

Barbados Tax Alert



Protocol to the Barbados– Canada DTA

On 8 November 2011, the Government of Canada and the Government of Barbados concluded a new Protocol to revise the existing income tax convention between the two countries, which dates back to 1980. Although the announcement concerning the protocol focuses on the replacement of the provisions in article XXVIII dealing with the exchange of tax information, the protocol would introduce a number of important additional changes to the convention.

If implemented by the respective countries, the protocol would generally have effect as of first day of January in the calendar year next following that in which it enters into force (i.e. in respect of taxes withheld at the source, for amounts paid or credited on or after the first day of January in that calendar year; and for other Canadian taxes, for taxation years beginning on or after the first day of that January). However, the protocol's provisions on the exchange of tax information would be effective from the date of entry into force of the protocol, without regard to the taxation year to which a request for information relates.

This Tax Alert highlights the main revisions contemplated by the protocol.

Treaty residence & treaty benefits

The protocol would replace the main definition of “resident of a Contracting State” in paragraph 1 of Article IV of the convention - to exclude from residence persons taxed only on a source basis, and to include the two contracting states and their political subdivision or local authorities and their agencies or instrumentalities. These changes are intended to make the definition conform with more modern tax concepts.

The protocol would also replace the residence tie-breaker rule for companies in paragraph IV(3) of the convention - defaulting to nationality - meaning place of incorporation in the corporate context, and would introduce a new tie-breaker rule (paragraph IV(4)) that would address persons other than individuals and companies,

requiring competent authority determination, failing which the persons would be denied benefits under the convention. There would be no change to the tie-breaker for individuals in paragraph IV(2).

Although perhaps relevant in certain circumstances, these changes would not seem to have a significant impact as a practical matter on the determination of treaty residence for companies. Under Barbados domestic income tax law, companies are considered resident in Barbados only if their central management and control is located there. There is no general deemed residence rule for companies incorporated in Barbados. There is such a rule, for example, under section 3 of the Barbados *International Business Companies Act*, but this provision only applies for the purposes of that statute and does not affect the determination of the residence of such a company in general for Barbados income tax purposes.

The effect of the Barbados *International Business Companies Act* - and of similar statutes - is merely to reduce the rate at which the relevant entities are taxable under the general Barbados *Income Tax Act*, not to substitute the fundamental basis of their taxation in Barbados, nor to limit that taxation only to income from sources in Barbados. Thus, a company that is incorporated in Barbados but managed in Canada would not be regarded as a treaty resident of Barbados. On the other hand, since there are presently no Barbados resident companies that are subjected only to source based taxation, the exclusion of source based taxpayers should not affect the determination of the Barbados treaty residence of a company that is incorporated in Barbados. The fact that a non-domiciled resident person, individual or company, is taxed on its local income and on its foreign income on a remittance basis, should not preclude such person from qualifying as resident under the new definition.

In addition, the protocol would replace paragraph XXX(3) of the convention, which currently precludes the application of the convention to companies that are entitled to special tax benefits under the *International Business Companies Act*, the *Exempt Insurance Act*, the *Insurance Act*, the *International Financial Services Act*, the *Society with Restricted Liability Act*, or the *International Trusts Act*, or any substantially similar law subsequently enacted. In its place, a more limited restriction would be introduced, which would only exclude such companies from certain benefits under the convention - in particular, benefits under the "distributive" provisions in Articles VI to XXIV. This would also affect any person or other entity entitled to any special tax benefit in either country

under a law of that country which has been identified in an Exchange of Notes between the two countries, although no such persons or entities have been identified at this time.

From a Canadian perspective, these revisions would have the effect of changing the analysis applicable to determining whether or not any such company, that is a "foreign affiliate" of a person resident in Canada, can be considered to derive "exempt earnings" in respect of its treaty-country income from an "active business". However, these changes would *not affect the conclusion* typically reached under current rules.

- ▶ A foreign affiliate can derive exempt earnings in respect of its treaty-country income from an active business if it is resident in a "designated treaty country" (DTC) as defined in subsection 5907(11) of the *Income Tax Regulations* (the Regulations), provided that it is not deemed to not be such a resident under Regulation 5907(11.2).
- ▶ The DTC non-residence deeming rule in Regulation 5907(11.2) applies to a foreign affiliate unless, under Regulation 5907(11.2)(a), the affiliate "is a resident of that country for the purpose of the agreement or convention". A companion rule in paragraph 5907(11.2)(c) is intended to preserve the ability of companies such as Barbados International Business Companies to derive such exempt earnings where the relevant agreement or convention entered into force before 1995, and the affiliate would be a resident of that country for the purpose of the agreement or convention but for a provision in the agreement or convention that has not been amended after 1994 and that provides that the agreement or convention does not apply to the affiliate.
- ▶ Under the new protocol, a Barbados International Business Company (or a company enjoying similar tax benefits) could be regarded as a resident of Barbados, since new paragraph XXX(3) would not provide that the convention does not apply to such a company. Thus, although this provision would have been amended after 1994, the amendment would not have the effect of precluding such a company's treaty residence in Barbados, with the result that such a company could meet the conditions in Regulation 5907(11.2)(a), and would no longer need to rely on Regulation 5907(11.2)(c).

Interestingly, although these revisions would not preclude a Barbados International Business Company from deriving exempt earnings in respect of its treaty-country income from an active business, the protocol would replace the "exempt surplus" guarantee in current paragraph XXV(1)(b) of the convention with a more limited guarantee that "credit" for

taxes payable in Barbados will be provided by Canada in respect of a dividend paid by a company which is a resident of Barbados to a company which is a resident of Canada and which controls directly or indirectly at least 10 per cent of the voting power in the first-mentioned company. The protocol would also eliminate the current “tax sparing” provision in paragraph XXV(4) of the convention. These provisions would not affect the analysis of the surplus treatment of a foreign affiliate’s earnings under current rules.

The protocol would also introduce a rule (new paragraph XXX(5)) to restrict treaty benefits in respect of income that is subject to tax in one of the countries by reference to the amount of the income that is remitted to or received in that country (and not by reference to the full amount of the income). In such a case, treaty benefits to be granted by the other country would be allowed only to so much of the income as is taxed in the remittance country. This change could restrict treaty benefits available to taxpayers that are resident but not domiciled in Barbados.

Finally, the protocol would replace the “saving clause” in paragraph XXX(2) of the convention, which currently permits Canada to impose its tax on amounts included in the income of a resident of Canada according to section 91 of the *Income Tax Act* (the Act). This provision is limited to the taxation of a foreign affiliate’s “foreign accrual property income”. New paragraph XXX(2) of the convention would permit a broader scope for taxation by Canada, extending to “amounts included in the income of a resident of Canada with respect to a company, partnership, trust, or other entity, in which that resident has an interest”.

Gains from taxable Canadian property

The protocol would replace the rule in paragraph XIV(3) that permits the source country to tax a gain derived by a resident of the other country from the disposition of the shares of a company (or an interest in a partnership or trust) where the property of the entity “consists principally of immovable property” situated in that country. This provision would be expanded to permit such taxation where the value of the relevant shares or other interests “is derived principally from immovable property” situated in the relevant country. The intent of this change would appear to be to permit Canada to tax gains (indeed, the new provision would refer to “income or gains”) derived by a resident of Barbados from the disposition of the shares of a company the assets of which consist of the

shares of yet another company rather than direct holdings in Canadian immovable property, provided that the ultimate value is derived principally from Canadian immovable property.

The protocol would also replace the “claw back” provision in paragraph XIV(5) of the convention, permitting each country to tax its former residents in certain circumstances. The new provision would permit each country to tax gains from the alienation of property derived by an individual who is a resident of the other country and has been a resident of the taxing country at any time during the six years immediately preceding the alienation of the property, other than property to which the provisions of new paragraph XIV(6) would apply. New paragraph XIV(6) would provide that, where an individual who ceases to be a resident of a country (the emigration country), and immediately thereafter becomes a resident of the other country (the immigration country), is treated for the purposes of taxation in the emigration country as having alienated a property (referred to as the “deemed alienation”) and is taxed in that country by reason thereof, the individual may elect to be treated for purposes of taxation in the immigration country as if the individual had, immediately before becoming a resident of that country, sold and repurchased the property for an amount equal to the lesser of its fair market value at the time of the deemed alienation and the amount the individual elects, at the time of the actual alienation of the property, to be the proceeds of disposition in the emigration country in respect of the deemed alienation. However, this provision would not apply to property any gain from which, arising immediately before the individual became a resident of the immigration country, may be taxed in that country nor to immovable property situated in a third country.

Tax Information Exchange

The protocol would replace the provisions in Article XXVIII of the convention applicable to the exchange of tax information – in favour of provisions more in line with international standards developed by the Organisation for Economic Co-operation and Development. Current Article XXVIII addresses only the exchange of information “necessary for the carrying out of this Agreement” or “concerning taxes covered by this Agreement”. The scope of Article XXVIII would be expanded to address the exchange of information that is “foreseeably relevant for carrying out the provisions of this Agreement” or to the administration or enforcement of the domestic laws “concerning taxes of every kind and description imposed on behalf of the Contracting States”, insofar as that taxation is

not contrary to the convention. In addition, new paragraphs XXVIII(4) and (5) would ensure that each country would be required to obtain and provide the requested information “even though [it] may not need such information for its own tax purposes”, and that a request could not be denied “solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because the information relates to ownership interests in a person”. As a result, it would seem that these provisions would apply to information concerning all residents, including International Business Companies and other entities that may not enjoy full benefits under the convention.

Learn more

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