# *Canadian Taxation of Personal Investment Income*

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## INTRODUCTION

This paper discusses the Canadian taxation of individual investment income in the form of interest, dividends, capital gains, and rents. The taxation of investment income has always been controversial and complex. Debates about how an income item such as capital gains should be taxed have been a constant feature of policy discussions, and the mobility and fungibility of capital have created challenges for both drafters and administrators of tax law. The major pressures rocking the taxation of investment income in Europe and the options opened up by the taming of the deficit problem at home may have set Canada at a threshold where the system that has evolved for the taxation of investment income, and the taxation of income from capital in general, will be questioned. It is thus an opportune time to review the direction that such taxation should or could be forced to take in the near future.

## BACKGROUND

The taxation of individual investment income in Canada to a large extent continues under the superstructure introduced in the 1972 tax reform, which was based on the concepts of a comprehensive income tax as espoused by the Royal Commission on Taxation in its 1966 report.[1] A comprehensive income tax calls for equal tax rates on labour and capital income. In this paper, we suggest, however, that the specific rules in the Income Tax Act for the taxation of interest, dividends, and capital gains have become largely irrelevant for a substantial portion of such income, which is now recognized in registered savings plans, under special rules such as the lifetime capital gains exemption, or in other ways that do not attract immediate taxation for individual Canadian-resident taxfilers. Discussions of individual investment income must therefore pay equal

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[1] Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) (herein referred to as "the Carter commission").

attention to the implications of the rules of the registered plans for tax purposes and other special tax treatments. In addition, one must consider the issue of investment in foreign jurisdictions by taxpayers using vehicles that may either avoid current tax in Canada or hide the income from tax authorities. In Europe, for example, we see that rapid growth in the use of foreign investment vehicles has led to dramatic changes and proposed changes in the taxation of investment income.

In this paper, we provide statistical information describing the relative importance of the various ways in which individual investment income is received. We discuss in detail the underlying nature of the taxation of personal investment income as it now occurs, and analyze the route and forces that have brought about this method of taxation. We also try to identify where the hybrid structure that currently exists may be imposing costs on the economy and where pressures for change may arise during the next few years. Although the taxation of business income per se is outside the scope of the paper, we touch upon it in a number of places, because one can fully analyze the current state of taxation of personal investment income only in the broader context of the taxation of capital income in general, including the income of unincorporated and incorporated businesses.

This discussion of the tax treatment of personal investment income in Canada comes at a time when major policy changes are under active discussion in some countries and have already occurred in others. We pay particular attention to the dual income tax system now being used in the Nordic countries, and the so-called hybrid approach, which incorporates a withholding tax on interest at source, along with the option for greater information exchanges among member countries in the European Union. Under the Nordic dual income tax system, investment income is taxed proportionally at the lowest marginal tax rate of 28 or 30 percent, while labour income is taxed progressively with top rates as high as 56 percent. In the European Union, there is a proposal to require each member country, including Luxembourg with its banking secrecy laws, to apply a withholding tax of at least 20 percent on interest income with its source in that country. The source country, not the residence country of the taxfiler, would retain the revenues from the withholding tax.

In general, these structural changes have come about in reaction to some startling forces that have rapidly eroded the ability of governments to tax investment income in a more conventional manner. For example, a recent newspaper story refers to reports from Germany's Bundesbank that show tax revenues on non-wage income in that country declining from $51.9 billion in 1992 to $14.5 billion in 1995.[2] By the second quarter of 1996, there was a negative figure of minus $2.5 billion, indicating that, for the first time, interest deductions exceeded the amount of non-wage income being reported.

[2] John Vinocur, "Subtlety of German Wealth Masks Inequalities," *The Globe and Mail*, 1998.

The approaches to the taxation of investment income briefly described above (and discussed in more detail later) essentially involve an acceptance that interest income and other investment income be taxed at lower tax rates than much of labour income, and in a proportional not a progressive fashion. They seem to answer questions that for some time have been raised in the academic literature under such titles as "Is There a Future for Capital Income Taxation?"[3] This paper seeks to analyze how two major issues, under discussion for some time in the public finance literature, are playing themselves out in the treatment of individual investment income in Canada. First, there has been increasing skepticism in Canada about the ability of the government to maintain progressive taxation of income from capital in the face of the globalization of capital markets, expanding electronic commerce, and tax havens that have banking secrecy laws. Specifically, it has been argued that the threat of capital flight and international tax competition will force the rates of taxation on capital income to the lowest common denominator. Second, the actual merit of taxing the return to savings has been questioned because of the effects of such taxation on growth and risk-taking, and even its fairness in the context of lifetime consumption and income patterns. In European countries, the former fear has been realized in recent years, while the latter argument has made more acceptable the option of low-rate, proportional taxation, if not the full adoption of consumption tax bases.

Canada's treatment of personal investment income has also changed fairly dramatically, but the means of change, with the exception of the lifetime capital gains exemption, have been less direct, and the rationale involved has been more complex.

It should be noted that all the comments and estimates in this paper are made for the case of federal income taxation only. Although the comments are equally applicable to provincial income taxes, these are ignored for the sake of simplicity of exposition.

## TAXATION OF PERSONAL INVESTMENT INCOME

### The Basic Rules

The discussion that follows deals with the taxation of personal investment income from capital in the form of interest, dividends, capital gains, and rental income (as defined for tax purposes). To analyze and discuss this taxation fully, we must also pay some attention to the tax treatment of business income, particularly that earned by corporations.

The Canadian income tax system is modelled on a comprehensive income tax approach, in which capital income, labour income, business income, and other income sources such as pension income are totalled to form income for individual tax purposes. The basic approach and the general

[3] Jack M. Mintz, "Is There a Future for Capital Income Taxation?" (1994), vol. 42, no. 6 *Canadian Tax Journal* 1469-1503. See also the discussion in Roger H. Gordon, "Taxation of Capital Versus Labor Income: An Overview" (mimeograph, March 3, 1996).

form of the structural rules relating to investment income date back to the 1972 tax reform. The roots of this structure can be traced to the comprehensive income tax as originally proposed by Haig and Simons and as strongly endorsed in Canada in the Carter commission report of 1966.[4] The rate structure applied to the taxable income base is progressive, and the individual income tax, when combined with social welfare spending, has been considered and portrayed as a key means of supporting distributional fairness. The current rate structure was adopted as part of the 1987 tax reform: the top marginal tax rate is lower and the degree of progression in rates is more gradual than in the preceding structure. The basic rate structure involves rates of 17, 26, and 29 percent. Personal income tax surtaxes have been used in the period since reform to raise additional tax revenues and to increase the degree of progressivity slightly.

Business income earned at the corporate level is brought into the mix by coordinating the structure of corporate income tax with that of the personal income tax. The basic steps in this coordination are as follows:

1) The top marginal tax rates for individual income tax and corporate income tax are closely harmonized. (There is no deferral advantage from earning portfolio investment income in an investment holding corporation.)

2) An integration mechanism recognizes corporate level taxes upon the distribution of dividends through the dividend gross-up and dividend tax credit mechanisms.

3) Refundable tax mechanisms are aimed at integrating capital income flowing through chains of corporations. The mechanisms are designed to prevent deferrals in line with point 1, above, while fitting into the integration mechanism of point 2.

4) Dividends and interest received from foreign sources are taxed as part of total income, with credits for foreign taxes paid, and rules that require accrual taxation of foreign source interest received on portfolio investments.

It must be noted, however, that for various reasons some deviations from a strictly comprehensive income tax structure have always existed. For the purposes of this paper, these key deviations include

• a low tax rate for small businesses at the corporate level ("small business income" is taxed at a rate significantly below the top personal marginal rate, providing a tax deferral for retentions in small business corporations);

• underintegration, for taxation purposes, of the remainder of the corporate income upon distribution (no dividend tax credit is offered for distributions made to foreign shareholders, and less-than-full recognition of corporate taxes paid is generally the case for distributions made to domestic shareholders);

[4] Carter commission report, supra footnote 1.

- inclusion rules for capital gains (only a portion of *realized* capital gains, currently 75 percent, is taxable); and
- special treatment of principal residences (no taxation is applicable for imputed rents or capital gains on dispositions).

The rationales for certain of these exceptions are touched upon in more detail later, but in general the low rate for small business and the special treatment of principal residences exist for well-known policy reasons. The underintegration of the remainder of corporate income reflects revenue considerations and, in particular, responds to concerns about the appropriate level of taxation for business income with its source in Canada and the residence of the shareholder in a foreign jurisdiction. The realization rule for capital gains reflects concerns about administration and liquidity problems that the taxation of such gains on an accrual basis would raise. Finally, the inclusion rate equalizes the tax rate on dividends and capital gains, and represents a tradeoff between comprehensive taxation and the issues of inflation effects and equity investment incentives.

Although these exceptions are important, the history of the basic rules since 1972 clearly underlines the benchmark role of the comprehensive income tax. Any deviations from the comprehensive income tax base have been catalogued as tax expenditures in the periodic reviews of tax incentives released by the Department of Finance. Whenever issues have arisen in the treatment of investment income because of institutional or market developments and changes in investor behaviour, efforts have been made to move the system back toward the comprehensive income tax base. When significantly greater use began to be made of compound interest bonds and other interest-bearing vehicles that delayed recognition of interest, the treatment of interest was changed, in stages, from a realization basis to an accrual basis. The recent budget has taken further steps to deal with deferrals and tax avoidance that have occurred in respect of passive investment income through the use of offshore investment funds and trusts. The comprehensive income tax base has also been a guide in the case of structural issues affecting investment income. The 1987 tax reform increased the capital gains inclusion rate from one-half to three-quarters of realized gains, and it eliminated a $1,000 investment income deduction, which had been in place to reflect the impact of inflation on interest and dividend income.

The specific rules affecting the taxation of investment income must deal with timing and accrual issues and, when relevant, as during the 1970s and 1980s, the implications of inflation on the measurement of investment income. As a consequence, this area is one of considerable complexity. This point may not be evident in the above overview. Nevertheless, the maintenance of a general equality between the tax treatment of investment income in its various forms and the tax treatment of labour and business income has meant that the system has been largely silent regarding the nature of a particular income flow. For example, owner-operators of small business corporations have had great leeway in determining whether to make distributions as wage and salary payments to themselves, or as dividend payments out of after-tax income. Of course,

in the pre-1972 tax system, in which capital gains were not taxable, the need to distinguish between surplus distributions as dividends and as capital gains resulted in great complexity and systematic failure.

The requirement to identify income by type has greatly complicated systems like the Nordic dual rate system, in which investment income and other types of income are treated unequally. The problems that can arise when such equality is lacking were very evident during the period of overintegration of income earned by small business corporations, when dividend payments largely replaced the payment of wages and salaries to owner-operators.

## Beyond the Basic Rules

Although the superstructure of the investment income rules described above seems to provide for a comprehensive income tax approach, with the attendant implications for income distribution, there are now further provisions and types of taxpayer behaviour that, where they apply, override the basic investment income rules and may lead to non-taxation or lengthy deferrals for personal investment income. Most important among these are the various registered plans, the lifetime capital gains exemption, offshore investment vehicles, and taxpayer non-compliance. This section discusses the nature of these provisions and behaviours, and the following section takes an empirical look at which treatments predominate.

For purposes of the later discussion, it is useful to note how the tax treatment of each of the provisions and behaviours under discussion compares with the tax treatment that would be accorded under a pure consumption tax base. The rationale for this is that a significant portion of investment income for the benefit of individuals is now treated as it would be treated under a consumption tax base rather than an income tax base. Therefore, in analyzing and discussing the treatment of such income, a consumption tax base becomes the relevant benchmark.

A consumption tax treatment can effectively be grafted onto an income tax system in two ways that are of interest here. First, if a tax deduction is allowed for new savings out of otherwise taxable income, the investment income being then allowed to accrue without being taxed, and the total accumulation being taxed when consumed, then the tax treatment accords with a consumption tax base. (This is referred to below as type 1.) Second, if income is taxed as it is earned, and any income from the after-tax funds invested is allowed to accumulate tax-free with no further tax at the time of consumption, this is also equivalent to a consumption tax base (referred to below as type 2). Although at a conceptual level both of these treatments yield identical results under an annual income tax system with proportional tax rates, differences can emerge under a progressive rate structure, because the tax rate at the time of consumption is the relevant rate in the former case, while the tax rate at the time of savings is relevant in the latter. Such factors as cash-flow effects (the tax is prepaid under the type 2 approach) and the implications of bequests can also introduce significant differences in the impact of the two approaches.

Once a consumption tax base is applicable, any further tax concessions begin to erode the taxation of income giving rise to savings. At the extreme, this amounts to a "double dip," which combines both the type 1 and type 2 systems, giving rise, from a consumption tax perspective, to a negative tax on investment income. From an income tax perspective, it provides a zero tax rate for the earned income that produced the savings (tax deductible contributions), no tax on the investment income (in the plan or at withdrawal), and no tax on the withdrawal of the original savings. It thus amounts to a zero income tax rate for earned income used for savings, and a zero tax rate for the associated investment income. Below, we identify some situations in which this double dip treatment arises.

For clarity of exposition, the discussion in the remainder of this article implicitly assumes that the comparisons used are between a progressive income tax and a progressive consumption tax with the same rate structure. No attempt is made to consider the adjustments that would be needed to arrive at an equal-yield tax.

The registered plans discussed include the retirement tax assistance delivered as registered pension plans (RPPs), registered retirement savings plans (RRSPs), deferred profit sharing plans (DPSPs), registered retirement income funds (RRIFs), and two other plans, labour sponsored venture capital corporations (LSVCCs) and registered education savings plans (RESPs). The treatment of the investment income earned from certain life insurance reserves can also yield results similar to those for the registered plans.

The two most important registered plans, in terms of their impact upon the income tax system, are the RPPs and the RRSPs. Investment income within RPPs and RRSPs is not subject to tax, and the initial contributions are tax-deductible. Withdrawals are included within income for tax purposes at the time of withdrawal. Therefore, both RPPs and RRSPs effectively provide for consumption tax treatment of the type 1 form. To determine the contribution limit, only labour income and unincorporated business income are eligible. One can fully shelter savings of up to 18 percent of these types of income within the plans. Higher levels of saving and savings out of otherwise taxable investment income cannot be sheltered within the plans.

DPSPs allow only for employer contributions, but in other respects are equivalent to RPPs. In both cases, if it is assumed that the employer contributions would otherwise be payable to employees as labour income, the plans are equivalent in their basic characteristics to RRSPs. RRIFs are essentially continuations of RRSPs, but with no additional contributions allowed and with a minimum required annual payout. If the payouts are not consumed but are instead reinvested, the treatment of the savings reverts to an income tax treatment.

RESPs do not provide for a tax deduction for contributions, but the investment income in such plans does accumulate tax-free. Withdrawals of contributions are not taxable. RESP investment income is taxable in the hands of the student or beneficiary when it is distributed. In most cases,

the student will have little additional income. As a result, the RESP would be effectively tax-exempt up to the personal exemption amount of the student (currently $7,000 or more, allowing for the benefits of the tuition and education credits). Therefore, there is no tax on investment income, since contributions can effectively be withdrawn tax-free by the beneficiary. The basic RESP treatment is equivalent to that under a consumption tax (type 2). The result is essentially provided by income splitting through the transfer of the investment income from a tax-paying contributor to a non-tax-paying beneficiary.

An additional feature of RESPs, however, means that the system generally provides a negative tax result vis-à-vis a consumption tax base. Starting in 1998, contributions to RESPs became eligible for a 20 percent educational savings grant in the form of a government contribution to such plans. If contributions are made out of income that has been taxed at the lowest federal marginal tax rate of 17 percent, the 83 cents available after tax for the contribution is grossed up by 17 cents (20 percent of 83 cents) within the plan. This effectively reduces the tax rate on the underlying income to zero. Since the full dollar of pre-tax income reaches the plan, and investment income is accumulated tax-free, the grant also provides consumption tax treatment (type 1). When coupled with the type 2 consumption tax treatment provided by tax-free withdrawal, as described in the previous paragraph, this tax treatment is an example of a situation in which adding another feature to what is already a consumption tax result leads to zero taxation of the income from which the savings occur. Taxing the income supporting the contributions at more than the lowest marginal rate does not lead to an effective zero income tax rate, but it does lead to an effective tax rate that falls well below the statutory rate.

The form of LSVCCs as related to a consumption tax base is somewhat more complicated than under the other plans. LSVCCs provide a federal tax credit of 15 percent of the net cost of the shares in such plans. The tax credit provides for close to full sheltering of savings for contributions out of income that would otherwise be taxed at the lowest marginal tax rate, and partial sheltering of the income directed to such savings that would otherwise be subject to higher marginal tax rates. Income generated in the plans is not subject to taxation. When the shares are disposed of, the investor receives capital gains tax treatment on the excess of the sale price over the cost base if the cost base is not reduced by the value of the credit. Therefore, the treatment of the savings directed to these plans depends upon the tax position of the contributor, but approximates consumption tax treatment.

The LSVCC and RRSP contributions can be combined. In fact, most of the LSVCC contributions flow through an RRSP, where the RRSP in itself provides consumption tax treatment. As a result, the federal and provincial tax credits in respect of LSVCC contributions have the effect of reducing the tax on investment income or the tax on capital to a negative value, just as in the case of RESP contributions eligible for the 20 percent federal grant.

Certain life insurance policies also provide beneficial treatment of investment income. The exempt life policies (generally, policies other than term or universal policies) lead to a deferral of tax when the benefits are paid before death. However, many of these policies pay benefits only upon death, in which case all the investment income is exempt from tax as a death benefit. These policies thus effectively receive consumption tax treatment (type 2).

Substantial amounts of savings can achieve consumption tax treatment (or better treatment) through the maximum use of these plans. RRSPs allow sheltering of 18 percent of earned income up to an annual maximum, currently set at $13,500. Unused contribution room can be carried over and used in subsequent years, giving considerable flexibility in the timing of savings. RPPs and DPSPs are integrated with RRSPs in respect of the annual contribution limits. RESPs allow annual contributions of $4,000 up to a lifetime total of $42,000. LSVCCs allow annual contributions of up to $5,000. Individuals in a position to take full advantage of these plans can thus obtain consumption tax treatment on annual amounts of up to $22,500, plus any such treatment gained by contributions to exempt life insurance policies.

Another major structural exception to comprehensive income tax treatment is found in the capital gains exemption. A $500,000 exemption (that is, $375,000 of taxable capital gains) is now available on qualified small business shares and eligible farm property. From 1985 to 1994, a general lifetime capital gains exemption was available for up to $100,000 of capital gains. The current capital gains exemption available to a taxpayer is net of any amount that was claimed earlier, including under the general exemption.

If the source of the capital gain is eligible capital property, such as farmland held directly by an individual, the non-taxation of the gain, coupled with the fact that there has been no accrual taxation, provides tax treatment equivalent to a consumption base (type 2). If the source of the capital gain is shares in an eligible farm or small business corporation, the nature of the tax treatment depends upon the underlying source of the gain. If the source of the gain is related to an unrealized appreciation on real property or on another capital property held by the corporation that is capitalized in the value of the share, the treatment is the same as that for real or capital property held directly and taxation occurs as under a consumption tax base (type 2). But if the share gain is the result of retained earnings that have been subjected to corporate taxation, the situation is different. If the income that gives rise to the retained earnings was taxed at the full corporate tax rate (roughly equal to the top marginal rate), the capital gains exemption merely prevents any element of double taxation under the combined effect of the corporate and personal income tax. If the income was taxed instead at the low small business tax rate, the exemption does not provide full consumption tax treatment, but the capital income involved is taxed at a preferential income tax rate.

An issue of considerable interest recently has been the use of offshore investment vehicles to eliminate or at least substantially defer the taxation

of personal investment income. Assuming that the income invested in the offshore vehicle is out of taxed income, the avoidance of tax on subsequent investment income results in a type 2 consumption tax base. A popular approach to this type of result has been through the use of offshore discretionary trusts. Constantine Kyres comments on the role and basic enabling feature of these trusts in the *Canadian Tax Journal*:

> Offshore discretionary trusts resident in tax-free havens are commonly used for deferring or even eliminating income tax and capital gains tax on income and capital gains received and realized by the offshore trustee. For the most part, offshore trusts have been used to defer, reduce, or eliminate tax on investment types of income [but in some cases can be used in respect of business income]. . . . While assets remain in the offshore trust, and no distributions are made to Canadian-resident beneficiaries, current taxation of the beneficiary group cannot occur in the absence of specific legislation. Although such legislation exists in Canada in the form of sections 94 and 94.1 of the Income Tax Act, . . . these provisions are not exhaustive."[5]

In contrast to the legislatively provided consumption tax base seen for registered plans, the policy direction for offshore investment vehicles has been to attempt to limit the circumstances in which such vehicles can be used to avoid tax. Exhaustive provisions have been suggested most recently in the 1999 federal budget. Another step proposed in the 1997 budget, aimed at understanding offshore holdings better, is to require informational reporting whenever the value of foreign assets held exceeds $100,000. Significant opposition delayed this measure, but it has been implemented following recommendations by the auditor general.

One legislative provision allows for the non-taxation of capital income for immigrants to Canada, for whom non-resident trusts can be established in tax-free jurisdictions. If such trusts are properly structured, Canada allows for a five-year exemption from taxation under section 94 of the Act. Such individuals are thus effectively taxed on a consumption tax basis (type 2) for their first five years of residence in Canada in respect of investment assets held at the time of immigration.

A major component of the capital assets held by most individuals is their principal residence. None of the imputed rent received as a result of owner-occupied tenancy nor any of the capital gains that arise in respect of principal residences are subject to any tax. Capital income arising from this important asset is thus treated on a consumption tax base (type 2).

Finally, an extremely important issue in many countries is tax evasion through the non-reporting of investment income, which results in taxation of such income on a consumption base. Assuming that the assets involved in such evasion practices are purchased out of tax-paid income, the evasion of tax on personal investment income results in a type 2 consumption tax base. The recent European experience with this issue is discussed later on

[5] Constantine A. Kyres, "The Use of Non-Resident Trusts for Estate Planning and Asset Protection" (1995), vol. 43, no. 2 *Canadian Tax Journal* 314-46, at 318.

in this paper. Although such non-reporting has never been considered quite as seriously in Canada, it clearly does have an impact on the overall taxation of personal investment income. The tax evasion can take the form of non-reporting of investment income from Canadian sources as well as the failure to report investment income on offshore assets. It is the latter type of evasion that is of critical importance in the European context.

## HOW MUCH PERSONAL INVESTMENT INCOME IS TAXED?

The above catalogue of provisions and behaviours that may lead to the non-taxation of personal investment income and thus, effectively, to the existence of a consumption tax base for such income within the individual income tax shows how important this consideration is in understanding and analyzing the current treatment of such investment income. This section provides some empirical information on the issue.

Table 1 provides information from the 1996 Canadian individual income tax returns on income aggregated by broad types: labour income, investment income (interest, dividends, capital gains, and rents), business income, retirement income, and other income. The values in the table are only for those returns with taxes payable, since the analysis at this point focuses on how much investment income is subject to taxation, leaving aside the effect of the basic income exemption.

The table shows that investment income represents 7.8 percent of the total income assessed. Labour income is the dominant source of income for tax purposes, representing 70.7 percent of the total. Unincorporated business income, which can be considered a mix of return to capital and imputed labour income for owner-operators, is 5.3 percent of the total. Rental income has been included with investment income because it is largely a return to capital, but it could also be included as part of business income. The final column indicates the proportion of the income type as reported on taxable returns relative to such income for all taxfilers. In the case of investment income, 92.8 percent of such income is reported on returns where tax is payable.

Table 2 indicates the amount of federal tax payable that can be associated with each of these broad types of income. The calculations used aggregate data and thus depend upon a certain set of assumptions as to the appropriate tax rate to be used and the allocation of deductions and non-refundable tax credits by type of income. In general, the deductions and the credits were allocated on a proportional basis by type of income assessed across those types of income for which the deduction or credit would be relevant. The amount of federal tax associated with a particular income type was determined by applying the average tax rate to the taxable income determined under this approach, and then deducting credits allocated to the income type. An average tax rate was used, since the intention was to determine the contribution of each of the income types to the current tax revenues. The tax rate used in the calculations is thus less than the marginal tax rates typically used in calculating the revenue effects

**Table 1 Amounts of Income by Type, Reported for Personal Income Tax Purposes, Taxable Returns, 1996 Taxation Year**

| Income type | Total income assessed, $000 | Percent of total income | Percent of income type on taxable returns relative to income type on all returns |
|---|---|---|---|
| Labour income | 357,294,810 | 70.7 | 97.2 |
| Investment income[a] | 39,335,850 | 7.8 | 92.8 |
| Business income | 26,773,993 | 5.3 | 97.9 |
| Retirement income | 59,364,851 | 11.8 | 83.2 |
| Other income | 22,306,490 | 4.4 | 55.2 |
| Total | 505,075,994 | 100.0 | |

[a] Interest, dividends, capital gains, and rents.

Source: Revenue Canada, Individual Taxation Statistics, 1996.

**Table 2 Federal Income Tax Payable by Major Income Type, 1996 Taxation Year**

| Income type | Total income assessed | Federal tax payable |
|---|---|---|
| | *$000* | |
| Labour income | 357,294,810 | 48,527,973 |
| Investment income[a] | 39,335,850 | 4,289,584 |
| Business income | 26,773,993 | 3,726,987 |
| Retirement income | 59,364,851 | 8,344,558 |
| Other income | 22,306,490 | 3,615,966 |
| Total | 505,075,994 | 68,505,069 |

[a] Interest, dividends, capital gains, and rents.

Source: Calculations by the authors.

of tax changes and the value of tax expenditures, or the tax rates individuals would use in making investment decisions.

According to these calculations, tax on investment income contributed $4.2 billion in revenues toward a total of individual federal income tax revenues of $68.5 billion in 1996. Therefore, measured at average tax rates, individual income tax on investment income represents 6.1 percent of the total revenues collected.

For most analytical purposes and for personal investment decisions, the relevant tax rate is the marginal tax rate. Income for taxation at the marginal tax rate is calculated taking into account only the dividend tax credit and the lifetime capital gains exemption. Using this method, federal income tax on investment income at the margin is estimated to be $8.2 billion.

Table 3 looks at the contribution of each of the investment income types to the $4.2 billion federal tax payable. It shows that the amount of tax collected on dividends is some $217 million. The relatively low value of tax collected relative to the $9.7 billion reported taxable dividends reflects the impact of the dividend tax credit and, to a lesser degree,

**Table 3 Federal Income Tax Payable by Type of Investment Income, 1996 Taxation Year**

| Type of income | Total income assessed | Federal tax payable |
|---|---|---|
| | *$000* | |
| Taxable amount of dividends | 9,669,628 | 217,275 |
| Interest | 19,121,605 | 2,977,261 |
| Net rental income | 1,229,090 | 191,371 |
| Taxable capital gains | 9,315,527 | 903,677 |
| Total | 39,335,850 | 4,289,584 |

Source: Calculations by the authors.

offsetting interest deductions. The primary source of federal tax on investment income is the $3 billion of tax collected on interest (including all investment income from foreign sources). Some $191 million of federal tax payable was collected on net rental income. Finally, some $904 million of tax was collected on taxable capital gains. It can be noted that the effective tax rate on this type of income is relatively low, although not as low as the tax rate on dividends. The lifetime capital gains exemption is the key consideration. Also, the amount of capital gains realized is very sensitive to stock market performance and trends in real estate markets. Thus there can be considerable year-to-year variability in the size of capital gains reported.

It is also interesting to look at the concentration of the investment income types by income and age. Table 4 indicates the amount of the various types of investment income for taxfilers with incomes in excess of $100,000 and shows the proportion that each represents of the total amounts of the various investment incomes. Individuals with assessed incomes over $100,000 represent 2.4 percent of total taxfilers, but report 13.5 percent of the total income. In contrast, such taxfilers report more than one-half of taxable dividends and some two-thirds of taxable capital gains. As would commonly be expected, these types of investment income are strongly associated with higher incomes, and thus the concern about the implications of their tax treatment for distributional purposes, which is noted later, is understandable. In contrast, their share of interest income, at 17.5 percent, is only slightly higher than their overall share of total income assessed, 13.5 percent. This result is likely due to the fact that interest-earning assets tend to form a smaller percentage of the portfolios of individuals with incomes over $100,000; it may also be that such individuals tend to make more use of the provisions and planning described in the previous section to reduce the tax that would otherwise be payable on interest.

Table 5 looks at the same comparisons as table 4, but this time for taxfilers that are aged 55 and over, and thus either retirees or individuals approaching retirement. As might be expected, investment income is relatively more important for this group of taxpayers than for younger ones. Taxpayers 55 years of age and over account for about a quarter of the

**Table 4 Investment Income by Type for Taxfilers with Incomes in Excess of $100,000, 1996 Taxation Year**

| Type of income | Total assessed | For incomes over $100,000 | Proportion |
|---|---|---|---|
| | *$000* | | *percent* |
| Taxable amount of dividends | 9,669,628 | 4,999,268 | 51.7 |
| Interest income | 19,121,605 | 3,351,472 | 17.5 |
| Net rental income | 1,229,090 | 471,151 | 38.3 |
| Taxable capital gains | 9,315,527 | 6,192,911 | 66.5 |
| Total | 39,335,850 | 15,014,802 | 38.2 |
| Total income assessed | 505,075,995 | 68,381,253 | 13.5 |
| | *number* | | |
| Number of taxable returns | 14,172,530 | 334,900 | 2.4 |

Source: Revenue Canada, Individual Taxation Statistics, 1996.

**Table 5 Investment Income by Type for Taxfilers Aged 55 Years and Older, 1996 Taxation Year**

| Type of income | Total assessed | Taxfilers aged 55 years and older | Proportion of total |
|---|---|---|---|
| | *$000* | | *percent* |
| Taxable amount of dividends | 9,669,628 | 5,091,856 | 52.7 |
| Interest income | 19,121,605 | 14,195,620 | 74.2 |
| Net rental income | 1,229,090 | 1,267,950 | 103.2 |
| Taxable capital gains | 9,315,527 | 4,637,657 | 49.8 |
| Total income assessed | 505,075,995 | 130,805,200 | 25.9 |
| | *number* | | |
| Number of taxable returns | 14,172,530 | 3,674,570 | 25.9 |

Source: Revenue Canada, Individual Taxation Statistics, 1996.

returns and report about a quarter of the total income. But they report approximately half of the dividends and of the capital gains, three-quarters of the interest income, and all of the positive rental income. (The fact that their share of rental income exceeds 100 percent means that rental losses exceed rental income for taxpayers below age 55.) The tax treatment of investment income is thus obviously of particular importance to older taxpayers.

The tables above show how much personal investment income is taxed under the current system and the revenue to which it gives rise. We may now examine how much personal investment income escapes taxation. To do this, we must indicate how much investment income accruing to or realized by individual residents of Canada does not now bear income tax because of the tax provisions or the taxpayer behaviour described earlier.

In this paper we do not attempt to develop independent estimates of the amounts of investment income effectively receiving consumption tax treatment or better. We simply note estimates made elsewhere or adjust such estimates to make them consistent with the methodology used to compute the revenue from investment income under the current system presented above. In some cases, no estimates are available in respect of the amount of investment income realizable in a non-taxable manner. For example, there appear to be no reliable estimates available for the amount of investment income of Canadian residents received or accrued tax-free in non-resident trusts. Therefore, we cannot accurately determine the overall value of personal investment income that is not subject to income tax (and that can be considered to be taxable on a consumption tax base). Fairly reliable estimates are, however, available in respect of some of the major categories of such income.

Table 6 lists the provisions and behaviours that have been identified as providing consumption tax treatment or better and, where possible, attaches a value for the tax that would be assessed if the income in question were taxed at the applicable marginal tax rate. Where possible, the value shown is the latest tax expenditure estimate released by the Department of Finance, using its projection for 1996.[6] In the case of non-reporting of investment income, the estimate provided uses the extent of non-reporting of such income as estimated by the US Internal Revenue Service, in its periodic analyses of unreported income. It should be noted that the estimates shown are subject to a large error of estimate, with the value for the imputed rent on owner-occupied housing being particularly subject to uncertainty. The estimates are adequate, however, for the broad purpose for which they are being used here. No estimates are provided for the smaller registered plans or for offshore investment income held in trusts or foreign-based investment funds.

The amount of tax collected in 1996 at the individual level on personal investment income that is taxed was derived above as $8.2 billion. The total of the tax expenditure values shown in the table amounts to some $25 billion. This suggests that only about a quarter of personal investment income is subject to income tax. The other three-quarters receives what is generally equivalent to consumption tax treatment. Since this estimate excludes certain other incomes that receive consumption tax treatment, the estimate of three-quarters of such income receiving such tax treatment may actually be a lower bound.

The investment income being earned on funds set aside for retirement purposes and the investment income associated with principal residences are clearly the major forms of individual investment income. The special

[6] Canada, Department of Finance, *Government of Canada Tax Expenditures 1998* (Ottawa: the department, 1998). See also Ernst & Young unpublished internal studies, "The Wealth Report: The Wealth of Canadian Households, 1990"; "The Canadian High Net Worth Market: 1997"; and "The Retirement Savings Plan Market: 1997."

**Table 6 Federal Tax Payable on Investments Receiving Consumption Tax Treatment If Subject to Income Tax Treatment, 1996**

| Tax provision or taxpayer behaviour | Federal tax payable if income tax applied |
|---|---|
| | *$ millions* |
| Investment income, non-taxable | |
| RPPs | 9,455 |
| RRSPs | 3,885 |
| DPSPs | na |
| RRIFs | na |
| RESPs | na |
| LSVCCs | na |
| Investment income on life insurance policies | na |
| Lifetime capital gains exemption | |
| Small business | 475 |
| Farm property | 320 |
| Imputed rent on owner-occupied residences | 7,500 |
| Non-taxation of capital gains—principal residences | 1,245 |
| Offshore investment income—trusts and foreign-based investment funds | na |
| Non-reporting—domestic and offshore investment | 2,100 |
| Total (exclusive of na's) | 24,980 |

na not applicable.

Source: Canada, Department of Finance, *Government of Canada Tax Expenditures 1998* (Ottawa: the department, 1998); and authors' calculations.

treatment accorded to these investments would in itself provide consumption tax treatment on all but relatively small, liquid precautionary and transaction-purpose assets for a large number of individuals.

A similar conclusion can be arrived at by looking at personal asset holdings and noting the tax treatment involved. Such an analysis also provides a basis for some important observations about the taxation of personal investment assets. Table 7 summarizes the major components of the wealth of Canadian households. In the table, liquid assets include only those assets that can be readily cashed and spent immediately or reinvested elsewhere. The non-liquid assets are those that can be converted into cash, but their sale deprives the individual of the use of the asset (for example, personal residences and consumer durables) or of a source of livelihood (such as farms or private businesses), or they are assets that are cashable only under stringent conditions (such as pension plans). It should be noted that assets held in RRSPs and RRIFs amounted to some $130 billion in 1989. These are included in the asset group according to how they were held. The $130 billion of such registered assets are thus distributed as part of the $705 billion in liquid assets. The table excludes some assets, such as RESPs and offshore personal investments, for which there is no reliable information.

**Table 7 The Components of Household Wealth, December 31, 1989**

| | Total value | Percent of total |
|---|---|---|
| | *$ billions* | |
| Liquid assets | | |
| Personal deposits | 346.2 | 12.4 |
| Stocks | 185.0 | 6.6 |
| Bonds and marketable securities | 122.6 | 4.4 |
| Mutual funds | 38.0 | 1.4 |
| Foreign currency and deposits | 11.4 | 0.4 |
| Cash | 1.9 | 0.1 |
| Total liquid assets | 705.1 | 25.3 |
| Non-liquid assets | | |
| Personal residences | 958.7 | 34.5 |
| Investment real estate | 146.6 | 5.3 |
| Vacation homes | 36.5 | 1.3 |
| Farms | 69.4 | 2.5 |
| Private businesses | 297.9 | 10.7 |
| Pension plans | 311.5 | 11.2 |
| Life insurance (cash value) | 11.3 | 0.4 |
| Automobiles | 69.9 | 2.5 |
| Collectibles and jewelry | 23.0 | 0.8 |
| Precious metals | 2.0 | 0.1 |
| Household furnishings | 151.1 | 5.4 |
| Total non-liquid assets | 2,077.7 | 74.7 |
| Total household assets | 2,782.8 | 100.0 |
| Liabilities | | |
| Mortgages | 212.2 | 69.5 |
| Personal debt | 93.3 | 30.5 |
| Total liabilities | 305.5 | 100.0 |

Source: Ernst & Young, "The Wealth Report: The Wealth of Canadian Households, 1990," unpublished internal studies.

The assets shown in the table can be grouped under four headings, depending on their tax treatment: those subject to consumption tax treatment (55.2 percent), those subject to income tax treatment (28.1 percent), those taxed as business income (14.3 percent), and those treated as listed personal property for which gains may be taxable when realized (2.4 percent). Ignoring those assets that give rise to business income, roughly one-third of personal investment assets give rise to income that is taxable under the income tax.

For many reasons, however, we believe that the two-thirds value given for the proportion of personal investment assets not giving rise to taxable income, as based upon the 1989 values presented, is an underestimate. First, the personal investment assets that are excluded from the table are largely ones that are not subject to tax.[7] The table does not include offshore

[7] In "The Wealth Report," supra footnote 6, Ernst & Young provides a detailed list and discussion of the assets not included in the table.

investments, for example, which would be a significant addition to the category of personal investment assets not giving rise to taxable income. Second, the trend from 1989 to 1996 and beyond has indicated much more rapid growth for assets in registered plans than for assets in total. The liquid asset category grew at an annual compounded rate of 6.5 percent from 1989 to 1996, while assets held in RRSPs and RRIFs grew at an annual compounded rate of 16.6 percent. Therefore, the proportion of investment assets not subject to income tax because of being held in registered plans has risen continuously. Third, the estimate of the proportion of investment assets giving rise to investment income based on the form of assets held does not take into account tax factors, such as the lifetime capital gains exemption or the dividend tax credit, that eliminate or reduce the tax with respect to certain asset types. If all such factors could be assessed, the proportion of assets giving rise to income taxed on an income base as estimated by the tax treatment of the different asset types could be expected to approach the three-quarters estimate derived earlier using tax numbers.

Two important observations arise from the type of assets that are taxable under the income tax. First, except for investment real estate, all the assets that are taxed under an income tax approach are liquid assets. These assets are therefore truly of the most mobile form and can thus be considered to be most subject to incentives for capital flight. Second, these assets tend to be ones that, in economic terms, can be considered to arise from savings decisions that are at the margin; similarly, in a portfolio sense, the allocation of the assets can also be considered to be at the margin. The decisions are marginal ones in the sense that individuals with savings beyond transactional and precautionary purposes held outside of registered plans will tend to have already accumulated equity in a personal residence. This implies that, although the average tax rate on personal investment income tends to be relatively low, at the margin the tax rate approaches the top marginal tax rate and thus may impinge significantly upon savings and portfolio investment decisions.

While the above discussion indicates that only something on the order of one-quarter of individual investment income of Canadian residents is subject to taxation, it does not mean that the returns to capital largely escape taxation in Canada. When we turn to the other source of taxation of income from capital, the corporate income tax, we see a different picture.[8] The 1999 budget estimated the federal corporate income tax revenues to be $22.0 billion for 1998-99, reflecting the quite striking increase in the level of corporate tax revenues in recent years. Corporate income tax revenues in 1997-98 were 14.8 percent of total budgetary revenues. This represents a sharp rise from levels prevalent in the mid-1980s. In the intervening years, corporate income tax revenues had declined in relative importance as a revenue source (because of the recession of

[8] Provincial and local taxes on capital are also not being considered in this discussion.

the early 1990s and the transition phase of tax reform in the later years of the 1980s). It should be noted that the strength of the corporate income tax as a revenue source in the last few years cannot be explained by profit growth alone. Corporate tax revenues increased some 140 percent between 1984-1986 (the period leading up to tax reform) and 1997-1999. By comparison, between 1986 and 1997, corporate profits on a national accounts basis increased by only 70 percent.

## COMPARISON OF THE CANADIAN SYSTEM WITH BASIC TAX MODELS

In the introduction, we commented that a major decision concerning tax regimes that depend upon the use of a number of tax bases is what actual mix of tax bases should be used. As we indicated in the subsequent discussion, a substantial portion of personal investment income that is subject to income tax rules is, in fact, treated in a manner that is equivalent to a consumption tax base. Also, the corporate income tax has been revived as a major revenue source. As background to the discussion of the advantages and disadvantages of the present system, and the potential future directions that could be taken, it is useful to locate the Canadian system as it actually exists relative to purely conceptual models of income and consumption taxes.

There are two models of income tax: the classical and the comprehensive (with integration). While both share a comprehensive definition of the income base, the classical model applies separate layers of tax on income at the corporate level and on distributions to individual shareholders. The classical income tax thus violates the fundamental objective in a pure comprehensive income tax of taxing labour and capital income equally. In the comprehensive income tax model (with integration), an imputation system provides for recognition of corporate taxes already paid when corporate distributions are made.

The academic literature recognizes various ways in which a consumption tax base can be instituted through achieving the key property of consumption-based taxes: the exclusion from tax of either savings (a type 1 consumption tax base) or the return from savings (a type 2 consumption tax base). Under ideal conditions, all the approaches we describe can achieve these equivalent results.[9] A consumption tax can take the form of either an indirect sales tax, such as a value-added tax (VAT) or a retail sales tax, or it can take the form of a direct tax on income net of savings. This discussion considers several variants of the direct tax on income net of savings, each with its roots in a subtraction-method cash-flow tax at the corporate level. One can also arrive at a consumption tax through an

[9] In practice, however, each of the potential approaches gives rise to some serious and, in some cases, insurmountable implementation problems. For example, no practical method has yet been implemented under any consumption tax system to tax the consumption of financial services that are charged for in financial intermediation margins.

**Table 8 Federal Corporate Income Tax Revenues, Actual and as a Percentage of Federal Budgetary Revenues, 1984-85 to 1998-99**

| Year | Amount, $ billions | Percent of budgetary revenues |
|---|---|---|
| 1998-99 | 22.0 | 14.1 |
| 1997-98 | 22.5 | 14.8 |
| 1996-97 | 17.0 | 12.1 |
| 1995-96 | 16.0 | 12.3 |
| 1994-95 | 11.6 | 9.4 |
| 1993-94 | 9.4 | 8.1 |
| 1992-93 | 7.2 | 6.0 |
| 1991-92 | 9.4 | 7.7 |
| 1990-91 | 11.7 | 9.8 |
| 1989-90 | 13.0 | 11.4 |
| 1988-89 | 11.7 | 11.2 |
| 1987-88 | 10.9 | 11.2 |
| 1986-87 | 9.9 | 11.5 |
| 1985-86 | 9.2 | 12.0 |
| 1984-85 | 9.4 | 13.2 |

Source: Canada, *Public Accounts*, various years.

"income tax" that allows for the contributions of labour and capital income in excess of consumption needs to registered plans.

Table 9 sets out the variants of interest for both consumption and income tax bases. To focus the discussion on key issues, the table incorporates several simplifying assumptions. The implications of imports and exports are excluded by the assumption of a closed economy. All business income is assumed to arise in the corporate sector. The system is a mature one in that all physical capital still existing is assumed to have been purchased within the particular system under discussion, and any implications of the transition from one system to another are ignored. Finally, the role of bequests is also ignored.

The first column indicates the type of tax system under discussion: income taxes; indirect consumption tax; consumption taxes using corporate cash-flow taxes at the corporate level, often referred to as business transfer taxes or BTT; and income taxes exempting savings through unlimited registered plan contributions. In the case of the income tax, the first column also indicates whether imputation (recognition of corporate taxes paid) is allowed in determining individual income tax on distributions from corporations. The second column indicates what is taxed at the individual level. In all cases except the indirect consumption tax and the consumption tax with BTT 1 (see below), labour income is taxed at the individual level. In the two income tax systems, personal investment income comprising interest, dividends, and capital gains is also taxed at the personal level.

Column three indicates the type of corporate tax that is in place. The major distinction is between corporate taxes of an income tax type (where physical capital is depreciated) and cash-flow taxes (where the physical

**Table 9 Simplified Income and Consumption Tax Models in a Closed Economy, Corporate Business Income Only, Mature System, No Bequests**

| Tax system | Taxed at individual level | Taxed at corporate level | Key characteristics |
|---|---|---|---|
| Classical income tax | Labour income plus interest, dividends, and capital gains | Income (interest deductible and capital assets depreciated) | Double taxation of savings, double taxation of income earned in corporations and distributed |
| Income tax with integration | Labour income plus interest, dividends, and capital gains, less imputed corporate taxes | Income (interest deductible and capital assets depreciated) | Double taxation of savings |
| Consumption tax: retail sales tax or VAT | | | Consumption taxed directly |
| Consumption tax: BTT I | Nothing | Corporate cash flow (capital assets expensed, no interest deduction) | Labour and economic rents taxed at corporate level |
| Consumption tax: individual labour tax and BTT 2 | Labour income | Corporate cash flow (capital items expensed, no interest deduction) less labour | Economic rents taxed at corporate level |
| Consumption tax: individual labour and interest tax and BTT 3 | Labour income, interest | Corporate cash flow (capital items expensed) less labour and interest | Economic rents less interest equals refund of time value of money |
| Classical system with unlimited RRSPs: registered plans all receive capital income | Labour income | Income (capital depreciated, interest deductible) | Full corporate income taxable once, but consumption tax treatment for interest |
| Income tax with integration and unlimited RRSPs: registered plans receive all capital income and imputation credits | Labour income | Income (capital depreciated, interest deductible) | Consumption tax base |

capital is expensed). Among the income tax approaches, interest is always deductible. Among the cash-flow taxes, the basic model is shown as BTT 1, for which there is no interest deduction and no labour deduction. This model is equivalent to consumption tax, since the tax base equals the revenue from the sale of goods and services less the purchases of goods and services from other businesses (that is, what is left is the sale of goods and services to households, or consumption). The other variants of the BTT achieve identical results. Under BTT 2, the taxation of labour is

transferred to the individual level and a deduction for labour is allowed at the corporate level. This has some practical advantages, including the ability to tax labour income progressively at the individual level. (The Nunn-Domenici flat tax proposal in the United States was of this type.) Under BTT 3, labour is also taxed at the individual level, as is interest, with an interest deduction allowed at the corporate level.

The final column summarizes the key characteristics of each tax approach. For example, is it an income or a consumption tax base? Does it lead to double taxation of income at the corporate level?

The Canadian tax system can be described, in broad terms, as a hybrid that applies various of these models to portions of the savings and capital income in the economy.

Up to the level of savings in registered plans, the Canadian system functions like the classical system with unlimited RRSPs. Corporate income is fully taxable once, but interest income receives consumption tax treatment. Corporate income is taxable only once because effectively there is no further taxation of distributions as they flow through registered plans. However, since no dividend tax credits exist for corporate distributions received in registered plans, there is no relief from corporate income tax paid. The corporate tax rate determines the rate of tax applicable to the equity capital used in corporations. By contrast, interest is not taxed in registered plans and thus receives consumption tax treatment.

For savings in excess of the limits to the registered plans, tax treatment depends upon whether corporate income is taxed at the lower small business rate, at the manufacturing and processing rate, or at the full corporate rate. For corporate income taxed at the low small business rate, we have a form of the comprehensive income tax (with imputation). But the low small business rate provides a tax deferral. For the remainder of the income arising in corporations, the tax system falls between the classical system and the comprehensive income tax (with imputation) system, with the dividend gross-up and tax credit providing a partial offset for taxes paid at the corporate level.

As a historical note, before the tax reforms of the 1980s, the tax system had evolved toward a BTT 3 at the corporate level. Physical capital was partially expensed through accelerated capital cost allowances, such as the two-year writeoff for manufacturing and processing equipment, while interest was deductible. Under a BTT 3 system, the tax base is equivalent to economic rents less interest. For all sectors except those receiving significant economic rents on resource properties, this tax base would often be negative, involving a partial refund of the interest taxed at the personal level (assuming full loss offsets). In practice, no refunds existed, and every effort was made to block any schemes that arose for loss trading, either at the corporate level or at the level of the individual. At the same time, at the personal level the system was moving toward the flow of a larger share of savings through registered plans with, as a result, a significantly lower amount of interest being taxed at the individual level. This had two main implications.

First, tax collected at the corporate level began to dwindle, and loss corporations became common. This strained the system as attempts at loss trading became widespread. The public perception remained that corporate taxation was designed to tax income, not to remove the tax on capital income. This led to an increasing number of complaints about the corporate tax system and created the seeds for general tax reform, not only in Canada, but also in other countries where similar pressures had arisen. As a result, the corporate tax systems in almost all countries were pushed back toward an income tax base.

Second, governments were, in effect, trying to impose taxes on an aggregate base that had fallen below a consumption tax base to the extent that interest was being deducted at the corporate level and, because of registered plans or foreign borrowings, was not being taxed domestically. This further contributed to the serious budgetary deficit problems caused by high levels of spending and escalating interest rates.

The attempt to adopt a consumption tax base "by stealth" in the 1970s and 1980s as a way to stimulate investment and growth was thus a failure. Looking ahead, any move to eliminate or significantly reduce taxation of capital income that does not clearly address what will happen at the corporate level will run into serious perception problems. In general, systems that are closer to the BTT 1 model than the BTT 2 (and certainly the BTT 3) model would be more likely to gain acceptance, at least as far as this issue is concerned.

## A Summary of the Current System

It is useful at this point to summarize briefly the picture of the taxation of personal investment income as painted above.

### Investment Income of Individuals

A large and growing portion of personal investment income, at least three-quarters in the mid-1990s, escapes taxation through various avenues. In particular, registered plans are growing more rapidly than taxable investments. The personal investment income that is taxed, however, is generally subject to high marginal tax rates in an international context. The tax treatment can thus be summarized as one of low average tax rates coupled with high marginal rates.

To some degree, the savings that are taxed represent precautionary and transactional balances that are held by individuals at all income and wealth levels. But a substantial proportion of savings that are taxed tend to be those accumulated after basic housing and retirement savings objectives have been met. They are generally the savings out of whatever income of high-income individuals is in excess of retirement and housing needs, or they are the result of bequests.[10] These savings tend to be held in investment

[10] Ernst & Young estimates that some $40 billion of bequests are received annually in Canada, with the majority of such funds being retained in savings. (See "The Canadian High Net Worth Market," supra footnote 6.)

forms that make them relatively easy to convert into other investments or to move into foreign investments. Thus the savings involved seem to be those that are quite mobile, both in respect of the form in which they are invested and where they are invested.

### Investment Income Received by Registered Plans

Investment income received by registered plans is not subject to tax. It is important to note, however, that the dividend tax credit is not available to such plans. Therefore income received in the form of dividends or capital gains reflecting growth in the retained earnings of corporations has been subject to corporate tax. The tax treatment in registered plans thus removes double taxation of corporate level income, but not the underlying taxation of corporate income itself.

### Taxation of Capital Used in Business

Following a brief period when the corporate tax moved toward a cash-flow basis through accelerated writeoffs, the corporate tax has reverted firmly to an income tax base. But the tax rate regime applicable to corporations means that there are three distinct treatments of income depending upon the type of corporation employing the capital[11] and its use.

For income taxed at the low small business rate, substantial deferrals are available relative to the level of tax that would apply at the individual level. Income distributed as dividends is taxed at approximately the individual tax rate of the recipient through the dividend gross-up and tax credit mechanism. When a business is eventually sold, to the extent that the capital gains exemption applies, no further tax beyond the small business corporate tax is collected if the gain reflects retained earnings, and no income tax is collected at all on appreciation in goodwill or capital property in the corporation.

For income taxed at the manufacturing and processing tax rate, there is an element of double taxation upon distribution. The general level of tax, however, is probably not greatly dissimilar to what would be applicable to the equivalent use of capital in the United States.

For income taxed at the regular corporate rate, including much of the income of larger private Canadian corporations outside manufacturing as well as that of the non-manufacturing public corporations, there is a greater degree of double taxation, and the tax rate at the corporate level is typically higher than that in the United States.

[11] For reference, it is useful to note the relative amounts of income earned by each of the corporation types referred to in the discussion. In 1994, the total taxable income reported in the corporate sector was $55.5 billion. The amount by type of corporation (with the percentage of the total in parentheses) was $18.7 billion (33 percent) by Canadian-controlled public corporations, $12.2 billion (22 percent) by foreign-controlled public corporations, $5.8 billion (10 percent) by large Canadian-controlled private corporations, and $19.2 billion (35 percent) by small Canadian-controlled private corporations.

The overall effect of the hybrid system that has been developed is that the taxation of personal investment income and capital income in general is a bifurcated one in Canada. A substantial portion of personal investment income is not subject to tax. When taxes do apply on the returns to personal savings and equity capital employed in corporations, however, the high level of the tax rates applicable raises questions both about the ability to sustain taxation on the capital in question if the capital is mobile and about the economic implications of such marginal tax rates.

## THE FORCES BEHIND THE CURRENT STRUCTURE

Although it may seem unusual to find significant levels of personal investment income that is not subject to income tax within a system in which fairly high marginal tax rates apply to the remainder of capital income, the forces that have created this structure are fairly well recognized and the result is not unusual internationally. This section looks at the forces that have caused the current system to evolve as it has, while the following section provides a few international reference points.

One set of forces behind the evolution of the current system has been driven by domestic policy decisions in such areas as tax system progressivity, the need for savings incentives as well as investment incentives, and social priorities. These basic policy considerations are relevant both in setting the overall tax mix as it involves choices among tax bases, and also in developing the income tax structure as it affects individual investment income. The other set of forces has resulted from recognizing how the tax systems of other countries have shaped their resident and non-resident taxpayer behaviour, and have led to the design of tax systems that react to or anticipate such behaviour in order to maintain their own countries' tax revenues and investment capital.

It has been argued in recent years that the latter forces could become dominant in determining the tax treatment of capital income. One school of thought asserts that as a result of the increasing mobility of capital under globalization and through technological advances in electronic commerce and rising intergovernmental tax competition, governments will have to rely more heavily on labour and consumption taxes in the absence of international cooperation on income taxation, or else face capital flight. It has also been recognized, however, that the ability to "export" capital taxes exists, so that the taxed income accrues to foreigners, thus creating an incentive for the continued or increased use of taxes on capital income.[12]

In practice, the forces referred to above have largely manifested themselves in Canada in the determination of the top marginal individual and corporate income tax rates, rather than in driving the system toward a greater reliance on the taxation of consumption or labour. Canadian policy makers seem to have accepted the fact that Canada will face pressure not only in attracting investment capital, but also in retaining the income tax

[12] For a detailed discussion of this issue, see Jack M. Mintz, supra footnote 3.

base and the more mobile types of labour if its top marginal tax rates are too different from those of the United States. In the context of tax reform, for example, in choosing a top corporate tax rate it was a significant consideration to choose one that would allow the "export" of taxes and that would not simultaneously lead to incentives to shift the corporate tax base to lower tax rate countries.[13]

In the Canadian context, however, the threat of capital flight has apparently been less important as a rationale for the tax provisions that have significantly lowered the proportion of personal investment income subject to income tax. The principal contributing factors within the Canadian context instead appear to be the tax treatment of personal residences and registered plans, and the special rules for incomes earned in small businesses, including the lifetime capital gains exemption, each of which has been tied to addressing social priorities. At most, there has been a general desire to encourage savings, rather than a reaction to potential capital flight. Indeed, as argued earlier, the capital that is probably the most mobile—that which is surplus to housing and retirement needs—is the personal investment capital, which is exposed to income tax at high rates. The desire for tax fairness and for an element of progressiveness in the tax system has effectively barred any reduction of the tax level on personal investment income beyond what can be justified by the social priorities identified above. In general, the tax provisions introduced or enhanced over the past 15 years that limit the taxation of individual investment income, while perhaps having had the side effect of reducing pressures for capital flight, have been based in other policy concerns.

Specific recent policy actions have actually been directed toward shoring up the taxation of individual investment income within the area in which capital flight appears to have been growing, namely the use of non-resident trusts, foreign-based investment fund rules, and other offshore investments. In 1997, a new rule was proposed that would require residents of Canada to file information returns whenever their foreign assets were in excess of $100,000. Although investor concerns delayed its implementation, the rule has been put into operation. The 1999 budget put forward proposals aimed at addressing deficiencies in the rules governing foreign-based investment funds and non-resident trusts.

## THE EUROPEAN EXPERIENCE

Recent European experience, in respect of both taxpayer behaviour and government policy responses, has been quite different. Sijbren Cnossen has observed that two camps exist within the European Union when it comes to capital taxation: In answer to the question, "Should capital income be taxed?" one camp answers, "Yes, but we don't have the nerve";

[13] For example, see David A. Dodge and John H. Sargent, "Canada," in Joseph A. Pechman, ed., *World Tax Reform: A Progress Report* (Washington, DC: Brookings Institution, 1988), 43-69.

the other camp answers, "No, but let's pretend [to do so]." He concludes that "The two camps meet under the umbrella of hypocritical tax legislation that appears to tax capital income, but in fact leaves it untouched by the tax man."[14] Early in this paper we comment that German taxation of interest income has largely disappeared; this is true as well for most other European countries. The Nordic countries have made a major systemic change in their income tax systems in response to diminishing tax collection, and the European Union has proposed a source-based withholding tax regime.

The Nordic dual income tax (DIT) was introduced in the early 1990s in Norway, Finland, Sweden, and Denmark as an explicit response to the issue of capital flight and the non-reporting of capital income in those countries. The DIT effectively retains a comprehensive income tax base, but violates the principle of equal taxation of capital and labour income by taxing capital at a proportional rate approximately equal to the rate of the lowest labour tax bracket, while taxing labour income within a progressive rate structure.

That structure can be outlined very concisely: All income is identified as either labour income or capital income. Capital income includes business income as well as interest, dividends, capital gains, and rents. All capital income is taxed either at the proportional corporate tax rate or at a similar personal rate, while labour income is subject to additional progressive personal tax. A full imputation system is used to avoid double taxation of the income earned in corporations and distributed. Double taxation of retained earnings is avoided either by permitting shareholders to gross up the cost base of their shares by the retained profits net of corporate tax or by exempting capital gains. Profits of proprietorships and closely held corporations are split into their labour and capital components by imputing a return to the business's capital. This area adds a considerable degree of complexity to the system. A full withholding system exists for interest, royalties, and other capital income.

The corporate tax rates in the four countries are as follows: Norway, 28 percent; Finland, 28 percent; Sweden, 28 percent; and Denmark, 34 percent. In Norway and Finland, there is a pure DIT, with other capital income taxed at the corporate rate. In Sweden and Denmark, there is a slightly higher tax on the other types of capital income. The ranges of percentage tax rates for labour income are as follows: Norway, 28 to 41.7 percent; Finland, 25 to 56 percent; Sweden, 31 to 56 percent; and Denmark, 38 to 58 percent.

The switch to a such a system—that is, taxing capital income proportionally, explicitly, and at lower rates than the progressively taxed labour income—seems particularly striking in the Nordic countries, which have long been associated with egalitarian systems involving high levels both of social expenditures and of taxation. Certainly, the rates on labour income

[14] Sijbren Cnossen, "Dual Income Taxation" (draft, March 1997).

continue to be quite progressive, with the top marginal tax rate approaching 60 percent in most countries. Each of these countries also imposes hefty social security contributions on top of the income taxation, and their effective tax rates on labour income are even higher than suggested in the preceding paragraph. The rationale for the dual system is a thoroughly pragmatic one: mobile and fungible capital can be taxed only at low proportional rates, whereas immobile labour can be taxed at higher progressive rates, reflecting equity considerations that involve the unequal distribution of human capital.[15]

In May 1998, the European Union proposed a directive that was its prescription for responding to the disappearance of tax revenues on interest income.[16] The proposal involves the use of what is called a hybrid system. Under the hybrid scheme, a country can adopt a withholding tax on interest at an appropriate level, or an acceptable provision of information to the country of residence of the investor, or a combination of these two. The minimum rate of withholding tax for countries opting for the first approach is 20 percent.

The hybrid system is designed to reintroduce taxation of interest income in the European Union, where widespread non-reporting of the income earned on deposits outside the country of residence has largely extinguished such taxes. The hybrid scheme is seen as a way of enforcing a level of taxation of interest in a situation involving countries with banking secrecy laws and with an unwillingness to be involved in information exchanges as a way of responding to tax evasion. The scheme allows for greater cooperation through information exchanges among member states, but where such cooperation is not forthcoming, it forces countries to apply a withholding tax. There is no requirement that the revenues from the withholding tax be shared. Individual taxpayers who report interest income in their country of residence will be eligible for tax credits against the income tax payable on such income.

The hybrid system is being discussed at the Organisation for Economic Co-operation and Development (OECD) level, and the European Union directive envisages agreements that would extend the hybrid approach beyond the member states by multilateral or bilateral agreement. Several countries, including the United States, oppose the hybrid system as an unsatisfactory alternative to having access to the necessary information, allowing the effective taxation of interest in the state of residence. US policy makers believe that the approach is unfair to countries that exchange information as well as to compliant taxpayers and will ultimately prove to be no solution to the problem of tax evasion. It is yet unclear how effective

[15] Ibid., at 7-11. This study provides a discussion expanding and justifying these principles as embodied in the DIT.

[16] European Commission, *Proposal for a Council Directive To Ensure a Maximum of Effective Taxation of Savings Income in the form of Interest Payments Within the Community*, DAFFE/CFE/WP8(98)10, 1998.

the withholding system will eventually prove for the European Union if some countries outside the EU continue to maintain banking secrecy laws and do not apply withholding taxes.

In sharp contrast to the approaches being followed in both the European countries and Canada, New Zealand has shifted its system more toward a comprehensive income tax structure. In particular, in the mid-1990s the treatment of pension contributions changed significantly. No deduction is allowed for employee contributions, and employer contributions are deductible, but subject to a fringe-benefits tax, which is equivalent to taxing the employee on those amounts. New Zealand has opted in this respect for closer adherence to the comprehensive income tax model. It does not, however, have a general capital gains tax and thus deviates from the pure income tax model in this respect.

## THE WAY AHEAD

### Broad Options

Canada has developed a system of taxation of individual investment income and the income from capital employed in corporations that continues to raise significant revenues and that has remained stable in the face of globalization despite exempting substantial portions of the personal investment income arising in registered plans and home ownership, and exhibiting some signs of growing tax avoidance through foreign investments. Other countries have also developed systems that have explicitly exempted substantial portions of investment income from taxation, but, in the case of European countries at least, they have been much less successful in maintaining any degree of taxation of individual investment income and are moving in new directions with respect to the taxation of capital income. What broad options are therefore available to Canada within this environment?

The most dramatic option would be to adopt a consumption tax base by introducing one of the variants of the business transfer tax and exempting personal investment income. But given the concerns about the fairness of exempting investment income from tax and the relevant transition issues and, most important, the perils of operating such a system in a world in which other countries have maintained income tax bases, there is little likelihood that Canada could do this on its own. A few years ago, when Steven Forbes hit the news with his flat tax system and the Nunn-Domenici proposal was under discussion, there was some possibility that the United States would move in that direction. That possibility seems to have receded now, although there is always the chance that such a direction might be resurrected in future election campaigns.

The European approaches—a dual income tax, and the hybrid system involving the taxation of interest at source through a withholding tax—also appear to have little immediate appeal within the Canadian context. Such approaches have arisen in response to levels of evasion through offshore investment that have not occurred in Canada to the same degree. The policy direction here, as evidenced in the 1999 budget, continues to

be to ensure that the current approaches to offshore investment work. As long as the taxation of foreign investment can be made to function at an acceptable level, there seems little likelihood that one of the models that combines a lower, proportional tax on capital with a progressive tax on labour will take root.

Another approach to broad-based change is to shift the tax mix toward more use of consumption taxes without any further structural change. For an equal revenue change, this would involve raising the goods and services tax (GST) rate, while lowering income tax rates. The political hangover from the introduction of the GST makes this direction unlikely, perhaps impossible, in the near term, but the government could change the tax mix in other ways, such as using future budget surpluses to lower the personal income tax and, possibly, the corporate income tax as well, while holding the GST rate constant.

The tax base could also be oriented more toward a consumption tax by increasing the RRSP limits. This would relieve some of the pressures on the treatment of investment income that arise in the upper-middle-income range where these limits start to bind. It would also bring the Canadian system closer to those of other countries that do allow higher levels of savings in registered plans. Without a strong movement toward unlimited RRSP room, however, the economic benefit of merely increasing RRSP limits may be slight. Except for individuals who are making marginal decisions about saving and the location of their personal investments, such a step in itself does not deal with the problem of high marginal tax rates on savings, coupled with low average tax rates.

A more dramatic step involving further reliance on RRSPs would involve dismantling the Canada Pension Plan (CPP). The Reform Party has suggested that the CPP could be eliminated, with corresponding room being given to RRSPs. A variant on this would be to fold the CPP into the RRSP system by eliminating the CPP, but requiring mandatory contributions to locked-in RRSPs. This would ensure that individuals with earned income would set aside a minimum amount for their own retirement purposes, but it would eliminate the distributional effects that the CPP produces as it is now structured. Clearly, the debate on any such broad change would focus on social and economic policy issues rather than on tax policy considerations.

### Structural Options

If dramatic changes in the tax structure are unlikely in the absence of significant changes in the external environment and the level of foreign investment tax evasion, what guidelines should apply in respect of more structurally oriented changes, and where should such changes be contemplated?

In the discussion above, one issue stands out: the relatively high rate of tax on corporate income that benefits from neither the small business deduction nor the manufacturing and processing income deduction. The high rate of tax acts as a withholding mechanism not only for the capital income of foreigners, but also for capital income destined to registered

plans. Not only foreign-controlled multinationals, but also Canadian-controlled public corporations and larger private corporations in the service sector are subject to these tax rates. Canadians thus may be bearing a significant economic cost for retaining this high tax rate category of corporate tax. Two of the most common observations made today about Canadian economic performance are, first, that we are falling behind in productivity growth, and second, that small businesses are creating a disproportionate share of new employment. With high tax rates on larger businesses operating in the fastest growing economic sectors, we must also ask if our tax system is a significant source of drag on productivity. Furthermore, has the emphasis on tax policy support for small business deflected attention from the reason for the slow growth in employment among larger businesses? We should give serious attention to reducing the general tax rate for corporate income taxed at the top marginal rate.

This concern is reflected in major government studies of tax systems. Most recently, the Technical Committee on Business Taxation (the Mintz committee), reporting to the minister of finance, stated:

> The Committee proposes that the general federal and provincial corporate income tax rates be lowered, after a transitional period, to 33 percent on average. We recommend a general federal rate of 20 percent, and we suggest that provincial rates could be reduced on average by one point to 13 percent from the revenues generated from base-broadening. The Committee also recommends that the federal corporate income surtax for both large and small businesses be repealed.[17]

Following that recommendation would remove the differential between manufacturing and processing and service sector income by lowering the tax rate on non-manufacturing income. The Ontario Fair Tax Commission had made the same recommendation a few years earlier.[18] This key issue must, for economic reasons, be given priority.

At a political level, it will clearly be difficult to reduce the tax rates applicable to corporate income. In part, this reflects a lag in public perceptions, with public discussions often making more references to the pre-reform corporate income tax system, which is deeply ingrained in peoples' memories, than to the revenue-raising machine that has been evident over the last few years. This perception problem is partly because of very poor public information about corporate taxes paid. Every few years, the Department of Finance releases a tax expenditure study that details the taxes that corporations do not pay relative to a hypothetical benchmark tax system. The only actual revenue numbers it releases are gross tax revenues. The Statistics Canada publication on corporate tax revenues, whatever its merits as a link in the development of income and

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[17] Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), at 4.5.

[18] Ontario, *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission* (Toronto: University of Toronto Press, 1993).

expenditure data for the economy, is also deficient as a source of information on the corporate income tax. It largely represents a reconciliation of book income to taxable income by industry, but it does not divide information by profitable and non-profitable corporations, nor by the major categories of corporations for tax purposes. Of course, specialists have access to the Statistics Canada corporate tax file as well as to various studies of a technical nature that are available from the Department of Finance (and elsewhere) bearing on this issue, but there is no data source like the Revenue Canada *Tax Statistics on Individuals* that is readily accessible by interested parties. The information gap is even greater with respect to other taxes that corporations pay (for example, property taxes), which are typically much higher than taxes for personal residences with equivalent assessments. Governments would have a much better chance of making desirable policy changes in this area if there were up-to-date, easily accessible information on the taxes that corporations actually pay, as an antidote to the outdated perceptions that dominate much of the discussions on corporate taxation.

In contemplating adjustments to the system for the taxation of investment income, we should pay careful attention to neutrality. In this discussion, neutrality in the sense of equal treatment of different types of income, such as labour income, business income, and the various forms of investment income, has generally been evident in the basic Canadian rules. When investment income flows through registered plans, however, or when it is subject to special provisions such as the lifetime capital gains exemption, a second dimension of the rules comes into play. The norm for the treatment of such income is the consumption tax model. Earlier we identified some deviations from this model that result in negative taxation of savings and investment income. With the pools of financial capital in registered plans being so large, there will undoubtedly be pressures to allow more special treatment of this type of capital; it is very attractive for governments to use such special treatments to achieve their policy goals, since their revenue costs appear to be low. Registered plans should be monitored carefully, and a second notion of neutrality should be adhered to—that is, that savings flowing through registered plans should attract consumption tax treatment and should be subject neither to additional taxation, nor to special treatment that lowers the effective tax rate below zero.

A few years ago, when the budget deficit was still at substantial levels, rumours surfaced that government was considering a special tax on the return to funds held in registered plans as a possible revenue source to help in the budgetary deficit battle. Such a tax would clearly have violated the consumption tax treatment norm suggested above. There is one important situation in which income realized through registered plans effectively receives income tax treatment, namely the treatment of dividends. There is no imputation relief for dividends received in such plans. Therefore, such plans are biased against equity investments, just as the deductibility of interest and less than full imputation provide such a bias

for direct portfolio investment in corporate equity. This bias is exacerbated by the fact that the regular corporate tax rate is prohibitively high. A good response to this issue would be to provide the dividend tax credit to equity holdings in registered plans. But if that is not considered feasible, this bias is another reason for action on the corporate income tax front.

By contrast, the current rules already allow for withdrawals from RRSPs under the home buyers' plan (HBP) and the lifelong learning plan (LLP). The HBP and the LLP allow a qualifying individual to withdraw RRSP funds on a tax-free basis to purchase a home or to pay for education. The funds are required to be repaid to the RRSP over a 15-year period (for the HBP) or a 10-year period (for the LLP). For those individuals who are in a position to take advantage of these plans, the tax treatment becomes better than a consumption tax base (when deferrals are taken into account). For example, in the case of the HBP, savings for homes and the funds used for the equity component of a home purchase are allowed to be made free of tax. The repayment to the RRSP is out of tax-paid income, but the individual has gained a timing advantage over an individual who purchases a home outside the plan with tax-paid income. This doubling up of incentives through allowing access to RRSP funds for various purposes violates neutrality in terms of a consumption tax base and is an undesirable direction to take in making tax policy. The approach can be criticized on the grounds of horizontal neutrality, as taxpayers in similar economic circumstances will have greatly differing access to housing and educational support depending upon their past contributions to RRSPs. It would therefore be preferable, if more support for certain activities is to be given, to provide such support more transparently and without creating windfall gains for those who happen to have large pools of assets in RRSPs.

The lifetime capital gains exemption is another case of non-neutrality in the system, providing advantages to taxpayers on a particular type of capital gain. It has created a substantial level of planning activity to ensure that the use of the lifetime exemption is maximized and realized through various techniques to "crystallize" such gains. If it is primarily designed to place small business and farm operators on a more equal basis with respect to the ability to save for retirement, it would be better to provide special room for contributions to RRSPs for such gains. In this respect, the Mintz committee has proposed one mechanism that would convert the current lifetime capital gains exemption to additional, comparable RRSP room.

## CONCLUSIONS

Canada, like almost all other countries, has what could be called a hybrid system for the taxation of personal investment income, and capital income in general. At the individual "income" tax level, substantial (in many countries, almost all) investment income in the form of interest, dividends, capital gains, and rents is not subject to tax. This result is a function both of tax provisions, such as the treatment of principal residences and retirement savings, and of the significant avoidance or evasion of tax in some

countries, generally through offshore investment vehicles. Much of personal investment income thus effectively receives consumption tax treatment. At the corporate level, however, capital income in the form of business income is subject to tax regimes that, following the tax reforms in the mid-1980s, approach comprehensive income tax regimes. Tax systems in almost all countries thus are hybrids that combine a substantial degree of consumption tax treatment for individual investment income with income tax treatment for capital income earned by businesses. The sole exception appears to be New Zealand, which moved closer to a pure income tax system by eliminating deductions for pension contributions in the mid-1990s.

Canada adheres to the hybrid approach. We estimate that only some 25 percent of the investment income of individuals is subject to tax in Canada. Following the 1985-1987 reforms, however, corporate income tax does have the characteristics of an income tax in taxing the normal returns to capital plus economic rents. This paper discusses some of the reasons why hybrid systems exist and outlines the costs they impose. The Canadian structure appears to be particularly open to some of the costs of such hybrid systems. The 25 percent of individual investment income that is taxed relates to those savings that are surplus to housing and retirement needs, and it can thus be considered to be income that is at the margin with respect to investment decisions and that is typically held in mobile forms. This income is largely subject to the relatively high, top marginal tax rate in Canada. This structure means that the average tax rate on investment income is low, but the marginal tax rate is high. At the corporate level, any business income that is not eligible for small business or manufacturing treatment is also subject to relatively high tax rates in international terms.

The great debate in tax policy forums over the last quarter-century has been whether income or consumption should guide us in the design of our tax systems. However, the costs of the hybrid systems that combine aspects of these polar approaches are such that it seems reasonable to conclude that significant benefits would arise from moving to either of the purer systems. Certainly, we should give serious attention to this possibility in the next major tax reform exercise. If the polar income tax case were adopted, increased average tax revenues on capital income could allow a reduction in the high marginal tax rates. If the polar consumption tax system were adopted, the possible benefits of such an approach, which have been widely debated, could be achieved. Careful scrutiny may reveal that the forces that have driven us to the current hybrid system may not be sufficient barriers to deter us from achieving the benefits of one of the purer, and economically sounder, tax system approaches.

If major tax reform is not feasible in the near term, however, then maybe we should have a truce in the consumption versus income base debate, and carefully evaluate the hybrid system that we do have. Such an evaluation would try to identify why the system has developed, and the pros and cons associated with it. From this perspective, we may discover equal revenue or fiscal dividend financed changes that could be adopted

and that would ameliorate some of the costs of the hybrid approach. We might also identify some principles that could function as guidelines for policy discussions in the hybrid world. For example, we argue in the paper that one such principle should be that the tax rate for investment income should not fall below zero. This means that, where consumption tax treatment is available, for example, on retirement savings, we should not add additional bells and whistles that effectively create a negative consumption tax rate. Several provisions in the current Canadian tax system violate this principle for registered plans. We should also consider what form the integration of the personal and corporate systems should take in a hybrid system. Would it be desirable, for example, to extend the dividend tax credit to dividends received by registered plans?