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Stock lending -beneficial ownership and tax avoidance- again!

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Monday, February 12th, 2024

Although the meaning of beneficial ownership in tax treaties first burst onto the scene in *Indofood International Finance Ltd v JP Morgan Chase Bank N.A. London Branch* [2006] EWCA Civ 158 and, for the first time in Canada in *Prévost Car Inc. v R* 2008 TCC 231, (affirmed 2009 FCA 57), its meaning and application continues to throw up controversy. Much judicial and academic ink has been spilt on the subject. The latest Tax Court of Canada decision in *Husky Energy Inc. v The King*, 2023 TCC 167 (CanLII), considers beneficial ownership in relation to the common market practice of stock or securities lending.

Stock loans

The case concerned the rate of withholding tax on dividends paid by Canadian resident companies in respect of shares that were loaned by Barbados resident companies to Luxembourg resident companies. A dividend paid by a Canadian company to a Barbados resident in these circumstances would attract Canadian withholding tax at the rate of 15%. The rate to a Luxembourg resident would be 5%.

Stock lending involves the loan of shares by a lender to a borrower for the period of the loan. If dividends are paid during the loan, then the borrower is required to pay the lender an amount equal to the dividend on the share, usually called a compensation payment, substitute dividend or manufactured dividend. The borrower may be required to post collateral with the lender in cash or other liquid form. It is common practice for ownership of the shares to be in the name of the borrower for the duration of the loan. Thus, cash payment of the dividend is normally made by the dividend paying company to the borrower.

Contractual obligation to pay

In *Husky Energy*, the court contrasted the position in relation to a stock loan, in which the borrower is contractually bound to pay the lender an amount equal to the dividend and that of a holding company that has no obligation to distribute the dividend to its shareholders. The stock loans in this case required the amount to be paid within seven weeks of the borrower receiving payment of the dividend.

The court accordingly concluded that the Luxembourg “enjoyed nothing more than temporary custodianship of the funds received in payment of the dividends” under the stock loans. Furthermore, the compensation payments were “preordained” under the agreements which “ensured that at all times, the Barbados companies retained their rights to the full economic value

of the dividends.”

Although the Luxembourg companies each earned a small amount of interest on the cash dividend paid to them, that did not alter the” legal reality that the benefit of the dividends remained with the Barbados companies throughout”. That forgone interest was a minor cost of a transitory arrangement that was more than offset by receiving payments equal to the full amount of the dividends.

Foreign exchange risks

The court rejected the argument that foreign exchange losses suffered by the Luxembourg companies showed that they took on the risk associated with the receipt of the dividends as beneficial owners. The court found as a factual matter that foreign exchange losses resulted from their choice of Canadian currency for the stock loans even though Husky always paid dividends to the Barbado companies in United States dollars.

Borrowers not beneficial owners

The court concluded that the Luxembourg companies were not beneficial owners of the dividends paid by Husky Energy, based on the effect of the contractual arrangements that constituted the stock loans. Thus, the dividends paid by Husky did not qualify for the reduced rate of Canadian tax under Article 10(2) of the Canada-Luxembourg tax treaty.

This conclusion is consistent with the Netherlands decision of the Amsterdam Court of Appeal in cases 18/00318 and 18/00318 (12 May 2020) discussed in *Schwarz on Tax Treaties*, 6th Edition para 17.07[B], where the court ruled that the borrower had no economic interest in the shares that were the subject of a stock loan.

A similar issue came up last year under Danish domestic tax law in relation to stock loans as part of arrangements used in alleged cum/ex fraud in *Skatteforvaltningen (the Danish Customs and Tax Administration) v Solo Capital Partners LLP* [2023] EWHC 590. The case was brought in the English courts to recover the proceeds of the alleged fraud. Under Danish tax law, the “rightful recipient” is the person liable for tax on a dividend when declared. On basis of the unanimous opinion of all three Danish tax law experts, the English court found that the lender and not the borrower is the party liable to dividend tax on the declaration even though the lender transfers the shares with full title transfer to the borrower, at the start of the stock loan. On this basis it would follow that if any party can qualify for treaty relief, it would be the lender.

Which treaty applies?

The Canadian Revenue Agency argued in *Husky Energy* that the treaty with Barbados applied to the dividend and not the treaty with Luxembourg. The court however considered that suggesting that the Barbados companies were the beneficial owners of the dividends confused the question whether Article 10(2) of the Canada-Luxembourg tax treaty applied. This was because Husky Energy did not pay the dividends to a resident of Barbados. This follows from the fact that Article 10(1), in line with the OECD Model, applies to dividends paid by a resident of one state to a resident of the other state. The dividends here were paid to Luxembourg companies.

In contrast the French Supreme Administrative Court in *Sté Planet*, 20 May 2022, no 444451, suggested the possibility that a treaty with a third state may apply where the treaty with the state

where the direct recipient of a dividend was not the beneficial owner.

Tax avoidance

The Canadian Revenue Agency argued that even if the Luxembourg companies were beneficial owners of the dividends the general-anti avoidance rule(GAAR) applied to the arrangements. I will examine this complex argument in a later blog.

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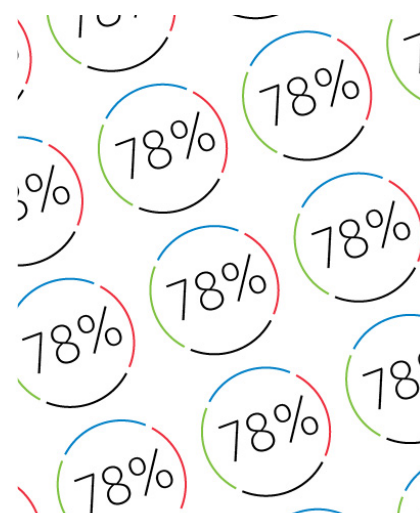
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