Canada Barbados Tax Treaty:
Controversy & Proposed Reform

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1. Introduction

After the United States and the United Kingdom, Canadians put more money into the tiny island nation of Barbados than anywhere else in the world. In past decades Barbados has become Canada's preferred tax haven, used by Canadian corporations operating abroad to minimize corporate tax on international income. In 2015 an estimated $80 billion of Canadian foreign direct investment was made in Barbados, primarily to take advantage of the Barbados international business company tax rate, which is as low as 0.25% for some amounts. In an increasingly globalized world, the use of tax havens to avoid tax liability is having a significant impact on government revenues. Despite this fact, Canada has chosen to enter into tax treaties with low tax countries and maintain polices that facilitates Canadian tax exemption for international corporate profits. This paper will give context to the Canada-Barbados Tax Treaty, examine its provisions, effect and recent criticisms and will argue that the Treaty and its application must be changed to put an end to the existing tax exemption on dividends paid out by foreign affiliates to Canadian parent companies.

2. Double Taxation & Canada-Barbados Relations

Double Taxation & International Tax Treaties

States levy taxes on individuals and entities under sovereign authority, the notion that a state has inherent authority to govern. In practice, there are no material limits on state tax sovereignty so long as the person or transaction has a connection to the taxing authority. Though tax regimes differ, worldwide income, citizenship and residence are all factors that are commonly used as a basis for taxation. Consequently, for taxpayers living or operating in more than one country, more than one tax regime can apply to the same event – an occurrence referred to as 'double taxation'. Double taxation can result in significant tax liability and is widely considered to be unfair to the taxpayer.[1] In an attempt to address double taxation, Canada has entered into tax treaties with 97 of the world's approximately 196 countries.[2] These double taxation conventions prevent double taxation by having each country agree to forego collecting tax in certain situations where it is agreed that the other country has a superior claim. While the particulars of each treaty can and do differ, in practice, the Organisation for Economic Co-operation and Development ("OECD") model conventions are widely used and closely followed.[3]

Canada-Barbados Economic & Political Relations

The Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital[4] (referred to herein as the "Canada-Barbados Tax Treaty" or the "Treaty") is no exception. Based on the OECD model convention of the day, it was signed and came into force in 1980 and was not changed until it was updated by way of protocol, signed in 2011 and taking effect in 2013.[5] The Canada-Barbados Tax Treaty was a continuation of strong relations between Canada and Barbados dating back to the 17th century when the two regions, both then British colonies, traded sugar and rum for salted cod and lumber. When Canadian Provinces were joining together Barbados plantation owners even proposed that Barbados be included in confederation.[6] Their proposal was not accepted but was raised again in the 1950s prior to Barbados gaining independence from the

United Kingdom in 1996.[7] Canada-Barbados diplomatic relations were established immediately upon independence and continue to present-day. These longstanding trade and political ties have resulted in the presence of Canadian banks in Barbados as well as a number of bilateral agreements for cooperation, of which the Canada-Barbados Tax Treaty is one.[8]

3. International Business Use of the Canada-Barbados Treaty

The Canada-Barbados Tax Treaty is, in addition to preventing double taxation, used to shield Canadian international corporate income from Canadian tax in conjunction with provisions of the Canada *Income Tax Act* ("*ITA*"), its Regulations and Barbados legislation. An overview of the applicable laws gives context to how Canadian foreign affiliates are structured in Barbados to reduce Canadian taxes on international income.

The Canada-Barbados Tax Treaty

The Canada-Barbados Tax Treaty was signed in 1980 and was amended in 2011 by protocol. The treaty applies to the taxation of income and capital imposed on behalf of each country.[9] The Treaty states that tax is imposed based on "domicile, residence, place of management or any other criterion of a similar nature,"[10] which can include permanent establishment.[11] Treaty Articles IV to XXIV outline the rules on how taxes are to be allocated between the countries on different items, respectively: income from immovable property, business profits, shipping and air transport, associated enterprises (carried out by either country in the other), dividends, interest, royalties, management fees, gains from the alienation of property, professional services, dependent personal services, directors fees, artists and athletes, pensions and annuities, alimony, government services, students, income not expressly mentioned and taxation of capital. The Treaty states how the non-taxing country will give tax deductions or credits to the taxpayer to prevent double taxation[12] and that neither country will require a higher rate of taxation than that charged for domestic taxpayers.[13] It also provides for a procedure for the mutual resolution of disputes regarding objections to the interpretation of the Treaty,[14] provides for the exchange of information between countries to administer the Treaty and related domestic laws[15] and includes provisions making certain exemptions, such as for financial privileges of diplomatic and consular officials[16] and for the tax laws of each party country.[17] Specifically, the Treaty states that it shall not preclude Canada from imposing tax on amounts included in income of a resident of Canada pursuant to Section 91 of the *ITA* (taxation of foreign affiliates).[18] The 1980 version of the Treaty excluded its application from companies entitled to special tax benefits under the *Barbados International Business Companies (Exemption from Income Tax) Act, Cap. 77* and similar laws,[19] while the Treaty Protocol amended this to include Barbados international business companies ("IBC"s) in the Treaty but to exclude them from the application of Articles VI to XXIV governing tax treatment. In summary, with the exception of the provision relating to IBCs, the Treaty is very similar to other double taxation treaties with countries that are not considered tax havens or low tax jurisdictions. The IBC Treaty provision, however, has led to significant tax savings for many Canadian corporations with international operations.

Barbados International Business Companies

The *Barbados International Business Companies Act* creates a special business entity in Barbados known as an international business company or IBC. The Act's purpose is to encourage "the development of Barbados as a responsible international financial centre"[20] and to provide "incentives by way of tax reduction, exemptions and benefits for international manufacturing and international trade and commerce from within Barbados."[21] The legislation allows for a resident Barbados company operating in international manufacturing or trade and commerce to apply to the Minister to become an IBC.[22] An IBC is then granted a special reduced graduated tax rate of between 2.5% and (as of 2013) 0.25%, is exempted from the Barbados *Income Tax Act*, and is exempted from withholding and asset transfer taxes.[23] Significantly, this legislation allows for businesses engaged in international manufacturing, trade or commerce to set up a Barbados IBC that operates outside of Barbados and that is subject to a significantly reduced tax rate in comparison to entities operating domestically in Barbados. On its own, such legislation would be of little consequence to Canada, but in conjunction with special concessions in the Canada-Barbados Tax Treaty and applicable Canada *ITA* provisions and Regulations, the IBC plays an important role in Canadian offshore structuring. A review of the applicable *ITA* provisions clarifies to how such tax structures are implemented.

Foreign Accrual Property Income Rules

ITA section 113(1)(a) permits "exempt surplus" dividends (defined in *ITA* Regulation 5907) from active business income earned by a foreign affiliate based in treaty partner countries (like Barbados) to be exempt from Canadian tax when they are distributed to Canadian resident shareholders. *ITA* section 91(1) requires the inclusion of income from a controlled foreign affiliate in the computation of income for a given tax year. The Foreign accrual property income ("FAPI") rules then apply to the treatment of income from foreign affiliates. These rules, found in *ITA* section 95, are very complex, but broadly are meant to help prevent the erosion of the Canadian tax base by differentiating between "passive income" (FAPI) and "active income" (everything that is not FAPI). FAPI includes interest, rents and royalties, while active income includes manufacturing, services, transportation and other activities that generally require the active involvement of people. *ITA* section 95(1) deems a non-resident corporation, like a Barbados IBC, to be a "foreign affiliate" of a Canadian resident if the Canadian resident alone or together with others owns 10% or more of the shares and the Canadian holds no less than 1%.[24]

The result of the interplay between the Canada-Barbados Tax Treaty, the *Barbados International Business Companies Act* and FAPI rules under the *ITA* and *ITA* Regulations is that if a Canadian resident corporation sets up a Barbados IBC and the IBC makes $100 in active income, the affiliate pays 2.5% or $2.50 in Barbados tax and the remaining $97.50 can be transferred to the Canadian parent company as a dividend completely free of Canadian tax.[25] This is significant and in effect exempts the international operations of many large Canadian corporations from Canadian tax. To understand why Canada would create such an exemption requires a review of the legislation's history.

4. Treaty Enactment & Development

When the Canada Barbados tax treaty was passed (along with others) by the Canadian Parliament in 1980, then New Democratic Party ("NDP") finance critic Bob Rae demonstrated prescience when speaking to the Bill, arguing that "[t]he government is entering into these tax treaties without being fully aware of the impact they will have on domestic taxation in Canada." He further asserted that, "[m]oney that is income and is not being taxed at the corporate level, on which the government receives no revenue, has the unfortunate effect of increasing the load of taxation on the average citizen." Despite such warnings, the Liberal and Conservative parties supported the Bill, which was then passed into law the next week.[26] Bob Rae's warnings were prescient in part because the agreement did not materially contemplate or preclude future changes to each country's tax laws and the impact that they might have on taxation and tax avoidance.

Barbados' Development as a Tax Haven

Though Barbados did have international business company legislation in place at the time of the 1980 treaty (first enacted in 1965 and updated in 1977[27]), the passing of the Canada-Barbados Tax Treaty facilitated the nation's development as an offshore tax haven for Canadian entities. After the treaty was put in place the Barbados international business companies legislation was amended again in both 1981 and 1985[28] and then replaced in 1991 with the Barbados *International Business Companies Act* (1991). With the amendments Barbados took steps to structure and promote itself as a destination for international business companies. Notably, the stated purpose of the 1991 *Act* was to "revise the law governing international business companies carrying on the business of international manufacturing or international trade and commerce from within Barbados."[29] It broadened the permitted activities of international business companies and reduced their corporate tax rate to a graduated rate of only 2.5% - 1% (reduced to 0.25% in 2013).[30] In a matter of years the NDP's prophecy was realized as Barbados took advantage of the Treaty and structured its legislative regime to promote its financial services industry and appeal to international business as an offshore destination.

Canadian Inaction

The 1992 Report of the Auditor General of Canada raised concerns about the use of tax havens in tax avoidance, stating that tax arrangements of foreign affiliates (including those in Barbados) were costing Canada hundreds of millions of dollars in lost tax revenues. Specifically, the applicable treaties and the then failure to adequately define "active income" or "passive income" in the *ITA* section 95(1) FAPI rules were being used to transfer foreign subsidiary losses to Canadian parent companies, move Canadian income offshore and convert income of Canadian corporations into tax-free income. The report further sated that the General Anti-Avoidance Rule ("GAAR") enacted in 1988 would not necessarily catch such transactions. It called for the completion of reviews of interest deductibility, foreign source income and foreign affiliates and corresponding legislative amendment.[31]

The election of a new Federal government in 1993 provided a new opportunity to address the Auditor General's concerns. Newly elected Liberal Prime Minister Jean Chrétien appointed Paul Martin as Minister of Finance, a position that he would hold until 2002 before making a bid for Party leadership and becoming Prime Minister himself in 2003 and until 2006. At the time of his appointment, Paul Martin was the owner of CSL Group Inc., an owner and operator of ocean faring cargo vessels, valued in the hundreds of millions of dollars.[32] Finance Minster Paul Martin's 1994 Budget responded to the concerns expressed by the Auditor General and others, vowing to "prevent Canadian-based companies from using foreign affiliates to avoid paying Canadian taxes."[33] The amendments enacted in early 1995 did tighten up the rules with changes like the *ITA* section 95(6) anti-avoidance provision, prohibiting acquiring foreign affiliate shares if the main purpose is tax avoidance, the clarification of definitions and the insertion of Regulation 5907(11.2)(a) deeming a foreign affiliate not to be a resident of a foreign tax treaty country unless the affiliate is a resident of the country for the purposes of the treaty. These amendments would have materially addressed the Auditor General's concerns, had an exemption to Regulation 5907(11.2)(a) not also been inserted. This provision had the effect of grandfathering all Barbados IBCs, as well as other similar entities in other jurisdictions like Cyprus and Luxembourg. This exemption, found in Regulation 5907(11.2)(c), states that:

> **…where the agreement or convention entered into force before 1995, the affiliate would, at that time, 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…**[34]

This means that, until and unless an applicable Treaty is amended, despite Regulation 5907(11.2)(a), Barbados IBCs and other similar entitles in other jurisdictions can take advantage of exempt surplus tax savings so long as the entity would otherwise be considered a resident in the offshore jurisdiction.[35]

Commentators criticized the 5907(11.2)(c) exemption as a blatant conflict of interest, asserting that it was designed to allow Paul Martin's CSL Group Inc. to operate its ships out of Barbados and repatriate its international profits exempt from Canadian tax.[36] The exemption made the amendments a half measure that failed to address the core of the Auditor Genera's concerns. As Canadian corporations began to increasingly rely upon the exemption in structuring their operations, the amount of money at issue and the impact on Canadian tax revenues grew. In response to the continuing trend, the 2002 December Report of the Auditor General of Canada again raised concern over Canada's tax arrangements with Barbados, stating that the use of foreign affiliates rules continued to erode Canadian tax revenues. The report noted that Canadian direct investment in Barbados had gone from \$628 million in 1988 to \$23.3 billion in 2001— an alarming increase of 3,600%!

The Auditor General's report reiterated the recommendation that the Department of Finance reassess the rules relating to foreign accrual property income and taxable dividends, reconsider allowing interest deductions on borrowed funds related to investments in foreign affiliates and reconsider allowing tax-privileged entities in treaty countries to repatriate income into Canada tax-free.[37] The Department of Finance (then headed by Ralph Goodale with Paul Martin as Prime Minister) responded to these recommendations quoting from its 1992 response, stating that "the existing foreign affiliate regime accurately reflects the policy intention of Parliament and provides for the taxation of all income that is intended to be subject to Canadian income tax." It further provided an overview of the changes that it did in fact make since 1992 and its ongoing review of the identified issues and related policy.[38] Notably lacking, however, was a commitment to address the system that continued to permit the use of offshore tax treaties to shield international income from Canadian taxation. A change to the Treaty did occur in 2011 though it did not address the main concerns raised by the Auditor General.

Canada Barbados 2011 Tax Treaty Protocol

The Protocol Amending the Agreement between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Done at Bridgetown on 22 January 1980[39] (referred to herein as the "Treaty Protocol") was signed on November 8, 2011. The Treaty Protocol introduced a modernized exchange of information article and expanded the list of persons covered by the Article XXX(3) limitation of benefit provision ("LOB"). The original LOB wording precluded the treaty's application only from companies entitled to special benefits under the Barbados *International Business Companies Act* or to companies entitled to any special tax benefit under any similar laws. The new provision, however, expanded the exemption to other entities including some trusts, while also including them in the Treaty.[40] This change means that the Treaty no longer excludes IBCs from its application (which put IBCs under the Regulation 5709(11.2)(c) exemption), but instead includes them while exempting the application of Treaty Articles VI to XXIV, which deal with the taxation of income from various sources.[41] The Treaty Protocol also makes several other more subtle changes such as applying the treaty tiebreaker rule for IBCs where the Canada Revenue Agency challenges the entity's residence. In summary, the Treaty Protocol asserts a Barbados exemption from Regulation 5709(11)(a) and, arguably, makes the use of Barbados by Canadian companies conducting international business even more appealing than prior to its implementation.[42] Consequently, the protocol has not inhibited the rapid growth of Barbados as an offshore destination for Canadian capital. In fact, as of 2015 Barbados is the number 3 destination for Canadian foreign direct investment abroad after the United States and United Kingdom with an estimated $80 billion,[43] despite a gross domestic product of only $4.4 billion in the same year.[44] Despite ongoing government inaction to the rise of offshore tax avoidance, attempts have been made by opposition parties to draw attention to the issue.

5. Attempted Legislative Reform

In February 2016 private members Bill C-222 *An Act to amend the ITA (Canada-Barbados Income Tax Agreement)* was introduced to Parliament by Bloc Québécois Member of Parliament for Joliette, Quebec Gabriel Ste-Marie.[45] The Bill sought to amend the definition of "taxable Canadian business" in *ITA* section 95(1) to include a business entitled to a special tax benefit conferred by the Canada-Barbados Tax Treaty. The amendment sought to tax Barbados IBCs as Canadian residents. On second reading the Bill was dismissed as null and void after the Speaker found that it was contrary to House of Commons Procedure and Practice as it should have been preceded by a ways and means motion, which can only be introduced by a Minister.[46] Though the Private Members Bill was inconsistent with Parliamentary procedure and would have applied only to Barbados, it *was* a cheeky way to press the issue and attempt to get the positions of other parties on record. Notwithstanding the Bill's failure, action to phase out the use of tax havens by Canadian corporations for international business is a justified and coherent policy aim.

6. Proposed Reform

Fundamental principles of the Canadian tax system are equity, neutrality and simplicity. Equity means that tax burdens should be shared fairly amongst taxpayers. Neutrality means that tax policy should bring about a minimal change in the allocation of resources in the private sector. Simplicity means that the tax system should minimize the costs associated with enforcement and compliance.[47] In contrast, the legislative history of the Canada-Barbados Tax Treaty and related *ITA* and Regulation amendments indicates that policy regarding the use of tax havens by Canadian corporations with international operations has been instead guided by the self-interest of business and political elites. The 1995 amendments in response to the Auditor General's 1992 report, rather than fully addressing the identified issues, merely narrowed the practice to certain exempted jurisdictions of which Barbados, a jurisdiction from which Paul Martin's CSL Group Inc. is reported to operate from, is one.[48] The Treaty Protocol then reinforced this policy decision.

Maintaining the existing offshore regime violates the principles of equity, neutrality and simplicity. It is inequitable to exempt the international income of mostly large Canadian corporations that are able to benefit from complex offshore structures because it gives an unjustified preference over smaller businesses operating internationally that cannot afford the professional fees, because it provides an unjustified preference to international income over domestic income and because it unfairly reduces corporate income that must then be made up with taxes from other sources. It is not neutral because it has resulted in Canadian corporations setting up structures and staff in a foreign jurisdiction that they would not otherwise operate from. It is not simple because it has resulted in an exceedingly complex set of FAPI rules that are difficult and costly to understand, comply with and administer.

The most compelling argument for the existing framework made by the Ministry of Finance is that ending the exemption would result in the international operations of Canadian companies moving entirely offshore so that there would be no increase in tax revenues and a weakening of the Canadian economy.[49] While it is undoubtedly the case that whenever government raises taxes there is a risk that taxpayers will reduce or cease their participation in the taxable activity, such line of argumentation in the Canadian context appears to only be persuasive where the interests of large international corporations and influential politicians intersect. Canada may terminate the Canada-Barbados Tax treaty pursuant tot Article XXXII upon the provision of notice. Furthermore, the Treaty Protocol in Article 5 explicitly allows Canada to impose taxes on amounts in the income of a resident of Canada with respect to a company in which the resident has an interest. To align the taxation of corporations with the principles of the Canadian tax system including equity, neutrality and simplicity, we must phase in a rate of taxation on exempt surplus dividends that would otherwise go untaxed until either the feared loss to the Canadian economy is demonstrably greater than increased tax revenues or until the exemption is eliminated and the international income of all Canadian corporations is taxed equally whether or not an offshore jurisdiction has been used.

7. Conclusion

The Canada-Barbados Tax Treaty, related *ITA* provisions and Regulations have developed in conjunction with foreign legislation to create a Canadian tax exemption on corporate dividends of Canadian foreign affiliates. This has resulted in a significant loss to the Canadian tax base as the Auditor General has twice warned against. The personal business interests of influential politicians appears to have resulted in tax policy inconsistent with fundamental principles of Canadian taxation and a failure to address this problem as it has continued to grow. The Ministry of Finance's assertion that the existing regime reflects the intention of Parliament and its unsubstantiated assertion that an increase in the applicable Canadian tax rate from 0% will result in widespread divestiture and insolvency is not supported. The tax exemption for Canadian international business income using offshore tax havens must start to be phased out.

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