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Canada proposes changes to withholding tax on dividend equivalent payments

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The Canadian federal budget (Budget 2019) tabled on March 19, 2019 (Budget Day) contains important tax changes relevant to participants in the stock lending market. It proposes modifications to the way Canadian withholding tax applies to dividend equivalent payments under the *Income Tax Act* (Canada) (the ITA) and Canadian tax treaties. This Osler Derivatives Advisory Group Update provides an overview of certain Budget 2019 proposals relevant to stock loans, identifies areas where they may usefully be refined, and describes our understanding of subsequent amendments that may be made to these proposals.

Under a securities lending transaction involving corporate stock, one party (the lender) transfers stock to a second party (the borrower) generally pursuant to an agreement under which the borrower agrees to make payments to the lender equivalent to the amount of dividends paid on the stock during the term of the agreement, and provides collateral to the lender to support its obligation to return equivalent stock to the lender at the conclusion of the agreement.

Under existing ITA rules applicable to “securities lending arrangements” (as defined in the ITA), where a Canadian resident borrows stock in Canada, and the lender is a non-resident of Canada, withholding tax on dividend equivalent payments can apply depending on the type and value of collateral posted by the borrower under the arrangement. In particular, where the borrower posts cash or government debt having a fair market value not less than 95% of the fair market value of the borrowed stock, and is entitled to enjoy directly or indirectly the benefits of all or substantially all income derived from the posted collateral (hereafter referred to as the “95% collateralization test”), dividend equivalent payments will be deemed to be dividends paid on Canadian stock. This result obtains whether or not the borrowed stock is in fact Canadian, such that dividend equivalent payments in respect of non-Canadian stock can effectively be treated as dividends paid on Canadian stock for withholding tax purposes.

Budget 2019 proposes to remedy this unusual result by excepting from Canadian withholding tax dividend equivalent payments on certain securities loans involving non-Canadian stock. The proposed exemption would apply where the borrowed security is a share of a class of the capital stock of a non-Canadian corporation, and the 95% collateralization test is satisfied. We understand that the Department of Finance has proposed relief only for stock loans that meet the 95% collateralization test out of concern that less robustly collateralized stock loans could be used a form of disguised financing. Where a Canadian borrower posts collateral sufficient to meet the 95% collateralization test, this risk is arguably mitigated, because cash and government bonds posted by a Canadian borrower as collateral could have been more easily used by the borrower directly to meet its financing needs.

The concern of the Minister of Finance regarding the use of stock loans as form of disguised financing is historical. When the "securities lending arrangement" rules were introduced into the ITA in 1989, interest paid to a non-resident of Canada on a cash borrowing was subject to withholding tax unless the borrowing met certain byzantine exemption criteria. At that time, a securities loan involving a Canadian borrower and non-resident lender that met the 95% collateralization test was unlikely to have been structured to defeat this withholding tax regime. However, in 2008, the ITA was amended to eliminate withholding tax on arm's length plain vanilla cash borrowings and a protocol to the Canada-U.S. tax treaty was introduced to eliminate withholding tax on interest paid on such cash borrowings in both the arm's length and non-arm's length contexts.

As Canadian withholding tax no longer applies to plain vanilla interest on arm's length cash loans, and similar non-arm's length cash loans made by certain treaty residents, the historical concern of the Department of Finance regarding stock loans and disguised financings should be more limited. It is therefore surprising that the proposed withholding tax exemption for manufactured dividend payments on non-Canadian stock loans in Budget 2019 would apply only to loans that meet the 95% collateralization test. Osler has raised this point with the Department of Finance. The response was encouraging: we understand that the Department of Finance will consider modifying the Budget 2019 proposals to extend the exemption to arm's length foreign stock loans that do not meet the 95% collateralization test. In our view, it would be logical to further extend the exemption to all non-arm's length foreign stock loans, provided the parties to the stock loan would not be subject to withholding tax on interest arising in the context of a plain vanilla cash borrowing.

Budget 2019 would also change the way withholding tax applies to dividend equivalent payments made on loans of Canadian stock. As is currently the case for non-Canadian stock, dividend equivalent payments made as part of a securities lending arrangement that meets the 95% collateralization test are deemed under existing legislation to be Canadian source dividends. Such payments made under arrangements that don't meet the 95% collateralization test are currently deemed to be payments of interest to which an alternate withholding tax regime may apply. Draft proposals in Budget 2019 would deem all dividend equivalent payments made by Canadian resident borrowers of Canadian stock under securities lending arrangements (and "specified securities lending arrangements," as defined in the ITA) to be Canadian source dividends, regardless of whether the stock loan satisfies the 95% collateralization test.

Budget 2019 also proposes to change the way in which the dividend article of a tax treaty would apply to dividend equivalent payments made under stock loans. Where a non-resident lender transfers Canadian stock to a Canadian borrower, the non-resident lender would be deemed for the purpose of applying the dividend article of the relevant treaty to remain the beneficial owner of the stock, and the "SLA compensation payment" (as defined in the ITA) made by the Canadian borrower to the lender deemed for purposes of the dividend article to be paid by the issuer of the Canadian stock. Osler has raised with the Department of Finance whether this treatment would apply to tax treaty articles other than the dividend article (e.g., such as the general withholding tax exemption for exempt organizations under Article XXI of the Canada-U.S. tax treaty). We understand from our conversations with the Department of Finance that all tax treaty articles are intended to be similarly treated, and that a clarifying amendment will be considered.

Budget 2019 proposals relevant to dividend equivalent payments on non-Canadian stock loans would be effective in respect of amounts paid or payable or credited on or after Budget Day. The remaining proposals discussed above would be effective in respect of amounts paid or credited as SLA compensation payments on or after Budget Day, subject to grandfathering for payments made prior to October 2019 pursuant to a written arrangement entered into before Budget Day.