Meanwhile, the Federal Government introduced the Small Business Development Bond. The interest income from the SBDB's is neither deductible in the hands of the borrower nor taxable to a bank or other corporate recipient. The government's objective in encouraging "after-tax" financing is to provide funds to borrowers at approximately one half the prevailing prime rate. Government policy has continued to encourage the banking system to increase its investment in tax-exempt loans to financially troubled businesses. This should lower the banks' effective tax rates further, as after-tax income continues to be substituted for taxable income on regular loans. As of October 31, 1981, the banks had $6.7 billion of term-preferred shares, $2.8 billion of income debentures and $1.2 billion of SBDB's for a total of $10.7 billion.

After-tax income has increased dramatically in relation to the banks' total after-tax balance of revenue. As noted in Table 4.2, tax-exempt income has increased from $80 million in 1976, 12.1 per cent of after-tax balance of revenue, to $1,144 million or 66.5 per cent of after-tax balance of revenue in 1981.

Table 4.2

PERCENTAGE OF TAX-EXEMPT INCOME OF THE BANKING INDUSTRY

(in millions of dollars)

	1976	1977	1978	1979	1980	1981
Tax-Exempt Income*	$ 80	$166	$386	$ 811	$ 908	$1,144
After-Tax Balance of Revenue	$663	$731	$977	$1,119	$1,243	$1,720
Tax-Exempt Income as % of After-Tax Balance of Revenue	12.1%	22.7%	39.5%	72.5%	73.0%	66.5%

* Source: Office of the Inspector General of Banks.

Background to After-Tax Financing

Before discussing the impact of after-tax financing on the tax rates of Canadian chartered banks, it is important to fully understand the concepts behind loan substitutes and after-tax financing. Since most of the loan substitutes are in the form of income debentures and preferred shares, these are described in more detail below.

i) Preferred Share—A preferred share is a class of share capital of a corporation that entitles the owners to a stated dollar value per share in the liquidation of a company and provides the owner with a dividend, paid before the company's common share dividend. Holders of preferred shares usually have no voting rights, unless a stated number of dividend payments have been missed. The dividends are paid out of the company's after-tax income. There are no specific assets guaranteeing these securities, and so their collateral value to a chartered bank is less than what the bank would normally receive when issuing a loan.

ii) Income Debenture—An income debenture is defined as a security on which interest is payable only if sufficient income has been earned by the issuing corporation. In some