Introduction

There are a number of problems that have been put on a shelf labeled "Long-term issues – to be dealt with in the future". Some date back to the beginning of the millennium, others to the 2008 recession. Some are widely discussed in the media, some less so, and some not at all.

Among the most serious of these problems are:

- the growth of consumer indebtedness;
- a growing proportion of the population retiring;
- the dire investment performance of pension funds;
- the increasing costs of age-related illnesses;
- the widespread fear that retirement benefits will prove inadequate.

These problems won't go away. They will simply grow and get more intractable year by year unless appropriate remedies are put in place.

The way corporations are taxed under the existing *Income Tax Act* is clearly unsatisfactory. The existing corporate tax structure is illogical, complex and lacks clarity and transparency. Canada needs a simple corporate tax that encourages savings and ensures that shareholders receiving dividends enjoy the same tax treatment as creditors receiving interest payments.

There are essentially only two ways that capital flows into a business corporation: either through the shareholders who own the company, or through the creditors who lend it money. If the corporation then produces earnings after all operating expenses and providing for depreciation and amortization, there are only two ways that the earnings can flow out to reward these investors: the debt holder by receiving interest which is paid out of untaxed earnings, and the shareholder by receiving dividends, which are issued only after the company has paid corporate tax on its earnings.

There are obviously differences between debt and equity. Debt holders get a prescribed amount that is protected by a contract. Shareholders have no contract and may get a fixed or discretionary percentage of the earnings in the form of dividends, as the directors may decide. But the biggest difference is that these earnings are subject to a corporate tax after the debt holder has received interest and before the shareholder has received dividends. It is illogical that one of the parties should receive their earnings before tax and the other after tax. They are both investors in the company.

The shareholders who created the company have to take all the risks. If the company collapses, the creditor is entitled to his principal and unpaid interest before the shareholder gets anything. If the company prospers, in addition to interest and dividends, the creditor gets repaid and the shareholder makes a capital gain, which, on realization, is taxed. In the meantime, the shareholder is taxed on receiving dividends issued out of the corporate earnings that have already paid corporate tax. This taxation system is known as “double taxation”.

So under double taxation, dividends are paid out of corporate earnings that have already been taxed. The investor has been indirectly taxed at the corporate rate, only to be taxed again when he receives the dividend. Recognizing that dividend payments were, like interest payments, a cost against corporate earnings but not accounted as such, governments were forced to adopt a complex structure which provides taxable investors receiving dividends with a “dividend tax credit”, reducing the tax paid on their other taxable income to offset the corporate tax already paid.

Registered Retirement Savings Plans (“RRSPs”) and pension funds have no other taxable income. This means that they do not benefit from any form of tax credit to compensate for the tax already paid. Savings portfolios are free of capital gains tax but all moneys withdrawn for use suffer income tax at normal rates which erodes some of this benefit. Dividend income gets taxed again.

In the 18th Century, Adam Smith, in his famous “Principles of Taxation”, wrote “the tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person.”

In 1972 I had been asked to advise the Government on ways and means of increasing the flow of savings into residential mortgages. It was quite obvious that to increase the flow of savings into the mortgage market, Canada needed vehicles through which small investors could participate in large diversified pools of mortgages providing them with the relatively high yields produced by insured mortgage loans.

I had studied the Real Estate Investment Trust structure in the U.S. and concluded that the REIT format had too many drawbacks for use in Canada. Accordingly, I suggested that it would be better to devise a simple financial vehicle in corporate form under which dividends were deductible from earnings before the corporate tax and subsequently taxed in the hands of shareholders as is interest payable on corporate debt. The Department of Finance concurred without demur, and the *Income Tax Act* was accordingly amended, also stipulating that foreign investors should pay an income tax of 25% on account of any taxable dividend. The incorporation of Mortgage Investment Companies became law under the Loan Companies Act at the end of 1973. This tax structure is known as “dividend deductibility”.

The Case for Dividend Deductibility

Under dividend deductibility, corporate earnings flow directly through to shareholders in the form of dividends to be taxed at normal rates of personal income tax, while earnings retained in the company to fund future growth are taxed at the corporate rate of income tax – approximately 25%. Dividend deductibility is logical and transparent. The tax is clear and plain to the investor and everyone else.

In a perfect world, the following principles should form the structure of Canadian corporate taxation:

- avoidance of indirect taxation;
- equality in the tax treatment of dividends and debenture interest;
- ability to quell any attempted evasion of tax;
- transparency in the levying of the tax;
- logic, clarity, simplicity and flexibility.

Dividend deductibility is not an abstract idea. The United Kingdom Finance Act of 1920, while not allowing the deduction of any dividends for the distribution of profits to common shareholders, allowed for the deduction of both debenture interest and dividends on preferred shares before corporate taxes were assessed. Deductions were not allowed if they benefited the controlling interest nor for any transaction that artificially reduced the amount of taxable profits. By 1929, debenture interest and dividend payments were treated equally for tax purposes, and a tax on interest payments and dividends at a standard rate was collected at the source by the corporation. In Canada, an amendment to the *Income Tax Act* in 1973 allowed the deduction of dividends before corporate taxes solely for Mortgage Investment Corporations. In other words, nothing in this paper is a new idea.

The purpose of registered savings plans is to help Canadians to have a satisfactory level of income for their families when retirement comes and they are no longer in a position to earn a living. The benefit to Canada is that the State itself won't have to provide the benefits to permit an acceptable level of prosperity for senior citizens. The more the private sector can be persuaded to save, the lower the burden on the taxpayer. Saving requires going without the consumption of goods and luxuries to put money away for future needs. While the need to save is reinforced by the very real fear of inflation, registered savings plans must offer a strong and effective incentive to save in order to overcome the temptation to spend in today's economy of non-stop advertising and easy money.

To achieve this, the Government needs to have a savings policy that will provide Canadians with secure expectations that their registered savings plans will not suffer undue erosion from taxation, and confidence that the capital in their registered savings portfolios will grow faster than the rate of inflation, so that by saving they will be assured of adequate retirement benefits in terms of real value, the cost of food, clothing and lodging. Inflation is relentless and the only way it can be overcome is if pension funds and registered savings portfolios largely consist of investments in the shares of well-managed, dividend-paying corporations with expectations of growth and increasing dividends at a rate faster than the rate of inflation.

Under existing tax legislation, dividends are paid only out of earnings which have already paid income tax to the government at the full corporate rate (roughly 25%). Shareholders who are taxable investors get a dividend tax credit against their other taxable income to compensate them for the tax already. The pension funds and registered savings plans who are also shareholders have no taxable income and so get no compensation for the indirect tax already paid.

The vast majority of investors have no knowledge whatsoever that their dividend income has suffered indirect taxation. Indeed, most taxable investors don't understand the dividend tax credit mechanism, leaving such matters to their accountants. This lack of transparency arises because the corporation has already paid tax before any dividends are distributed to shareholders out of the remaining earnings. None of this is remotely clear and plain to the investor. I find this unethical.

The double taxation system of distributing dividends out of after-tax earnings was adopted early in the 1940s presumably as a simple way of collecting the tax and avoiding tax evasion. This was during war-time when Alan Turing was only dreaming of artificial intelligence and long before the development of computerized accounting. Pension funds were essentially non-existent. When in 1971 the *Income Tax Act* was reviewed, no changes were made to the tax treatment of dividends, and no change was made to the ordinary rate of income tax applied to capital withdrawn from registered savings plans.

Pension funds were barely mentioned in the whole "Summary of 1971 Tax Reform Legislation".

Because debt interest accruing to registered savings portfolios is not taxed, investors assume that dividend income is not taxed. Apart from accountants, lawyers and investment advisors, I have not yet met anyone who doesn't believe registered savings portfolios are tax-free. The Government, on the other hand, faces little effective popular pressure to attend to the well-being of retired Canadians. One factor has been that lawyers and corporate executives have always enjoyed an easy access to officials in Ottawa to voice their own concerns, whereas retired Canadians must largely depend on the attention and goodwill of the Government without the constant nagging of professional lobbyists. The problems outlined above are an endemic result of the indirect taxation of dividends adopted in the 1940s which has become the status quo inherited by all subsequent finance ministers. It has become a tradition that is taken for granted.

As a policy to encourage Canadians to save during their productive years in order to enjoy a comfortable income when retired, double taxation under existing economic conditions is largely useless. Over the past decade, interest rates have been kept at an historic low, offering a pitiful income in terms of a real rate of return after inflation. Stock markets rose in a straight line to an all-time high. The point is that dividend income is the only element in pension funds and registered savings portfolios that will enable them to grow faster than the rate of inflation. Allowing only interest income at low rates to accrue tax-free in registered savings portfolios is not sufficient to make Canadians invest in savings during their productive years. Instead of investing in the future, consumers have been spending and borrowing, and personal indebtedness has kept on rising.

The lack of a well-thought-out savings policy in Canada has resulted in an increasingly weak propensity to invest in savings. The population is living longer as it grows older. Many citizens worry that their retirement benefits will prove inadequate for their needs. They fear continued inflation in the rising price of goods and services and face the possibility of ill-health needing costly medication. The head of research in Alzheimer's disease at the McGill Institute for the Aging, told me that one out of three Canadians who reach the age of 80 will succumb to Alzheimer's, requiring constant attention.

"Corporation" is derived from the Latin word "corpus" meaning "body". A business corporation is simply a limited liability company incorporated as a single body for tax purposes. The investor is a separate body. The investor, while a shareholder in the corporate body, has other interests apart from his shareholding. He should be taxed at his own individual rate of income tax only on the profits he receives dividends paid out of untaxed corporate earnings. The corporation itself should be taxed at the corporate rate only on profits retained in the corporation as earned surplus needed to fund its future expansion. Under double taxation the corporate earnings of both bodies are blended together and taxed as one body. This negates the concept and purpose of incorporation, which was to make a limited liability company itself taxable as a single body separate from its ownership and to tax any profits retained in the company.

The tax incentives to save in RRSPs offered by the Government are as follows: contributions to registered savings plans are deductible from taxable income. Capital gains are tax-free and debt interest is not taxed. This has not been changed since the 1971 tax reforms which confirmed that withdrawals from registered savings plans would be taxed at the normal rates of income tax. In the 1980s interest rates reached historic highs. The Bank of Canada rate was briefly at 20% in an effort to quell a vicious attack of inflation. Interest rates remained high through the millennium until 2008. Until then, tax-free interest offered a significant incentive to save. Over the past decade the opposite has been the case. Bond interest has offered little more than the rate of inflation while corporate earnings and dividend income increased as the market rose. The tax incentive to save has become negligible. A savings policy should provide a tax incentive which is flexible and able to respond to social and economic forces as they change.

As long as dividends are taxed indirectly out of corporate earnings that have already paid corporate tax, I cannot see how any logical, effective, flexible tax incentive to save can be established. However, if dividend deductibility is adopted, the income from dividends received by the investor would be taxed in the same way as interest payable on a bond issued by the corporation. **No dividend tax credit would be necessary to offset a corporate tax already paid**. The shareholder would know the exact amount of the dividend and of the tax. The structure is very flexible and would allow for a larger flow-through of earnings to shareholders. Dividend deductibility would provide a cleaner profit and loss statement. Earned surplus will become meaningful, instead of an untidy mixture of tax paid earnings and unissued dividends, as it is under double taxation.

The Department of Finance is always concerned about problems of collecting taxes and tax evasion. One of the oldest characteristics of the British tax system is the principle of collection at the source. In other words, the tax should be collected by the issuing corporation for remittance to the fiscal authorities before the income reaches the shareholder to whom it is due. A similar principle is "Pay As You Earn". Under dividend deductibility, income paid taxable to shareholders would be taxable at their individual rates of tax but would be subject to an income tax of 25% collected and withheld by the company for remittance to Ottawa on their behalf. The taxable investor would receive his dividend subject to the deduction of this tax and, when computing his own income tax, would be credited with the amount of the tax that had already been collected. He would be subject to an additional amount of tax if his individual rate is higher than 25%. Controlling shareholders would find it more difficult to practice tax evasion, the tax payment, at the corporate rate, being already in the hands of the fiscal authorities. Thus, no dividend tax credit would be needed and the tax would have simplicity and be transparent to all.

Under dividend deductibility, pension funds and RRSPs would be taxed directly at specific income tax rates. The taxes on total investment income, including both dividends and interest from debt, as well as capital gains and withdrawals would all be adjustable from time to time, making possible a flexible savings policy depending on evolving economic conditions. RRSPs and pension funds would not be tax-free; they aren't now, but income tax on dividends could be adjusted to provide a realistic incentive to persuade Canadians to invest in savings for their retirement.

Shareholders are more important than lenders. Entrepreneurs who have innovative ideas will take the risks of starting up a company which will flourish, needing employees and contribute to the real wealth of Canada. Their reward comes in the dividends they receive. Under dividend deductibility there will be a tendency to dividend out a much greater proportion of the profits to the shareholders. This will offer the investors who own the company wider opportunities to diversify their investment portfolio as they see fit.

Debt should be approached warily. Polonius advised his son “neither a lender nor a borrower be.” But lenders are important, and Canada’s banks are famous world-wide for their good management and stability. Nevertheless, Polonius had a point. A corporate income tax should not provide an incentive to borrow. Debt should be avoided and not encouraged wherever and whenever possible.

It is clearly impossible for Canada to have a wise and effective savings policy under the double taxation treatment of dividends. Double taxation has had a long life, starting in 1940. One can only suppose that it has been maintained by subsequent Governments as a matter of expedient convenience. The problem is that while it may have worked well in the distant past, it is not working at all well now. A savings policy that offers tax-free bond interest while surreptitiously taxing all dividend income accruing to pension funds and registered savings plans, which then gets taxed again on withdrawal, appears very much less than adequate. The case for dividend deductibility is very strong, but will it sell in Ottawa?