



***Canada v. Hutchison Whampoa Luxembourg Holdings
S.A.R.L. sub nom Husky Energy Inc. v. The King, Case Study***

In a recent case before the Canadian Federal Court of Appeal (“**FCA**”), new ground in judicial rulemaking was developed regarding the meaning of beneficial ownership, legal substance, and who is the true non-resident in respect of Canadian-source dividends, and the resulting liability for withholding tax.

In 2003, when Husky Energy Inc. (“**Husky**”), a Canadian resident public company,¹ declared a special dividend, three of its shareholders, resident in Barbados, (the “**Barbcos**”) loaned their shares (being approximately 71.5% of the total outstanding Husky shares) to related Luxembourg corporations (the “**Luxcos**”) under standard securities lending agreements published by the International Securities Lending Association (the “**Agreements**”). The standard form Agreement provided that the Barbcos would lend their Husky shares to the Luxcos, and deliver the necessary instruments to vest title to the shares in the Luxcos.

Husky paid the dividends to the Luxembourg corporations, and withheld tax at the rate of 5% under the Luxembourg-Canada Treaty (“**Luxembourg Treaty**”), instead of the rate of 15% which would have applied under the Canada-Barbados Treaty (“**Barbados Treaty**”) had the dividends been paid to the original Barbados shareholders.

At the termination of the Agreements, the Luxcos returned the borrowed Husky shares to the Barbcos, together with payments equal to the gross amount of the dividends paid by Husky and the borrowing fees.

The Canada Revenue Agency (the “**CRA**”) assessed Husky, the payor of the dividends, on the assumption that the Barbcos were the beneficial owners of the dividends and that tax should have been withheld at the 15% rate instead of the 5% rate. The shortfall was CAD\$32,898,696. Husky appealed on the basis that the Luxcos were the beneficial owners of the dividends. Strangely, the Tax Court of Canada at the trial level held that the Barbcos were not the beneficial owners of the dividends, either. It held that the Luxcos were the direct recipients of the dividends but were not entitled to a reduced withholding tax under the Luxembourg Treaty. Accordingly, the rate of withholding tax should have been the full statutory rate of 25%. The Barbcos appealed this part of the decision.

The Tax Court dismissed Husky’s appeal but allowed the Barbcos’ appeals and vacated the Barbcos’ assessments.

The FCA first examined whether the Luxcos had acquired beneficial ownership of the dividends. The test from previous jurisprudence was that beneficial ownership; lies with the “person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received.”²

The Court noted that Husky had represented to the Luxembourg tax authorities in seeking an advance ruling on the tax consequences of the Agreement under Luxembourg tax law that the

¹ Husky was successful in Canada’s oil and gas sector, and was then estimated to be worth over CAD\$15 billion.

² *Prévost Car Inc. v. Canada*, 2009 FCA 57.

Luxcos would not bear any material risk in connection with the Husky shares, and that profits and losses would ultimately be borne by related companies.

Overall, the FCA concluded that the Luxcos had not assumed any meaningful risks in relation to the Husky dividend. The Luxcos had agreements with related companies to hedge foreign exchange gains and losses, as “perfect hedges”, under which the Luxcos incurred no cost, yet were provided with protection against loss.

This reasoning is troubling for the securities lending market, as every standard securities lending agreement provides a “perfect hedge” in the sense that the borrower’s obligation to return an equivalent security and make compensation payments to the lender perfectly offsets the borrower’s pre-tax economic exposure to the transferred security.

In addition, it is unreasonable to require a securities lender to inquire into the nature or cost of any additional hedging transaction undertaken by the borrower.

The FCA then analyzed the legal substance of the transaction. It cited existing jurisprudence on the meaning of legal substance for the proposition that “the *true* legal relationship or the *true* legal effects of a transaction will govern rather than the formal description or nomenclature used”. In other words, does the language used in the Agreement reflect the *true* legal effects of the transaction? The FCA held that it did not, because the parties knew that the Luxcos would not likely sell or on lend the Husky shares representing 71.5% of the total outstanding Husky shares, worth between CAD\$10.7 billion and CAD\$14.3 billion. Such a subsequent sale or loan could have “seismic consequences” for Husky and significant difficulty for the Luxcos to fulfill their obligations to return equivalent Husky shares at the end of the borrowing period. In addition, witness testimony stated that the Agreement did not relate to a market or financing transaction of any kind, but the sole reason for the securities lending arrangements was to shift the receipt of the dividends from the Barbcos to the Luxcos to achieve a more favourable tax result. Accordingly, the FCA concluded that the Agreement did not reflect the *true* legal substance of the transaction.

However, one must ask whether the likely action or inaction of the borrower after the Agreement is entered into has any bearing on the *true* legal effect of the Agreement between the lender and the borrower. Arguably, this reasoning confuses the legal effect of the transaction (the granting of ownership rights in the borrowed shares sufficient to permit the borrower to convey good title to a third party) with the borrower’s intention to exercise those rights.

When the FCA turned to the interpretation of the Luxembourg Treaty, it cited the 2003 Commentaries to the OECD’s Model Tax Convention on Income and Capital which stated that an exemption from tax on income paid to a resident of a treaty country ought not to apply to person “who simply acts as a conduit for another person who in fact receives the benefit of the income concerned.” Moreover, “a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.” Here the FCA concluded, based on the expected inaction of the Luxcos, that they acted as mere conduits. Again, one may ask if this conclusion is also based on faulty reasoning.

A key takeaway from this case is that in a non-arm's-length transaction driven by tax benefits, the parties ignore factors present in similar arm's length market-driven transactions at their peril.

A handwritten signature in cursive script that reads "Lorne Saltman".

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