cases, income debenture interest is cumulative and, if not paid, is added to the bond holder's claim upon redemption of the debentures. This position is akin to that of a preferred stock, except that income debenture interest is a debt payable at a fixed date and the debenture holder rates as a creditor. For Canadian income tax purposes, income bond interest is eligible for the same tax credits applicable to dividends of taxable Canadian corporations. The interest payable on the debenture is paid out of the corporation's after-tax income.

These financing instruments are termed "loan substitutes". This term is used because income debentures and preferred shares are actually issued to replace a company's outstanding loans. It appeals to a company to have its short-term loans replaced this way because it improves the balance sheet and debt to equity ratio. The term "tax-exempt financing" is also used because the cost of these loan substitutes is not deductible from a company's revenue, as is regular interest on a bank loan. Likewise, the revenue in the hands of the bank is not taxable. This is not an unusual transfer of funds. The tax laws in Canada permit dividend payments to flow from one company to another to avoid double taxation of corporate profits. In effect this is an after-tax transfer of funds.

The next concept to be explained is the reason why any company would arrange for a "loan substitute" rather than taking out an ordinary bank loan where the interest would be deductible from its income. It happens because a company that does not have any taxable

Table 4.3

CALCULATION OF THE EFFECTIVE TAX RATE FOR BANKS

Assumptions: Prime rate at 20 per cent
Bank A $500,000 regular loan at prime rate
Bank B $450,000 regular loan at prime rate
$ 50,000 loan substitute at one-half prime rate.

Calculation of Effective Tax Rate	**BANK A**	**BANK B**
Regular Interest Revenue	$100,000	$90,000
Tax-exempt Revenue	—	5,000
Total Revenue	$100,000	$95,000
Total Expenses	85,000	85,000
Total Income before tax	$ 15,000	$10,000
Less: Non-taxable income	—	5,000
Taxalbe Income	$ 15,000	$ 5,000
Statutory Tax Rate	50%	50%
Taxes payable	$ 7,500	$ 2,500
Calculation of After-Tax Profit	**BANK A**	**BANK B**
Total Income before tax	$ 15,000	$10,000
Tax payable	7,500	2,500
After-Tax profit	$ 7,500	$ 7,500
Effective Tax Rate (Taxes payable/Total Income Before Tax)	50%	25%