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Stock lending -beneficial ownership and tax avoidance- again! Part 2

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Tuesday, April 2nd, 2024

In my previous blog I examined the Tax Court of Canada's analysis of the meaning of beneficial ownership in tax treaties in Husky Energy Inc. v The King, 2023 TCC 167 in relation to stock or securities lending. This post examines the application of the General Anti-Avoidance Rule(GAAR) in Canada to the transactions. The facts of the case are set out in my previous blog.

While the GAAR is expressed to override tax treaties, its significance is its similarity with the Principal Purpose Test (PPT) in Article 29(8) of the OECD and UN Model treaties as well as Article 16(1) of the BEPS MLI. See https://kluwertaxblog.com/2020/02/27/alta-energy-treaty-shopping-is-no-abuse/.

The GAAR and the PPT comprise three elements:

(1) there must be a ""tax benefit"(GAAR)/ treaty benefit (PPT);

(2) the transaction must be an ""avoidance transaction"", meaning one that is not undertaken primarily for a bona fide non-tax purpose (GAAR)/ the one of the principal purposes of the arrangements giving rise to the benefit must be obtaining that benefit (PPT); and

(3) the avoidance transaction giving rise to the tax benefit must be an ""abuse"" of the tax provision in question (GAAR)/ the arrangements must be inconsistent with the object and purpose of the treaty provision in question (PPT).

Tax Benefit

The court found that, if it were not for the securities lending arrangements, the Canadian withholding tax on the dividends would have been borne by the Barbados lending companies at 15% the Barbados-Canada treaty. The tax benefit to those companies was the elimination of tax on the dividends because the securities lending arrangements, Husky did not pay the dividends to those companies but rather to the Luxembourg companies to whom the shares were loaned. The court said that the specific benefit should not be confused the overall tax result of the arrangements with the identified tax.

There would have been a benefit to the Luxembourg borrowing companies if Article 10(2) had reduced the withholding tax to 5% if the scheme had worked as intended. Since the scheme did not because the Luxembourg companies were not beneficial owners, the Canadian dividend payer did

not receive a benefit – it was liable to withhold tax at the full 25% rate.

Avoidance Transaction

If a transaction is not undertaken primarily for a bona fide non-tax purpose and results in a tax benefit, it will be an avoidance transaction for the Canadian GAAR. This is a higher threshold than the PPT requirement where only one of the principal purposes is sufficient to engage the PPT. Judging the primary or principal purpose of a transaction can be difficult. The court said that where there is both a tax and a bona fide non-tax purpose, then the relative importance of the driving forces of the transaction must objectively assessed to determine the primary purpose of the transaction.

The taxpayers accepted that the stock lending arrangement was entirely tax motivated, but argued that its main purpose was to avoid Barbados income tax. The judge observed that the effect of the arrangements for the Barbados companies was to eliminate the Canadian tax on the dividends entirely by shifting that obligation to the Luxembourg borrowers.

The judge concluded that the fact that the Barbados tax authorities did not challenge the significantly increased interest expense claimed by the Barbados companies, which resulted from a retroactive increase to 13.8% of the interest rate on US dollar intercompany debt, even though the companies treated the full amount of the compensation payments as tax-free contributions to capital and created a large loss carry-forward, led to the conclusion that that the Barbados tax risk was considerably lower than as suggested by the taxpayers.

These risks, compared with Canadian tax issues of both withholding tax on the dividend and a capital gain on disposal of the shares. The court was of the view that the primary concern was not Barbados income tax. The interest rate increase would have sufficed to eliminate the Barbados income tax issue without raising any Canadian tax issues and without the need to rely on the tax-free status of the compensation payments under the stock loan. On this basis, the only reason for the arrangements was to reduction Canadian withholding tax.

Abuse

Even if there is tax (treaty) benefit and the principle purpose of the transaction is obtaining that benefit, the GAAR or PPT is only engaged if the transaction is contrary to the object or purpose of the relevant tax rule. In this case it was the Canadian domestic law on withholding tax on dividends and article 10 of the two treaties. For this purpose, a single, unified approach to the textual, contextual and purposive interpretation of the provisions in issue is required under domestic law. This is consistent with Article 31(1) of the Vienna Convention on the Law of Treaties.

Barbados- Canada treaty -abuse

However, since the court had already concluded that neither treaty applied because the dividend was not paid to the Barbados companies and the Luxembourg companies were not beneficial owners of the dividends, so that full Canadian withholding tax applied, the transactions were not abusive. The court further considered that the Barbados- Canada treaty could not be abused because it did not apply.

Luxembourg- Canada treaty -abuse

The court concluded that the rationale of Article 10(2) is to provide relief from double taxation by allocating the right to tax dividends between Canada and Luxembourg in accordance with the theory of economic allegiance while retaining the protections against the use of conduit?type arrangements afforded by the beneficial owner requirement and the voting power requirement.

In light of this e court rejected arguments put forward by the Canada Revenue Agency In relation to Article 10(2) of the Luxembourg- Canada treaty. First, they argued that Article 10(2) represents a bargain between the two states whereby each agrees to lower the withholding rate on outgoing dividends in the hopes of attracting foreign direct investment. If the is no foreign investment, the article is abused by using the Luxembourg companies as a conduit to access treaty benefits that were not otherwise available, thereby circumventing the purpose of the article.

The court rejected this argument because it would require the article only to apply if the shareholder subscribed for the shares in owned. However, the article also applied when shares where purchased and there is no investment in the source state.

Second, the court considered that the economic allegiance theory underpinning allocation of taxing rights did not support a finding of abuse on the basis that non-residents earning passive income less allegiance to the source state than to the residence state.

Third, the count observed that the CRA did not address the beneficial owner requirement and the voting requirement in its analysis of the rationale of Article 10(2). Instead the CRA advanced a vague policy objective that is disconnected from the text of Article 10(2).

Fourth, in relation to the facts, because the CRA accepted that, as a result of the stock loans, the dividends to the Luxembourg companies, the court said that the only question raised is whether the means by which the dividends ended up in the hands of those companies is abusive in light of the rationale of Article 10(2).

Fifth, the CRA argued that because the Barbados companies were the beneficial owners of the dividends, the beneficial ownership requirement of Article 10(2) is abused. The court noted that if the Luxembourg companies are not the beneficial owners of the dividends, the reduced rates of tax in Article 10(2) do not apply in any event.

Observations

A clear distinction was drawn between the beneficial ownership requirement and the GAAR. Each has its own function and must be evaluated separately. It is clear that if as a matter of analysis, a tax benefit does not arise in any event, then the GAAR or PPT is not relevant. That is the case even if the principal purpose (or one of the principal purposes of the arrangement is obtaining the benefit.

The two step approach in determining abuse, that is, first identifying the purpose of the treaty provision and then considering objectively whether the arrangements circumvent that purpose is equally appropriate to the application of the PPT.

The taxpayer has appealed the decision to the Federal Court of Appeal.

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