WILDEBOER DELLELCE LLP Business Law

High-Yield Common Shares: The Northstar Healthcare Inc. IPO

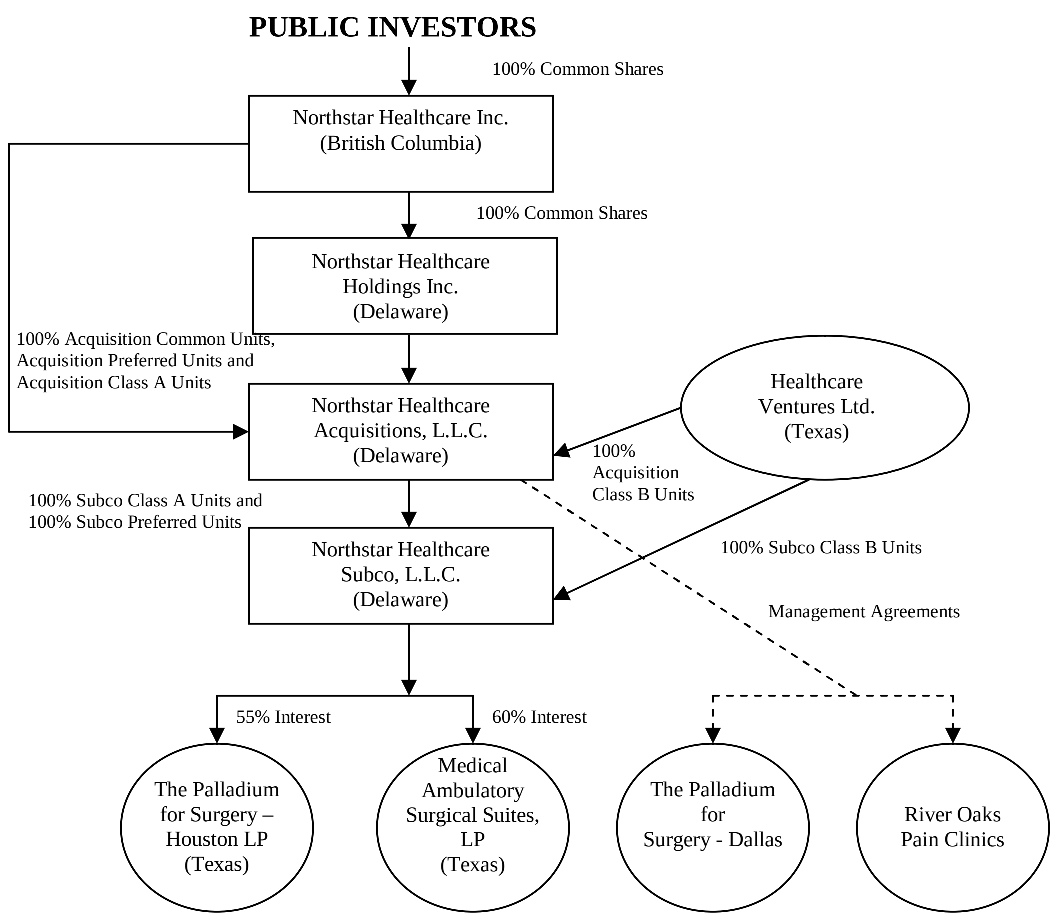
To date, 2007 has been a slow year in the Canadian IPO market. Mid-way through the year, Canadian companies had raised approximately $770 million through initial public offerings, as compared to $4.55 billion in the first half of 2006. Although there are many reasons for this IPO slowdown, one key factor is the end of new income trust conversions following the federal government's announcement last October 31st that it would be introducing amendments to the *Income Tax Act* (Canada) to eliminate the tax advantages provided by the income trust structures.

Canada's largest IPO in 2007, Northstar Healthcare Inc. ("**Northstar Canada**"), used an innovative structure to replicate some of the advantages of the income trust structures that have now been effectively shut down by Ottawa.

First, it offers a high yield return to investors (9.8% at the IPO price) through the payment of monthly dividends. Second, the structure creates significant tax deductions to the underlying business to eliminate corporate level taxes.

The Offering

Northstar Canada, a Canadian resident corporation, raised just over $170 million through the issuance of common shares. At first blush, there is nothing novel in this. However, as can be seen from this corporate chart, there was a great deal going on beneath the surface, with the underlying business consisting of ambulatory surgical centres in Texas.



Certain aspects of this structure will look familiar to those accustomed to the features found in many income trust structures. For instance, the business operations are ultimately carried on by partnerships, the founders of the business have retained an interest in the business through separate classes of shares (through Healthcare Ventures Ltd. in this case) and the lower level entities have agreed to distribute all available cash up the chain.

The unique aspect of the Northstar structure is its use of a repurchase agreement to take advantage of certain differences in the characterization of dividend payments from Northstar Healthcare Acquisitions, LLC ("**Northstar Acquisitions**") to Northstar Canada. For Canadian income tax purposes, these payments are treated as dividends, while the United States treats them as tax deductible interest payments. This differs from the approach taken in other cross-border income trust structures, such as Income Participating Securities ("**IPS**") and Income Deposit Securities ("**IDS**"), which combine a common share with a high-yielding debt instrument.

Canadian Income Tax Issues

According to the prospectus, Northstar Canada will receive the bulk of its cash flow through dividend payments on the Class A Units that it holds in Northstar Acquisitions (the "**Units**"). The dividend entitlement is a fixed, cumulative monthly preferential dividend of 11.1% per month. For Canadian income tax purposes, these dividends will be treated as exempt surplus dividends from a foreign affiliate and will not be subject to any Canadian income tax.

Northstar Canada has adopted a dividend policy providing for the payment of monthly dividends in an annual amount of $1.20 per share. As the company is a taxable Canadian corporation, Canadian resident shareholders will benefit from the new enhanced dividend tax credit. For individuals at the highest marginal tax rate in Ontario, this results in a tax rate of approximately 25.1% on Northstar Canada dividends. This compares very favourably with the tax rate of 46.4% on interest income that would have been payable on an equivalent IPS or IDS security. U.S.-resident shareholders will generally be subject to a 15% Canadian withholding tax on dividends from Northstar Canada.

United States Income Tax Issues

As part of the transaction, Northstar Canada entered into a repurchase agreement with Northstar Healthcare Holdings Inc. ("**Northstar Holdco**"). Under the terms of the agreement, Northstar Canada purchased the Units from Northstar Holdco for approximately $97 million. Northstar Holdco is obliged to repurchase these Units from Northstar Canada in 12 years for an amount that results in Northstar Canada realizing an internal rate of return of 11.1% per year on the purchase price of the Units. In addition, Northstar Acquisitions provided a guarantee of Northstar Holdco's obligations under the repurchase agreement.

Opinions were received from U.S. legal counsel that for United States federal income tax purposes, (i) the transactions including the repurchase agreement and the guarantee "should" be treated as a financing transaction with Northstar Holdco as the borrower and Northstar Canada as the lender, and, as a result, (ii) the dividend payments made on the Units "should" be treated as a deductible interest expense of Northstar Holdco. The risk factors in the prospectus state that the IRS may disagree and treat the transaction as equity rather than debt for U.S. tax purposes, in which case the otherwise deductible deemed interest paid in the form of dividends on the Units would be treated as non-deductible distributions. Interestingly, No advance tax ruling was sought from the IRS.

Distributions made to Northstar Canada on the Units that are subject to the Repurchase Agreement will be subject to a 10% U.S. withholding tax. Under proposed amendments to the Canada-United States Income Tax Convention announced in the recent Canadian federal budget, the rate of withholding tax on interest will be reduced to 7% in the year in which the amended treaty becomes effective, 4% in the second year and nil in the third year and thereafter. This would be an added tax bonus to this structure, which could not have been foreseen by its designers. Of course, it is uncertain whether these amendments will be enacted as proposed, if at all.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation. If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact:

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