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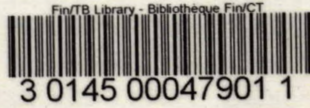
Report of the Ministerial Advisory Committee on Inflation and the Taxation of Personal Investment Income

Submitted to
The Honourable Marc Lalonde
Minister of Finance

September 30, 1982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EXECUTIVE SUMMARY

The Advisory Committee, appointed by the Minister of Finance at the time of the June 28, 1982 budget, has examined a series of proposals set forth in the Paper for Consultation entitled **Inflation and the Taxation of Personal Investment Income** (the "Paper"). In this Report, we present our recommendations and conclusions along with some of the supporting evidence and reasoning.

The Committee recommends that the government:

- vigorously pursue the goal of reducing or eliminating inflation as the best long-term solution to the problems presented in the Paper;
- adopt a modified form of the Registered Shareholder Investment Plan (RSIP) for listed common shares as a partial approach to exempting the inflation component of capital gains from taxation;
- not proceed with the Indexed Term Deposit and Indexed Term Loan proposal because of the economic distortions and other difficulties that would arise;
- initiate a broad study to examine ways to correct for the effects of inflation on the taxation of investment and business income and of gains on other assets;
- consider, in the meantime, raising and indexing the contribution limits and extending the coverage of Registered Retirement Savings Plans (RRSPs) and Registered Pension Plans (RPPs), possibly combined with an increase in the $1,000 investment income exemption for those over 65 years of age;
- facilitate the development of contracting in real terms by removing legal and practical impediments and tax uncertainties;
- adopt the Consumer Price Index (CPI) as the price index to use in adjusting for inflation in the taxation of personal investment income;
- establish an independent body to examine regularly the design of an appropriate set of price indices and to confirm the integrity of these indices.

These recommendations are based on examination and consultation by the Committee that focused on the problems addressed by the Paper as well as its proposals. The Committee has based its recommendations on the assumption that tax reform should have no impact on the fiscal position of the government; that is, tax reductions in some areas should be balanced against tax increases in others.

Chapter 1 addresses the overall problem of the adverse effects on the level and allocation of savings and investment arising from the interaction between price inflation and the tax system. We recognize that society might well attempt to protect itself from the worst effects of inflation, as the Paper suggests, by indexing the tax system to remove distortions in the measurement of income and the real value of investment capital. Concerns were expressed that extending the practice of indexation may lead to less price stability. We examine arguments for and against such a case, on which individual members of the Committee expressed varying viewpoints. We agree unanimously that the best long-term solution to the problem is to reduce greatly or eliminate inflation.

The Paper implied another broad policy objective as well, namely to provide short-term economic stimulus to the housing, small business, farming and fishing sectors. We recognize the serious problems faced by these sectors during the current recession, but after careful consideration we concluded that, if it were decided to pursue this objective in conjunction with the tax reform objective, significant institutional and resource allocation problems would be created.

Chapter 2 examines the original RSIP proposal and presents the major elements of the modified version that we recommend. The following changes to the original proposal, we believe, will increase the attractiveness of the RSIP: deferral of taxation of accrued gains; broadened eligibility for assets to include other types of publicly traded or quoted equity securities; extension of eligible RSIP holders to include estates; and inclusion of mutual and other pooled funds in the RSIP.

In the first part of the chapter, two major concerns about the RSIP proposal were carefully taken into account. One is the case for and against eliminating or reducing the capital gains tax. The Committee was persuaded that this alternative would create serious problems for the integrity and enforceability of Canada's tax system. The second concern relates to deficiencies in the RSIP design, particularly the accrual taxation feature and some restrictions on eligible assets. The Committee decided that modifications to tax accrued gains on an amortization basis would improve the proposal. We oppose any further movement towards including accrued but unrealized gains in the current tax base for gains. We also recommend study of ways and means to achieve inflation adjustment of the tax base for gains on other assets, equivalent to that provided by the modified RSIP. As an interim measure, it is suggested that consideration be given to the possibility of providing relief for taxation of inflation-induced illusory gains on the disposal of common shares of private corporations held for five years or more.

Chapter 3 examines the Indexed Term Deposit (ITD) and Indexed Term Loan (ITL) proposal. The initiative suggests creating interest-bearing savings deposits on which only the real interest component would be taxed and allowing selected borrowers to deduct only the real interest cost that is paid. The proposal's advantages

and serious disadvantages are analyzed. Major economic distortions and other difficulties would arise, in part due to the fact that this proposal was narrowly focused in an attempt to provide short-term assistance to the housing, small business, farming and fishing sectors. The Committee was sympathetic to the serious economic problems faced by Canadians in these sectors that were singled out for access to the Paper's proposed ITLs. The Committee concluded that aid to particular sectors can be more efficiently achieved by other means. Many submissions by the affected sectors confirmed this view. We therefore recommend that the proposal not be implemented.

Three broader approaches to correcting the tax treatment of interest income are then considered:

- taxing individuals only on real interest income without changing interest deductibility for borrowers;
- permitting the broad use of tax-corrected funds on which only real interest income would be taxable for lenders and tax-deductible for borrowers;
- adjusting the tax system so that only real interest income is taxable for lenders and deductible for borrowers.

The Committee considered that the first two alternatives presented special problems and these are summarized in the latter part of the chapter. We concluded that a satisfactory reform of the taxation of interest income probably will involve the third alternative. We also concluded that a broad reform of this kind is unlikely to be feasible unless there are corresponding adjustments to the tax treatment of business inventories and capital cost allowances. Finally, recognizing that broad reforms might be impractical or take too long to implement, the Committee recommends that in the meantime consideration be given to raising and indexing the contribution limits and extending the coverage of RRSPs and RPPs, possibly combined with an increase in the $1,000 investment income exemption for those over 65 years of age. Such a measure would take account of the negative effect on savings and investment resulting from the interaction of inflation and the tax system.

Chapter 4 examines the broad issue of correcting the taxation of business income. We believe that because business investment decisions and personal investment decisions are so closely related, failure to examine and correct taxation of one would make it impractical to proceed with tax reform of the other. The magnitude of current overstatements of income caused by inflation is substantial, as evidence presented in this chapter shows. These considerations have led to our recommendation that the government undertake a comprehensive study of ways to correct for the effects of inflation on the taxation of interest and business income.

Chapter 5 reviews one of the other broad issues raised by the Paper's proposals, namely that of contracting in real terms. By this we mean entering into contractual arrangements in which an agreed real rate of interest will be paid in addition to compensation for inflation's erosion of the value of the principal during the life of the contact. Recognizing that this kind of financial contract is not well understood, the Report outlines the nature and role of instruments that might facilitate contracting in real terms. We point to the experience with such contracting in other countries. After examining the legal impediments, tax uncertainties and other factors that prevent or retard the adoption of these instruments in Canada, we conclude that the removal of these obstacles should be considered.

Chapter 6 summarizes our conclusions and recommendations, most of which have been stated above. One outstanding concern addressed in this chapter is the choice of price index. We have concluded that the CPI should be used to adjust the taxation of personal investment income because it is familiar and quickly available each month, is already in use for indexing exemptions and tax brackets of the personal income tax and represents a reasonable measure of the cost of goods and services purchased by individual taxpayers.

We recommend, however, that in view of the large and possibly growing importance of the CPI, an independent body be established to examine regularly the design of an appropriate set of price indices for various purposes and to confirm the integrity of these indices.

CHAPTER 1

INTRODUCTION

With his budget on June 28, 1982, the Minister of Finance tabled a Paper for Consultation (the "Paper") setting out a series of proposals on **Inflation and the Taxation of Personal Investment Income.** At the same time he appointed an Advisory Committee to examine these proposals with the following terms of reference:

The present accounting rules coupled with the effects of inflation and the present tax system create distortions and have detrimental consequences on the financing of businesses, farmers, fishermen and home buyers. The objective of the Government of Canada is to reduce insofar as possible these tax-related effects of inflation at a pace which takes into account the financial constraints of government financing.

The Paper for Consultation outlines two initiatives for reducing these inflation-induced distortions in the measurement of selected forms of investment income of individual Canadians. In particular, the measures proposed in the Paper include the creation of indexed term deposit certificates and indexed term loans to new home buyers and small businesses and farmers and fishermen, and the indexing of capital gains on Exchange-traded shares of Canadian corporations.

The Committee has been asked to advise the Minister on the practicality of the proposals or appropriate modifications and on the most effective means of implementing them. In reaching its conclusions the Committee must remain cognisant of the need to employ scarce economic resources in a manner that provides the most effective stimulus to the economy in the short run while preserving the basic principles of the Income Tax Act. In this respect, the Committee is to consider and report to the Minister upon:

1. *The desirability of providing selective corrections for inflation in the tax system at the risk of introducing some new economic distortions into the system.*

2. *The desirability of restricting the use of funds from indexed term deposit certificates to lower interest costs to new home buyers, small businesses, and farmers and fishermen.*

3. *The types of financial institutions that should be eligible to provide the indexed term deposit certificates and make the indexed loans to eligible borrowers.*

4. *The design features that might be built into the indexed loans to enhance their safety and acceptability for borrowers and lenders, including the amortization period of mortgages and loans, conditions for renegotiations and renewal, the extent to which repayments are indexed, loan-to-value ratios, and initial gross debt service ratios.*

5. *Administrative difficulties that could affect the implementation of the proposals.*

6. *The desirability of broadening the list of eligible borrowers, recognizing that while allowing a broader group to qualify reduces distortions, it would reduce the interest rate advantage that would likely find its way to the eligible borrowers and would increase revenue costs to the government.*

7. *The desirability of providing an indexing adjustment in respect of capital gains on publicly-traded common shares of taxable Canadian corporations, given that it is not currently feasible to extend it to capital gains on other properties.*

8. *The agents that would be eligible to administer registered shareholder investment plans.*

9. *The effects of the proposals on existing financial markets.*

10. *The economic and financial effects of the proposals on interest rates, the level of savings, activity in the housing industry and on business investment.*

11. *Such other related matters as the members consider pertinent or relevant to the specific proposals in the Paper for Consultation.*

The Advisory Committee must submit its report by September 30, 1982.

In discussions the Minister indicated to the Committee that it should interpret these terms of reference broadly and should be prepared to suggest viable alternatives, provided that the integrity of the tax system was maintained.

The Committee had its first meeting on July 5, 1982 and concluded its work at the end of September. The Committee met in full session for 16 days, and in addition held numerous subcommittee meetings. It received many briefs and letters from interested parties (see Appendix II). All of the members participated voluntarily on a part-time basis. Staff work was provided by government officials and outside consultants. Given the serious constraints of time and staff resources, the Committee has obviously not been able to pursue to its complete satisfaction many of the issues that arose.

This chapter outlines some of the main features of the problem and some of the issues raised by tax reforms aimed at inflation-indexing of the taxation of investment income (which we take, throughout this Report, to include capital gains). Chapter 2 focuses on the taxation of capital gains. Chapter 3 examines the taxation of interest income. Chapter 4 considers issues relating to the taxation of business income. Chapter 5 deals with "contracting in real terms". The final chapter summarizes our conclusions.

1.1 The Problem

The Committee agrees unanimously that the interaction of price inflation and the taxation system, coupled with conventional accounting concepts, has a significantly adverse effect on both the level and allocation of savings and investment. There are three possible solutions to this important problem.

1. **Greatly reduce or eliminate inflation.** All members of the Committee agree that this is the best long-term solution to the problem posed by the Paper. It is recommended unanimously that governments in Canada, as well as all other sectors, exert every effort to reduce or eliminate inflation. This is not the place to examine the sources of inflation nor to set out a prescription for its cure. Nevertheless, no statement in this Report should be construed as condoning inflation or any relaxation in efforts to attain a more stable price level.

2. **Change conventional taxation and accounting concepts to reflect current rather than historical costs.** This approach has been addressed intensively over many years by the tax and accounting professions. A host of difficulties have been uncovered and, at the moment at least, it is doubtful whether these difficulties can be resolved quickly. At the same time, some of the evidence presented suggests that progress might be made with further intensive study. This issue is taken up in Chapter 4.

3. **In the absence of comprehensive changes in the definition of taxable income, modify the tax system where feasible to reduce or eliminate the effects of inflation on the taxation of investment income.** This is the thrust of the Paper's proposals, and hence of our deliberations.

Before proceeding to discuss in detail the Paper's proposals and the Committee's views and recommendations, a number of general issues need to be addressed, namely the policy objectives, the financing of tax reform and issues related to the extension of indexation.

1.2 Policy Objectives

The Paper implies three broad policy objectives:

1. to exempt from taxation the inflation component contained in investment income;

2. to encourage innovations that would strengthen long-term financial markets;

3. to provide short-term economic stimulus to certain sectors of the economy, in particular housing, small business, farming and fishing.

In its deliberations, the Committee addressed separately the first two of these objectives since they ought not necessarily be linked. After careful consideration, the Committee concluded that it could not concurrently pursue the third objective, on two grounds. The first is that, as a matter of principle, short-term stimulus should not be considered within the context of tax reform and financial innovation.

The second is that the linkage of this objective with the first two created significant institutional and resource allocation problems, which are discussed in Chapter 3.

The Committee fully recognizes the seriousness of the current recession and that certain sectors of the Canadian economy, including those identified in the Paper, have been very hard hit. This situation is of major concern throughout the country and deserves a high priority in current policy making. It is the Committee's view, however, that more effective and less expensive methods are available to deal with this situation than through a structural change in the taxation of personal investment income. This said, from a longer-term standpoint, a "better" tax system and more efficient financial arrangements should improve the average rate of growth in employment and real incomes.

1.3 Financing Tax Reform

In the Committee's view, tax reform should be considered as an issue separate and apart from the fiscal position of the government. Tax reform should instead focus on the appropriate allocation of the tax burden, and be carried out on the basis that there is no impact on the budgetary balance. This means that tax reductions in some areas should be balanced off against tax increases in others. When considering modifications to the Paper's proposals, we have assumed that if there are any additional costs, these would have to be met with additional revenues from else-

where in the system. Viewing tax reform in this light breaks any link that might otherwise exist between tax reform and the present size of the budget deficit.

1.4 The Indexation Quandary

A basic concern throughout the Committee's discussions about reforming the taxation of investment income and the consequences of financial contracts written in real terms was that these innovations, while worthwhile in themselves, could make it more difficult to attain a stable price level.

What can be said about the substance of this issue?

1. A case can be made both for and against the argument that widespread indexation will provide the slippery slope to a less stable price level. The available empirical evidence is inconclusive; opinions vary and are often strongly held. Indexation eases the process of adjustment to both lower and higher rates of inflation. As such it has little to do with the rate of inflation per se. It is analogous to a flexible exchange rate system which eases the process of adjustment without much affecting the equilibrium level of the rate.

2. Indexation may reduce the political pressure on governments to give price stability as high a priority as it might otherwise have, just as a flexible exchange rate system reduces the discipline imposed by a fixed exchange rate on domestic monetary and fiscal policy.

3. Even widespread indexation is unlikely to be universal. In particular, one asset that none of the indexation proposals embraces is money (currency and low-interest or non-interest-bearing deposits). Money serves three important functions in an advanced economy. It is a unit of account, a medium of exchange and a store of value. These benefits of money are greatest when the value of money remains constant over time.

   Inflation creates uncertainty concerning values and diverts resources into non-productive activities because inflation itself cannot be anticipated with certainty. This is true whether the system is indexed or not. It is increased, however, if the tax on capital arising from the interaction between inflation and the tax system is reduced on all (or most) other assets except money. Thus it seems likely that indexation will increase the substitution of indexed assets for unindexed money.

4. The possibility of contracting in real terms is likely to reduce the recent tendency to contract in U.S. dollars as a purported hedge against inflation-prone Canadian dollars. On the other hand, contracting in real terms might be perceived as reflecting acceptance of more price instability and possibly a higher rate of inflation.

5. Financial innovation, whether through the introduction of indexed assets or the widespread use of foreign monies, may tend to reduce or make unstable the demand for money in Canada. Since the control of the Canadian price level, and hence the value of the Canadian dollar, depend on a stable demand for Canadian dollars, indexation and other financial innovations may increase the future instability of prices. On the other hand, the information provided by a market-determined real rate of interest on indexed securities could be helpful to the monetary authorities in their efforts to control the price level.

6. One aspect of the proposals which appears to be inconsistent is that they have been presented at the same time that the indexation of exemptions and rate brackets of the personal income tax has been significantly reduced for a two-year period. The Paper's proposals relate to the proper definition of investment income, so as to treat all forms of income in a similar fashion. In this sense, there is no inconsistency with the limitations on general indexing of the income tax as applied to all income. However, one of the chief objectives of the Paper is to reduce or eliminate the effects of inflation on the taxation of investment income, and this obviously cannot be done if the inflation indexation of the personal income tax exemptions and brackets is placed in jeopardy. This limitation of the personal income tax system also gives conflicting and confusing signals about the extent of the government's commitment to removing the effects of inflation on the real tax burden.

7. Another concern expressed to the Committee relates to timing. Will extension of indexing to the taxation of investment income at this time have the effect of blunting the public perception of governments' resolve to fight inflation, and hence make slower and more costly the progress to a less inflationary environment? Some members think that it will; others think not. We do not know.

In considering these many issues, the Committee deems it very important to be precise about what is meant by indexation. Indexation covers a broad range of adjustments designed to allow for the effects of changes in the price level. Three broad classes of indexation can be distinguished:

i) indexation related to the definition of taxable income and to the tax brackets and exemptions applied to taxable income;

ii) indexation in contracts between borrowers and lenders;

iii) indexation of current claims on national income through automatic inflation adjustments to wages, prices, salaries and transfer payments.

These distinctions drawn, it is clear that the tax base and tax rates can be indexed independently of financial assets and liabilities. Nor does it follow that indexing the

tax system and financial assets and liabilities is necessarily linked to indexing claims on national income, or to the political will to control inflation.

Furthermore, it is not likely that the same price index is appropriate for all classes of indexation. For example, the appropriate index to adjust taxation is the index of goods and services bought by individual taxpayers - i.e. the Consumer Price Index (CPI). It might be convenient to use the same index to adjust financial assets and liabilities, but it is not surprising to see that some existing financial assets are linked to commodity prices or to other indices that are more suitable to the particular circumstances. Indexation of wages and salaries and other claims on national income might best be related to the price of national production, which reflects better than the CPI the value of the economy's output.

The Committee, following the Paper, has proceeded on the assumption that it is feasible to adjust the tax base for inflation and to have contracting in real terms without escalating claims on national income. Another underlying assumption is that indexing the tax system and facilitating contracting in real terms would not significantly increase the problems of monetary management. Some members of the Committee seriously question one or both of these assumptions. None of us is sure.

CHAPTER 2

TAXATION OF CAPITAL GAINS

The direct objective of the fiscal reform for capital gains, as put forth in the Paper, is to eliminate the taxation of inflation-induced illusory capital gains on listed common shares of corporations taxable in Canada. The Paper proposes that the way to effect this is by including only inflation-adjusted, that is "real", gains on such shares in the taxable income of individuals.

Ideally, a fundamental tax reform as envisaged by the Paper should not discriminate between categories of assets. The Paper recognizes that such a wide-ranging approach would be "desirable on conceptual grounds for all assets". However, for reasons related to the substantial complexities and transitional problems that would have to be overcome in order to implement a broad reform, the Paper limits its proposed indexation of capital gains to publicly-traded common shares of Canadian corporations.

2.1 The Indexation of Capital Gains: The Registered Shareholder Investment Plan (RSIP)

At this point, it is useful to itemize the elements of the RSIP framework as suggested in the Paper:

- Individuals residing in Canada could purchase common shares of taxable Canadian corporations listed on a Canadian stock exchange and hold them in RSIPs administered by investment dealers, brokers or specified financial institutions.

- The cost of the pool of shares would be adjusted upward to reflect inflation at the end of each calendar year. The difference between the prevailing year-end market value of all the shares registered in the RSIP and the indexed cost base would be reported as a capital gain or loss for tax purposes. The year-end market value of the shares would become the cost base of the RSIP for the next year.

- Half of the "real" capital gains so recognized in the RSIP would be taxable, and half of such losses would be deductible, without limit, from other income. This tax treatment of losses differs from present tax rules whereby a capital loss realized upon the sale of shares is deductible only against realized capital gains and a maximum of $ 2,000 of other income.

- Recognition of capital gains and losses would occur annually on an accrual basis, with 50% of all capital gains or losses arising in the RSIP in a particular year taxable or deductible in that year whether or not the shares were actually sold.

- There would be no need to calculate or report capital gains or losses on actual dispositions of shares in the RSIP, as the calculation of the aggregate gain or loss at the year end of the plan would be automatically adjusted to reflect such dispositions.

- Dividends would be taxed in their present manner.

- Interest on funds borrowed for the purpose of investing in the RSIP would not be deductible for tax purposes.

- Capital gains earned in the RSIP would not be eligible for the present $1,000 investment income exclusion.

Illustration of the Problem

The interaction between inflation and the tax system creates a disincentive to individual savers to invest in corporate equity. For instance, an investment in a representative portfolio of ten common shares(1) of large Canadian companies from 1971 to 1980 would have yielded a 7.5% real capital gain before taxes. However, tax would have been levied on the nominal capital gain, resulting in a 201.6% effective tax rate on the real gain, and an after-tax real capital loss of 7.6%.(2) Of course, if the shareholder had borrowed the funds to purchase all or part of his investment, the effective tax rate would be different because of the deductibility of interest. Indeed, one of the defects in the present tax system is the variability of effective tax rates on investment income, depending on the proportion of borrowed funds employed, the utilization of the $1,000 exemption and other factors.

2.2 Reactions to the Proposal

The Committee noted two general types of responses to the Paper's RSIP proposal. The first argued that the proposal's objectives should be achieved in entirely different ways, either through the elimination or substantial reduction of the capital gains tax, or through the general indexing of the cost base of all assets. The

(1) The shares are Alcan Aluminium Limited, Bank of Montreal, Bell Canada, Canadian Pacific Limited, Dome Petroleum Limited, Gulf Canada Limited, Inco Limited, Moore Corporation Limited, The Royal Bank of Canada and The Seagram Company Ltd.

(2) Assuming on investor with a 50% marginal tax rate, who provides the total investment with equity capital and who has already utilized the $1,000 Canadian investment income exclusion.

second concentrated on perceived deficiencies in the design of the Paper's proposal, such as the accrual basis of taxation.

These are reviewed in the following discussion.

2.2.1 Elimination or Reduction of the Capital Gains Tax

A significant number of submissions to the Committee, as well as some Committee members, expressed the opinion that elimination or reduction of the capital gains tax on shares of taxable Canadian corporations would be preferable to an inflation adjustment scheme. Particular exception was taken to the perceived complexity and cost of an inflation-adjusted tax system and the immediate taxation of accrued capital gains. In contrast, the elimination or reduction of the capital gains tax on Canadian equities was seen as a simple, easily understandable step which would immediately solve the problem of taxation of the inflation component of capital gains, while serving as a more effective stimulus to equity investment.

It was further argued that the elimination or reduction of the capital gains tax on Canadian shares would represent a clear signal that the government wished to encourage equity ownership and entrepreneurship in Canada and it would do much to improve the overall level of business and investor confidence in this country.

It was noted that a reduction or elimination of the capital gains tax on Canadian shares would have the advantage of providing immediate benefits for all such investors, whereas the RSIP proposal would require each investor to take specific action to establish a qualifying account with all attendant costs.

The Committee gave serious consideration to the desirability of recommending the elimination or reduction of the capital gains tax on Canadian shares.

The Committee accepted representations made to it by officials of the Department of Finance and others that the elimination or reduction of the capital gains tax would give rise to problems related to the basic fairness and enforceability of Canada's tax system. It was indicated that such a tax change would inevitably be accompanied by new tax constraints on the conduct of the affairs of many businesses.

For instance, a repeal or substantial reduction of the capital gains tax on the shares of listed Canadian corporations would likely involve a number of changes in order to protect the integrity of the tax system and prevent abuse, including:

- an increase in the discretionary powers of revenue authorities in ruling on the tax consequences of corporate reorganizations;

- severe restrictions on tax-free roll-overs of assets permitted to Canadian companies;

- adjustments with respect to the capital gains tax on the shares of private companies going public, and of public companies going private - an issue which could be avoided by extending the benefits to private company shares although this would create new anti-avoidance issues;

- transitional rules on accrued gains on listed shares which had not yet been taxed under the present system;

- adjustments to the taxation of dividends to maintain a balance with the taxation of capital gains, or alternatively acceptance of the likelihood of reduced dividend payouts by Canadian companies because of the increased attractiveness of capital gains.

The Canadian income tax system functions more effectively if investment income from all sources is taxed on a reasonably comparable basis.

It is also necessary to retain a perception of basic fairness in the tax system. It is one thing to correct the current inequities in the tax treatment of capital gains by eliminating the taxation of illusory inflation "gains". It is quite another matter to eliminate or to shield from taxation real increases in the income of individuals from realized gains.

For this reason, there could be some question concerning the stability of a tax system which imposed no significant taxes on capital or capital gains. Further, the repeal of the tax on a major element of capital gain could lead governments to introduce estate or other taxes on capital.

In short, the elimination or reduction of the capital gains tax would have a major impact on the basic structure of the present tax system, with attendant transitional costs of considerable magnitude.

The feasibility of reducing the capital gains tax on listed shares and the tax problems which might arise therefrom is a complex matter. Although some members of the Committee would have favoured a significant reduction in the tax on capital gains realized from listed Canadian shares, embarking upon such a course would represent a departure from the principles underlying the present tax system. These members would, however, recommend further analysis by the Department of Finance together with outside tax advisors concerning the possibility of reducing the capital gains tax.

2.2.2 General Indexation of the Cost Base of Assets in the Tax System

The Committee recognized that arguments rooted in both equity and economic efficiency can be and are being advanced that gains realized on assets other than listed Canadian equities should also be adjusted to remove the illusory inflation element. The Committee accepts that in a fair and reasonable tax system, artificial additions to income resulting from erosion in the value of money should be excluded from the tax base.

To do so is not some concession or bonus to those who have had their income overstated in nominal terms because of a fall in the value of money, but rather an entirely appropriate way of recognizing real ability to pay.

We have concluded that the development of any such comprehensive set of adjustments would be a complex and difficult task, and would be far beyond our resources in the time available.

Because of the substantial complexities of implementing such a broad reform, the Paper has limited its immediate proposal on inflation adjustments for capital gains to publicly-traded Canadian common shares. For the aforementioned reasons, we have adopted the same approach.

The Committee recommends to the government that a study be initiated as soon as possible to examine ways of achieving an equivalent inflation adjustment of the tax base for gains on the shares of private companies and other assets, and for comprehensive adjustments for taxation purposes to business income, in order to achieve the fundamental objectives of equity and economic efficiency. We believe that such a review could be usefully carried out as part of the broad study of possible inflation corrections to the taxation of business and interest income which we recommend in section 4.4.

2.2.3 Objections to Features of the RSIP

Most of the submissions dealing with the RSIP raised objections about its accrual feature. This issue overshadowed the acknowledgement found in a number of submissions that the RSIP would in most instances provide a higher after-tax return to investors than is possible under the present tax system. The objection to taxation of capital gains on an accrual basis appears to be based largely on principle (the belief that capital gains should be taxed only when assets are sold), rather than on a consideration of monetary benefit to investors.

Almost all commentators objected to the accrual feature on two grounds:

- Taxation of RSIP gains on an accrual basis would constitute a dangerous precedent.

- Taxation of unrealized gains would pose problems of liquidity for some taxpayers, forcing them to liquidate some of their assets prematurely in order to pay the relevant taxes.

The Committee shares these concerns regarding the annual taxation of unrealized capital gains on listed shares. The accrual issue is addressed in section 2.3.2. The principle of taxation on an accrual basis, while appropriate for RSIPs, ought not, in the Committee's judgement, constitute a precedent for similar treatment in the taxation system as a whole.

Representations were also made to the Committee that, rather than accepting the RSIP, we should suggest that inflation adjustments be made to the cost base of all capital assets, or at least of Canadian equity shares. The introduction of any general indexing of the cost base of assets would however cause certain difficulties:

- Taxpayers would face serious practical problems in computing the adjusted cost base of individual assets or groups of assets, including dealing with adjustments for such matters as stock dividends and splits, partial sales of identical properties, roll-overs or conversions of property.

- There would be a corresponding difficulty for tax authorities in reviewing such calculations.

- Difficult structural and transitional issues would arise relating to restricting the deduction of interest on loans to acquire indexed assets. The Paper indicates that allowing the deduction of the full amount of interest expense and also indexing the cost base of assets to reflect depreciation in the value of money can provide a

double adjustment for inflation since interest costs include compensation to the lender for the loss in the real value of the loan principal.

- There could be a problem of indexing the cost of certain business and other assets outside of the context of a general inflation adjustment in the determination of business income.

Even if adjustments to the cost base were confined to a narrow group of assets such as shares of listed Canadian companies, there would still be difficulties for taxpayers and tax administrators in computing the adjusted cost base of each separate lot of shares, and of effectively restricting interest deductibility.

We considered that the RSIP was, on balance, preferable to a perhaps complex system of indexing the cost of a still limited group of assets outside the RSIP.

The Committee concluded that the RSIP, despite certain drawbacks, provides a means of eliminating the inflation element from gains on the shares of listed companies in a cost effective manner.

Other specific concerns about the RSIP are addressed in the following sections dealing with the details of our proposal.

2.3 Modified Registered Shareholder Investment Plan

After careful consideration, the Committee concluded that the RSIP proposal in the Paper provided a basis for desirable reform. However, the Committee considers that the RSIP proposal would be improved by incorporating the following changes, amongst others:

- introduction of a deferral of the taxation of accrued gains in RSIPs;
- extension of assets eligible for inclusion in RSIPs to some other types of publicly traded or quoted equity securities;
- extension of the right to own RSIPs to estates;
- inclusion of mutual and other pooled funds in the RSIP arrangements.

We believe the modified RSIP proposal, as outlined below and further detailed in Appendix I, addresses to the greatest extent practicable the major concerns raised by Committee members and interested parties.

2.3.1 Adjusting Capital Gains for Inflation in RSIPs

The Committee accepts the basic structure of a pooled investment system [3] as proposed in the Paper. A taxpayer would thus be permitted to adjust the cost base of his or her eligible equity investment in such an account by an inflation factor based on the tax "cost" of the pool of securities, and on the holding period. Gains and losses would be determined annually on an accrual basis. At calendar year end, the market value of securities in the RSIP would be determined, and compared with the inflation-adjusted cost base of the taxpayer's investment in the account. The difference between these two amounts would be the accrued capital gain or loss of the taxpayer; one half of that amount would be a taxable capital gain or allowable capital loss to be recognized for tax purposes.

The way in which the inflation adjustment for shares held in RSIPs might take place is illustrated in greater detail in Appendix I.

2.3.2 The Accrual Basis for Taxation

The Committee does not recommend that the full amount of a taxable capital gain or loss should be reflected in the taxpayer's current income. Because of our concerns about the immediate taxation of accrued but unrealized gains, the Committee recommends that the amount of such taxable gain or loss should be recognized for tax purposes on an amortization basis. A percentage, not to exceed 35%, of the net balance of gain or loss would be considered as income or as a deductible loss in the current year, with the balance being included in income in subsequent years under a declining balance approach. An illustration of how this would be done is set out on the next page.

We are suggesting that the portion of the gain not recognized in income in the current year be excluded from the adjusted cost base of the plan's assets for the purpose of computing its opening "cost" for the succeeding year. This means that the deferred gain will be automatically included in the calculation of gains and losses in following years and no separate calculation or adjustment with respect to such deferred gain is required. Correspondingly, the portion of any loss not recognized in in-

(3) A pooled concept means that the taxable capital gain or loss is calculated as the cumulative gain or loss of all eligible assets in the RSIP, rather than separately for each asset.

TABLE 2-1

Simplified Example of Calculation of Taxable Gains and Allowable Losses in the Modified RSIP

First Year			
Jan. 1	Purchase of shares in Co. A		$200
	Purchase of shares in Co. B		300
Dec. 31	Total cost of investments		$500
	Add – adjustment to cost base for inflation (assumed to be 10%)		50
			$550
Dec. 31	Market value of securities in the RSIP	$700	
	Less – adjusted cost base	550	
	Gain	$150	
	Portion of gain to be recognized in income – 35% of $150	53*	
	Gain deferred	$ 97	
	Add to cost base amount of gain recognized		53
Second Year			
Jan. 1	Cost base of investment		$603

* One half of this gain would be included in taxable income.

come in the current year would be added to the market value of the securities in the RSIP at the year end to determine the opening "cost" of the plan for the succeeding year. The deferred loss would therefore be included in the calculation of gains or losses in following years.

It should also be noted that, as explained in the Paper, it would not be necessary to calculate separately or report any gains or losses on actual sales or dispositions of shares in the RSIP. Such gains and losses would be dealt with automatically in the

calculation of the aggregate gain or loss in the entire pool at the year end, since the proceeds of disposition of shares sold and the market value of shares withdrawn would be deducted from the "cost" balance of the pool.

However, the Committee also recommends that taxpayers have the option to elect, annually and in advance, to recognize all gains and losses on a full accrual basis, as proposed in the Paper. Such an election would not be effective with respect to accrued losses in the taxpayer's RSIP at the date of the election.

2.3.3 Investments Eligible for RSIPs

Given the objectives of the RSIP proposal, the Committee believes that as many corporate equity investments as possible should be eligible for the RSIP. We therefore suggest that, in addition to the common shares of taxable Canadian corporations listed on a recognized Canadian stock exchange, the following assets should also be eligible for inclusion in RSIPs:

(i) warrants, rights and options in respect of listed Canadian common shares;

(ii) investments in segregated pooled funds of insurance companies, trust companies and others to the extent that these funds meet specified criteria with respect to the investment of the funds;

(iii) investments in specified mutual funds;

(iv) other listed securities, such as units in Canadian trusts deriving income in Canada, provided that they are recognized as the equivalent of an equity investment;

(v) new issues that qualify for listing on a recognized Canadian stock exchange, provided that an application for listing is pending and accepted within a reasonable period.

The Committee recognized the importance of preferred shares as a means of raising corporate equity capital and gave careful consideration to their possible inclusion in RSIPs. Preferred shares, although legally considered as equity, incorporate features of both debt and equity. The Committee concluded that most preferred shares, like debt, sell on a yield basis and, therefore, are inappropriate for inclusion in RSIPs. In order to avoid arbitrary and ineffective rules for preferred share eligibility, the Committee proposes that all preferred shares be excluded from RSIPs. If the tax treatment of interest is adjusted at some future date, the treatment of preferred shares should also be reviewed and adjusted.

2.3.4 Eligibility of Foreign Shares

The Committee wishes to make clear that in principle there is no tax or economic reason to restrict the listed common shares eligible for inclusion in RSIPs to those issued by Canadian companies. Indeed, it would be preferable if Canadian investors had no tax restrictions on the diversification of their portfolios through the purchase of listed foreign common shares. Any decision to confine the shares eligible for RSIP inclusion to shares issued by Canadian companies must rest on policy considerations which are outside the scope of the Committee's mandate.

2.3.5 Investor Eligibility

The Paper suggested that only individuals resident in Canada be eligible to invest in RSIPs. We suggest that eligibility should be extended to estates provided that these entities are resident in Canada and the investments in the RSIP may reasonably be expected to be held for the benefit of individuals resident in Canada.

2.3.6 Other Features of the RSIP

A number of other recommendations regarding the RSIP are discussed fully in Appendix I. The most important of these are:

(i) Interest deductibility and margin accounts:

After due consideration, the Committee accepts the position of the Paper that the full or nominal amount of interest on funds borrowed for the purpose of investing in RSIPs not be tax-deductible, since to do so would grant an allowance for inflation in addition to the one already provided for. The Committee recommends that this non-deductibility provision should apply only to loans specifically taken out for this purpose, as determined in the same manner as other possible non-deductible interest under the present terms of the Income Tax Act. It should be noted, however, that the arguments in the Paper justify the non-deductibility of only the "inflation" component of interest expense. The "real" interest element should be allowed as an expense except for the practical issue of computation.

There is no reason why any effort should be made to prevent RSIP accounts from being used for purchases on margin or as security for other debt.

(ii) Transfers into RSIPs:

Unlike the Paper, which proposes that only new purchases of qualifying Canadian securities be eligible for inclusion, the Committee believes that existing holdings of eligible securities should be transferable into RSIPs at the current market value, with gains or losses already accrued dealt with under existing tax legislation and subject to the existing restrictions on deductibility of capital losses.

(iii) Management and administration:

All regulated institutions and organizations which wish to offer RSIPs should be eligible to do so, subject to any applicable federal law or provincial securities legislation. RSIP administrators would be responsible for the provision of timely information to investors for tax purposes. The Committee also believes that all administrative fees paid by taxpayers in connection with RSIPs should be fully deductible.

(iv) Treatment of cash in RSIPs:

Only eligible securities should be accorded an inflation adjustment for tax purposes. Cash balances in RSIP accounts would therefore be excluded from any calculation of inflation-adjusted capital gains or losses.

(v) Choice of index for inflation adjustment purposes:

The Committee recommends that the index to be selected for use in adjusting the RSIP cost base should be the Consumer Price Index, as this is the index which is widely recognized as the measure of the impact of inflation on the value of funds to taxpayers. The Committee proposes that the indexing factor should be established by the use of CPI figures applied two months in arrears, so as to provide immediately at each year end the figures to undertake all necessary calculations. As discussed in Chapter 6 of this Report, the Comittee suggests that it would be prudent to examine the design of an appropriate set of price indices for various purposes.

2.4 Possible Concerns about the Proposed RSIP

The modified RSIP does not eliminate all points of concern raised with respect to the original proposal in the Paper. However, the Committee generally believes that the modified RSIP is a viable improvement on the present situation. The Committee did identify and review the following areas of concern that might exist with respect to the modified proposal.

2.4.1 Accrual Basis of Taxation in RSIPs

The Committee received numerous representations against the annual accrual basis of determining taxable capital gains in RSIPs.

It should be noted that the RSIP proposal does offer the following advantages resulting from its use of the accrual method:

- the ability to deduct allowable capital losses in full from other income;
- simplified tax accounting, as the inflation indexing can be done on a pooled basis and not on the basis of separate calculations of the cost base of each individual security as would be required under a realization approach;
- removal of immediate tax consequences from individual trading decisions.

The Committee further believes that much of the concern over immediate taxation of accrued capital gains is alleviated by our proposal that an individual may defer a major portion of taxable accrued gains (and losses).

The Committee accepts that the accrual basis of calculation is appropriate in the limited circumstances of a relieving provision where it can offer clear administrative advantages. However, the Committee opposes any further movement towards including accrued but unrealized gains in the current tax base.

2.4.2 Cost and Complexities

It must be recognized that to obtain the advantage of the RSIP, each investor would need to take specific action to set up a qualifying RSIP account. The costs of establishing such accounts and related systems could be significant. The Committee has received varying estimates of the annual administrative costs of handling the RSIP arrangements and accounting, and has reviewed the capability of present accounting systems to be adjusted to handle RSIP reporting.

Following this review, the Committee is confident that the necessary activities can be carried out for a reasonable charge, based on modifications to the existing computerized bookeeping systems widely employed by almost all brokers and mutual and pooled funds.

However, the financial institutions and stock exchanges should be given as much advance notice as possible of the detailed design of the plan, and their representatives, including the Financial Administrators Section of the securities industry, should be involved in commenting on draft legislation and regulations so as to minimize costs and disruption.

2.4.3 Extension of the RSIP

Representations were made to the Committee that other assets, most notably shares of private Canadian corporations, should also be eligible for inclusion in the RSIP. The Committee is sympathetic to providing equivalent adjustments in the taxation of gains from the sale of shares of private companies. The suggestion has been examined and the Committee concluded that such adjustments cannot feasibly be carried out within the RSIP or any other similar plan. Any gain arising on the disposition of a share of a private company should only be subject to tax when actually realized. It is inappropriate to include in RSIPs assets such as the shares of private companies which cannot be readily valued and which have limited liquidity. In any event, there are complications in any system of indexing the cost of shares of private companies, such complications relating to the deductibility of interest on loans taken out to acquire such shares.

The Committee believes that the introduction of the RSIP would act as an inducement for more private companies to qualify their shares by listing such securities on a stock exchange and views this as a desirable result.

The Committee recognizes, however, that in order to maintain fairness and avoid long-run distortions, a more equitable tax treatment for capital gains on the shares of public corporations needs to be followed by an equivalent tax modification for the shares of private corporations and the assets of unincorporated enterprises. The Committee believes that the potential problems in providing a fairer capital gains tax treatment to these businesses should be surmountable.

The Committee recommends that, as an interim measure, the government undertake a study to develop a system whereby taxpayers who have held shares of Canadian-controlled private corporations for five years or more, and who dispose of such shares in an arm's length transaction, might obtain relief from the taxation of the illusory inflation element in their taxable gain.

2.5 Cost of Proposal

The Paper estimated the revenue loss to the federal government from the adoption of the RSIP proposal at about $100 million annually.(4)

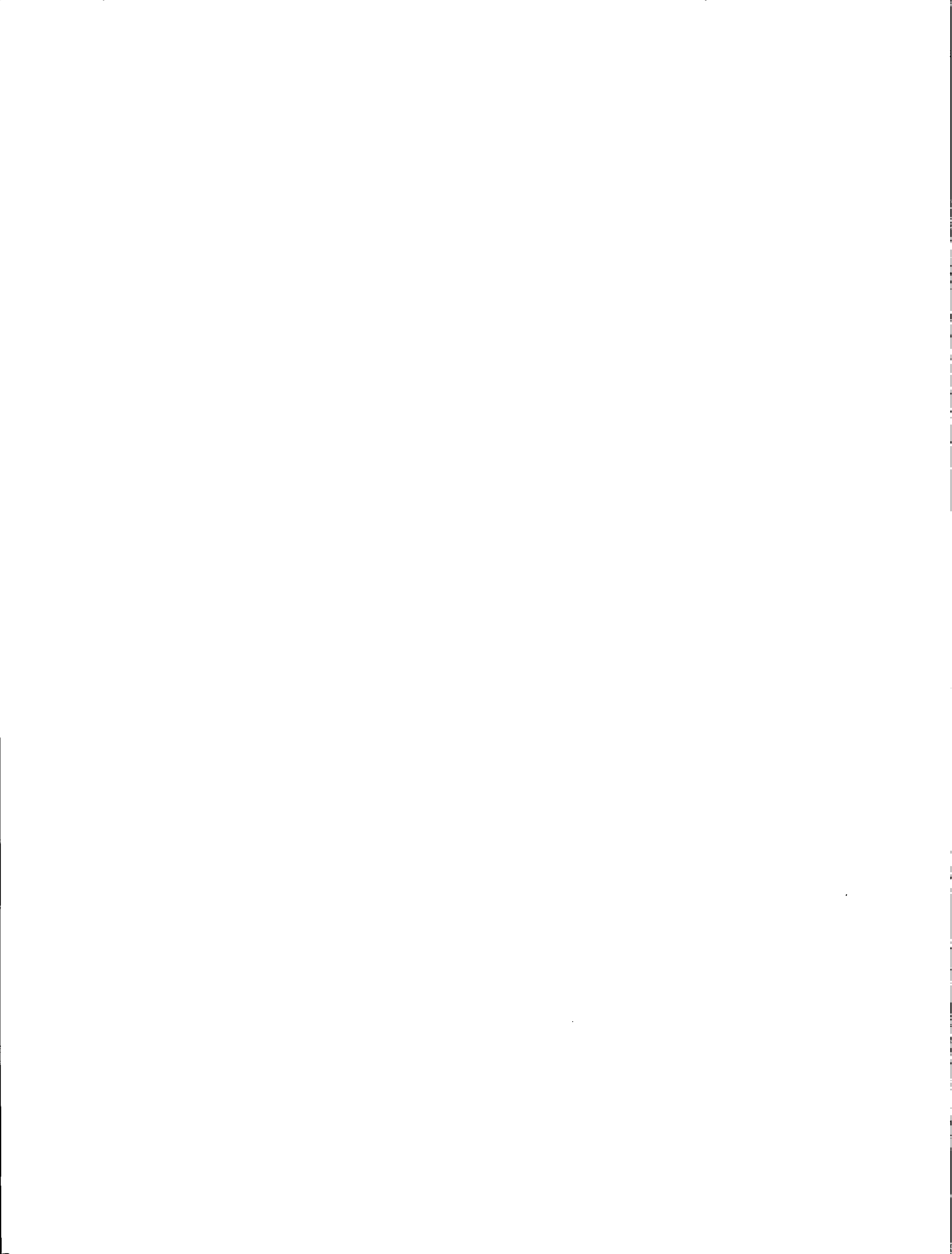
The Committee has not been able to make an independent estimate of the revenue loss. The cost will depend on the rate of inflation, market performance and the degree of acceptance of the RSIP proposal. However, our impression is that the revenue cost could well be higher, perhaps substantially higher, than the preliminary estimate in the Paper.

2.6 Conclusion

Subject to the preceding discussion, the benefits to equity investors of the modified RSIP have been demonstrated to the Committee's satisfaction, and the Committee recommends the adoption of the modified RSIP as described above. The adoption of this proposal will have the desirable result of removing the inflation-based and therefore illusory component of capital gains from the tax base. We also believe that the introduction of the RSIP will increase the willingness of Canadian investors to accept the risks associated with equity investments.

The Committee also recommends, as indicated in section 2.2.2, that the government initiate as soon as possible a study to examine ways of achieving an equivalent inflation adjustment of the tax base for calculating gains on other assets, including shares of private corporations. As an interim measure, the Committee recommends in section 2.4.3 that consideration be given to adopting measures to provide relief from the taxation of illusory inflation gains on the arm's length sale of shares of private companies, provided that such shares have been held for at least five years.

(4) The revenue loss to the provinces, if they all adopt the proposal, might amount in the aggregate to about 50% of the federal cost.



CHAPTER 3

TAXATION OF INTEREST INCOME

The purpose of the Paper's second proposal is to address problems created for the holders of interest-bearing debt by the interaction of the current system of taxation with high and variable rates of inflation. It is proposed to change the tax system to encourage savers and borrowers to use new financing instruments in the form of Indexed Term Deposits (ITDs) and Indexed Term Loans (ITLs) on which the real interest component is specified by contract and the inflation component is allowed to vary.

Under a comprehensive reform, there are substantial costs and difficulties encountered in taxing only the real interest received by a lender and in allowing as a deduction only real interest costs paid by a borrower. In the Paper, these costs and risks were limited by confining the proposed tax changes to newly created interest-bearing instruments for which only specific lenders and borrowers would qualify.

3.1 The Proposal

The initiative advanced in the Paper would establish a new "channel through which funds could be invested and borrowed on an inflation-insulated basis." The basic elements would be as follows:

- **Indexed Term Deposits.** ITDs would be offered by financial institutions. The inflation component of interest received on the deposits would be tax-exempt; interest offered would be set in real terms. Minimum maturity on deposits would be one year with no maximum on the amount that could be invested by an individual. It was anticipated that depositors would accept a lower real rate of interest than on conventional deposits because of the tax exemption. It was further anticipated that most taxpayers with investment income in excess of $1,000 would find ITDs attractive, as the following comparison illustrates. An individual with a 40% marginal tax rate who receives 13% annual interest on a deposit when inflation is 10% earns a net after-tax real (inflation-adjusted) rate of return of -2.2%. For every $100 deposited the individual loses $2.20 in purchasing power. By comparison, with an ITD having an assumed 1% "real" yield, the depositor would receive 60 cents in after-tax interest income plus $10 as compensation for the decline in purchasing power of the deposit.

- **Indexed Term Loans.** ITLs would be available from institutions offering ITDs. ITLs would be negotiated in real terms with the inflation component added to a real rate of interest. This real component would be fixed for the term. Because of the favourable tax treatment of ITDs and restricted eligibility for ITLs, it was an-

ticipated that the supply of deposits would significantly exceed the demand for loans, and hence that the interest rate charged on these funds would be lower than on conventional funds. Availability of the loans would be restricted to specific borrowers, namely purchasers of new homes as well as farmers, fishermen and small businesses acquiring new depreciable assets. Restricted eligibility was considered essential to maintenance of the preferential interest rate since ITLs would be attractive to all potential borrowers not benefitting from the tax deductibility of interest costs.

- **Matching.** Financial institutions would be required to match the aggregate amounts of their ITDs and ITLs. Because of the lower interest rates associated with these instruments, the funds would have to be segregated from the conventional market. Matching mechanisms for ITDs and ITLs would have to be developed within and among participating financial institutions which would be responsible for their design.

3.2 Possible Advantages of ITDs/ITLs

Three major advantages, consistent with the broad objectives of the proposal in the Paper, can be identified:

- **Protection of savings from erosion by inflation:** The after-tax real return to many taxable savers holding ITDs would improve significantly over that for conventional deposits as long as inflation remains high.

- **Increased supply of longer-term funds:** Uncertainty about the impact of future inflation on expected real returns would be reduced, possibly increasing savers' willingness to lengthen the term for which they are prepared to invest their savings.

- **Benefits to eligible borrowers:** Eligible borrowers would benefit from the favourable tax treatment of ITDs through lower cost loans. These borrowers would not, however, be allowed to deduct for tax purposes the inflation component of interest charges.

3.3 Issues Arising from the Proposal

Notwithstanding these advantages, the proposal entails serious disadvantages which are discussed below. Four issues have been identified which arise primarily from the borrower eligibility requirements that are imposed to aid borrowers in particular sectors of the economy hard hit by high interest rates. These issues include:

- problems in resource allocation;

- mandatory use of real-term instruments to obtain tax benefits;
- problems for financial intermediaries;
- government intervention in credit allocation.

3.3.1 Problems in Resource Allocation

One of the three objectives implied by the proposal is selective stimulus of the economy. This objective is to be achieved by restricting eligibility for indexed loans to a limited number of borrowers. Since those eligible borrowers would have access to loans at significantly lower costs than on conventional markets, they could be expected to invest beyond what they were planning to do in the absence of the proposal. This stimulus would be reinforced by easing the short-term cash flow problems experienced in some of the eligible sectors.

While acutely aware of the pressures created by the current economic recession, the Committee is concerned by the potential distortions that would be created by the channelling of the tax benefits to a small group of borrowers. These distortions, which are discussed below, are of three types and in the long run their collective impact could be significant. The first kind of resource allocation distortion is one that could arise within eligible sectors; the second between the eligible and non-eligible sectors; and the third among financial institutions.

- **Distortions within Eligible Sectors:**

Several examples can be used to illustrate potential distortions that could arise among eligible borrowers. One could arise in housing because ITLs are restricted to new house purchases – a restriction that might adversely affect the relative market value of existing housing. Housing renovation could also be discouraged. Because the benefits would not be available for the purchase of existing homes, fewer households would purchase renovated houses or existing houses with a view to renovating them. Broadening the eligibility criteria, as most commentators have suggested, would reduce some but not all of these distortions.

A second example can be drawn from the fishing industry. The Paper's proposal envisages that fishermen will increase their investments in equipment. However, there is evidence that various incentives for capital spending in the fishing industry have tended to perpetuate excess capacity and hence to reduce average incomes for fishermen.[1]

(1) "Of all the needed changes, the most obvious is the removal of subsidies that encourage construction of fishing vessels. It is incongruous for government to provide financial incentives to build new fishing vessels when the

A third example is drawn from agriculture. Representatives of the farming community have indicated that the "greatest need for long-term financing in agriculture is for land acquisition and debt refinancing. There exists also a very real need to provide farmers with medium-term loans for feeding livestock".[2] The incentive contained in the proposal would nevertheless favour investment in depreciable fixed assets, the financing of which does not seem to be the greatest source of difficulties.

- **Distortions between Eligible and Non-eligible Sectors:**

The relative attractiveness of ITDs could result in diversion of savings away from conventional investments that supply the non-eligible borrowers, thereby increasing their relative cost of borrowing. For instance, several submissions have indicated that implementation of the proposal would seriously undermine the market for preferred shares, the major source of public equity capital raised in recent years. Substitution among assets and liabilities could also occur, because borrowers could be induced to rearrange their affairs so as to use ITLs for purposes other than those intended by the proposal.

- **Distortions among Financial Intermediaries:**

Different types of financial intermediaries operate under differing limitations on their businesses and powers. The composition of their assets and liabilities is not identical. For example, trust companies have limited access to commercial credit markets in relation to their capacity to attract indexed deposits, and would therefore be placed at a competitive disadvantage in this sector under a segmented plan. Similarly, financial intermediaries without a deposit base, such as RoyNat, would be disadvantaged by a plan providing for indexation of deposits but not debentures. Some institutions, such as life insurance companies, would be placed at a disadvantage in both raising and placing indexed funds.

3.3.2 Mandatory Use of Real-Term Instruments

Although a case can be made for the benefits of contracting in real terms, there has been little experience in Canada with such instruments. Various commentators have indicated that, at least initially, there would be a strong reluctance by borrow-

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overriding problem is one of too much fishing power, particularly when they are maintained in the face of general disapproval from the fishing industry, at least on the Pacific Coast. Last year, as in previous years, the government was advised to eliminate "perverse subsidies" to vessel construction and the overwhelming weight of opinion expressed at my public hearings was consistent with that position". Preliminary Report of the Commission on Pacific Fisheries Policy (Peter H. Pearse, Commissioner) p.59, October 1981.

(2) Ontario Federation of Agriculture, "Brief to The Advisory Committee to the Minister of Finance on Inflation and Taxation of Personal Investment Income", August 1982.

ers to undertake these contracts. The feasibility of introducing a significant and at the same time mandatory innovation into Canadian financial markets is, therefore, very much open to question.

Traditionally, innovative financial instruments have been introduced in Canada on a voluntary basis. Canada Mortgage and Housing Corporation, for example, has introduced several new types of mortgages. It seems that not only would the requirements in the proposal strengthen the negative attitudes of those who are suspicious of contracting in real terms, but it would also bypass the experimental phase essential in the sound development and maturity of any new product. "Too much too soon" could hurt the acceptance of real-term instruments. The Paper estimates that in the first year of the program more than $10 billion in real-term financing could occur with home-buyers, farmers, fishermen and small business. This estimate seems unrealistically high. Rather, it is believed that significant resistance to the mandatory use of real-term instruments could work against the stimulative objective of the proposal.

Numerous commentators have observed that innovation should be facilitated rather than forced on the market. We agree that contracting in real terms should not be made the price of tax reform. Our views on the subject of facilitating contracting in real terms are elaborated in Chapter 5.

3.3.3 Problems for Financial Intermediaries

The management of the indexed assets and liabilities of a financial intermediary would be constrained by the relative amount of loans eligible for indexation, on the one hand, and the amount of deposits (or equivalent liabilities) eligible for indexation, on the other. The two sides of the balance sheet would have to be kept in balance over whatever time period was permitted for averaging the total values of ITLs and ITDs.

The need for balance between indexed deposits and indexed loans arises from the general principle of tax symmetry. By symmetry, we mean that funds which deliver a tax benefit to the depositor would have to be passed on by the financial intermediary as funds associated with an equivalent tax liability to the borrower. If the inflation component of interest on deposits were free of tax, then the corresponding component of interest expense should not be deductible.

If, as we estimate, the supply of indexed deposits were to exceed by a wide margin the demand for indexed loans, there would be a significant gap which would have to be closed. This is the "matching problem".

There are various ways to achieve matching. The one visualized in the Paper would bring about matching through market forces acting on interest rates. This could lead to very low real rates on deposits in the short run. In our view, the United Kingdom's experience with limited issues of indexed securities (which we describe in Chaper 5) suggests that even in the short run the real rate on ITDs would not be negative. In the past six months during which the U.K. indexed bonds have been trading without ownership restrictions, real rates have ranged between 2% and 3 1/4%.

A second method of matching would be to permit very long averaging periods. However, even this would probably not close the gap which might occur under the eligibility rules in the Paper.

The Committee examined the feasibility of developing a new type of money market instrument which would be used for lending surplus indexed funds among institutions experiencing a deficit in such funds. Whether this is feasible would have to be explored in depth with the central bank. One problem would be that, even if all the participating institutions could together balance indexed funds, individual institutions might themselves be left with a significant imbalance of indexed funds. The gravity of this problem would depend on the asset structure of the institution, and would be a more serious problem for some than for others.

Further, some institutions do not have direct access to the Bank of Canada, which would most likely be called upon to play a role in the management of liquidity in the indexed market. This could lead to significant operating complications.

A third method of matching would be to make all assets and liabilities eligible for indexation. This would reduce the size of the problem for individual institutions and for all institutions in the aggregate. Depending on demand and supply, the matching problem would still exist over time and among institutions at a given time, and would require a mechanism for settling balances.

3.3.4 Government Intervention in Credit Allocation

The proposal in the Paper represents a significant extension of government intervention in the capital markets. There are already numerous forms of government intervention such as selective taxation, regulation of the power of the financial intermediaries, direct subsidies and loan guarantees. In this proposal, the federal government selects four categories of borrowers to benefit from the plan. It also requires that the financial intermediaries set up the mechanisms to handle the segmented flows of funds.

Some commentators have also pointed to the jurisdictional and political difficulties which could result from this proposal.

On the whole, the Committee has strong reservations about this proposed extension of direct government intervention in the allocation of credit.

3.4 The Concerns of the Farming, Fishing, Small Business and Housing Sectors

Representations made to the Committee from the farming, fishing, small business and housing sectors all stressed the severe hardships resulting from high interest rates and their serious difficulties in securing medium-term and long-term financing.

Submissions from these groups therefore supported the objectives of lowering the cost of borrowing and extending the maturity period of debt financing. The Committee was extremely sympathetic to the real and serious problems facing some members of these groups, and gave careful consideration to the proposal in the Paper which would benefit them. The Committee noted, however, that many of the submissions from these four groups questioned whether the proposal would be either efficient or effective in achieving these objectives.

For example, the proposals limit farmers, fishermen and small businesses to the purchase of new depreciable property. The submissions received generally agreed that the greatest need for long-term financing relates to debt refinancing. The exclusion of land from the list of qualifying assets for farm credit was considered to be a further shortcoming. As far as small business is concerned, there seemed to be no strong support for the proposal from this sector.(3) Submissions from those involved

(3) "In principle our members do not favour special interest rate subsidies as proposed in the White Paper... We do not believe that the indexed term deposit instrument - proposed as a permanent program - is a long-term measure to reduce inflation and increase productivity. As a device to deliver cheaper money to small business it would be, at best and presupposing no corresponding increase in market rates, a minor help." Submission to

in the housing sector, while stressing the problems faced by those purchasing or refinancing homes because of high interest rates, also focused on the problems likely to result from the limitation on qualifying loans to new home buyers. The exclusion of resale housing, at least in respect of first-time buyers, was seen as giving rise to depressed prices on resale housing as purchasers opted for new housing at lower financing costs.

It was also evident that certain lending institutions, such as provincial fishermen's loan boards and the Farm Credit Corporation, are already providing financing at rates somewhat below those available from commercial sources. Since these institutions are not deposit-taking and therefore would not have access to indexed deposits, concern about their continued viability was expressed.

Because of the possible distortions created by the proposals, the Committee was frequently advised not to proceed with measures that would provide some short-term relief for present-day conditions but which would have the effect of creating serious long-term distortions in the marketplace.

The Committee also noted that the substantial reduction in market interest rates between the June 28th budget and the submission of our report is likely to have reduced somewhat the problems of financing new capital spending in housing, farming, fishing and small business. Furthermore, both the federal government and many of the provincial governments have recently adopted special measures offering some relief for high interest costs to small business and to homeowners. The Committee notes the existence of a wide variety of government programs to provide direct aid and support to the sectors singled out in the proposal.

3.5 Summary

The Committee was therefore persuaded that, on balance, while recognizing the serious problems faced by the farming, fishing, small business and housing sectors of the Canadian economy, it could not recommend that the proposals in the Paper be implemented. Assistance to particular sectors of the economy can better be achieved through a more direct allocation of resources than indirectly through fundamental tax reforms.

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the Advisory Committee on Inflation and the Taxation of Personal Investment Income, Canadian Federation of Independent Business, August 25, 1982.

"The indexed loan proposals ignore the need for more equity investment in small business." Submission to the Advisory Committee to the Minister of Finance on Inflation and the Taxation of Personal Investment Income, Canadian Organization of Small Business, August 1, 1982.

3.6 Broader Approaches to Correcting the Tax Treatment of Interest Income

Having come to the conclusion that the Paper's proposal is too narrow in scope, the Committee considered some approaches that could be more broadly applicable. Unfortunately, the time and resources available to us were not sufficient to permit a thorough examination of these alternatives. However, we were able to group the approaches into three main categories, and to make some overall judgment about them.

The three main possibilities are:

(i) tax individuals only on their real interest income, without making any changes in the deductibility of interest paid by borrowers;

(ii) permit the broad use of tax-corrected funds (which might, but need not, be contracted in real terms) on which only real interest income would be taxable in the hands of the lender and tax-deductible for the borrower; and

(iii) adjust the tax system so that only real interest income is taxable in the hands of the lender and tax-deductible for the borrower.

The attraction of the first approach is that it exempts from taxation the inflation component of interest income without requiring any change in the tax treatment of business income. Under the first approach, business borrowers would continue to receive a tax deduction for the full nominal amount of interest paid, while individuals would pay tax only on real interest income received. We accepted representations from several sources, including Department of Finance officials, that this approach would seriously threaten the integrity of the income tax system by creating large incentives to convert other types of income into the form of interest so as to obtain more favourable tax treatment.

The second approach maintains symmetry, because whatever interest income was taxable in the hands of lenders would be tax-deductible for borrowers. Taxpayers who borrow "tax-corrected" funds (on which the inflation portion of interest income would be exempt from tax) would only be able to deduct the real component of interest expense on the same basis. Borrowers who did not use the new tax-corrected instruments would continue to deduct their full nominal interest payments, and the matching interest income would continue to be fully taxable in the hands of savers. The co-existence of the two tax treatments would tend to lead to a certain segmentation of financial markets. This system would give rise to a self-selection process determined largely by the tax status of savers and borrowers. Non-taxable borrowers would tend to borrow on a tax-corrected basis, and chiefly from taxable lenders. Taxable borrowers would tend to avoid tax-corrected funds

and would borrow principally from non-taxable lenders. Moreover, this approach would still leave substantial opportunities for tax avoidance. Financial intermediaries would have to match their tax-corrected assets and liabilities separately from their conventional assets and liabilities, thus raising some of the matching problems that we noted earlier in this chapter in relation to the ITD/ITL proposal.

The third approach is preferable to the others in terms of tax neutrality. It also avoids the matching problems of the second approach and maintains the integrity of the income tax system better than either of the first two approaches.

The key problems with the third approach relate to transition and, even more importantly, to its impact on the taxation of business income. Converting from the current tax system to one where the inflation component of interest income is non-taxable for lenders and non-deductible for borrowers would involve, at current inflation rates, a significant rearrangement of the tax burden, creating capital gains and losses on existing securities and enterprises. Careful design of transition measures would ease some of the problems, but taxable corporations that are net borrowers would lose, in the absence of the other necessary inflation adjustments in the taxation of business income. In the next chapter we explain why it is necessary to adjust the tax treatment of business inventories and capital cost allowances, as well as interest expense, if full and balanced inflation corrections are to be made to the taxation of business income.

If further study shows that it is feasible to make the appropriate tax adjustments to business income, then it should also be feasible to adopt the full inflation-corrected tax treatment for all interest income and expense. This third broad approach to interest income seems to us to be promising, but only if it can be introduced with careful attention to transition problems, and in parallel with the other necessary corrections to the taxation of business income. The first two broad approaches could be introduced without simultaneous reform of the taxation of business income. However, we think that further study would support our view that both of the first two approaches have such shortcomings that they are not likely to be suitable even as interim measures.

3.7 Possible Interim Measures to Offset the Effects of Inflation on the Taxation of Personal Interest Income

A substantial amount of research would be required in order to determine the feasibility and design of a system for the comprehensive adjustment of business and investment income. In this context, the Committee believes that it would be advisable that interim measures be adopted. Accordingly, we sought some way of reducing the taxation of the inflation component of interest income without either threatening the integrity of the income tax system or introducing additional complexities.

The Registered Retirement Savings Plan (RRSP), Registered Pension Plan (RPP) and the $1,000 exemption for investment income all provide a partial offset to the effects of taxation on interest income in a period of inflation.

None of these has been recently adjusted to take account of the effects of inflation [4]. In a fully inflation-adjusted tax system, RRSP and RPP limits would rise with the inflation rate, while the $1,000 investment income exemption would be unnecessary. With an inflation-corrected tax system, the role of the RRSP/RPP is to permit a certain portion of income to be accumulated tax-free until retirement, thus shifting the balance of taxation away from income and towards consumption. Without general correction for inflation, the RRSP and the RPP provide the additional advantage of inflation-correcting the tax on all investment income earned within them. Since taxation of RRSP/RPP investment income is deferred on its inflation component, raising and indexing the RRSP and RPP contribution limits would be an appropriate interim measure.[5] It would be especially helpful for interest income, since the relative tax advantage of these plans is greater for interest than for dividend income.

If adjustment of the RRSP is accepted as a possible interim measure, consideration should also be given to adopting flexible lifetime contribution limits, and extending eligibility to those who are not in paid employment, to permit RRSP protection to be more widespread.

Raising the RRSP and RPP contribution limits does nothing to reduce the impact of inflation on the taxation of the interest income of those now past retirement age. It might therefore be equitable to combine any increase in RRSP and RPP contribution limits with an increase in the investment income exemption for taxpayers over 65 years of age.[6]

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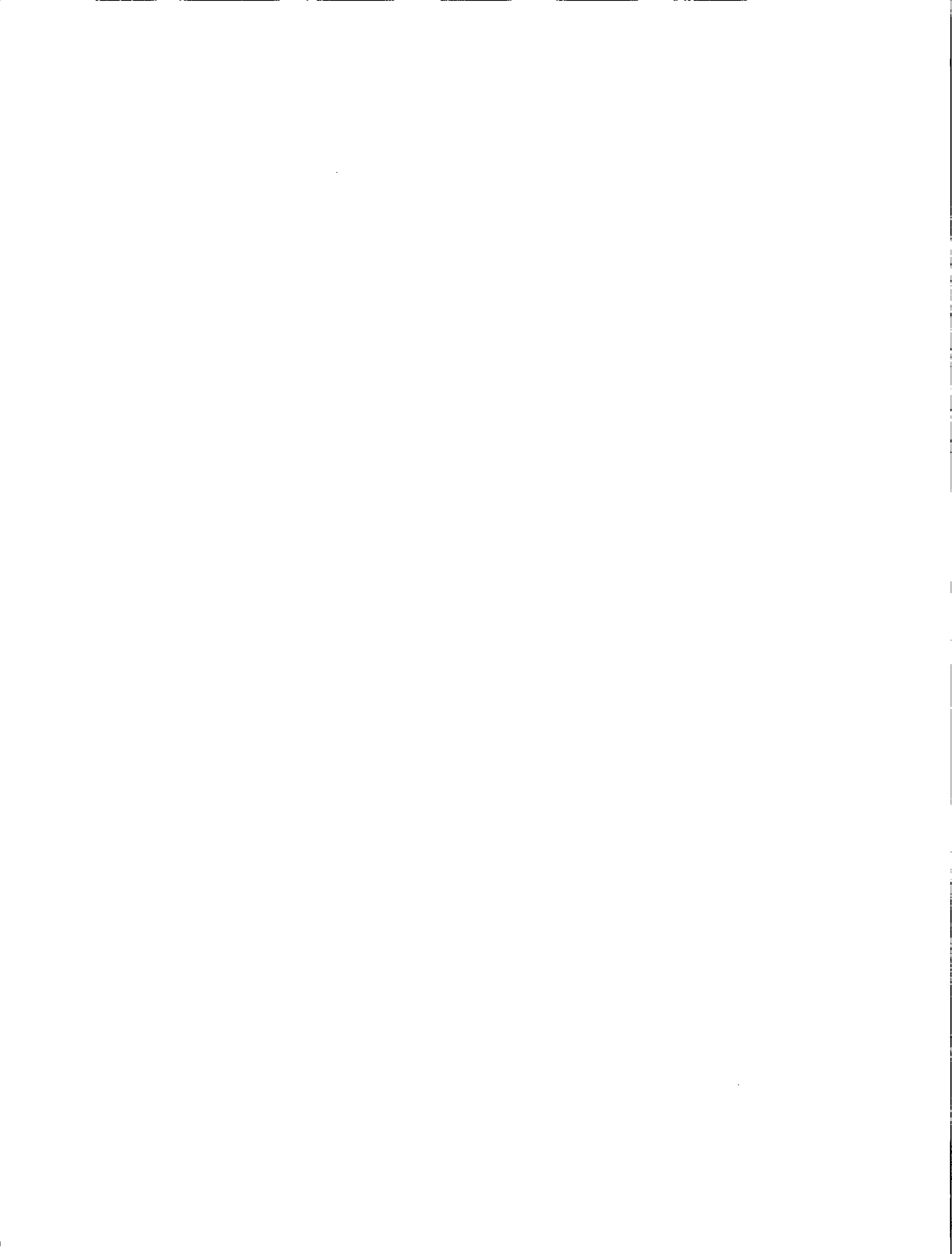
(4) The RRSP and RPP limits were last increased in 1976. The $1,000 investment income exemption was introduced in 1974 and has not been changed since.

(5) For purposes of illustration, the annual revenue cost to the federal and provincial governments of alternatives discussed in this chapter has been estimated by the Department of Finance as follows:

• across-the-board increase from $1,000 to $2,000 in investment income exemption	$ 1,000 million
• increase of $1,000 in the RRSP/RPP contribution limits	$200 – 300 million
• broadening of RRSP to include unearned income	$200 – 300 million
• increase from $1,000 to $2,000 in the investment income exemption for individuals over 65 years of age	$200 million

The cost of indexing the RRSP/RPP contribution limits would be a function of the indexing factor used. By comparison, the Paper's ITD/ITL proposal would have cost $900 million in the first year.

(6) Two members of the Committee would prefer that the extension of the $1,000 investment income exemption not be confined to those over 65 years of age.



CHAPTER 4

TAXATION OF BUSINESS INCOME

This chapter deals with correcting the taxation of business income. This matter was not specifically included in our terms of reference, which pertained to the taxation of personal investment income. However, the two are closely tied. Because business investment decisions and personal investment decisions are so closely intertwined, the fact that the taxation of business income has not been corrected makes it impractical to proceed with a comprehensive tax reform for personal interest income. The Paper recognizes this link. Although it deals chiefly with personal investment income, one of its chapters sketches a comprehensive correction scheme that would include business income.

4.1 The Shortcomings and Effects of the Present System of Taxation of Business Income

Inflation interacts with our present system of taxation of business income to create serious effects relating to fairness and the allocation of resources. None of these was presumably intended when the tax system was designed. One of the implicit underpinnings of the present tax rules is the assumption that the general price level will remain reasonably stable over time and hence that the traditional accounting principle of matching historical costs with current revenues can be relied upon to produce an appropriate measure of income. With price instability, this income measure is less appropriate.

It is important to recognize the degree to which business income is incorrectly measured in inflationary periods as a consequence of using the basic conventional accounting principles now followed both in financial reporting and in calculating taxable income. Current measures of net business income are distorted in three major ways by inflation.

First, depreciation or capital cost allowances are understated since they are presently based on the historical acquisition cost of depreciable assets rather than on their replacement cost. Hence, taxable income is overstated. Second, the cost of goods sold is similarly understated because it does not reflect the current cost of replacing inventory. This also inflates taxable income. Third, interest income and expenses on conventional debt are overstated for businesses, as for individuals, because of the inclusion of the inflation component of nominal interest in the calculation of taxable income. For those businesses that are significant net debtors, this third distortion has the effect of understating their income and offsetting to a large extent the effect of the first two distortions.

These inflation-induced tax anomalies are not simply measurement oddities, but have some worrisome consequences for the capital structure of Canadian corporations. They also have a negative impact on the magnitude and allocation of business investment.

Under conventional accounting and existing tax rules, the interest expense of a business constitutes a deduction from income and its interest income is an addition to income. With inflation, however, part of this interest represents compensation paid by debtors to creditors for the anticipated reduction in the real value of debts. By failing to recognize this, conventional accounting and existing tax rules result in an understatement of the debtor's income and an overstatement of the creditor's.

The problem is compounded when the actual rate of inflation differs from the anticipated one, which is frequently the case. Depending upon the direction of the difference between the anticipated and actual rates of inflation, real transfers take place between debtors and creditors. These cannot be captured under accounting and tax rules.

The consequences of this should not be underestimated. When the rate of inflation increases, taxable businesses are induced to increase their indebtedness since they can deduct the full amount of interest for tax purposes. Then, when inflation declines, taxable businesses are required to service a relatively high cost of debt which severely erodes their cash flow. This is one of the factors which explains the present illiquidity in a number of Canadian corporations. Although it presents itself at this time with particular severity, it is important to realize that, to the extent that the phenomenon is compounded by present tax rules, it is also a structural problem.

A comprehensive correction of the taxation of business income would have a beneficial impact on most businesses. This would arise from the elimination of inflation-induced taxes. When taken together with tax corrections at the shareholder level, the correction of business income taxes would affect materially the after-tax return on personal savings invested in equity investments. This would, in turn, have a positive effect on the cost and availability of new equity funds for businesses.

In addition, comprehensive tax correction would eliminate distortions that now affect the allocation of investment funds. These distortions affect the allocation of business investment among different types of investments, since the amount of tax distortion varies for assets with differing expected useful lives and income patterns. The total amount of business investment is also affected because of inflation-induced tax distortions that now favour personal investments in less productive uses and consumption.

In addition, because inflation-induced distortions do not occur in a uniform relationship to income for different businesses, inflation has caused effective tax rates on businesses to vary widely. This, in turn, has led to significant distortions in the allocation of business investment.

4.2 Some Evidence on the Magnitude of Tax Distortions

Various Canadian studies have attempted to measure the differences between the nominal and real effective tax rates for selected industries from 1975 to 1980. These measurements incorporate inflation adjustments for depreciation, depletion, inventories and net debt. The results show that the magnitude of these distortions is large. Effective tax rates are higher than nominal tax rates, sometimes significantly so. For instance, in 1980, effective tax rates for manufacturing industries were approximately 138% of nominal tax rates. The evidence also shows that these differences vary considerably both within and across different sectors of the economy.

4.3 A Difficult Undertaking

Admittedly, tax measures - such as the 3% inventory allowance and accelerated depreciation allowances - have been instituted to reduce the impact of inflation on taxable income. These measures have been helpful, but in most industries they have not been sufficient to close the gap between nominal and effective tax rates.

The transitional problems of going from the present system to an inflation-corrected system for the taxation of business income are significant, as this would involve major corrections to corporate balance sheets. The Paper duly notes major problem areas:

- design complexity, such as the application of the debt adjustment, which can have an immediate and significant impact on net income;
- administrative and enforcement complexity, mainly associated with the replacement of the historical cost rules;
- redistribution of tax liabilities; that is, the windfall gains and losses which would give rise to winners and losers in the adjustment process.

A tax reform of business income would also have to confront structural problems which are peculiar to the Canadian economy. For instance, given the close integration of the Canadian economy with the United States economy, is it feasible to un-

dertake a tax correction out of step with what is done in the United States? The answer is not obvious.

4.4 A Major Study is Warranted

In the time available and given our terms of reference, the Committee has not analysed the feasibility of implementing an inflation correction of the tax system for business income. We have noted the difficulties which have been correctly emphasized in the Paper. We have also noted possible solutions to these difficulties which have been proposed by several authorities. It seems worthwhile to emphasize that many proposals do not depend upon the introduction of a comprehensive inflation accounting system. While not in a position to judge whether or not the proposed solutions are feasible, the Committee is persuaded that the problem warrants an urgent and careful study. We are convinced that the present corporate tax system should be reviewed as a whole, with the goal of ensuring that taxes are levied upon real rather than nominal income.

The Committee recommends that the government undertake such a study in consultation with experts from outside the government. This study could first investigate to what extent a comprehensive correction of the tax system for inflation would benefit the Canadian economy by removing distortions. The study could also determine under what conditions such a correction can be implemented, and it should present a range of practical options. These could then be published as part of a future Paper for Consultation so that they may be the subject of widespread public review and comment.

CHAPTER 5

FACILITATING THE DEVELOPMENT OF CONTRACTING IN REAL TERMS

The past ten years have been characterized not only by rising inflation but also by growing uncertainty about its future course. There are significant economic costs associated with this uncertainty. In this context, the development of contracting in real-term instruments appears as a potentially positive development. Given the relative unfamiliarity with real-term instruments, the Committee concluded that some explanation of their nature and role would be useful.

5.1 Contracting in Real Terms

A real-term financial contract is one which earns or pays interest at a "real rate" of interest; that is, a rate designed to yield a specific real rate of interest above and beyond a full compensation for the erosion of the capital and interest payments due to inflation during the period of the contract. Thus, contracting in real terms implies that the parties to the transaction agree upon a real rate of interest to be paid in addition to the inflation component. How the repayment is structured is also a matter for the parties to decide. Two examples illustrate this point, but it should be understood that numerous intermediate combinations are feasible.

- **Full capitalization.** This approach is the purest form of a real-term contract. Only the real rate of interest is paid annually (or semi-annually) and the inflation component is capitalized. This is the method used by the United Kingdom government for the indexed bonds which it has issued since 1975. The real interest coupon on such bonds is paid semi-annually; the principal is indexed to the United Kingdom Consumer Price Index and paid at maturity.

- **Zero capitalization.** At the opposite end of the spectrum, the parties could agree that both the real interest rate and the inflation component would be paid at the same time, the principal being repaid at maturity. Thus if the real interest rate was 2% and the inflation rate in a given year was 10%, the total interest rate would be 12.2%. In a subsequent year, if the inflation rate were to fall to 5%, then the total interest payment that year would be 7.1%[1], since the real rate is fixed by the contract while the inflation component is allowed to vary with a pre-selected index.

(1) Since the inflation adjustment applies also to the real interest component, there is a compounding of the two factors. Thus in the first case the net result is 1.02 X 1.10 or 1.122 (and not simply 2% plus 10%); in the second case 1.02 X 1.05 becomes 1.071.

- **Comparison of the two approaches.** To make the case as simple as possible, our examples assume bonds with two-year terms and annual payment of interest. The assumed real rate of interest is 2%, and the annual rate of inflation is taken to be 10%. The real values are in terms of prices at the beginning of year 1. The examples show the cash-flows arising from the two types of contracts and do not show what happens subsequently to the cash flows received by investors.

	Full Capitalization		Zero Capitalization	
	Nominal Value	Real Value	Nominal Value	Real Value
Beginning of year 1				
Principal	$100.00	$100.00	$100.00	$100.00
End of year 1				
Interest paid	$ 2.20	$ 2.00	$ 2.20	$ 2.00
Inflation component paid	$ 0		$ 10.00	
Beginning of year 2				
Principal	$110.00	$100.00	$100.00	$ 90.91
End of year 2				
Principal repaid	$121.00	$100.00	$100.00	$ 82.64
Interest paid	$ 2.42	$ 2.00	$ 2.20	$ 1.82
Inflation component paid	$ 0		$ 10.00	

These examples show that if the inflation component of interest is capitalized, the real value of the principal and of the interest it produces remains constant over the life of the bond. If the inflationary part of interest is paid out, the real value of the principal declines over the life of the loan. In this latter case, if the inflation rate rises, the real principal is repaid faster. This is the so-called "tilt" problem.

A fundamental characteristic of real-term contracts is that the link between the risks of inflation and other risks associated with the contract is severed. Under conventional debt contracts, it is the nominal interest rate that is fixed so that the real rate of interest received by the investor varies. It is the difference between the nominal rate and the rate of inflation. With real-term debt contracts, the real rate of interest is fixed by the contracting parties, making the nominal cost of the loan variable. This is precisely one of the main advantages of contracting in real terms; because of the clear separation of the two components of the interest rate, uncertainty about inflation no longer has an impact on the real rate of interest.

Floating rate conventional loans share some of the characteristics of "real" rate contracts with zero or partial capitalization. But there are significant differences. First, although the nominal bank prime lending rate fluctuates with the evolution of inflation rates, the correlation is not perfect. Second, from an overall perspective, contracting in real terms gives rise to an explicit and independently determined real rate of interest in the market.

A number of debtors are concerned about the implications of borrowing on a "real-term" basis, since they will not know the amount in nominal terms that they will have to pay as compensation for inflation or as the total cost of the loan. However, if the alternative for these borrowers is to obtain funds at floating interest rates, they may well be exposed to an equivalent or even greater risk since interest rates are historically more volatile than the inflation rate.

5.1.1 Advantages to Lenders and Borrowers

From a lender's viewpoint, contracting in real terms has two effects. First, the indexation of the inflation component of the nominal return on floating-rate debt contracts can be made exact, so that the real rate of interest to be obtained by the lender over any period can be specified with virtual certainty. Secondly, for lenders wishing to invest for a long period of time, the ability to write a loan contract in which the real return is known permits a real rate of interest to be fixed over a longer maturity than would otherwise be possible.

The advantage of receiving a fixed real rate of interest on invested funds depends on whether the overall riskiness of an investor's total portfolio is reduced by the ability to avoid inflation risk.

The effects on borrowers of contracting in real terms are essentially the same as for lenders. Fixing the real rate of interest over the period of the loan contract eliminates uncertainty as to the real cost of the loan. Where a long-term asset being acquired by a borrower yields a real rate of return that is unlikely to be negatively affected by an increase in inflation, the borrower is able to reduce the riskiness associated with debt-financed investments by contracting in real terms and fixing a real rate of interest over a long period.

The potential gain to the economy from the introduction of real-term financial instruments is the possible reduction for both lenders and borrowers of their exposure to risk.

5.1.2 The Response of Capital Markets to Inflation

Various innovations have characterized the adaptation of the capital markets to higher inflation and more importantly to uncertainty about future levels of inflation. In the housing market, variable rate mortgages have allowed the interest rate to fluctuate during the life of the mortgage contract. Graduated payment mortgages, which implicitly capitalize part of the interest, have allowed borrowers to increase their monthly payments gradually, in line with the expected increase in their personal income. When selling their houses, some vendors have combined higher nominal prices with mortgages at low interest rates, thus capitalizing part of the interest, to ease the payments by the borrowers. The fact that no capital gains tax is levied on the proceeds of the sale of a house by an individual facilitates this adaptation. Corporate lending has been characterized by the growing use of floating-rate covenants and by frequent changes in the rate of interest. Other innovations have attempted to deal with the increase in the short-term variability in interest rates. These include exchange-traded options and futures markets for financial instruments.

These innovations have somewhat reduced the negative impact of inflation and of uncertainty about its future course. Still the adaptive behaviour of borrowers and lenders has taken its toll on the capital market. The virtual disappearance of long-term debt markets is but one manifestation of this. The real rate of interest built into nominal loans, defined as the nominal rate of interest net of inflation, has also risen significantly, increasing the cost of capital to users.

Various reasons have been suggested to explain the fact that real-term contracting has not yet appeared as a response to uncertainty about inflation:

- Uncertainty about inflation is a recent phenomenon in Canada. Prior to the recent upsurge, financial markets generally assumed that inflation would subside. Consequently, the incentives to develop markets in real-term instruments have been lessened.

- The legal environment is uncertain; actual or perceived problems in certain statutes may discourage lenders and borrowers from contracting in real terms.

- The asset and liability sides of the market have to be developed simultaneously to provide for matching and elimination of intermediation risks.

- There are significant start-up costs, which have to be borne by the innovating institutions.

- There is substantial risk that the value of specific assets acquired with funds borrowed in real terms will not rise with the rate of inflation.

5.1.3 Contracting in Real Terms is Not Advantageous in All Circumstances

While some borrowers would lower their overall risk by the use of real-term debt contracts, this may not be true for most businesses so long as the taxation of business income remains uncorrected for the effects of inflation. For many businesses, effective tax rates on business income are increased by inflation. In addition, other factors may cause income from business operations to be negatively correlated with inflation. As a result, many taxable businesses effectively reduce their overall exposure to inflation risk by borrowing fixed-rate conventional long-term debt. Where such debt is not available and businesses must finance their operations with floating-rate debt, the advantages of conventional debt are significantly reduced. In fact, the uncertainty associated with the annual interest charges on loans contracted in real terms is not likely to be greater than is the case for conventional floating-rate loans. Whether or not business borrowers utilize debt contracted in real terms depends both on the extent to which their overall exposure to risk is changed by so doing and on whether the expected real cost of debt is reduced.

The suitability for taxable businesses of contracting real-term loans has been addressed in many briefs presented to the Committee. Discussions were also conducted with underwriters and institutional investors. The general thrust of the comments received is to the effect that, generally, taxable corporations would be reluctant to issue real-term debt instruments. Many reasons were provided to support this opinion.

For example, real-term contracting redistributes the inflation risk between borrowers and lenders in a way that may be less advantageous to some parties. Borrowers are also concerned by their cash-flow situation. They are reluctant to lock themselves into a contract with an open-ended liability. It was felt that, for many firms, real-term loans would increase bankruptcy risks. Other factors, mentioned earlier, were also cited.

These comments point to genuine difficulties and constraints with which businesses must cope. They also provide evidence that even if real-term financial contracts possess benefits, they are not suitable in all circumstances.

5.1.4 Impact on the Functioning of Capital Markets

The effects on conventional debt markets from the introduction of real-term instruments are likely to be relatively small. The co-existence of markets in real-term and conventional debt instruments would give a broader range of investment opportunities to individuals and institutional lenders. Where real-term debt contracts are pref-

erable to conventional debt, the economic effects of introducing these new financial instruments would be similar to simultaneously increasing the real rate of return to savers and reducing the real cost of debt to borrowers.

In addition, changes in the equilibrium real rate of interest in the newly-created markets for real-term debt would provide additional information on capital market conditions which would be of value both to participants and to monetary authorities. Therefore, the gradual introduction of these new instruments should not cause any dislocations.

It was noted, however, that the rapid and large-scale introduction of real-term bonds issued by governments could have an unsettling effect on capital markets, resulting in large adjustments in present borrowing and lending patterns, and possibly impacting on the cost and availability of money for the corporate sector.

5.2 The Potential Effects: A Sectoral Approach

From an overall perspective, it has been seen that, in some circumstances, real-term financial instruments present advantages over nominal instruments. These potential benefits are illustrated by an examination of possible specific applications of real-term contracting. Whether or not this financial innovation becomes widespread in a given sector will depend on a variety of factors specific to that sector.

5.2.1 House Mortgages

With a conventional mortgage and a relatively high inflation rate, the affordability of housing is reduced significantly. The problem stems from the fact that the particular design of conventional mortgages forces homeowners to repay a substantial proportion of the real value of the capital they borrowed in the early years of the mortgage contract. This occurs because the requirement for equal instalment payments means that, in reality, the monthly repayment in the first year of the contract is worth considerably more than the same repayment three or five years later. This tilt effect has a considerable impact on the affordability of housing.

The use of real-term mortgages can reduce this problem. A real-term mortgage, with a fully capitalized inflation component, completely eliminates the tilt; that is, repayments are constant in real terms over the length of the mortgage. Some mortgagors might wish to accelerate the build-up of equity in their houses; this can be easily accommodated with a mortgage contracted in real terms by specifying that a

portion of the inflation component is to be capitalized. At the limit, there can be no capitalization of the inflation component which can be paid monthly.

As can be seen, the major advantage of a real-term mortgage stems from the fact that the rate of amortization - the tilt - can be determined in advance by the mortgagor. The amortization schedule in real terms is explicity determined from the start and is not implicitly adjusted from year to year by variations in prices as it is in a conventional mortgage whatever amortization schedule may be provided. Morever, a mechanism is provided which explicitly links repayments to a price index which is a more accurate reflection of price movements than the inflation component contained in the nominal interest rate provided in both fixed and variable rate mortgages.

Buyers' resistance to an increase in the principal amount of the loan outstanding (also called capitalization or negative amortization) is often cited as an explanation for the low current popularity of variable rate mortgages which have some of the characteristics of real-term mortgages. The incidental or systematic increase in the nominal value of the loan or, at least, a slower decrease in the outstanding loan, could entail a risk because house values in any given community may not keep pace with inflation. Similarly, any increase in personal income may lag behind an increase in the payments, leading to a higher-than-anticipated debt service ratio. Both of these risks, which are also present in conventional mortgages, can be minimized through suitable design.

A simulation [1] was carried out for the Committee comparing certain risk aspects of conventional and real-term mortgages, using actual changes in property values in various housing markets in Canada from 1973 to 1982, in combination with actual rates of interest, price increases and wage increases.

Rules and guidelines that have been developed for conventional mortgages in an inflationary context may require some adaptation to mortgages contracted in real terms. However, the results of the simulation demonstrate that, by sound design, the risks can be made quite comparable with those which used to be acceptable under conventional mortgages. It also shows that, under present market conditions, conservative designs, where only 25% of the inflation component is capitalized, increase the affordability of housing by approximately 20%.

The extension in the effective maturity of the mortgage, the availability of funds at a lower net cost and the reduction of the tilt that real-term contracts could permit would increase the affordability of housing in periods of inflation.

(1) Pouliot, Guérard Inc.,"Simulation of Various House Mortgage Designs in Canada", Working Paper, Department of Finance. Available upon request.

5.2.2 Farm Mortgages

Loans to farmers secured by mortgages on farmland also appear suited to real-term financing. Analysis of the real prices of farmland and buildings in Canada since 1965 shows that there has been significant growth in the real value of farmers' fixed assets.

Historically, the operating rates of return on equity in agriculture have been low relative to other sectors. When operating returns are combined with capital appreciation in the farm sector, they may be comparable to rates of return in other sectors. However, the rates of return through capital appreciation are only realized when assets are sold or the increased equity is used as collateral for borrowing. In its brief to the Committee, the Farm Credit Corporation asserted that "a mechanism by which this appreciation could be used to assist farmers to improve their liquidity would provide additional opportunities in the farm sector." It pursued this by stating that contracting in real terms offered potential because it facilitated the development of "repayment schemes compatible with the unique needs of the farm sector."

The use of real-term farm mortgages could result in a reduction in initial monthly payments relative to conventional farm mortgages. This would ease cash-flow constraints on present farm operations.

5.2.3 Utilities

Substantial funds will be required over the next decade to finance investments by utilities. Utility projects are typically built to satisfy demands over a very long planning horizon, and so are most appropriately financed by long-term debt. Prices for utility services are largely set by regulation in order to pass financing costs through to customers. Hence the effects of inflation on interest rates have been particularly important for utility financing and pricing. Lenders' requirements for large inflation risk premiums have resulted in material increases in borrowing costs. The introduction of contracting in real terms could benefit the utility sector. While design questions have not been analyzed in detail, a high degree of capitalization of the inflation component of nominal interest would appear justifiable for utilities, potentially resulting in a more even pattern of real debt service requirements over the term of the debt.

In cases where current nominal financing costs are passed through to customers by regulatory decisions, the use of real-term contracting could result in significant reductions in the current rate of increase in utility tariffs. For example, current practices combined with high interest rates imply initial nominal tariffs for a new utility

project that are two to four times as high as they would be if the interest and capital charges were made approximately constant in real terms over the life of the project.

5.2.4 Pension Funds

High and uncertain inflation is the most difficult problem now facing the private pension system. Although most large businesses have made ad hoc cost-of-living adjustments to pensions, few plans in the private sector provide for contractually-indexed benefits. In part, the absence of indexing in the private pension sector can be traced to the manner in which inflation affects the real rates of return on pension assets. Evidence shows that unanticipated inflation depresses the real rates of return on both fixed-income securities and common shares. The latter result reflects, at least in part, the effective increase in the tax rate on corporate-source income which occurs when inflation increases.

Plan sponsors could more easily offer annuities indexed partially or totally as the normal form of pension or as an option, if they could invest the corresponding accumulated assets in real-term bonds or mortgages. If long-term bonds were priced by the market to yield 3% in real terms, this would be the rate (after allowing for administrative costs) at which fully indexed annuities would be sold.

At present, this choice is not available. A plan sponsor who wishes to provide an annuity adjusted for inflation and to minimize his risk exposure would invest the pension fund reserve in very short-term securities such as Treasury bills. Because the nominal interest rates on these securities track the inflation rate quite closely, and since capital gains and losses on these securities are minimal, the plan sponsor's underwriting risk would be limited. On the other hand, the long-term real return on Treasury bills has averaged less than 1%, which makes this approach costly relative to real-term bonds.

Trusteed pension plans and life insurance companies, with respect to their pension business, should be natural participants in a market for real-term instruments. For retired plan members who desire a stable stream of real pension income, pension reserves are likely to be targeted toward real-term bonds or mortgages. For active plan members, however, plan sponsors are likely to invest pension funds in assets such as common shares because of their higher expected real returns. In short, plan sponsors will continue to confront the risk/return tradeoffs that exist in the capital market, but with a broader set of choices available to them.

There is much current discussion of pension reform. The most active proposal is for interest returns in excess of a base rate to be used for improved inflation protection. It is important to note the limitations of an "excess interest" solution to the problem.

If the base rate used to define excess interest is equal to the expected real return on the pension fund, then, on average, the real value of pension incomes will be preserved. However, there is no guarantee that real pension benefits will be stable from one year to the next, or that they will not decline for an extended period. Even if the excess interest is tied to very short-term securities such as Treasury bills, considerable year-to-year fluctuations in the real value of pension incomes would still occur.

Real-term bonds guarantee, in effect, that the inflation component of interest income will be sufficient to offset the impact of inflation. Inflation protection would be more adequate if plan sponsors or holders of RRSPs could buy real-term annuities.

Once a market for real-term instruments exists, indexed pensions may emerge as a better solution to the joint concerns of plan sponsors and plan members. In short, for a given level of pension contributions, the private pension system could provide better inflation protection to retired pensioners if a market for real-term financial instruments were to exist.

5.2.5 Insurance

Contracting in real terms could be of interest to the insurance industry on both the asset and liability sides. Insurance contracts are long-term in nature or cover a financial risk that is deferred long enough to be materially affected by inflation. Capital sums insured under whole life policies or term policies of even modest durations are seriously eroded by inflation. Even participating contracts have been an imperfect hedge against inflation as they do not provide for a benefit guaranteed in advance in real terms.

Annuity contracts, immediate or deferred, pose the same problem as retirement pensions. Their attractiveness as a means to ensure that earnings keep pace with inflation is diminished since their purchasing power is not protected. Contracts for long-term disability or survivor benefits share the same limitations. Even in the property and casualty area, the change in the coverage-to-value ratio causes problems that are mitigated by replacement value riders but tend to render loss reserves less adequate than anticipated.

Contracts and policies established in real terms could enhance the capacity of insurance companies to reduce uncertainty by better covering policyholders against the risks of inflation. The fact that such contracts have begun to appear indicates that they meet a need in the market.

Insurance companies could therefore become active participants in a market for real-term bonds or mortgages contracted in real terms in order to offer better inflation-proof insurance and annuity contracts at a lower cost.

5.3 Experience in Other Countries

The Committee has not examined in any detail the extent to which contracting in real terms has occurred in other countries nor what the experience has been where it has occurred. We understand that an extensive study on this subject is being prepared at the Organization for Economic Co-operation and Development.

From the limited information readily available to us, it seems that real-term financial instruments have appeared in one form or another in a number of industrialized countries in Europe as well as elsewhere. As might be expected, such instruments are more common in countries with relatively high rates of inflation than in those with moderate rates of inflation. To the Committee's knowledge, real-term instruments apparently are unavailable in the market in Germany, Switzerland and Japan, though in some of these countries arrangements are available to adjust amortization schedules to avoid the "tilting" problem referred to earlier. In the United States, at least one public utility has issued a real-term bond.

Several other features of the experience in other countries can be identified.

- Indexed instruments have most commonly been mortgages as well as government bonds and savings certificates, usually issued subject to restrictions such as the total size of the issue, the amount any one individual can hold and the age and income characteristics of the buyer.

- In some countries a few indexed instruments have been issued by private borrowers. In these cases, the index has frequently been tied to gold, some other commodity or basket of commodities, interest rates or earnings of a company or industry.

- Where they have appeared, the "real interest rate" on real-term instruments has generally been in the range of 2% to 3 1/2% per annum. Market acceptability of such instruments has apparently varied considerably depending on the economic circumstances of the country and the term of the instruments.

- Some countries where indexation of financial instruments has appeared have abandoned or restricted the use of such instruments. In Finland this was done in conjunction with a range of policies to achieve greater price stability and reduce inflationary expectations in order to deal with devaluation and foreign exchange problems. In Sweden, indexation provisions have been severely curbed by the combination of restrictions on nominal interest rate levels and high inflation rates.

The United Kingdom government started issuing real-term bonds in 1975; these were offered exclusively to senior citizens and in a limited amount. In March, 1981, Index-Linked Treasury Stocks (Gilts) were first offered. Real-term government bonds have been trading without restriction in the United Kingdom since March, 1982. There are now five issues, with the longest maturing in 2011. Since the first Gilt issue in March, 1981, approximately one-third of new government marketable debt securities have been issued on a real-term basis. Real yields have ranged from 2% to 3 1/4%, with the rates generally higher for longer-term maturities.

These real-term bonds co-exist with traditional bonds in the United Kingdom and, while there was considerable apprehension in the British financial community about the potential effects of introducing such bonds, the initiative had a minimal impact on financial markets from the outset. Some building societies have begun to accept real-term deposits, investing the funds thus obtained in real-term government bonds. Predictably, private firms are thus using their access to the market for real-term government bonds to perform new financial intermediation services.

The U.K. experience differs from the Committee's recommendation in one important and fundamental manner: the inflation component on these bonds is fully capitalized and is not taxable. This tax discrimination against other forms of personal investment income is a major source of distortions. In a move to alleviate some of these problems, the U.K. recently modified its system of taxation of capital gains in order to provide some, albeit not complete, indexation of the cost base of the assets of individuals for tax purposes.

5.4 Assisting the Development of this Financial Innovation

The introduction of real-term instruments into the capital market would be a significant innovation. It may involve considerable innovation costs for the first businesses, financial institutions or individuals to participate in real-term instrument markets while benefits of creating such markets will be distributed among all future participants.

5.4.1 Some Prerequisites

For real-term debt instruments to be successfully used in retail financial markets, a number of conditions must be satisfied. These include developing designs for real-term deposits, mortgages, and term loans that effectively meet the needs of borrowers while at the same time not exposing lenders to new risks. Other issues concern removal of legal constraints, development of consumer understanding of new instruments, common definitions of terms used in real-term contracts, implementation of bookkeeping systems, conformity with interest disclosure regulations, and

the need to create markets in real-term instruments that can be used by financial institutions to facilitate matching of their liabilities and assets contracted in real terms.

Canada Mortgage and Housing Corporation could provide insurance to financial institutions for principal, current interest and capitalized interest for mortgages contracted in real terms. The premium could be set at a rate sufficient to cover actuarially expected costs in order not to prevent private insurers from entering this market. This insurance program could also be extended to cover mortgage renewals where the homeowner switches from a conventional to a real-term mortgage. These programs would not be costly for governments, yet they would have the effect of increasing the affordability of home ownership.

A similar role could be played in the farming sector. At present, the Farm Credit Corporation, a Canadian government agency, provides long-term farm credit at fixed interest rates for periods of up to 30 years and in amounts of up to 100% of the value of the property. A program could be established whereby principal, current interest and capitalized interest of mortgages contracted in real terms would be insured. Such a program would be akin to that of CMHC.

The creation and development of markets in real-term debt instruments is likely to be an evolutionary process. For financial institutions the problems associated with the matching of liabilities and assets contracted in real terms is a major impediment to the emergence of such a market.

It has been suggested that the government should issue a moderate quantity of marketable real-term bonds in order to accelerate the process. Once such a market is established, these instruments could be used by financial institutions as a buffer stock, permitting them to collect real-term deposits to obtain funds which could then be invested in the real-term bonds. With a pool of real-term deposit funds available, financial institutions would then be in a position to invest such funds in other real-term assets.

Arguments can be presented to support the view that there is a legitimate role for government to provide the initial impetus in creating this new financial market. However, an equally good case can be made that it would not be prudent for the government to embark on such a course.

The rationale for suggesting that the government be the initiator revolves around the fact that it does not have to match its real-term borrowings with assets contracted in real terms. Free of this obligation, the government could "prime the pump", so to speak, and thus provide a facility for financial institutions to match their real-term liabilities with their real-term assets.

Those who assert that embarking on such a course would be imprudent argue in terms of broad policy considerations and a possible "crowding out" effect. The major concern about this approach is that over a period of years it could result in less discipline in stabilization policy and could open the way to less price stability.

If in time the federal government - and other levels of government which could be expected to follow suit quickly - begin issuing substantial volumes of indexed debt, the size of reported current deficits could be reduced by the indexed component of current nominal interest costs. This component would be deferred to some time in the future leaving to some succeeding government the task of coping with the increase in the public debt. In this situation, it may be more difficult to resist the already strong political pressures to increase current public expenditures without corresponding tax changes, thereby adding to the inflationary bias of spending policies at all levels of government.

Keeping the deficit in current dollars, clearly visible, up-front and subject to continuous market testing as governments issue conventional securities to fund their requirements may have advantages from the standpoint of resisting the political pressures bearing on stabilization policy. In such a system it may be more politically feasible to pursue anti-inflationary policies than in a system where a significant part of the nominal deficit is relegated, outside the market, to the future for the attention of future taxpayers.

Concerns are also expressed that a single experimental issue would likely be followed by frequent issues, or by provincial issues. This could lead to the "crowding out" of the private sector by the public sector, especially if there were a long lead time while legal obstacles were being overcome in the private sector. These obstacles, which we discuss below, relate mainly to the acquisition of assets rather than the issuance of liabilities.

These are profound and complex questions on which members of the Committee have strong and divergent views. We have presented them here because, in our opinion, they provide a vivid illustration of the dilemma confronting those who are concerned that the Canadian economy not embark inadvertently on the "slippery slope" to a less stable price level when attempts are made to reduce, through some new arrangements, the distorting effects of high and variable inflation.

5.5 Removing the Legal Impediments

5.5.1 General Comments

The Committee has consulted counsel with respect to possible legal impediments that might constrain the use of real-term instruments. There are certain impediments which have been identified by counsel and these are discussed below.

There does not appear to be any legislation that would prohibit parties from voluntarily contracting in real terms. Deposit-taking institutions such as chartered banks and trust companies are not prohibited by their governing legislation from taking real-term deposits. These financial institutions and other lenders are also free to lend their funds in real terms. Despite the absence of specific legislative prohibitions, however, there are legal problems that arise as a result of certain statutory provisions that may discourage lenders and borrowers from contracting in real terms.

There are a number of federal and provincial statutes that affect the legal position of lenders and borrowers by requiring disclosure in loan documents, establishing prerequisites to the validity or enforceability of loan documents and determining priority among creditors. In addition, the income tax treatment of real-term instruments will affect their acceptance by lenders and borrowers.

These statutes were generally introduced at a time when only conventional loan instruments were used and floating term or variable rate instruments were non-existent. The special features of floating term, variable rate and, for that matter, real-term loan instruments have not been addressed specifically by legislation. It might be appropriate to undertake legislative clarification or amendment to eliminate the legal impediments described below which might inhibit contracting in real terms.

5.5.2 Real-Term Deposits

Deposit liabilities of banks, trust companies and loan corporations are not considered to be "securities" under applicable securities legislation in Canada. Financial institutions could accept real-term deposits from the public in the ordinary course of their business in the same manner as other deposits are accepted.

Under the Bank Act a chartered bank cannot open an interest-bearing deposit account in Canada in the name of an individual unless the bank discloses to the depositor, in the manner prescribed by the Regulations, the rate of interest applicable to the account and the manner in which the amount of interest to be paid is to be calculated. The Regulations to the Bank Act require the bank to provide the person who opens an account with a written statement which sets out, among other information, the annual rate of interest applicable to the deposit account.

A real-term deposit could be designed to provide an inflation return in any month based on the cost-of-living increase in the preceding month. At the date such a deposit account is opened, the overall return would be known at least for the following month and compliance with the Regulations should not present a problem. However, if a real-term deposit is designed to provide an inflation return based upon a cost-of-living increase in a future period, it is doubtful that disclosure of the method by which the overall return is determined complies with the Regulations. To the extent that the latter type of real-term deposits is used, it follows that an amendment might be made to the Regulations of the Bank Act to require disclosure of the method by which the overall return to the depositor is calculated rather than of the annual rate of interest.

5.5.3 Real-Term Loans - Drafting of Loan Documents

While deposits may only be made with certain financial institutions, any person, firm or corporation may make a real-term loan. Any such lender would be required to take special care in the drafting of the appropriate loan documents since the lender's return consists of a real component and an inflation component. Various disclosure requirements are imposed by statute which will vary depending upon whether the real-term loan is a consumer loan, mortgage loan or small business loan. A common objective would be precise legal drafting to ensure that the real-term borrower is appraised of the dual nature of the lender's return, the timing of real interest payments, the timing of inflation payments and the extent to which they are capitalized, and the manner in which interest payments are to be calculated.

There is no unique form of document that would be required to record the rights and obligations of parties to a real-term loan. The usual commercial documents that have been used in conventional loans are appropriate for real-term loans with modifications to reflect the differences in the lender's return and the borrower's obligation. Loan agreements, debentures, mortgages, security agreements and other commercial documents could be suitably revised to properly deal with the real-term indebtedness of consumers, homeowners or corporations. Under the Bills of Exchange Act, a promissory note must be an unconditional promise to pay a "sum certain in money" and it would therefore be inappropriate to use a promissory note to evidence real-term indebtedness.

5.5.4 Real-Term Mortgage Loans - Disclosure Requirements

It is uncertain whether a lender of real-term funds secured by a mortgage of real estate can comply with section 6 of the Interest Act where the mortgage loan is repayable in blended instalments of principal and interest. This statutory provision prevents the recovery of interest on any loan secured by a mortgage of real estate which is repayable in such blended instalments unless the mortgage states the amount of the principal and the rate of interest, calculated yearly or half-yearly, not in advance. The jurisprudence is not clear as to what constitutes a blended payment of principal and interest within the meaning of section 6. Generally, the courts have narrowly interpreted the meaning of blended principal and interest payments in order to avoid the application of this statutory provision.

In the case of a conventional mortgage loan, compliance with section 6 of the Interest Act should not present a problem. The specific rate of interest to be charged by a lender of conventional funds is stated in the mortgage typically on the basis of a half-yearly calculation.

Certain lenders provide variable rate mortgage loans in which the rate of interest charged varies with the prime commercial lending rate. The rate varies automatically, without notice to the borrower, upon each change in the prime rate. The rate is usually calculated monthly, not in advance. The mortgage specifies the rate initially applicable and, in order to comply with section 6 of the Interest Act, the equivalent rate of interest calculated half-yearly or yearly, not in advance. Since the rate will vary during the term of the loan, it is necessary to specify for each possible rate the equivalent half-yearly or yearly rate. In order to accomplish this, the practice among Canadian lenders is to attach a schedule to the mortgage document listing the different rates that may possibly be in effect from time to time throughout the term of the mortgage loan and the equivalent half-yearly or yearly rates.

It is uncertain whether the provision of this range of equivalent interest rate conversions complies with the Interest Act because a court might construe the statute to require a specific statement of the effective interest rate calculated on a half-yearly or yearly basis if the payments under a variable rate mortgage loan are ruled to be blended payments. To date, a court has not specifically considered this issue.

The schedule attached to a variable rate mortgage document usually confirms that the amount of each monthly instalment to be paid by the borrower is fixed, but that the amount of the interest and principal components of each instalment varies as the prime rate varies. The schedule provides a formula describing the manner in which the interest and principal components of each monthly instalment are calculated. The amount of interest accrued on the principal sum to any monthly instalment date may exceed the fixed amount payable, in which case the excess (or de-

ferred interest) bears interest at the rate charged under the mortgage. An instalment payment made by a borrower is applied first to interest (other than deferred interest) on the principal sum accrued to the date of payment, secondly to deferred interest accrued to the date of payment and thirdly in reduction of the principal sum. Accordingly, the formula in the schedule to a variable rate mortgage document is quite complicated in outlining the manner in which a borrower could calculate the portion of each monthly instalment that will be applied to the payment of interest or deferred interest or in reduction of the principal sum.

It is unclear whether the provision of such a formula is sufficient to avoid the categorization of a monthly instalment as a blended payment of principal and interest and thereby render section 6 inapplicable.

The same problem regarding compliance with section 6 would apply in the case of real-term mortgage loans which are repayable in blended instalments of principal and interest. The additional feature in the case of a real-term loan is the payment of an inflation component which could be made in the form of interest, or capitalized as part of the principal sum, or partly in the form of interest and partly capitalized as principal. If the inflation payment is made in the form of interest and the real-term loan provides for the payment of interest only during the term of the loan, section 6 would not apply since the payments would not be blended payments. Similarly, section 6 would not apply to a real-term loan which provides for the payment of fixed principal instalments.

In the case of real-term loans that provide for blended payments of principal and interest, the combined return and inflation return will not be ascertainable at the date the real-term loan is made and accordingly compliance with section 6 is not possible. This combined return is determined monthly, as instalment payments are made, if the inflation payment is to form part of the instalment payment, or upon the expiration of the term if the inflation payment is not made until that date, or there may be some combination of the foregoing. This might be overcome by amendment of section 6, possibly requiring lenders of real-term mortgage loans to specify the formula or manner in which the inflation component of interest or capitalized interest is calculated rather than the equivalent yearly or half-yearly rate of interest.

The same amendment might also clarify the meaning of blended payments of principal and interest.

5.5.5 Real-Term Consumer Loans - Disclosure Requirements

Consumer protection legislation of many provinces presents a problem in the case of real-term consumer loans by requiring that a lender provide a borrower with a

written statement disclosing the cost of borrowing, expressed as a fixed sum and also as an annual rate on the unpaid balance of the obligation, prior to advancing the funds. A lender of real-term funds would not be able to comply with this requirement since the cost of borrowing cannot be ascertained at the time the funds are advanced.

For example, under the Consumer Protection Act of Ontario, prior to advancing funds, a lender must provide the borrower with a "clear statement in writing" disclosing, among other things, the "cost of borrowing" expressed as a single sum and the annualized percentage that the cost of borrowing bears to the amount of the loan. Detailed Regulations to this Act prescribe the manner of calculating such rate. It is apparent that under a real-term loan that is subject to the Consumer Protection Act of Ontario, a lender would not be able to comply with these requirements because, at the time the loan is made, there would be no means of determining what the inflation payment under the loan would be. A lender might attempt to comply with the purpose of the legislation by adopting an approach similar to that used by lenders of variable rate mortgage loans, as discussed above. The penalty for non-compliance is onerous; a lender, among other things, would not be entitled to recover all or part of his return.

Although the consumer protection statutes of most provinces, including Ontario, do not apply to an advance of funds secured by a mortgage of real estate, which is dealt with to a certain extent by section 6 of the Interest Act, it is apparent that, if the use of real-term consumer loans is to be facilitated, amendments to the legislation of the respective provinces will be necessary. One possible amendment might be to allow a lender under a real-term consumer loan to provide the borrower with a precise statement as to how the "cost of borrowing" will be ascertained on a periodic basis in substitution for the present disclosure requirements. The consumer protection statutes may not apply to consumer loans by banks in view of the exclusive federal constitutional competency over banks and banking. However, disclosure of the cost of borrowing is also required in the case of a bank consumer loan and a similar amendment might be necessary under the Regulations to the Bank Act.

5.5.6 Real-Term Loans - Preservation of Priority

As in the case of a conventional loan, a real-term loan may be unsecured or secured. The nature of a real-term loan does not, by itself, preclude a lender from taking the usual forms of security applicable to conventional loans such as a security interest in personal property, a mortgage of real estate, a floating charge debenture or an assignment of accounts receivable. A lender of real-term funds will take the usual steps to protect his security by the filing of instruments or financing statements under applicable personal property, real property and corporate registration legislation in amounts sufficient to protect the maximum sum recoverable by the lender under the combined real and inflation returns.

In the case of a security interest in personal property granted by a borrower, the lender who registers the relevant real-term instrument or financing statement could, by appropriate language in the security agreement and timely registration, maintain priority over a subsequently registered security interest to the full extent of any increase in the principal indebtedness due to the inflation adjustment. It would be important, however, for the security agreement to clearly describe the nature and timing of the payment of the inflation component.

Similarly, lenders of real-term funds who take security over the assets and undertaking of a corporate borrower in the form of a floating charge debenture could, by appropriate language in the debenture and timely registration, maintain priority over subsequent creditors both in respect of the inflation component and the amount advanced. Again, it would be important to describe clearly the mechanism which gives rise to the payment of additional principal or interest.

In certain provinces, however, a lender of real-term funds secured by a mortgage of real estate would be limited in his priority over subsequent lenders to the amount actually advanced. For example, in Ontario the Registry Act provides that a "registered mortgage is ... a security upon the land comprised therein to the extent of the money or money's worth actually advanced or supplied under the mortgage, not exceeding the amount for which the mortgage is expressed to be a security ...". The lender would likely lose his priority as against a subsequent registered encumbrancer with respect to the inflation component of his return to the extent that it forms part of, or is added to, the principal sum. If the inflation component of the lender's return consists of interest payments, however, the lender may not lose his priority with respect to such payments.

Nevertheless an amendment to the relevant provincial land registration statutes might be advisable to ensure that lenders of funds secured by real-term mortgages have priority over subsequent creditors in respect of the inflation component, regardless of whether it is received as additional principal or as interest.

5.5.7 Real-Term Loans - Unconscionability

The nature of real-term loans also renders necessary the consideration of certain federal and provincial statutes designed to prevent lenders from charging exorbitant rates to borrowers. The Criminal Code of Canada makes it an offence for a person to enter into an agreement to receive interest at an effective annual rate exceeding 60% on the credit advanced (the "criminal rate") or to receive such a payment. Interest is broadly defined and would include an inflation return, whether capitalized or paid currently. Where a loan agreement violates the Criminal Code's prohibition, the lender would be prohibited from recovering any interest under the loan (not merely any portion exceeding 60%) on the basis of the fundamental legal

rule that no person may benefit from his own criminal act. It is not possible for a lender of real-term funds to know what rate of "interest" he will ultimately obtain. The Criminal Code might therefore be amended to permit the conversion of the nominal rate constraint to an appropriately defined real-rate constraint.

It is unlikely that those provincial statutes which provide relief from unconscionable loan transactions constitute an impediment to real-term loans. The effect of the provincial legislation, generally, is to provide the courts with the power to amend the loan agreement or to set aside the transaction, in whole or in part. In Ontario, for example, the Unconscionable Transactions Relief Act provides that where any money is lent (including any loans secured by a mortgage) and the court finds, having regard to the risks and all the circumstances of the loan, that the "cost of the loan is excessive" and "the transaction is harsh and unconscionable", it may relieve the borrower from payment of any sum in excess of the sum adjudged by the court to be fairly due, order the lender to repay any excessive amount, or "set aside either wholly or in part or revise or alter any security given or agreement made in respect of the money lent."

A lender's concern in making a real-term loan would be that, if the inflation payments were large in absolute terms, the borrower might be able to successfully argue that the loan contravenes the Unconscionable Transactions Relief Act. The cases which have interpreted this statute indicate that neither the rate nor amount of interest will conclusively determine the classification of the relevant loan, but rather the courts will also take into consideration the relative positions and sophistication of the parties and the extent of fair and true disclosure made by the lender to the borrower at the time the loan is made. It is doubtful, for example, that a transaction would be ruled unconscionable if the borrower were an established corporate entity, regardless of the actual rate of interest.

In contrast, if the borrower were a commercially unsophisticated and needy individual and the lender were experienced in the field, the borrower would have a much greater chance of establishing unconscionability and the lender would be required to exercise great care to fully explain the significance of the real-term loan to the borrower. If a lender takes the necessary safeguards to ensure that the borrower thoroughly comprehends the significance of a real-term contract, it is unlikely that the provincial legislation in this area will constitute an impediment to the use of real-term loans.

5.5.8 Real-Term Loans - The Bankruptcy Act (Canada)

Under the Bankruptcy Act of Canada, a lender who is fully secured can realize upon his claim for repayment of indebtedness under a real-term loan despite the bankruptcy of the borrower and the existence of other creditors. Any real-term contract

would have to be worded so as to provide that the security included the inflation payments as well as the original amount advanced and the interest thereon.

A secured creditor will enforce his secured claim for the principal and interest owing to him at the date of bankruptcy. If the value of the security is insufficient, he may file a proof of claim for the deficiency as an unsecured creditor. The general rule is that an unsecured creditor is only entitled to interest up to the date of bankruptcy. Interest continues to run, however, on a secured debt until the secured creditor has completed his realization of the security.

A secured creditor's claim for a deficiency will be determined under the provisions of section 95 of the Bankruptcy Act. If a creditor is entitled to increased amounts of principal which are payable after the date of bankruptcy, he may file a proof of claim for the amount owing subject to a discount based on an interest factor of 5% per annum. If the additional payments owing to the creditor are characterized as interest payable after the date of bankruptcy, no unsecured claim could be submitted for these amounts. If additional payments are characterized as contingent or unliquidated claims, they will be given a value by the Court.

5.5.9 Real-Term Loans - Effect on Financial Covenants and Tests

A borrower of real-term funds may find it necessary to determine whether the proposed borrowing would conflict with various financial tests or other restrictions in existing debt instruments. In certain loan documents or trust deeds it is common for a lender to restrict the ability of a borrower to incur additional indebtedness. The principal restrictions in this regard relate to tests with respect to consolidated net tangible assets as against consolidated funded obligations, and consolidated net earnings as against aggregate interest requirements on an annual basis and frequently over a period of years. Thus it would be important for a borrower to determine whether the inflation component in a proposed real-term loan is interest or an addition to principal for the purpose of ascertaining the borrower's compliance with various covenants in any relevant debt instruments.

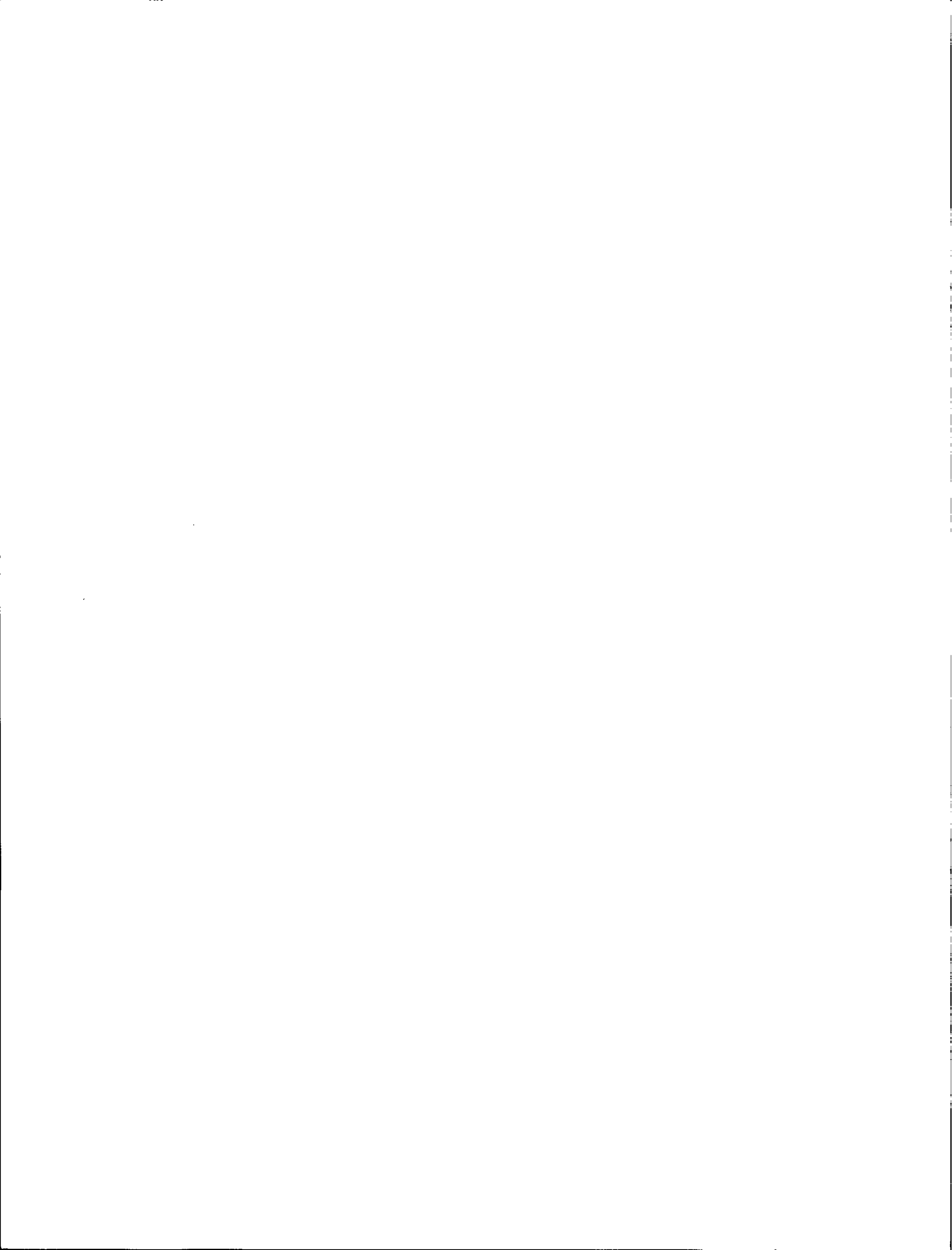
5.5.10 Real-Term Loans - Income Tax Considerations

Under current Canadian tax law, interest on a conventional loan is included in computing the lender's income for tax purposes. A borrower is generally entitled to deduct interest on a conventional loan if the borrowing is made for the purpose of gaining or producing income.

As a matter of law, the real interest and inflation interest components are as much interest, or a cost of borrowing funds, as interest paid on a conventional loan. Accordingly, in the case of a real-term loan, the inflation component, as well as the real interest component, would be included in computing the lender's income for tax purposes. The capitalization of interest by a borrower in whole or in part under a real-term loan or deposit should not affect the lender's tax consequences as described above. Different results to the lender and the borrower may obtain if the inflation component were structured as a bonus or a discount rather than as interest.

The timing of the inclusion of the inflation component would depend upon whether such component is received, receivable or accrues from year to year. For individuals reporting interest income on an accrual basis and for corporations, the inflation component would be included in income whether or not paid. For individuals who report interest income on a cash basis, the inflation component is not includible in income until paid. In the case of an individual reporting interest income on a receivable basis, the inflation component is included in income when payable even if not actually paid.

However, the June 28, 1982 Ways and Means Motion proposes to require individuals who report interest income on a cash or receivable basis to report such income on an accrual basis every three years. Excluded from the application of the proposed three-year rule are certain financial instruments such as small business development bonds. If real-term contracts were to receive the same treatment, it would be necessary to add them to the list of excluded instruments.



CHAPTER 6

CONCLUSIONS

This chapter draws together the main conclusions reached by the Committee and summarizes the recommendations made in the Report.

- The Committee accepts that the Paper's objective of tax reform, which is aimed at removing the inflation component in personal investment income from the tax base, is desirable on grounds of both fairness and economic efficiency. In a period of inflation, a part of personal investment income is illusory. The inflation component of investment income does not reflect an increase in real income or purchasing power and consequently should not be taxable. Inflation and a tax system based on historical cost accounting principles have combined, especially in recent years, to distort the measurement of income and erode the real value of investment capital. A strong case can therefore be made for a basic tax reform.

- The Committee has concluded that the best long-term solution to the problem would be to greatly reduce or eliminate inflation. This does not mean that society should not attempt to protect itself from the worst effects of high and variable inflation, but great care should be taken not to lose sight of the priorities.

- The Committee recommends the adoption of a modified form of the Registered Shareholder Investment Plan (RSIP) for listed common shares as a partial approach to removing the inflation-based and therefore illusory component of capital gains from the tax base.

- The Committee recommends that the government not proceed with the Indexed Term Deposit and Indexed Term Loan proposal. This conclusion rests on our evaluation of the economic distortions and other difficulties that would arise, in large part due to the fact that the proposals are narrowly focused in an attempt to provide short-term economic assistance to particular sectors. The Committee is sympathetic to the serious economic problems faced by some Canadians in the farming, fishing, small business and housing sectors that were singled out for access to the Paper's Indexed Term Loan proposal. However, the Committee has concluded that aid to particular sectors can be more efficiently achieved by other means. A number of submissions received support this assessment.

- The Committee has concluded that a satisfactory reform of the taxation of interest income is likely to involve adjusting the tax system so that only real interest income is taxable in the hands of the lender and tax-deductible for the borrower. We have also concluded that this broad reform is not likely to be feasible unless there are corresponding inflation adjustments to the tax treatment of business inventories and capital cost allowances. Such broad reforms of the taxation of interest and business income lie beyond our terms of reference.

- The Committee therefore recommends that the government undertake a comprehensive study, as a basis for public discussion, of ways to correct for the effects of inflation on the taxation of investment and business income. As one part of such study, consideration should be given to ways of achieving an appropriate inflation adjustment to the gains on the sale of all assets.

- As an interim step, the Committee recommends that consideration be given to means of extending tax relief, equivalent to that provided under the RSIP for listed common shares, to long-term gains on the disposition of private company shares.

- The Committee recommends that as a further interim step the government consider raising and indexing the contribution limits and extending the coverage of Registered Retirement Savings Plans and Registered Pension Plans, possibly combined with an increase in the $1,000 investment income exemption for those over 65 years of age.

- The Committee sees advantages in the gradual and voluntary development of a market in real-term financial instruments. We have concluded that governments should consider removing any legal impediments and tax uncertainties, but not give special tax treatment to real-term securities.

- The Committee has concluded that the Consumer Price Index (CPI) is the only feasible price index to use for inflation adjustments for the personal income tax. The CPI is widely available on a monthly basis, and has already been used for indexing the exemptions and rate brackets of the personal income tax. It is also utilized for many other purposes. As we noted in Chapter 1, however, the CPI is not likely to be the most appropriate price index for all inflation adjustments. With this in mind, the Committee suggests that it would be prudent to establish an independent body to examine regularly the design of an appropriate set of price indices for various purposes and confirm the integrity of these indices.

- The Committee believes that its own experience confirms the desirability of issuing tax proposals for public discussion and advice. We have received many constructive suggestions from interested individuals and organizations, and we have learned much as we have gone along. The Canadian economy is very complex and diversified. For this reason, the Committee believes that it is highly desirable for widespread public discussion and consultation to precede the introduction of important policy changes in taxation and other areas.

APPENDIX I

DISCUSSION OF THE COMMITTEE'S RSIP PROPOSAL

This appendix elaborates on the Committee's proposal for the adoption of a modified RSIP, as presented in Chapter 2 of the Report. The modified proposal, while based on the original RSIP, differs from it in that it provides a wider base of eligible investments, a moderation of the immediate taxation of accrued capital gains, and a broader access by investors through pooled funds.

A.1.0 Eligibility of Equity Investments

It is suggested that, in addition to the common shares of taxable Canadian corporations listed on a recognized Canadian stock exchange (as proposed in the Paper), the following assets should also be eligible for inclusion in RSIPs, for the reasons noted:

1. Warrants for the purchase of listed Canadian common shares, if separately traded; these are equivalent to a call upon equity. Warrants attached to debt securities or preferred shares, and non-qualifying securities convertible into common shares would not be eligible for inclusion in RSIPs since the equity component of these securities cannot be readily valued and eligibility for inclusion in RSIPs cannot be logically extended to some non-qualifying securites and not to others.

2. Options, if the underlying shares are of Canadian public companies listed on a recognized Canadian exchange, for the same reason as noted above.

3. Investments in segregated pooled funds of insurance companies, trust companies and others and in mutual funds, provided the assets of the funds are invested principally in either Canadian listed equity securities or short-term cash investments, and the funds meet other conditions as discussed below. It is important that investors have access to RSIP benefits through as broad a range of investment vehicles as possible, and small investors in particular may prefer to make equity investments through such pooled funds.

4. Otherwise eligible shares or new issues that qualify for listing on a recognized Canadian stock exchange, where an application for listing is pending and is approved within a reasonable period. This provision will enable new issues of securities to qualify for eligibility even though the formal listing arrangements are not yet completed.

5. Other listed securities, such as units in trusts deriving business income in Canada and others, provided that they are recognized as the equivalent of an equity investment.

A.1.1 Mutual Funds and Other Pooled Funds

Mutual funds are at present organized, in general, either as mutual unit trusts or as mutual fund corporations. All mutual funds are required to pay capital gains tax in respect of realized capital gains not distributed to fund holders. We are advised that mutual fund trusts typically pay or allocate gains in a year to unit holders to avoid tax being imposed on the fund itself, while mutual fund corporations may recover the capital gains tax paid in the corporation if gains are subsequently distributed, as capital gains, to shareholders.

Trust companies and other institutions have established various pooled funds in which investors purchase units. The income of such funds, including capital gains, is usually allocated to unit holders annually for tax purposes. A number of insurance companies also maintain segregated pooled funds.

The Committee considers it important that investments in qualifying mutual and pooled funds, which have the substantial bulk of their assets invested in Canadian listed equity securities, be eligible for inclusion in RSIPs. It is recognized that a very large number of taxpayers make their investments in Canadian equities through such funds.

The Committee recommends that means be found whereby both existing investments in qualifying mutual and other pooled funds, and new investments in special mutual funds that might be established to take advantage of the RSIP legislation, should be eligible for appropriate RSIP treatment. This might be accomplished in the following manner:

- In respect of new funds established exclusively for RSIP investments, the fund itself should be invested principally in either qualifying Canadian equity securities or cash. The percentage of indexing to be permitted to investors in the fund would depend on the percentage of fund assets actually invested on average in Canadian listed equity shares during a taxation year. (It is inappropriate to require any fund to remain invested in the market, and hence cash must be a permitted investment of qualifying funds). The cost base adjustment for inflation would be allowed only with respect to the percentage of the investment that is represented by average investment in Canadian listed common stocks. For example, if the fund is 60% invested in qualifying shares during the year, and 40% in cash, the indexing adjustment for an individual investor in the fund would be calculated on the basis of 60% of his investment.

- The fund would calculate annually for each investor the gain or loss which the investor had experienced, on an accrual basis, in respect of his investment in the fund, by first of all adjusting the investor's cost base of his investment in the fund by an appropriate inflation factor (adjusted if the fund was less than totally invested in listed Canadian securities) and then comparing that with the "market value" of the investor's interest in the fund at the end of the year. The fund would perform all calculations with respect to the tax aspect of the fund and the investments in it by investors, and would report the adjusted capital gain or loss to the investor annually. On disposal or on realization of an interest in a fund, the investor would have to recognize in an appropriate manner any difference between his adjusted cost base of the fund and the proceeds received.

- With respect to existing mutual and other funds, any fund whose investment criteria are generally consistent with the policy objectives should be permitted to be a qualifying RSIP if it allocates or distributes all realized capital gains and can satisfactorily allocate unrealized gains to shareholders on an appropriate RSIP basis. There may be special problems encountered by such funds (particularly incorporated funds, which must receive further study), which should be dealt with sympathetically. A significant proportion of all mutual funds are incorporated funds, and hence it is important that the complex tax issues relating to existing incorporated funds be dealt with.

A.1.2 Preferred Shares

The Paper did not specifically address the question of the appropriate tax treatment of preferred shares, although it did suggest that only listed Canadian common shares be eligible for inclusion in RSIPs. Subsequently, the Committee received a number of submissions, the majority of which advocated the inclusion of preferred shares as eligible investments for RSIPs. In its deliberations, the Committee considered whether preferred shares should be more appropriately treated for tax purposes as debt or equity. We arrived at the conclusion that most preferred shares, while legally equity, are generally valued on a yield basis in the same manner as debt, and their tax treatment with respect to possible adjustment for inflation should be linked to the treatment of debt securities. We therefore believe that, on balance, such shares should be excluded from investments eligible for RSIPs.

The Committee realizes that there are arguments favouring the inclusion of at least convertible preferred shares of Canadian companies in RSIPs. Such preferred shares have a substantial possibility of being converted into common shares at a future date. Notwithstanding these arguments, the Committee feels that the inclusion of such convertible shares would be open to abuse, in that it would be difficult to distinguish preferred shares with a significant possibility of conversion from other preferred shares. This argument is of course less applicable to presently outstanding issues of convertible preferred shares. The Committee suggests that any further study of the treatment of the inflation component of interest income also address

the tax treatment of preferred shares. There is no conceptual reason why holders of preferred shares should not receive appropriate adjustments to offset illusory inflation-induced income.

A.2.0 Eligibility of Investors

The Committee considers that, in addition to individual resident taxpayers, persons eligible to invest in RSIPs should also include estates of deceased persons, provided that the estate is resident in Canada and provided that the RSIP investments may reasonably be expected to accrue for the benefit of individuals resident in Canada. The Committee considers that it is important that estates have an opportunity to invest in RSIPs and obtain the appropriate adjustment of their capital gains. Such estates contain large pools of investment capital which should be available for investment in Canadian listed securities on a tax basis no less favourable than applies on direct investment by individuals.

A.2.1 Private Investment Companies Require Further Study

The Committee considered the possibility of allowing private investment companies to be eligible to establish RSIPs. In principle, there is no reason why such companies should not be able to establish RSIPs and obtain appropriate adjustments in respect of the inflation-induced illusory elements of their gains on equity shares. However, there are complex technical issues that would have to be dealt with before such companies could be permitted to hold RSIPs.

- The shareholders of such companies would have to be individuals resident in Canada, to maintain parity with the policy consideration relating to the establishment of RSIPs by Canadian individuals and estates. However, it would be difficult to deal with lengthy chains of ownership (through a number of corporations and trusts) for this purpose.

- Adjusting the cost base of the eligible investments in RSIPs would not in itself be sufficient to overcome the impact of inflation on the measurement of taxable gains; rather, some additional means would have to be found to enable the distribution of the inflation component amount to shareholders without further taxation. In the case of private companies this might be accomplished by adding the inflation adjustment to the capital dividend account, thus allowing it to be paid out without further tax.

- Providing treatment equivalent to that allowed in RSIPs established by individuals would require some restriction on the deduction of interest incurred by companies to acquire eligible RSIP securities, but it would also require that interest expense incurred by individual investors to buy shares in the company itself be appropriately restricted.

- Changes in the ownership of the private company during a taxation year, and in its capital structure, might also result in additional complexities.

The Committee suggests that further consideration be given to the possible inclusion, on a reasonable and fair basis, of private corporations in the group of persons eligible to form RSIPs.

A.3.0 Interest Deductibility and the $1000 Investment Income Exclusion

The Committee recognizes the arguments put forward in the Paper against permitting taxpayers to deduct interest incurred on loans taken out to invest in a plan such as the RSIP. Essentially, to allow such interest in addition to permitting indexing would be to give a double allowance for inflation since the interest expense includes a large element of inflation compensation.

It should be noted that the arguments in the Paper justify the non-deductibility of only the "inflation" component of interest expense, and the "real" interest element should be permitted as an expense. However, there are practical difficulties in segregating the two components in many situations, and at the moment the inflation component is significantly larger than the real component.

The Committee believes that the appropriate answer would be to disallow interest incurred by taxpayers directly for the purchase of RSIP securities, but only on the basis that is provided under existing law; that is, only in respect of loans specifically taken out for this purpose. Interest incurred on other loans obtained by taxpayers for the purpose of earning business or property income should remain deductible as under present rules. The Committee recognizes that many taxpayers will so arrange their affairs as to maximize borrowings for "deductible" purposes and minimize borrowings for investment in RSIPs or other non-deductible purposes. This would, however, simply be an extension of the position under the present law.

The Committee believes that imposing non-deductibility of interest on such a basis will still provide taxpayers with a reasonable degree of flexibility and balance, while allowing the Department of National Revenue some protection against blatant abuse that could otherwise occur if taxpayers were allowed to deduct without limit all interest expense relating to RSIP investments. If the government wishes to provide greater encouragement to equity investment, the interest deductibility restriction could be modified or removed.

Further, the Committee considers that the question of whether taxable capital gains arising from RSIPs should be eligible for inclusion in the amount of $1,000 of Canadian dividends, interest and capital gains excluded from income is a question of judgement based on the desired degree of stimulus to equity investment. We cannot disagree with the Paper's proposal that such gains should not be included in the exemption.

A.4.0 Transfers to RSIPs

The Paper has suggested that eligible assets included in its proposed RSIP would represent new purchases of qualifying Canadian securities. The Committee can see no particular merit in this restriction, which could be circumvented by taxpayers simply selling and then repurchasing these securities. The Committee recommends that taxpayers should have an opportunity to transfer their existing qualifying securities to RSIPs.

However, the Committee also believes that it is appropriate that any capital gain or loss accrued to date on presently-owned securities should be dealt with under the present provisions of the Income Tax Act, and that only future fluctuations in value should be recognized in the RSIP. Accordingly, we suggest that taxpayers be permitted to transfer securities to RSIPs, but that such a transfer be regarded as a deemed disposition at current market value for tax purposes. Any capital gain arising on such a disposition would be included in the taxpayer's income currently. Any capital loss on the transfer would be recognized, but dealt with under the present law. The taxpayer could offset such a loss only against capital gains, or against other income up to a limit of $2,000 a year.

To permit the transfer of appreciated securities to RSIPs without recognition of the gain would permit taxpayers to then immediately sell the securities out of the RSIP, and still substantially delay the payment of the tax on the gain under the proposed RSIP rules set out in this Report. This result is inappropriate with respect to gains accrued before the taxpayer elects RSIP treatment.

It is also suggested that any withdrawal of securities by a taxpayer from the RSIP - which withdrawal the taxpayer should be entitled to make - be treated as a disposition from the RSIP at the current market value of the securities.

A.5.0 Management, Administration and Participation

In general terms there are two ways in which RSIPs can operate. The first method would involve a direct investment in common shares of taxable Canadian corporations by qualified participants through investment dealers or brokers. This direct investment would involve no change in the traditional broker/client relationship apart from the documentation necessary to establish such a plan.

Alternatively an investor could enter into a contract with a portfolio manager or investment consultant whereby the latter might have discretion and authority to invest the client's funds.

The second method would involve the pooling of funds by a number of investors with certain financial institutions or organizations such as trust companies, insurance companies and mutual funds. With respect to banks, we are advised that current legislation restricts their participation to providing administrative and custodial services.

Participation in RSIPs is of course voluntary. While it appears that the plan would offer advantages to many investors, it would be open to each taxpayer to decide if he or she wished to participate, and if so, to what extent. The Committee recognizes that certain individuals, perhaps including those whose investments are highly levered or who own major control blocks of shares, might prefer to keep all or part of their investments outside of RSIPs.

A.6.0 Treatment of Cash in RSIPs

The Committee concluded that the conversion of investments into cash, even temporarily, should be treated as a withdrawal from the RSIP, with the appropriate adjustment to the cost base. New purchases of qualifying securities would of course be treated as an addition to the RSIP. While the Committee appreciates the view that such a treatment would add to the perceived complexity of the program, it nevertheless seems impractical to include cash in RSIPs without appropriate and complex adjustments to prevent the inflation adjustment of cash balances.

A.7.0 Calculation of Market Value

The Committee suggests that the government establish, in collaboration with the Canadian exchanges, the year-end market value of listed Canadian securities as an

average of quoted market values in some short period immediately prior to the year-end, rather than as the value established by the last transaction, or by the average of closing bid and ask prices if there was no transaction on the last day of the year. The Committee believes that this approach might give a fairer indication of market values, less subject to market aberrations and other influences. (Mutual funds and other similar organizations would however use the appropriate valuation on the last working day of the year, as calculated for the purpose of their reporting to shareholders).

A.8.0 Registration and Reporting

The investment plan is referred to in the Paper as the Registered Shareholder Investment Plan. While we have used the same title for our proposed modified Plan, we suggest that it is not necessary that RSIPs be formally registered or meet any onerous reporting requirements, beyond perhaps a simple notification of the establishment of each RSIP and a requirement that the plan administrator furnish a standard report on the plan's investments and their tax consequences to the investor at the end of each year.

A.9.0 Tax Arbitrage

The Committee has reviewed a number of possible means whereby taxpayers could obtain unintended benefits from the manipulation of RSIP investments. There are approaches which could have such results, such as those which involve investments in RSIPs and corresponding short sales outside RSIPs. The tax benefits of all such approaches, however, would seem to be largely or more than offset by the transaction costs involved. The Committee also considered the problems caused by allowing the indexation in RSIPs of shares of listed companies which are largely invested in marketable unindexed assets such as bonds or real estate, but concluded that this should not create any objectionable revenue leakages. The income on such assets will be subject to tax in the corporation, and there appears to be no reason to provide any discriminatory treatment of the shares of such companies.

A.10.0 Deferral and Amortization of Capital Gains and Losses

In order to reduce the problems associated with the original RSIP scheme, which would tax immediately all accrued capital gains on an annual basis, the Committee recommends that only part of the RSIP's capital gains and losses be included in current taxable income, with a major portion deferred to subsequent years.

The appropriate method and rate of amortization is obviously a matter of judgment.

If too much of any accrued capital gains is included in annual taxable income, the liquidity problem of investors who have accrued, but unrealized, capital gains would remain.

On the other hand, if too little of any accrued capital gains is amortized in a given year, this could lead to situations where taxpayers with significant accrued balances of unamortized gains could run down investments in RSIPs by withdrawing current funds, or by incurring losses. The issue in this case is not so much the collectibility of tax, but rather the time of payment of tax that might be deferred under the Committee's proposal. The payment of tax should not be long removed, in time, from the point when the taxpayer has consumed the corresponding resources from the RSIP.

Furthermore, the Committee recognizes that actual capital gains realized on the disposition of assets in RSIPs are not directly taxed, but rather the sale of securities is regarded as a withdrawal of funds from the RSIP, reducing its cost base for tax purposes. There is therefore some argument in equity that taxpayers should not be able to realize large capital gains in RSIPs, delay the recognition of these through the deferral method suggested by the Committee, and simultaneously withdraw funds for current consumption.

The Committee believes that if the percentage of accrued gain to be included in current income is set high enough - say up to 35% - then the need for any special rules to directly impose some recognition of gains on partial withdrawals from RSIPs could be avoided, since the effective amortization of the gain into income would be so rapid as to prevent any substantial unintended advantage. It is for this reason, as well as the maintenance of a significant current loss offset in respect of RSIP losses against other income (1), that the Committee suggests that the recognition of accrued and realized gains and losses in RSIPs should not be unduly retarded.

The Committee accordingly recommends that the proportion of gains and losses in RSIPs that should be recognized currently should be established at no more than 35% of the total gain or loss. The balance of the gain or loss not currently recognized would be deferred until future years, when it would be recognized and amortized into income on the declining balance basis.

(1) The more rapid taxation of capital gains in market booms and the quick tax credits in market slumps helps to stabilize prices and employment for the economy as a whole.

The Committee suggests that this approach would result in taxpayers including in income, over a lengthy period of time, virtually the same total amount of accrued gain or loss as they would under the proposals in the Paper, but that the recognition of such gains or losses would be on a "smoothed" basis, with more moderate annual fluctuations. The Committee recognizes that, under its proposal, taxpayers suffering accrued losses in the modified RSIP would be in a less advantageous position than under the Paper's original RSIP proposal, because they would not have an immediate offset of the full amount of any capital losses against other income. However, under the Committee's proposal, the portion of the loss recognized in the year would still be permitted to be deducted from any other income of the taxpayer in that year, with the remaining balance available for carryover and future offset.

Further, the Committee recommends that taxpayers have an annual option - in advance - to select full accrual accounting, with full offset. This option would provide taxpayers with the same treatment as proposed in the Paper. A taxpayer making such an election would then recognize currently all gains and have the right of immediate full offset of all losses in his RSIP. Such an election would not be effective with respect to losses already accrued at the time it was made, and would apply to all of a taxpayer's RSIPs.

A.11.0 Details of Deferral Mechanism

These are a number of different mechanical approaches to deal with deferral and amortization of capital gains and losses in RSIPs. Under one approach, a portion - say 35% - of the gain or loss recognized in the RSIP would be included in the computation of taxable income, with the balance - 65% - being placed in an amortization account and taken into income in future years on a declining balance basis. RSIP gains and losses in subsequent years would be added to or subtracted from this account, and 35% of the net balance at each year end would be included in the taxpayer's income. This method is illustrated under the column "Declining Balance Gain Amortization" in the table below.

There is an alternative approach to dealing with the deferral and amortization into income of gains and losses in RSIPs. Under this method, a portion of the accrued gain or loss from the RSIP is included in current income, with the balance of the gain or loss - the part not recognized currently - being subtracted from or added to the market value of the account to determine the opening "cost" base of the account for the next year. Only this adjusted "cost" would be included in the computation of the balance of the account to be inflation-adjusted in the subsequent year.

The major advantage of this approach is that there is no need to maintain any separate balance of unamortized gain or loss, or indeed deal specifically with the amortization of deferred gains or losses. This is handled automatically through adjusting

the cost base of the account, which will result in the deferred gain or loss being recognized in subsequent years. This second alternative is illustrated under the heading "Deferred Gain Removed from Cost Base" in the table below.

TABLE 1

Two Versions of Deferral under RSIP

Assumptions – inflation is 12% a year
– amortization factor is 35%

		Deferred Gain Removed from Cost Base	Declining Balance Gain Amortization
First Year			
Jan. 1	Asset cost	100.0	100.0
Dec. 31	Cost adjustment for inflation	12.0	12.0
		112.0	112.0
Dec. 31	Value	120.0	120.0
	Gain	8.0	8.0
	Taxable – 35%	2.8	2.8
	Deferred – 65%	5.2	5.2
Second Year			
Jan. 1	Cost base for year 2	114.8*	120.0
Dec. 31	Cost adjustment for inflation	13.8	14.4
		128.6	134.4
Dec. 31	Value	150.0	150.0
	Gain	21.4	15.6
	Taxable – 35%	7.5	7.3**
	Deferred – 65%	13.9	13.5
Third Year			
Jan. 1	Cost base for year 3	136.1*	150.0

* Deferred gain subtracted from cost base of asset for the purpose of the next year's indexing.
** Gain recognized is 35% of 20.8 (5.2 + 15.6), or 7.3; remaining balance of deferred gain is (20.8 - 7.3) or 13.5.

It should be noted that the second method - the approach involving subtracting the deferred gain (or adding the deferred loss) to the opening "cost" base of the subsequent year - provides a slightly different level of indexing adjustment. Compared to the first approach, taxpayers with deferred balances of unrecognized gains tend to have somewhat lower index adjustments to their cost base, while taxpayers with deferred losses would tend to have somewhat higher indexing adjustments.

The Committee has concluded that the second method noted above - the method involving the removal of deferred gains and losses from the RSIP base - is the preferable method on the grounds of practicality and equity.

A.12.0 Details of RSIP Operations

The calculation of capital gains or losses in RSIPs is to take place on a pooled basis. The acquisition cost of Canadian listed shares and other eligible assets in RSIPs would be added to the single pooled cost base of the RSIP. All dispositions of securities from the RSIP (including the withdrawal of securities by the taxpayer) would require the deemed or actual proceeds of disposition to be subtracted from the cost base of the RSIP. The net cost base would be adjusted by an inflation factor, and this adjusted cost base would be compared with the market value of the assets held at the end of every calendar year to determine the net gain or loss in the RSIP. A purchase of an asset in the RSIP would accordingly constitute an addition to the cost base, which would be adjusted for inflation from that point on. A sale of an asset in the RSIP would decrease the cost base by the proceeds received with the effect that the inflation adjustment for that asset would be reduced from that point on. If the balance in the RSIP became negative for any period of time, no indexing adjustment would be provided.

A.13.0 Examples of RSIP Calculation

(A) An investor owns a portfolio of shares in RSIP, which has a market value of $1,000 at the beginning of the year. This is the RSIP cost base. The investor makes no changes in the composition of this portfolio, and at the end of the year the market value of the shares has risen to $1,200, resulting in a nominal capital gain of $200 (20%). The inflation rate during the year, as measured by the CPI, is 10%. The cost base at the beginning of the year ($1,000) is adjusted upward by the inflation factor (10%), and this adjusted cost base ($1,100) is subtracted from the year-end market value ($1,200) in order to obtain the accrued real capital gain ($100). One half of this accrued real capital gain is included in taxable income. Taxation of the real capital gain takes place on a partial deferral basis over several years, or, if the investor has so elected in advance, occurs in full in that year (see section 2.3.2 of the Report or section 10.0 of this appendix).

(B) A purchase of an asset in the RSIP during the year would result in an immediate addition to the cost base. For example, assume that the above investor buys shares valued at $200 on June 1. Two calculations then take place to arrive at a new adjusted cost base. First, the original cost base of $1,000 is adjusted upward by the calculated rate of inflation between January 1 and June 1. If this has been 5%, then this would result in a $1,050 cost base on June 1, before the stock purchase. Secondly, the share purchase price of $200 is added to the $1,050 amount to obtain a new adjusted cost base of $1,250. If no other transactions take place in the RSIP portfolio for the remainder of the year, then the accrued real capital gain for the year is calculated by taking the year-end market value of the shares in the portfolio and subtracting from this the June 1 cost base adjusted by the rate of inflation from June 1 to the end of the year. Given a year-end market value for the portfolio of $1,400 and an inflation rate of 5% from June 1 to December 31, this results in an accrued real capital gain of $1,400 - ($1,250 x 1.05) or $87.50. One half of this amount is included in taxable income, either immediately or on a deferral basis depending on the election of the taxpayer.

For the purpose of RSIP index adjustments, it is likely that one single factor representing the increase in the CPI for the year would be used, prorated for shorter periods.

(C) If, in the above example, the June 1 purchase of securities were to be followed later in the year by a share sale, an immediate reduction in the cost base of the RSIP would take place. For example, assume that on September 20 the investor sells securities at a price of $400. The cost base as of June 1 was $1,250. Again two calculations take place to obtain a new adjusted cost base. First, the June 1 cost base is adjusted upward by the June 1 to September 20 rate of inflation. If this has been 3%, then the resulting September 20 cost base before the share sale would be $1,287.50. Secondly, the share sale price of $400 is subtracted from the $1,287.50 amount to obtain a new adjusted cost base of $887.50. Assuming the investor performs no other transactions during the year, then the accrued real capital gain for the year is obtained by adjusting the September 20 cost base by the September 20 to December 31 inflation rate, and subtracting this from the year-end market value of the RSIP portfolio. If this value is $900 and the rate of inflation from September 20 to December 31 is 2%, then the accrued real capital gain is $900 - ($887.50 x 1.02) or -$5.25. In other words, the investor has suffered an accrued real capital loss of $5.25 in the RSIP for the year. One half of this $5.25 accrued real capital loss is deductible from all other income, either on a partial deferred basis, or if so elected in advance, in full in that taxation year.

(D) To take a new example, assume that a taxpayer has established an RSIP with the purchase of a security for $200 at the beginning of January, followed by a purchase of another security for $400 in May, with the first security then being disposed of for $300 in September. Also assume that the rate of inflation is 12% a year, or 1% a month. The following simplified illustration indi-

cates the manner in which the calculations of the adjusted cost base and RSIP gain would be made:

Illustration

		Cost Base		Inflation Adjustment (1% per month)
First Year				
Jan.	Purchase of Security A	$200		
Jan.	Index adjustment – 1% of cost base			2
Feb	" "			2
March	" "			2
April	" "			2
May	Purchase of Security B	400		
May	Index adjustment			2
June	" "	600		6
July	" "			6
Aug.	" "			6
Sept.	Sale of Security A – proceeds	(300)		
Sept.	Index Adjustment			6
Oct.	Index Adjustment	300		3
Nov.	" "			3
Dec.	" "			3
	Closing balance	$300		$43
	Closing market value of remaining securities		$383	
	Closing "cost"		343	
	Gain in RSIP for year		$ 40	
	Gain recognized by taxpayer – say 35% (taxable capital gain included in income is one half of this amount)		$ 14	
	Gain deferred		26	
			$ 40	
Second Year				
	Market value at end of year 1		$383	
	less deferred gain		26	
	Opening cost base for year 2		$357	

1. The above example shows indexing adjustments being made monthly. For the purpose of illustrating the calculations, actual index adjustments would be calculated annually, and might be based on a daily calculation basis.

2. The pooled basis of calculating cost base and indexed adjustments does not provide an absolutely precise result, when contrasted with indexing the cost base of individual assets. In virtually all cases, the difference between the indexing adjustments provided under the pooled system, and those calculated on the basis of the indexing of specific assets, is minimal.

3. The above example is provided only as an illustration of an approach to the calculations.

As can be seen, the calculation of the taxable accrued real capital gains or losses inRSIPs involves first of all computing the running net balances in the account throughout the year, updated for stock purchases and sales as they occur, and then applying an indexing factor to such balances based on the rate of inflation and the time periods involved. While these calculations would be tedious to perform for individual investors, particularly those who frequently buy and sell RSIP assets, they can be routinely done by the computerized bookkeeping systems of those institutions which would administer RSIP accounts for individual investors. Indeed, the automated performance of capital gain and loss calculations on a pooled basis would reduce the complexity and time taken to calculate gains and losses by investors when compared to the present tax system.

A.14.0 Additional Technical Issues

The Committee suggests that the Department of Finance give further consideration to other rules that would have to be adopted to deal with certain technical issues relating to the RSIP, along the following lines:

1) The RSIP investments would be deemed to be disposed of at market value in the year of the taxpayer's death, and no further deferral of gain would be permitted except in those "roll-over" situations now permitted under the Income Tax Act which would be broadened to include RSIP accounts.

2) The fair value of the RSIP assets would also be fully recognized upon relinquishing Canadian residence, but any capital loss so recognized on emigration would only be available to be applied against capital gains (and to the extent of $2,000 against other income, as under existing rules on the offset of capital losses).

3) The treatment of net credit balances in the pool of assets in an RSIP should be clarified. The question arises as to whether such a balance should be immediately taken into income or continue to

A.15.0 Final Notes

While the Committee has taken every opportunity, within the limits of the resources and time available to it, to review the many valuable submissions made to it, to undertake its own research, and to consider the many issues involved, the Committee recognizes that it cannot possibly deal with all aspects that should be considered in the design and implementation of an effective RSIP.

Accordingly, the Committee recommends that if the government proceeds with the adoption of the RSIP tax reform for capital gains as proposed in this Report, it should prepare draft legislation and regulations necessary to implement the RSIP and expose these for public comment before they are enacted in final form.

APPENDIX II

SUBMISSIONS RECEIVED BY THE COMMITTEE

The Committee sought and received advice from a number of sources. The members of the Committee, individually and as a group, received many useful comments and suggestions by means of meetings, letters and written submissions. The Committee thanks all those who took the time to provide their views. The Committee wishes to acknowledge the formal briefs which were contributed by the following groups:

Association Provinciale des Constructeurs d'Habitations du Québec Inc.

Atlantic Fisheries Task Force

Business Committee on Pension Policy

Business Council on National Issues

Campbell River Chamber of Commerce

Canada Mortgage and Housing Corporation

Canadian Advanced Technology Association

Canadian Certified General Accountants' Association

Canadian Chamber of Commerce

Canadian Federation of Agriculture

Canadian Federation of Independent Business

Canadian Institute of Chartered Accountants

Canadian Institute of Public Real Estate Companies

Canadian Life and Health Insurance Association Inc.

Canadian Manufactured Housing Institute

Canadian Organization of Small Business

Certified General Accountants' Association

Civil Service Co-Operative Credit Society

Comité économique de l'Association canadienne française

Economic Council of Canada

Employers' Council of British Columbia

Farm Credit Corporation

Housing & Urban Development Association of Canada

Independent Petroleum Association of Canada

Institute of Chartered Accountants of Alberta

Investment Dealers' Association of Canada

Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants

La Société Nationale de Fiducie

National Union of Provincial Government Employees

Newfoundland Fishermen, Food and Allied Workers Union

Ontario Economic Council

Ontario Federation of Agriculture

Ontario Real Estate Association

Ottawa-Carleton Board of Trade

Profit Sharing Council of Canada

Prospectors & Developers Association

Society of Management Accountants of Canada

The Canadian Bankers' Association

The Canadian Co-Operative Credit Society

The Canadian Manufacturers' Association

The Canadian Real Estate Association

The Conference Board of Canada

The Investment Funds Institute of Canada

The Mortgage Insurance Company of Canada

The Natural Sciences and Engineering Research Council

The Society of Management Accountants of Canada

The Trust Companies Association of Canada

Toronto Stock Exchange

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