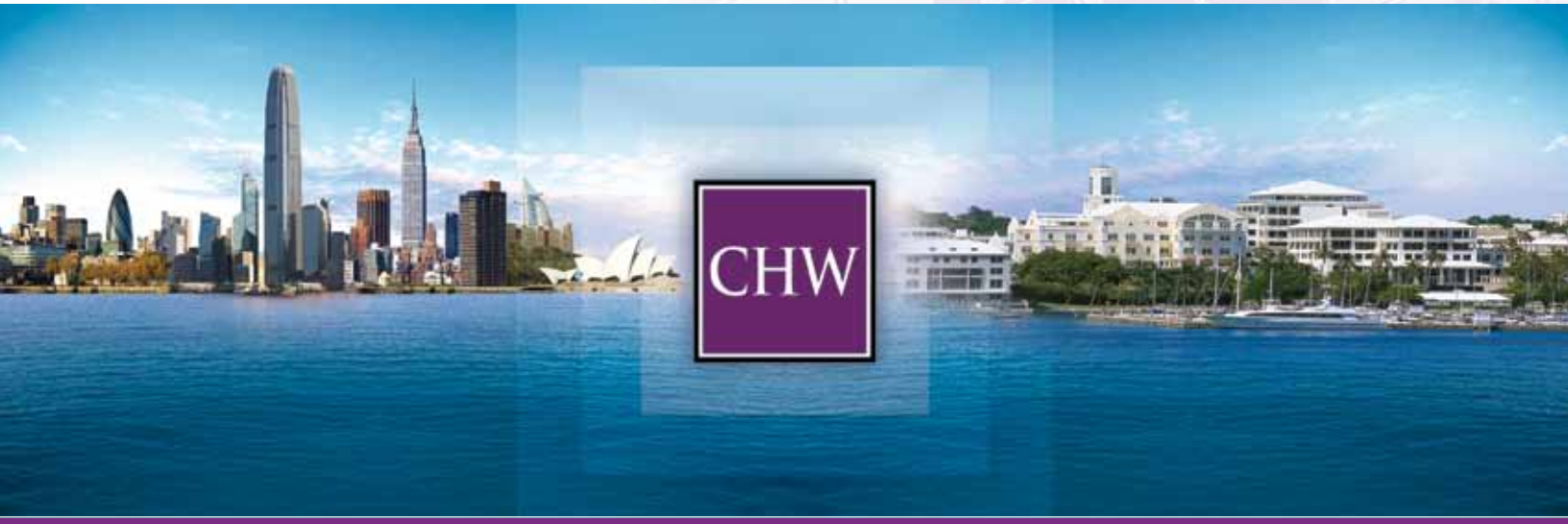
Canada's First TIEA June 2010



On 14 May 2009, Bermuda's Minister of Finance, on behalf of the Government of Bermuda, signed a bilateral tax information exchange agreement (the "Bermuda TIEA") with Canada.

This was the 22nd TIEA entered into by Bermuda and the first TIEA for Canada. It is significant, as Canada will be extending an important benefit to Bermuda. By virtue of the Bermuda TIEA, active business income earned by a foreign affiliate residing in and carrying on business in Bermuda will now be included in "exempt surplus". This benefit was generally provided only to countries with which Canada has a comprehensive tax treaty. By entering into a TIEA, the contracting parties will provide mutual assistance through the exchange of tax-related information that is relevant to the administration and enforcement of the domestic laws of the contracting parties.

Canada has become increasingly concerned with Canadians using international tax-avoidance structures. In order to uncover these structures, OECD countries such as Canada have sought access to tax-related information from countries that do not have tax treaties ("non-treaty countries") as well as from countries with tax treaties, where the particular treaty has information exchange provisions that are perceived to be inadequate.

On 19 March 2007 the Federal Budget of Canada introduced a number of significant changes to Canada's foreign affiliate rules by modifying how Canada taxes foreign-source income. The most significant change is the added role that TIEAs play in Canada's foreign affiliate system.

The new TIEA rules provide for a significant departure from linking exempt surplus to the presence of a tax treaty (a system which

has been in place since 1976). Under Canada's foreign affiliate rules, if a foreign affiliate earns active business income in a "designated treaty country" (i.e. a country with which Canada has a comprehensive income tax treaty) and pays a dividend to its Canadian corporate shareholder, the foreign affiliate's business earnings are deemed to be paid out of the foreign affiliate's exempt surplus, and the Canadian corporate recipient will not be required to pay Canadian tax, provided the foreign affiliate is resident in the jurisdiction that has a tax treaty with Canada. As an incentive for non-treaty countries to enter into TIEAs with Canada, the Canadian government has now extended the exempt surplus treatment to a foreign affiliate that is resident and carrying on business in a non-treaty country if that country enters into a comprehensive TIEA with Canada. Specifically, the definition of "designated treaty country" has been expanded to include a country with which Canada has entered into a comprehensive TIEA. By virtue of the Bermuda TIEA, Bermuda is a "designated treaty country".

For purposes of determining whether a foreign affiliate is generating exempt surplus, the foreign affiliate must be resident in a designated treaty country under the common law mind, management and control test (i.e. "common law test") and it must also be resident in that country under the applicable tax treaty. Generally, this means the foreign affiliate is liable to tax in that country by reason of that entity's domicile, residence, place of management, place of incorporation or any other criterion of a similar nature.

If the foreign affiliate fails to satisfy both tests, it will not be a resident in the treaty country for purposes of calculating the foreign affiliate's surplus accounts. Commentators note that there appears to be a more stringent requirement placed on foreign affiliates in a treaty jurisdiction as compared to a TIEA jurisdiction, where only the common law test must be met.

It has also been noted that the new regime appears to create the result that it would be easier and more tax efficient for a foreign affiliate in a TIEA jurisdiction to receive exempt surplus treatment as compared to a foreign affiliate in an established treaty jurisdiction. For instance, an international business corporation that carries on an active business in Barbados will generally be taxed at the rate of 2.5%, while the same corporation carrying on the same business in Bermuda will pay no income tax.

At the date of this memorandum, Bermuda does not tax profits, dividends or income and it does not have capital gains tax, withholding tax or sales tax. With the benefit of the Bermuda TIEA, Bermuda's attractiveness as a possible domicile for Canadian-based multinationals seeking to shift their existing foreign affiliates or establishing new ones in countries with zero or little tax is expected to increase.

For further information, please contact:
Ernest Morrison, Partner and Head of Corporate Department on 001 441 294 1503 or email emorrison@chw.com

Cox Hallett Wilkinson

Milner House
18 Parliament Street
P.O. Box HM 1561
Hamilton HM FX
Bermuda

Tel: 441.295.4630
Fax: 441.292.7880
email: chw@chw.com
web: www.chw.com

CHW