THE STANDING SENATE COMMITTEE ON BANKING, TRADE AND COMMERCE

EVIDENCE

OTTAWA, Wednesday, December 12, 2007

The Standing Senate Committee on Banking, Trade and Commerce, to which was referred Bill C-10, An Act to amend the Income Tax Act, including amendments in relation to foreign investment entities and non-resident trusts, and to provide for the bijural expression of the provisions of that Act, met this day at 4 p.m. to give consideration to the bill.

Senator W. David Angus (*Chair*) in the chair.

The Chair: Good afternoon, ladies and gentlemen, and welcome to the Standing Senate Committee on Banking, Trade and Commerce.

(French follows - The Chair contg: Aujourd'hui nous débutons ...)

(après anglais)(Chair)

Aujourd'hui nous débutons notre étude du projet de loi C-10, Loi modifiant la Loi de l'impôt sur le revenu, notamment en ce qui concerne les entités de placement étrangères et les fiducies non résidentes ainsi que l'expression bijuridique de certaines dispositions de cette loi et des lois connexes.

(Chair : My name is senator David Angus)

(anglais suit)

(Following French -- The Chair contg after: ...des lois connexes.)

My name is Senator David Angus, from the province Quebec. On my right is Senator Yoine Goldstein, from Quebec, who is the Deputy Chair of the Committee. Senator Michael Meighen is from Ontario and has strong roots in Quebec. On my left is Senator Mac Harb, from Ottawa. Senator Massicotte is from Quebec and has strong roots in Manitoba.

I apologize for the low turnout today, but as this is part of the session leading up the to the holidays, many things are going on in many rooms at the same time. We have Committee of the Whole meeting in the Senate and the Finance Committee and the Legal Committee are also meeting at the same time, with everyone requiring use of the same resources.

(French follows - The Chair contg: Comme je viens. ...)

(après anglais)(Chair)

Comme je viens de le dire, on commence notre étude aujourd'hui du projet de loi C-10.

(Chair : In that regard, I would like to make…)

(anglais suit)

(Following French -- The Chair contg after: ...du projet de loi C 10.)

In that regard, I would like to make the following point: Representatives of the sponsoring department, the Department of Finance, as well as a representative of the minister's office, either the minister or his parliamentary secretary are busy on other matters, although they will be available around five o'clock.

I would like to ensure that honourable senators are in agreement. We have verified precedent, but it is out of sync and I want to ensure that senators are agreed.

Senator Harb: Yes.

The Chair: I would ask officials present if they are comfortable with this process.

NEW SPEAKER: Absolutely.

The Chair: I would like to make a personal declaration under the terms of the Conflict of Interest Code for Senators, to which we are all subject. I have addressed the following letter to the Clerk of the Committee and a copy to Mr. Jean Fournier, who is the Senate Ethics Officer. It reads as follows:

> Dear Dr. Gravelle:
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> For the record, I believe that I have a private interest that might be affected by or perceived to be affected by the deliberations of the Senate and of the Standing Senate Committee on Banking, Trade and Commerce in respect of Bill C-10.

I will not go into the description of the bill it has been referred to the committee with hearings scheduled to take place today and tomorrow.

The general nature of this interest is that I am a partner in the Montreal office of the law firm Stikeman Elliott LLP, and a member of that firm, Mr. Charles Gagnon, who is sitting in front of us, will be making representations to our committee on behalf of clients who are seeking amendments to the bill.

I wish to make it very clear that I have no personal interest or involvement, past, present or future, in the matters being handled by Stikeman Elliott in respect of Bill C-10, nor have I had any dealings whatsoever with the clients involved.

Please file this declaration with the official record of the committee's proceedings respecting Bill C-10 and take such other steps as you consider appropriate as clerk of this committee. I am sending a copy of my declaration to Mr. Jean Fournier, the Senate Ethics Officer.

As I say, instead of proceeding with the parliamentary secretary, Ted Menzies, and the officials from Finance Canada, we have other witnesses who have expressed to us, over the recent weeks, an interest in making representations to this committee about the bill. They have submitted in each case a brief or supporting document.

We have, from the The Society of Trust and Estate Practitioners, acronym STEP, Mr. Stewart Lewis, the CEO of STEP, and Mr. Paul Lebreux, past chair. We also have their counsel, Mr. Robin J. MacKnight.

Robin J. MacKnight, Counsel, The Society of Trust and Estate Practitioners: Mr. Chairman, I am a director of STEP Canada. That is my capacity today.

The Chair: From this Montreal law firm I mentioned earlier, Mr. Charles Gagnon, who is here representing himself, other tax lawyers that he associates with, I believe, and some commercial clients. He will tell us about it, I am sure. I have made it a point of not wanting to know, and I do not.

I think we will have two presentations and then open for questions. I believe Mr. MacKnight is the designated opening batter.

Mr. MacKnight: I believe that is correct. Thank you, Mr. Chairman, and it is a pleasure to get the first word before the Department of Finance.

Senator Goldstein: It has never happened before.

The Chair: They are rejoicing that they get a right of rebuttal.

Mr. MacKnight: That is what we were afraid of. We were talking about it before the hearing started.

I would like to introduce Mr. Lebreux, who is a past chair of STEP Canada and is a member of the worldwide council of STEP, which is an international organization, and Stewart Lewis, who is the Chief Executive Officer of STEP. I am here in my capacity as a director of STEP Canada.

This is STEP's first appearance before the Senate committee, and it is our first appearance for the sole reason that this is the first time this proposed legislation has actually come before this committee. This concept that we would like to discuss, which is only a portion of Bill C-10, the portion dealing with foreign investment entities, which in the tax world are known as FIEs, and non-resident trusts, which are referred to as NRTs. Those are the areas we wish to discuss.

These two concepts were first introduced in the budget of February 1999, and it has taken eight years to get this concept before this committee. It has been a long, tortuous route. There have been six different versions of the bill or of the draft legislation. I have the version that came out last year. Thankfully the NRT and FIE legislation is not this entire book, but a very large portion of it is.

It is unduly complicated and, in our view, it is fundamentally flawed. One thing I would like to point out is that in the intervening eight years there have been a number of changes to Canada's domestic tax rules, our international tax rules, our tax policies and our administrative procedures, many of which make a number of the rules or proposals in Bill C-10 irrelevant or moot. We would be happy to answer questions on those points.

Why do we think this legislation is poorly conceived? Quite apart from the complicated drafting, we have 150 pages of complicated definitions, each with substantial amendments over the six or eight years. We have a number of deeming rules and exceptions and we have, at last count, over 200 pages of explanatory notes.

As some commentators have pointed out, it seems that the Department of Finance has lost interest or given up on keeping up-to-date with the amendments and the explanatory notes because there are a number of changes that have been made in the draft legislation that have not been reflected in the explanatory notes. Therefore, the explanatory notes we would rely on to help us understand what these rules are about no longer necessarily apply to the legislation before the House.

One of the fundamental concepts of our tax system is that income is taxed in the hands of the recipients as earned or realized. The new rules, particularly the FIE rules, accelerate this tax by making income taxable before earned or realized, which is a fundamentally different concept.

Further, there are a number of exceptions in the FIE rules for those who have the fortitude to work their way through the minefield and bramble bushes that allow

people to avoid the application of the FIE rules. Therefore, rather than catching income, in fact for those fortunate few or brave souls, there are ways to completely defer or avoid tax. The whole thrust of these rules was to prevent improper tax avoidance.

On the other hand, the NRT rules pass the tax liability on to a person who, in many cases, has no authority to force the trust to actually pay the tax. You could find a circumstance where a Canadian resident is either a settlor or a beneficiary of a non-resident trust and they could be on the hook for the liability of that trust even though that trust has no other connection with Canada and has no Canadian source income. That is fundamentally offensive, in our view.

One of the comments we have heard is that trusts are only used by high net-worth individuals and why should you, as legislators, worry about protecting the economic interests of high net-worth individuals? That is a fair comment, but trusts are not just used by high net-worth individuals. People with a lot of money will always find ways to hire substantial law firms, including certain well-known firms in Montreal, to find ways to legitimately work their way through these rules. Our concern is for the people who do not have access to that kind of sophisticated advice. The way these rules work, many average Canadians, many individuals in Weyburn, Estevan, Sault Ste. Marie and Longueil will be caught by these rules, quite inadvertently. They would not know they are caught. If they have professional advisers who prepare their tax returns, those advisers will not know their clients are caught, will not ask the right questions and consequently there will be inadvertent noncompliance with our tax rules.

Canada has historically had an enviable reputation for voluntary compliance. In fact, the CRA suggested in a report about seven years ago that our compliance rates were over 95 per cent. That compliance assumes that people can understand the tax system. They can make sense of the rules, and they believe the rules are fair and applicable to everyone. In our view, these rules fail those tests. They are not comprehensible, even to seasoned tax practitioners. They are hardly comprehensible to the man on the street. We do not understand how people will be able to comply with these rules. If they cannot comply with them, that is the thin edge of the wedge. They will be moving down the slippery slope towards noncompliance. Down the road, if they get caught, they will be assessed penalties and interest for something they knew nothing about. That is not a good way to run a tax system. If we want to ensure our tax system is fair and applicable to all, we must ensure it is comprehensible by all.

Thankfully, with the reduction in tax rates that have been introduced over the past many years and a number of other changes, the wholesale need to move income and assets offshore has dissipated. It has been significantly reduced. That is one of the many public policy accomplishments of the governments over the past decade which has not been reflected in these new rules.

In our view, there are concerns that these rules will tarnish Canada's reputation in the international community.

They expose a number of taxpayers to retroactive taxation. They expose Canadian business to rules that are not reflected in the tax systems of other jurisdictions. They expose the Canadian tax system to occasional ridicule. For instance, I would refer the committee to a tax alert that was issued by a European law firm two weeks ago wherein they advised international trustees that if they had any trusts that had a Canadian connection they should cease and desist and try to figure out what is going on with these rules because they are so cumbersome and the consequences can be so dramatic.

The Chair: Mr. MacKnight, you have suggested that this tax alert be taken into consideration. Do we have a copy of that? When witnesses refer to a document, we normally like to have it filed with the clerk.

Mr. MacKnight: I will give a copy to the clerk.

The Chair: Thank you very much. Can you identify the document?

Mr. MacKnight: It is from the law firm of Withers L.L.P. It is entitled, "Stop Press. Canada to Tax Discretionary Interests in Foreign Discretionary Trusts."

Senator Goldstein: We have an opinion from them, but not the alert itself.

Mr. MacKnight: In conclusion, our recommendation is that you refer this portion of Bill C-10, the proposals relating to NRTs and FIEs, to the new committee that the Minister of Finance has created to deal with international tax rules and Canada's international tax competitiveness. These rules have been in proposal form for eight years. There are still a number of complaints about them that have not been addressed by the Department of Finance. In our view, they should be referred to an expert committee for them to consider as part of the overall review of Canada's tax rules.

Senator Meighen: Should the entire bill be referred or just a portion thereof?

Mr. MacKnight: Just the portion dealing with non-resident trusts and foreign investment entities.

The Chair: In your view, is that easily severable from the main bill?

Mr. MacKnight: It should be. We could refer to them by clause numbers in the draft legislation.

The Chair: Can you list the clauses?

Mr. MacKnight: Not offhand, but I can provide it.

The Chair: Let us get it on the record before we leave.

Based on your summary of your documentation, you appear not to be too happy with this bill. The Senate is here to review that legislation and give it some sober second thought, so we are very interested in your input on this. We assume, but I would like you to confirm, that you have made representations to the officials and this will not be new for them.

Mr. MacKnight: No, it is not. We were earlier discussing how many submissions we have been sent in.

Paul Lebreux, Past chair, The Society of Trust and Estate Practitioners: I think we have sent in seven submissions over the last eight years.

The Chair: "We" is this organization, The Society of Trust and Estate Practitioners?

Mr. MacKnight: Yes.

The Chair: In your documents you have some things about your organization which, in the interests of time, you did not put on the record.

Mr. MacKnight: That is correct.

The Chair: Is this organization like the bar association; is it a subsection of the legal organization? Is your work here pro bono? Are you getting paid or are you here for the betterment of Canadian legislation?

Mr. MacKnight: Yes, yes, no and yes, I think.

STEP was originally created in England 16 years ago. Nine years ago, a branch of STEP Worldwide was set up in Canada, STEP Canada. We have been operating here for over nine years. In Canada, we have about 1,900 members -- surprisingly more lawyers than accountants, considering it is largely a tax trust organization -- but our members are generally lawyers, accountants, trust and estates officers of financial institutions, international trustees, professional trustees and financial advisers. The lawyer base is comprised of tax practitioners and trust and estate planning practitioners. The accountants would be the same, and the financial planners would be estate planning type people. Then there are people who actually administer trusts within financial institutions -- professional trustees.

The Chair: To make clear what we are dealing with, you are quite direct in your criticism of the bill. The Steering Committee of this committee was somewhat surprised and wondered why, if the situation is as bad as you say it is, there were not more witnesses lining up to appear before us, such as the bar association, the accounting association and various others. Perhaps you will say that they are all embraced in STEP. If so, that might explain that.

Mr. MacKnight: I would like to say they are all embraced within STEP, but that would be a gross overstatement. As far as the bar association goes, it takes so long for the bar to get its act together that they could not meet the time frames.

I do not know why the joint committee of the CICA and the Canadian Bar Association is not here. That committee has made several submissions to the Department of Finance as well. I do not believe it appeared before any of the House of Commons committees as this legislation wound its way through the House of Commons. I do not know why they are not here today or tomorrow.

Frankly, we drafted our submission in a blunt fashion to ensure that we got your attention.

The Chair: Mr. Gagnon was going to speak next. Is he quite separate, or is his presentation complementary? Would you rather that we ask you questions before he speaks?

Mr. MacKnight: No, Mr. Gagnon is also a member of STEP in the Montreal chapter but he has a separate comments. It might be better to hear his submission and then we can take questions together.

The Chair: There has been some suggestion that there has been some litigation in connection with this bill. Do you know whether that is the case?

Mr. MacKnight: Not to our knowledge.

Charles C. Gagnon, Counsel, Stikeman Elliott: We were involved in litigation.

Senator Massicotte: I am not sure we all understand the issue. This is a very complicated bill and I would not mind dealing with it more conceptually, if we could.

The Chair: That is fine. These preliminary comments will help us all.

Senator Massicotte: I think you dealt directly with your concerns with the bill, but you made the important presumption that we understand the bill fully, and I am not sure we do. It is very complicated.

We would all agree that, if any Canadians are taking advantage of a loophole or are manipulating the act in order to get better treatment than other Canadians, that should be corrected, which was the intent of this measure. That is the easy part. Obviously you saying that in attempting to reach that objective a bill is being proposed that, as you said earlier, complicates the issue very unfairly.

In the United States they are saying that whenever there is a Canadian beneficiary to a trust, it is deemed to be Canadian for tax purposes. Is that accurate?

Mr. MacKnight: That is correct.

Senator Massicotte: Tell us what the problem is with that. Choose a specific example so you can get our attention and show us that there is a major issue here.

Mr. MacKnight: I will go back to your first comment. We agree with you that any device, whether a trust or a corporation, that is used for inappropriate tax avoidance or deferral should be shut down. STEP and its members agree with that proposition.

We disagree with the underlying assumption in this legislation that all trusts are bad. We also disagree with the concept that, just because there is a passing connection with Canada, a trust or any other international entity should automatically be subject to Canadian tax rules.

We think there are circumstances where international organizations, whether corporations or trusts, are properly taxable in Canada on their Canadian source income.

Our concern with these rules is that, for instance, you can have a trust which may have a passing connection with Canada, such as a Canadian settler. Let us use the example of someone from a fisherman from Nova Scotia who sold his fishing licences and had retired. He and his family moved down to the United States. Given that one of his children had a degenerative disease, he set up a trust to take care of his child while –

Senator Massicotte: A U.S. trust?

Mr. MacKnight: It would be a U.S. trust because they moved to the United States. However, then they moved back to Canada for a particular reason and the trust is left behind. That trust is taxable in Canada, even though the beneficiary of the trust is in the United States. The corpus of the trust is in the United States. The intent of the trust was to take care of an individual in the United States. Why should that trust be taxable in Canada?

Senator Massicotte: If I could go back a little bit. Deal with the big subjects otherwise you will lose us. My understanding of the bill is if any Canadian contributes to a trust and it is a U.S. or offshore trust, if he is at all connected, then it is deemed to be a Canadian entity and taxed under tax laws.

I presume the intent of the bill in 1999 was to hinder the following: There was a method to create an offshore trust whereby, if the laws of the country were such that interest was not taxable and there was no deeming of income to Canadians, it was a way for Canadians to put money aside, not pay taxes, and somehow convert the interest of the capital. Essentially, they would get their money back eventually and there was no taxation whatsoever. I gather that is the problem that you are trying to correct. Is that accurate?

Mr. MacKnight: That is an accurate statement. The rules were designed to attack trusts set up for tax avoidance purposes. Our concern and comment is that trusts set up for tax avoidance purposes alone face a number of challenges as to their validity. There are a number of ways that they can be challenged under existing law and under existing rules.

Senator Massicotte: Are you saying the existing laws are not adequate to catch those tax avoidance vehicles?

Mr. MacKnight: I think it is the opposite: Our existing laws have not been shown to be inadequate.

Senator Massicotte: Finance people are pretty sharp. Since 1999, they have made a number of presentations and they believe it is necessary because they have made many attempts to find a solution to the problem. You acknowledge the problem but do not agree with the method.

Mr. MacKnight: I am not sure we acknowledge the problem, either. We acknowledge that there are people who avoid in tax avoidance transactions.

Senator Massicotte: You agree something must be done.

Mr. MacKnight: I am not sure we agree that the existing rules cannot be used to address that.

Senator Massicotte: Are you sure in that?

Mr. MacKnight: The Income Tax Act has not been shown to be inadequate.

Senator Massicotte: Why did not Revenue Canada aggressively pursue it?

Mr. MacKnight: I would have to defer that to our colleagues at the Department of Finance. I look forward to an answer to that question because we have asked in the past and not received an answer.

Senator Massicotte: You think the rules are adequate and they are using a hammer to avoid a problem. Therefore, you believe they are taxing all foreign jurisdictions as opposed to dealing with the problem.

Mr. MacKnight: That is exactly one of our concerns.

The Chair: This is a large act and it has many elements. It is towards the foreign investment entities and the non-resident trusts that you are directing your criticism, is that correct?

Mr. MacKnight: That is correct. Our comments are only directed at those.

The Chair: As far as you are concerned, the bill is okay?

Mr. MacKnight: We are not as fussed by the other provisions as these.

Senator Meighen: You asked the question I wanted to ask, but I do not know whether we are dealing with half this bill or one-third or one-fiftieth.

The Chair: They will give us the sections after. I think it is a substantial part of the bill.

Mr. MacKnight: It is a substantial part.

The Chair: We are preparing it for Mr. Gagnon. Is everyone ready to proceed?

Mr. Lebreux: If I can make one quick comment to Senator Massicotte's point. In 1999 when the budget came out and this concern was brought to the attention of Canadians, the concern was originally addressed that anyone who had a trust outside of Canada was doing that for tax avoidance or evasion purposes. I think that is what led to the draft legislation and to this movement over the last eight years. The reality that has been missed is there are a number of trusts set up for a variety of reasons, some by default such as estates, and all of these trusts get caught under the same umbrella. That has created the problem.

There have been significant amendments to the Income Tax Act over the last ten years to capture what would be considered very aggressive non-resident trusts. However, at this point, we have not seen any legislation in this regard. I think to a large extent, with the existing legislation as it stands – if there was legislation – most of these trusts would be blocked. We do not have the same secrecy we had 15 years ago. Canada has done a tremendous job ensuring there is more tax information exchange, and a lot of these structures have disappeared on their own. I do not think what this legislation is attempting to do truly addresses the problem anymore.

(French follows, Mr. Gagnon: Je suis tout à fait d'accord...)

(après anglais)

Charles C. Gagnon, avocat, Stikeman Elliott : Je suis tout à fait d'accord avec les commentaires qui ont été faits par mes collègues de STEP.

Dans la mesure où vous décidez de ne pas référer cette législation au nouveau comité et de continuer l'étude de cette législation, j'aimerais attirer votre attention sur des points précis de la législation où des amendements sont nécessaires.

Comme c'était indiqué, lorsque les changements à la législation sur les entités de placement étrangères et les fiducies non résidentes ont été annoncés, en 1999, le seul but, tel qu'énoncé dans le budget, était d'éviter l'accumulation sans impôt de revenus dans des fiducies ou autres entités à l'étranger, principalement dans des paradis fiscaux. Le budget contenait cette référence très claire, dont l'extrait se trouve annexé à mes représentations où nous avons fait une référence très claire à l'effet que tout ce qu'on visait, c'était l'accumulation à l'intérieur de paradis fiscaux de revenus passifs.

Donc, depuis que le budget a été déposé, il y a 8 ans, des modifications importantes ont été faites au but poursuivi par la législation, et ce, sans annonce détaillée du pourquoi des changements opérés par rapport à l'objet poursuivi initialement.

L'un des changements fondamentaux qui ont été apportés était d'assujettir les fiducies américaines à la nouvelle législation et ne pas donner l'exemption prévue dans le budget de 1999.

Un autre changement fondamental a été d'imposer le revenu étranger gagné par une fiducie étrangère et versé à des bénéficiaires non résident.

À mon avis, il s'agit de deux changements fondamentaux de politique fiscale qui ne sont aucunement justifiables. À ce sujet, j'aimerais qu'on prenne un peu de recul et qu'on regarde les principes fondamentaux qui sous-tendent notre régime d'imposition.

Au Canada, de manière générale, notre loi de l'impôt est basée sur l'imposition des résidents sur leurs revenus de source mondiale et l'imposition des non-résidents sur leurs revenus de source canadienne. Nulle part, dans notre loi de l'impôt, on impose des non-résidents sur des revenus de source étrangère. Si cette législation n'est pas modifiée, cela créera un précédent dangereux. Cela risque d'envenimer nos relations avec nos partenaires, parce que ces règles ne s'appliquent pas strictement aux paradis fiscaux, mais à toutes les juridictions.

Lorsque le gouvernement avait annoncé que ces règles ne devraient pas s'appliquer aux fiducies américaines, on a cru à un premier pas pour étendre l’exemption à d’autres pays que les Etats-Unis, un peu à la manière de certains autres pays industrialisés comme l’Australie, par exemple, doté d’une liste de pays où leurs règles un peu semblables ne s’appliquent pas. Le Canada apparaît d’ailleurs sur cette liste australienne.

Maintenant, on dirait que le ministère des finances a fait marche arrière et, plutôt que d'encadrer adéquatement l'exception pour les fiducies américaines, devant la complexité de la tâche, ils ont tout simplement abandonné et décidé de ne plus faire bénéficier les fiducies américaines d'une exception, par conséquent de ne pas avoir à regarder les règles d'autre juridictions. Cela fait en sorte que, non seulement ces règles s'appliquent maintenant dans un contexte de paradis fiscaux comme elles devraient le faire, mais également aux fiducies établies dans toutes sortes de pays qui ont des taux d’impôts comparables ou même plus élevés que le Canada. Vis-à-vis de ces pays, si vous leur dites que l'entité est maintenant assujettie à l'impôt canadien, même s'il n'y a aucun bénéficiaire canadien, aucun actif au Canada, aucun revenu de source canadienne et aucun fiduciaire au Canada, vous pouvez comprendre que c'est perçu par nos partenaires comme étant complètement inacceptable.

À cet égard, nous avons été impliqués dans un cas où l'application potentielle de ces règles faisait en sorte qu'une fiducie était à la fois résidante au Canada et aux États-Unis. Le gouvernement canadien a catégoriquement refusé de négocier avec les Américains la double résidence de la fiducie, donc la résidence en vertu des anciennes règles et également de ces règles-ci. La position canadienne de ne pas négocier a été communiquée aux Américains, qui ont envoyé la réponse dont je vous ai joint une copie en annexe de ma représentation, à l'effet que les Américains considèrent que la position canadienne est tout à fait inacceptable et va à l'encontre à la fois de la lettre de notre traité avec les États-Unis et de l'esprit du traité.

Il s'agissait d'un cas un peu prématuré, mais on peut imaginer qu'on va a avoir des réactions semblables de nos autres partenaires commerciaux et de traités. Avoir une confrontation avec nos partenaires de traité n'est pas en soi mauvaise si on a des intérêts légitimes à le faire, mais ici il faut se poser la question : est-ce que, oui ou non, on est légitimement en droit de taxer des entités étrangères établies dans des juridictions qui ont des impôts sur le revenu comparables avec le Canada et où il n’y a

pas de bénéficiaire canadien et pas de revenu de source canadienne? Je pense que poser la question c'est y répondre.

J'aimerais, avant de terminer attirer votre attention sur des cas typiques de problèmes soulevés par ces nouvelles règles, pour illustrer encore mieux le non-sens de leur application, à moins que des changements ne soient effectués. À de nombreuses occasions, dans les derniers mois, des investisseurs institutionnels canadiens se sont vu refuser l'accès à des fonds d'investissement étranger qui étaient structurés sous forme de fiducie, pour la seule et unique raison que les fonds d'investissement étrangers ne voulaient pas s'exposer à l'application de ces règles en acceptant les souscriptions des Canadiens. On se retrouve dans la situation où ces règles font en sorte que nos investisseurs, à la fois institutionnels et privés, n'ont pas accès aux investissements qu'ils perçoivent comme étant optimaux, pour la simple et unique raison que les entités étrangères ne veulent pas courir le risque d'être imposé au Canada sur l'ensemble de leurs revenus par l'application de ces règles-ci.

Un autre exemple qui cause problème, c'est dans un contexte familial où des gens créent légitimement des fiducies dans le pays où le bénéficiaire réside. Par exemple, un Canadien dont tous les enfants habitent maintenant aux États-Unis et qui décide de créer une fiducie pour le bénéfice de ses enfants, se retrouve lui-même assujetti à l'impôt au Canada sur les revenus de la fiducie, même s'il n'a aucun intérêt dans la fiducie et même si la fiducie paye ses pleins impôts aux États-Unis – qui, comme on l'a indiqué plus tôt, connaissent maintenant des taux assez comparables à ceux qu'on retrouve au Canada étant donné nos baisses de taux au Canada. En fait, les taux américains risquent de remonter davantage que les taux canadiens dans le contexte actuel.

Dans de nombreux pays, côté européen ou ailleurs, les taux sont en fait plus élevés que les taux canadiens. En 1999, lorsque les règles ont été introduites, à l'occasion de la conférence annuelle de l'association fiscale canadienne, j'avais posé la question à la personne qui avait rédigé les règle à l'époque, Simon Thompson, de savoir si l'exception américaine allait être étendue à d'autre pays sur la base de la considération que, si on acceptait de ne pas appliquer ces règles aux fiducies américaines, on devrait donner le même traitement à des fiducies d'autre pays qui ont un niveau d'imposition comparable. La réponse était qu'on allait prendre la question en délibéré et considérer effectivement que, sur une base de politique fiscale, si on allait exempter les États-Unis on devrait également exempter d'autres pays avec des niveaux d'imposition élevée.

Devant la complexité de la tâche, comme je l'indiquais tout à l'heure, on a tout simplement laissé tomber.

La proposition qui est faite dans mes représentations, c'est simplement de réintroduire l'exception pour les fiducies américaines et potentiellement regarder, sur une base juridiction par juridiction, d'autre pays qui pourraient plus tard être ajoutés; et, pour s'assurer qu'il n'y ait pas d'abus, de tout simplement prévoir que, dans la mesure où une fiducie veut se prévaloir d'une exception pour fiducie américaine ou fiducie d'un autre pays à taux d'imposition élevé, il y ait effectivement des impôts payés par la fiducie ou par ses bénéficiaires dans le pays en cause. Dans la mesure où effectivement des impôts sont payés dans le pays en cause à un niveau comparable au niveau canadien, je ne vois aucune justification possible pour maintenir l'application de ces règles à des pays semblables.

L'autre proposition qui est faite est de restreindre l'application de ces règles ou que ces règles ne s'appliquent pas dans un contexte où le revenu gagné dans une année est du revenu de source étrangère, et que ce revenu de source étrangère est payé dans l'année à un bénéficiaire qui est à l'étranger. Cette règle ne devrait pas s'appliquer dans un tel cas de figure simplement parce que, dans la mesure où le revenu a été gagné et distribué dans l'année à un non résidant, on a une certitude que le revenu ne reviendra pas à un Canadien, ce qui était la préoccupation du départ, c'est-à-dire ne pas permettre une accumulation sans impôt de profiter en fin de compte à un Canadien.

Il s'agit des deux points essentiels auxquels il devrait être remédié dans la législation, dans la mesure où vous décidez de ne pas le rejeter d'emblée.

Le président : Merci beaucoup Me Gagnon. J'aimerais vous poser la même question qu'à M. MacKnight : est-ce que vous avez soulevé ces deux points primordiaux avec les fonctionnaires du ministère des finances?

M. Gagnon : Effectivement, à l'occasion de la conférence annuelle du *Canadian Tax Fundation*, j'étais la personne qui avait posé ces mêmes questions aux gens responsables à l'époque. Cela a été rejeté d'emblée; en fait ils ont resserré les règles par la suite. L'imposition du revenu étranger remis à un bénéficiaire nom résidant, c'est quelque chose qui est arrivé subséquemment. Les règles ont muté au fil de ces huit ans, non pas pour faire des assouplissements, même s'il y en a eu quelques-uns, mais pour l'essentiel ces règles ont été resserrés, selon moi sans justification à l'intérieur du ministère des finances.

Le président : Donc nous devons comprendre que, malgré vos efforts sérieux, les fonctionnaires en question n'ont montré aucun intérêt à discuter et à régler vos problèmes. Est-ce que j'ai bien compris? Car nous devons aborder nos question en ayant bien compris cela.

M. Gagnon : Je crois qu’il n’y avait pas de mauvaise intention.

Je pense simplement qu’il y a une certaine hantise, à l’intérieur du ministère des finances, de créer quoi que ce soit dont les praticiens ou les contribuables pourraient abuser. Et plutôt que de regarder de façon détaillée pour créer des exceptions qui se justifient, on décide tout simplement de rejeter le concept d'emblée et de ne pas se lancer dans de la rédaction d'exceptions. Je pense que c'est cela.

Il y a un autre point qui est important, et le document est annexé à mes représentations; l'Association du barreau canadien et l’institut des comptables agrées, par le biais de leur comité conjoint, ont fait plusieurs représentations au fil des années au ministère des finances sur plusieurs des changements qui devraient être apportés à ces règles. On se pose la question sur l'absence du comité conjoint du CBA-CICA, or de toute évidence ils ont fait plusieurs représentations qui ont été, pour l'essentiel, ignorées par le ministère des finances.

(Chair : They gave up before they got to this committee…)

(anglais suit)

(Following French, Mr. Gagon -- par le ministère des finances. TAKE 1700 begins here)

The Chair: They gave up before they came to this committee.

Honourable senators, we have the following dilemma. The Parliamentary Secretary, Mr. Menzies, has arrived. He can only stay, if I understand correctly, for half an hour. One way we could proceed is for the witnesses to move aside and let him give his testimony, but the officials stay on. We can then ventilate all the issues the witnesses are raising and Mr. Menzies will have an opportunity to respond. Does everyone agree with that?

If so, then I would ask the officials from the department and Mr. Menzies to come to sit at the table.

Ladies and gentlemen, I omitted to say this earlier, but I should let you all know now that we are not just here, in this room. We are also on the webcast and on CPAC. We have many interested Canadians out there taking note of our deliberations and I want you to be aware of that. I say to all of those viewers, you are welcome as well.

Without further ado, I welcome Ted Menzies from the riding of McLeod. You are the Parliamentary Secretary to the Minister of Finance, Mr. James Flaherty. We are delighted to have you at the committee, sir. We are proceeding in a rather unorthodox manner today. That is because of all of the trials that we are faced with, coming up as we are to Christmas. I know this is about your third or fourth committee presentation today and you are filling in for the Minister of Finance here and there, and so on. Originally, you were supposed to be the first group of witnesses to present the government's position on this legislation. However, with all of us agreeing, and in the interests of time, at four o'clock we started with these witnesses from two organizations.

It is only fair to tell you up front, and before you give your presentation, that these witnesses are very critical of the bill. These are serious people from an organization called STEP, which is a worldwide organization called The Society of Trust and Estate Practitioners. There is also a lawyer here who is not only a member of that society but also a person who is representing both private clients and the bar association, and so forth. We had not questioned these witnesses yet, but they are very critical of the legislation. Your officials were in the room at the time. They have had an opportunity

to hear that testimony. Later, not only will these first witnesses be subjected to our questioning, but so will your officials. If you have to really go at 5:30, we will let you decide whether you first wish to have a chance to discuss the controversial parts. Why do not you start, Mr. Menzies, and then we will see where it leads, keeping in mind the constraints.

Ted Menzies, M.P., Parliamentary Secretary to the Minister of Finance, Department of Finance Canada: Thank you, Mr. Chairman. I do appreciate the opportunity to appear here. First, I beg forgiveness for having to leave at 5:30. I had to duck out of my last Senate committee appearance because we had an emergency call to vote back in the House and I ended up missing it. You know how these days go. I recognize the challenges and I applaud your efforts to try and accommodate the difficulties we are dealing with today.

We have officials here who will be able to answer the details of the questions, so I think that my absence at 5:30 will not be missed by honourable senators. We will have some capable individuals to answer the difficult questions.

The Chair: I know you understand how things work here. However, I want to underline the fact that, unlike some of the bills you have been before us, there seems to be some serious criticisms of this bill. The consequences may well be a report back with amendments -- who knows. I want you to understand that.

Mr. Menzies: I do appreciate that. That is the purpose of these committees, namely, to ensure that it is the best thing for Canadians. I certainly respect that. I also want to emphasize that there is a lot of support for this bill. I am sure that you will have the opportunity to hear those witnesses as well, and I encourage that. There is certain expediency to getting this bill done. If there is some criticism of some pieces of it, let us not forget the importance of getting this overall bill done as quickly as we can. We have been waiting a long time to get this done. I will proceed very quickly here with my opening remarks and then we will open it to questions.

Thank you again for this opportunity to discuss this. Bill C-10 proposes to implement measures regarding the taxation of non-resident trusts and foreign investment entities -- I understand this is what these individuals were speaking about when I came in -- along with technical amendments to the Income Tax Act. I will keep my remarks brief to allow for questions that you may have about this proposed legislation.

This bill is in line with our government's larger efforts to facilitate a fair and more competitive tax system. The important question is: How do we go about it achieving this? Unquestionably, lower taxes are part of the answer. Our government has been consistent in its belief that Canadians face an excessive tax burden. We believe lower taxes lighten the burden shouldered by all taxpayers, thus enhancing incentives to work, save and invest. Lower taxes also help businesses and entrepreneurs to grow their enterprises, in turn encouraging investment in Canada leading to greater economic growth and job creation.

Indeed, to reference the Rotman School of Management, Professor of Business Economics, Jack Mintz, Canada should avoid imposing undue tax burdens. Tax rates should be kept reasonably low to encourage investment and job formation. We are incredibly proud of the robust job growth occurring in Canada today. Statistics Canada's November employment figures noted 42,600 new jobs were created last month alone. Despite claims to the contrary, these were primarily high quality jobs. As TD Securities Economist, Jackie Douglas, noted, the bulk of the employment growth came from full time, as opposed to part time and, more importantly, private-paid sector actually added a significant number of jobs. Furthermore, in the year to date, an astounding 388 jobs have been created in Canada. In the past three months, we have seen employment growth that one would typically observe over an entire year. We intend to advance policies that will continue to preserve and build on our economic growth. That is why, since coming to office, our government has taken action to reduce the overall tax burden for Canadians and Canadian businesses -- a reduction of approximately $190 billion bringing taxes to their lowest level in 50 years. In the recent fall economic statement, we took action to fulfill our campaign promise to cut the GST to 5 per cent -- a tax cut benefiting all Canadians.

The Chair: I do not want to interfere with your train of thought, but a number of my colleagues have sent me little notes, with which I find myself in agreement, that although this is interesting material, it has nothing do with the bill. Given the time constraints, if you want to carry on, that is fine and the record will show. We are trying to get to the nub of non-resident trusts, NRTs, Foreign Income Trusts, FIEs, and others.

Mr. Menzies: I was prepared to give introductory remarks but I can leave this with the committee if you wish.

The Chair: We have it and we will make it part of the record.

Mr. Menzies: I would certainly encourage you to read these numbers because they are very important, relevant to the content of Bill C-10. However, you might prefer to go to questions.

The Chair: If you have comments that speak directly to the bill, I do not mind you making them. We did hear from Minister Flaherty last week.

Mr. Menzies: That is fine. I am trying to re-affirm the good news that this government is bringing.

The Chair: We are happy to hear that but we need to get to the bill.

Mr. Menzies: I will leave it that then, if you wish to start questions. I want to make sure you read all of the good points we have made.

The Chair: There is a section in your presentation starting at page 5 on non-resident trusts and foreign investment.

Senator Goldstein: Again, these are principles with which we agree. It is not the principles but rather the details. We do not need to be convinced about fair taxation. We are worried about an inadvertent catching of otherwise legitimate arrangements. We are not experts in the field but we are told that this proposed legislation as drafted may well do that. The part at issue at the moment is fewer than 50 clauses the bill, which contains more than 200 clauses. We are talking about only one quarter of the bill, and then we are not even talking about all of the pieces of those 50 clauses. We are talking about somewhat less than that. We are trying to attack those and I would suggest that we accept your kind offer to deal immediately with your officials who can talk to us about the details that are of concern to us.

Mr. Menzies: In the essence of time, I will accept your suggestion.

The Chair: Senator Ross Fitzpatrick, from British Columbia has joined us.

Senator Harb: I have a question for the officials. One element deals with Mr. Menzies' presentation. Members raised a point before you arrived. The scenario is: A Canadian citizen has children who are residents of the United States, therefore non-resident status in Canada, and he sets up a trust in the United States for his children. The question is: Why should the income from that trust be taxable if the beneficiaries of that income are the children who are, in the end, U.S. residents. I thought that tax on foreign income was based on the beneficiary of that income being a

Canadian resident. A Canadian who receives such income from investments or other sources of income worldwide is taxed under Canada's income tax system. Are we trying to have it both ways in a sense?

Mr. Menzies: Certainly, the point of the overall intention is to ensure that there is not double taxation or tax avoidance. Our comfort level comes from knowing that taxes are paid in one country or the other. That is why it is a joint agreement.

There is an exception for bona fide family trusts for benefits and for disabled and charitable trusts. It is my understanding that there is an exemption for that. I would ask one of the officials to confirm that.

Gérard Lalonde, Director, Tax Policy Branch, Department of Finance Canada: That is correct. Paragraph A of the definition "exempt foreign trust" would cover off the type of trust that was described dealing with the disabled child. There is an exemption for such trusts.

Senator Harb: We are not talking about disabled persons. Rather, we are talking about children who are residents of the United States. Mr. Gagnon will make a note of that and when his turn comes, he will rebut what you are saying.

On that note, I want to be clear for the record. It is my understanding there is an issue before the courts dealing with just such a case. Perhaps the clerk could direct us because I have a many questions and I want to ensure that whatever we say will not be used as part of a court case, whether for or by Mr. Gagnon or against the Department of Finance or the Canada Revenue Agency.

The Chair: Everything said here is privileged information and I do not think it can be used in a court of law. I asked earlier if there was some litigation and I was told there was none.

Senator Harb: My understanding is that there is litigation. Perhaps Mr. Gagnon can tell us.

Mr. Gagnon: There is litigation surrounding a double resident's case getting resolved under the treaty. That is what the litigation is about.

The Chair: It is not on these points.

Mr. Gagnon: It is on these points.

Senator Goldstein: It is only indirectly.

Mr. Gagnon: Litigation is under the current 94, and if this one is enacted, it will become relevant.

Senator Goldstein: Is it section 94?

Mr. Gagnon: It is under the current 94 – non-resident trust rules. In a sense, this one would affect it, but only to the extent that it becomes law.

Senator Harb: I want to have an understanding and ensure that my comments are not prejudicing a case one way or another or the department. I am seeking some advice.

Honourable senators, there is a trust in this whole issue where the position of the Government of Canada and that of Revenue Canada is that we want to avoid double taxation. Mr. Menzies talked about that briefly as well when he previously appeared before us.

The position of the U.S. authorities is that we have told the Canadians, the Canadians are not listening and they are telling us they did so for this reason or that.

What we are hearing now is an interesting scenario where they say the Americans agree with us. The Government of Canada, through the revenue agencies, are not correct, whereas we are.

They are appearing before us in order to make submissions so we will amend the legislation. I presume the by-product of any amendment may or may not resolve their situation. That does not take away the fact that their case before the court deals right with the heart of the matter that this committee is dealing with now.

I am seeking advice as to whether or not it is appropriate for us to be having this hearing at all.

The Chair: You certainly raise an interesting point. It is perhaps something we will have take advice from Mr. Audcent, counsel to the Senate.

Given the nature of the point raised by my colleague, Senator Harb, you gentlemen from the Department of Finance might want to comment on that. Is this an issue for you? Are you concerned in terms of the litigation? I understood these are privileged proceedings.

Mr. Lalonde: In the context of litigation generally, we appear before this committee regularly on bills to amend the Income Tax Act, often with a variety of amendments to that act.

It is probable that some of the provisions being amended from time to time would be the subject of litigation. Therefore, it is likely that that issue has come up before. I do not have any personal knowledge of that being the case. I do not have any knowledge of this issue having been raised with the committee previously.

Therefore, I do not know the answer to your question straight up, but my inclination would be that it is unlikely that we have not encountered a similar situation previously in our appearances before this committee.

The Chair: You have lived with it.

Mr. Lalonde: We managed to live with it, yes.

Senator Harb: Does he feel comfortable, then, answering the question based on that?

Mr. Lalonde: Yes, we are comfortable in answering the question. This is not a disabled person. They are an able-bodied person who is a non-resident, and the father set up that account for them. Why should they have to pay tax on that?

The Chair: I have Mr. Brian Ernewein, Mr. Grant Nash and Mr. Gérard Lalonde on my list.

Mr. Lalonde: With respect to Mr. Ernewein, as you had mentioned earlier in your comments, there are a number of pieces of Senate business being dealt with today, and he is at one of the other committees.

The Chair: I just wanted to get on the record that Mr. Gérard Lalonde has been answering these questions about the litigation. You are here with your colleague, Mr. Grant Nash, who is Acting Chief, Tax Policy Branch of the Department of Finance. You, Mr. Lalonde, are the director of the Tax Policy Branch.

Mr. Lalonde: I am the director of the tax legislative division of the Tax Policy Branch, yes.

Senator Harb: I answered the question: The person is not disabled. The children are able-bodied, but they are non-resident to Canada. They are in the United States,

and the trust is set up in the United States for the benefit of the children. Why should we dip into their pockets when they are non-resident?

The Chair: This is a hypothetical question.

Senator Harb: Yes, it is a hypothetical question.

Mr. Lalonde: To clarify my answer earlier, talking about the disabled child, was responding in part to a conversation between you and Mr. Menzies, and the comments earlier about a Nova Scotia trust set up in the example for a disabled child. Then Mr. Menzies' remarks, some of the comments were related to your example and some were related to the other.

With respect to the example where you have a Canadian contributor to a trust, the beneficiaries are U.S. residents, and the issue is why would Canada seek to tax a trust such as that?

First you have to step back and look at the policy behind these rules. There was some indication about an exemption for U.S. trusts, and that is correct. In the 1999 budget, there was an indication that U.S. trusts would be exempt from these rules based on an understanding that the U.S. has a mature tax system, certainly every bit as complicated and detailed as ours. Therefore, we ought not to apply these rules to those trusts.

Layered on that is the initial impetus for these rules, which is that when you look at the taxation of trusts, a trust generally has three key elements to it. It has the contributor, who contributes amounts to the trust; the beneficiaries, who are entitled to amounts from the trust; and, of course, the trustees, who administer the trust.

Historically, one has looked to two of those elements, the trustees or the beneficiaries, to determine the incidence of taxation. The problem encountered in the run-up to the 1999 budget was that relying on the existence or non-existence, as the case may be, of Canadian beneficiaries was creating a fertile field for tax planning to ensure that while income was accumulating in these foreign trusts, there were no Canadian beneficiaries, or at least there were no Canadian beneficiaries evident on the paper trail. Later on, it would turn out that in fact some Canadian beneficiaries would be folded into the mix and, at that point, the capital could be distributed by the trust.

The issue at that point was, maybe we ought to rethink what we look to as being the incidence of taxations of trusts. Should we look to solely the existence of trustees or beneficiaries in Canada, or should we look to the contributors in Canada?

It is certainly not nonsensical to look to whether there is a Canadian contributor. If you have Canadian presence, an individual or corporation, that has the capacity to earn investment income, and then, in turn, turn that income over to a beneficiary, perhaps in another country such as the States, certainly if that income is earned by that entity in Canada, it is taxable. If it were earned in a Canadian trust, it would be taxable in Canada.

The question is: Should we take that income out of the Canadian net simply because the beneficiaries are now not resident in Canada? The decision in the 1999 budget was no, we should look to see whether there is a Canadian contributor to the trust. In those circumstances, deem the trust to be resident in Canada. From that flows all of the incidents of taxation for entities resident in Canada.

Coming back to your question in particular, then, what is the policy behind taxing a trust that has a Canadian contributor with solely U.S. beneficiaries? We start with a rule where, applicable to foreign trusts anywhere in the world, a convenient turn of phrase but perhaps not completely accurate would be at that point we could not trust trusts. We could not ensure that the existence of a trust as it looked on any particular day was what it would look like on the next day, next year or 10 years hence. Therefore, determining the incidence of taxation at that point was not particularly an effective way to run a tax system.

At the outset, the announcement of the rules in the 1999 budget thought that we could probably exempt American trusts. Canada is right next door to the U.S., we have a lot of cross-border migration. Many families have members on either side of border. They have a mature tax system certainly, as I mentioned earlier, every bit as complicated and detailed as ours. Therefore, it seemed like a good idea at the time to exempt these U.S. trusts.

In that same year, by November 1999, and before any draft of the legislation was released, the government announced it was not going to proceed with the exemption for U.S. trusts. The reason for that was that while the U.S. has a very good and robust tax system as applied to trusts created by its own residents, in the context of trusts created by non-residents, it was not quite that robust.

There can be planning opportunities where the U.S. simply would not tax the income of a trust even though it had been created in the States, particularly where there were Canadian beneficiaries. Then you are right back into the soup again, depending on what the particular trust that would otherwise be resident in the United States has done in their own investments. Therefore, we did not exempt U.S. trusts – even in the first iteration of the legislation.

Where do we get off taxing a U.S. trust otherwise resident in the U.S. with U.S. beneficiaries that has a Canadian contributor? First, it does have a Canadian contributor – the money came from Canada – so it is not completely unreasonable that we would seek to tax it.

Second, we cannot rely simply on the existence of a trust in the U.S. as being satisfactory to protect us from tax planning.

Third, we found on many occasions, in circumstances where there were no Canadian beneficiaries but only beneficiaries that were non-resident of Canada, that can change. That is the nature of trusts. The fact that there are only U.S. beneficiaries in any particular trust today does not mean there will necessarily be any or only U.S. beneficiaries to a trust on any subsequent day.

The Chair: I want to let the parliamentary secretary know that is now after 5:30. Before you leave for the vote, I wanted to thank you for coming to the committee. We know what a busy day it has been for you.

You are getting a sense of what is going on in the room here. We are not prejudging this thing; we have other witnesses to hear. We will hear more from the officials and we have more witnesses tomorrow.

There has been a suggestion from the STEP group that we could go ahead and pass this legislation. We could get all the stuff that you were saying is urgent, all these amendments, but carve out – at least on an interim basis, subject to bringing it back again – the things on the NRTs, non-resident trusts, and on the foreign investment, the FIEs.

We have not heard enough to decide one way or the other. It has been suggested that it is easily severable. We have not even asked Mr. Nash or Mr. Lalonde if it makes any sense.

If you would like, we would offer you an opportunity to come back tomorrow morning. We sit at 10:45. You might want to think about it. It has been unfair to you to have to grasp this stuff so quickly and speak for the government.

Mr. Menzies: Thank you for your kind consideration. The only comment I would make is I would assume that if there was anything taken out of this bill or an amendment made to it, it would go back to the House to be reassessed there. That does not happen again until January.

I hope that the rest of your witnesses can clear the air and we can move forward with this. We think it is certainly in the context of tax fairness. I realize there are individuals who may feel it is not fair. We have looked at it long and hard; it has been in the works since 1999.

Everyone has had a good chance to address it. I would encourage you, because of all the good things in this, to get this through so that we can put this into place in 2008.

The Chair: What you have just said is very helpful and you might want to complete it in the following sense. Representations have been made before we got into the room today; copies of briefs have been sent to the minister's office. His people – not only his officials, but members of his staff, some of whom are sitting here, tax experts and so forth – have reaffirmed, I understand indirectly, that they are aware of these criticisms but are not prepared to bend or change. Is that your evidence?

Mr. Menzies: I think these folks are very flexible and accommodating, but maybe not to the point that these individuals might like to see them. At this point, we are hoping that you get witnesses who provide a balance that would suggest that this should go through the way it is, and I would encourage you to do that. I do need to run. I wish you all a Merry Christmas. Tomorrow morning I am busy in the other House, but thank you for the offer.

Mr. Lalonde: I was closing in on the elements of this. We had come to the conclusion that the existence of the trust in the United States was not enough to preclude planning opportunities. The existence of a series of only U.S. beneficiaries was not enough to preclude planning opportunities because beneficiaries can change. Therefore, that exception was not proceeded with, as I mentioned, even in the first iteration of the draft legislation.

What is there instead is the ability for a trust in the U.S. or anywhere else to claim a foreign tax credit in competing Canadian tax in respect of the taxes paid elsewhere. For example, if it is true that in the foreign country, the taxes are being paid at a significant level, then foreign tax credits will be available in Canada.

We did have a lengthy discussion with Mr. Gagnon two or three weeks ago about this particular issue. There is a question about whether, on the face of the law, the tax credit can be available in respect of foreign taxes paid in excess of 15 per cent. It has to do with Canada giving generally only a 15 per cent foreign tax credit in respect of income from property.

That is true; and it is also true that this issue came up a couple of weeks ago. That may be indicative of a couple of things. It may be indicative that the places where these trusts generally are do not have taxes payable in excess of 15 per cent. I will not conclude whether that is true or not, but it is curious that Mr. Gagnon's is the only submission. Perhaps it is because he is sharper than the rest of the pencils in the box, but his is the only submission we have received on that particular issue.

We have also identified that in the Canada-U.S. tax treaty, in particular in the new protocol – although it was there before – there is an ability for Canada and the U.S., under the mutual agreement provisions, to look at a couple of things. One is what do you do with dual residency; and the other is what do you do about double taxation?

On dual residency, the whole purpose behind this provision is to ensure that Canada has the right to tax these trusts and resolves that issue by offering a foreign tax credit. That is why the Canada Revenue Agency has not agreed to relinquish our right to residency under these examples that have come up. They, of course, are dealing with the U.S. Internal Revenue Service, the IRS.

In our experience with the policy end of the U.S. Treasury, and in particular in the run-up to the agreement on the Canada-U.S. tax treaty and the fifth protocol, that was not raised as an issue. It is certainly accurate that the IRS has sent a letter saying they were disappointed in Canada not acceding to waiving our right to tax on a residence basis.

It is not particularly accurate to say that Americans have done that because, quite clearly, all Americans have not, and, in particular, the policy end of the treasury department has not and has not raised the issue at all during the negotiations of the recent protocol under the Canada-U.S. tax treaty.

That leaves one more issue, which is whether we can resolve double taxation through the mutual agreement procedures of the tax treaty. We are perfectly willing to enter into negotiations with our friends in the U.S. in that regard. Furthermore, given that this issue has only come up in the last couple of weeks, we are also at the departmental level perfectly willing to look into whether improvements to the tax system, writ large, can be made to resolve situations where, in this type of example, the foreign tax paid might exceed 15 per cent.

That is the long-winded answer as to why we would see our way to tax a trust with a Canadian contributor and only U.S. resident beneficiaries at this time.

Senator Harb: It strikes me, from your comments, as being like someone who cannot fall asleep at night because he is worried someone else might still be up and having a good time.

Your argument here about not being sure whether the Americans will tax it puzzles me a bit. You can help me here with that, if the treasury department has already taken the position that it takes issue with this and the fact that they disagree with CRA and the Government of Canada. This committee recently dealt with the double taxation issues, and, in fact, the chair was the sponsor of the bill. Officials appeared before the committee, and everyone without exception told us there was absolutely no issue whatsoever, that everything is hunky-dory.

Frankly, to tell you the truth, I am a bit surprised today to read what I read here from the U.S. Department of Treasury. Those things should have been raised at the time. At least this committee would have had a proper hearing on the double taxation issue, and we would have been able to bring in officials from both sides. We would have been able to discuss thoroughly what is happening. It is my understanding that although we have adopted the bill ourselves, the Americans have not.

Someone like Mr. Gagnon and others, I presume, will be running right to the government of the United States to say that it is important, and could the U.S. government ensure that those concerns are addressed when they deal with the double taxation issues.

In essence, we are creating other problems along the way.

The Chair: Bill S-2 that you are referring to is still in the House. It has not cleared the House of Commons, and I thought you were going to say -- I wish you had,

but I will remind you -- that we all received a series of letters saying there are serious issues with Bill S-2 after the fact, and we were left having been told there were none. Do you remember that?

Senator Harb: Of course, and, I got one of them.

In the end, we have to bring sanity to the system. I understand your responsibility is to introduce tax laws, and from time to time there are those who get trapped in the process. I appreciate the fact that you said there is always a mechanism to try to deal with those issues, and I am encouraged by what you said.

My final question to you deals with the size of this trust. How big is it? How many trusts do we have? You should be able to tell because you are taxing them. How many are there in the U.S, and how much are we talking in terms of tax dollars? How many are there elsewhere that you are aware of?

Mr. Lalonde: You have at least three questions, so let me see if I can remember them, and we will deal with them seriatim.

Regarding the first about not being able to sleep because of concerns that someone else is enjoying the party, in developing a tax system, we have to be cognizant of the ability to avoid whatever it is that we put out. It is not a question of worrying about whether the U.S. will or will not tax a particular trust. It is a question of knowing that there are planning opportunities to use U.S. trusts in such a way as to avoid Canadian tax and U.S. tax in the same way that we have had troubles before.

Why would we knowingly create a system that will reinvent the wheel with a complete exemption for all U.S. trusts? Rather, we preferred to perfect the system in a different way, which is to tax the trust and provide a foreign tax credit.

The second question dealt with being disappointed by what has been described as a letter from the U.S. treasury that deals with this issue and expresses disappointment about Canada not being willing to relinquish the rights of taxation on a residency basis of a certain particular trust. That letter is from the Internal Revenue Service.

The Chair: It from the treasury.

Mr. Lalonde: I cannot see what you are reading, but you mentioned you were reading from something. I think the letterhead says something like treasury department on the top and, immediately below, Internal Revenue Service.

The Internal Revenue Service in the United States is the organization that is similar to our Canada Revenue Agency. They are the administrators. There is also the branch of the U.S. Treasury that deals with policy issues, much like the Department of Finance. It is that branch that negotiates tax treaties. That branch has expressed no concern at all with our rules here under Bill C-10 and what we all call the "FIEs" and "NRTs".

Senator Harb: I do not mean to correct you, but we have a letter signed by Tina Byrd who is a manager for tax treaty. Not only do you have the deputy commissioner, who is involved with the large and mid-sized internationals and dealing with this issue of acquisition, but we also have a letter signed by someone from the tax treaty, a manager of the tax treaty.

Mr. Lalonde: The manager of tax treaties for the Internal Revenue Service.

Senator Harb: That is treasury.

Mr. Lalonde: It is a branch of treasury, but not the policy branch. It is the administrative branch. It would be like receiving a letter from an official at the Canada Revenue Agency as opposed to receiving a letter from an official from the Department of Finance. One administers the law; the other develops tax policy.

Senator Harb: How big is the trust, and how much do you collect out of that from the U.S. and elsewhere?

Mr. Lalonde: I have no idea in this particular trust. First off, tax rate information is privileged, and I do not have access to it.

Senator Harb: I do not mean individually. I am talking in general. How much do we collect from trusts collectively, not individually? Do we know?

Mr. Lalonde: I do not have those figures at hand right now. However, it is indicated in the 1999 budget, and that is some eight years ago, that this had become a large and growing problem dealing with these non-resident trusts and the foreign investment entities. It was a problem that was reaching what might be referred to as the "retail level of tax planning."

(French follows in 1750, Senator Biron: De quelle façon ...)

(après anglais)

Le sénateur Biron : De quelle façon ces règlements sur les fiducies étrangères vont-ils affecter la caisse de placement et les agences de placement canadiennes en général, qui administrent les fonds qui assurent les revenus de pension que les employés canadiens vont recevoir?

Si les fiducies américaines et d'autres pays refusent les placements de ces agences parce qu'ils seront obligés de payer des impôts ici, quelle est l'importance globalement des fonds de ces compagnies, qui pourraient être affectés, et de quelle façon cela pourrait affecter leur rendement et la sécurité globale de leurs placements en général?

Avez-vous une idée des impacts que cela aura sur ces agences d'investissement?

(Mr. Lalonde: That is an issue...)

(anglais suit)

(Following French by Senator Biron -- agences d'investissement?)

That is an issue which is a good place to start. Why would we want to apply these rules which deal with tax avoidance and tax deferral from the Canadian system where the taxpayer involved is a tax-exempt large pension plan?

That question was raised two or three years ago. At that time, it was not presented very forcibly. Recent representations were made by a large Canadian pension investor. I cannot tell you which investor, but I think I can give the general flavour. The question posed to them was why are you coming out of the woodwork now in writing with your submission? Their answer was, at the time, they did not invest heavily in that product. Now it is becoming more prevalent and is a desirable product for the pension industry. Therefore, they have made submissions to the department for an exemption.

There are gradations to consider whether you would exempt only the largest public pension plans or whether you go down to RRSPs and individual pension plans.

Can it affect Canadian large pension administrators in the terms you have described? Yes. We are certainly not averse to the suggestion. I do not have the presence of the minister to advise the committee that the department would approve such an exception or not or what gradations it would go for. We are aware of it and looking at it seriously.

(French follows -- Senator Biron: Est ce qu'il y a...)

(après anglais)

Le sénateur Biron : Est-ce qu'il y a d'autres pays qui agissent de la même façon que nous et qui taxent les fiducies de la façon dont on veut le faire?

(Mr. Lalonde: I am not aware of any other country that has...)

(anglais suit)

(Following French by Senator Biron -- veut le faire?)

Mr. Lalonde: I am not aware of any other country that has used this particular mechanism. That is, looking at the contributor to a trust as opposed to the beneficiaries or trustees in determining resonance. However, it is one of the three elements in determining the existence of a trust.

(French follows -- Senator Biron: Est il possible...)

(après anglais)

Le sénateur Biron : Est-il possible que, si nous agissons de cette façon, que les autres pays agissent de la même façon avec nous? Quelles seraient les conséquences pour le Canada si tous les autres pays faisaient de même?

(Mr. Lalonde: If I understand your question, ...)

(anglais suit)

(Following French by Senator Biron -- faisaient de même?)

Mr. Lalonde: If I understand your question, is it possible other countries may look at what we have done and determine that they would like to do the same? Would that have negative ramifications for Canada? I think not.

In Canada, we have a fairly robust tax system. We try to make it as fair for Canadians as possible. As you plug holes in the system to ensure that you minimize loss of revenues, it puts the government in a position where you can reduce tax rates generally. That is what the government has done.

To the extent that other countries look to a mechanism similar to Canada's where the foreign tax credit is the offset would be a fair and equitable way of handling that.

(French follows by Senator Massicotte: Si je comprends...)

(après anglais)

Le sénateur Massicotte : Si je comprends bien l'exemple donné tantôt, vous voulez vous assurer que toute la taxation soit complète. Mais lorsque vous avez donné l'exemple plut tôt d'une fiducie créée aux États-Unis, vous avez invoqué la raison d'être de son imposition en argumentant que c'est important, si un Canadien crée une fiducie et fait une contribution dans une fiducie américaine, de l'imposer au Canada. Mais si ce même Canadien avait donné un cadeau à ses petits-enfants ou à un particulier américain, il n'aurait subi aucune imposition. Est-ce exact?

(Mr. Lalonde: You have asked if a Canadian makes a gift...)

(anglais suit)

(Following French by Senator Massicotte: Est ce exact?)

Mr. Lalonde: You asked if a Canadian makes a gift to his grandchildren in the States whether there is taxation of that. No.

Senator Massicotte: Is it not odd that if he did it through a trust for the same beneficiary then it becomes cumbersome and complicated? Why would it be treated differently when the intent is the same?

Mr. Lalonde: In the context of a trust, the property has not been turned over to the beneficiary. If a Canadian gifts property to a foreign person -- there you go, it is yours, and it is theirs. The problem with a trust is that it is not clear whether it is theirs or not. When it comes time to determine where the income on that property goes, those beneficiaries can change.

That is what we saw in the lead-up to the 1999 budget where a variety of techniques designed to obfuscate the real beneficiaries of these trusts were used. They might be indicated to be non-Canadian beneficiaries and change at a later date. In some cases you had a Canadian contributor, you had a non-resident trustee and behind the scenes you had another person, sometimes referred to as a protector. That protector comes in later and informs the trustee what they are supposed to do. In many cases what the trustee was supposed to do was introduce Canadian beneficiaries somewhere down the line. All of that is very difficult for the Canada Revenue Agency to follow up.

Senator Massicotte: I can appreciate your answer, but no other country has chosen this approach and they probably all have the same interests and objectives as you do. We want to make income tax simple and when I read this draft amendment to the law, it seems very complicated.

The only people who will be happy are those will make money advising clients. It will lower our productivity in this country. What did the other countries do? Why did they not take the sledgehammer approach? Every country must have this issue.

My other question is in regard to the 1999 budget act. It was trying to get to tax regimes or offshore schemes to avoid double taxation. We all acknowledge those schemes and we must find a solution.

I understand the United States tax trusts much like we do. If the trust is taxed and the distribution is taxed, one would not create a U.S. trust for tax avoidance. There is

likely another reason for establishing a U.S. trust. The assumption is that the purpose must be for tax avoidance, so tax it. If I put money in Germany or England, I suppose it is probably the same interest, likely not for tax avoidance and there are probably good fiduciary reasons. Why did you assume it is tax avoidance regardless of country and not do it by way of exception?

Mr. Lalonde: The problem is your presumption that the U.S. will tax these trusts heavily, but that is not always the case, particularly in respect to trusts set up by non-residents. In many cases, the U.S. treats such a trust as a flow-through and does not tax it at all. It treats it as source income from wherever it is being distributed to. In those circumstances, you can have situations where, notwithstanding that by reason of the location of the trustees of the trust -- the trust might be resident in the U.S -- that was not enough of a reason to assure us that the U.S. would be taxing those trusts.

Where the U.S. does, in fact, tax those trusts then we will grant a foreign tax credit as discussed earlier.

Senator Massicotte: What do the other countries do? How come nobody else chose this? If it is such a winner, why are there not more people at the trough?

Mr. Lalonde: I do not know the answer to that question. My response would be conjecture.

Senator Meighen: I understand we now have until 6:30 p.m., perhaps, but obviously this is not an easy matter to deal with in a short period of time. From your own evidence, Mr. Lalonde, it sounds like there have been questions raised in the last few weeks that have not yet had an opportunity to be thoroughly debated.

The minister himself has set up an expert committee to study matters of fairness and equity in foreign tax rules. Would this not be a very large part of it? Should it not be included in the legislation?

Mr. Lalonde: Your question as posed raises a number of interesting issues. In the submissions made, it was pointed out that this package of legislation has gone through six different iterations. The Department of Finance should not be apologetic for that. In some cases, the iterations have been made because there have been changes in government. That can be an issue.

Also, in other cases, we have had exemptions. For example, regarding the FIE rules, we had an exemption in the rules on an elective basis, to elect to calculate on a

very exact manner how much of the income of the FIE was an individual's particular share. Was it complicated? It was very complicated. The department and the minister at that time agreed that particular option was just not one that should be proceeded with in the interests of simplicity. The next iteration went out without that option. There were representations from various parts of the economy that stated that, "Those rules are complicated, but we like them and want them, so please put them back in."

Therefore, there was another iteration of the rules that included this incredibly complex thing back in because we were lobbied to do so.

I will swing back to having received submissions within the last couple of weeks and raise one aspect. This is something that we think we have well in hand but are willing to look at to see whether there is a better way to do it: The foreign tax credit whereby taxes paid are in excess of 15 per cent. In the other case, the large pension funds: Having made submissions to us – and I did indicate that we had submissions from tax exempts two or three years ago on an informal basis but not pushing very hard – seem to have been satisfied with an answer at that time that we were not looking for an exemption.

Legislation that has come before this committee is a great package of legislation in terms of size, complexity, work that has gone into it, and iterations that have benefited from consultation; iterations that have been criticized because they have been iterated so many times as a result of that consultation. In essence, should legislation coming before this committee be reiterated by sending it back to the House for further amendments?

On the other side of the coin: Should it be recognized that the government of the day has taken these rules and brought them to a point where the government is satisfied with them to the extent that issues are brought up during the bill process in the Parliamentary system? That said, it may be after a point where it is reasonably considered that a policy could be determined and amendments put in place in the other House at their committee. Should that government derail that portion of the bill and send it back around?

I will note that this particular piece of legislation has had its coming into force deferred twice already. It was originally announced for 2001, then 2003, then 2007. Each time we have done that, the federal government has abandoned revenues. I do think it is important to remember, before one reaches a conclusion, that you should

send this bill back to the other House for unspecified amendments because we are not sure how you would amendment to take into account, for example, the issue with large pension funds, defining "large," et cetera. Certainly we have issues that we have explained with a blanket exception for U.S. trusts. We would not recommend that.

In short, the answer to your question is: No, we would not recommend that the bill be sent back to the other House for amendment. There was another piece to your question but it has alluded me.

Senator Meighen: I think you have delivered the gist of it. I think I understand where you are coming from.

I do not quarrel with the fact that very few pieces of legislation, particularly ones that are complex that cover that much ground, are likely to be perfect. There are various options that this committee has adopted in previous instances where we have had undertakings from the minister to hold up the promulgation of one or more parts of the legislation until such time as some problem is worked out. You alluded to instances of this.

Will you be here tomorrow before us? Tomorrow morning we have more witnesses.

Mr. Lalonde: I am not scheduled to be here before you. I would like to address holding off promulgation of various pieces of the legislation. Sometimes legislation is drafted in such a manner as the coming-into-force for it is to be affected on a date fixed by proclamation. Income tax legislation is generally not that way, and this bill follows that pattern. This material, dealing with FIEs and NRTs in the bill, is to be effective for the 2007 subsequent taxation years.

Senator Meighen: Since you have raised that, one of the concerns from STEP is a possible retroactive effect of this legislation. So as to not put their case improperly, let me read you a couple of lines:

> The effective date of these rules has been deferred several times since the first announcement of these proposals, and currently the rules are supposed to apply to taxation years beginning after 2006.

As you have said, Mr. Lalonde.

> However, there are many provisions of these rules which have retroactive effect, to a time when the earlier drafts of these rules were still in transition, and when taxpayers could not have foreseen the current rules. Basically, the rules of the game have not been finalized, yet the taxpayer is expected to know, understand and comply with them. Further, there are few grandfathering provisions, so that transactions that were implemented before the introduction of these proposals could now offend the rules, without any period for transition...

Would you have any comment?

Mr. Lalonde: These rules were originally proposed in the 1999 budget. In changing the coming-into-force, so as not to be retroactive back to 2003, as was the last announced coming-into-force, there were a number of representations to the department from taxpayers to the effect that we have been dealing with these rules since 2003, we would very much like to have these rules in place since 2003 and allow us to adjust afterwards, to the extent there is any difference between the levels of taxation, extant under this legislation and what would be in place in the absence of this legislation, and we did that. Those amendments were introduced at the committee in the other House, and I think may be the subject of some of the commentary earlier on about the explanatory notes being out of date with the legislation. The explanatory notes of course are prepared before the legislation is tabled in the House, either as a detailed notice, a ways and means motion, or as a bill. As a result, the explanatory notes do not reflect any amendments introduced in the committee in the other House.

Senator Meighen: Since you will not be here tomorrow, Mr. Lalonde --

The Chair: He might want to be here.

Senator Meighen: He is not scheduled to be here.

Mr. Lalonde: I am not scheduled to be here. That does not mean I cannot or will not be here.

Senator Meighen: We might offer you a more interesting place to be than you are scheduled to be.

The Investment Counsel Association of Canada will appear before us tomorrow and, if one can rely on the brief submitted to us, they are concerned about tax exempt accounts being inadvertently penalized along with those wrongfully evading paying their fair share. They refer to pension plans, RRSPs, et cetera.

They feel or are concerned they may face a tax liability in that regard. They are suggesting that legislation be brought in line with the exemptions provided for registered pension plans and other exempt taxpayers. Is that a concern for you?

Mr. Lalonde: That is what we were discussing earlier about whether there should be an exemption for tax exempt pension plans and, if so, whether that should be only for the largest and public plans or whether that exemption should cascade all the way down to the smallest individual pension plans.

The Chair: Senators' RRSPs.

Senator Meighen: You did not dismiss that policy out of hand.

Mr. Lalonde: No. What I indicated was it is an issue that has come up to us recently in terms of written submissions. It is something that we will be looking at. It is not something we have come to ground on. The submission by the ICAC was not made to us -- it was made to this committee -- but it is very similar to the submission and in fact it is the same wording as the submission that the ICAC made in their submissions to the consultations for the lead-up to the 2008 budget and recommended to the government that consideration for such amendments be made in the context of determining proposals to be announced in the 2008 budget, which leads me to believe that while the ICAC has the right to and is interested in raising the issue with this committee, they are also willing, apparently, to accept the possibility, given their submission to the consultations for the lead-up to the 2008 budget that something like that be considered in that context rather than here.

The Chair: While I know Mr. Lalonde gives such wonderful answers that you have all been directing your questions to him, do not forget that these other gentlemen are here too and they may want to have a rebuttal.

If you find that you have not been asked questions, because we only have about 15 minutes to go, I will give you an opportunity to make suggestions or rebut things you have heard.

Senator Goldstein: I will be brief because I think there is another item of business we have to deal with.

The Chair: There is.

Senator Goldstein: I will try to just deal with what Mr. Lalonde has said. Thank you, first, for the candour and skill with which you have testified and responded to questions.

There is an expression that we use in French which is, qui trop embrasse mal étreint. If you try to embrace too much, you end up with very little.

You have gathered, I assume, from the tenor of the questions that you have been asked, that members of this committee are concerned about your having captured, in the course of trying to very legitimately capture income and avoid temptations for tax avoidance, you have --

The Chair: Or evasion.

Senator Goldstein: Well, evasion is its own issue. Really you are trying to close doors to sophisticated tax planning, which have the effect of avoiding but not evading, which is a different concept.

In so doing, we heard earlier, from witnesses who testified, and we have read documentation that has been submitted to us by tax experts, including Thortenson and a number of others, that you are inadvertently perhaps capturing arrangements which are otherwise quite legitimate and appropriate for Canadians to enter into.

I am sure you do not want to do that, and you can rest assured we do not want that to happen, so we are at one in that respect.

What kind of carving out do you think the department could do to avoid these kinds of problems and have the legislation clarified so that we do not find ourselves with positions or situations where people feel they are potentially unfairly taxed?

I think, for instance, of your response to the question of taxation of trusts in a foreign jurisdiction, and you indicated that there would be a foreign tax credit. That is all very true, but we also know that foreign tax credits are limited to 15 per cent, and anything beyond that is not credited on Canadian taxation. That yields a very unfair result for Canadian taxpayers. I am sure you do not want that, and you know we do not want that.

How do you think -- and how long do you think it would take you -- to carve out, to avoid these particularly inappropriate situations by way of changing some other wording in the legislation? How big a task would it be?

Mr. Lalonde: The short answer is we think we already have carved out those situations where it would be inappropriate to apply these rules. We have exempt foreign trusts that accommodate what are, in essence, commercial trusts. We have rules that deal with the split-up of a marriage relationship and trusts created in respect of that. We have rules that deal with the disabled and children. You are absolutely correct that the Income Tax Act provides that the foreign tax credit in respect of income from property is limited to 15 per cent. Just to make sure that the record states it, that does not hold in the context of income from business. There are provisions under the Canada-U.S. treaty, already, to deal with incidents of double taxation where the foreign tax credit is insufficient to resolve double taxation.

We would look to that as an existing potential way to deal with this issue, but we will be, as I had mentioned earlier, looking into the situation. It has not come up in the some eight years that this mechanism has been winding its way through the system. As I indicated earlier, the U.S. exemption was withdrawn before the first iteration of the legislation, withdrawn in a release on November 30 of 1999.

It certainly has not been pressed to us as a pressing issue but we do understand it. As I mentioned, we think there is an existing mechanism that may very well deal with the issue through the treaty and the competent authority mechanism. That is admittedly cumbersome and we will be looking at ways to deal with it.

In terms of how long will that take us, I cannot answer that question. It is not something that is entirely within our control. Obviously we have a parliamentary system. We have a Minister of Finance. The Minister of Finance decides when and where and how to announce measures if such measures were to be recommended to him. Therefore I cannot answer that second part of your question.

Senator Goldstein: One thing that this legislation appears to capture is the discretionary trust, where you do not know who the beneficiaries will ultimately be. From your perspective, you want to tax that on the theory that one or more or all of the beneficiaries may be Canadian. You are taxing essentially on the way in, but it may well be that one or more or all of the beneficiaries are not Canadian taxpayers and therefore you will have taxed a corpus, with respect to which the beneficiaries will never see any income or capital. Does that not strike you as unfair?

Mr. Lalonde: If you go back and look at the three key elements of a trust -- the contributor, the beneficiary and the trustees -- if we are not sure who the beneficiaries

are, I think it is fair to look at who the contributor is and in the absence of parking the funds in the trust the contributor would be the taxpayer, and so it is certainly not inappropriate that a contributor be taxable on amounts contributed to a trust. Certainly if it with contributed to a Canadian trust it would be taxable and we see just the existence of a non-resident trust and having knowledge of the beneficiaries can and often do change from time to time, that that is not enough to convince us that that trust ought not be taxable in Canada.

Senator Goldstein: Your approach is very different from the approach of a lot of other people in terms of taxation. You appear to be approaching this as a function of the proposition that a discretionary trust precisely because you do not know who the ultimate beneficiary will be, should have it is corpus or its revenue taxed in the hands of the settler. You mentioned earlier the possibility that the trust could but need not necessarily have a protector and that that protector may know well in advance, on instructions of the settler, who the ultimate beneficiaries will be.

That is an approach that makes a number of presuppositions, which I am not sure Canadians will be happy to accept. Surely you can find some way to tax the beneficiary if in fact it turns out that the beneficiary is or, from your perspective, ought to be a Canadian taxpayer. I just do not understand why you are taxing on the way in when you do not know who is ultimately going to have the revenue. It is very difficult for me to understand.

Mr. Lalonde: The answer is generated by the history with this particular issue. We did have a tax system that taxed on the basis of the residency of the beneficiaries, and that tax system was proven to be leaky. When one is looking for a mechanism to deal with that, one can either look at what we have come up with as a conclusion that says, look, we really do not know who the beneficiaries are and we cannot depend on who the beneficiaries are and therefore we will look to the next best as the contributor for an indicia of the residence of the trust or, alternatively, which I think is the better response, which is to say there are three key elements in a trust. There is the contributor, the beneficiary and the trustees, and which one of those three should trump is every bit as good a reason to look to who the contributor to a trust is as there is to look to who the trustees are or to look to who the beneficiaries are.

Senator Goldstein: It is a catch-as-catch-can concept. If you cannot get the beneficiaries you will get the settler. It is a strange way to tax, with respect.

Have you had occasion read the letter of November 15 from the department of the treasury which says that the issue is the question as to whether a Canadian resident provided property of the trust and it was taxed because certain Canadian residents might in the future become beneficiaries of the trust. We objected to this position as inconsistent with the spirit and letter of our income tax treaty. We further related our views on this matter to our own treasury department, et cetera. The Canadian representative at a July 11, 2006 meeting promised a letter finalizing this case from their standpoint however to date we have received no such letter.

Is that not a matter of some concern to the department if our largest trading partner and the partner with respect to whom our tax convention is the most meaningful convention that we have with a foreign country, is concerned about positions inconsistent with the spirit and letter of the treaty and failure to respond when there has been a promise by a Canadian official to respond? Does that concern you?

Mr. Lalonde: I have read the letter. I would note that the letter is from the Internal Revenue Service of the U.S., which is the administrative branch. In the letter they indicate, as you pointed out, that from their administrative perspective they do not like it and that they are going to send these views to their own treasury department so they will be aware of it. Evidently, therefore, the U.S. Treasury Department, the policy end of the treasury was aware of it. They did not raise this issue at all during the negotiations leading up to the conclusion of the fifth protocol of the Canada-U.S. tax treaty, which leads me to believe that the policy people in the United States must recognize as well as we do the difficulties in dealing with non-resident trusts and have decided not to raise this issue with us because they did not.

Senator Goldstein: They do not have laws equivalent to the law you are proposing. They do not see it as a problem. I cannot understand why they do not see it as a problem, France does not see it as a problem, the United Kingdom does not see as a problem and we do.

Mr. Lalonde: With all due respect, your point was that an individual in the Internal Revenue Service has written this letter indicating that, from his perspective, he objects to the fact that the Canada Revenue Agency will not relinquish taxation rights on the basis of residence over a trust that is deemed resident in Canada as a result of these rules. Furthermore, he has indicated in his letter that he will let the policy people in the U.S. treasury department know about this. Evidently, he did. The policy people

in the U.S. treasury department did not raise this with us during the negotiations of the fifth protocol of the Canada-U.S. treaty.

Senator Goldstein: That was not my point, sir. My point was that, as far as I am aware, there is no civilized jurisdiction in the world that has laws as onerous as the one that is being proposed with respect to non-resident trusts. We are not the only country where citizens create trusts; we are not the only country where there are non-resident trusts that one seeks to tax. In the past, we have been taxing non-resident trusts under other provisions of the Income Tax Act. This proposed law is so much more onerous than anything in the western hemisphere, as far as I am aware, that it tends to make us stand out as being a bit trop gourmant, to use a French term; you understand it.

Mr. Lalonde: I will not agree or disagree whether this tax is more onerous than anything in the western hemisphere. Certainly, it is difficult enough to keep up with development in Canadian tax law and to try to keep my finger on what is happening in the U.S. without dealing with every country in the world.

I would reiterate, though, that the government of the day in 1999 felt that this was a serious problem that required a serious response. The government of the day in 2006 felt that this was a serious problem that required a serious response. We have this response here. We have received, as I have indicated, a couple of interesting submissions in the last couple of weeks in circumstances where do not really have the opportunity to deal with the legislation at that time.

The department -- and I can only speak for the department -- would not recommend that this legislation be sent for another go around through the House. It is important to get this legislation passed in order to protect the Canadian tax base. To the extent that other things can be considered in the lead up, for example, to the 2008 budget, as the submissions from the ICAC have indicated, certainly the government would be perfectly willing to consider those.

Senator Goldstein: You have been very candid. Thank you.

Senator Massicotte: Given that the foreign entity in this case or the other case will be treated differently or will be imposed to be deemed to be a Canadian taxpayer, I wonder if these fund managers or private equity managers, for example, will say, "I do not want any Canadians in my fund. This is too complicated." Therefore, pension funds, teachers, whatever, could be found to say, "You have diminished the vehicles of investment to Canadians to our detriment." Is that a possibility?

Mr. Lalonde: The foreign investment entity rules, as opposed to the non-resident trust rules, deal with the situation in a slightly different manner. They impute to the Canadian taxpayer, one way or another, a return on the investment in the foreign investment entity. The foreign investment entity itself should be neutral as between Canadian investors.

Senator Massicotte: Will they have to get involved? How about the trust issues? Does that imply any complication for these people that are either the trust rules or the other side? Does it complicate their life at all?

Mr. Lalonde: In the context of garden variety commercial trusts, where there are more than 150 investors and we have an exemption --

Senator Massicotte: Private equity is often not. Individuals put up a lot of money. It could be teachers or caisses des dépôts. Would it complicate their lives?

Mr. Lalonde: I agree that there is an issue with large pension funds. We have had that issue brought to our attention in the very recent past and, as I have indicated, the department is willing to look at that issue. Would it complicate the lives of large investors?

Senator Massicotte: The funds managers. For example, our chairman decides to invest $5 million in private equity and is left with 150. Would it be such that they will say, "Mr. Chairman, we do not want your money. This complicates our life. We do not want to be involved in the Canadian taxation system." Would that be the case?

Mr. Lalonde: That has certainly been the story -- not in a pejorative sense, but that message has been given to us in submissions from, as I mentioned earlier, a very large Canadian pension administrator whose name I am not at liberty to disclose now. That is one reason why we would consider looking into this.

Senator Massicotte: I think you should.

The Chair: The question is: Are you sympathetic?

Senator Massicotte: But not only large pension funds, it could be individuals with large sums, and so on. I think it is important that you pursue that.

Mr. Lalonde: We will, at the officials level. To respond to the chair, it is not up to me to be either sympathetic or not sympathetic. We will make our recommendations to the Minister of Finance.

Senator Massicotte: But you are sympathetic to that and appreciate the concern? It will be as positive recommendation?

Mr. Lalonde: I am open to making a recommendation to the minister, should he ask us about our willingness to look into this.

Senator Massicotte: That sounds like the Income Tax Act.

A comment made earlier that the existing act may be adequate. The GAR rules are applicable and many amendments have been made since 1999 with many tools available to you. Why has it not been tested if it is obvious that it is tax avoidance? I thought the GAR was adequate to go after those people. Have you attempted to go after those people and has it proven to unsuccessful, therefore the need for this very complicated act?

Mr. Lalonde: I understand that the GAR has been applied to a number of what is commonly referred to as Barbados spousal trusts. Those cases have not come to a close yet, but the real point here is that in the leadup to the 1999 budget, at a time when GAR was in place -- the coming into force for the GAR was September 13, 1988 -- the Canada Revenue Agency at that time was not in a position to deal with the issue. They were seeing retail level tax avoidance. It was an important issue to the government of day and to this government.

It was mentioned earlier that since that time, and in the last few years, successive governments have been in the business of reducing tax rates. I think we all believe that is a good thing. But it was also represented that that was a reason why we could abandon these rules, given that it would reduce the pressure on Canadians to offshore their income.

Senator Massicotte: What is the answer?

Mr. Lalonde: I have not finished.

Senator Massicotte: You are doing a good job of losing me.

Mr. Lalonde: The point there is that so long as there is a difference in the tax rate, even reduced, between that and zero, or whatever the rate is in the foreign country, there will always be an incentive, wherever the costs of entering into the transaction are less than the tax savings to be achieved by doing it.

Senator Massicotte: I think your answer, and I will repeat it, is that we do not think the existing laws are adequate to catch the significant tax avoidance we presume is going on. Is that the answer?

Mr. Lalonde: Without prejudicing any cases that are currently on the go in the application of GAR to particular transactions, in which the Canada Revenue Agency is firmly of the belief that they have a very good case in proceeding with those particular GAR submissions, the GAR is applied on a case-by-case basis following the very specific particulars of what went on.

Senator Massicotte: Subject to all that, the answer is yes?

Mr. Lalonde: Subject to all that, the answer is yes. We believe that the previously existing rules were inadequate to deal with the situation, and that is why the 1999 budget proposed them and why successive governments continue to apply them.

Senator Massicotte: We have significant professional groups, such as the Canadian Tax Foundation, and the CA association has a group involved with taxation and so on. I gather you have acknowledged they have been in contact with you relative to the problems with earlier drafts and earlier issues. Is it correct to say that, given they are not here, they now agree finally with what you are proposing?

Mr. Lalonde: I would love to say yes. The fact of the matter is that organizations such as the Joint Committee of the Canadian Institute of Chartered Accountant and the Canadian Bar Association have made a number of representations to us. We have accommodated some, not all, of their representations. Similarly, with other organizations such as the Tax Executives Institute, we have accommodated some but not all of their representations. Clearly, as the department responsible for creating tax policy and ensuring that the Government of Canada manages to obtain the revenues that it needs, our perspective may be different from that of others. I would not put words in their mouth to say they are agreeable. I would say that they must be in a position where they do not feel that it is to their advantage to come and make representations to the committee.

Senator Massicotte: It is not to suggest you people are not open. It is not to suggest they are frustrated and giving up on complaining their position.

Mr. Lalonde: If you knew the individuals in those particular groups, they do not give up easily.

Senator Massicotte: Thank you.

The Chair: Thank you. I am watching the clock. It has gone past when we should have been out of here. This is a very complicated situation. We want everyone to have an opportunity. Senators, I hope none of you will leave, because I have a brief in camera matter to deal with afterwards. Perhaps the witnesses from STEP or Mr. Gagnon would care to make a comment.

Mr. Lebreux: I want to make two quick comments. First, with respect to what may be just slightly misleading in some of the comments made, there was an issue with respect to the new legislation being required because it is possible that at some point a Canadian could become a beneficiary of a trust and receive a benefit. That already exists in the current legislation. The way the legislation currently is designed, if any Canadian can receive a benefit, whether on the deed or not, at any time, that trust is captured in Canada and taxed here. That is a very broad amendment that came in in 1998.

My second point is a comment that I think I should put on the record from the STEP perspective. In my capacity as chair of the technical committee, which was the committee that put in a majority of these submissions, we did put in a number of submissions to Finance, but I would like to say we have worked very closely with Finance and have had a very good relationship with them and hopefully will continue to. A number of those submissions were acted upon. A number of changes were made which we were happy to see. Part of the challenge with legislation spanning eight years and a number of iterations is that obviously not all of our submissions were addressed, which does happen, but others of our submissions that were addressed adequately and changed we now see have gone back to older versions and have put us back in the same boat. That may be an reason why we do not see as many representation here today, because a number of these have already been made. I just would like to add from STEP's point of view that the relationship we have had has been very strong.

To follow the analogy of the party, we felt we were in the middle of a party and having a good time with Finance working through the legislation, only to be advised that the party was now over. I think that is what has caused our concern that we are halfway through a process. From a STEP perspective, we make our lives dealing with trusts and clients, and we are extremely strong proponents of ensuring that trusts are not used for ill purposes. We believe there are a number of ways that not only can

Canada's tax base be protected, but far better ways to protect the Canada tax base that do not have these same implications.

Senator Goldstein: If you were called upon to draft one page of amendments, do you think that one page would capture, from your perspective, the most egregious problems?

Mr. Lebreux: From a non-resident trust point of view, we could. I believe that the foreign investment rules are extremely complex and cause problems, but for the non-resident trusts, I believe we could.

The Chair: Have you already done so?

Mr. Lebreux: We have put in a number of submissions with specific drafting.

The Chair: Is it in the material that you submitted? If you have something like that, it would be useful. You have been here for several hours now and understand what is happening.

Mr. Gagnon: To go to Senator Goldstein's point, you already have in my submissions two precise amendments.

I would like to comment on the position in respect of trusts established in high tax jurisdictions. I have not heard anything from the Department of Finance to justify taxing those trusts. In my mind, they just did the ultimate bootstrap. They decided these trusts were deemed resident in Canada and therefore they should be taxed, but we have not heard anything today that explains why trusts in high tax countries should be taxed. If the concern is that trusts in high tax countries may not be paying the high tax in the high tax country, then why not just make it a condition that the tax be paid in the high tax country? If you make it a condition, which could be a very easy to draft, then in my mind all the justification or fear or all what we have heard just goes away. There is nothing left. There is no more justification whatsoever for putting forward legislation that taxes trusts in all jurisdictions irrespective.

To go back to square one, this was a measure for tax havens, and now they are trying to justify why they should give a better foreign tax credit in countries where tax is above 15 per cent. If you go back to square one, this was a measure for tax havens and it should have remained so.

The other point I would like to make, and I will be brief, is that in order to qualify under most tax regimes, including the U.S. one, the foreign trusts needs to be liable to tax in the foreign country. It is already a condition in the treaties, so I would think the fear is not even there.

Finally, under our treaty with the U.S., to the extent that the income of the trust is distributed to a U.S. beneficiary, Canada, under article 22(2), has already given up the right to tax the income. What we have heard today is not even what is under the treaty right now. If we have already given up the right to tax to the extent that the income is distributed to a U.S. beneficiary, to the extent that the trust is for U.S. beneficiaries, then why could not the trust accumulate the income for those beneficiaries for bone fide reasons? The analysis does not hold.

The Chair: That is very helpful. We have taken that on board.

Mr. MacKnight: First, addressing Senator Massicotte's question about the joint committee. I can assure you that the joint committee has not given up and does not agree with the proposed legislation.

Senator Massicotte: I understood that.

Mr. MacKnight: Second, addressing Senator Goldstein's comment about the tax policy, it brings to mind a comment from Bob Brown many years ago. He was the chair of Price Waterhouse for many years and was a frequent adviser to the Department of Finance.

The Chair: He was a witness, too, even during my 15 years here.

Mr. MacKnight: His famous comment was a tax system has to be built like a wooden ship; it has to expand and contract depending on the weather and if you try to make it watertight, it will sink.

The comments that we have advanced about these rules on the FIEs and NRTs are trying to make the system watertight; and that makes it unwieldy, cumbersome and subject to sinking.

The Chair: Unseaworthy.

Mr. MacKnight: Absolutely, so I think we do need to take a closer look. Finally, with all due respect to our colleagues at the Department of Finance – and we know they giving their best efforts to implement the undertakings that they give to taxpayers,

both in writing and in fora such as this – they have admitted this afternoon that there are issues in this legislation. We have pointed out a number of other issues with which we obviously have genuine disagreements. In any event, why would you pass legislation knowing that there are issues outstanding that have to be addressed – and that the department has admitted it is taking under consideration?

Again, coming back to our recommendation, we think you should excise the FIE and NRT components of this legislation, refer it to the expert committee and then pass the balance of the legislation which, as the parliamentary secretary said, contains a number of very important proposals.

Mr. Lalonde: We did indicate on a number of occasions why it is that we would seek to tax U.S. trusts, so I am not sure about the first comment.

With respect to the second comment that all would be happy if we put in a rule that said this is not going to apply if the trust actually does pay tax at a level comparable to that in Canada, that, in effect, is the result of offering the foreign tax credit.

Finally, with respect to the comment that why would you pass legislation when the department has indicated they know of a couple of issues that have come up, first, these issues have come up late in the game, certainly in a formal basis in any event.

Second, we do not necessarily agree with one of the issues as to whether there absolutely is a problem with the 15 per cent limit on the creditability of tax on income from property. We have not heard anyone yet complaining there is any tax payable in a trust that exceeds that threshold. I have indicated we also have the provision in the Canada-U.S. treaty that can deal with that.

With respect to the large pension funds, I indicated we are certainly willing to look into that. Indeed, the pension funds themselves – or at least the ICAP – has indicated in the pre-budget submission that they recommend that the Minister of Finance look at that in the context of the 2008 budget.

Why would someone pass this legislation now? It depends on whether you are taking the view of the industry that uses the existing rules to the largest extent possible, or whether you are from the perspective of a government that is trying to design a system to prevent tax avoidance. Every time this legislation takes another iteration and another delay in its coming into force, we see additional avoidance.

This is an important measure. It is not one, in our view, that you should side stream because there is an issue that even the representative has indicated is something we should look at in the context of the next budget.

The Chair: Thank you very much. I would like to say to all of you, thank you for coming. On a subject this complicated, we have had a very constructive discussion and give and take. Everyone has had their chance, I think, to say what they want to say.

I would like to thank my colleagues on the committee also for their focus. We are all experiencing a difficult time here on the Hill. It is almost 7 p.m. and everyone is awake and focused, so I am very happy.

In closing on that subject, you may be assured we will give these matters our most serious consideration. You are all welcome to be here tomorrow morning. I know the department monitors all our hearings; but Mr. Lalonde, I want to particularly single you out for your tremendous work. I know you are exhausted. You have been very responsive and did a very good job and tomorrow you will probably want to be here.

If you do not want to, I would like to nudge you to be here because it is quite possible some new issues or other issues will come up, especially if we get to whether or not to do certain things in the clause-by-clause consideration. We will give you an opportunity to speak. I know your people might be here too. It is up to you.

The committee continued in camera.