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News Analysis: Bermuda: Canada's First TIEA Partner?

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COUNTRY DIGEST

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In March 2007 Canada announced to the world's tax havens that if they entered into tax information exchange agreements, they would become tax-favored jurisdictions for Canada's multinationals to do business in, and that if they didn't, they would become tax pariahs.

On May 7 the government of Bermuda (but not Canada) announced[1] that the two countries had reached agreement on a TIEA. This would be Canada's first TIEA[2] and would make Bermuda Canada's first pure tax haven tax partner.[3] Given that certain relevant draft regulations released last June have now been finalized,[4] that would mean that once the agreement is brought into force, Bermuda could become a much more tax-effective base for Canadian-owned foreign operations than it now is.

Actual (or deemed) active business profits of a Bermuda-based corporation would become eligible for tax-free dividend repatriation to a Canadian parent corporation (or other Canadian corporation with a ''foreign affiliate'' interest[5] in the distributing Bermuda corporation).[6] Significantly, deemed active business

[1]''TIEA Agreements Reached With Canada,'' *available at* http://www.plp.bm/node/1943. *See also* Jonathan Kent, ''Canada TEIA [sic] Spin-Off Could Boost Business,'' *Bermuda Royal Gazette*, May 7, 2009.

[2]Since adopting the TIEA program as part of its controversial 2007 March budget, the Canadian government has provided no information about its progress, but there is some indication that the government will break its silence on the status of negotiations at the May 21-22 annual tax seminar of the Canadian branch of the International Fiscal Association.

[3]Kent, *supra* note 1, notes that Canada has long granted, by entering into double tax agreements, such status to countries such as Barbados, which may have generally substantial tax systems but offer tax-haven-like regimes to foreign multinationals and other investors.

[4]Nathan Boidman, ''Draft Regs for Novel Use of TIEAs,'' *Tax Notes Int'l*, July 21, 2008, p. 228, *Doc 2008-15603*, or *2008 WTD 138-2*. This second legislative leg of the carrot-and-stick approach to inducing TIEAs was announced July 14, 2008, with draft amendments to the foreign affiliate (see below) regulations that would provide tax exemptions (the carrot) to Canadians who carry on business in TIEA countries. *See* legislative proposals and explanatory notes relating to the Income Tax Act, the Excise Act, 2001 and the Excise Tax Act, Department of Finance, Ottawa, July 14, 2008. The regulation was brought into force (by the unusual procedure of enactment) as part of Bill C-10, enacted as S.C. 2009, c.2 (Mar. 12, 2009).

[5]This (foreign affiliate) status entails a minimum specified share ownership in general, at least 10 percent of any class of stock. *See* sections 95(1) and 95(4) of the Income Tax Act, (Canada), R.S.C. 1985, Chap. 1 (5th supp.), as amended (herein, the act or ITA).

[6]Before the recent reg. enactment (see *supra* note 4), ''exempt surplus'' status and treatment (arising under section 113(1)(a) and Part 5900 of the Income Tax Regulations) had been accorded only to foreign subsidiaries resident in, and operating in, countries that Canada has a double tax agreement with. A Canadian corporation pays no permanent tax on dividends it receives out of the exempt surplus of a foreign affiliate. It may pay a potentially fully refundable tax under Part IV of the act, on such dividends if it does not own more than 10 percent, by both votes and value, of the affiliate and it does not have certain affiliated party nexus to the affiliate. *See* Part IV of the act. The exempt surplus is the after-tax active (or deemed active) business profits of an affiliate that is resident in a designated treaty country (DTC), provided those profits are earned in that or any other DTC. Residency in the DTC requires such status under the treaty between Canada and the DTC as well as that status as understood under Canadian domestic law (that is, based on mind and management) under section 5907(11.2) of the regulations. Since the introduction of the system in 1976, a DTC had meant a country with which a comprehensive income tax treaty is in force. Section 5907(11) of the regulations refers to a ''comprehensive agreement or convention for the elimination of double taxation on income.'' The favorable aspect of the system will arise when a country that has no tax treaty with Canada enters into a TIEA, which has been brought into force. In particular, the July 14, 2008, draft proposals (as enacted in Bill C-10) have extended the entire current exempt surplus system to countries with which a TIEA has come into force. That was effectuated through the simple mechanism, set out in revised subsection 5907(11), of including as a DTC a country with which ''a comprehensive tax information exchange agreement, in respect of that sovereign jurisdiction, that has entered into force and has effect.'' Note that the above cited reg. section 5907(11.2) has not

(Footnote continued on next page.)

income would generally include generically passive interest or royalty payments to a Bermuda corporation subsidiary by a third country, or a sister or corporate member of a Canadian-based multinational group.[7] Under existing arrangements and law, although unrepatriated actual or deemed active business profits of a Bermuda subsidiary are not subject to Canadian tax, distributions thereof are taxed because there is neither a double tax agreement nor a TIEA.[8]

The Bermuda Ministry of Finance's anticipation of benefits of the TIEA was stated as follows:

> In signing the TIEA, Canada will extend an important benefit to Bermuda that had previously been conferred only to countries with which Canada has a double tax treaty in force. Dividends of foreign affiliates that are resident in Bermuda that are paid to their Canadian parent companies out of the active business income earned in Bermuda will be exempt from Canadian taxation.[9]

Separately, bringing into force a TIEA would eliminate the specter of the punitive side of the TIEA-related rules Canada enacted in 2007. That would result in the unrepatriated active business profits of a Bermuda subsidiary taxed in the hands of a Canadian parent (or other Canadian shareholders) under rules primarily aimed at passive income (the foreign accrual property income rules[10] akin to the U.S. subpart F rules) if a TIEA were not brought into force within five years of Canada's inviting Bermuda to negotiate one.[11]

Finally, and ironically, the entire matter would become academic if the Canadian government followed the December 10, 2008, recommendations of a government-appointed advisory panel and eliminated tax on repatriation of foreign subsidiary profits regardless of whether the subsidiary is based in a country with which Canada has a double tax treaty or a TIEA.[12] ◆

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been amended so that residency in a TIEA country will be determined by reference only to Canadian domestic law.

[7]*See* section 95(2)(a)(ii) of the act.

[8]Profits earned in these circumstances (that is, in the absence of any treaty) are classified as taxable surplus. There is effective credit (through calibrated deductions) for any applicable foreign taxes. In other words, the Canadian treatment is comparable to the U.S. code section 902 approach to taxing U.S. corporations on dividends from CFCs. *See* section 113(1)(b) and (c) of the act and relevant portions of the regulations.

[9]*See supra* note 1.

[10]Where a foreign affiliate is a controlled foreign affiliate (meaning that it is controlled by the relevant Canadian shareholder, by that shareholder and other unaffiliated Canadians or affiliated nonresidents or by certain unaffiliated Canadians), its passive (or deemed passive) income (foreign accrual property income) is immediately taxed through attribution in the hands of the Canadian shareholder (whether corporate or noncorporate). *See* sections 91 and 95(1) of the act.

[11]This aspect of the TIEA-related rules was enacted in December 2007, in Bill C-28. *See* section 95(1), which links these elements primarily through two definitions: income from a nonqualifying business, and nonqualifying country. A nonqualifying country is one that Canada has no tax treaty with and that has failed to enter into a TIEA with Canada within 60 months after Canada had ''sought by written invitation to enter into negotiations for a comprehensive tax information exchange agreement.''

[12]The government presumably would also adopt the panel's recommendation to repeal the punitive (FAPI) side of the TIEA rules. For a full discussion, see Nathan Boidman, ''Reforming Canada's International Tax Regime: Final Recommendations, Part 1,'' *Tax Notes Int'l*, Jan. 19, 2009, p. 247, *Doc 2009-79*, or *2009 WTD 12-16*, and Nathan Boidman, ''Reforming Canada's International Tax Regime: Final Recommendations, Part 2,'' *Tax Notes Int'l*, Jan. 26, 2009, p. 345, *Doc 2009-84*, or *2009 WTD 15-11*.

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