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• (1215)

[*English*]

The Chair (Mr. Massimo Pacetti (Saint-Léonard—Saint-Michel, Lib.)): Good afternoon, Mr. Farber and Mr. Ernewein. We're here for a study on the fiscal conventions—or is it the tax treaties—between Canada and Barbados. I understand you have an opening statement. If you could keep it to five or ten minutes it would be helpful, and then we'll have the members ask questions.

I know we are over in our time; it's not necessarily our fault. But how long can we go? Could we go to about 1:30 p.m.?

Mr. Len Farber (General Director, Tax Policy Branch, Department of Finance): I think, Mr. Chairman, that would be up to you. We'll certainly make ourselves available.

The Chair: Okay, thank you. So 1:30 p.m. is fine. I appreciate it.

Mr. Len Farber: I appreciate the opportunity to appear before the committee today to discuss the Canada-Barbados income tax agreement. While we're not certain of the specific issues the committee is seeking to address, I'll make some brief opening comments with a view to providing the committee with some background information regarding Canada's relationship with Barbados and the rationale for having a treaty with that country. We'll then be pleased to take any questions. My colleague, Mr. Ernewein, who is the director of the tax legislation division and also has charge of the treaty negotiation section, including some members of his negotiating team who are here with us, will be more than happy to take whatever questions the committee has.

Canada has had a long-standing relationship with Barbados. In fact, Barbados is one of Canada's oldest tax treaty partners. While Canada's existing tax treaty with Barbados was signed in 1980, Canada had agreed with the United Kingdom in 1951 to extend the 1946 Canada-U.K. income tax agreement to cover certain British colonies, including Barbados.

Barbados was the first eastern Caribbean island to achieve self-government in 1961 and the first to achieve independence in 1966. Barbados is also leading the Caribbean community efforts toward implementation of the Caribbean single market and economy. Barbados is a strong advocate regarding the accommodation of small-state issues within the process of the free trade agreement of the Americas and the World Trade Organization negotiations.

Canada and Barbados enjoy close working relations bilaterally and through the Commonwealth, the UN, and the OAS. Furthermore, Canada represents Barbados at the IMF. On the trade side, Canadian exports totalled $49 million in 2004, while Canadian imports totalled $7.8 million. Barbados benefits from the CARIBCAN, Canada's preferential trade agreement introduced in 1986, under which 97% of Commonwealth Caribbean exports to Canada enter duty free. In addition to a double taxation agreement, Barbados has a social security agreement and a foreign investment protection agreement with Canada.

As committee members will know, Barbados is sometimes depicted, whether it's in the press or in the AG report, as having attributes associated with a tax haven, and in particular that happens when it is focused on Barbados' special rules for what they call international business corporations, IBCs. That characterization, quite frankly, is somewhat unfair in that context. Barbados has a comprehensive tax system with personal and corporate tax rates generally equal to or greater than those in Canada.

Barbados IBCs, however, do enjoy certain tax privileges in that they generally pay a low rate of Barbados tax in comparison to other Barbados corporations. However, one must keep in mind that as sovereign nations, most developing and developed countries alike provide within their respective tax systems various incentive regimes to meet particular fiscal and economic objectives. Barbados is not unique in that regard. In fact, Canada's tax system provides many such tax incentive regimes, including lower corporate tax rates for small Canadian-owned businesses and some of the most generous research and development tax credits in the world.

While such incentive regimes are an integral component of most countries' tax systems, they are of particular importance to developing countries seeking to attract foreign investment and modernize their economies. The existence of a long-standing cooperative relationship between Canada and Barbados, coupled with significant cross-border trade and investment as well as a comprehensive tax system in Barbados, were key factors in Canada's decision to enter into an agreement directly with Barbados subsequent to the updating of Canada's 1946 agreement with the U.K. Canada was not alone in deciding in this manner, as other countries, such as the U.S., the U.K., Finland, Norway, and Sweden also have tax treaties with Barbados.

The provisions of the Canada-Barbados agreement are also not significantly different from those found in the treaties that Barbados has with those other countries. They are all based for the most part on the OECD model tax convention. These facts speak to the continued case for having a tax treaty with Barbados. Tax treaties are the principal tool utilized by countries throughout the world to eliminate tax barriers to trade and investment. They do so by providing greater certainty to taxpayers regarding their potential liability to tax in the foreign jurisdiction, by allocating taxing rights between the two jurisdictions so that the taxpayer is not subject to double taxation, by reducing the risk of excessive taxation that may arise because of high gross bases withholding tax, and by ensuring that taxpayers will not be subject to discriminatory taxation in the foreign jurisdiction.

● (1220)

As tax treaties also have as their purpose the prevention of fiscal evasion, a key element of Canada's tax treaties is the article addressing the exchange of information between the tax authorities. In this regard it should be noted that Barbados prides itself on its transparency, its adherence to the rule of law, its strict financial regulations and controls, and its sharing of information with international partners such as Canada under the Canada-Barbados double taxation agreement, all very essential elements of what the tax treaty relationship with Barbados is all about.

I mentioned earlier that Barbados is not, despite the way it's sometimes portrayed, a tax haven. This view is shared by the OECD. The OECD has explicitly concluded that Barbados is not among the jurisdictions where there are concerns about transparency and information sharing. Although it has recommended that its member countries not have tax treaties with a number of jurisdictions—those that are in fact tax havens—the OECD has not raised any concerns about having treaties with Barbados or about the operation of the exchange of information rules found in treaties with Barbados. Consistent with the OECD's conclusions, our own experience is that Barbados is a good partner when it comes to sharing tax-related information under the treaty. This is information that the Canadian revenue authorities need to enforce Canadian laws, and the absence of a tax treaty with Barbados would prevent us from obtaining it.

One important question that arises is whether use of the Canada-Barbados tax treaty can affect the amount of Canadian tax that Canadian businesses pay on their foreign income. The answer is clearly yes, it can, but this is not a peculiar feature of the treaty. Rather, Canada has a system for taxation of foreign-source business income that links the Canadian tax treatment of that income to the existence of a tax treaty with the country where the income is earned. This exempt surplus system is not the only choice that could have been made back when the exempt surplus system was introduced. Many other countries, for example, simply exempt all foreign-source business income from tax without regard to the existence of a treaty or anything else. The Canadian approach ensures that where an exemption is claimed, Canada can generally get from the other country information about the Canadian taxpayer and so can do a better job of enforcing Canadian tax laws.

What about outright tax avoidance and so-called treaty shopping provisions? The media has certainly focused some of its attention on schemes that have attempted to utilize the treaty to avoid paying tax. The Auditor General as well has reported in the past that some have tried, for example, to incorporate the Canada-Barbados tax treaty into complicated schemes designed to avoid Canada's capital gains tax. The Canada Customs and Revenue Agency has dealt decisively with these schemes, just as it would if any other treaty were being abused. Millions of dollars of tax have been assessed.

In conclusion, Mr. Chairman, the Canada-Barbados tax treaty serves the interest of Canadian business, assists the Canadian tax administration, and is a key part of Canada's long-standing cooperative relationship with Barbados. As all of Canada's tax treaties do, it interacts with a system that Parliament has chosen for the tax treatment of foreign-source income. That choice can always be revisited, but it is in no sense unique to Barbados. Attempted abuses of this treaty are dealt with in the same way as abuses of any of the more than 80 other tax treaties Canada has signed.

My colleague, Mr. Brian Ernewein, who I indicated earlier has responsibility for this section, is here with me. We would be very pleased to answer any questions that committee members have.

The Chair: Thank you, Mr. Farber.

Mr. Pallister, go ahead, please.

Mr. Brian Pallister (Portage—Lisgar, CPC): Thanks, Mr. Chairman.

Thank you, Mr. Farber, for your presentation.

Regardless of the definition of tax haven that you might choose to apply, I would hope you'd agree it seems pretty clear that there's some sweet deal going on with regard to the Barbados situation as reflected by the amount of outflow of capital from Canadian companies to the Barbados. We had some numbers presented to us earlier that said in 1994 the amount from the Barbados was about $3.5 billion, and last year.... Do you know how much it was, sir?

Mr. Brian Ernewein (Director, Tax Legislation Division, Tax Policy Branch, Department of Finance): I'm guessing you're referring to the—

Mr. Brian Pallister: Foreign direct investment flows.

Mr. Brian Ernewein: That's right.

The total was.... I'm sorry, just a moment please.

Mr. Len Farber: While Mr. Ernewein is looking up that particular number, to answer your question, what's important, if I may say so, is a context as well. While the numbers are quite large for Canadian investment in offshore financial centres—and it's about 21% of total direct investment—it's also interesting that this proportion is very similar to the proportions we see in the United States and the United Kingdom. In the U.S. there is 24% total direct investment. In the United Kingdom it's 21%.

● (1225)

Mr. Brian Pallister: It's clear that we have a pretty strong and long-standing trading relationship with those two countries. But it's my understanding that foreign direct investment to Barbados now surpasses the gross domestic product of the country by a factor of six. So it's pretty clear that...let's cut to the chase. People don't pay as much tax in Barbados, so they suck the money out of the Canadian economy and put it down there. Isn't that a fact? Isn't it an advantageous transaction for Canadian companies to do? I think it's pretty clear Canadian companies think so and also foreign companies that choose to locate here.

You talked about complicated schemes. I want to outline a process and then you tell me if you see it as either a scheme or complicated. It's double-dip financing. My understanding is a multinational company based in Canada—like CSL or any other—can take money out of our country by borrowing it and transfer it to a U.S. corporation. The U.S. corporation can then give it to their Barbados affiliate by way of a loan. The U.S. affiliate can deduct the interest it pays to the Barbados affiliate, and the Canadian transfer is also tax deductible. So in effect you have a double deduction for money that is then transferred to Barbados, where tax rates are virtually nil on that money. Following those transactions, the money can then be transferred back to Canada by way of a tax-free dividend.

That may strike some people as complex, but it seems pretty straightforward to me. Is that the gist of how transactions can work and how capital can flow?

Mr. Brian Ernewein: First of all, let me apologize for my hesitation before. I was just trying to confirm the number of $24.7 billion from the Library of Parliament report. I was aware of the total figure they had cited, but I wasn't aware of the Barbados number. The number you gave seems to conform with what the—

Mr. Brian Pallister: That's a sixteenfold increase over about 14 years.

Mr. Brian Ernewein: Yes, as Mr. Farber indicated that's consistent with what we've got in the U.S. and U.K. experience—

Mr. Brian Pallister: But that's totally inconsistent with any other jurisdictions you're aware of.

Mr. Brian Ernewein: I don't know about other jurisdictions, but as far as the U.S. and the U.K. are concerned, the total number—

Mr. Brian Pallister: It's much higher than any other jurisdictions you're aware of. Is that not true?

Mr. Brian Ernewein: No. It's entirely consistent with what other jurisdictions—

Mr. Brian Pallister: You said the U.S. and the U.K., but you didn't say any others.

The Chair: Mr. Pallister, let him finish.

Hon. Maria Minna (Beaches—East York, Lib.): Let him answer you.

Mr. Brian Pallister: Maria, if you want to be chair, please take over.

Hon. Maria Minna: You interrupted him, so I think you must—

Mr. Brian Ernewein: I'm sorry. It was a modest point. I was just saying that of the countries of which I'm aware, the U.S. and the U.K.—which I would have picked—are fairly important examples. Canada's representative share of foreign investment in Barbados and offshore centres seems to be consistent with those two countries.

Mr. Brian Pallister: For clarity then, are you suggesting that the foreign direct investment from Canada to the Barbados has not grown exponentially and much faster than the rate of foreign direct investment made out of Canada into the United States and the U.K.? Is that what you're suggesting?

Mr. Brian Ernewein: Foreign investment has grown across the board. I don't think it's exponential, but it has grown at a faster pace than in Barbados and the other countries.

Mr. Brian Pallister: I just described for you a mechanism for deducting interest from Canadian income and transferring the money to the U.S. Clearly your point supports my own.

You're citing increases in direct foreign investment that would be necessary statistically in order to achieve the double deductibility I talked about earlier. Is that right?

Mr. Brian Ernewein: I'm pleased to discuss that. I did want to provide an answer to your first question.

Mr. Brian Pallister: Of course, but I wouldn't want a false impression created that because investment was going up in the U.S. and the U.K., somehow there wasn't a tax advantage to be gained. That seemed to be the impression that might have been created by your comments.

Mr. Brian Ernewein: No. I just wanted to report the facts.

With respect to the transaction you described, I understand it is possible and is sometimes done. A Canadian company would seek to invest in the U.S. through Barbados, for example. In that example, a company capitalized in Barbados that loaned that money into the U.S. would be able to reduce its U.S. tax by claiming an interest deduction on the amount paid back from the U.S. to Barbados. So that represents a U.S. tax saving.

The income could be brought back into Canada and we would not impose further tax, assuming the U.S. firm was related to the Barbados and Canadian firms.

● (1230)

Mr. Brian Pallister: Naturally this committee is at least as concerned with the degree of effect it might have on Canadian taxes. Is it not true that at the outset, the money deducted from the Canadian-located corporation would also be tax deductible?

Mr. Brian Ernewein: If borrowed money were used to capitalize the intermediate company, in our example in Barbados, a deduction would generally be available in Canada for that.

Mr. Brian Pallister: The Mintz report did an estimate in their technical committee on business taxation in 1994, and they estimated a tax loss, a revenue loss, of $3.5 billion to Canada. Do you concur with that observation? Do you have any numbers that contradict those numbers?

Mr. Brian Ernewein: I can't speak to that. I don't know whether I concur or not. I haven't looked at the thing for a great length of time.

Mr. Brian Pallister: You have read the technical committee report, the Mintz report, and you're aware of these assertions.

Mr. Brian Ernewein: Yes, but it's been several years since I read it.

Mr. Brian Pallister: That's okay. If the Mintz committee is approximately accurate, we have a concern. The report was done at a time when foreign direct investment might have been one-tenth as much as it is today. In 1994, by their numbers, there was a loss of $3.5 billion in tax revenue. Does your department have some concerns that we're losing tax revenue as a consequence of the interest deductibility of money and the use of the schemes, or rules, that exist today? Have you done some studies that would demonstrate the degree to which this is eroding the Canadian tax base? This could be creating greater taxation responsibilities for others in our society, as opposed to the companies that use these rules.

Mr. Brian Ernewein: I'm not in a position to answer the question about the revenue estimates. I want to make it clear that I'm not affirming or contesting that.

With respect to the decomposition of the transaction we've been talking about, you can have an interest deduction in Canada if foreign funds were used to capitalize the intermediate company. In our example, we show an interest deduction in the United States.

The first question was whether we have any concern with the interest deduction being claimed in the United States. Many would say that we ought not to be concerned about that.

Mr. Brian Pallister: That wasn't my question.

Mr. Brian Ernewein: No, but I want to provide a comprehensive response. With respect to the interest deduction claimed in Canada, the question is what would happen in the absence of this sort of structure. Would they borrow in Canada anyway to lend to the U.S. or to capitalize the U.S. company? If they borrowed in Canada just to capitalize the U.S. company, as an alternative to the transaction we've been talking about, there would still be an interest deduction in Canada and the U.S. would pick up more tax revenue. The question, as a policy matter, is whether this is in our interest.

Finally, if the alternative is that they would have borrowed money in Canada, and we think it's not appropriate to allow that interest deduction for investment in foreign subsidiaries, there's the policy question having to do with the competitiveness of Canadian firms. It's reasonable to discuss whether you want to impose limits on the interest deduction in those circumstances. There's a question of how it might be done.

The Mintz committee, as I recall, spoke to this issue and suggested that one might consider such limits. This would involve a tracing mechanism that would keep the interest on funds used to capitalize foreign subsidiaries from being deductible in Canada. This approach would have its merits and demerits. One technical demerit of it, in addition to the concern about competitiveness, is that a tracing approach can lead to enforcement problems. You could end up with a situation in which companies dam up cash from operations in Canada to make sure the free funds are the ones used to capitalize offshore. They would then borrow money for direct Canadian purposes. They're always supporting or arranging their operations through this so-called cash damming to make sure they are not subject to the interest limits.

As a counter to that, some have suggested a consolidation method. I believe the U.S. uses this approach to some degree. With this method, it doesn't matter where the actual money is being used; we look at the overall operation, take a portion of it, compare its debt to its overall assets, and deny interest deductions for assets invested in a foreign subsidiary. This avoids the cash damming issue, but it creates other issues.

Say a Canadian firm has $1 billion invested in Canada and $1 billion invested offshore. For the sake of this example, I'll assume there's no debt. The Canadian company decides it wants to spend another $1 billion to increase its investment in Canada, so it borrows $1 billion to do this. One of the effects of consolidation is that the company wouldn't get a full interest deduction on borrowing used exclusively for Canada. Under the formula approach, one-third of the assets, $1 billion out of the $3 billion total assets, would be foreign. So the system would deny the deduction on one-third of the interest expense, even though all of this borrowed money was used for Canadian purposes.

I apologize for the length of my response, but it is reasonable to consider whether or not limits on interest deductibility are appropriate. There is also a higher-level question about the effect this has on the competitiveness of Canadian firms, as well as a more technical issue of how to go about it if you were to decide you wanted to do it irrespective of competitiveness concerns.

● (1235)

The Chair: Thank you, Mr. Ernewein.

M. Côté, and then Mr. Bell.

[*Translation*]

Mr. Guy Côté (Portneuf—Jacques-Cartier, BQ): Thank you very much, Mr. Chairman.

Thank you for your presentations.

There has been a lot of talk about the level of investment by Canadian businesses in Barbados. As we speak, how many companies have an affiliate in Barbados?

[*English*]

Mr. Len Farber: I'm sorry, Mr. Chairman, we don't have a specific number for how many Canadian multinationals have affiliates in Barbados.

[*Translation*]

Mr. Guy Côté: That is no problem, I was just wondering.

If I understand correctly, until the mid 1990s, the Income Tax Act mentioned a certain number of countries where companies could have an affiliate and repatriate profits tax-free. Following criticism by the Auditor General of the day, those provisions of the Income Tax Act were repealed, and the tax treaty between Canada and Barbados took on new-found importance.

Is my analysis accurate?

[*English*]

Mr. Len Farber: Mr. Chairman, I don't believe the member is either right or wrong in thinking that. At that point in time, we had a different system for the way we dealt with countries that were able to repatriate exempt surplus or dividends on a tax-free basis.

Prior to that point in time we had a list of countries, and that list included countries we had double taxation agreements with, some countries we were in the process of negotiating treaties with but hadn't ratified, and other countries that for whatever reason got on the list because of political imperatives, to entice them into some level of discussion.

At the point in time you're talking about, those regulations were changed to remove the list and only deal with countries with which we had a tax treaty. There were some modifications with regard to those listed countries. We introduced a residency test with regard to whether they're resident for treaty purposes as well as a resident under our own Canadian domestic tax law. Whether that in itself would have created an environment to make Barbados more relevant is conjecture. Certainly, with regard to some countries that had been on the list before—there's a list of countries that were on the list, and I have them here—countries like Liberia, for example.... But in that context, it's quite possible some countries sought other locations in order to set up operations.

● (1240)

[*Translation*]

Mr. Guy Côté: The tax treaty contains conditions on companies repatriating tax-exempt profits. What are the conditions a company has to meet in order to take advantage of this tax benefit?

[*English*]

Mr. Brian Ernewein: The conditions are essentially that the profits have to be from an active business, and there's a definition of that term in our foreign affiliate rules. The income has to be generated by a company that is resident in a treaty jurisdiction. If those conditions are met, the income won't be subject to current tax by Canada but will be subject to tax in the treaty country. Distributions of that income to Canada, whenever that may occur, would be exempt or tax-free. That's known as the exempt surplus regime.

[*Translation*]

Mr. Guy Côté: All right.

Is it true that under the treaty, companies that already enjoy enhanced status in the Barbados are excluded from repatriating their profits tax-free, that they must not already enjoy special tax treatment in Barbados? Is that true?

[*English*]

Mr. Brian Ernewein: No, I don't believe so. The requirement for the exempt surplus treatment, as I say, under the Barbados treaty and under our other treaties is that you be a resident of that country. I think you're speaking of international business corporations, for instance. If you're an international business corporation that is resident in that country, there is a rule under the treaty saying that IBC itself is not entitled to treaty benefits, but in terms of its profits being distributed back to Canada, those profits being distributed back to Canada would qualify for the same treatment as profits distributed by another Barbados firm back to its Canadian parent or by another company in another treaty country back to its Canadian parent.

[*Translation*]

Mr. Guy Côté: But is it not true that what you were just talking about is not in the tax treaty between Canada and Barbados, it is in the Income Tax Regulations? It is not in the tax treaty.

[*English*]

Mr. Brian Ernewein: The tax treaty with Barbados—and this is not true of all of our treaties—like most of our treaties up until the last five or six years, includes a guarantee of exempt surplus treatment, so the treaty itself would guarantee that residents of that treaty country could pay their profits back to Canada on a tax-free basis.

I believe you're referring to a regulation in the Income Tax regulations, in 5907(11.2), and that rule preserves that same treatment. But with or without the regulation, it would seem that the income could return tax-free.

[*Translation*]

Mr. Guy Côté: I will let you have the rest of my time.

The Chair: Mr. Loubier, your time is already up.

Mr. Yvan Loubier (Saint-Hyacinthe—Bagot, BQ): I would just like to ask one last question, Mr. Chairman.

The Chair: No.

Mr. Yvan Loubier: Have you ever been pressured by Canadian companies to agree to regulations...

[*English*]

The Chair: Mr. Bell.

[*Translation*]

We will have a second round, Mr. Loubier.

[*English*]

Mr. Don Bell (North Vancouver, Lib.): Thank you.

I have a question that is a follow-up on the guarantee issue you talked about, and the exemption and the reference to this 5907(11.2)(c), that continuity clause, which says it "enshrines an interpretation that predates the residency test introduced in 1995". Is that only for companies that had agreements prior to that time, or does that mean any company that comes up, the country is exempted because of that? Is it a grandfathering, in other words, of companies or a grandfathering of the relationship?

Mr. Brian Ernewein: There are certainly two aspects to the rule, the general rules, as Mr. Farber described, which is to say when exempt surplus treatment would arise there has to be a treaty actually in place, not proposed or hoped for but actually in place, in effect; and secondly, that the company in question that's paying the profits out is a resident of that treaty country.

There is, in addition to that, a rule that says that if there is somebody who loses their status by virtue of that test, by virtue of a carve-out in a particular treaty, their status will be preserved as long as that treaty is in place—I believe as of 1994—and hasn't been changed since. So the rule in 5907(11.2)(c) sets the conditions for entitlement to exempt surplus and then goes on to say that prior treaties will be transitioned or grandfathered.

● (1245)

Mr. Don Bell: So we're not in any new deals, either rewrites or new arrangements; we're not guaranteeing this exempt surplus treatment? That's in the previous treaties?

Mr. Brian Ernewein: That's right. Our policy for the past several years has not been to provide an exempt surplus guarantee in the treaty itself. We used to do that. I think it operated, or was viewed, as an incentive to get a treaty country to enter into treaties with us and provided some measure of certainty to the firms, but it just didn't seem to us it was necessary to commit ourselves to that as part of the treaty negotiation process.

Now, not putting in that guarantee doesn't change anything directly, because our own rules in the Income Tax Act and regulations provide exempt surplus treatment when a treaty is in place. But by virtue of not having that guarantee in the treaty, and once we go through our treaty system and take it out of all our existing treaties as well, it does position the government and Parliament to consider whether they want to make any changes to the exempt surplus regime. It's really not flagging any sort of particular change; it's just changing the context or the environment in which changes could be considered.

Mr. Don Bell: Mr. Farber, you said Barbados is not a tax haven. The 2000 report of the OECD said it was. I gather they listed three: Barbados, Cyprus, and Malta. And then there was a subsequent report that, as I understand it, defined two types of tax havens, the cooperative and the non-cooperative. The difference I think you made reference to is that Barbados had moved from what might have been perceived as non-cooperative into cooperative by virtue of having transparency in their process. There are still five that don't have transparency, as I understand it, and they're Andorra, Libya, Liechtenstein, the Marshall Islands, and Monaco.

I have a question. There was an assumption made I think that there is a certain amount of money being lost by virtue of companies investing in Barbados or moving their operations there. Is it fair to make an assumption that this money is lost to Canada, because if that benefit was not there, wouldn't a company just then move to either one of the five that are non-cooperative or one of the others that are cooperative tax havens but still represent tax havens because of a differential in the taxing rates? Isn't that the whole idea of going to these countries in the first place?

Mr. Brian Ernewein: It goes to the heart of what you call a tax haven. To the extent Canadian companies invest abroad—and using the statistics you just quoted—and invest in Barbados, if they can't do that, they may very well invest elsewhere. Anything done to Barbados in that context could very well hurt Barbados as a country. It doesn't necessarily, even by itself, mean that you're going to get any more tax revenue here in Canada.

Mr. Don Bell: That's the point I was making.

Mr. Brian Ernewein: They may very well go to one of the five countries you listed or, alternatively, go to any one of a number of other countries, depending on where they see their economic influence and where they are carrying on business.

Mr. Don Bell: But one country that's been talked about in the past has been Ireland, has it not? There were tax advantages in Ireland. I know there are a bunch of companies that seemed to locate there because of tax benefits.

Mr. Brian Ernewein: That's right, and I think Ireland has created a taxation regime for corporations where they've had quite low rates of tax in order to attract companies, but it was a convergent regime. It treated its domestic corporations and foreign corporations alike, with very low rates of tax.

Mr. Don Bell: In terms of foreign investment from Canada, I gather that Barbados has about $24.7 billion. Ireland has somewhere around $18 billion, so there's a lot of money from Canada going into Ireland as well.

● (1250)

Mr. Brian Ernewein: I don't have those statistics, but yes, there are Canadian companies investing through Ireland as well.

But again, it's very much influenced by where they want to set up in order to conduct business in a certain environment, and companies will naturally set up in Ireland if they want to service the EU, for example. For companies wanting to service the Caribbean, it would be a little bit more difficult, I would suggest, doing it out of Ireland. Barbados or other jurisdictions in the Caribbean could be far more hospitable, even entirely non-taxing jurisdictions, and there certainly are some in the Caribbean as well.

Mr. Don Bell: We had the situation of Canadian banks, and the statement I've seen is that two-thirds of Canadian banks have their foreign and direct investment assets held in these offshore financial centres. I was aware that although they can get tax benefits, the suggestion is that this taxing benefit should somehow be limited. There can be the rare situation...and normally it's because they're making a profit. Was it Scotiabank that lost a lot of money in Argentina, for example? Those losses are not transferrable back now either on the same basis, are they? They're a loss incurred in that country, are they not?

Mr. Len Farber: If the income is exempt, the loss is exempt.

Mr. Brian Ernewein: Yes, if the income is exempt, the loss will be exempt as well.

Mr. Don Bell: So the risk or the benefit is in that jurisdiction.

Mr. Len Farber: That's right.

The Chair: Thank you, Mr. Bell.

Mr. Pallister.

Mr. Brian Pallister: Of course if you don't have to pay taxes, your chances of profit go up a titch.

The Auditor General said in December of 2002 that $1.5 billion in taxes is lost to the Canadian economy annually as a result of the Barbados agreement. She called for a rewriting of the rules to protect the integrity of the tax base. The Prime Minister promised he would tighten the regulations to stymie the flow of tax-free dividends from foreign affiliates back to Canada, but he left the loophole open in Barbados and, as we well know, moved his company there.

The Mintz report says a similar thing. It says that the integrity of the tax base is at risk. It says the tax structures result in the erosion of the Canadian tax base and can result in the need to increase the tax on other taxpayers or reduce public expenditures at the same time.

I'm curious about the work the department has done on this topic. Have there been any studies since the Mintz report examining the issue of foreign tax—not tax havens specifically—in regard to the issues we're talking about today, the dividend repatriation issue, the tax deductibility issue? Have there been any studies on any of those issues since the Mintz report was released?

Mr. Len Farber: Mr. Chairman, since the Mintz report, and also since the Auditor General's report that the member is referring to, this area has been constantly under review. Revisions or amendments to the Income Tax Act are being made constantly.

Let me just give you a bit of an example of what has happened since that point in time. Since 1995, numerous amendments were made to the foreign accrual property income rules in order to further protect the Canadian tax base from erosion caused by the shifting of passive income to foreign jurisdiction by Canadian residents.

Mr. Brian Pallister: Sir, to be fair, I didn't ask you about that. I did ask you, though, about the tax deductibility issue and the repatriation of tax-free dividends issue. I asked you a specific question. Have there been studies done in regard to those issues since the Mintz report? I just need a specific answer. You know the time limitations we're under in committees.

Mr. Len Farber: I would have thought, Mr. Chairman, that the honourable member would have been interested in the various amendments that we've made to shore up the tax base to ensure that nothing is happening in an inappropriate way.

Mr. Brian Pallister: I'm interested in what I asked you about, Mr. Farber.

Mr. Len Farber: But in terms of a public study—if you'll give me the opportunity to answer—there's no study per se that we have made public. It's an area that is constantly under study. If one follows the number of budgets that have been put forward to Parliament since 1992, if my memory serves me right, almost each and every budget has had amendments to the foreign affiliate and foreign property rules in order to shore up the base and to ensure that Canada's tax base is protected.

Mr. Brian Pallister: Thanks, Mr. Farber. That was actually what I was asking you about.

You mentioned that there are no studies that have been made public. Are there studies, though, in regard to these issues that were done internally that you think might be beneficial for this committee to look at? Is there any reason they wouldn't be made public?

● (1255)

Mr. Len Farber: It's a question of how you define a study. We constantly study the various provisions in the Income Tax Act. We constantly deal with our colleagues at the Canada Customs and Revenue Agency and the Department of Justice with regard to specific issues, which they either review under audit or which the justice department is litigating before the courts. In that context, we study these matters internally with a view to seeing what amendments can be brought forward to ensure that the Canadian tax base is being protected, and we shore it up to the extent possible. As I indicated, there have been numerous amendments brought forward in each and every budget since 1992.

Mr. Brian Pallister: Mr. Farber, given the fact that there have been numerous discussions with your fellow departments on issues—and you've answered in a general sense—can you answer my first question then? Have there been discussions specifically on the issues of interest deductibility and the repatriation of tax-free dividends?

Mr. Len Farber: Yes, there have been ongoing discussions about that. Clearly, as in the example that Mr. Ernewein gave you with regard to how that works, there's no obvious solution as to how one should deal with it that may be better than what the solution is within our Income Tax Act at the moment.

Mr. Brian Pallister: So you're saying that conclusions have been reached as a result of your discussions, that there isn't a better solution than the status quo in regard to those two issues.

Also, if I could ask you this, if you have these—

Mr. Len Farber: I don't think it's fair for you to say that conclusions have been reached. I did not say that.

Mr. Brian Pallister: Yes, you actually just said, sir—

The Chair: Okay, Mr. Pallister—

Mr. Len Farber: I'm very sorry, but I did not say that conclusions had been reached. I indicated that discussions have been ongoing.

The Chair: Okay, Mr. Pallister, thank you.

Monsieur Loubier, then Ms. Wasylycia-Leis, and then Mr. Hubbard.

[*Translation*]

Mr. Yvan Loubier: Thank you, Mr. Chairman.

I too would like some short answers, because I am curious about the sequence of certain events that have taken place since 1992. I believe we have discussed this often, Mr. Farber, but without ever actually getting to the bottom of it. I would like some short and real answers today.

The story goes as follows. Beginning in 1992, the government was pressured from all quarters to close off the tax loopholes, particularly in connection with its relations with tax havens. The Auditor General of the day wrote in his 1992 report, if I recall correctly, that the government was losing huge amounts of tax revenue because of the provisions of certain tax treaties, and especially because of a list of favoured countries where businesses were protected from double taxation. If a country that was considered to be a tax haven charged minimal tax, when the profits in those countries were repatriated to Canada, they were taxed.

At that time, Mr. Martin was the favourite for Minister of Finance. He had undertaken, during the election campaign, to eliminate relations with tax havens and to protect the federal tax base. He announced, in his first budget speech in 1994, that he was in fact eliminating the list of countries with which we maintained favoured ties and which were considered to be tax havens. From then on, companies would be protected under tax treaties. We had one with Barbados; we kept it. However, people and companies with affiliates in countries considered to be tax havens began to worry, particularly those with affiliates in Barbados, because that is where you find most of the capital takenout by Canadians to be put in countries considered to be tax havens.

Here is my first question. Did any companies pressure you when Mr. Martin, in 1994, eliminated the list of countries considered to be tax havens and fell back on treaties for corporate tax conditions? Were your department and the then minister pressured by any companies worried about the elimination of that list?

[*English*]

Mr. Len Farber: Mr. Loubier said we should give short answers, and I think the short answer to that is no. And in keeping with what I said earlier, we were looking at the listed countries at that point in time in terms of trying to revise the policy. The listed countries at that point in time included countries that we had a tax treaty with, countries that we had no tax treaty with, and countries we were hoping to have a treaty with.

● (1300)

[*Translation*]

Mr. Yvan Loubier: Mr. Farber, were you pressured by any Canadian companies with affiliates abroad, in Barbados in particular, to protect them because the elimination of that list created some ambiguity about their tax situation? Were you pressured or approached, yes or no, following the elimination of that list?

[*English*]

Mr. Len Farber: I think it's fair to say that once the list was scrapped and there was an ambiguity, as Mr. Loubier suggests, the question that came to bear was how can one clarify the ambiguity? There was no clarity by the tax professional community as to whether or not exempt surplus, in and by itself, from a country like Barbados could be repatriated, because on the one hand, the clarity in the regulations you're referring to was one thing that said it couldn't be.

Just let me finish one—

[*Translation*]

Mr. Yvan Loubier: So, Mr. Farber, you were pressured by companies.

[*English*]

The Vice-Chair (Mr. Charlie Penson (Peace River, CPC)): Mr. Loubier, I think Mr. Ernewein also wanted in on this point, so maybe we can bring him in.

[*Translation*]

Mr. Yvan Loubier: Okay, but I am not finished with the first question.

Did any companies pressure you so that companies with affiliates in Barbados, in particular, that formerly were not paying tax in Canada, could go on enjoying a favourable regime like tha?.

[*English*]

Mr. Brian Ernewein: I think I can be fairly precise. The proposal that was put out in the 1994 budget with respect to cleaning up the foreign affiliate regulations and making sure the list of countries that received exempt surplus treatment corresponded with our list of treaty countries, and furthermore, that not only did we think the company was resident there but the other country thought the company was resident there—the way that was expressed in the draft regulations was interpreted by some as actually interfering with our treaty countries.

And just to finish—

[*Translation*]

Mr. Yvan Loubier: I understand all of that, sir, but that is not what I want to know.

Was your response to adopt...

[*English*]

The Vice-Chair (Mr. Charlie Penson): Mr. Loubier, we'll have to come back to you in the next round. You're out of time.

Ms. Wasylycia-Leis.

[*Translation*]

Mr. Yvan Loubier: I just have one last little question, Mr. Chairman.

[*English*]

The Vice-Chair (Mr. Charlie Penson): In the next round, Mr. Loubier.

[*Translation*]

Mr. Yvan Loubier: Is your response the regulation in relation to article XXX of the tax treaty between Canada and Barbados? Is that the response you gave to companies that were concerned about being able, yes or no, to go on enjoying a preferential tax regime, i.e., not paying tax to the federal government and continuing to pay minimum tax to the Barbados government? The tax treaty between Canada and Barbados...

[*English*]

The Vice-Chair (Mr. Charlie Penson): Mr. Loubier, we'll ask our witness for a short answer, and then we're going to move to Ms. Wasylycia-Leis.

Mr. Brian Ernewein: No, my answer was going to be that the intent of the 1994 regulations was not to interfere with our treaty countries. The revised regulations made it clear that we did not do that.

The Vice-Chair (Mr. Charlie Penson): Thank you.

Ms. Wasylycia-Leis, five minutes.

Ms. Judy Wasylycia-Leis (Winnipeg North, NDP): I didn't have a first round, so perhaps I could have seven minutes. No? Too bad.

Thank you, Mr. Chairperson, and thank you to our witnesses today.

I'd like to first of all reference some of the earlier questioning around the Auditor General reports. We've had two Auditor General reports that I know of, one in 2001 and one in 2002. In the first instance, the Auditor General did comment on the Canada-Barbados income tax agreement and said there was a need to actually investigate the situation. I think the department responded at the time that it would continue to be vigilant. In 2002 the Auditor General acknowledged that tax arrangements for foreign affiliates had eroded Canadian tax revenue by hundreds of millions of dollars. The department said at the time that the system was continually being reviewed.

So I guess I have the question that others have had as well. We've had lots of information from the Auditor General, and lots of publicity around money that could be invested in Canada. I know you said that some steps have been taken, but instead of seeing a slowing down of investment leaving the country in terms of tax havens, it's going up. You would think at least you'd see a slowing down or some impact from these changes. The latest Statistics Canada report shows that from 1990, which is just around the time we started making changes, to 2003, we've seen tax money in tax havens soar from $1.1 billion to $88 billion, with no sign of that slowing down.

I guess we'd all be interested in some specific things that were supposed to have worked and haven't, or what you've planned to put in place that will work. We have a major problem in terms of keeping investment in Canada, attracting new investment, and I don't think the solution is more tax breaks for corporations. I think even the Conservatives and Bloc will agree with me on this one. All the while that tax breaks have increased over this past decade, and profits have increased for the corporations, investment has declined. There's something else at play here that needs to be addressed, and I guess we're all anxious to see what plans the department has for actually finding a way to keep this money in Canada.

● (1305)

Mr. Brian Ernewein: First of all, it is fair to say that we have been responsive to concerns raised by the Auditor General and others. For example, there was a large package of foreign affiliate changes put forward in 1994 included in these regulations we were just speaking about with Mr. Loubier, making a number of changes to the foreign affiliate regime. Speaking specifically of the foreign affiliate regime, there were changes in the 1998 budget relating to section 17 of the act, and that concerned investments by Canadian firms being put out through their foreign subsidiaries and being redirected outside of the Canadian control group.

We also have foreign affiliate changes in draft form that were released in 2002, which would tighten up the system to make sure that exempt surplus couldn't be generated on internal transactions. We are continually working to develop the system.

With respect to the issues raised by the Auditor General in relation to interest deductibility, I spoke to that before. There are considerations going either way. The most fundamental question the Auditor General raises is the exempt surplus regime: whether or not we should have a system that respects the other country's jurisdiction to tax and says we won't impose further tax, or whether we ought to adopt instead a regime that attempts to tax that income with a credit for the underlying foreign tax when it's paid back to Canada.

There are positive and negative effects of doing either. The positive effect is that you neutralize the tax payable, in the Canadian sense, if you tax it when it comes home. The negative effect is that it hurts Canadian competitiveness and it can have the incidental negative effect, which the U.S. seems to have observed lately, that if you propose to tax income when it's brought home, people just won't bring it home.

What the U.S. has done with its credit system in its recent U.S.A. Jobs Protection Act is to actually recognize this and slash the rate of tax it applies to income being brought home in an attempt to try to bring more profits home to be reinvested in that country and possibly distributed to shareholders and generate tax at that level.

On that particular point, I'm not sure there is agreement with the AG's fundamental approach that we should switch from an exemption system to a credit system, but that's really a decision for the government and for Parliament to make.

The Vice-Chair (Mr. Charlie Penson): You have one more question, Ms. Wasylycia-Leis.

Ms. Judy Wasylycia-Leis: I will ask two really quick questions then.

Notwithstanding what you've said, we certainly get the sense that the Department of Finance tends to cater to those big corporate interests that are looking for tax loopholes. The experience of Project Loophole, the $2 billion that left the country with a prominent family and was the matter of a Supreme Court case, is evidence of the fact that it had to go this route before the department listened and changed its ways. Even though George Harris didn't win the Supreme Court case, the Supreme Court sent a strong message to the department about doing things inappropriately. That's one question.

The last one is why not simply end this special arrangement with Barbados? We're talking about a relationship between countries that are not equals. We're talking about using Barbados for tax evasion purposes. Why not just end the relationship?

The Vice-Chair (Mr. Charlie Penson): It's time for an answer.

Mr. Brian Ernewein: Without commenting on the identity of the taxpayer in question or the trust in question, in fact the government did act in 1996, before that litigation was launched, to close down or to tighten the migration rules to make sure that individuals, including trusts, on departure from Canada would be subject to departure tax. I believe the government is responsive.

With respect to this particular question, it is true that the department has, in its response to the Auditor General, both in 1992 and again in 2002, sought to explain—not to defend or to criticize—the considerations that support having an exempt surplus regime for foreign business profits. My role as a civil servant would be to do that, and if Parliament chose to pursue another route, what we would seek to do is to advise on the possible effects of that. That's what I tried to discuss earlier today.

● (1310)

The Vice-Chair (Mr. Charlie Penson): Thank you, Mr. Ernewein. Maybe we'll have a chance to come back to this.

Mr. Hubbard, go ahead for five minutes, please.

Mr. Charles Hubbard (Miramichi, Lib.): Thank you, Mr. Chair.

It appears that we're just as confused this morning as most Canadians are on this, because there's a great deal of frustration and anxiety. Many people think big companies can avoid taxes, and that basically most taxes in this country are paid by people who are getting a weekly or a monthly cheque.

Just to clarify what Mr. Pallister asked earlier, can a Canadian company headquartered in Toronto set up a sub-office in Boston and borrow money in Canada, send it to Boston and use that money as a writeoff against their business income in Canada? Yes or no?

Mr. Len Farber: If it needs a one-word answer, the answer is no. It may be able to deduct the interest on the amount it has invested, but not on the borrowing itself.

Mr. Charles Hubbard: So the interest can be written off. They could borrow $10 million in this country and write off at 5% half a million dollars in interest as an expense that that Canadian company has. Is that correct?

Mr. Len Farber: No, it isn't, Mr. Chairman, because that's too simplistic an example for anyone to give a definitive answer to. It depends on what that $10 million is used for. Is it being invested in active business? Is it carrying on some kind of operation? Is it just going to go there without any prospect of a dividend being paid back? There are a lot of conditions attached to it.

Mr. Charles Hubbard: If I can, I only have five minutes.

The money can go to Boston and the interest on that loan can be written off against Canadian corporate expenses. Then that money can go to Barbados to be used in an enterprise down there and the company can bring back the profits, whatever it makes from that enterprise in Barbados, as a Canadian income and pay less than 5% in taxes as a result of the tax haven in Barbados. Can that happen, yes or no?

The Vice-Chair (Mr. Charlie Penson): Mr. Ernewein.

Mr. Charles Hubbard: I just want it clarified.

The Vice-Chair (Mr. Charlie Penson): Mr. Ernewein wants to answer the question.

Mr. Brian Ernewein: Again, a one-word answer would be no. I think the transaction might be structured differently to achieve something along the lines of the effect you described.

Mr. Charles Hubbard: So it actually can happen.

Mr. Brian Ernewein: Not on your transaction, because the income in your example I think would be going back through the U. S. and would be subject to whatever U.S. tax rules apply. I think the earlier transaction we discussed was something more to the effect of Canada borrowing to invest in an intermediate country, and we used the example of Barbados, to then invest in the United States. With that routing—

The Vice-Chair (Mr. Charlie Penson): Would the example Mr. Pallister put forward earlier be the more appropriate example?

Mr. Brian Ernewein: Well, appropriate or not, it's probably the more tax-effective one, yes.

Mr. Charles Hubbard: The department must be very much concerned that this is actually happening.

I always thought that where you do business is where you're taxed. Mr. Loubier refers all the time to shipping. We not only have shipping, we have trucks headquartered here in Canada that are being used as far south as Central America, supposedly making money back and forth. We have airlines headquartered in Montreal that are flying the Pacific. How do we deal with income in terms of reporting Canadian corporations? Do they report the income on the basis of the business they do in this country? That seems to be the realistic approach to it, but if they can transfer some of that to some other tax haven, you wonder whether the Canadian people or Canadian constituents are getting a fair share in terms of how this taxation process works.

Mr. Brian Ernewein: Canadian companies and all Canadian residents are liable for tax on a worldwide income, but that stops when you're talking about a foreign subsidiary. That's now a separate taxpayer, and that taxpayer, being a resident of wherever, is liable for tax in that jurisdiction, probably on its worldwide income as well. When you're talking about active business profits, the income paid out of that foreign company to the Canadian owner, the Canadian multinational, may then be subject to tax. Again, that depends, under our rules, on whether a treaty is in place. If a treaty is in place, it's not subject to further tax under our so-called exempt surplus regime. If a treaty is not in place, the dividend distribution would be subject to Canadian tax with a credit for underlying foreign tax.

● (1315)

Mr. Charles Hubbard: So really, a Canadian trucking company that's trucking all the way down to Central America could put its headquarters down there, or maybe leave it here and have a subsidiary in Guatemala or someplace, and divert all its so-called profits to the subsidiary, and literally, as Canadians, we would not benefit from any of the work that Canadian company is actually doing throughout North and Central America. Is that a fact? I can't quite believe this actually could happen.

The Vice-Chair (Mr. Charlie Penson): Let's see if we can get an answer then.

Mr. Brian Ernewein: I believe it's the case that, yes, a Canadian company could incorporate its foreign operations, which would make that foreign corporation liable for local tax. The benefit the Canadian firm would get from that, of course, is through the returns generated by the foreign corporation and paid up to it.

The Vice-Chair (Mr. Charlie Penson): Thank you, Mr. Ernewein.

Mr. Pallister, five minutes, please.

Mr. Brian Pallister: Thanks.

And thanks for the fullness of your answers, Mr. Ernewein.

Is it fair to say little domestic tax revenue is raised by outbound foreign direct investment? Is that a fair statement? We don't make much money on the money that gets shipped out to Barbados. Is that true or not?

In Canada we don't raise much money here by shipping money out to Barbados. Is that true?

Mr. Brian Ernewein: When you speak of foreign direct investment, you're talking about investment by multinationals?

Mr. Brian Pallister: Yes.

Mr. Brian Ernewein: I think that often if they've incorporated in a foreign jurisdiction, there won't be tax here, provided it's a treaty country.

Mr. Brian Pallister: Right, so we don't make much money here.

But Barbados doesn't tax much. I just want to cut to the chase. Barbados has a special deal, right? Just to be clear, there's a good deal there.

Mr. Brian Ernewein: They have special investment regimes. They have a—

Mr. Brian Pallister: How much would I pay? How little could I pay in tax, my corporation, if I were to funnel some money out of Canada to the Barbados? Let's just cut to the chase—what's the rate?

Mr. Brian Ernewein: I think the rate—

Mr. Brian Pallister: Under 5%? Would that be fair?

Mr. Brian Ernewein: Their general rate was 40%. I think it's due to come down to 25%. Under the special investment regimes, the rate I think is 2.5% at the start.

Mr. Brian Pallister: That sounds like a good deal.

I think maybe we could cut to the chase a bit more and say that's probably what angers a lot of Canadian taxpayers—the thought that somebody else can do that and they can't. The number one reaction I get from people when I talk about this sort of circumstance is, how can I get on board myself? Therefore, naturally, the self-interest of Canadians would say, if somebody else can get away without paying their taxes, or paying next to nothing, in fact writing off the carrying costs of moving the money offshore, I shouldn't be having to pay as high a rate as I do.

I just have that broad general concern. I make that observation. You're not here for the revenue department, but I wonder if they aren't concerned that the general perception of the Canadian people may be, combined with some of the goings on in recent months that have come to light here in this government, that they're not getting good value for their money here, let alone that these other Canadians are taking advantage of rules that allow them to get away with paying hardly any tax.

Do you know of any dialogue or studies that have been done with regard to the discussion about forecasted revenue impacts as a consequence of people losing trust or faith in the system as a consequence of things like this? Have you had some dialogue on that?

Mr. Brian Ernewein: I'm not an economist, but I think it would almost be impossible to forecast revenue effects of such a thing. If I understood your point correctly, it would suggest that the only way to resolve it is to tax on a current basis profits that Canadian-owned foreign firms generate outside this country. If you did do that, I think we might be—

Mr. Brian Pallister: Well, I wasn't proposing that, sorry.

Mr. Brian Ernewein: Well, if we did, I think we might be the only country in the world to do such a thing.

Mr. Brian Pallister: Of course, and that's why I wasn't proposing that. There's no need to respond to something I didn't say.

But that being said, I want to quote from the Mintz report and just ask you about this:

> ...where income earned in treaty countries is subject to low effective tax rates under special rules applicable to such income. It is the Committee's view that permitting exempt surplus treatment for such income tends to encourage tax-planning mechanisms that erode the Canadian tax base.

Would you share that observation? What would your view be on that?

Mr. Brian Ernewein: I think I would like to make reference to that, because I believe the finance minister touched upon this before this committee earlier this year.

The current policy is to simply link treaties with exempt surplus treatment. If a treaty is in place and a company is a resident of the treaty country, exempt surplus follows. What the minister mentioned I think earlier this year was the question as to whether or not there ought to be some finer distinction drawn between the general rate or the broad-based rate applicable in the other country and special investment regimes, and whether or not, where there's a special investment regime, the same exempt surplus treatment ought to apply.

Now, if you'd like, I could talk about the considerations of going one way or the other.

● (1320)

Mr. Brian Pallister: You know already I like the shorter answers.

Mr. Brian Ernewein: Fair enough.

Mr. Brian Pallister: We'll use other ways to get the long ones.

This is another quote from the Mintz thing here:

> It is our view that the current rules have resulted in a substantial erosion of the Canadian domestic revenue base, and that other Canadian taxpayers are paying more tax to make good on the shortfall.

That was their observation way back when, in 1996.

Again, on the issue of repatriating tax-free dividends, wasn't the original intention of that rule to try to have some sense of tax neutrality so that we avoid double taxation? People are paying tax in another country, so why should they have to pay tax twice? I know it's policy, so it's a difficult question to answer, but it seems an unfair policy that we should apply a rule that gives an exemption to income earned in a country where they pay 2%.

The Vice-Chair (Mr. Charlie Penson): Let's get an answer, and then we'll move to Mr. Loubier.

Mr. Brian Ernewein: I think the issue is much easier when the rates are identical in both jurisdictions, because there's really no difference between an exemption system and a credit system. It becomes harder when there is a difference. It gives rise to the question, if we only did treaties with countries that had a rate as high as or higher than ours, we'd probably have a third of the treaties we actually have now, and there would be a question as to whether or not we want to kick out of our treaty network many of the European countries and other jurisdictions.

I'm sorry for answering the question with a question, but I think that's what it amounts to or shakes down to.

The Vice-Chair (Mr. Charlie Penson): Thank you.

Mr. Loubier, five minutes.

[*Translation*]

Mr. Yvan Loubier: Thank you, Mr. Chairman. I hope you will give me three extra minutes too, because Mr. Pallister took three minutes more than the time he was allotted.

I would like to come back to my initial question. In the 1994 budget speech, the then Minister of Finance, Mr. Martin, announced the disappearance of the list of countries with which we had privileged tax relations and which protected certain companies and allowed them to avoid double taxation by paying very low tax in tax havens and repatriating their profits here without paying their fair share to Revenue Canada.

At the time, in 1994, Mr. Martin said that those companies would be protected under treaties from then on. However, we have such a treaty with Barbados, but when you look at it closely, you see that it is very well drafted, except for article XXX—and that was what I was getting at with my earlier question—which says that the companies that can take advantage of a regime under which they pay 1.5 per cent tax in Barbados and can repatriate their profits to Canada without paying more tax have to be real, active companies, i.e., companies with economic activities, etc.

Anything that is just a cover—inactive, hollow-shell companies, purporting to have a headquarters and an office that are actually bogus—could not take advantage, under the tax treaty, of this preferential treatment that was available before Minister Martin eliminated the list.

In 1997, cabinet ordered what had been announced in 1994. It adopted a regulation, paragraph 5907(11.2) *c*), which provided that from then on , by regulation, an exception was being made to article XXX of the treaty between Canada and Barbados and that from then on, companies would be protected, i.e., they would pay tax of around 1.5 per cent in Barbados and could come back here without paying their fair share to Revenue Canada. And it is on the basis of this provision of the Income Tax Regulations that people managed to get around article XXX of the tax treaty between Canada and Barbados, which stipulates that companies that are not truly established and do not have any real economic activity should not be able to take advantage of an exemption from double taxation.

After the enactment of paragraph 5907(11.2) *c*), along came Bill C-28, tabled by Mr. Martin, in 1998. That legislation provided that inactive companies would be treated the same way, i.e., that a holding company could be treated the same way as an active company, which was not the case before.

Am I correct in my interpretation? It is quite a convenient coincidence.

● (1325)

[*English*]

Mr. Len Farber: Well, the short answer to that is no. You're not correct in that interpretation. The whole issue with regard to the regulation and article XXX of the treaty pointed out that there was not clarity with regard to how it applies. Article XXX in the treaty itself grants exempt surplus treatment, so how does something that purports to deal with exactly the same thing take it away?

There was no clarity, so the question from the tax professional community came up: what is the intention behind this? Well, the intention was not to override the treaty, because we couldn't override the treaty with that domestic rule. We said this was not the intention and that article XXX in the treaty, which granted exempt surplus treatment, was the intention. That's what happened with regard to that interpretation. It was a clarification that came out almost immediately after those draft regulations were put out into the public domain.

With regard to Bill C-28—

[*Translation*]

Mr. Yvan Loubier: But it is not a clarification, Mr. Chairman, it is quite simply a reversal of the provisions of article XXX of the Tax Treaty between Canada and Barbados. It is a tailor-made measure so that companies that used to enjoy a tax exemption from Revenue Canada and from the provincial finance departments could continue taking advantage of the system, continue repatriating their profits here without paying tax. It is a tailor-made measure to thwart article XXX of the tax treaty between Canada and Barbados and it is the result of pressure put on you by Canadian companies with affiliates in Barbados. That is the way it happened. It was not done to clarify the situation, it was done to turn the interpretation of article XXX of the treaty on its head.

[*English*]

The Vice-Chair (Mr. Charlie Penson): Okay, Mr. Loubier.

You can answer, and then we're going to move on.

Mr. Len Farber: I'll let my colleague respond more fully, but I will state yet again that in our view it was a clarification. There was no pressure from Canadian business. The point came up as to whether or not this was our intent. Even if that had not changed, we believe that article XXX of the treaty would have prevailed in any event because that specifically gave exempt surplus treatment. That was a double-taxation treaty between Canada and Barbados, and part of our normal clauses in those treaties at that point in time—which has changed, as we indicated to this committee in earlier testimony —provided exempt surplus treatment. So when you have two conflicting provisions, it was a point of clarification. We clarified it immediately.

The Vice-Chair (Mr. Charlie Penson): Mr. Ernewein, did you have something to add?

Mr. Brian Ernewein: No.

The Vice-Chair (Mr. Charlie Penson): Okay. I have a couple of short questions from the chair, and then we're going to go to a short question from Mr. Hubbard and Ms. Minna.

Gentlemen, the questions I have for you are as follows. How many countries offering special tax incentives, like Barbados with that 1.25% to 2.5% tax rate, do we have a tax treaty with in that tax range? If you don't have it, maybe you can provide the committee with a written response later.

I'll put the other question to you as well, and you can let us know.

Could we have an idea of how many Canadian corporations have operations in Barbados benefiting from the low tax rates? Earlier you said you didn't know the specific number, but can you give us a sort of rough idea of how many Canadian companies are benefiting from those low tax rates?

Mr. Ernewein, go ahead, please.

Mr. Brian Ernewein: I was just going to say that if it's publicly available, certainly we'll track it down and provide it to the committee.

The Vice-Chair (Mr. Charlie Penson): You don't have that information here, but you will provide it if you have access to it. Is that correct?

Mr. Brian Ernewein: That's right.

The Vice-Chair (Mr. Charlie Penson): Thank you for that undertaking.

Mr. Hubbard, a short one.

Mr. Charles Hubbard: Very briefly, I'm troubled by Mr. Pallister's original questioning about how a Canadian company can borrow money to invest in another country where it sets up a subsidiary or a branch office or whatever, and they can use that expense—the money that's costing, the borrowing money, the interest rates or whatever—to offset profits back here in Canada. What is the rationalization that a company can borrow money in our country to write off that expense on its yearly report but transfer the money to invest somewhere else where it can make a profit under another regime where there's a very low interest rate? There must be some rationalization for it. How do we say you can do this? There must be some reason why we would permit it.

● (1330)

Mr. Brian Ernewein: I would reference your comment a little earlier talking about there having to be sort of an income-earning purpose, you would have thought, to justify an interest expense. I think that's true, and it can go beyond our domestic borders. If you or I were to borrow money to invest in a foreign company, we would have thought probably that it would be appropriate to get an interest deduction for that amount even though the moneys are being used by the foreign company to generate profits offshore. We hope to make a return in some form on that investment. Similar considerations can apply in a multinational borrowing in Canada to invest offshore.

The Vice-Chair (Mr. Charlie Penson): Thank you, Mr. Hubbard. We are over time here, so we're going to Ms. Minna next.

Mr. Charles Hubbard: What is my time then?

The Vice-Chair (Mr. Charlie Penson): No, we're over our time already, and we'll allow one more question to Ms. Minna.

Mr. Charles Hubbard: Why do we allow it?

Mr. Charlie Penson: Ms. Minna, please.

Ms. Judy Wasylycia-Leis: On a point of order, could we extend the hours a bit?

The Vice-Chair (Mr. Charlie Penson): That's up to the committee. We've extended once already, until 1:30, and we will have a short question from Ms. Minna. We are going to be talking about this issue into the future. Mr. Hubbard, you will have other opportunities.

Ms. Minna, could we have a short question, please?

[*Translation*]

Mr. Yvan Loubier: Mr. Chairman, since we expect there to be another session when we return, we could invite the witnesses to come back in October and bring them face to face with the Auditor General or do something like that.

[*English*]

The Vice-Chair (Mr. Charlie Penson): I agree, Mr. Loubier. I think it would be helpful to explore this further.

Ms. Minna, let's have your question.

Hon. Maria Minna: Like Mr. Hubbard, I'm not terribly convinced it's the right thing to do. But I have just one question.

Why not tax all foreign income and just provide a credit for foreign-paid taxes, instead of having all these deductions for borrowed money, investing, and profits somewhere else? Is there a much quicker way of doing this so it's much more transparent than what we now have?

Mr. Brian Ernewein: Mechanically it's probably somewhat more difficult to have a system of taxation with credit than a basic exemption system, but that probably ought not to be the driving consideration.

What other countries do is an issue for competitiveness and the effects it might have to tax, versus having an exemption system. If you have any Canadian firms or want to have any Canadian firms investing offshore, do you want them to dam up the income offshore or bring it home? If you have a tax that's going to be imposed when they bring it home, it's obviously a disincentive to them returning it. I think that leads to considerations at play.

Hon. Maria Minna: Thank you.

The Vice-Chair (Mr. Charlie Penson): Mr. Ernewein, in anticipation of having you back some time in the fall, maybe I could ask that you give some thought to how other countries that have anti-avoidance clauses in their tax treaties with the Barbados—like Finland, Norway, the United Kingdom, and Sweden—treat this matter, if it's different from how Canada treats it. We would be interested in following that up at some future point.

At this time I'd like to adjourn the meeting. We'll continue this subject at some other point.

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