test: an entity is considered a stapled entity if more than 50 percent of the value of ownership interests is attributable to stapled interests. This particular threshold leaves room for the use of stapled securities, apparently under the assumption that they may be used in some instances for non-tax reasons. This 50 percent bright line essentially functions as a primary purpose test under which the relevant deeming rules will be applied where stapled interests can reasonably be considered to be used primarily to obtain a tax benefit. The 50 percent bright

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96 IRC section 269 authorizes the IRS to disallow deductions, credits, or other allowances if the principal purpose of the acquisition of control of a corporation, or the acquisition by a corporation of property of a non-controlled corporation with the property having a carryover basis from the transferor corporation, is to evade or avoid US income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise be available.

97 As suggested by the structure in figure 6, the concept of “public trading” or the concept of a “stapled interest” would probably have to be extended specifically to investments that can be exchanged for publicly traded securities and/or stapled securities.

line may be used as a proxy for this kind of purpose test in an effort to minimize the compliance and administrative costs associated with a more qualitative assessment. Absent evidence of the use of stapled securities generally for non-tax purposes, there seems to be no compelling case for a less restrictive bright line, such as a 75 percent or more test. On the other hand, the US experience does not suggest a need for a lower threshold to extend the application of IRC section 269B to a range of transactions in which stapled security structures have been used as tax-effective substitutes.

Changes to the draft legislation along the lines of those suggested immediately above would still leave open, as an avoidance technique, the disintermediated holding of junk debt in IDS and IPS structures (figures 3 and 4). Because these structures do not involve the intermediated holding of debt, they would avoid the SIFT dividend trap and could continue to be used as a means to avoid the unintegrated corporate income tax, whether such debt is stapled to shares of the issuer or is otherwise held proportionally with its shares. Indeed, the elimination of the foreign property holding restrictions for tax-exempt deferred income plans, such as RPPs and RRSPs,<sup>98</sup> means that there is very little in the way of a tax-law constraint on the acquisition of direct junk bond substitutes by this class of investors.<sup>99</sup> We believe, nonetheless, that there are defensible policy reasons for acceptance of this particular substitute structure, but only where the junk debt is not held proportionally with shares of the issuer.

A comprehensive legislative response to the transactional substitutions characteristic of the income trust phenomenon cannot avoid the need to address two fundamental definitional issues that are endemic to a corporate income tax system that treats the return on debt and equity inconsistently and leaves a range of entities, such as partnerships and trusts, outside that system. The draft legislation addresses only one of these issues explicitly: the concept of a corporation, the equity interests of which are subject to dividend taxation. In the context of publicly traded entities, this definitional issue is effectively resolved by treating all publicly traded trusts and partnerships as corporations to the extent of the return realized from carrying on a business, either directly by the particular entity or indirectly through the acquisition of indebtedness and shares of a highly leveraged corporation. The other definitional issue—the distinction between corporate debt and equity—is addressed only as a secondary effect of the definition of a corporation in the publicly traded context.

As emphasized in an earlier article,<sup>100</sup> an equity recharacterization rule is required to address the essence of income trust structures—namely, the substitution of unsecured, high-yield, and subordinated junk debt for shares, in an attempt to massage the tax-law boundary between debt and equity and take advantage of the differences in their tax treatment. The popularity of income trusts in Canada is reminiscent of the

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98 See *supra* note 23.

99 For non-resident investors, the thin capitalization rules in subsections 18(4) to (6) limit the amount of deductible interest on indebtedness held by certain non-resident shareholders (that is, “specified shareholders,” defined generally in subsection 18(5) as 25 percent or more shareholders on a votes and value basis).

100 Edgar, *supra* note 37.

leveraged buyout (LBO) craze in the United States in the 1980s. As in the case of US LBOs, the undesirable consequential attributes of income trusts can be completely eliminated (assuming an unintegrated corporate income tax) only through a targeted legislative response that recharacterizes as equity the high-yield junk debt characteristic of standard income trust structures. However, such a response must also be supported with two additional rules. One rule would address the use of debt substitutes, such as royalty and lease arrangements. The other rule would address the use of flowthrough entities, such as trusts and limited partnerships, as direct substitutes for the corporate form. A failure to treat a range of royalty and lease arrangements consistent with recharacterized debt, or a failure to treat a range of trusts and limited partnerships as corporations, would mean that such arrangements or flowthrough entities could be used to realize the same result as a standard income trust structure.

Taken together, these elements of a suggested legislative agenda would effectively kill the income trust structure (as well as its close substitutes, including its older royalty trust cousin) and restore the corporate income tax status quo ante. This particular legislative agenda would obviously differ from the draft legislation in its use of an equity recharacterization rule. In fact, the draft legislation, even if modified to address stapled security structures, remains nothing more than the kind of supporting legislation, focused on entity substitution, that would be necessary in conjunction with an equity recharacterization rule to address the possible use of substitute structures that do not incorporate high-yield junk debt. But as noted already, extension of the draft legislation to address stapled securities would address the entire range of income trust structures using high-yield junk debt in an intermediated investment structure, as well as the direct substitution of the trust or partnership form for the corporate form in a publicly traded context. Given this broad application, there would be no need for a generalized equity recharacterization rule. Targeting income trust structures and their close substitutes may even be an easier legislative exercise using the concepts of a SIFT trust or a SIFT partnership as a dividend trap for income from non-portfolio properties.<sup>101</sup> However, there would remain a need for a limited equity recharacterization rule as a supporting rule to address the disintermediated holding of junk debt as a tax-effective substitute.

The case for a limited equity recharacterization rule is based on a recognition that income trusts present a tax-driven substitution of a debt instrument for shares,

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101 See *supra* note 43 and the accompanying text for the targeting difficulties presented by the use of derivative financial instruments. Another targeting issue arises with trust capital securities, which are capital interests of a trust the proceeds of which are used to acquire subordinated debt of a bank or a pool of securitized assets such as residential mortgages. These structures have been used primarily for regulatory purposes, with banks improving their capital adequacy ratios either through the qualification of the subordinated debt as tier 1 capital or the removal of the risk-weighted assets from the balance sheet. Without any specific amendments to the draft legislation, these trusts would be treated as SIFT trusts where the interests are publicly traded. Income on the underlying debt of the bank or the securitized assets would be subject to dividend tax treatment. Application of the draft legislation in these circumstances is arguably overinclusive, at least to the extent that the structures are not tax-driven substitutes.

which differs significantly from the substitution of debt for equity generally.<sup>102</sup> The difference is the high-yield, subordinated nature of the indebtedness used in income trust structures, which, when held by the trust in proportion to any remaining shares of the operating entity, mimics closely the cash flow pattern otherwise associated with a preferred share or income bond. The replication is simply much closer than that associated with a debt instrument that is not held proportionally with the equity of a corporate issuer. In the latter instance, the tax benefit otherwise associated with the corporate interest expense deduction is accessed only at the cost of some sacrifice in the cash flow pattern associated with an equity instrument. Although the difference is one of degree and not of kind, the difference in cash flow patterns of arm's-length debt and the high-yield, subordinated junk debt used in income trust structures means that the latter can defensibly be characterized as "equity in drag,"<sup>103</sup> consistent with market perceptions. No such characterization extends to arm's-length indebtedness generally, because of the absence of a proportional holding of the debt and shares of the issuer. The debt-equity substitution associated with income trusts is therefore qualitatively different from that associated with the choice between debt and equity generally in the corporate capital structure.

If supplemented with some specific provisions addressing the use of stapled securities in intermediated structures, the draft legislation would apply dividend tax treatment to almost the entire range of indebtedness that could defensibly be characterized as disguised equity because of its proportional holding. Targeting the disintermediated holding of high-yield junk debt by investors and, in particular, distinguishing it from disintermediated holdings that can be respected as indebtedness would remain, nonetheless, a difficult exercise. As emphasized here, the distinguishing feature is the proportional holding of debt and shares of a particular corporate issuer. More particularly, when the relevant securities are not held proportionally, at some point differences in the non-tax attributes of debt and equity constrain tax-driven substitution. When debt and shares of the same issuer are held proportionally by an investor, these differences are entirely formalistic. In effect, a proportional holding raises a presumption that the investor will not exercise the rights of a creditor, with the proportional holding indicating a tax-driven substitution of debt for equity.

However, except in the case of a formal stapling of securities, or a pooled holding in an intermediated investment, it is difficult to design a target-effective requirement that would limit an equity recharacterization rule to indebtedness that is held

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102 But see, for example, Avery Shenfeld, "The Economic Benefits of Income Trusts," *Economic Perspectives* (CIBC World Markets, March 7, 2003) (arguing that income trusts do not represent special treatment in the ability of these structures to shelter income from corporate-level tax using the interest expense deduction). Much the same argument was made in the literature in defence of the use of high-yield debt in LBOs in the United States. See Michael C. Jensen, "Eclipse of the Public Corporation" (1989) vol. 67, no. 5 *Harvard Business Review* 61-74.

103 This characterization of the high-yield junk debt used in LBOs is found in Jeremy I. Bulow, Lawrence H. Summers, and Victoria P. Summers, "Distinguishing Debt from Equity in the Junk Bond Era," in John B. Shoven and Joel Waldgogel, eds., *Debt, Taxes and Corporate Restructuring* (Washington, DC: Brookings Institution, 1990), 135-66, at 152.

proportionally with shares of an issuer. To avoid problems of underinclusiveness, the requirement should probably not be expressed in terms of a quantitative bright line.<sup>104</sup> Indeed, it is not even clear what such a bright line might look like as a legislative starting point. To constrain planning focused on a proportionality requirement, the legislative expression of this requirement would probably have to be cast in general terms, such as a requirement that the affected debt be stapled with shares of the issuer or otherwise issued or acquired in circumstances that make it reasonable to expect that it will be held in rough proportion with shares of the issuer.<sup>105</sup> Application of a proportionality requirement in the latter context would be an admittedly indeterminate exercise.

This kind of expanded legislative response to income trust structures would explicitly address the debt-equity definitional issue by extending dividend treatment to the return on debt that is held proportionally with the equity of an issuer, whether or not stapled together. It would limit the unintegrated corporate income tax to publicly traded entities, on the assumption that public trading, as a defining feature of the tax-law boundary between flowthrough and separate-entity status, can be used because it provides a robust non-tax constraint on a tax-driven substitution. This assumption has been challenged, however, by a recent wave of leveraged acquisitions of public corporations by private equity funds.<sup>106</sup> Assuming again that there are important normative arguments and revenue constraints that dictate maintenance of a corporate income tax that is to some extent unintegrated,<sup>107</sup> this wave of going-private takeover transactions raises the issue of even more fundamental reform. Given

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- 104 For example, the US courts appear to have adopted a quantitatively imprecise approach to the articulation of the content of the proportionality requirement in their application of a multifactor debt-equity analysis. The same approach is apparent in the description of the proportionality factor to be taken into account in a debt-equity analysis under IRC section 385.
- 105 Where high-yield junk debt is stapled to a specified number of shares of the issuer and cannot be separately traded, a requirement of proportional holding is not especially problematic. For example, the IDS and IPS structures were specifically developed to avoid the application of this same factor of proportional holding articulated in the US debt-equity case law. In particular, the common shares can be separately traded, as can the stapled securities. The subordinated debt cannot, however, be separately traded, a restriction that significantly limits, in practice, the ability to separate the component parts of the IDS or IPS. In theory at least, the ability to trade the component parts separately means that the high-yield junk debt component may not necessarily be considered to be held proportionately with the shares of the issuer. (Snider, *supra* note 20, at 10-11, reports that in one such structure, a major accounting firm resigned as auditor of the issuer because of concern over the classification of the particular subordinated debt.)
- 106 See, for example, Lee A. Sheppard, “Monetizing Old Europe” (2006) vol. 44, no. 8 *Tax Notes International* 587-90. The acquisition of Canadian publicly traded businesses (both income trust and corporate structures) by foreign-controlled private equity funds was the subject of evidence given before the House of Commons Finance Committee hearings on income trusts. See *Taxing Income Trusts*, *supra* note 10, at 15-16.
- 107 These normative arguments are comprehensively canvassed in Kim Brooks, “Learning To Live with an Imperfect Tax: A Defence of the Corporate Tax” (2003) vol. 36, no. 3 *UBC Law Review* 621-72.

these assumptions, a more comprehensive equity recharacterization rule than that suggested here would be required,<sup>108</sup> along with expansion of the concept of a corporation to include a range of business trusts and partnerships, especially in the context of inbound foreign direct investment.<sup>109</sup>

### Maintaining the Exception for REITs

Our suggested modifications of the draft legislation to address the use of stapled security structures would maintain the REIT exception from SIFT status, but only outside such structures. The tax-law boundary that is implicated in the case of REITs is the boundary between trusts and corporations and, in particular, the flowthrough treatment of the former versus the separate-entity treatment of the latter. Income trusts (and their older royalty trust cousins) substitute a tax-deductible form of security (high-yield acquisition indebtedness or a royalty interest) for what would otherwise be a share investment in the underlying assets. The unintegrated portion of the corporate income tax is avoided through the conversion of the cash flows associated with the assets from a non-deductible dividend distribution to a deductible interest expense or royalty distribution. For tax-exempt entities at least, the substitution is required because of the tax-law limitation that prevents such entities from carrying on a business and thereby holding the assets directly. In effect, the higher-taxed corporate form must be used, which requires the substitution of high-yield acquisition indebtedness or a royalty interest to avoid the unintegrated portion of the corporate tax on income from the underlying asset or assets. But real estate is generally an eligible investment for tax-exempt entities and can be held directly as passive investments by such entities. The trust form is substituted for the corporate form to realize the economies of scale and management expertise available with the latter form, while ensuring only one level of tax on the earnings of the underlying assets.

At a broad conceptual level, this different margin of substitution implicated by REITs does not mean that the associated policy issues are entirely different from those implicated by income trusts and royalty trusts.<sup>110</sup> In fact, as a substitute for the

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108 As a response to leveraged private equity takeovers, broad limitations on the deduction of corporate interest expense have been proposed in Germany and Denmark. See Arne Møllin Ottosen and Michael Nørremark, "Private Equity Funds—Amendments to Denmark's Anti-Avoidance Legislation" (2006) vol. 60, no. 10 *Bulletin for International Taxation* 402-10; and Martin A. Sullivan, "Denmark, Germany To Cut Interest Deductions" (2007) vol. 114, no. 8 *Tax Notes* 820-22.

109 Applying the corporate income tax to the return on inbound foreign direct investment would require extension of a corporate deeming rule to all domestic entities that are controlled by non-resident investors. For a discussion of the dimensions of such a rule and its associated rationale, see Tim Edgar, "Corporate Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage" (2003) vol. 51, no. 3 *Canadian Tax Journal* 1079-1158. As discussed in the context of income trusts, maintenance of an unintegrated corporate income tax would require an equity recharacterization rule for interest, rent, and royalty payments made in the context of inbound foreign direct investment.

110 See Martin A. Sullivan, "Passive Activity or Active Passivity? Rising REITs Rock the Corporate Tax" (2003) vol. 99, no. 9 *Tax Notes* 1298-1302.

corporate form, REITs result in the same avoidance of an unintegrated corporate income tax, with the associated revenue loss. REITs may also present many of the same efficiency effects as income trusts and royalty trusts.<sup>111</sup> The sector benefiting from the allocative consequences of their use is obviously the real estate sector, rather than businesses with stable cash flows and mature producing assets, which are perceived to be especially suitable for income trusts and royalty trusts, respectively. But unlike the latter transactional forms, it is not clear that the use of REITs imposes efficiency costs that warrant the movement of the tax-law boundary between flowthrough and separate-entity taxation. In other words, it is not clear that the line-drawing exercise proposed in the October 2006 proposals, and implemented in the draft legislation, should be modified in an effort to realize a measure of efficiency gains. The prospect of the use of stapled security structures using the REIT exception from SIFT status does not alter this proposition. Because these structures could be used as tax-effective substitutes for income trust structures, they should be taxed consistently by extending the application of the draft legislation to explicitly include stapled securities using the REIT exception. The need to address the use of stapled security structures does not, however, require elimination of the general exception from SIFT status for REITs.

As suggested in the US context, the policy underlying the flowthrough treatment of REITs,<sup>112</sup> as well as mutual fund investments generally, appears to be a desire to avoid the tax wedge and associated distortions otherwise imposed by an unintegrated corporate income tax. Flowthrough treatment permits the realization of certain efficiencies associated with the pooling of portfolio investment while maintaining consistency of tax treatment with a direct holding of the underlying assets in unincorporated form. In this respect, status as a mutual fund trust (and the flowthrough treatment following from such status) is limited, in particular, by a set of defined conditions that can be seen as an attempt to ensure that the cash flows for the holder of a trust unit largely mimic those that would be associated with a direct portfolio holding of an interest in the underlying assets. Similar eligibility conditions in the draft legislation for REIT status perform much the same function.<sup>113</sup> The use of stapled

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111 *Ibid.*, at 1299-1300.

112 See *supra* notes 41 and 42 and the accompanying text. See also the October 2006 proposals, which state only that the flowthrough exception for REITs “recognizes the unique history and role of collective real estate investment vehicles.” Evidence given before the House of Commons Finance Committee on the rationale for the REIT exception in the draft legislation was unenlightening, amounting to no more than the proposition that the exception was required because other countries, particularly the United States, provide flowthrough treatment. See *Taxing Income Trusts*, *supra* note 10, at 11-12.

113 The most significant conditions are the limitations on the assets that can be held by the entity. See *supra* notes 41 and 42 and the accompanying text. The limitations effectively draw a boundary between passive real estate investment and the carrying on of a business, with the former serving as a proxy for disintermediated investment in real estate. As indicated in note 42, the March 2007 notice of ways and means motion shifted the previous boundary by extending the class of eligible assets to include securities of an entity carrying on a property management function on behalf of a REIT.

security structures, however, requires a modification of these eligibility conditions to ensure that REIT status cannot be accessed to avoid the unintegrated corporate tax by substituting deductible rental payments for high-yield junk debt of a corporate issuer.

Given these eligibility conditions, it is simply not clear, outside the context of income trusts and royalty trusts, that mutual fund trusts in general, or REITs in particular, have involved massaging of the relevant tax-law boundary between flowthrough and separate-entity treatment in a way that attempts to substitute the cash flow pattern associated with a direct investment in underlying corporate assets for the cash flow pattern otherwise associated with shares of a corporation. In short, apart from the possible use of stapled security structures, there is no evidence that REITs can be, or are, used as substitutes generally for the corporate form of carrying on a business. Nor is there any evidence that mutual fund trusts, with the exception of income trusts and royalty trusts, are used for anything other than the holding of what would otherwise be disintermediated portfolio investment.

By way of comparison, it has been suggested that US legislative amendments extending the asset base of REITs to include securities of their taxable subsidiaries (TRSS) could allow the expansion of the REIT structure to avoid the corporate income tax beyond the real estate sector.<sup>114</sup> Apparently, a TRS would permit the use of transfer-pricing techniques such as the payment of deductible rent to the REIT on real estate properties formerly owned by the TRS, as well as interest payments on debt of the TRS. Indeed, this structure mimics, to a large extent, that of income trusts and royalty trusts and potentially presents a similar threat to the corporate income tax generally.<sup>115</sup> Any such expansion of the REIT structure as a substitute for the corporate form should be constrained in Canada by the conditions for qualification as a closed-end mutual fund trust,<sup>116</sup> as well as the eligibility conditions for REIT status under the draft legislation, which together appear to limit substitutability largely to the real estate sector.<sup>117</sup>

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114 Sullivan, *supra* note 110.

115 But see Sullivan, *ibid.*, at 1300: “To our knowledge, no McREIT or WalREIT has yet to be formed. Although the tax advantages could be large, there are many countervailing business reasons for corporations to maintain control of their real estate.”

116 For REITs, the more significant conditions are those relating to (1) the composition of eligible fund assets, which include real estate; (2) the requirement that trust units be listed on a prescribed share exchange in Canada; and (3) the limitation on the holding of securities of a single issuer (not more than 10 percent of fund property).

117 This proposition is accurate provided that a property management function and services ancillary to the rental function are properly characterized as part of the real estate sector. The extension of eligible assets for REITs in the United States to include shares of a TRS provides for a much more expansive concept of the real estate investment function. But see, in this respect, Tony M. Edwards, “REIT Analysis Was Wrong on Many Counts” (2003) vol. 99, no. 12 *Tax Notes* 1851-52. In a letter to the editor, Edwards challenged Sullivan’s contention regarding the conversion of US corporations to REITs, on the basis of the following three conditions that constrain such conversions: (1) no more than 20 percent of total assets of a REIT can be TRS securities; (2) payments from a corporation owned 10 percent or more by a REIT do not qualify as “good”

In the absence of any evidence of the tax-driven substitution of trusts for the publicly traded corporate form generally, it is difficult to defend the application of separate-entity treatment to REITs with the associated tax wedge in the form of the unintegrated corporate income tax for tax-exempt investors.<sup>118</sup> A policy decision would have to be made that consistency of treatment of business trusts and the corporate form generally is desirable, as opposed to consistency of treatment of disintermediated and intermediated investments in the limited circumstances set out by the eligibility conditions for REIT status.<sup>119</sup> For REITs, this kind of movement of the boundary between flowthrough and separate-entity treatment would presumably cause a shift of investment out of the real estate sector. However, it is not clear that any such shift would offset existing tax provisions that induce a flow of capital into the real estate sector, thereby correcting existing distortions. In the absence of any such offset, it appears that moving the tax-law boundary between flowthrough and separate-entity treatment in this manner would produce few, if any, efficiency gains.

The broader tax treatment of REITs brings us back to the issue of fundamental income tax reform as an alternative to more narrowly focused measures. The latter merely attempt to adjust the tax-law boundaries between the return on debt and equity securities and/or between flowthrough and separate-entity taxation of trusts, partnerships, and corporations. The goal of a more fundamental tax reform would be to achieve consistency of tax treatment by eliminating the boundaries altogether. There are a number of approaches that could be adopted to realize this broad policy goal. These approaches have been thoroughly reviewed in the literature and are not discussed here. In the context of this article, the principal point to be emphasized is that the policy arguments supporting fundamental reform are entirely independent of the narrower issues presented by income trusts and royalty trusts (and even REITs). The allocative, distributional, and revenue effects of broader reform measures should be assessed independently of the narrower substitution effects associated with the problem presented by these particular business trusts.

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rental income; and (3) a 100 percent excise tax is imposed when a REIT and a TRS enter into a non-arm's-length transaction. In response, Sullivan appeared to accept that Edwards was correct in his analysis of the effect of the current REIT legislation, but warned that further legislative pressure to loosen eligibility conditions for REITs could have the effect of a substantial disincorporation of widely held, non-real-estate businesses that would otherwise be limited to corporate status under the check-the-box regulations. See Martin A. Sullivan, “Marty Sullivan Convinced But Worried” (2003) vol. 99, no. 12 *Tax Notes* 1852.

- 118 See Edwards, *supra* note 117 (arguing that the real estate sector is predominantly organized in unincorporated form, and that REITs realize consistency of treatment with this organizational form while allowing access to economies of scale through pooling).
- 119 New Zealand, for example, has made a policy decision to realize consistency of treatment of business trusts and corporations generally. In particular, a policy choice was made to treat business trusts as corporations to ensure consistency of treatment of realized capital gains distributed to investors. However, it is also recognized that this policy choice creates a bias for disintermediated investment, with associated inefficiencies. See Robin Oliver, “Capital Gains Tax—The New Zealand Case,” paper prepared for the Fraser Institute 2000 Symposium on Capital Gains Taxation, September 15-17, 2000, 16.

**APPENDIX IRC SECTION 269B**

(a) **GENERAL RULE.**—Except as otherwise provided by regulations, for purposes of this title—

(1) if a domestic corporation and a foreign corporation are stapled entities, the foreign corporation shall be treated as a domestic corporation,

(2) in applying section 1563, stock in a second corporation which constitutes a stapled interest with respect to stock of a first corporation shall be treated as owned by such first corporation, and

(3) in applying subchapter M for purposes of determining whether any stapled entity is a regulated investment company or a real estate investment trust, all entities which are stapled entities with respect to each other shall be treated as 1 entity.

(b) **SECRETARY TO PRESCRIBE REGULATIONS.**—The Secretary shall prescribe such regulations as may be necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities. Such regulations may include (but shall not be limited to) regulations providing the extent to which 1 of such entities shall be treated as owning the other entity (to the extent of the stapled interest) and regulations providing that any tax imposed on the foreign corporation referred to in subsection (a)(1) may, if not paid by such corporation, be collected from the domestic corporation referred to in such subsection or the shareholders of such foreign corporation.

(c) **DEFINITIONS.**—For purposes of this section—

(1) **ENTITY.**—The term “entity” means any corporation, partnership, trust, association, estate, or other form of carrying on a business or activity.

(2) **STAPLED ENTITIES.**—The term “stapled entities” means any group of 2 or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of stapled interests.

(3) **STAPLED INTERESTS.**—Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of 1 of such interests the other such interests are also transferred or required to be transferred.

(d) **SPECIAL RULE FOR TREATIES.**—Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section.

(e) **SUBSECTION (a)(1) NOT TO APPLY IN CERTAIN CASES.**—

(1) **IN GENERAL.**—Subsection (a)(1) shall not apply if it is established to the satisfaction of the Secretary that the domestic corporation and the foreign corporation referred to in such subsection are foreign owned.

(2) **FOREIGN OWNED.**—For purposes of paragraph (1), a corporation is foreign owned if less than 50 percent of—

(A) the total combined voting power of all classes of stock of such corporation entitled to vote, and

(B) the total value of the stock of the corporation,

is held directly (or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section 318(a)) by United States persons (as defined in section 7701(a)(30)).