Distress Preferred Shares and Small Business Development Bonds: A Tax Expenditure Analysis

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PRÉCIS

Selon la notion des dépenses fiscales, toutes les règles comprises dans un régime fiscal sont divisées en deux catégories : les règles fiscales techniques et les dépenses fiscales. Les unités, la période, l'assiette et les taux de l'impôt sont définis dans les règles fiscales techniques. L'ensemble de ces règles forme le régime fiscal normatif. Les dépenses fiscales sont des déviations à la norme : de fait, il s'agit de programmes de dépenses ou de subventions accessibles par le biais du régime fiscal. Puisque les dispositions sur les dépenses fiscales sont des programmes de dépenses, leur efficacité doit être évaluée en termes de critères budgétaires, comme le raisonnement à l'appui d'un programme donné, l'efficacité du ciblage, les frais administratifs et les difficultés de mise en place. Les critères traditionnels de la politique fiscale de l'équité, de la neutralité et de l'efficacité administrative ne sont pas pertinents.

Dans le passé, les gouvernements de plusieurs pays de l'OCDE, y compris le Canada, ont déposé des budgets ou des comptes spéciaux dans lesquels ils tentent d'identifier et d'estimer le coût des dépenses fiscales afférentes à leur régime fiscal. Cependant, ces comptes comprennent rarement une évaluation de l'efficacité des provisions particulières à titre de dépenses fiscales. Dans cet article, les dépenses fiscales sont analysées afin d'évaluer l'efficacité de la législation sur les actions privilégiées d'une société en difficulté financière et les obligations pour le développement de la petite entreprise de la Loi de l'impôt sur le revenu.

Depuis 1978, la Loi de l'impôt sur le revenu a contenu diverses règles sur les actions privilégiées. Ces règles, qui font partie du régime normatif de l'impôt sur le revenu des sociétés au Canada, ont toujours comporté une exception sur les actions privilégiées émises par des sociétés éprouvant des difficultés financières. Ces actions, nommées «actions privilégiées émises d'une société en difficulté financière», permettent aux sociétés en difficulté financière d'obtenir un coût du capital après les impôts moins élevé. Le même avantage a été étendu à certaines obligations, nommées «obligations pour le développement de la petite entreprise», émises par les petites entreprises en difficulté financière.

L'auteur soutient que la législation portant sur les actions privilégiées émises dans une situation de difficulté financière et les obligations pour le

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développement de la petite entreprise est correctement caractérisée comme une dépense fiscale. Selon l'analyse des dépenses fiscales, la législation comporte des raisonnements imparfaits, elle est mal ciblée et elle est difficile à mettre en oeuvre. De plus, le montant des dépenses n'est pas limité en vertu de la législation. Ce manque de contrôle est en partie attribuable au manque de responsabilisation politique en général quant aux dépenses sous formes de dépenses fiscales.

Le moyen le plus efficace de corriger chacune de ces imperfections serait d'abroger la législation et de la remplacer par un programme direct de dépenses. Ce programme permettrait l'octroi de subventions, de remboursements de paiements d'intérêts ou de garanties d'emprunts aux entreprises en difficulté financière qui seraient admissibles à une aide en vertu de critères plus rigoureux élaborés pour traduire un raisonnement approprié pour l'aide.

ABSTRACT

Under the tax expenditure concept, all rules in a tax system are divided into two types: technical tax rules and tax expenditures. Technical tax rules define the tax unit, period, base, and rates. Together, these rules form the normative tax system. Tax expenditures are deviations from the norm: in effect, they are spending or subsidy programs delivered through the tax system. Because tax expenditure provisions are spending programs, their effectiveness should be assessed in terms of budgetary criteria such as the rationale for a particular program, target-effectiveness, administrative cost, and implementation difficulties. The traditional tax policy criteria of equity, neutrality, and administrative efficiency are irrelevant.

In the past, the governments in several OECD countries, including Canada, have released special budgets or accounts that attempt to identify and estimate the cost of tax expenditures in their tax systems. However, these accounts rarely include an assessment of the effectiveness of particular provisions as tax expenditures. In this article, tax expenditure analysis is used to assess the effectiveness of the distress preferred share and small business development bond legislation in the Income Tax Act.

Since 1978, the Income Tax Act has contained various preferred share rules. These rules, which are part of the normative corporate tax system in Canada, have always excepted preferred shares issued by corporations in financial difficulty. These shares, referred to as "distress preferred shares," enable financially troubled corporations to obtain a lower after-tax cost of capital. The same benefit has been extended to certain bonds, referred to as "small business development bonds," issued by small business corporations in financial difficulty.

The author argues that the legislation that provides for distress preferred shares and small business development bonds is properly characterized as a tax expenditure. The application of tax expenditure analysis indicates that the legislation is fundamentally flawed in its rationale, poorly targeted, and suffers from certain implementation difficulties. Moreover, there is no limitation on the amount of spending under the legislation. This lack of control may be attributable, in part, to the lack of political accountability generally for spending in the form of tax expenditures.

Each of these flaws could be corrected most effectively by repealing the legislation and replacing it with a direct spending program. Such a program would provide grants, interest payment reimbursements, or loan guarantees to financially troubled businesses that qualify for assistance under a more rigorous set of criteria designed to reflect an appropriate rationale for the assistance.

INTRODUCTION

Over the last 15 years, the government has amended the Income Tax Act[1] on several occasions to add rules intended to foreclose the benefits of after-tax financing through the issue of preferred shares. In each instance, an exception has been made for corporations in financial difficulty. These corporations may continue to use preferred shares (referred to as "distress preferred shares") to lower their after-tax cost of financing. In addition, small business corporations in financial difficulty are permitted to issue bonds (referred to as "small business development bonds" [SBDBs]) to realize the same saving. There is a considerable literature regarding the technical requirements for a successful issue of distress preferred shares and SBDBs.[2] Nothing, however, has been written on the policy underlying the provision of the benefits of after-tax financing for corporations in financial difficulty.

This article examines the distress preferred share and SBDB legislation from a policy perspective using tax expenditure analysis. Arguably, the legislation is fundamentally flawed in its rationale and should be repealed for that reason alone. Moreover, a theoretically defensible program of

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[1] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[2] See, for example, Jack Bernstein, "Tax Planning for the Financially Troubled Business," in *Report of Proceedings of the Forty-Third Tax Conference,* 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 27:1-30, at 27:12-17; John A. Brussa, "Strategies for Troubled Times," in *Report of Proceedings of the Forty-Second Tax Conference,* 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 17:1-31, at 17:18-25; Gordon W. Flynn, "Restructuring Financially Troubled Corporations," in *Report of Proceedings of the Forty-First Tax Conference,* 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 19:1-45, at 19:24-45; Joel Shafer, "Tax Implications of Restructuring and Refinancing," in *Income Tax and Goods and Services Tax Considerations in Corporate Financing,* 1992 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1993), 4:1-25, at 4:7-18; Amy L. Shaffron, "Tax Issues in Hard Times: Part V," in *Canadian Tax Reports,* no. 996 (Don Mills, Ont.: CCH Canadian, April 11, 1991), 2-6; Wallace Shaw, "After-Tax Financing for Corporations in 'Financial Difficulties'" (Spring 1989), 2 *Canadian Petroleum Tax Journal* 123-34; and Lawrence Teltscher, "Small Business Financing," in the 1992 Corporate Management Tax Conference, supra, 6:1-67, at 6:17-22. For a statement of Revenue Canada's views and administrative practices, see C. Brian Darling, "Revenue Canada Perspectives," in the 1992 Corporate Management Tax Conference, supra, 5:1-42, at 5:1-10 and 5:18-20; *Interpretation Bulletin* IT-507R, January 31, 1994; *Interpretation Bulletin* IT-52R4, October 20, 1983; "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Third Tax Conference*, 1981 Conference Report (Toronto: Canadian Tax Foundation, 1982), 726-66, question 8, at 732-33; and *Income Tax Ruling* ATR-46, February 21, 1992.

government assistance for financially troubled businesses should take the form of a more effectively targeted spending program delivered outside the tax system. Such a program would minimize implementation problems, as well as improve government accountability and control of the amount of the assistance. In this respect, the distress preferred share and SBDB legislation is just one specific example of the general case against the use of tax expenditures.

In the first part of the article, the tax expenditure concept and its development as a budgetary tool are explained briefly. The next three parts examine the characterization of the distress preferred share and SBDB legislation as a tax expenditure. The examination involves a discussion of the normative corporate tax system in Canada, including the preferred share rules; it is concluded that extending after-tax financing to corporations in financial difficulty is an exception to the norm and a tax expenditure. The final part of the article assesses the distress preferred share and SBDB legislation as spending programs.

Many governments, including the Canadian government, have used the tax expenditure concept for informational purposes, usually in the form of a list of purported tax expenditures presented in tax expenditure accounts or budgets. This use of the concept is unnecessarily limited. Once identified as a tax expenditure, a particular provision should be assessed as if it were a spending program. Such an assessment involves the application of conventional budgetary criteria to what is, in fact, a spending program delivered through the tax system. This article attempts to illustrate the broader use of the tax expenditure concept by applying it to the distress preferred share and SBDB legislation. The approach is patterned on an excellent application of tax expenditure analysis to the "small business deduction"[3] by another author in an earlier article.[4] Because examples of the application of tax expenditure analysis to particular provisions of the Act are still relatively rare, it seems worthwhile to bring the analysis to bear on a significant tax expenditure, such as the distress preferred share and SBDB legislation. These kinds of specific examples illustrate, in a concrete way, the usefulness of tax expenditure analysis.

TAX EXPENDITURE CONCEPT IN THEORY AND PRACTICE

The tax expenditure concept is deceptively simple in principle. It divides all rules in a tax system into two categories: technical tax rules and tax expenditure provisions. The first set of rules defines the tax base, unit, period, and rate structure, which are elements of any tax system. The specific rules in each of these areas form the technical structure of the system designed to raise revenue. Tax expenditure provisions are not part of the technical tax structure; they are exceptions to that structure designed to

[3] Section 125.

[4] Neil Brooks, "Taxation of Closely-Held Corporations: The Partnership Option and the Lower Rate of Tax" (1986), vol. 3, no. 4 *Australian Tax Forum* 381-509, at 475-508.

realize certain economic or social policies independent of equity, efficiency, and administrative concerns.

In designing technical tax rules, policy makers must answer a number of difficult questions. With an income tax, for example, policy makers must decide what amounts should be included in calculating income. What expenses should be deductible? Should the individual or the family be chosen as the tax unit? What is the appropriate treatment of entities such as corporations, partnerships, and trusts? What period is appropriate for the calculation of income? Once a period is chosen, how are revenue and expense items to be allocated among the different periods? Should some provision be made for the deduction in one taxation period of losses incurred in another? Should the rate structure be flat or progressive? If progressive, how progressive should the rate structure be? The possible answers to these kinds of questions are usually evaluated using four general policy criteria: horizontal equity, vertical equity, economic efficiency, and administrative simplicity. The evaluation provides some sense of the effectiveness of a particular technical rule in fulfilling its revenue-raising function.

Tax expenditures are deviations from the technical tax structure intentionally adopted by policy makers. They can take various forms, such as an exclusion or exemption from income, a deduction in calculating income or taxable income, a tax credit, or a deferral of tax.[5] The expenditures may be provided to encourage a particular activity, enhance regional development, or provide relief from personal circumstances such as physical disability. Whatever their form or rationale, tax expenditures are the equivalent of direct subsidy programs; they differ from such programs primarily in their administration and delivery through the tax system. In effect, under a tax expenditure provision, the government agrees to write a cheque to an eligible taxpayer equal to the tax that would have been collected under a normative tax system. Because it is equivalent to a subsidy program, a tax expenditure should be evaluated in terms of budgetary criteria such as target efficiency, government control, and administrative cost. The technical tax policy criteria of equity, economic efficiency, and administrative simplicity are irrelevant.

Politicians and tax professionals have recognized for some time that governments spend through the tax system. However, the tax expenditure concept was not developed in detail until the 1960s and early 1970s by the late Stanley Surrey, a professor at Harvard Law School and assistant secretary of the US Treasury department. Surrey popularized the tax expenditure concept, coined the phrase, and wrote two definitive works on the subject.[6] According to Surrey, much of the debate about specific tax provisions

[5] The various forms that tax expenditures may take and their various purposes are set out in the Canadian government's tax expenditure accounts (see footnotes 17 through 22 infra).

[6] Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* (Cambridge, Mass.: Harvard University Press, 1985); and Stanley S. Surrey, *Pathways to Tax Reform: The Concept of*

(The footnote is continued on the next page.)

and their reform is really an issue of spending reform and the delivery of expenditure programs through the tax system. The tax expenditure concept allows the debate to be joined in terms of budgetary criteria relevant to spending reform. Proper application of these criteria may lead to the amendment of a tax expenditure provision to enhance its effectiveness. Alternatively, a tax expenditure may be repealed where budgetary criteria reveal that the underlying rationale for the provision is flawed or a non-tax subsidy would be more appropriate.

One of the more difficult and controversial aspects of the tax expenditure concept is the identification of the elements of a normative tax system and the deviations from that norm which may be characterized as tax expenditures. In the United States, academics and policy makers have debated this issue vigorously. The Haig-Simons concept of income,[7] defined as the sum of present and future consumption (represented by increases in net wealth), is most often cited as a theoretical benchmark. Some commentators have argued, however, that Haig-Simons income is too theoretical and difficult to translate into a workable norm.[8] Moreover, the Haig-Simons theory of income says nothing about certain normative issues, such as the appropriate tax unit.[9] The definition of a normative income tax is thus too problematic and renders the tax expenditure concept ineffective. This general point has been illustrated through an analysis of certain provisions, such as the deduction for charitable donations.[10]

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[6] Continued . . .
Tax Expenditures (Cambridge, Mass.: Harvard University Press, 1973). For an excellent review of Surrey and McDaniel's book and a general discussion of tax expenditure analysis, see Neil Brooks's comments in the Current Tax Reading feature (1986), vol. 34, no. 3 *Canadian Tax Journal* 681-98, at 681-94.

[7] Henry C. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), at 50, where personal income is defined as "the algebraic sum of (1) the market value of rights expressed in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." Simons's definition is a refinement of the earlier economic definition found in R. Murray Haig, "The Concept of Income: Economic and Legal Aspects," in R. Murray Haig, ed., *The Federal Income Tax* (New York: Columbia University Press, 1921). Haig defined income as the money value of the net accretion to one's economic power between two points in time.

[8] See, for example, the early criticisms of Boris I. Bittker in "Accounting for Federal 'Tax Subsidies' in the National Budget" (June 1969), 22 *National Tax Journal* 244-61 and "The Tax Expenditure Budget: A Reply to Professors Surrey and Hellmuth" (December 1969), 22 *National Tax Journal* 538-42.

[9] Victor Thuronyi, "Tax Expenditures: A Reassessment" [1988], no. 6 *Duke Law Journal* 1155-1206, at 1165.

[10] William D. Andrews, "Personal Deductions in an Ideal Income Tax" (December 1972), 86 *Harvard Law Review* 309-43. There has even been a recent debate regarding the characterization of the tax treatment of qualified retirement savings plans, which conventional wisdom regards as a tax expenditure. See Edward A. Zelinsky, "The Tax Treatment of Qualified Plans: A Classic Defence of the Status Quo" (January 1988), 66 *North Carolina Law Review* 315-65. See also Norman P. Stein, "Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky" (Fall 1991), 9 *American Journal of Tax Policy* 225-56; and Edward A. Zelinsky, "Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein" (Fall 1991), 9 *American Journal of Tax Policy* 257-82.

In response, some proponents of the tax expenditure concept have rejected the Haig-Simons definition of income in favour of a normative tax structure expressed in terms of what is "widely accepted by tax analysts."[11] Others have recognized that this alternative standard is excessively vague and subjective. They argue that the tax system need not be unambiguously divided into technical and tax expenditure provisions.[12] Instead, if a particular provision may be justified as a spending provision, it should be analyzed as a tax expenditure. In other words, if a tax provision functions as a spending program, it should be analyzed as a spending program. This "functional" approach to the characterization issue attempts to avoid an endless debate over the normative tax system and permit the tax expenditure concept to be applied more readily as a useful analytical device.

Despite the controversy over the attributes of a normative income tax and the proper approach to the identification of tax expenditures, the US government has formally adopted the tax expenditure concept as a budgetary tool.[13] The governments in many other OECD (Organisation for Economic Co-operation and Development) countries also regularly publish tax expenditure accounts or budgets. In Canada, there has been some work on tax expenditures generally[14] and some analysis of particular provisions.[15] Unlike the situation in the United States, the tax expenditure concept has not been formally integrated in the budgetary process. The Department of Finance has instead produced accounts of tax expenditures

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[11] See, for example, Surrey and McDaniel, supra footnote 6, at 186-88. This more pragmatic approach to the definition of a normative tax system has been adopted, to some extent, by the Department of Finance in its various tax expenditure accounts. See footnotes 17 through 22 and accompanying text infra.

[12] See Paul R. McDaniel and Stanley S. Surrey, eds., *International Aspects of Tax Expenditures: A Comparative Study* (Deventer, the Netherlands: Kluwer, 1985), 10-11; Michael J. McIntyre, "A Solution to the Problem of Defining a Tax Expenditure" (Fall 1980), 14 *University of California Davis Law Review* 79-103; and Thuronyi, supra footnote 9.

[13] See Surrey and McDaniel, supra footnote 6, at 31-68, for a thorough review of the tax expenditure concept and the US budget process.

[14] See, for example, Neil Bruce, ed., *Tax Expenditures and Government Policy* (Kingston, Ont.: Queen's University, John Deutsch Institute for the Study of Economic Policy, 1988); Kevin McLoughlin and Stuart B. Proudfoot, "Giving by Not Taking: A Primer on Tax Expenditures" (Spring 1981), 7 *Canadian Public Policy* 328-37; Roger S. Smith, *Tax Expenditures: An Examination of Tax Incentives and Tax Preferences in the Canadian Federal Income Tax System*, Canadian Tax Paper no. 61 (Toronto: Canadian Tax Foundation, 1979); and the Tax Expenditure Analysis feature in (Summer 1979), 1 *Canadian Taxation* 3-28.

[15] See, for example, André Blais and François Vaillancourt, "The Federal Corporate Income Tax: Tax Expenditures and Tax Discrimination in the Canadian Manufacturing Industry, 1972-1981" (1986), vol. 34, no. 5 *Canadian Tax Journal* 1122-39; Brooks, supra footnote 4; Kathleen A. Lahey, "The Small Business Credit: A Tax Expenditure Analysis" (Summer 1979), 1 *Canadian Taxation* 29-34; Kenneth N. Matziorinis, "Tax Expenditures for Capital Investment" (Fall 1980), 2 *Canadian Taxation* 172-79; Michele Meakes, "The Tax Credit for Political Contributions: Financing the Government Big Business Deserves" (Summer 1979), 1 *Canadian Taxation* 51-57; Donald Savoie, "Cash Incentives Versus Tax Incentives" (Spring 1985), 8 *Canadian Journal of Regional Science* 1-15; and Edward Tamagno, "The Medical Expense Deduction" (Summer 1979), 1 *Canadian Taxation* 58-62.

on an irregular basis.[16] These accounts have been released on six separate occasions: 1979,[17] 1980,[18] 1981,[19] 1985,[20] 1992,[21] and 1993.[22]

The 1979, 1980, 1985, and 1993 accounts cover the personal and corporate income taxes as well as the commodity tax system. The 1981 and 1992 accounts are limited to the personal income tax. Despite the differences, all of the accounts follow the same general format. Each includes some discussion of the general criteria used in identifying tax expenditures. For that purpose, the benchmark tax system is defined as "one that provides no preferential treatment to taxpayers on the basis of demographic characteristics, sources or uses of income, geographic location, or any other special circumstances applicable only to a given taxpayer or to a particular group of taxpayers."[23] This benchmark or norm is modified in a number of ways. First, there are no dramatic departures from the public perception of what the normative income tax should be. For example, imputed income from spousal services or owner-occupied homes is not included in the benchmark system. Second, where the characterization of a tax provision is uncertain, it is considered a deviation from the benchmark and a tax expenditure. Third, even though available to all taxpayers, a particular provision is characterized as a tax expenditure if it is functionally equivalent to a direct subsidy. For example, an abatement for provincial income taxes is considered a tax expenditure since it functions as a direct grant to the provinces. Fourth, certain provisions, such as partial indexing of the tax rate brackets, are characterized as tax expenditures when provided selectively, even though they would be considered part of the benchmark system if provided generally.

Each report also includes a discussion of certain significant issues, such as the relation between the corporate and individual income taxes, inflation adjustments, tax rates, federal-provincial fiscal arrangements, the accounting period, and the treatment of losses. Appendixes provide itemized lists of tax expenditures along with revenue estimates for particular

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[16] Some provincial governments have also produced tax expenditure accounts, but again, on an irregular basis. For a recent discussion of the use of tax expenditures by provincial governments, see *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission* (Toronto: University of Toronto Press, 1993), 218-25.

[17] Canada, Department of Finance, *Government of Canada Tax Expenditure Account* (Ottawa: Supply and Services, December 1979).

[18] Canada, Department of Finance, *Government of Canada Tax Expenditure Account* (Ottawa: Supply and Services, December 1980).

[19] Canada, Department of Finance, *Analysis of Federal Tax Expenditures for Individuals* (Ottawa: Supply and Services, November 1981).

[20] Canada, Department of Finance, *Account of the Cost of Selective Tax Measures* (Ottawa: Supply and Services, August 1985).

[21] Canada, Department of Finance, *Government of Canada Personal Income Tax Expenditures* (Ottawa: Supply and Services, December 1992).

[22] Canada, Department of Finance, *Government of Canada Personal and Corporate Income Tax Expenditures* (Ottawa: Supply and Services, December 1993).

[23] *Government of Canada Tax Expenditure Account* (1979), supra footnote 17, at 4.

taxation years. Total revenue estimates are not provided, since estimates for a number of items are unavailable. The lists are divided into general subject categories to provide a sense of government spending in the various areas. Provisions that may legitimately be characterized either as part of the normative tax structure or as tax expenditures are included in the accounts but listed separately as "memorandum items."

In addition to the government's tax expenditure accounts, the auditor general of Canada spent considerable time in his 1985 report[24] discussing the tax expenditure concept and the risks associated with the delivery of spending programs through the tax system. The auditor general was particularly critical of the failure of the Department of Finance to implement formal procedures to monitor tax expenditures and the failure to provide adequate information to Parliament regarding such expenditures.[25] The same lack of information and failure to coordinate tax expenditure programs with direct spending programs was emphasized by the Ministerial Task Force on Program Review in its report released in 1986.[26] The task force estimated that of total government spending of $93 billion, 39 percent, or $36 billion, was in the form of tax expenditures. Other statutory expenditures made up 40 percent or $37 billion; non-statutory expenditures made up the 21 percent balance or $20 billion.

The reports of the auditor general and the Ministerial Task Force highlight the absence of a systematic budgetary approach to the assessment of tax expenditures in Canada. Within this general context, it is not surprising that there has been little analysis of the distress preferred share and SBDB legislation as a tax expenditure.

DEFINING A NORMATIVE CORPORATE TAX SYSTEM: THE CANADIAN CORPORATE INCOME TAX

For practical purposes, the definition of a normative tax system remains crucial to the tax expenditure concept and a source of some disagreement, particularly regarding the personal income tax. The corporate income tax presents different, but equally difficult, definitional problems. In determining the appropriate tax unit under an income tax, policy makers must decide whether a corporation should be treated as a taxable unit separate from its shareholders. This issue may be resolved by selecting one of three general approaches: treat the corporation as a conduit, use a classical corporate tax, or implement an imputation system.

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[24] Canada, *Report of the Auditor General of Canada to the House of Commons* (Ottawa: Supply and Services, 1985), paragraphs 4.1-4.149.

[25] In response to the auditor general's report, the Department of Finance established a special unit to evaluate and account for tax expenditures on a regular basis (see the Department of Finance's published response in *Report of the Auditor General of Canada*, supra footnote 24). That group has now been disbanded; the 1992 and 1993 accounts are the only evidence of its work released publicly.

[26] Canada, Task Force on Program Review, *An Introduction to the Process of Program Review* (Ottawa: Supply and Services, March 1986), 20-23.

As the name implies, the conduit approach treats a corporation as an administratively convenient device to calculate income or loss that is flowed through to the shareholders. The corporation is not treated as a taxable unit separate from its shareholders; instead it serves as a conduit through which income or loss is attributed to shareholders for recognition by them.

In contrast to the conduit approach, the classical corporate tax treats a corporation as a taxpayer separate from its shareholders. This treatment is based on the assumption that a corporation has taxable capacity independent of its shareholders. Income or loss is calculated at the corporate level, with the relevant tax rates and procedural rules applied to the corporation. On distribution of after-tax profits as a dividend, the shareholders are taxed again without any credit for corporate tax paid on those profits. This approach is referred to as a classical corporate tax because it was the original system adopted by many Western countries; it is unintegrated in the sense that the corporate and shareholder level taxes on distributed profits are independent of one another.

An imputation system lies somewhere between the conduit approach and the use of a classical corporate tax. Initially the corporation is treated as a separate taxable entity; income or loss is calculated at the corporate level and the relevant rates or procedural rules are applied to the corporation. On payment of a dividend, a shareholder is also subject to tax but is entitled to a tax credit equal to the corporate tax paid in respect of the underlying profit from which the dividend is paid. Because of this credit, the corporate tax is ultimately treated as a withholding tax in respect of profits earned for the benefit of shareholders; the corporate tax is imputed to the shareholders and effectively considered to have been paid by them.

Each of these three approaches is justifiable as a matter of tax policy; each approach also presents certain problems. The case for the conduit approach begins with the principle that only individuals have the capacity to consume either in the present or in the future by drawing on net wealth. A fictional legal entity such as a corporation does not have the capacity to consume. Moreover, because a corporation is a fictional legal entity, it cannot bear the burden of an income tax. Any such tax levied nominally on a corporation will ultimately be borne by individuals in their capacity as shareholders, employees, suppliers, or consumers, depending on the extent of the shifting of the tax burden. Because shifting and the incidence of a corporate tax are uncertain, the equity effects of the tax are uncertain. For this reason alone, corporate income is not a desirable tax base. In addition, where unincorporated entities are not subject to a separate income tax, a corporate income tax may create non-neutralities and, hence, inefficiencies regarding the decision to carry on business in corporate form. Similar non-neutralities and inefficiencies may be created regarding the decision to retain corporate earnings or pay those earnings out as dividends subject to tax at the shareholder level. The conduit approach avoids these problems because it ignores the corporation as a taxable entity.

Despite the theoretical appeal of the conduit approach, a number of practical considerations can be cited in support of a classical corporate tax. For example, a corporate income tax is relatively easy to administer, since the number of taxpayers is modest. Where the tax has been in place for some time, any inequities that may be created between corporate and non-corporate investment are eliminated through the capitalization of the corporate tax in share prices. The tax on corporations is also politically attractive as a proxy for a direct tax on high-income shareholders. And, perhaps most important, the conduit approach presents certain administrative problems. In particular, the attribution of income or loss between shareholders is problematic where the shares trade frequently on a stock exchange or there are a number of outstanding shares with various dividend and liquidation entitlements.[27]

An imputation system attempts to approximate the theoretical result on which the conduit approach is based while addressing the administrative problems presented by that approach. An imputation system thus appears to be an administratively workable norm for the design of a corporate income tax. Even an imputation system is flawed, however, in its fundamental assumption that the burden of a corporate tax is borne fully by shareholders. Although the extent of the shifting of a corporate tax is uncertain, it seems that at least some portion of the tax is shifted forward in an increased price for corporate goods and services or shifted backward in a reduced cost of labour or other supplies. Consequently, an imputation system may provide shareholders with a withholding tax credit that more properly belongs to consumers, labour, and corporate suppliers.

The lack of an obvious norm for the treatment of a corporation under an income tax led Surrey and McDaniel to conclude that the norm is simply the approach that tax policy makers have chosen in any particular case.[28] This conclusion may have been coloured somewhat by the continued use of a classical corporate tax in the United States.[29] Many OECD countries have now adopted some form of an imputation system,[30] which may indi-

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[27] Some countries have addressed these problems by limiting conduit treatment to closely held corporations with a limited number of classes of shares. For widely held corporations, the shares of which trade publicly, a reasonable alternative for conduit treatment is the recognition of gain or loss on shares on an annual accrual basis. In effect, the accrued gain or loss provides a reasonable proxy for the underlying income or loss realized by the corporation. Valuation difficulties are eliminated because the shares trade publicly. However, imposing an accrual-based capital gains tax only for certain shares creates non-neutralities as between those assets and other assets, the gain on which may be deferred until a disposition. Although theoretically justified, an accrual-based capital gains tax for all assets presents serious political difficulties that make it an unrealistic policy choice.

[28] Surrey and McDaniel, supra footnote 6, at 215.

[29] For a number of years, US policy makers and academics have debated the adoption of some form of integrated corporate tax. For the latest proposal, see United States, Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington, DC: US Government Printing Office, January 1992); and United States, Department of the Treasury, *A Recommendation for Integration of the Individual and Corporate Tax Systems* (Washington, DC: US Government Printing Office, December 1992).

[30] See, for example, Organisation for Economic Co-operation and Development, *Taxing Profits in a Global Economy: Domestic and International Issues* (Paris: OECD, 1991).

cate a growing consensus that such a system is the appropriate benchmark for a corporate income tax.

In Canada, it is unclear what approach policy makers have adopted. The Canadian corporate tax system is neither a classical nor an imputation system, but a curious combination of both. Under the Act, a corporation is treated as a separate taxable entity. Income and loss is computed at the corporate level, and a general flat rate is applied to the income. In calculating net income or loss, a corporation may not deduct dividend payments, and shareholders must include in income all dividends received.[31] However, in calculating taxable income, corporate shareholders may deduct the amount of any dividends from Canadian corporations.[32] This intercorporate dividend deduction ensures that dividends are paid tax-free between Canadian corporations. Income earned by a corporation and distributed as a dividend is thus taxed only once at the corporate level as earned, and again at the individual shareholder level. The deduction is available whether or not the corporate payer has actually paid tax equal to the nominal rate on its underlying profits.

For individuals resident in Canada, the burden of the shareholder-level tax is also reduced through a tax credit equal to one-quarter of the amount of all dividends received from taxable Canadian corporations.[33] This dividend tax credit compensates resident individuals for 20 percentage points of corporate tax on income out of which dividends are paid. To that extent, the Canadian corporate tax resembles an imputation system. However, where a corporation pays tax at an effective rate less than 20 percent, the dividend tax credit is still equal to one-quarter of the amount of dividends received. In effect, the dividend tax credit is calculated on the assumption that the corporation has paid sufficient tax to support the credit. If this assumption is incorrect, the individual shareholder receives credit for tax that has not been paid at the corporate level. Conversely, where a corporation pays tax at an effective rate in excess of 20 percent, individual shareholders do not receive credit for the excess. To this extent, the Canadian corporate tax resembles a classical corporate tax with no withholding credit for the excess.

The hybrid nature of the Canadian corporate tax presents difficulties for tax expenditure analysis as evidenced by the tax expenditure accounts issued by the Department of Finance. In the 1979, 1980, and 1981 accounts, the dividend tax credit was characterized as a tax expenditure, even though it was recognized that the credit reduces, in part, the double

[31] Paragraphs 12(1)(j), 82(1)(a), and 12(1)(k), and section 90.

[32] Subsections 112(1) and (2).

[33] Paragraph 82(1)(b) and section 121. The federal government provides two-thirds of the dividend tax credit. Because provincial personal tax is calculated as a percentage of federal tax payable after all tax credits, including the dividend tax credit, the provincial governments effectively provide the other one-third (at an assumed provincial rate of 50 percent).

taxation under a classical system.[34] This characterization was based on the premise that a fully integrated corporate tax is fundamentally different from the Canadian system and, therefore, does not provide a useful benchmark.[35] In particular, two primary differences were cited. First, the dividend tax credit is based on a notional or assumed amount of corporate tax, not the actual tax paid.[36] Second, there is no integration of undistributed corporate income, which is not taxed to a shareholder until paid as a dividend or realized as a capital gain on a disposition of shares.[37] These differences led to the conclusion that the Canadian system is predominantly a classical corporate tax and, therefore, such a tax is the appropriate benchmark system. When assessed against this benchmark, "the whole of the dividend gross-up and tax credit at the individual level is logically a tax expenditure."[38] The same approach is apparent in the 1977 budget papers where it was stated that the proposed enrichment of the dividend tax credit was not intended to provide greater relief from the double taxation of corporate income, but to attract increased investment in Canadian equity securities.[39]

In contrast, a completely different approach was adopted in the 1985, 1992, and 1993 accounts. It was conceded in those accounts that a fully integrated corporate tax in the form of a conduit system is too far removed from the Canadian system to provide a useful benchmark.[40] It was also stated, however, that a complete separation of the corporate and shareholder level taxes under a classical system produces anomalous results, such as the characterization as a tax expenditure of any measure that provides relief at the shareholder level for corporate tax paid.[41] Any such measures were assumed to be partial integration mechanisms and part of the benchmark system. Consequently, the dividend tax credit was charac-

[34] *Government of Canada Tax Expenditure Account* (1979), supra footnote 17, at 7-8 and 39. The 1980 account followed the tax expenditure characterization in the 1979 account without comment. See *Government of Canada Tax Expenditure Account* (1980), supra footnote 18, at 17. See also *Analysis of Federal Tax Expenditures for Individuals* (1981), supra footnote 19, at 22-24.

[35] *Government of Canada Tax Expenditure Account* (1979), supra footnote 17, at 8.

[36] Ibid.

[37] Ibid.

[38] Ibid.

[39] Canada, Department of Finance, Budget Papers, Budget Document, March 31, 1977, at 34-35. This tax expenditure characterization was also recently cited by the Department of Finance in its response to the auditor general's 1992 report which, among other things, criticized the provision of the dividend tax credit in respect of exempt foreign source income earned by Canadian corporations. See Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992). See also *Report of the Ontario Fair Tax Commission*, supra footnote 16, at 340-43.

[40] *Account of the Cost of Selective Tax Measures* (1985), supra footnote 20, at 15.

[41] Ibid. For example, the refundable dividend tax on hand account and the dividend refund mechanisms for the investment income of private corporations were characterized as tax expenditures in the 1979, 1980, and 1981 accounts.

terized as part of the normative corporate tax, although its value as a tax expenditure was included as a memorandum item in the three accounts.[42]

Arguably, the approach taken in the 1985, 1992, and 1993 accounts is preferable, since it recognizes that the Canadian corporate tax is, at least in part, an imputation system. Even so, none of the accounts addressed the fact that the dividend tax credit is provided on the basis of an assumed amount of corporate tax and the effect that this aspect of the credit may have on its characterization as a tax expenditure. Similarly, the government has never characterized the intercorporate dividend deduction as a tax expenditure, even though it is provided irrespective of the actual tax paid by the corporate payer.[43]

These characterization problems can now be limited to common share investments. For preferred share investments, the Act has contained since 1987 a comprehensive series of rules ("the preferred share rules") designed to ensure that the intercorporate dividend deduction and the dividend tax credit are available only to the extent that some corporate tax has actually been paid. The preferred share rules have a long history arising out of the different tax treatment accorded interest and dividends under the Act. Specifically, in contrast to the tax treatment of dividends, interest on corporate debt is generally deductible for a corporation and taxable to the debt holder. There is thus only one level of tax on corporate income distributed as interest. The different tax treatment of interest and dividends gave rise to the growth of after-tax financing in the 1970s and a series of legislative responses designed to address the revenue problem caused by this financing technique. The preferred share rules have become part of the normative corporate income tax in Canada, with explicit exceptions for preferred shares issued by corporations in financial difficulty, as well as an extension of dividend tax treatment to interest on bonds issued by small business corporations in similar circumstances. These exceptions and the special provision for small business corporations are properly considered tax expenditures and should be analyzed as such.

AFTER-TAX FINANCING AND THE PREFERRED SHARE RULES[44]

Preferred Shares, Income Bonds, and the Origin of After-Tax Financing

The Act does not contain a comprehensive definition of a debt obligation or a share, even though different tax consequences follow from the classi-

[42] Ibid., at 16 and 48; *Government of Canada Personal Income Tax Expenditures* (1992), supra footnote 21, at 5 and 14; and *Government of Canada Personal and Corporate Income Tax Expenditures* (1993), supra footnote 22, at 19 and 60.

[43] See, for example, *Government of Canada Personal and Corporate Income Tax Expenditures* (1993), ibid., at 7, where the intercorporate dividend deduction is characterized as part of the benchmark tax system on the basis that it eliminates multiple levels of corporate tax.

[44] See generally Tim Edgar, "The Classification of Corporate Securities for Income Tax Purposes" (1990), vol. 38, no. 5 *Canadian Tax Journal* 1141-88.

fication of a security as one or the other. Most important, a security must be classified as a debt obligation or a share for the purposes of the interest deduction, the intercorporate dividend deduction, and the dividend tax credit: only interest on a debt obligation is deductible; only dividends on a share are eligible for the intercorporate dividend deduction or dividend tax credit.

For income tax purposes, the form of a security as a matter of non-tax law is determinative. However, the classification of two types of securities for income tax purposes—preferred shares and income bonds—has been the subject of specific legislation. These securities contain some rights and obligations normally associated with debt and some rights and obligations normally associated with equity. Consequently, they are referred to as "hybrid securities."

Despite the hybrid nature of preferred shares and income bonds, dividends and interest on these securities are treated as dividends for income tax purposes. For preferred shares, this treatment follows from the decision of the Exchequer Court in *Dupuis Frères Ltd. v. MNR*.[45] In that case, the court held that the dividend payment on a preferred share should be treated as a dividend for tax purposes because the payment was not a liability that the issuing corporation must service, and was thus more in the nature of a dividend on a common share than interest on debt.

Dividend treatment for income bonds has been expressly provided under the Act since 1935. In the 1930s, a number of corporations issued income bonds in substitution for outstanding debt. The bonds maintained the debt holder's investment, yet gave an issuer in financial difficulty time to work out of its difficulties.[46] The government became concerned that the fixed return on an income bond would be treated as deductible interest for an issuer, even though the return was comparable to dividends on preferred shares.[47] To address this concern, the government amended the Income War Tax Act to prohibit the deduction by an issuer of interest on an income bond and deem the interest to be a dividend received by the holder.[48] An income bond or debenture was defined as any instrument "the interest or dividend on which is payable only when the debtor company has made a profit before taking into account the interest or dividend obligation on such bond or debenture."[49]

During the early to mid-1970s, a number of non-tax-paying corporations began to issue income bonds or preferred shares to financial

[45] (1927), 1 DTC 104; [1917-27] CTC 326.

[46] A brief account of the early history of the income bond may be found in William R. Lawlor, "Income Debentures and Term Preferred Shares" (1978), vol. 26, no. 2 *Canadian Tax Journal* 200-16, at 200-1.

[47] Canada, Senate, *Debates*, June 11, 1935, 354-55.

[48] SC 1935, c. 40, section 6 (adding paragraph 6(1)(k)) and section 11 (adding subsection 12(2)).

[49] Ibid., at section 3 (adding paragraph 2(o)).

institutions instead of debt. The substitution occurred as a means of lowering the after-tax cost of financing for issuers while increasing the after-tax return for lending institutions. Assume, for example, that a tax-paying corporation subject to a 40 percent tax rate issues debt on which it pays $100 of interest. The after-tax cost of this financing is only $60 because the issuer saves $40 in tax on its income through the interest deduction. A tax-paying financial institution that is also subject to a 40 percent tax rate realizes an after-tax return of $60 because interest on the debt must be included in income. If the issuer is non-tax-paying because, for instance, it has unused loss carryovers, excess tax credits, or income deductions, the after-tax cost of the debt financing is $100. The issuer cannot use the interest deduction currently and may not be able to use it as a loss carryforward within the relevant period. The after-tax return to the financial institution remains $60.

Instead of advancing the funds by way of a loan, the financial institution could subscribe for preferred shares or an income bond of the issuer. Dividends or interest on these securities are treated as dividends for income tax purposes and are not deductible for the issuer. The issuer is not concerned about the loss of the interest deduction, since it is in a non-tax-paying position. Dividend treatment is attractive to the financial institution because the intercorporate dividend deduction means that the dividends are received tax-free. If the parties use a preferred share paying a $70 dividend or an income bond paying the same amount of interest, the issuer incurs an after-tax cost of financing of $70, which is $30 less than the cost of debt. The financial institution also realizes a $70 after-tax return, which is $10 more than that realized on debt. The government loses $40 in tax that would have been payable if debt had been issued. In such a transaction, the preferred shares or income bonds are used as substitutes for debt because they receive dividend tax treatment while providing some of the rights, obligations, and risk characteristics normally associated with debt. This substitution is particularly attractive where the issuer is a non-tax-paying, financially strong corporation and there is some assurance of payment of dividends on preferred shares or of interest on an income bond.

In the mid- to late 1970s, after-tax financing increased at a rapid rate. The holdings of income bonds and floating-rate preferred shares by chartered banks alone increased from $765 million in October 1976 to $10,100 million on November 16, 1978.[50] These amounts represented 80 percent of all chartered bank holdings of Canadian corporate securities. Not surprising, the growth in after-tax financing caused a significant revenue loss. In the November 16, 1978 budget, the government estimated that the combined federal and provincial revenue loss would be $500 million in the 1978-79 fiscal year alone, assuming that after-tax financing continued to

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[50] See Canada, House of Commons, *Debates*, November 2, 1979, 899; and Canada, House of Commons, *Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs,* 30th Parliament, 4th session, 1978, issue no. 12, November 30, 1978, 7-9 and appendix FTEA-10.

grow at the same pace as in the previous year.[51] To address the revenue loss, the government introduced measures in the November 1978 budget that initiated a series of legislative responses culminating in the taxable preferred share rules introduced in the 1987 tax reform.

Legislative Responses to After-Tax Financing Using Preferred Shares[52]

The government's legislative responses to after-tax financing using preferred shares have taken two general forms: the series of provisions enacted from 1978 to 1987 and the introduction of the taxable preferred share rules in 1987. The first series of responses addressed the after-tax financing problem in a narrow manner. The legislation defined certain shares with specific debt features. For dividends on these shares, the intercorporate dividend deduction was denied. In contrast, the taxable preferred share regime is a much more comprehensive approach to after-tax financing; it applies to almost all preferred shares and, instead of denying the intercorporate dividend deduction, imposes a special distributions tax. This tax attempts to ensure that the intercorporate dividend deduction and the dividend tax credit are supported by corporate tax actually paid on the underlying profits. The government's initial response consisted of four different pieces of legislation: the term preferred share, guaranteed share, short-term preferred share, and collateralized share rules. The term preferred share rules were first introduced in the November 16, 1978 budget.[53] The budget proposal became subsection 112(2.1), which denies the intercorporate dividend deduction on term preferred shares held by a specified financial institution where the shares are acquired in the ordinary course of the institution's business. The Act defines a term preferred share as any share that is retractable, redeemable, guaranteed, or convertible into debt or a term preferred share.[54]

The government originally limited the denial of the intercorporate dividend deduction to term preferred shares acquired by financial institutions in the belief that those taxpayers were the primary lenders in the after-tax financing market. Such a limited legislative response was considered to be sufficient to address what was a limited problem.[55] This perception soon

[51] Canada, Department of Finance, Budget Papers, Notices of Ways and Means Motions and Supplementary Information on the Budget, November 16, 1978, 38.

[52] Preferred shares were generally more popular than income bonds as after-tax financing instruments. The popularity was attributable primarily to the fact that dividends on preferred shares could be paid subject only to the corporate law solvency tests. For income tax purposes, interest on income bonds could be paid only out of "profits," the determination of which was uncertain. This article focuses on preferred shares and distress preferred shares as after-tax financing instruments, recognizing that income bonds can be, and were sometimes, used for the same purpose. The government's response to the use of income bonds is discussed in footnotes 77-78 and accompanying text, infra.

[53] Supra footnote 51, at 10, resolution 69.

[54] See the definition of a "term preferred share" in subsection 248(1).

[55] See the testimony of Dr. E.P. Neufeld, Assistant Deputy Minister, Department of Finance, in Canada, *Proceedings of the Senate Standing Committee on Banking, Trade and Commerce,* 31st Parliament, 1st session, 1979, issue no. 6, November 15, 1979, 6:15.

proved to be mistaken. Shortly after the introduction of the term preferred share legislation, it became apparent that financial institutions could still participate in the after-tax financing market by guaranteeing for a fee the investment in term preferred shares of a non-financial institution.[56] Even after absorbing the cost of the guarantee fee, a non-tax-paying issuer would obtain a lower cost of capital than with a loan. The government moved to eliminate this form of after-tax financing by denying the intercorporate dividend deduction on shares held by any person where a specified financial institution provides a guarantee or some form of loss protection.[57]

By the summer of 1981, it became apparent that after-tax financing was continuing in the form of short-term preferred shares.[58] Typically, a non-tax-paying corporation issued shares for a term of five years or less in substitution for short-term debt. Neither the term preferred share nor guaranteed share legislation applied to deny the intercorporate dividend deduction because the shares were held by investors other than financial institutions, and a financial institution did not provide any guarantee or loss protection. In the November 12, 1981 budget, the government responded to this form of after-tax financing by introducing a proposal to deny the intercorporate dividend deduction on shares issued for a term of five years or less.[59] In the final legislation, this proposal was narrowed to those shares that were issued for a term of 18 months or less and in lieu of commercial paper or other short-term debt that would have been sold on the money market.[60]

The series of narrow legislative responses concluded with the collateralized share legislation, introduced on November 27, 1986.[61] A number of these shares were issued, or proposed to be issued, in the summer and fall of 1986 in order to transfer losses from a corporation to an unrelated corporate investor other than a financial institution. The shares had a term in excess of 18 months and were secured through arrangements that did not include a guarantee by a specified financial institution. Consequently, the term preferred share, guaranteed share, and short-term preferred share

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[56] Canada, *Proceedings of the Senate Standing Committee on Banking, Trade and Commerce,* 31st Parliament, 1st session, 1979, issue no. 3, November 8, 1979, 3:36-37.

[57] Subsection 112(2.2), added by SC 1979, c. 5, section 36.

[58] See the testimony of R.A. Short, Director, Tax Policy and Legislation Branch, Department of Finance, in Canada, *Proceedings of the Senate Standing Committee on Banking, Trade and Commerce,* 32d Parliament, 1st session, 1982, issue no. 94, June 1, 1982, 94:29; and Canada, House of Commons, *Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs,* 32d Parliament, 1st session, 1982, issue no. 117, September 28, 1982, 117:124-25.

[59] Canada, Department of Finance, Budget Papers, Supplementary Information and Notices of Ways and Means Motions on the Budget, November 12, 1981, 89-90, resolution 160(c).

[60] SC 1980-81-82-83, c. 140, section 128(11), adding the definition of a short-term preferred share in subsection 248(1), and section 71(3), adding subsection 112(2.3).

[61] Canada, Department of Finance, "Changes Announced on Tax Treatment of Intercorporate Dividends," *Release*, no. 86-197, November 27, 1986.

provisions did not apply to deny the intercorporate dividend deduction. The government responded by introducing the collateralized share legislation, which denies the intercorporate dividend deduction on shares issued for loss-trading purposes.[62]

Despite the introduction of these four pieces of legislation and numerous technical modifications, after-tax financing continued[63] until, in the June 1987 tax reform, the government introduced the taxable preferred share rules.[64] These rules require an issuer of taxable preferred shares to pay a special distributions tax under part VI.1 of the Act. A taxable preferred share is defined as any share that has a fixed dividend entitlement, a fixed liquidation entitlement, guarantee or loss protection, or is convertible into debt or a taxable preferred share.[65] Because of the scope of this definition, dividends on most types of preferred shares attract part VI.1 tax.

The basic part VI.1 tax rate is 25 percent of dividends paid on taxable preferred shares.[66] This rate attempts to ensure that sufficient corporate tax is paid to support the provision of the dividend tax credit. Where the payer elects, the rate is increased to 40 percent.[67] This rate attempts to ensure that some corporate tax is paid to support the provision of the intercorporate dividend deduction.[68] A special rate of 66$^2/_3$ percent applies to dividends on "short-term preferred shares,"[69] which are included in the definition of a taxable preferred share. A short-term preferred share is defined as any share that has a term of five years or less, is convertible into debt or a short-term preferred share within five years of its issue, or provides some form of guarantee or loss protection within five years of its issue.[70] The 66$^2/_3$ percent rate attempts to ensure that the intercorporate dividend deduction on such shares is supported in full with corporate tax paid.

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[62] SC 1987, c. 46, section 41, adding subsections 112(2.4) through (2.9).

[63] For an overview of preferred share financing in the 1980s, see Vijay M. Jog, "Leasing, Preferred Shares, Financial Innovations, and Tax-Loss Utilization," in *Policy Options for the Treatment of Tax Losses in Canada* (Toronto: The Clarkson Gordon Foundation, 1991), 6:1-41, at 6:18-34.

[64] Canada, Department of Finance, "Legislation on Preferred Share Financing Tabled," *Release*, no. 87-101, June 18, 1987 and the attached "Taxation of Preferred Shares: General Notes on Proposed Regime and Draft Legislation." See also Canada, Department of Finance, "Ways and Means Motion for Tax Reform Proposals Tabled," *Release,* no. 87-102, June 18, 1987 and the attached "Notice of Ways and Means Motion To Amend the Income Tax Act," resolution 10.

[65] Definition of a "taxable preferred share" in subsection 248(1).

[66] Subparagraph 191.1(1)(a)(iii).

[67] Subparagraph 191.1(1)(a)(ii).

[68] Where a corporation pays part VI.1 tax at the 25 percent rate, a shareholder that is a public corporation and in receipt of dividends on the relevant shares may be subject to a special tax under part IV.1 equal to 10 percent of the dividends received. See sections 187.1 and 187.2. This special tax attempts to ensure that the combined part VI.1 and IV.1 taxes approximate the 40 percent part VI.1 tax in support of the intercorporate dividend deduction.

[69] Subparagraph 191.1(1)(a)(i).

[70] Definition of a "short-term preferred share" in subsection 248(1).

A corporation liable for part VI.1 tax may effectively offset the tax against part I tax payable on its net income. The offset is realized through a deduction in calculating taxable income.[71] Because of the offset, the part VI.1 tax affects only those corporations that are non-tax-paying or subject to a relatively low effective rate.

In calculating part VI.1 tax for a taxation year, all corporations are entitled to a $500,000 dividend allowance.[72] The government apparently enacted this allowance to exempt small corporations from the part VI.1 tax.[73] This goal is realized by clawing back the amount of the allowance on a dollar-for-dollar basis to the extent that a corporation pays dividends in excess of $1 million on taxable preferred shares. The availability of the allowance meant that financial institutions could still participate in the after-tax financing market in significant amounts by holding or guaranteeing preferred shares of a number of issuers. To prevent this type of financing, the government maintained the term preferred and guaranteed share legislation. Consequently, there is some overlap between the pre-1987 legislative responses and the taxable preferred share rules.

As a response to after-tax financing, the preferred share rules form the normative tax base for preferred share investment, whatever theoretical benchmark may be chosen for the Canadian corporate tax. The rules also contain a number of important exceptions in addition to the dividend allowance. One of the more significant exceptions is in respect of preferred shares issued by corporations in financial difficulty.

CHARACTERIZATION OF THE DISTRESS PREFERRED SHARE AND SBDB LEGISLATION AS A TAX EXPENDITURE

All the preferred share rules contain two major types of exceptions to their application: one for intragroup financing and one for preferred shares issued by corporations in financial difficulty. In both instances, after-tax financing using preferred shares is permitted.

The government has implemented the first type of exception in several ways, all of which follow from the attempt to eliminate after-tax financing as a means to transfer the benefit of the interest deduction or unused losses between unrelated parties.[74] That goal is itself part of a larger goal to prevent the use of any arrangement or transaction that transfers losses, tax credits, or any other tax attribute from one person who cannot use it to

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[71] Paragraph 110(1)(k).

[72] Subsections 191.1(1) and (2). At an assumed dividend rate of 7 to 9 percent, the allowance permits all corporations to use preferred shares to raise $7 million to $8 million in financing on an after-tax basis.

[73] See "Taxation of Preferred Shares," supra footnote 64, at 5; Canada, House of Commons, *Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs,* 33d Parliament, 2d session, issue no. 73, June 23, 1987, 73:5 and issue no. 74, June 25, 1987, 74:57 and 74:65.

[74] See Edgar, supra footnote 44, at 1156-57.

an unrelated person who can. These various exceptions thus operate to limit the application of the legislation to the perceived problem: after-tax financing between unrelated parties.[75]

The government has implemented the second type of exception through the definitions of an income bond and term preferred share. As noted above,[76] the government initially proposed to address the after-tax financing problem in the November 1978 budget by introducing the term preferred share concept. Along with this concept, the government proposed to restrict the use of income bonds by adding to the definition of an income bond the condition that the issuer be a corporation in financial difficulty.[77] This proposal was subsequently enacted for issues of bonds or debentures after the budget date[78] and, with some amendments, has remained an element of the income bond definition. A bond or debenture qualifies as an income bond if the interest on it is payable only to the extent of corporate profits and the bond or debenture is issued in one of the following circumstances:

1) as part of a proposal or arrangement approved by a court under the Bankruptcy and Insolvency Act;[79]

2) at a time when all or substantially all of the assets of the corporation are under the control of a receiver or trustee in bankruptcy; or

3) at a time when, by reason of financial difficulty, the issuer is in default, or could reasonably be expected to default, on a debt obligation held by an arm's-length person, and the bond or debenture is issued, in whole or in substantial part, in exchange or substitution for the obligation.

In addition to these requirements, the term of the bond or debenture may not exceed five years and, for issues after November 12, 1981, the proceeds must be used by the issuer to finance a business carried on in Canada immediately before the issue. Where all these conditions are met, the particular bond or debenture is treated as an income bond for tax purposes, and interest on the obligation is treated as a dividend.

This financial difficulty condition in the definition of an income bond has been incorporated in the definition of a term preferred share as an exclusion.[80] As a result, a share that would otherwise be considered a term preferred share is excluded from such status if issued in circumstances similar to those set out in the definition of an income bond.[81] Similar ex-

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[75] See Canada, House of Commons, *Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs,* 33d Parliament, 2d session, issue no. 74, June 25, 1987, 74:53.

[76] See footnotes 53 through 55 and accompanying text, supra.

[77] Supra footnote 51, at 10, resolution 69.

[78] SC 1979, c. 5, section 66(6), amending the definition of an "income bond" in subsection 248(1).

[79] Bankruptcy and Insolvency Act, RSC 1985, c. B-3, as amended.

[80] Paragraph (e) of the definition of a "term preferred share" in subsection 248(1).

[81] Technically, the term of a distress preferred share is unlimited. However, a share may retain its status as a distress preferred share for no more than five years from its issue date, which effectively limits the term.

clusions are found in the definitions of a short-term preferred[82] and taxable preferred share.[83] As well, the guaranteed share provision has never applied to a share issued in the same circumstances.[84] These exclusions mean that the relevant shares are not subject to the denial of the intercorporate dividend deduction for a shareholder, nor is the issuer subject to part VI.1 tax on the payment of dividends. As a result, an eligible corporation in financial difficulty may refinance outstanding debt at a reduced after-tax cost by issuing either preferred shares or an income bond.

In 1979, the government extended the benefits of after-tax financing to issues of SBDBs by certain corporations in financial difficulty.[85] Interest on all such bonds is deemed to be a dividend received by the bondholder and is not deductible for the issuer.[86] The SBDB legislation differs from the income bond definition in that a qualifying debt obligation need not limit the payment of interest to profits realized by the issuer. The legislation also differs in some of the conditions that must be met for a debt obligation to qualify as an SBDB. In particular, the issuer must be a Canadian-controlled private corporation (CCPC)[87] in financial difficulty.[88] In addition, the debt may not have a term in excess of five years,[89] and must have a principal amount between $10,000 and $500,000.[90] Where the issuer is considered to be in financial difficulty because of a default, or reasonable expectation of default, on outstanding debt, the SBDB must be issued as a substitute for the outstanding debt.[91] In this respect, the SBDB legislation does not differ from the financial difficulty condition in the income bond definition and the preferred share rules. However, the proceeds from the issue must reasonably be considered to have been used by the issuer in an active business carried on in Canada immediately before the issue[92] and not just in a business. The issuer must also be a small business corporation

[82] Paragraph (i) of the definition of "short-term preferred share" in subsection 248(1).

[83] Definition of "taxable preferred share" in subsection 248(1). See the wording between paragraphs (b) and (c).

[84] Paragraph 112(2.2)(c). Subclause 51(1) of Bill C-27, An Act To Amend the Income Tax Act, the Income Tax Application Rules, the Canada Pension Plan, the Canada Business Corporations Act, the Excise Tax Act, the Unemployment Insurance Act and Certain Related Acts, tabled in the House of Commons, May 5, 1994, proposes to add new paragraph 112(2.6)(c) to the definition of an "exempt share" for the purposes of the collateralized share legislation. This proposed addition will exclude shares issued by corporations in financial difficulty from the application of the legislation.

[85] SC 1980-81-82-83, c. 48, section 8, adding section 15.1 applicable after December 11, 1979.

[86] Subsection 15.1(1) and paragraph 15.1(2)(a).

[87] Definition of a "small business development bond" in subsection 15.1(3).

[88] Paragraphs (d) through (f) of the definition of "qualifying debt obligation" in subsection 15.1(3).

[89] Paragraph (b) of the definition of "qualifying debt obligation" in subsection 15.1(3).

[90] Paragraph (a) of the definition of "qualifying debt obligation" in subsection 15.1(3).

[91] Paragraph (f) of the definition of "qualifying debt obligation" in subsection 15.1(3).

[92] Subparagraph 15.1(2)(c)(ii).

throughout any taxation year after the qualifying debt is issued.[93] If these conditions are not met, the issuer, in effect, must pay a penalty equal to the tax payable on the amount of the interest on the qualifying obligation.[94] Status as an SBDB is available only where the issuer and the lender file a joint election to treat a bond as an SBDB.[95]

As with the various provisions permitting after-tax financing within a corporate group, the distress preferred share and SBDB legislation may be justified as a necessary part of the technical design of the after-tax financing legislation and, hence, a necessary part of the normative corporate tax system. In enacting the preferred share rules and restricting the income bond definition to corporations in financial difficulty, the government has attempted to address after-tax financing between unrelated parties using hybrid securities that are treated as equity for tax purposes, but which have characteristics normally associated with debt. The government finds this use of hybrid securities as debt substitutes offensive. The legislative responses to after-tax financing should thus be limited to hybrid securities that have characteristics normally associated with debt. Where an issuer is in financial difficulty, the risk associated with an income bond, a preferred share, and even a debt obligation is comparable to a common share investment. Because of the increased risk, the securities should be accorded dividend tax treatment and excepted from the after-tax financing legislation in the same manner as common shares.

Initially, some government officials advanced this technical policy rationale for the addition of the financial difficulty condition to the definition of an income bond.[96] However, some tax practitioners and taxpayers did not see the issue in these terms. For example, when the government originally decided to address the use of income bonds and term preferred shares as after-tax financing instruments, certain individuals argued that the financing technique should be permitted to continue generally as a cheap source of capital for Canadian corporations.[97] Others adopted a more limited approach, arguing that after-tax financing should be permitted for certain projects or activities.[98] Both of these positions appear to be based on an

[93] Subparagraph 15.1(2)(c)(i). A "small business corporation" is defined in subsection 248(1).

[94] Subparagraphs 15.1(2)(c)(iii) and (iv).

[95] Definition of "small business development bond" in subsection 15.1(3).

[96] See footnote 55 supra.

[97] See, for example, G.E. Cronkwright, "Canada's Business Taxation System," in *Report of Proceedings of the Thirtieth Tax Conference,* 1978 Conference Report (Toronto: Canadian Tax Foundation, 1980), 23-33, at 30-31 and the statement of the then opposition member, Donald Johnston, in Canada, House of Commons, *Debates*, November 2, 1979, 898.

[98] See, for example, the submission of the Mining Association of Canada in Canada, *Proceedings of the Senate Standing Committee on Banking, Trade and Commerce,* 31st Parliament, 1st session, 1979, issue no. 28, February 28, 1979, 28:23-24; and W.T. Cannon, *New Mining Ventures: The Case for Preserving After-Tax Financing* (Kingston, Ont.: Queen's University Centre for Resource Studies, August 1979).

assumption that after-tax financing is properly regarded as a deviation from a normative corporate tax system, which would ensure that the provision of an intercorporate dividend deduction or dividend tax credit is supported by actual tax paid at the corporate level. The only issue is to what extent, if any, after-tax financing should be permitted as a deviation from the normative system.[99]

In each of the 1979, 1980, and 1985 tax expenditure accounts, the government also characterized after-tax financing as a tax expenditure.[100] The accounts cover the period 1976 to 1982 and, for preferred shares and income bonds, can be divided into two distinct periods: pre- and post-November 16, 1978 when the term preferred share legislation and income bond amendments were introduced.

With respect to the first period, the accounts characterized after-tax financing through the use of all preferred shares and income bonds as a tax expenditure. This conclusion is obviously premised on a normative corporate tax that, at least for preferred shares and income bonds, provides an intercorporate dividend deduction only where full corporate tax has been paid by the issuer. It also assumes that the government permitted after-tax financing to continue in this period as a conscious policy choice. The more plausible view is that after-tax financing was simply a tax minimization technique based on a technical deficiency in the corporate tax system that the government did not address until 1978.

After November 16, 1978, the normative corporate tax system included the original term preferred share legislation and the income bond amendments. As a result, the ability of corporations in financial difficulty to after-tax finance by issuing term preferred shares and income bonds was characterized in the accounts as an exception to the norm and was, therefore, a tax expenditure. The ability to after-tax finance during this period by issuing term preferred shares to non-financial corporations was also characterized as a tax expenditure. Although such a characterization is debatable, the issue is now unimportant since the taxable preferred share rules apply equally to holders who are financial or non-financial corporations.

The government's characterization of after-tax financing as a tax expenditure is appropriate for several reasons. First, the technical tax policy rationale is not persuasive. If the exceptions for issuers in financial difficulty were an attempt to classify preferred shares or income bonds as more in the nature of equity than debt, interest on all debt issued by any corpo-

[99] The government appeared to reject the case for the provision of after-tax financing for certain projects because of targeting problems. Yet, at least initially, there seems to be no recognition of the financial difficulty provisions as a tax expenditure. See Canada, *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce,* 30th Parliament, 4th session, issue no. 29, March 1979, 29:14-16.

[100] *Government of Canada Tax Expenditure Account* (1979), supra footnote 17, at 40 and 74; *Government of Canada Tax Expenditure Account* (1980), supra footnote 18, at 18; and *Account of the Cost of Selective Tax Measures* (1985), supra footnote 20, at 50 and 118.

ration in financial difficulty should qualify for the same tax treatment as a dividend on a common share. In that case, the risk borne by the debt holder may be comparable to or greater than that borne by a common shareholder of a financially strong corporation. Conversely, dividends on a common share of a financially strong corporation with a policy of paying dividends should be treated as interest on debt. In that case, the risk borne by the shareholder may be comparable to that of a debt holder of a financially weaker corporation. However, this approach to the classification of securities as debt or equity has never been adopted generally under the Act for good reason. Such an approach would be too difficult to administer because it depends on a factual determination of the substantive risk characteristics of all securities of all issuers. The preferable, simpler approach is based on an examination of the formal terms of securities.

Second, only small business corporations receive the benefits of after-tax financing through the issue of a conventional bond. If the distress preferred share and SBDB legislation were an attempt to classify corporate securities as debt or equity based on the risk borne by the holder, all debt issued by all corporations in financial difficulty would presumably be equivalent to equity and treated as equity.

Third, the conditions on the availability of the distress preferred share and SBDB legislation are more consistent with an attempt to target a tax expenditure than with the classification of a security as debt or equity. In particular, the conditions as to the use of the proceeds of an issue, the limitation of the term of a security to five years, the requirement that the relevant security be issued in substitution for an outstanding debt obligation, the limitations on the principal amount of an SBDB, and the status of an issuer as a small business corporation are all irrelevant considerations in assessing the risk borne by an investor. As this is the only possible basis on which these conditions could be relevant to the classification of a security as debt or equity, they must have some other purpose, such as the targeting of a tax expenditure.

Fourth, in the November 1981 budget, the government proposed to deny the intercorporate dividend deduction on the first 6 percentage points of interest on an income bond or SBDB as well as dividends on a term preferred, guaranteed, or short-term preferred share issued by a corporation in financial difficulty.[101] Although never enacted, the proposal was an obvious attempt to limit the amount of the tax subsidy provided to such corporations. If the risk borne by a holder of these securities is considered analogous to the risk attached to a common share because of the issuer's financial condition, the amount of the interest or dividend should be irrelevant.

Fifth, for SBDBs, the original legislation extended dividend treatment to interest on debt issued by an eligible issuer not in financial difficulty, if

[101] Supra footnote 59, at 58-59.

the proceeds of the issue were used to acquire land, certain depreciable property, or to finance scientific research.[102] As of 1981, dividend treatment was also extended on the same conditions to debt issued by a sole proprietor or partnership, even though a dividend may be paid only by a corporation.[103] Both of these features of the SBDB legislation are irrelevant to any attempt to classify corporate securities as debt or equity and are more consistent with the definition of the scope of a spending program. Even more significant, the SBDB legislation has always been a temporary feature of the corporate tax system. The original proposal applied to eligible debt obligations issued after December 11, 1979 and before 1981.[104] Application of the legislation was subsequently extended on several occasions.[105] After expiring at the end of 1987, the legislation was reintroduced for debt issued after February 25, 1992 and before 1995.[106] This lack of permanence is more characteristic of a subsidy program than legislation that is part of the technical tax structure.

The distress preferred share and SBDB legislation may also be characterized as a tax expenditure by applying a "functional" approach. This type of an approach does not depend on a definition of a normative tax system and the identification of exceptions to the norm. As noted earlier,[107] it has been argued that the debate over the definition of a normative tax system cannot be resolved satisfactorily. Focusing attention on this debate needlessly detracts from the usefulness of tax expenditure analysis. To avoid these difficult definitional issues, it has been suggested that tax expenditure analysis should be applied to any provision that has been justified using spending or subsidy arguments. In short, a provision that has been justified as a spending program should be analyzed as a spend-

[102] See subparagraph (iii) of the definition of "qualifying debt obligation" in former paragraph 15.1(3)(b) (repealed by SC 1993, c. 24, section 6(1)).

[103] Section 15.2.

[104] Canada, Department of Finance, Budget Papers, Notices of Ways and Means Motions and Supplementary Information on the Budget, December 11, 1979, at 2, resolution 9, and at 60.

[105] See Canada, Department of Finance, Budget Papers, Notices of Ways and Means Motions and Supplementary Information on the Budget, October 28, 1980, 102-3; Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, June 28, 1982, resolution 8(2); Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, December 1, 1982, resolution 21; Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, November 25, 1983, resolutions 7 and 9; and Canada, Department of Finance, Budget Papers, Supplementary Information and Notices of Ways and Means Motions on the Budget, May 23, 1985, 108-9, resolution 53.

[106] Canada, Department of Finance, Budget Papers, Notice of Ways and Means Motion To Amend the Income Tax Act, February 25, 1992, resolution 1; and Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, December 2, 1992, resolution 3.

[107] Supra footnote 12 and accompanying text.

ing program.[108] Alternatively, a provision the purpose of which can be realized through a non-tax spending program should be considered a tax expenditure. Because these "substitutable" tax provisions may be replaced with non-tax spending programs, they should be analyzed as such.[109]

A functional approach to the characterization of a provision as a tax expenditure obviously depends on a determination of the purpose of the particular provision. Where the purpose is unclear, the appropriate application of tax expenditure analysis is unclear. Clarity of purpose is not, however, a problem with the distress preferred share and SBDB legislation. On several occasions, the government has justified the legislation as a means of providing cheaper financing for failing businesses. In fact, when the term preferred share rules and income bond amendments were introduced in 1978, the government stated that the original income bond legislation had been introduced in the 1930s to "help companies in serious financial difficulty."[110] As already described,[111] this view of the income bond legislation is incorrect. Income bonds were issued in the 1930s by corporations in financial difficulty for non-tax reasons. The government then introduced legislation in 1935 to deny an interest deduction on what were perceived to be securities that were more in the nature of equity. There was no intention to permit corporations in financial difficulty to lower their after-tax cost of financing through the issue of income bonds. Nonetheless, the exception to the term preferred share rules for issuers in financial difficulty and the limitation of the definition of an income bond to these issuers were initially supported because they preserved the perceived intention of the original 1935 legislation—that is, they restricted the benefits of after-tax financing to corporations in financial difficulty. The goal has been expressed in terms of realizing a reduced cost of borrowing for such corporations in the hope that they will be able to work out of their difficulties.[112]

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[108] McIntyre, supra footnote 12.

[109] Thuronyi, supra footnote 9.

[110] See, for example, Canada, Department of Finance, Budget Papers, Notices of Ways and Means Motions and Supplementary Information on the Budget, November 16, 1978, 38; and *Proceedings of the Senate Standing Committee on Banking, Trade and Commerce,* supra footnote 55, at 6:15 and issue no. 8, November 22, 1979, 8:9.

[111] Footnotes 47 through 49 and accompanying text supra.

[112] See, for example, Canada, House of Commons, *Debates*, December 12, 1979, 2282 and 2308; Canada, *Proceedings of the Senate Standing Committee on Banking, Trade and Commerce,* 32d Parliament, 1st session, 1980-81, issue no. 33, February 17, 1981, 33:12-14 and issue no. 37, February 24, 1981, "Report of the Standing Committee on Banking, Trade and Commerce on the Subject Matter of Bill C-54," 37:9; Canada, *Proceedings of the the Senate Standing Committee on Banking, Trade and Commerce,* 32d Parliament, 1st session, 1980-81-82, issue no. 113, December 9, 1982, 113:24-27; *Government of Canada Tax Expenditure Account* (1980), supra footnote 18, at 2-3 and 15; and *Account of the Cost of Selective Tax Measures* (1985), supra footnote 20, at 50 and 119.

Moreover, this apparent purpose of the distress preferred share and SBDB legislation could be realized through a non-tax spending program. In an after-tax financing, the government forgoes the tax that it would have collected from a lender on interest payments on an outstanding debt obligation. This forgone tax is then effectively provided as a subsidy payment to the issuer in financial difficulty, who refinances the debt with an issue of distress preferred shares or an SBDB. The subsidy payment takes the form of a reduced after-tax cost of financing. This result may be illustrated by slightly modifying the example already described.

Assume that a corporation is in default on outstanding debt with a $100 annual interest obligation and substitutes a preferred share with a dividend obligation of $70. Provided the shares qualify as distress preferred shares, the corporation reduces its after-tax cost of financing by $30. The lower cost results from the fact that the issuer is non-tax-paying because, for example, it has unused loss carryovers. Thus, the interest deduction is worthless, while income out of which the substituted dividends are paid is sheltered from tax by the issuer's loss carryovers. Any dividends are excepted from the preferred share rules and may be received tax-free by the lender. The government loses the tax it would have collected from the lender on any interest payments. The lender and issuer share the savings from this forgone tax in the form of a lower after-tax cost of financing for the issuer and an increased after-tax return for the lender.

A comparable result to the subsidy available through an after-tax financing could be realized where the government provides a corporation in financial difficulty with a direct grant, reimbursement of any interest obligations, or loan guarantees. In the first two instances, government assistance directly reduces the financing cost to the corporation; in the third, the lender presumably requires a lower return because of the support of the government loan guarantees. Along with the various expressions of a subsidy rationale for the distress preferred share and SBDB legislation, the possible substitution of these non-tax subsidy programs to realize the same result as an after-tax financing indicates that the legislation functions as a subsidy or spending program. Accordingly, a good case can be made to apply tax expenditure analysis to assess the effectiveness of the legislation as a spending program.

Assessment of the Distress Preferred Share and SBDB Legislation as a Spending Program

The assessment of a tax expenditure as a spending program focuses on traditional budgetary criteria, such as the rationale for a program, the program's target effectiveness, administrative and implementation costs, and government control and accountability. The following section of the article applies these budgetary criteria to the distress preferred share and SBDB legislation. The analysis reveals that the legislation is fundamentally flawed in terms of its rationale and targeting. Furthermore, even if these shortcomings were addressed, the legislation should be repealed and replaced with a direct spending program to avoid implementation problems and a lack of government control and accountability.

Rationale for Assistance for Financially Troubled Businesses[113]

A defensible spending program should have a principled rationale. Governments may be guilty of spending money unwisely but rarely without reason, even if the reason is exclusively political. Identifying the rationale underlying a spending program is crucial to its target effectiveness, which can only be assessed in terms of the rationale.

As noted above,[114] the government has justified the distress preferred share and SBDB legislation as a means of assisting financially troubled businesses by lowering the after-tax cost of financing. The apparent hope is that the lower financing cost will provide a business with time to turn its fortunes around. This vague rationale is not a sound policy basis for providing financial assistance. From an economic perspective, the basic starting point for the design of any assistance program for financially troubled businesses is simple: assistance of any kind should not be provided.[115] This principle is based on the proposition that the market for goods, services, and capital is constantly operating to allocate resources to their most efficient use. As part of this process, resources will be shifted or reallocated from certain uses to more efficient uses. Businesses that are identified by the market as inefficient should be left to die because the resources they use are then reallocated to more efficient uses. If the difficulties of a particular business are attributable to factors which indicate that the difficulties are temporary, the market will take this information into account and the business will be allowed to continue as long as the particular use of the relevant assets is the most efficient use. For other financially troubled businesses, a reallocation of resources ensures that society is better off materially in the long run. Assets are put to more productive uses, which means that more jobs are created, the return on capital is increased, and the economy is generally more competitive. Providing financial assistance to financially troubled businesses retards the reallocation of resources to their most efficient use.

There are some legitimate exceptions to this basic principle of "no assistance"; indeed, a theoretically sound case can be made for furnishing

[113] See, for example, Peter Berg, *Corporate Bailouts* (Ottawa: Library of Parliament, 1983), 2-7; Marsha Gordon, *Government in Business* (Montreal: C.D. Howe Institute, 1981), 150-57; and Donald J. Savoie, *The Politics of Public Spending in Canada* (Toronto: University of Toronto Press, 1990), 305-7. The following summary of the possible rationales for providing assistance to financially troubled businesses is from a comprehensive study commissioned by the Ontario Economic Council. See Michael Trebilock, Marsha Chandler, Morley Gunderson, Paul Halpern, and Jack Quinn, *The Political Economy of Business Bailouts*, vols. 1 and 2 (Toronto: Ontario Economic Council, 1985).

[114] Footnotes 110 through 112 and accompanying text, supra.

[115] Trebilock et al., supra footnote 113, vol. 1, at 3-4.

assistance in certain circumstances.[116] The case depends on the identification of perceived market failures that necessitate government intervention as a corrective measure. Alternatively, the reallocation of resources may have consequences for the distribution of income that should be alleviated in the short run. Both of these general reasons for helping financially troubled businesses tend to focus on the adverse effects on employees.

The loss of income for employees and the effects of an insolvency or bankruptcy on the local community are most often cited as justifications for assisting a failing business. The loss of income for employees does not, however, represent a market failure. In fact, it is the logical outcome of the proper functioning of the market as it reallocates resources, including labour, to their most efficient use.[117] The case for assistance based on the income loss of employees is instead a distributional issue. A failing business may be supported through government assistance as a means of preserving the income of the affected employees. This action is based on a judgment that the income distribution resulting from the operation of the market is inequitable, and the government should intervene to redistribute income in favour of the affected employees. The policy instrument chosen for the redistribution is assistance to the failing business and the preservation of jobs instead of increased unemployment insurance or welfare payments, which might be required if the business were allowed to fail. Assistance thus eases the transitional costs for employees and allows them to adjust more gradually to the inevitable failure of the business and re-employment. The need for such assistance is greatest for low-income employees where alternative employment opportunities are scarce because of the regional dominance of an employer, a recessionary economy, or a lack of demand for the particular skills of the employees. Extending the life of a failing business may similarly alleviate adverse effects on the community at large, such as any income loss for local businesses that are directly dependent on a larger failing business or indirectly dependent through the consumption of goods or services by the employees. Assistance will also benefit taxpayers generally if its cost is less than the cost of the increased unemployment and welfare payments that would result if a business were allowed to fail.

A related but different justification for assistance to a financially troubled business is the alleviation of "congestion externalities" that may follow from a failure of a business and the mass layoff of its employees.[118] These "congestion externalities" occur when employees of a failing business cannot be laid off and re-employed without increasing the length of time and costs for other unemployed individuals attempting to find employment. These adverse effects on other individuals represent a market failure or "externality" because the market cannot adequately take them into account and

[116] Ibid., vol. 1, at 80-189.

[117] Ibid., vol. 1, at 80-104.

[118] Ibid., vol. 1, at 84-86.

provide compensation to the affected individuals. The problem tends to arise where a number of factors are present, including the following:[119]

1) mass layoffs occur in a small community dominated by a particular employer,

2) a large pool of unemployed individuals with similar skills already exists,

3) most of the unemployed are unlikely to leave the labour market, and

4) limited employment opportunities exist as a result of a national or local economy in recession.

In these circumstances, government intervention may be necessary to keep a failing business operating until other unemployed individuals can find alternative employment and the employees of the failing business can be laid off gradually. The avoidance of a mass layoff may allow the labour market to adjust to the re-employment of all individuals at the lowest possible cost.

A much weaker rationale for providing assistance for financially troubled businesses can be found in perceived failures in the capital market.[120] This market functions to reallocate the valuable assets of a failing business to their more efficient uses. The market operates through insolvency or bankruptcy proceedings, which lead to the reorganization of the business or its liquidation and sale of the assets. In these processes, creditors will attempt to redeploy the assets in a manner that maximizes their wealth. The business will be liquidated where a liquidation realizes the optimum result for the creditors. An inappropriate liquidation may occur where conditions impede the proper functioning of this market. For example, with small businesses, there may be imperfect information that leads to an inappropriate liquidation. Similarly, some creditors may engage in behaviour that is designed to block an efficient reorganization and extort an excessive return at the expense of other creditors. For the most part, however, the various arguments and empirical evidence supporting the existence of market failures in the insolvency or bankruptcy context are not persuasive.[121] In effect, the decision to liquidate a business or continue it as a going concern is analogous to the decision to lend money. As with the loan market, it seems that the capital market for the redeployment of the assets of a financially troubled business is able to distinguish correctly among those businesses which should be liquidated and those which should be allowed to continue. Certain regulatory constraints, such as trade competition legislation, may prevent the most efficient reallocation of assets, but these constraints do not justify assistance for a failing firm. Instead, the benefits of the constraints should be weighed against the benefits of the unconstrained reallocation of assets, and certain of those constraints

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[119] Ibid., vol. 1, at 272.

[120] Ibid., vol. 1, 105-89.

[121] Ibid., vol. 1, at 273-76.

weakened or strengthened where appropriate. The problem of inappropriate "gamesmanship" or "strategic behaviour" by creditors can also be addressed more directly in bankruptcy or insolvency legislation.

Although the general case for assistance based on capital market failures is problematic, the government may intervene to provide assistance for small businesses in financial difficulty based on such a perceived failure unique to that sector. This case for assistance is the logical extension of the case for providing assistance to small businesses generally.[122] It is often argued that small businesses generate social benefits or "positive externalities" that are not reflected in the private return on investment. The capital market thus fails to allocate sufficient capital to small businesses. This underinvestment can be corrected by providing investment incentives or other financial assistance. For example, it is alleged that small businesses are more innovative and contribute disproportionately to technological development because owner-managers have longer time horizons than professional managers and are more likely to undertake riskier investments with higher potential returns. Small businesses are also said to be particularly labour-intensive and more likely to locate in regions that larger businesses avoid. Small businesses may thus promote employment goals and regional economic development. Increased investment in small businesses provided by investment incentives or other financial assistance should lead to increased generation of these positive externalities.

Arguably, the failure to take into account the positive externalities generated by small businesses may lead to the premature insolvency or liquidation of certain of those businesses. Additional assistance may be needed to correct this market failure. Despite its intuitive appeal, this justification of assistance for small businesses suffers from two major difficulties. First, the case for the favourable treatment of small businesses generally on the basis of the positive externalities they generate is ambiguous.[123] Second, there is no obvious reason why a small business in financial difficulty should be provided with assistance when other small businesses are successful. In fact, in the light of the various investment incentives and subsidies provided to small business, it may be appropriate to let failing businesses die and reallocate their assets to other more efficient uses, which may include other viable small businesses.

The weaknesses in the possible capital market rationale leaves the distributional consequences following from the income loss of employees and the prospect of "congestion externalities" as the only plausible economic rationales for providing assistance to financially troubled businesses. In reality, such assistance is rarely given with these specific problems in mind. The rationale is most often entirely political. The spectre of the loss of jobs and the potential political consequences have led governments to aid financially troubled businesses on an ad hoc basis or by structuring

[122] For an excellent summary of the possible rationales for the subsidization of small business, see Brooks, supra footnote 4, at 482-87.

[123] Ibid.

programs for a particular region or sector of the economy, such as small business.[124] This rationale for assistance is extremely short-sighted. It substitutes perceived political gain in the short term for the long-term growth that would be realized if troubled businesses were left to die. Nonetheless, because political motivations tend to be driven by the perceived adverse effects on employment, assistance for failing businesses could conceivably be delivered under conditions that adequately reflect the economic rationale based on the employment consequences of a business failure. The same result could be realized with small businesses on the assumption that the economic rationale for assistance for that sector is defensible. However, this incidental convergence of political motivation and economic justification has not occurred with the distress preferred share and SBDB legislation. When assessed in terms of the possible economic rationales, these tax expenditures are hopelessly ineffective.

Target Effectiveness

An efficient spending program should be designed so that any benefits are limited to those persons or activities within the rationale underlying the program. In other words, a spending program should be designed so as to benefit only those persons or activities for which the program was created. This simple maxim is often referred to as the "target-effectiveness" of a spending program.

As argued above,[125] there are two defensible economic rationales for financial assistance for failing businesses: alleviation of the loss of income for affected employees and the alleviation of "congestion externalities" in the labour market that may result from a mass layoff. The distress preferred share legislation is assessed below in terms of these two rationales. It is also recognized that the provision of financial assistance for small businesses, including those in financial difficulty, is a practical reality, even though the theoretical basis for such support is equivocal. Consequently, the targeting of the SBDB legislation is assessed in terms of the specific case for the support of small businesses.

Distress Preferred Shares and Targeting Assistance for Employees

An assistance program intended to alleviate the impact on employees of the failure of a business should have a number of design features. For example, businesses should be eligible for assistance only if they are relatively labour-intensive with, perhaps, a minimum number of affected employees. Assistance should also be available only if there are a significant number of low-income employees with limited employment opportunities. Alternative employment may not be readily available because the employees' skills are relatively limited and easily replaced, the national or local economy is in recession, or the failing business is pre-

[124] Savoie, supra footnote 113.

[125] Footnotes 113 through 124, and accompanying text, supra.

dominant in the particular region. These kinds of factors indicate that the affected employees are especially vulnerable and in need of help to ease the transition to alternative employment. They also indicate that a mass layoff could result in "congestion externalities" in the local labour market, particularly if the unemployment rate is high.

Any number of specific tests could be used to reflect the features of an ideally targeted program. Whatever tests are chosen, the assistance should be provided on a temporary basis as a means of easing the transitional costs that arise on the failure of a business. Long-term assistance only impedes the reallocation of resources that is ultimately necessary for the greater benefit of an economy. Some attempt might also be made to require employees to retrain and relocate in other expanding sectors in order to assist the reallocation process. In all cases, an evaluation of the costs of the assistance should be weighed against any improvement in income distribution or reduction in the costs resulting from labour congestion.

When assessed against these general features of an ideal spending program, the distress preferred share legislation is poorly targeted, largely because it is overinclusive. As already described,[126] the legislation provides the following four important conditions:

1) the issuer must be a corporation in financial difficulty;

2) the proceeds of the issue must be used in a business carried on in Canada by the issuer immediately beforehand;

3) the term of the shares must effectively be limited to five years; and

4) where financial difficulty is evidenced by a default or expected default on an outstanding debt obligation, the shares must be issued to refinance that obligation.

The overinclusiveness of the legislation is attributable to the ineffectiveness of these conditions, which are generally irrelevant to any attempt to target a spending program to alleviate the income loss of employees or possible "congestion externalities." For the most part, almost any corporation in financial difficulty qualifies for refinancing at a reduced after-tax cost.

The condition regarding the use of the proceeds from a distress preferred share issue is the only one with any possible connection to a labour-based rationale for a spending program for financially troubled businesses. The condition may be characterized as a crude attempt to limit assistance to circumstances in which "Canadian jobs" will be preserved. This characterization follows from the fact that the issue proceeds must be used in Canada and only in a business, which presumably generates employment for Canadians. However, the conditions are far too inclusive. As interpreted by the courts, the concept of a business for tax purposes is extremely broad[127] and includes passive operations that are not labour in-

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[126] Footnotes 78 through 84, and accompanying text, supra.

[127] For an excellent discussion of the concepts of "business" and "business income" under the Act and case law, see John Durnford, "The Distinction Between Income from

(The footnote is continued on the next page.)

tensive and, therefore, do not employ a significant number of persons. These kinds of failing businesses should not qualify for assistance where it is provided to alleviate income loss for employees or "congestion externalities." Moreover, not all failing businesses that are labour-intensive should qualify for assistance. The class of eligible recipients should be defined on the basis of the makeup of their respective work forces and the prevailing economic circumstances. Such a definition requires information regarding the income level and skills of the affected employees, the health of the local economy, and the importance of the employer in the particular region. These kinds of factors focus assistance on the need for relief from income loss for particularly vulnerable employees and possible "congestion externalities."

Although the problem of overinclusiveness is the most serious targeting problem, certain aspects of the distress preferred share legislation can be criticized as too narrow and underinclusive. For example, the legislation is unnecessarily restricted to corporate issuers. This restriction may not be significant in practice because the ability to issue distress preferred shares has tended to be limited for non-tax reasons to larger businesses, which are almost always conducted in corporate form. However, some larger businesses are conducted in unincorporated form, and there is no principled reason to limit the use of distress preferred shares to corporations in financial difficulty. This argument has been recognized in the SBDB legislation, which extends to the issue of a bond by a qualifying partnership or sole proprietorship.

It is also curious that the SBDB legislation permits a small business corporation in financial difficulty to after-tax finance through the issue of a conventional bond, while other corporations must use preferred shares or an income bond. The reason for this restriction is unclear; it may simply be a historical accident. Larger corporations have been able to use preferred shares and income bonds to after-tax finance because these hybrid securities have equity features sufficient to attract dividend tax treatment, along with enough debt features to satisfy a lender for non-tax reasons. When legislation was enacted to foreclose the benefits of after-tax financing for financially strong issuers using these securities, the exceptions for issuers in financial difficulty were limited to the same securities. With small businesses, lenders generally have required the increased security or protection available through the issue of a conventional bond. Therefore, the benefits of after-tax financing can be extended practically to small businesses in financial difficulty only if dividend treatment is available on a conventional bond. Whatever the historical reason, there is no principled reason why all issuers in financial difficulty cannot after-tax finance using a conventional bond. If a corporation, partnership, or sole proprietorship in financial difficulty otherwise qualifies for assistance, whether

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[127] Continued . . .
Business and Income from Property, and the Concept of Carrying On Business" (1991), vol. 39, no. 5 *Canadian Tax Journal* 1131-1205.

refinancing is effected through the issue of preferred shares, an income bond, or a conventional bond should be irrelevant.

On the positive side, the effective five-year limitation on the term of a distress preferred share appears to ensure that the delivery of tax assistance for corporations in financial difficulty is temporary. However, even this condition can be criticized. In particular, five years may be rather generous where the goal is to alleviate the adjustment costs incurred by employees. A legitimate case can be made for a shorter period and perhaps one that varies with each issuer and the particular circumstances. More important, the five-year limitation is not necessarily effective. Once the term expires, an issuer is free to refinance any arm's-length debt outstanding at that time, provided the debt is in default or the issuer may reasonably be expected to default. Revenue Canada accepts that such debt may include debt issued to a lender on the redemption of distress preferred shares at the end of a five-year term.[128] This debt can then be refinanced with a new issue of preferred shares and the issuer can gain access to another five years of assistance. By that time, the continued financial difficulty of the issuer is evidence that, in the judgment of the market, the relevant resources should be reallocated to a more efficient use. No further financial assistance should be available.

As with the five-year term limitation, the requirement that an issue of distress preferred shares must be made in order to refinance outstanding debt appears reasonable. This requirement is intended to ensure that an issue of these securities enables only a refinancing at a lower after-tax cost, which should ease the adjustment costs for employees on the failure of a business. Except for the original SBDB legislation, which permitted issue proceeds to be used to acquire certain property or fund research and development, the government has refused to extend the benefits of after-tax financing for expansive purposes. The limitation may have the added benefit of restricting, in part, the benefits that might accrue to shareholders from a lower after-tax cost of financing. Where after-tax financing is available only to refinance existing debt of a failing business and not for expansion purposes, the benefits of the reduced financing cost may be more likely to accrue to the affected employees in the form of continued salary and benefit payments.

The requirement that an issuer be in financial difficulty is an obvious condition for any assistance program for a financially troubled business. Once an issuer ceases to be in financial difficulty, the benefits of after-tax financing should not be available. To avoid the administrative difficulties of applying this condition to every taxation year in which an issue of preferred shares is outstanding, the legislation requires that the issuer be in financial difficulty at the time of issue and then limits the effective term of the shares to five years. This approach means that the benefits of after-tax financing are potentially available to financially strong recipients who

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[128] See Darling, supra footnote 2, at 5:3.

were in difficulty at the time of an issue but have worked out of those difficulties before the end of the five-year period. A shorter term limitation would lessen the possibility of this occurrence, although it is not a serious practical problem.[129]

SBDBs and Targeting Assistance for Small Business

A program intended to provide assistance for small businesses in financial difficulty should be designed so that eligible recipients are limited to the small businesses that generate positive externalities such as employment, regional development, and increased technological research. There should thus be some limitation on the size of eligible recipients to ensure that they are, in fact, small. For the purpose of this limitation, size could be measured in terms of objective criteria, such as the amount of debt and equity capital, net asset value, gross revenue, or some combination. There should also be a requirement that a failing business has actually created a certain number of jobs within a defined period, is engaged in research and development, or operates within a region that is economically depressed. These kinds of requirements could again be defined using reasonably clear criteria, which would ensure that only those small businesses actually generating positive externalities receive assistance when in financial difficulty.

Like the distress preferred share legislation, the SBDB legislation is poorly targeted when compared with an ideal spending program. Again, the targeting problem is largely one of overinclusiveness. The problem arises from two major aspects of the legislation: the lack of any size restriction for issuers and the failure to limit the legislation to businesses that generate positive externalities.

An issuer qualifies for the benefits of an SBDB issue if it is a small business corporation, which is defined as a CCPC all or substantially all of whose assets are used principally in an active business carried on primarily in Canada.[130] This definition permits almost any private corporation in financial difficulty to qualify for an SBDB issue regardless of size. The only requirements are a business connection with Canada and an element of Canadian share ownership. The legislation does limit the benefit from an issue by limiting the principal amount of an SBDB to a maximum of $500,000. However, this limitation in no way ensures that an SBDB issue is limited to small businesses. Any qualifying corporation may issue an SBDB with a principal amount up to $500,000 regardless of its size.

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[129] Revenue Canada will issue a favourable advance ruling for a proposed issue of distress preferred shares if the issuer agrees to use any "cash flow in excess of operating requirements" to redeem the shares. This requirement minimizes the possibility of a corporation's continuing to receive the benefit of after-tax financing when it is no longer in financial difficulty. For a description of the department's administrative position and the basis for that position, see Darling, supra footnote 2, at 5:6-7.

[130] See the definition of a "small business corporation" in subsection 248(1) and the definition of a Canadian-controlled private corporation in paragraph 125(7)(b).

The definitions of a CCPC and small business corporation used in the SBDB legislation are also used for the purposes of many other tax expenditures provided for small businesses. As a result, the lack of adequate restriction based on the size of a business is a general problem in the Act. For example, the small business deduction has been criticized as poorly targeted because, among other things, it contains no limitation on the size of otherwise eligible corporations.[131] Its overinclusiveness means that the deduction provides the equivalent of a lower rate of corporate tax on the first $200,000 of taxable income of many corporations that, under almost any set of criteria, would not be considered small.[132]

The lack of any size restriction in the SBDB legislation contrasts, however, with some tax expenditure provisions for small businesses. These provisions limit the amount of a particular tax benefit by reducing or eliminating the benefit entirely where an otherwise eligible recipient has earned a defined amount of taxable income. For example, the enhanced investment tax credit for research and development expenditures of a CCPC is eliminated where the CCPC and other associated CCPCs have earned $200,000 or more of taxable income in the preceding taxation year.[133] Similarly, for corporate income tax purposes in Ontario, the amount of the small business deduction is reduced for associated CCPCs with taxable income in excess of $200,000 and eliminated entirely where taxable income exceeds $500,000.[134] On the assumption that taxable income is a reasonable proxy for size, these types of limitations function as size restrictions in respect of those otherwise eligible taxpayers who receive no benefit and are effectively disqualified.

These kinds of restrictions are essentially simplified versions of the "total business limit" and the "cumulative deduction account," which were part of the original small business deduction. The limit and the account together attempted to ensure that the small business deduction was unavailable to otherwise eligible CCPCs where they had, in previous taxation years, earned a defined amount of taxable income calculated on a cumulative

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[131] Brooks, supra footnote 4, at 496-501.

[132] The February 22, 1994 budget attempts to address this problem by limiting the availability of the small business deduction on the basis of the "taxable capital" of a corporation. See footnote 138 and accompanying text, infra.

[133] Subsection 127(10.1) provides the enhanced credit unless the $200,000 limit is exceeded. For qualifying expenditures incurred in taxation years beginning after 1993, the government has proposed that the enhanced credit be phased out between taxable income of $200,000 and $400,000. See Canada, Department of Finance, *The Budget 1993*, April 26, 1993, 79-80 and subclause 15(10) of Bill C-9, An Act To Amend the Income Tax Act, tabled in the House of Commons on February 4, 1994. Any enhanced credit is also refundable under section 127.1.

[134] Corporations Tax Act, RSO 1990, c. C.40, section 41.1, which imposes a surtax on CCPCs equal to 3.7 percent of taxable income in excess of $200,000. For taxation years ending after April 30, 1992, the small business deduction was increased for Ontario income tax purposes. The special surtax was also increased to a rate of 4 percent. See Ontario, Ministry of Treasury and Economics, *1992 Ontario Budget*, April 30, 1992, 36-37.

basis.[135] The same restriction was part of the original SBDB legislation but was repealed in 1984 when, for the sake of simplification, the restriction was repealed for the purpose of the small business deduction.[136] Any similar restriction based on taxable income would have little effect for small businesses in financial difficulty, since they are likely to have been in a loss position for most preceding taxation years. In fact, the use of the cumulative deduction account in the original SBDB legislation was probably intended to limit the access of financially strong corporations to after-tax financing for certain expansive purposes, which were initially permitted.[137] Nonetheless, a limitation with a similar effect for corporations in financial difficulty could be designed. One possibility would be to reduce the $500,000 maximum principal amount for which an SBDB can be issued. The reduction could be based on the average amount of debt of an otherwise eligible issuer outstanding for a certain number of preceding taxation years, and could be calculated at the rate of one dollar for every dollar of outstanding debt in excess of the $500,000 maximum or some other acceptable ratio. Although far from perfect, such a restriction would at least provide some limitation on the size of potentially eligible issuers.

A more obvious, and perhaps more effective, response would be to extend the proposal in the February 22, 1994 budget regarding the small business deduction. In general, the budget proposes to reduce the amount of the small business deduction for corporations with "taxable capital" between $10 million and $15 million.[138] The deduction will not be available to corporations with taxable capital in excess of $15 million. A similar definition of a "small corporation" could be extended to the SBDB legis-

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[135] See the definition of "cumulative deduction account" in former paragraph 125(6)(b) and the definition of a CCPC's "total business limit" in former subsection 125(2) added by SC 1970-71-72, c. 63. Taxable income was taken into account only to the extent that it had benefited from the small business deduction. The defined upper limit was determined by the CCPC's "total business limit," which was originally $400,000. It was raised to $500,000 in 1974, $750,000 in 1976, and $1 million in 1982.

The cumulative deduction account originally included only taxable income that was retained. CCPCs could thus "refresh" their accounts by distributing taxable income as a dividend. After 1981, all taxable income, whether retained or distributed, was included in the cumulative deduction account (SC 1980-81-82-83, c. 140, sections 85(5) and (6), amending former paragraph 125(6)(b)).

[136] SC 1984, c. 45, section 8(2) and section 40, applicable to 1985 and subsequent taxation years.

[137] See footnote 102 and accompanying text, supra.

[138] Canada, Department of Finance, Budget Papers, *Tax Measures: Supplementary Information*, February 22, 1994, 15-18 and 44-50, and Notice of Ways and Means Motion To Amend the Income Tax Act, resolution 16, at 64. The concept of "taxable capital" will be that used for the purposes of the large corporations tax in part I.3 of the Act. See also the proposal to require financial institutions and investment dealers to "mark-to-market" certain debt and share investments (ibid., at 21-22, and resolution 20, at 66). This proposal specifically excludes shares of small business corporations defined as certain CCPCs with total assets of $50 million or less and 500 or fewer employees.

lation to determine its availability. For example, the $500,000 maximum principal amount for which an SBDB may be issued could be reduced on a straight-line basis for corporations with a defined amount of taxable capital.

Even if the SBDB legislation contained some sort of size restriction on eligible issuers, the lack of any conditions to limit the legislation to those small businesses that actually generate positive externalities is a serious targeting problem. Once an SBDB is issued, a corporation must maintain its status as a small business corporation throughout a taxation year or pay an effective tax penalty, which eliminates any financing benefit. The definition of a small business corporation, along with the condition that the proceeds of an SBDB issue be used in an active business carried on in Canada, requires that the issuer have a connection with Canada. In short, the conditions may be seen as an attempt to ensure that eligible issuers generate some positive social benefits in Canada. The concept of an "active business," however, is inappropriate for this purpose.

In relation to any business carried on by a taxpayer resident in Canada, an "active business"[139] is defined as any business carried on by the taxpayer other than a "specified investment business"[140] or a "personal services business."[141] The former includes the earning of certain passive investment income; the latter includes arrangements by which an employee attempts to convert what would be employment income into business income earned by a CCPC. Because these exclusions do not apply where a business employs more than five full-time employees, they are extremely narrow. Consequently, many income-earning activities that are relatively passive are considered "active businesses" since, as previously noted,[142] the courts have adopted a very liberal interpretation as to what constitutes "carrying on a business." The result is that many businesses that do not generate any significant employment benefits, regional development, or technological innovation qualify. This aspect of the SBDB legislation does not appear to be difficult to correct. For example, the employment criterion in the definition of a "specified investment business" could be strengthened significantly by increasing the required number of employees and then applying this requirement to all small businesses.[143] An issuer could also qualify if it located a required portion of its business in certain designated regions or conducted a defined amount of research and development.

Unlike the distress preferred share legislation, the SBDB legislation extends to partnerships and sole proprietorships in financial difficulty and thus

[139] See the definition of "active business" in subsection 248(1).

[140] Defined in subsection 248(1) and paragraph 125(7)(e).

[141] Defined in subsection 248(1) and paragraph 125(7)(d).

[142] See footnote 127, supra.

[143] The specific number of employees would have to be set such that a corporation could still be considered "small." See, for example, the exception for shares of a "small business corporation" in the February 22, 1994 budget proposal regarding financial institutions and the recognition of investment gains, supra footnote 138.

avoids a particularly serious targeting problem. Many small businesses are operated in unincorporated form, and there is no reason why the SBDB legislation should not extend to these businesses that would otherwise qualify if incorporated. Even so, other aspects of the legislation can be criticized as being underinclusive.

As previously argued,[144] an assistance program provided to alleviate the income effects for employees of a failing business or perceived "congestion externalities" should be temporary. The same reasoning does not necessarily apply where the assistance is provided to a small business because of the positive externalities that it generates. So long as those externalities are apparent, the business might arguably be provided with assistance. However, the term of an SBDB bond and, therefore, the availability of the benefit of after-tax financing is arbitrarily restricted to a maximum of five years, presumably on the assumption that beyond that time any positive externalities generated by a small business in financial difficulty are no longer worth the cost. In this respect, it is unclear why the government has always enacted the SBDB legislation on a temporary basis, while the distress preferred share legislation has never been subject to a similar limitation. Both sets of legislation are spending programs for businesses in financial difficulty and should probably be treated similarly, at least insofar as the permanence of the spending programs is concerned. The frequent extensions of the effective dates for the SBDB legislation seem to acknowledge this basic similarity.

The requirement that the issue of an SBDB be made only to refinance outstanding debt may also be too narrow for small businesses that generate positive externalities. In effect, the SBDB legislation could be extended to provide a lower after-tax cost of financing for any small business that uses the issue proceeds in eligible activities, whether or not the business is in financial difficulty and the issue proceeds are used for refinancing purposes. Such an extension should be made only if a more effective definition of a small business based on size is applied and the eligible activities are restrictively defined to ensure that the presumed social benefits are actually generated by program recipients.

Delivery of Assistance

A well-designed spending program ensures that eligible recipients in similar circumstances receive the same benefit. This principle is similar to the tax principle of horizontal equity; it attempts to avoid the irrational provision of unequal benefits for equally deserving recipients defined in terms of the targeting criteria of a spending program. A well-designed spending program also ensures that the full amount of any assistance ultimately benefits only eligible recipients, and that the assistance is delivered at the lowest possible cost.

[144] Footnotes 113 through 124 and accompanying text, supra.

Equal Entitlement and Windfall Gains

The distress preferred share and SBDB legislation defines eligible recipients as all corporations or small business corporations that are in financial difficulty and carry on a business or active business in Canada. These eligible recipients are, by definition, considered to be in similar circumstances and should receive comparable amounts of assistance in the form of a lower cost of financing. However, the legislation may not realize this result because the amount of such benefit is solely a function of bargaining between an issuer and a lender willing to refinance outstanding debt in default.

Assume, for example, that corporations A and B have been in a loss position for a number of years and each have defaulted on an outstanding debt with an annual interest obligation of $100. Both corporations issue distress preferred shares in substitution for their debt. For various reasons, corporation A's financial prospects are somewhat better than corporation B's, which allows it to negotiate a $65 dividend obligation. Corporation B is able to negotiate a $70 obligation. Each corporation realizes a reduction in its after-tax cost of borrowing, but the reduction for corporation A is $5 more than for corporation B. Because the targeting criteria of the distress preferred share legislation define these two corporations as in essentially similar circumstances in terms of their eligibility, the amount of any assistance they receive should be equivalent.

Admittedly, a competitive financial market should minimize apparent inequities by ensuring that all issuers in financial difficulty with comparable risk characteristics are able to after-tax finance at comparable rates. This proposition assumes that an issuer in financial difficulty is free to refinance with any lender willing to offer the lowest after-tax rate and there is perfect information about all issuers. Even accepting these assumptions, the important point is that inappropriate differences in after-tax financing rates may still remain because of relative differences in creditworthiness and the liquidation value of a corporation. These differences are inappropriate because they are irrelevant criteria in the targeting of the distress preferred share and SBDB legislation. Moreover, they would not be relevant under an ideally targeted spending program designed to alleviate employment difficulties caused by the failure of a business or to capture the positive externalities generated by a small business in financial difficulty.

Another serious problem with the legislation is the windfall provided to taxable lenders who increase their after-tax return on the substitution of distress preferred shares or an SBDB for outstanding debt in default. This windfall results from the fact that the amount of any benefit provided under the legislation is solely a function of bargaining between an issuer and a lender willing to refinance debt in default.

Assume that a financial institution subject to a 40 percent tax rate has loaned money to a corporation and will earn an after-tax return of $60 on $100 of interest. The borrowing cost for the corporation subject to the same 40 percent tax rate is also $60 because of the $40 tax saving from the deduction of the $100 annual interest expense. By substituting distress preferred shares for outstanding debt in default the financial institution may receive a tax-free intercorporate dividend of $70. The corporate borrower is willing to accept this dividend rate because it is $30 less than the cost of the borrowing, which is now $100, since the borrower is in a non-tax-paying position and the interest deduction is worthless. In this case, the government forgoes $40 in tax that it would have collected on the interest income for the taxable lender. Three-quarters of this forgone tax ($30) goes to the borrower as a reduction in its after-tax cost of financing. One-quarter ($10) goes to the taxable lender as an increase in its after-tax return.

There is no sound policy reason to divert any portion of assistance available to a borrower in financial difficulty to a taxable lender. In fact, an assistance program comparable to the distress preferred share and SBDB legislation, but delivered in the form of a direct grant, would provide a borrower with a $40 cash payment that could be used to pay its interest obligations and reduce its cost of financing from $100 to $60. The taxable lender would continue to earn a $60 after-tax return on the interest, with the cost of the program being $24 for the government ($40 grant paid to the corporate borrower less $16 of tax on the grant received as interest by the taxable lender). The corporation in financial difficulty would thus receive the full $40 benefit of the assistance; there would be no windfall for the taxable lender; and the program would actually cost the government less. Such a direct grant might even be delivered as a refund of the tax losses of qualifying borrowers in financial difficulty.

As with perceived inequities in the amount of assistance, a competitive financial market should minimize the amount of any windfall gains. This result should occur as taxable lenders compete for the refinancing of a debt obligation with distress preferred shares or an SBDB in a way that ensures the lowest possible after-tax cost for an issuer. The cost should be determined by the lowest possible dividend rate that taxable lenders subject to the highest effective tax rate on interest income are willing to accept. However, some windfall gains will remain, if for no other reason than the enhanced risk premium that lenders will demand on a refinancing because of the financial difficulties of a borrower. The additional premium constitutes a windfall because any such premium that was part of the interest rate on debt in default was presumably adequate. Moreover, borrowers in financial difficulty will accept the provision of a higher after-tax return for lenders on distress preferred shares or SBDBs because the after-tax cost will remain lower than that on the refinanced debt. In effect, these borrowers are able to trade a worthless interest deduction to taxable lenders for a lower cost of financing with distress preferred shares or SBDBs. Any compensation received for that deduction is acceptable, even if a taxable lender is able to increase its after-tax return. A rational market will operate to provide this windfall for lenders because the government is the only party that bears any cost. The sole question is the amount of the gain determined in the bargaining process between borrowers and lenders.

Administrative Costs and Implementation Problems

Proponents of tax expenditures often argue that such provisions entail fewer administrative costs than direct spending programs. The delivery of a tax expenditure appears to require only the addition of a few lines on a tax return and perhaps some additional forms. As part of the self-assessment process, a taxpayer determines eligibility, which is verified or disallowed through the assessment and audit procedures. Using the existing tax administration appears to avoid the costly and meddlesome bureaucracy required to deliver a direct spending program.

This argument in favour of the use of tax expenditures has been rejected for two reasons.[145] First, the comparison of administrative costs is often made between a tax expenditure provision with minimal eligibility criteria and a much more restrictive direct spending program. Restrictive eligibility conditions necessarily entail increased administrative costs, as it becomes more difficult for those responsible for the delivery of the program to distinguish between eligible and ineligible claims. To compare adequately the administration of a tax expenditure provision and a direct spending program, the eligibility conditions must be comparable. In that case, nothing indicates a preference for direct spending over a tax expenditure, at least insofar as administrative costs are concerned. Second, a sizable portion of the costs of administering a tax expenditure provision are incurred by the private sector in fees for tax lawyers and accountants who assist taxpayers in determining their eligibility and submitting claims for assistance. These costs are often ignored when comparing a tax expenditure provision with a direct spending program where most of the administrative costs are borne by the government in the form of salaries and benefits for employees who fulfil a role similar to tax lawyers and accountants. When the costs incurred by the private sector are considered, the administrative costs of a tax expenditure provision may be roughly equivalent to, and even exceed, those of a comparable direct spending program.

The distress preferred share and SBDB legislation illustrates all of these arguments regarding administrative costs. A lender willing to accept an issue of distress preferred shares in exchange for a debt obligation in default will accept a reduced before-tax return on the assumption that the return will qualify as a tax-free intercorporate dividend. If the shares do not qualify as distress preferred shares, any dividends will be taxable, which will mean a reduced after-tax return. The lender will thus require some certainty that a proposed issue satisfies all of the statutory conditions for qualification as distress preferred shares. To that end, the lender ordinarily will demand that an issuer in financial difficulty obtain an advance income tax ruling as to the status of a proposed issue of preferred shares. For SBDBs, a borrower and lender must file a joint election claiming eligibility as an SBDB issue. The joint election procedure is acceptable for a

[145] See, for example, Brooks, supra footnote 4, at 502-3; and Neil Brooks, "Comment," in *Tax Expenditures and Government Policy*, supra footnote 14, at 324-29.

lender because the cost of an error in the determination of the status of a bond as an SBDB is borne by the issuer in the form of a tax penalty.[146] The lender remains entitled to tax-free dividend treatment.

These administrative procedures appear deceptively simple and cost effective. In the course of considering ruling requests, Revenue Canada has developed considerable expertise in interpreting and applying the conditions for an issue of distress preferred shares.[147] Moreover, Revenue Canada's administrative practices in this area are well-publicized and well-known.[148] The process has effectively become the counterpart of an efficient application procedure designed to implement a direct spending program. Similarly, the joint election procedure for SBDBs makes it easy to identify a claim for SBDB status on an audit of an issuer or lender. If inappropriate, the claim may be disallowed.

Despite appearances, the tax system offers no unique administrative advantages for the delivery of assistance to financially troubled businesses. A direct spending program with the same eligibility conditions as the distress preferred share and SBDB legislation could be administered by any government bureaucracy using either administrative procedure. For instance, government officials could review the applications for loan assistance of all corporations in financial difficulty other than small business corporations. The officials would approve an application only if it could be determined that the issuer is in financial difficulty and carries on a business in Canada. A small business corporation could file a declaration as to its financial circumstances and the nature of its income-earning activities. Assistance would be provided for all such applicants, with random reviews of a defined percentage of the applications.

These procedures should cost no more than the present administrative procedures for the distress preferred share and SBDB legislation. In fact, it might result in a net saving from a reduction in the amount of fees paid to tax professionals.[149] Any saving is difficult to estimate because lawyers and accountants would probably remain involved to some extent in advising potential applicants as to their eligibility. As well, a measure of the

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[146] Shortly after the introduction of the SBDB legislation, officials from the Department of Finance and Revenue Canada met with representatives of the Canadian Bankers' Association to clarify definitional problems regarding the financial difficulty condition and avoid the need to obtain advance rulings for SBDB issues. See Canada, *Senate Standing Committee on Banking, Trade and Commerce,* issue no. 113, supra footnote 112, at 113:25.

[147] Over a one-year period ending in 1992 Revenue Canada processed approximately 35 advance ruling requests for proposed issues of distress preferred shares. Favourable rulings were given in most instances. See Alan Freeman, "Distress Shares Option for O&Y," *The Globe and Mail*, April 1992.

[148] See footnote 2, supra.

[149] Because a qualifying issue of distress preferred shares or an SBDB takes the form of a refinancing, it entails legal costs necessary to ensure that the appropriate private law steps are implemented. A direct spending program in the form of an interest reimbursement would avoid these costs. For a description of the standard structure used for an issue of distress preferred shares, see the articles cited in footnote 2, supra.

costs borne in fees for professional advisers would be shifted to the public sector, with government officials probably taking a more active role in determining the eligibility of applicants. In any event, it seems clear that the administration of assistance for financially troubled businesses through the tax system offers no clear cost advantages.

An issue related to administrative costs is the question of the implementation of a tax expenditure versus a direct spending program. Opponents of tax expenditures commonly argue that a spending program should never be delivered through the tax system because it must be implemented by tax administrators.[150] This argument is not an attack on the competence of a tax administrator; rather, it is based on the simple point that tax administrators are trained to collect taxes; they are not trained to administer spending programs with various spending goals in areas with which they are unfamiliar. The unfamiliarity may lead to inappropriate decisions regarding the eligibility of certain potential recipients. The problem may be particularly serious where the tax system contains an inordinate number of tax expenditures covering several different subjects and spending goals.

This argument against the use of tax expenditures assumes a well-targeted, sophisticated spending program. Such a program would likely entail a number of detailed eligibility conditions and some administrative discretion. These features require expertise in the particular area to ensure that the conditions are properly applied, and eligible recipients are determined on the basis of the specialized goals of the program. This type of spending program should not be implemented by tax administrators unfamiliar with the relevant subject matter. However, a spending program that contains only a few, relatively simple conditions can be effectively implemented by tax administrators. The experience with the distress preferred share and SBDB legislation supports this assertion.

Revenue Canada officials (who, for the most part, are accountants) have all the technical skills necessary to determine whether a corporation is in financial difficulty. Their tax background also makes them familiar with the concept of a business and an active business and the requirements for status as a small business corporation. These fundamental conditions of the legislation have, therefore, been quite capably implemented. Nonetheless, the efficient implementation of a well-targeted assistance program for financially troubled businesses requires expertise in areas with which tax administrators are unfamiliar. As already argued,[151] such a program should be designed to alleviate the income loss for employees or "congestion externalities" resulting from the failure of a business. Alternatively, assistance may be provided to small businesses because of the positive externalities those businesses generate. In either case, the criteria relevant to the targeting of the assistance program would be more familiar to government officials responsible for employment policy, industrial strategy, and small business investment.

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[150] See, for example, Brooks, supra footnote 4, at 504-5 and supra footnote 145.

[151] Footnotes 113 through 124 and accompanying text, supra.

Tax expenditures have also been criticized on the basis of additional implementation problems that are said to result from the involvement of professional tax advisers in the delivery of a spending program through the tax system.[152] These costs can arise because of the aggressiveness and ingenuity of some advisers in devising arrangements designed to gain access to tax expenditure benefits for clients whose eligibility is questionable. A significant amount of time and expense may be necessary to ensure that such arrangements are unsuccessful. Although real, this problem may be somewhat overstated by opponents of tax expenditures. Some tax advisers are admittedly aggressive in their advice, but there is no reason to believe that some of the same difficulties would not be encountered with a direct spending program for financially troubled businesses.

The more important point is that any spending program delivered through the tax system tends to have minimal eligibility criteria.[153] This feature simplifies tax expenditures and makes them easier for tax administrators to implement. As well, the compliance burden for tax advisers and taxpayers is minimized. Yet, this simplicity has a cost. Tax expenditures are inevitably poorly targeted in order that they may be more easily implemented. A well-targeted spending program usually requires relatively technical and sophisticated eligibility criteria that necessitate a measure of expertise for adequate implementation. Consultation between tax administrators and other government officials with the necessary expertise can assist in the implementation of a sophisticated tax expenditure provision. However, this approach does little for the compliance burden of taxpayers. All else being equal (including administrative costs), there appears to be no sound policy reason to implement a spending program other than directly through the particular government department responsible for the subject matter of the program.

The distress preferred share and SBDB legislation is no exception to this proposition. Assistance for financially troubled businesses would be more effectively delivered through a program with detailed eligibility criteria familiar to government officials responsible for employment and industrial policy. These officials could take a more activist position than tax administrators in ensuring the eligibility of potential recipients, with the courts limited to a review of the procedural aspects of substantive decisions. At the very least, the minimal eligibility criteria of the distress preferred share and SBDB legislation should be improved in some of the ways already suggested.

Accountability and Cost Control

Ideally, governments should be held accountable for their spending and have some control over it. One of the more serious general problems with

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[152] See Brooks, supra footnote 4, at 504-5 and supra footnote 145.

[153] Ibid.

the use of tax expenditures remains a lack of political accountability.[154] Despite the release of tax expenditure accounts in Canada, tax expenditures continue to be a form of hidden spending with virtually no political accountability. The problem is attributable primarily to a failure to integrate tax expenditures with direct spending programs for budgetary purposes. Without this integration, it is impossible to acquire a sense of the overall spending in any particular area and set budgetary priorities appropriately.[155]

The distress preferred share and SBDB legislation is an excellent example of the accountability problem. The legislation is buried as an exception to an extremely complex set of technical provisions; it is, therefore, practically invisible as a spending program, particularly when compared with the high-profile bailouts of certain Canadian corporations undertaken in the last 15 years.[156]

The government has compounded the accountability problem by selectively drawing attention to the legislation. In particular, the SBDB legislation has been highlighted on several occasions in budget documents as a means of providing assistance for small businesses and heralded as one component of an overall financing package for this sector of the economy.[157] Estimates of the cost of the SBDB spending program have often accompanied these pronouncements.[158] In contrast, the distress preferred share

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[154] For a discussion of the use of financial incentives generally and the accountability problem, see Kernaghan Webb, "Thumbs, Fingers, and Pushing on String: Legal Accountability in the Use of Federal Financial Incentives" (1993), vol. 31, no. 3 *Alberta Law Review* 501-35.

[155] This problem was emphasized by the auditor general and the Ministerial Task Force on Program Review. See footnotes 24 through 26 and accompanying text, supra. See also Alex MacNevin, "Tax Incentives: Problems in Identification and Accountability" (1993), vol. 31, no. 3 *Alberta Law Review* 539-43.

[156] See, for example, Savoie, supra footnote 113; and Trebilock et al., ibid., vol 2.

[157] See Canada, Department of Finance, *Economic and Fiscal Statement* (Ottawa: the department, December 2, 1992), 6, and *Economic and Fiscal Statement: Additional Information* (Ottawa: the department, December 2, 1992), 15; Canada, Department of Finance, *The Budget 1992: Budget Papers*, February 25, 1992, at 160-61; and Canada, Department of Finance, Budget Papers, Supplementary Information and Notices of Ways and Means Motions on the Budget, May 23, 1985, 17-18. It is understood that neither the Department of Finance nor Revenue Canada maintains any formal statistics regarding the number of issuers who successfully avoid liquidation after an issue of distress preferred shares or an SBDB. The lack of any such statistics is curious in the light of the fact that some Department of Finance officials have stated that one measure of the success of the SBDB program might be the number of businesses that "subsequently did not go under." See Canada, *Senate Standing Committee on Banking, Trade and Commerce,* issue no. 113, supra footnote 112, at 113:24.

[158] In the December 1992 *Economic and Fiscal Statement*, supra footnote 157, at 15, the government estimated that extending the SBDB legislation would cost about $10 million per year in lost revenue. In the May 1985 budget, ibid., at 18, the government proudly stated that, from the time of the introduction of the SBDB legislation until 1985, nearly $700 million of small business bonds (SBDBs and qualifying bonds issued by partnerships and sole proprietorships) had been issued. Some 60 percent of these bonds were issued by farmers. For 1980, 1981, and 1982, the cost of the SBDB program was estimated to be $2

(The footnote is continued on the next page.)

provisions have rarely been mentioned. The only official recognition of the provisions as a tax expenditure is found in the 1979, 1980, and 1985 tax expenditure accounts, without a cost estimate. The government's obvious willingness to take responsibility for the SBDB legislation and avoid any scrutiny of the distress preferred share provisions is more than likely attributable to perceived political effects; it is simply much easier to find political support for assistance for small businesses.

Even if there were some formal attempt to maintain cost estimates and integrate the distress preferred share legislation more closely into the budgetary process, the legislation suffers from a fundamental flaw. There is no overall limitation on the program's cost, nor even a limitation on the amount of assistance that a particular corporation may receive. Any corporation in financial difficulty carrying on business in Canada qualifies for assistance, the amount of which depends on the difference between the interest obligation on outstanding debt and the dividend rate on distress preferred shares issued in substitution. Unlike the SBDB legislation, which limits the principal amount of an SBDB to $500,000, there is no limit on the amount for which distress preferred shares may be issued. The cost of the spending program to the government is thus potentially unlimited. For any particular issuer, it depends on the size of an issue and the tax revenue forgone on the substituted interest obligation.[159] The total cost of the spending program is also unlimited; it depends primarily on the number and size of the corporations that may encounter financial difficulty and qualify for assistance.[160]

In theory, governments can be held accountable for and may control tax expenditures as effectively as direct spending programs. This result has not been realized in Canada, however, either generally or specifically regarding the distress preferred share and SBDB legislation. To improve accountability and cost control, the legislation could be repealed and assistance for financially troubled businesses delivered as a direct spending program. The open-ended nature of the distress preferred share legislation is a particularly significant problem because of the amount of spending potentially at stake. Conversion to a direct spending program would force

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158 Continued . . .
million, $75 million, and $145 million, respectively. See *Account of the Cost of Selective Tax Measures* (1985), supra footnote 20, at 50. These estimates were based on the assumption that issuers would have sufficient taxable income in future taxation years to claim any available loss carryforwards. When the SBDB legislation was originally introduced, the government estimated that it would cost $70 million annually. See Canada, Department of Finance, Budget Papers, Notices of Ways and Means Motions and Supplementary Information on the Budget, December 1979, 60.

159 An estimate of the tax forgone on the substituted interest obligation should presumably be based on some assumption regarding the length of time that the relevant loan would have remained outstanding in the absence of any assistance.

160 Apparently, the Department of Finance does not maintain statistics on the cost of distress preferred shares. On an informal basis, Revenue Canada maintains a record of the size of favourable advance rulings given for proposed issues of distress preferred shares.

the government to consider directly whether financial assistance for financially troubled businesses has a budgetary priority sufficiently high that the amount of any assistance should be unlimited.

CONCLUSION

As an exception to the application of the preferred share rules, the distress preferred share legislation enables corporations in financial difficulty to issue preferred shares as a substitute for outstanding debt and realize a lower after-tax cost of financing. Similar treatment is extended under the SBDB legislation to the issue of conventional bonds by small business corporations in financial difficulty. Both pieces of legislation are exceptions to the normative corporate system in Canada and should be characterized as tax expenditures. Generally, the government has expressed a subsidy rationale for the legislation and accepted a tax expenditure characterization.

The application of tax expenditure analysis to the distress preferred share and SBDB legislation reveals five significant flaws. First, the government's expressed rationale for the legislation is unsound economically. Second, in terms of a more appropriate rationale, the legislation is poorly targeted, largely because it provides assistance to recipients who should not qualify. Third, these targeting problems could be corrected in several respects, but the range of necessary corrections would be severely constrained by the needs of the tax system for relatively simple eligibility criteria. Fourth, the legislation may not provide an equal amount of assistance to equally deserving recipients and provides an unjustified windfall to creditors of financially troubled businesses. Fifth, there has been little or no political accountability and control of the amount of spending under the legislation.

Each of these flaws could best be corrected by repealing the legislation and substituting a direct spending program. Such a program would provide grants, interest payment reimbursements, or loan guarantees to financially troubled businesses qualifying under a more rigorous set of criteria designed to reflect an appropriate economic rationale for the assistance.