S T E P

Society of Trust and Estate Practitioners

To: Senate Committee on Banking, Trade and Commerce

Re: Bill C-10, An Act to amend the *Income Tax Act*, including amendments in relation to foreign investment entities and non-resident trusts

Date: December 12, 2007

The Society of Trust and Estate Practitioners (STEP) is a professional organization whose members include lawyers, accountants, financial advisors, and trust professionals involved in trust and estate planning matters. In Canada, STEP has approximately 1,900 members, and worldwide, STEP has over 12,000 members in more than 30 countries. Our Canadian STEP members advise Canadian and international clients on domestic and international trust and estate planning and related financial matters, including tax planning and compliance.

Although this is our first appearance before this committee, STEP (as well as other professional organizations) has made several submissions to the Department of Finance and senior parliamentarians on the foreign investment entity ("FIE") and non-resident trust ("NRT") rules since they were first announced in February, 1999. However, our fundamental concerns have not been addressed.

Summary of Concerns: In our view, the current draft legislation suffers from at least five fundamental problems:

1. **It is incapable of compliance**. The rules are complex and virtually incomprehensible even by expert practitioners. It is likely that there will be wholesale inadvertent non-compliance with these rules by average taxpayers and tax practitioners, who will assume that the publicly traded investments and

mutual funds will not be affected by these rules. We cannot allow our tax system, which is based on voluntary compliance, to become infected with rules which are incapable of compliance or enforcement.

2. **It has retroactive effect**. 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 for taxation years beginning after 2006. 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 taxpayers are 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 to compliance.

3. **There is potential for multiple and over taxation**. A basic premise of our tax system is that income should be taxed once, at a time when income or gain has been realized and the taxpayer has the ability to pay the tax. The Income Tax Act contains anti-avoidance rules to support this basic premise. However, the proposed FIE and NRT rules result in artificial and premature inclusion of income and gain, potential for over-taxation of investment income and unwarranted double taxation.

4. **The proposed rules may abrogate Canada's obligations under international tax treaties**. These rules contemplate Canadian taxation of foreign source income paid to non-residents of Canada. It purports to impose tax collection and reporting obligations on non-resident trustees which may be unenforceable.

5. **The excessive delay in developing these rules from the date the concept was announced reflects the number and severity of the issues it raises**. These rules were announced in the budget of February 1999. This Bill is the seventh version of legislation relating to FIEs and NRTs (each generating considerable controversy and requiring considerable change after comments from professional organizations), and the effective date of the legislation has been delayed four times. The fact that these proposed rules have been in development for eight years, and are still not clear, fair or administrable, reflects the multiple flaws and challenges their viability.

Recommendation: On November 30, 2007 the Minister of Finance announced the formation of an expert committee to study the fairness and competitiveness of Canada's system of international tax rules. In our view, the proposed legislation relating to FIEs and NRTs has serious deficiencies, and lacks a conceptual framework which is comprehensible, fair and administrable. The proposed rules are both unfair and out of step with international norms for the taxation of income earned outside the jurisdiction seeking to tax it. We recommend that this committee refer this proposed legislation to the expert committee for its consideration as part of an overall review of Canada's international tax rules.

Background to the Proposed Legislation

The legislation originated in the Federal Budget of February 1999, which stated that the Canadian tax base was being eroded by the extensive use of offshore vehicles by Canadian resident persons. To our knowledge, no hard evidence has ever been presented to substantiate this claim, and while it may be true that Canadians have made extensive use of offshore vehicles, this does not necessarily mean they have not reported their tax affairs in compliance with Canadian law.

Since the introduction of the initiative, the legislation has been delayed four times, from 2000 to 2001, from 2001 to 2002, and from 2002 to 2003, and finally from 2003 to 2007. The legislation is still not final, and it has now been over eight years since the conceptual framework for the legislation was announced. Such delays lead one to question the basic premises and viability of the legislation itself.

FIE Rules

We believe that since Canadians are free to invest as they see fit domestically or internationally, they should pay the same tax on such income, regardless of whether it is earned in Canada or elsewhere. Income of like character should be taxed the same way, regardless of where it is earned.

This means that Canadians should pay tax on income earned outside Canada in the same way as if it were earned in Canada. The income should be taxed when earned,(or for capital gains, when realized) and the tax should not be unduly deferred. Similarly, Canadians should not expect to pay tax prematurely, nor to pay a higher rate of tax, or

incur double taxation, with respect to international income.

Unfortunately, the FIE rules as currently drafted give rise to all of these possibilities. In certain cases, the rules permit an undue tax deferral because of exceptions built into the rules. More importantly, the use of the mark-to-market method may result in approximately twice the amount of tax that would result had the investment been made through a Canadian vehicle. Moreover, the "designated cost" method of reporting income from an FIE may result in an artificial and premature income inclusion when no income has in fact been earned. Lastly, because of the way in which capital gains are treated under the FIE rules, and because of the inappropriate relief given to foreign taxes, unwarranted double taxation can result.

Under the current draft legislation, Canadians will find that many of their investments in non-tax motivated arrangements, such as foreign mutual funds, will be subject to the FIE rules, simply because it is common for a corporate structure or a trust to be the underlying entity in a mutual fund, which attracts these rules.

Canadian individual taxpayers, and their professional advisors, are currently ill equipped to deal with the complexities of the FIE legislation. Even seasoned tax practitioners who specialize in international taxation have difficulty with the rules, because of their enormous complexity (for instance, the rules contain three alternate methods of calculating income). It is likely that the level of compliance with these new rules will be extremely poor, since they will catch large numbers of taxpayers, many of whom may be of modest income means and who have small investments in mutual funds. Similarly, the rules catch insurance policies issued by non-Canadian insurers, and it is doubtful that most taxpayers will have sufficient information to comply with the rules, even if they were aware of what the rules required. It is unrealistic to expect that the Canada Revenue Agency will be able to enforce these rules in these situations.

The conceptual framework of the rules is, in our view, fundamentally flawed because of the enormous complexity of the rules, and the fact that three methods of income computation are available, none of which is entirely satisfactory. A different conceptual framework needs to be developed, which will be simple and understandable, if widespread compliance with the rules is to be expected and if the stated policy objectives are to be attained.

The non-resident trust rules contain two very significant difficulties, which require correction.

First, a Canadian who contributes property to a non-resident trust may be liable for the taxes of the non-resident trust, even though the person may have no interest in the trust, have no ability to exercise control over the trust, and have no ongoing relationship with the trust, the trustees, the trust property or the beneficiaries. This joint and several tax liability rule, in our view, violates the principles of natural and fundamental justice, in that a person may be liable for the tax liability of another in an undetermined and unlimited amount, without any remedy to obtain compensation from the trust. Furthermore, the legislation has very broad rules concerning persons who make contributions, such that Canadian corporations which issue shares to non-resident trusts may, for example, be liable for the tax liability of such trusts, even if the shares are issued for fair market value, and the corporation is otherwise unrelated to the trust, its settlor, the trustees, and/or its beneficiaries.

Second, non-resident persons earning foreign income through a non-resident trust established by a Canadian person may now be subject to Canadian tax. Canadian residents are subject to Canadian tax on worldwide income. Non-residents are subject to Canadian tax on Canadian source income, but not on foreign source income. If a Canadian person establishes an international trust for the benefit of, for example, children who reside in a foreign country, and if that trust subsequently earns non-Canadian source income, there is no reason why Canadian tax should be paid on this income if the income is paid to a non-resident. In such a case, there is no concern with a Canadian resident obtaining the income. In fact, previous versions of the legislation stated this as a fundamental principle. However, in the October 30, 2003 version of the legislation this was changed, although certain other aspects of the legislation and the accompanying explanatory notes were clearly inconsistent with this new policy. Furthermore, it was indicated that no policy changes were contained in the revised draft of the legislation, and yet this is surely a fundamental shift in policy.

The manner in which Canada taxes non-resident trusts is unusual in the world of international tax, although not unique. By extending this taxation to include foreign income paid to non-residents of Canada, it is quite possible that Canada is overstepping its jurisdiction to tax on an international level. It is possible that this may violate Canada's international tax treaties and, more fundamentally, the Vienna Convention on international tax treaties to which Canada is a signatory. Rather than extending Canada's tax base to

cover appropriate situations where erosion could otherwise occur, this in fact weakens Canada's ability to tax by opening the door for international criticism, and possibly a legal challenge as to jurisdiction.

We again suggest that the conceptual framework be reviewed, and these errors corrected, so that the system ultimately implemented will be equitable and administrable. Such a system would allow Canadians to utilize international trusts but ensure that income which is undistributed or which is distributed to Canadians will be subject to an appropriate level of Canadian tax.