

Coping with U.S. withholding taxes

The IRS's decision to scrutinize self tenders is impacting Canadian investment dealers and investors

IT HAS BEEN A DIFFICULT AND CHALLENGING time for investors. And to make matters worse, they are now confronted with different and conflicting views on the market's and the economy's direction.

So, the last thing investors need are administrative problems to complicate investment decision-making even further. But that is just what they are getting as the U.S. Internal Revenue Service takes a more aggressive posture in terms of withholding tax treatment on U.S. dividends paid to foreign investors.

The IRS is giving careful scrutiny to share buybacks or "self tenders" as well as partial redemptions of shares to determine whether these payments are really ersatz dividends and, therefore, subject to U.S. withholding taxes. This initiative appears to be part of an IRS effort to tighten up on perceived revenue leakages to offshore investors. In the past, the process of determining bona fide tenders appeared straightforward. Investment dealers, acting as qualified intermediaries (QI) or designated withholding agents for the IRS, examined self tenders and interpreted the event as proceeds in exchange for shares and not subject to withholding taxes.

In October 2007, the IRS tabled regulations requiring U.S. withholding agents to default to the dividend interpretation for self tenders. This means that withholding agents, including custodians and depository agents such as a depository trust company (DTC), would interpret self tenders as de facto dividend payments and withhold 30% of the value of the tender proceeds in

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escrow until the investor certifies the transaction is in fact a self tender and not a dividend under Section 302 of the U. S. Internal Revenue Code. The client has the option of avoiding these consequences by not tendering into the cash offer at all and simply selling the stock in question prior to the tender as it approaches the value of the offer.

Although the IRS regulations will be effective as of January 2009, withholding agents were permitted to implement the provisions earlier if they so wished. Almost all depository agents, including DTCs, introduced the measures effective January 2008, having the effect of applying the escrow provisions to most U.S. equities held by Canadian investors. Moreover, investment dealers who act as withholding agents for their clients under the QI designation were not permitted to follow the same procedures as U.S. withholding agents. This meant that Canadian dealers could not escrow the proceeds of share tenders on behalf of clients, withhold the 15% withholding tax subject to certification under Section 302 and then remit full proceeds to the client.

The IRS problem is particularly acute for Canadian investors. Facilitated by the removal of the Foreign Property Rule, many have invested in U.S. dividend-paying companies to better diversify their portfolios in recent years. At the same time, many U.S.

companies have engaged in share buybacks to boost price-earning multiples.

The IRS decision caught the Canadian securities industry off guard. Almost all self-clearing dealers now undergo a rigorous and costly IRS audit to qualify as a QI in order to withhold on behalf of their clients. The QI designation has heretofore been a great convenience to Canadian clients by avoiding a 30% withholding tax taken at source and giving the Canadian dealer discretion to apply the Canada-U.S. tax protocols, a 15% dividend withholding tax and exemption on dividends for U.S. stocks in registered pension plans.

DTCs estimate that 600-700 events in 2007 would have been considered subject to Section 302 interpretation. However, detailed research on approximately 50 of these events demonstrated that these self tenders resulted in a pro-rata reduction in the investor's proportionate shareholding. Consequently, the share redemption was not deemed a dividend payment. In almost all tenders for publicly-traded stock, proportionate shareholdings of the investor decline as a result of redeeming shares for cash. In these cases, the transaction is considered a bona fide exchange of shares for cash and not a dividend payment. As a result, withholding taxes are not applicable on the cash proceeds.

The Canadian securities industry was disappointed that QI-designated investment dealers failed to qualify — along with U.S. withholding agents — for the specific procedures in connection with the recent IRS decision on self tenders. The **Investment**

Industry Association of Canada, on behalf of its member firms and clients, has mounted a strong campaign for remedial action.

Earlier this year, the IIAC persuaded DTCs not to withhold the proceeds from self tenders to dealer clients and instead give the Canadian QI discretion to determine the shareholder impact under Section 302 and assess the appropriate withholding. It has also made a detailed submission to the IRS on the proposed regulations and appeared at a recent IRS hearing in Washington, D.C. The IIAC has also argued that the default provisions in Section 302 can be simplified; that QIs should qualify for any procedures related to the new regulations; and that QIs should be permitted to determine the shareholder impact of self tenders on behalf of their clients, thus avoiding unnecessary and impractical client certification.

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