Withholding Tax on Domestic Interest and Dividends

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PRÉCIS

La retenue d'impôt à la source est un moyen important d'assurer l'observation de tout impôt sur le revenu fondé sur un régime d'auto-cotisation. Bien que le régime canadien d'impôt sur le revenu soit un régime d'auto-cotisation, seuls les paiements de revenu d'emploi, certains autres montants en vertu du paragraphe 153(1) et certains paiements à des non-résidents en vertu de la partie XIII sont assujettis aux obligations de retenue contenues dans la Loi de l'impôt sur le revenu. L'auteure de l'article soutient que la retenue devrait viser également les paiements d'intérêts et de dividendes effectués entre résidents canadiens.

L'article contient en premier lieu un examen du régime de retenue actuel en vertu de la Loi de l'impôt sur le revenu. Ensuite, les avantages et les désavantages de l'exigence de retenue sur les paiements d'intérêts et de dividendes entre résidents canadiens sont examinés. Les avantages sont importants et persuasifs. La retenue est depuis longtemps reconnue comme un mécanisme simple et efficace de perception des impôts, et de nombreux pays membres de l'OCDE ont mis en place avec succès un régime de retenue national comportant une assiette large. L'auteure soutient que la retenue devrait avoir un rôle plus important dans le régime fiscal canadien, étant donné en particulier la préoccupation du gouvernement canadien d'améliorer l'observation fiscale. La retenue est plus efficace pour diminuer les cas d'évasion fiscale que toute autre mesure d'application, car elle restreint les occasions de non-respect. En améliorant l'observation fiscale, la retenue peut également améliorer l'équité fiscale et procurer des recettes additionnelles sans qu'il soit nécessaire d'adopter de nouveaux impôts. L'auteure reconnaît qu'un régime fiscal comportant une assiette large entraînerait des coûts d'observation additionnels. Cependant, ces coûts seraient largement compensés par les avantages.

Après avoir prouvé qu'il est souhaitable et possible d'élargir la retenue aux paiements d'intérêts et de dividendes entre résidents canadiens,

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l'auteure présente quelques suggestions préliminaires pour l'élaboration d'un régime élargi de retenue. Ses propositions visent des points comme les paiements auxquels s'appliquerait la retenue, les personnes qui seraient tenues de faire des retenues, le moment de la retenue, ainsi que les taux applicables, les exemptions et des questions d'ordre administratif.

ABSTRACT

Withholding of tax at source is an important means of ensuring compliance with any income tax that is based on a system of self-assessment. Although the Canadian income tax system is a self-assessment system, the Income Tax Act imposes withholding obligations only on payments of employment income, certain other amounts under subsection 153(1), and certain payments to non-residents under part XIII. The author of this article argues that withholding should be extended to interest and dividend payments made between Canadian residents.

The article begins with a review of the existing withholding regime under the Income Tax Act. This is followed by a discussion of the advantages and disadvantages of requiring withholding on domestic interest and dividend payments. The advantages are substantial and persuasive. Withholding has long been recognized as a simple and efficient tax collection mechanism, and many OECD countries have successfully implemented a broad-based domestic withholding regime. The author argues that withholding should be given a greater role in the Canadian income tax system, particularly in view of the government's concern to improve tax compliance. Withholding is more effective in reducing tax evasion than other enforcement measures because it restricts opportunities for non-compliance. By improving tax compliance, withholding can also improve tax equity and generate additional revenue without requiring the introduction of any new taxes. The author recognizes that a broad-based withholding regime would result in additional compliance costs; however, those costs would be greatly outweighed by the benefits.

Having demonstrated that it is both desirable and feasible to extend withholding to domestic interest and dividend payments, the author puts forward some preliminary suggestions for the design of an expanded withholding system. Her proposals address such matters as the payments to which withholding would apply, the persons who would be required to withhold, the time of withholding, the applicable rates, exemptions, and administrative issues.

INTRODUCTION

Administration of the Canadian income tax is based on a self-assessment system under which taxpayers are required to determine and report their income tax liability in annual returns. This self-assessment system depends on the voluntary compliance of taxpayers and the government's ability to identify and respond to taxpayers' avoidance of their obligations. Compliance is ensured in certain situations through withholding of tax at source. At present, however, withholding is required only for payments of employment income, certain other specified payments, and certain amounts paid to non-residents of Canada.[1] This article argues that, in order to improve compliance, withholding should be extended to interest and dividend payments made by one Canadian resident to another.

Non-compliance is a persistent problem for tax authorities in Canada and elsewhere. The estimated amount of tax evaded by individuals in Canada is at least $4 billion a year,[2] and between 16 and 30 percent of taxpayers annually commit some act of non-compliance.[3] Non-compliance is most prevalent with respect to income that is not subject to withholding.[4] Apart from the loss of revenue, non-compliance has other detrimental effects on the tax system. In particular, when some taxpayers succeed in avoiding their tax obligations, the fairness of the system is impugned, and other taxpayers begin to question why they should be honest in reporting

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[1] Sections 153 and 215 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act. For general discussion, see David G. Broadhurst, "Issues in Withholding," in *Income Tax Enforcement, Compliance, and Administration*, 1988 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1988), 11:1-18; Robert F. Lindsay, "Withholding Tax: Compliance Problems of the Canadian Payor," in *Corporate Management Tax Conference 1976* (Toronto: Canadian Tax Foundation, 1977), 52-74; and James Rossiter, "The Application of Part XIII Nonresident Withholding Tax to Deemed Payments" (1986), vol. 34, no. 3 *Canadian Tax Journal* 511-32.

[2] Statistics Canada estimates that the size of the "unrecorded economy" in Canada exceeds $20 billion. Brenda Dalglish, "Cheaters: Tax Evasion Costs $30 Billion," *Maclean's*, August 9, 1993, reported that tax evasion costs $30 billion—enough to cover the federal deficit. See also Seymour Berger, "The Unrecorded Economy: Concepts, Approach and Preliminary Estimates for Canada, 1981" in Statistics Canada, *Canadian Statistical Review*, April 1986, catalogue no. 11-003E, vi-xxvi; Neil Brooks and Anthony N. Doob, "Tax Evasion: Searching for a Theory of Compliant Behaviour," in M.L. Friedland, ed., *Securing Compliance: Seven Case Studies* (Toronto: University of Toronto Press, 1990), 122-64; Colin W. Boyd, "The Enforcement of Tax Compliance: Some Theoretical Issues" (1986), vol. 34, no. 3 *Canadian Tax Journal* 588-99; Kevin J. Dancey, "Current Compliance Problems," in *Income Tax Enforcement, Compliance, and Administration*, 1982 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1983), 218-41; Mireille Éthier, "The Underground Economy: A Review of the Economic Literature and New Estimates for Canada," in François Vaillancourt, research coordinator, *Income Distribution and Economic Security in Canada*, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada, vol. 1 (Toronto: University of Toronto Press, 1985), 77-109; Gerald H. McCracken, "Preventing Tax Evasion Through Enforcement: The Government Perspective," in the 1988 Corporate Management Tax Conference, supra footnote 1, 2:1-14; and Michael W. Spicer, "Civilization at a Discount: The Problem of Tax Evasion" (March 1986), 39 *National Tax Journal* 13-20.

[3] Although no official data are available in Canada indicating the extent of tax avoidance and evasion, fairly detailed studies of tax evasion in the United States have been conducted by the Taxpayer Compliance Measurement Program (TCMP) of the Internal Revenue Service (IRS). The voluntary reporting percentages for individual filers and non-filers in 1981 were as follows:

([3, 4] Continued on the next page.)

their own tax liability. The very foundation of the self-assessment system is consequently undermined.

This article begins with a description and evaluation of the existing withholding regime under the Income Tax Act. There follows a discussion of the advantages and disadvantages of extending withholding to domestic interest and dividend payments. Finally, some preliminary suggestions are put forward for the design of a withholding system applicable to these types of domestic income.

OVERVIEW OF THE CURRENT WITHHOLDING SYSTEM

Historical Development

Federal personal income tax legislation was first enacted in 1917.[5] The 1917 Act called for a broad withholding of tax at source on all "payments of fixed and determinable annual or periodic gains, profits or income of any taxpayer."[6] That provision was apparently inspired by the withholding systems in Britain[7] and the United States.[8] The withholding requirement

[3, 4] Continued . . .

Source of income	*Compliance rate*
Wages and salaries	93.9
Dividends	83.7
Interest	86.3
Capital gains	59.4
Non-farm proprietor income	50.3
Partnership and small business corporate income	47.0
Farm proprietor income	−18.5
Informal supplier income	20.7
Pensions and annuities	86.9
Rents	37.2
Royalties	61.2
Estate and trust income	74.2
State income tax refunds, alimony, other income	62.7
Total income	87.2

Source: United States, Internal Revenue Service, *Income Tax Compliance Research: Estimates for 1973-1981* (Washington, DC: Department of the Treasury, 1983) (herein referred to as "the US Treasury study"), 22. Subsequent studies have shown that compliance in proportional terms has remained relatively constant in the United States: see *American Bar Association Commission on Taxpayer Compliance Report and Recommendations* (Washington, DC: ABA, July 1987) (herein referred to as "the ABA report"), 54. The Brooks and Doob survey, supra footnote 2, shows that the extent of self-reported tax evasion in Canada is generally consistent with the data obtained by the IRS.

[4] Ibid. According to the 1994 report of the auditor general of Canada, 1.6 million taxpayers owed $6.6 billion in taxes at the end of 1993, and about 31 percent of that amount had been outstanding for two years or more. A significant portion may never be recovered. See Canada, *Report of the Auditor General of Canada to the House of Commons 1994*, vol. 16 (Ottawa: Supply and Services, 1994), 29-5.

[5] The Income War Tax Act, 1917 was enacted to provide revenues to defray the expenditures incurred by the government of Canada in prosecuting World War I.

[6] Section 6 of the Income War Tax Act, 1917 provided that "all persons in whatever capacity acting, having the control, receipt or disposal or payment of fixed or determinable annual or periodic gains, profits or income of any taxpayer . . . shall, on behalf of such

([6, 7, 8] Continued on the next page.)

was, however, short-lived. It was withdrawn the following year and not reintroduced until 1942.[9]

Withholding tax on dividends and interest paid to non-residents by residents of Canada was introduced in 1933 during the Great Depression to ensure payment of tax by non-residents.[10] In addition, a special tax of 5 percent was imposed on all interest and dividends received by Canadian residents by way of bearer coupons or cheques if such coupons or cheques were payable in a foreign currency that was at a premium over par of Canadian funds.[11] The purpose of this tax was to ensure that income from

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[6, 7, 8] Continued . . .
taxpayer, deduct and withhold an amount equal to the normal tax." For a discussion of the deduction of tax at source, see J. Harvey Perry, *Taxes, Tariffs, and Subsidies: A History of Canadian Fiscal Development*, vol. 1 (Toronto: University of Toronto Press, 1955), 217.

[7] Withholding tax was first introduced in England, in 1803, by Chancellor Addington, to address the problem of widespread evasion. It applied to interest, dividends, rents, income from funds, and the emoluments of Crown servants. Withholding tax was said to have two advantages. First, it relieved the taxpayer from the necessity of disclosing for the purpose of taxation the exact amount of his income. Second, by the ease and certainty with which it reached the income subject to taxation, it greatly diminished, if not entirely eliminated, the opportunities for evasion. See Richard A. Toby, *The Theory and Practice of Income Tax* (London: Sweet & Maxwell, 1978), 111.

[8] The US Income Tax Law of 1913 provided that all persons, corporations, or associations, in whatever capacity having control, receipt, disposal, or payment of fixed or determinable annual or periodical gains, profits, or income of another person subject to tax, were required to deduct and withhold the annual tax of 1 percent from all "interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments or other fixed or determinable annual gains, profits and income of another person exceeding $3,000 for any taxable year." The "stoppage-at-source" tax did not apply to payments made to corporations. It was abandoned in 1917 and reintroduced in 1942. See Edwin R.A. Seligman, *The Income Tax: A Study of the History, Theory, and Practice of Income Taxation at Home and Abroad*, 2d ed. (New York: Macmillan, 1914), 692.

[9] See Charles Percy Plaxton and Frederick Percy Varcoe, *A Treatise on the Dominion Income Tax Law* (Toronto: Carswell, 1921), 12.

[10] Section 9B(4) of the Income War Tax Act was first enacted by SC 1932, c. 41, section 9 and provided, "In the case of interest or dividends in respect of fully registered shares, bonds, debentures, mortgages or any other obligations, the taxes imposed by this section [15 percent tax on all persons who were non-residents of Canada in respect of interest, dividends, etc.] shall be collected by the debtor who shall withhold five per centum of the interest or dividend on the obligation and remit the same to the Receiver General of Canada."

[11] Section 9B(1) of the Income War Tax Act, as amended by SC 1940-41, c. 18, section 15, provided, "In addition to any other tax imposed by this Act an income tax of five per centum is imposed on all persons resident in Canada, except municipalities, or municipal or public bodies which in the opinion of the Minister perform a function of Government, in respect of all interest and dividends paid by Canadian debtors directly or indirectly to such persons, which interest by the terms of the mortgage, deed, hypothec or other instrument under which the debt was contracted, or which dividends by the terms of issue, are payable in a currency which is at a premium in excess of five per centum in terms of Canadian funds. Provided, however, that no tax hereunder shall be payable if no part of the premium is paid by the Canadian debtor to the creditor." See Herbert A.W. Plaxton, *The Law Relating to Income Tax and Excess Profits Tax of the Dominion of Canada*, 2d ed. (Toronto: Carswell, 1947), 235.

bearer coupons did not escape taxation. The tax was collected by withholding at source; banks, trust companies, and other agents that made payments of such interest or dividends were required to deduct tax from each payment.[12]

Withholding tax on employment income was reintroduced in 1942 to finance World War II.[13] At that time, it was necessary for the federal government to raise revenue quickly and dampen the inflationary tendencies in the economy.[14] Withholding of tax at source addressed both needs; it ensured a regular cash flow for the government and reduced the purchasing power of taxpayers on an ongoing basis. Employers were required to deduct from salary or wages a prescribed amount of tax and remit it to the government within one week after the amount became payable or at such other time as the minister prescribed.

There was little public debate about the justification for reintroducing withholding on employment income.[15] It was believed that a withholding regime prevented many taxpayers from being left short of funds when their taxes became due.[16] In addition, withholding made it virtually impossible for employees to evade or avoid tax on their employment income.[17]

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[12] Section 9B(3) of the Income War Tax Act was first enacted by SC 1932-33, c. 41, section 9 and read as follows: "In the case of bearer coupons or warrants, whether representing interest or dividends, the taxes imposed by this section shall be collected by the encashing agent or debtor who shall withhold 5 per centum of the obligation and remit the same to the Receiver General of Canada, provided that any encashing agent so withholding and remitting shall be entitled to recover 100 per centum of the obligation from the debtor."

[13] Section 92(2) of the Income War Tax Act was first enacted by SC 1942-43, c. 28, section 31 and read as follows: "Every employer who, after the first day of September, one thousand nine hundred and forty-two, pays any salary or wages to any person in his employ who is resident or employed in Canada with respect to any established payroll period commencing after the thirty-first day of August, one thousand nine hundred and forty-two, shall deduct or withhold from such salary or wages such amount in respect of the taxes payable under section nine of this Act by such person, as may be prescribed by regulations made by the Governor in Council and published in the *Canada Gazette*, and shall remit the same to the Receiver General of Canada as a payment on account of such taxes within one week of the day when he becomes liable to pay such salary or wages or at such other time as the Minister may by regulation prescribe." See H. Heward Stikeman, ed., *Income War Tax Act and Excess Profits Tax Act 1940* (Toronto: De Boo, 1948), 313-15; and Plaxton, supra footnote 11, at 383.

[14] Perry, supra footnote 6, at 361-69.

[15] This has been the case in most countries, the United States being a notable exception. See infra footnotes 47 and 53.

[16] Making one annual payment at wartime tax rates would have been an unmanageable burden for many taxpayers newly covered by the tax legislation. The marginal tax rate was 37 percent (3 percent pre-war) on taxable income exceeding $1,000, 59 percent (8.4 percent pre-war) on taxable income exceeding $5,000, 74 percent (28.4 percent pre-war) on taxable income exceeding $20,000, 88 percent (36.8 percent pre-war) on taxable income exceeding $50,000, and 98 percent (69.3 percent pre-war) on taxable income exceeding $500,000. See Perry, supra footnote 6, at 368.

[17] Ibid. Opportunities for tax evasion were still left open to taxpayers who did their own accounting and paid their tax directly, as was the case before the war. The resentment felt by some wage earners was understandable, especially when marginal tax rates were as high as 90 percent or more.

The withholding system was retained after the war. In 1966, the Carter report noted that few complaints had been made about overwithholding and recommended retention of the system.[18]

Operation of the Current Withholding System

The present tax system contains two withholding regimes: withholding from employment income and certain other payments under subsection 153(1) and withholding from payments to non-residents under part XIII. Under both regimes, the recipient is liable to tax, but payers are responsible for withholding and remitting tax to the government.[19] The nature of withholding is, however, different under the two regimes. Wage withholding operates on the same basis as the requirement to pay instalments of tax and acts as an enforcement mechanism. The amount of tax withheld is creditable against the tax liability of the recipient taxpayer when a return is filed. Non-resident withholding, on the other hand, normally represents the final amount of tax payable by a non-resident taxpayer.[20]

The two essential features of withholding are collection of tax when income is paid to a person and notification of Revenue Canada and the recipient concerning the amount of tax withheld. The principal merits of withholding are the immediate collection of tax and the provision of information relevant to the assessment process. Withholding is also cost-effective as compared with alternative methods of tax collection.[21]

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[18] The Carter report recommended expanding the coverage of withholding to casual workers: see Canada, *Report of the Royal Commission on Taxation*, vol. 3 (Ottawa: Queen's Printer, 1967), 315 and 321.

[19] Failure to withhold or remit tax may result in the imposition of a penalty. The Act provides for a two-tier penalty for failure to withhold tax as required under the Act. Paragraph 227(8)(a) imposes a penalty of 10 percent of the amount that should have been withheld for the first failure to withhold in a calendar year. Paragraph 227(8)(b) imposes a second-tier penalty of 20 percent of the amount that should have been withheld where, at the time of the failure to withhold, a penalty under subsection 227(8) had previously been assessed against the same person during the same calendar year and the failure was made knowingly or under circumstances amounting to gross negligence. Subsection 227(9) imposes a similar two-tier penalty for failure to remit the tax deducted. The payer is also liable for the tax that should have been withheld and remitted under subsections 227(8.4) and 215(6) and for interest on the amount not withheld or withheld but not remitted under subsections 227(8) to (9.2). Persons who fail to comply with subsection 153(1) are guilty of an offence under subsection 238(1) and, in addition to the payment of any other penalty, are liable to a fine and possibly also imprisonment for a term not exceeding 12 months.

[20] A non-resident taxpayer may apply for a refund of the overpaid tax pursuant to subsection 227(6). The withholding-type tax for capital gains on the disposition of taxable Canadian property by non-residents is discussed later in this article.

[21] The cost to the government of collecting $100 in tax is slightly over $1. See Revenue Canada, *Inside Taxation 1988-89* (Ottawa: Supply and Services, 1989), 63. The compliance cost to employers of the requirement to retain and remit personal income and payroll taxes is about 0.1 percent of their gross business income. The average annual cost of tax compliance for all Canadians was $117 per capita in 1986. See François Vaillancourt, *The Administrative and Compliance Costs of the Personal Income Tax and Payroll Tax System in Canada, 1986*, Canadian Tax Paper no. 86 (Toronto: Canadian Tax Foundation,

(The footnote is continued on the next page.)

The major defect of the withholding system is that the amount of tax withheld may not be an accurate estimate of the ultimate liability of the recipient, especially with respect to wage withholding under a progressive rate schedule. Underwithholding returns the requirement for reporting and remitting unpaid taxes to the taxpayer and consequently may result in a shortfall of tax revenues. Overwithholding gives the government an interest-free loan from taxpayers until a refund is claimed and paid. There are also some compliance difficulties that may arise under the present withholding system. For example, there is potential for avoidance of withholding in respect of income from employment;[22] uncertainties may arise regarding withholding on payments to non-residents;[23] and there is the possibility that withholding agents may misuse the funds withheld.

Wage Withholding

Under the wage withholding system, employers[24] must withhold tax at the time of payment of wages, salaries, or any other form of remuneration[25] based on prescribed schedules under the regulations.[26] In general, the

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[21] Continued . . .
1989), 53. Vaillancourt found that these compliance costs, expressed as a percentage of the size of the firm, decrease with an increase in firm size. For a discussion of compliance costs in other countries, see International Fiscal Association, *Cahiers de Droit Fiscal International*, vol. 74b, *Administrative and Compliance Costs of Taxation* (Deventer, the Netherlands: Kluwer, 1989); J. Pope, R. Fayle, and M. Duncanson, *The Compliance Costs of Personal Income Taxation in Australia, 1986/87* (Sydney: Australian Tax Research Foundation, 1990); and Cedric Sandford and John Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (Wellington, NZ: Victoria University of Wellington, Institute of Policy Studies, 1992).

[22] Since withholding applies to employment income and not to other "earned income," it is necessary to determine whether income is paid to an employee or an independent contractor and whether an employee benefit is a taxable benefit subject to withholding. Both payers and recipients may have some incentive not to classify income as employment income in order to escape withholding tax liability.

[23] One of the most common problems under part XIII occurs when a Canadian payer of investment income to a non-resident is not certain whether a particular payment is subject to withholding and, if so, what is the rate of withholding. Potential compliance problems also arise under section 216 and regulation 105(1).

[24] Subsections 153(1.3) and (1.4) provide that liquidators, receivers, receiver-managers, trustees in bankruptcy, and other defined persons who in their specified capacity authorize or otherwise cause the payment of remuneration on behalf of another are jointly and severally responsible for salary withholding.

[25] Under regulation 100(1), "remuneration" includes any payments of wages, salary, or commissions paid to an officer or employee or former officer or employee; superannuation or pension benefits; an amount of a distribution out of or under a retirement compensation arrangement; a retiring allowance; a death benefit; a benefit under a supplementary unemployment benefit plan; and an amount under a deferred profit-sharing plan. Non-cash remuneration also is subject to withholding.

[26] Regulations 100 to 103. Booklets are published by Revenue Canada showing the amounts to be withheld under subsection 153(1) and the regulations. These booklets take into account both federal and provincial rates of tax based on various pay periods. In the case of undue hardship, the minister may permit withholding of a lesser amount under subsection 153(1.1).

schedules require slight overwithholding. If the employee's income for the year is less than a specified amount, however, there is no withholding.[27] Employees must file form TD1 with the employer when commencing employment.[28] Tax withheld under subsection 153(1) must be paid to the receiver general[29] within a specified period.[30] At the end of the taxation year or on the termination of employment, the employer must notify the employee and Revenue Canada, by way of an information return, of the total wages and salaries paid to the employee during the year and the total amount of tax withheld and remitted to the receiver general.

Tax withheld under subsection 153(1) is paid to the receiver general on account of the employee's part I tax for the year.[31] The receipt by the minister of a remittance discharges the employer's liability to the employee for the amount remitted.[32] An employee has no right of action against the employer for withholding any sum of money in compliance with the Act.[33] An employee is deemed to have received the amount of tax withheld at the time of withholding, whether or not the amount is actually remitted to the receiver general.[34] The Act is not clear as to whether the employee is deemed to have paid tax where the employer has deducted the tax but failed to remit it to the receiver general. It appears, however, that the employee may claim the payment as an instalment of tax only if the amount is remitted to the receiver general.[35] Revenue Canada may not credit employees with amounts that employers have withheld but failed to remit to the receiver general.[36] On the other hand, the employer, in its

[27] The specified amount normally represents the amount of income that is exempt from tax by virtue of the personal tax credits under the Act.

[28] Subsection 227(2).

[29] The withholding tax may be deposited in financial institutions to the credit of the receiver general. Some financial institutions have agreements with the receiver general under which they charge for each remittance they process and pay interest on amounts they have received but not yet credited to the receiver general. Other financial institutions charge no service fees and pay no interest. See Canada, *Report of the Auditor General of Canada to the House of Commons* (Ottawa: Supply and Services, 1989), 399.

[30] Regulation 108 prescribes that amounts withheld under subsection 153(1) shall be remitted to the receiver general at various times. Generally, under regulation 108(1), amounts of tax deducted must be remitted on or before the 15th day of the month following the month in which the amounts were withheld. Regulations 108(1.1) to (1.3) provide for more frequent remittances for employers whose "average monthly withholding amount" for the second calendar year preceding the calendar year in question is not less than $15,000.

[31] Under section 156.1, an individual is required to make quarterly payments if the difference between tax payable and amounts withheld at source is greater than $2,000 in both the current year and either of the two preceding years. The instalment threshold for taxpayers in Quebec is $1,200.

[32] Subsection 227(13).

[33] Subsection 227(1).

[34] Subsection 153(3).

[35] This conclusion seems to be supported by subsection 227(13). See Broadhurst, supra footnote 1, at 11:5.

[36] Ibid.

role of "deputy tax collector," is held fully responsible for taxes withheld and is deemed to hold such amounts in trust for Her Majesty.[37]

An employee's tax return and information returns filed by employers are matched by Revenue Canada in the assessment process. The amount of tax deducted and remitted by the employer is credited against the employee's tax liability and, in effect, is treated as an instalment of tax. Since Revenue Canada has no obligation to refund any overwithheld tax to a taxpayer who fails to file a tax return, overwithholding encourages employees to file returns.

Non-Resident Withholding

In general, non-residents are liable to tax on their Canadian source income. Net income earned by a non-resident from business or employment in Canada, or from the disposition of a taxable Canadian property, is taxed under part I of the Act.[38] Investment income is generally taxed on the gross amount under part XIII. Tax is deducted by payers and remitted to the government.

Under part XIII, a resident payer[39] must deduct 25 percent (except where the rate is reduced by treaty) from each payment made to a non-resident of management fees, interest, rent, royalties, dividends, or other specified amounts.[40] For part XIII purposes, some other payments, such as shareholder benefits[41] and payments made on the redemption of bearer coupons or warrants,[42] are deemed to be interest or dividends.

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[37] Subsection 227(4).

[38] Non-residents are required to file tax returns under subsections 150(1) and (2).

[39] For the purposes of part XIII, certain non-resident payers are deemed to be residents. For example, subsection 212(13.2) provides that where a non-resident person whose business is carried on principally in Canada, or a non-resident who manufactures or processes goods in Canada or operates an oil or gas well in Canada or extracts petroleum, natural gas, or minerals in Canada, pays an amount to another non-resident, the payer is deemed, in respect of the amount that is deductible in computing taxable income earned in Canada for any taxation year, to be a person resident in Canada.

[40] Subsection 215(1). The only class of persons exempt from the withholding obligation in respect of payments made to them are registered non-resident insurers who have elected to file annual returns: see subsection 215(2). Any person who fails to withhold and remit an amount required under the Act is liable to pay tax equal to such amount for the non-resident and is liable for penalties under section 227.

[41] For example, under subsection 214(3), certain amounts that are deemed to be included in income under section 15 or subsection 56(2) are deemed to be dividends received by a non-resident.

[42] Subsection 215(2). Amounts of accrued interest realized by a non-resident on the transfer of a debt obligation with accrued interest to a person resident in Canada are deemed to be interest paid by the transferee to the transferor for the purpose of part XIII under subsections 214(6), (7), and (7.1). These provisions apply only if the obligation was issued by a resident of Canada. They do not apply if the interest is exempt from tax because it relates to bonds or other securities listed in subparagraph 212(1)(b)(ii), (iii), or (vii) or where interest is payable on prescribed public issue securities. For further discussion, see Rossiter, supra footnote 1.

In addition to part XIII, the Act imposes a withholding obligation on persons who make certain payments to non-residents. For example, regulation 105 requires the payer of a fee, commission, or other similar amount to a non-resident in respect of services rendered in Canada to deduct tax from the payment. In certain circumstances, section 116 requires a person who purchases taxable Canadian property from a non-resident to withhold tax from the purchase price.[43]

The effect of a Canadian resident's payment of tax owed by a non-resident under part XIII is the same as an employer's payment of tax owed by an employee. The resident payer is entitled to deduct from any amount paid or credited to the non-resident, or to recover from the non-resident in some other way, any amount paid on the non-resident's behalf.[44] Where a non-resident was not liable to pay tax but did pay, or paid tax in excess of the amount required, the non-resident may apply for a refund of that tax.[45]

THE CASE FOR EXTENDING WITHHOLDING TO DOMESTIC INTEREST AND DIVIDEND PAYMENTS

For more than 50 years, most personal income tax in Canada has been collected by withholding on wages and salaries at source.[46] Withholding is now accepted as an indispensable part of virtually every contemporary income tax system.[47] In my view, the Canadian withholding system should be expanded to include domestic payments of interest and dividends.

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[43] A non-resident must pay to the receiver general on account of tax one-third of the gain immediately before disposition or furnish the minister with acceptable security in respect of the disposition. The purchaser may be liable to pay tax on behalf of the vendor on the excess of the amount payable by the non-resident over the amount fixed in the certificate. Under subsection 116(5), the purchaser is not liable if there is no reason to believe that the vendor is not resident in Canada.

[44] Subsection 215(6).

[45] Subsection 227(6). Where a non-resident has assets in Canada, Revenue Canada may assess the non-resident for the tax not withheld and, if successful, may not take further action against the resident payer.

[46] For example, in 1988, 13,666,992 individuals were subject to withholding tax, and over $80 billion of the total individual taxes of $88.4 billion was withheld at source. See *Inside Taxation 1988-89*, supra footnote 21, at 63 and 31.

[47] There have been few complaints about withholding in Canada or in most other countries. In the United States, proposals to expand the withholding system in the early 1980s led to some debate on the merits of withholding: see Richard L. Doernberg, "The Case Against Withholding" (December 1982), 61 *Texas Law Review* 595-653, at 599-603; and Michael H. Hoeflich, "Withholding at Source on Non-Wage Income: A Brief Historical Excursus" (May 23, 1983), 19 *Tax Notes* 678-82. Doernberg was severe in his criticism and argued that a system of comprehensive reporting of income to both the tax authorities and the recipient would be as effective in ensuring compliance as a comprehensive system of withholding. He claimed, supra, at 603, that "[t]he withholding system has become anything but a paragon of government efficiency during the past forty years." While providing no empirical information about the cost of withholding, Doernberg stated that costs borne by employers, employees, and the government were significant enough to

(The footnote is continued on the next page.)

A broad-based domestic withholding regime has been adopted in many OECD countries,[48] including Belgium, Finland, Germany,[49] Greece, Ireland, Italy, Japan, New Zealand, Portugal, Spain, Switzerland, Turkey, and the United Kingdom.[50] In Japan, for example, a domestic withholding tax has been in place for over 40 years, which is imposed not only on employment income, but also on interest and dividends paid to residents of Japan.[51] The general public seems to prefer a comprehensive withholding system because it is simpler to comply with. In New Zealand, the

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47 Continued . . .
warrant attention. He also pointed out that there are difficulties in implementing the withholding system, such as confusion surrounding the scope of the withholding requirement and the temptation of withholding agents to misuse the funds withheld, but he acknowledged that these difficulties are perhaps endemic in any collection system. According to Doernberg, withholding also suffers from some basic philosophical shortcomings: first, it is contrary to the annual accounting concept that is central to the Internal Revenue Code (IRC); second, it is regressive since it applies only to wages and not to other types of income; and third, it has adverse effects on private savings and investment since taxpayers must remit to the government money that they might otherwise save (economists believe that a high rate of savings can lead to increased productive capacity and a higher level of income). The fate of the US government's proposals is described in footnote 53, infra.

48 Organisation for Economic Co-operation and Development, *Taxpayers' Rights and Obligations: A Survey of the Legal Situation in OECD Countries* (Paris: OECD, 1990), 30-32.

49 The German government introduced a withholding tax in 1989, but with little success. It repealed the law six months later. The withholding tax rate then was 10 percent. On July 6, 1992, the government reintroduced the withholding tax with effect from January 1, 1993. The legislation provides for a 30 percent withholding tax assessed on a gross basis. The withholding tax will apply to interest accrued as well as received. Interest payments are defined as income from bonds and obligations entered in an official debt register. The withholding agent is generally the payer. For more discussion, see Jörg-Dietrich Kramer, "Germany" (August 1991), 3 *Tax Notes International* 853-56, at 854-55; and Friedhelm Jacob, "Germany: Administrative and Legislative Developments of Interest to US Tax Advisers" (July/August 1993), 47 *Bulletin for International Fiscal Documentation* 383-88.

50 Domestic withholding tax on interest is nothing new in the United Kingdom. Historically, "deduction at source" has always been an important element of UK income tax law; for example, section 208 of the Income Tax Act 1803 provided that tax was to be charged on all "annuities, yearly interest of money or other annual payments, and the payer was to be taxed on the full amount of the payment made by him and deduct the tax from the interest payment made where interest was paid out of profits or gains brought into charge to tax." The current income tax law contains similar withholding taxes. Because of the schedular system of taxation, interest and dividends are taxed under different schedules, and "yearly interest" is taxed differently from other interest. The rules on deduction of tax at source also are different for the various types of income.

51 According to book IV of the Japanese Income Tax Law, payers of interest and dividends are required to withhold income tax and remit it to the government before the 10th of the month following the month of payment. Interest paid to residents on bonds and deposit and savings accounts is normally subject to withholding at source at the rate of 20 percent. Interest on loans paid to residents and interest on short-term credits (less than 6 months) extended in connection with the purchase of goods or services are exempt from withholding. Gains from original issue discounts on debentures also may be subject to withholding at the rate of 18 percent. The issuer is required to collect the tax at the time of issuance. See Gary M. Thomas, "Tax Compliance: A Review of the Japanese Rules Regarding Withholding Tax on Interest" (June 1990), 2 *Tax Notes International* 546-49.

government introduced a resident withholding tax system in 1989, under which persons making payments of interest or dividends to New Zealand residents are required to deduct tax from each payment at the time the payment is made.[52] Australia and the United States[53] have a "backup" withholding system for payments of interest and dividends to residents, which applies only where a taxpayer has failed to comply with information-reporting requirements.

The implementation of a broad-based domestic withholding system in other OECD countries suggests that there is a reasonable case for adopting a similar system in Canada. At the very least, the proposal deserves serious scrutiny. The major arguments in favour of a withholding tax on domestic interest and dividend payments are analyzed below.

Withholding Reduces Non-Compliance

The Problem of Non-Compliance

Non-compliance takes many forms, including the failure to report income, the underreporting of income, the overstating of expenses, and the failure to file tax returns. The most common form of non-compliance is underreporting of income, especially investment income. In the United States, studies show that while employment income is underreported by 2 to 3 percent, interest and dividend income is underreported by 9 to 16 percent.[54] In New Zealand, before a resident withholding tax on interest and dividends was introduced, unpaid tax on this type of income was thought to be about 20 percent; once the system was in place, the figure was revised to 50 percent[55] on the basis of the amount of tax collected

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[52] The New Zealand government introduced a resident withholding tax (RWT) in 1989 as part IXA of the New Zealand Income Tax Act 1976.

[53] In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. no. 97-248, the US government introduced a number of provisions to improve taxpayer compliance. One of the measures was the imposition of withholding tax on interest and dividends paid to residents. The withholding tax was scheduled to apply to payments of interest and dividends on July 1, 1983. However, owing to widespread antagonism from the banking industry and taxpayers, the US Congress repealed the withholding tax before it became effective. In place of mandatory withholding of tax on interest and dividends, the US Congress substituted a backup withholding system under IRC section 3406, which requires withholding at 20 percent on reportable payments of interest and dividends when the payee fails to furnish his or her correct taxpayer identification number or fails to report the income.

[54] See the US Treasury study, supra footnote 3, at 22. The estimates of unreported income for interest and dividends were 11 percent and 15 percent respectively. See "New Withholding Rules Are Aimed at Twenty Billion Dollars of Unreported Interest" (February 7, 1983), 18 *Tax Notes* 477. In Australia, a substantial amount of tax withheld by employers is not claimed by taxpayers. In the 1980-81 taxation year, some $519 million deducted remained unclaimed at June 30, 1984. The figures were believed to be much higher for later years. On the assumption that taxpayers would claim all such credits if it were to their advantage to do so, the sheer magnitude of the unclaimed tax withheld suggests significant avoidance and evasion of tax. See Daryl Dixon, "Tax Avoidance and Withholding Tax" (Autumn 1985), 2 *Australian Tax Forum* 33-52. No similar data are available for Canada.

[55] This estimate was obtained by correspondence with revenue officials in New Zealand.

through withholding. Revenue Canada has not published much information on the extent of underreporting of investment income. The experience in New Zealand suggests that non-compliance in Canada is a more serious problem than is generally thought. If the non-compliance rate is 20 percent for domestic interest and dividends, the annual loss of revenue could be as high as $2 billion.[56]

Unless more effective collection measures are implemented, the problem of non-compliance is likely to worsen. Since the late 1960s, personal income tax has become increasingly important as a source of government revenues. In 1965, personal income tax represented 23 percent of total tax revenues; in 1989, 38 percent; and in 1993, over 40 percent.[57] Interest and dividends accounted for 2 percent of total reported personal income in 1966, 7.5 percent in 1988, and 6.2 percent in 1992.[58] If the trend continues and domestic withholding is limited to payments under subsection 153(1), the increase of interest and dividend income as a percentage of personal income will result in a decrease in the proportion of income subject to withholding (and the proportion of taxes collected by withholding), an increase in the degree of non-compliance (assuming that taxpayers will continue to underreport investment income), and a corresponding decrease in tax revenues to which the government is entitled.

A high rate of non-compliance is unacceptable at any time, and most of all at a time of enormous government deficits and widespread economic difficulty. Given the government's heavy reliance on personal income tax as a source of revenues, there is an urgent need for the introduction of measures to improve compliance.

Withholding and Other Compliance Measures

Non-compliance can be reduced through such measures as enforcement, the use of penalties, third-party information reporting, and withholding. Research has shown that taxpayer behaviour is influenced by many factors, the most important of which is the opportunity for tax evasion or a

[56] In 1989, the amount of taxable dividends and interest (bond, bank, and mortgage interest) assessed in Canada was $36 billion. Assuming a non-compliance rate of 20 percent, the amount of income underreported was approximately $7.2 billion. At an effective tax rate of 30 percent, the total tax evaded in 1989 would have been more than $2 billion.

[57] See *The National Finances, 1994* (Toronto: Canadian Tax Foundation, 1994), 3:6-7; and Organisation for Economic Co-operation and Development, *Revenue Statistics of OECD Member Countries, 1965-1990* (Paris: OECD, 1991), 77.

[58] Based on information published by Revenue Canada in *1968 Taxation Statistics* (Ottawa: Queen's Printer, 1968), 35; *1990 Taxation Statistics* (Ottawa: Supply and Services, 1990), 107; and *1994 Taxation Statistics* (Ottawa: Supply and Services, 1994), 68-69. There has also been a consistent increase in the relative significance of interest income in other countries. For example, in the United States, in 1960 personal interest income of $25 billion was only 6.8 percent of total personal income; in 1982, personal interest income of $371.8 billion represented 14.47 percent of total personal income. See James W. Severt II, "The Battle Over Interest and Dividend Withholding: Beyond the Hysteria" (May 23, 1983), 19 *Tax Notes* 683-91, at 683.

low probability of detection.[59] The deterrence theory suggests that those who believe that they are likely to get caught if they fail to comply with the law are more likely to comply with it.[60] Taxpayers whose economic or employment situation offers greater opportunities for escaping detection are more likely than others to evade tax. Revenue Canada can detect non-compliance through enforcement activities and through the matching of information returns filed by payers of income with returns filed by taxpayers.

Although enforcement and information reporting can be effective in improving compliance, they are inadequate in restricting non-compliance with respect to domestic interest and dividend income. As discussed below, withholding is the best solution to the problem.

Withholding

For several reasons, non-compliance is effectively restricted through withholding of tax at source. First, tax is collected at the time of payment of income. The payer is obliged to withhold tax and remit it to the government; withholding thus leaves the recipient of the income little opportunity for non-compliance, unless the rate at which tax is withheld is substantially lower than the recipient's marginal rate. Second, withholding removes financial incentives for not reporting income from which tax has been withheld. Third, the administration of withholding and accounting to Revenue Canada is concentrated in the hands of corporations and institutions, and the compliance cost to them is relatively low. The smaller number of

[59] Other important factors include the complexity of the tax laws, the perceived morality of tax evasion, penalties for non-compliance, taxpayers' perceptions of government, and the overall fairness of the tax system. The Brooks and Doob study shows that between 16 and 32 percent of the respondents to their survey indicated that they "probably" would evade tax if, in the future, they had the opportunity and thought they would not be caught: see Brooks and Doob, supra footnote 2, at 139-46. For further discussion of factors associated with non-compliance, see S.S. Aitken and L. Bonneville, *A General Taxpayer Opinion Survey*, prepared for the IRS Office of Planning and Research by CSR Incorporated (Washington, DC, 1980); Peter Dean, Tony Keenan, and Fiona Kenny, "Taxpayers' Attitudes to Income Tax Evasion: An Empirical Study" [1980], no. 8 *British Tax Review* 28-44; Robert Mason and Lyle D. Calvin, "A Study of Admitted Income Tax Evasion" (Fall 1978), 13 *Law and Society Review* 73-89; Robert Mason and Lyle D. Calvin, "Public Confidence and Admitted Tax Evasion" (December 1984), 37 *National Tax Journal* 489-96; and I.G. Wallschutzky, "Possible Causes of Tax Evasion" (1984), 5 *Journal of Economic Psychology* 371.

[60] There has been little research demonstrating how well the deterrent effect operates in Canada. Revenue Canada has stated that wide exposure of taxpayers to enforcement activities helps to promote voluntary compliance. It expects that taxpayers who become aware of Revenue Canada's attention to their tax returns will improve their compliance in the future. Other taxpayers also often improve their compliance after becoming aware of enforcement activities. See the 1989 auditor general's report, supra footnote 29, at 559. However, even if other taxpayers become aware of enforcement activities and the conviction of tax evaders, studies have shown that many people view wilful non-compliance with income tax laws as a victimless and not particularly serious crime. In the Brooks and Doob survey, most taxpayers did not believe that the compliance structure of the tax system ensured apprehension of tax evaders: see Brooks and Doob, supra footnote 2, at 143-46.

payers responsible for withholding enables Revenue Canada to detect non-compliance and pursue offenders more easily. Finally, withholding reduces the anxiety and financial difficulty that may result when taxpayers are required to make a single year-end payment. The prospect of obtaining a refund or paying no tax when returns are filed may encourage taxpayers to file returns and report income.

Enforcement and Penalties

Revenue Canada uses about one-third of its resources for enforcement;[61] most of these resources are devoted to auditing taxpayers' returns.[62] Audits are designed to detect and correct instances of non-compliance, particularly by individuals in higher income brackets, corporations, and taxpayers with significant opportunities for avoidance. Despite the recognized financial results of enforcement,[63] Revenue Canada's resources for enforcement have been decreasing as a result of the overall reduction of government personnel. Audit coverage was 2 percent of individuals in the 1982-83 fiscal year but only 1 percent in the 1989-90 fiscal year.[64] If we accept that enforcement has a significant deterrent effect, the decline in enforcement coverage, particularly through audits, is cause for serious concern. For the majority of taxpayers, the chance of being subject to any enforcement action is remote.[65]

The effectiveness of enforcement as a deterrent depends on the probability of detection and the severity of the penalties.[66] Revenue Canada lacks the necessary resources to deal vigorously with tax delinquents. For example, where a taxpayer files a tax return but fails to pay, Revenue Canada may not take any measures until the return is assessed or audited. The taxpayer may then receive a written notice asking for full payment. If

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[61] Canada, *Report of the Auditor General of Canada to the House of Commons* (Ottawa: Supply and Services, 1990), 555. Enforcement activities include the audit of tax returns, office examination and post-assessing, matching information in the taxpayer's return with information from other sources, taking action to identify taxpayers who fail to comply, and the use of special investigations when tax evasion is suspected.

[62] Ibid., at 556.

[63] In the 1989-90 fiscal year, $1,229 million in additional tax was assessed: ibid., at 563. Revenue Canada's enforcing strategy is to target its efforts at non-compliance activities so as to obtain high levels of additional tax revenue while achieving a visible presence throughout the taxpayer population to discourage non-compliance. Certain enforcement activities, such as special investigations, are pursued even when they yield financial results significantly below those obtainable in other areas, in order to protect the integrity of the system.

[64] Ibid., at 560. In the same period, audit coverage for corporations also was reduced from above 1.5 percent in 1980-81 to below 1 percent in 1989-90.

[65] Only 19 percent of the respondents to the Brooks and Doob survey thought that they would probably be audited in the next five years: see Brooks and Doob, supra footnote 2, at 143-46. The low rate of audit coverage is probably unknown to many taxpayers. Once it is publicly known, non-compliance may become more serious.

[66] Civil penalties are provided under sections 162, 163, 235, 237, and 238 of the Act.

payment is not received, Revenue Canada personnel may contact the taxpayer personally and give him or her a final opportunity to pay or to make satisfactory arrangements for payment. In cases where these efforts still do not result in payment of tax, Revenue Canada may garnish the taxpayer's wages or confiscate and sell his or her assets.[67] Seizure of a taxpayer's assets, however, is rare. A first offender generally is given a chance to pay in instalments, and interest is sometimes forgiven. Revenue Canada has a practice of waiving penalties for gross negligence or wilful evasion if taxpayers voluntarily disclose their past non-compliance, as long as they do so before an audit or a special investigation has begun.[68]

Criminal prosecution may be brought against a taxpayer for an offence under the Act.[69] Prosecution of tax evaders is carried out primarily to deter others from breaking the law, and therefore deterrence requires publicity to be effective. Only half of the prosecutions in 1988 were reported by the media; by contrast, between 1981 and 1983, almost every case received media coverage.[70] Revenue Canada used to publish the names of tax evaders, then ceased to do so, but recently it appears to have reinstated the practice.[71]

Information Reporting and Matching

Information reporting[72] applies to a much broader range of payments than withholding.[73] Payers of the specified amounts, such as interest and dividends paid to individuals, must file information returns.[74] Information returns must generally be filed on or before the last day of February for the preceding calendar year.[75] The returns normally include the name, address, and social insurance number (SIN)[76] of the recipient of income,

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[67] *Inside Taxation 1988-89*, supra footnote 21, at 33.

[68] Ibid., at 53.

[69] Sections 238 and 239. Tax evaders are treated less severely than persons who commit other types of fraud. Revenue Canada's policy is not to recommend prosecution by indictment unless a case involves attempted evasion of a minimum of $100,000 in tax. The Criminal Code makes fraud over $1,000 an indictable offence. See section 380 of the Criminal Code, RSC 1985, c. C-46, as amended, and the 1990 auditor general's report, supra footnote 61, at 561.

[70] See the 1990 auditor general's report, supra footnote 61, at 560.

[71] See, for example, Revenue Canada, *News Release*, no. 58T/94, September 2, 1994; *News Release*, no. 19T/95, February 20, 1995; and *News Release*, no. 10T/95, April 10, 1995.

[72] Information reporting was first introduced in 1927. Employers, corporations that paid dividends, and agents who had control of periodical gains, profits, or income of any other taxpayer were required to file information returns with the minister. In 1933, debtors who paid interest on fully registered bonds or debentures also were required to file information returns. In 1947, the governor in council was authorized to make regulations requiring any class of persons to make information returns respecting any class of information required in connection with assessments under the Act. See Stikeman, supra footnote 13, at 229-31.

[73] The major information returns under part II of the regulations are summarized below.

([73, 74, 75, 76] Continued on the next page.)

the amount of income paid during the taxation year, and any other information that Revenue Canada requires. The person responsible for filing information returns must also forward two copies of the return to the person in respect of whom the return is filed.[77] One copy of this information slip is filed by the individual with his or her tax return. Information

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[73, 74, 75, 76] Continued . . .

Form	*Type of income*	*Payers*
T4, T4 supp. T4-T4A T709 magnetic media . . .	Employment income	Employers
T4A supp.	Pension, retirement, annuity	Various entities
T4RSP summ.	Income from RRSP	Various entities
T1-CSB	Cash bonus payments on Canada savings bonds	Banks, brokers
T4A-NR	Fees and commissions paid to non-residents	Various persons and entities
NR4 supp. NR4-NR4A	Payments to non-residents	Various entities
T5 supp. T619: magnetic media . . .	Investment income	Banks, corporations, brokers
T-BD	Gains from disposition of debt obligations in bearer form	Brokers, banks
T600	Accrued bond interest	Financial companies
T5002	Income from tax shelters	Promoters
T3	Trust and estate income	Trustees
T5013	Partnership income	Partners

[74] Part II of the regulations. In addition to the payers and types of income listed in footnote 73, supra, the following persons must file information returns relating to the following items: investment dealers and financial institutions in respect of securities transactions under regulation 230; persons paying patronage dividends under regulation 218; and corporations resident in Canada or non-resident persons carrying on business in Canada in respect of transactions with non-arm's-length non-resident persons under section 233.1.

[75] Regulation 205. Persons who fail to file a return as required by the Act or regulations are subject to a penalty equal to the greater of $100 and $25 per day for a maximum of 100 days. Persons who fail to provide information required on a prescribed form or to provide a social insurance number are liable to a penalty of $100 for each failure. See subsections 162(5), (6), and (7).

[76] The Act provides that every individual who is required to file an income tax return must obtain a SIN. The SIN must be provided to third parties for all information-reporting purposes under the Act and the regulations. An individual who fails to provide a SIN on his or her tax return is liable to a penalty of $100 for every failure (unless the individual had applied for a SIN by February 1 of the relevant year). Third parties such as banks, financial institutions, public corporations, or other persons who are required under the Act or regulations to obtain a SIN from an individual also are subject to a penalty of $100 for every failure, unless they make a reasonable effort to obtain the SIN. See subsections 162(5) and (6), subsections 237(1) and (2), and subsection 239(2.3); see also Revenue Canada, *Information Circular* 82-2R2, "Social Insurance Number Legislation That Relates to the Preparation of Information Slips," November 20, 1992.

[77] Regulation 209.

matching is probably Revenue Canada's primary method of detecting unreported income. Revenue Canada matches the information return with the taxpayer's return to verify the return and to detect non-compliance.[78] Information matching results in either an acceptable match or a reporting discrepancy or the identification of an apparent non-filer. Upon detecting unreported income, Revenue Canada personnel may contact the taxpayer, advise him or her of the discrepancy, and revise the assessment to reflect the increase in income.[79]

Information reporting and matching may reduce non-compliance in two ways. First, they assist taxpayers in record keeping. A taxpayer is likely to rely on and use information recorded on an information slip in preparing a tax return. Second, information reporting makes the financial transactions of taxpayers more visible to Revenue Canada. Since taxpayers know that Revenue Canada has access to information and will use it in matching, they may be less tempted not to report income.

Withholding Versus Other Compliance Measures

Although it is impossible to assess the relative deterrent impact of increasing enforcement activities and penalties, it is clear that these measures are less efficient than withholding in limiting non-compliance.

Withholding is more effective than other enforcement measures because the deduction and remittance of tax by the payer removes the opportunity for tax evasion. Even if it is accepted that enforcement and the use of penalties have some deterrent effect, in view of the cut in government expenditures, any increase in Revenue Canada's enforcement activities seems unlikely in the near future.

Information reporting by itself is not now, and is not likely to be, an adequate solution to the problem of non-compliance. Information-matching programs can be thwarted by taxpayers by the simple strategy of giving financial institutions inaccurate information. Many returns contain inadequate or inaccurate information; consequently, matching is difficult or impossible. By contrast, with respect to withholding from employment income, the number of information returns that cannot be processed is much lower because taxpayers have an incentive to obtain proper credit for withheld taxes. Furthermore, the expansion of information reporting and matching faces several obstacles. Revenue Canada must have enough qualified personnel to resolve mismatches and pursue discrepancies, and current spending restrictions may not allow Revenue Canada to hire and train such people. Revenue Canada also must have a computer system capable of processing the large variety of information returns that are

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78 Information slips filed on paper are converted into computer-readable form. The data are computer matched against tax returns that have been filed. Paper returns that cannot be converted are matched manually. Manual processing of information is labour-intensive and is not generally feasible. See the 1990 auditor general's report, supra footnote 61, at 557.

79 Significant additional revenues are collected as a result of matching; for example, in 1988, $105 million was collected. Ibid., at 556.

filed. Most important, not all returns are computer readable.[80] Information returns on interest and dividends (T5 slips) are only partially matched because some returns include incorrect SIN or other information or are not convertible into computer inputs.[81] Finally, even assuming that all information returns are machine readable, Revenue Canada does not have the resources to make full use of the information supplied to it. Revenue Canada's administrative costs in verifying information, detecting noncompliance, and enforcing the collection of unpaid tax on interest and dividends may outweigh the benefits of the extra revenue collected.[82] Much of the unreported interest or dividend income consists of relatively small amounts that thousands of taxpayers simply neglect to report—often as a result of failure to maintain records or for other reasons that do not amount to fraud.

Withholding Generates Additional Revenue Without Imposing Any New Taxes

Withholding on domestic interest and dividend payments is a collection mechanism; it is not a new tax and will not increase anybody's tax liability. The current rules for taxing income remain unchanged; only the method of collecting tax will change. In effect, withholding will garner revenues that should already be accruing to the government. As noted earlier, more than $2 billion in lost revenues[83] might be recovered if withholding were extended to dividend and interest income. Additional tax revenues would result solely from improved tax compliance.[84] Reference was made earlier to the experience of New Zealand, where the amount of tax recovered through withholding far exceeded the original estimate of the amount of tax evaded.[85] In the United States, the US Treasury's estimate of increased revenue from levying a 10 percent domestic withholding tax on interest and

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[80] For 1989, only 20 percent of T4 slips sent in by employers and 38 percent of T5 slips received from financial institutions were filed on magnetic media. In contrast, in the United States in 1988, 94 percent of such slips were on magnetic tapes. Revenue Canada is aiming to have 80 percent of the returns filed on magnetic media in the near future. Ibid., at 568.

[81] For example, it was estimated that in 1989 only 50 percent of the T5 returns on investment income submitted on magnetic tapes included SINs. Ibid., at 567, and correspondence between the author and Revenue Canada. In the absence of electronic filing of all information returns, which may be too costly for small businesses, information returns cannot be fully matched and used by Revenue Canada.

[82] It is also extremely expensive for Revenue Canada to use letters, telephone calls, and personal visits to pursue delinquent taxpayers, especially when the potential tax to be collected is very small.

[83] See supra footnote 56 and the accompanying text.

[84] Several aspects of a withholding regime suggest that additional revenue would be raised. Tax on interest and dividend income that is currently unreported or underreported would be collected through withholding, whether taxpayers filed returns or not. Withholding encourages taxpayers to report their income. The government will collect even more tax if, as a result of improved compliance, taxpayers' willingness to pay tax is improved.

[85] See supra footnote 55 and the accompanying text.

dividends was $1.334 billion for the first year and $5.246 billion for the second year.[86] In Germany, the government estimated that a withholding tax on interest alone would raise tax revenues by DM4 billion annually.[87]

Withholding Improves Tax Equity

Tax equity between employees and investors can be enhanced through an expanded system of withholding. The principle of tax equity requires that persons with the same ability to pay should pay the same amount of tax (horizontal equity) and that persons with greater ability to pay should pay more tax (vertical equity).[88]

Under the current tax system, wage earners are subject to withholding, whereas recipients of interest and dividends can defer the payment of tax until the end of April of the following year unless the net tax owing for the year (or for each of the two preceding years) exceeds $2,000.[89] This treatment lacks horizontal equity because investors have the advantage of a delayed tax payment. In addition, investors have more opportunities for underreporting income or evading tax and shifting their tax burden to other taxpayers. The current method of taxing domestic investment income also lacks vertical equity because investment income earners tend to be high-income taxpayers who benefit more from the current limited withholding regime.[90]

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[86] Severt, supra footnote 58, at 683.

[87] Kramer, supra footnote 49, at 855.

[88] Application of the principle of tax equity in the context of domestic interest payments was recently demonstrated by the German Supreme Court. The court mandated the legislature of Germany to pass a law ensuring that interest income will be taxed like other types of income. This equal taxation is required by the equality clause of the German constitution, which provides that taxpayers must bear the burden of a tax law equally. The German system of taxing interest income did not meet this constitutional standard because no withholding tax was imposed on interest payments and the tax authorities could not obtain any information from the banks; consequently, most taxpayers who earned interest income did not report it or pay tax on it. According to the court, the equal treatment provision requires that the tax burden on all taxpayers must be legally and factually equal. If taxation depends on a tax declaration, the legislature must provide an effective instrument of control. Otherwise, payment of tax is left totally to the discretion of the taxpayer and an unequal tax burden results. Ibid., at 854-55.

[89] See subsection 156(1) and supra footnote 31.

[90] The proportion that interest and dividends constitute of total personal income is higher in both low-income groups (pension earners) and high-income groups. The percentage of dividend and interest income of the total income assessed in 1988 was as follows:

- 8.5 percent for taxpayers reporting $5,000-10,000;
- 7.3 percent for taxpayers reporting $15,000-20,000;
- 5.15 percent for taxpayers reporting $30,000-40,000;
- 8.5 percent for taxpayers reporting $50,000-100,000; and
- 15.3 percent for taxpayers reporting $150,000-200,000.

This information is based on statistics published by Revenue Canada in *Taxation Statistics 1988* (Ottawa: Supply and Services, 1988), 84-107.

These inequities between wage earners and investors can be reduced by the extension of withholding to investment income.

Withholding Simplifies Compliance for Certain Taxpayers

Withholding of tax may simplify tax compliance for those taxpayers (mostly pensioners) whose income is mainly from interest and dividends and who are currently required to pay tax by instalments. Instead of making instalment payments, a taxpayer would have his or her tax deducted by the payer of interest or dividends and would file an annual return at the end of the year.

Summary

The above arguments seem to establish an overwhelming case for expanding withholding to domestic interest and dividend payments. Major advances in electronic data processing over the past decade will make expansion of the withholding system feasible for both withholding agents and Revenue Canada. Information gathering, processing, reporting, and audit can be handled by computers.

The Case Against Extending Withholding to Domestic Interest and Dividend Payments

The principal arguments against withholding on domestic interest and dividends are concerns that the costs of administering the system might outweigh any benefits; that withholding will create hardship for many recipients of interest and dividend income, especially pensioners; and that withholding may reduce the competitiveness of the Canadian capital market and discourage savings and investment. I believe, however, that these arguments are rebuttable and that the case for withholding remains strong.

Costs of Withholding

Potential costs of the proposed domestic withholding system include direct costs for investors, compliance costs for withholding agents, and administrative costs for Revenue Canada.

For the majority of individual investors, the increased compliance cost will be reflected in the loss of the use of the money for some time, since tax will be paid at the time interest or dividend income is earned, rather than at the end of the taxation year. This loss should be minimal for most taxpayers because the amount of income involved will generally be small.[91] Even if the cost were relatively large to investors, it would be justified on the ground of tax equity since wage earners currently suffer the same loss of the time value of money. Moreover, taxpayers who must pay tax by

[91] If the interest rate is 6 percent and compounding occurs quarterly, the government gains $0.14 annually from the earlier use of every $1,000 tax collected, and the taxpayer loses this amount: see Severt, supra footnote 58, at 687. The extent of the loss will depend on whether or not tax would otherwise have been payable by quarterly instalments. It will also depend on the actual rate of withholding.

instalments in respect of investment income will experience little, if any, increase in compliance cost.

The potential increase in compliance costs to banks, other financial institutions, and corporations might account for the greater portion of withholding costs.[92] Payers of interest and dividends will incur startup costs in hiring personnel responsible for administering the withholding system, acquiring data-processing equipment, and advising customers about withholding. In addition to these startup costs, there will be ongoing costs with respect to routine operations associated with withholding. While it is difficult to estimate these costs, no large increase in compliance costs is anticipated for the following three reasons:

1) Payers can recover a portion of their compliance costs if they are allowed to use the amounts withheld before remitting them to the receiver general.[93]

2) The government could provide specific one-time relief to defray the startup costs.

3) Most important, payers are already incurring a substantial portion of the ongoing costs associated with withholding in the course of complying with existing information-reporting requirements. The proposed withholding requirement for domestic interest and dividend income will be much simpler to comply with than the wage withholding requirement. Domestic withholding will be based on the information-reporting regime and will not require much additional information. On the information return, the payer of dividends or interest is required to provide the amount of income paid, the nature and source of income, and the recipient's name, address, and SIN. The same information will be needed for withholding; the only extra step required of payers will be the deduction of tax at a flat rate from each payment and subsequent remittance of the tax to the receiver general.

Revenue Canada will incur startup costs similar to those of payers. These costs will relate to the development of new forms, staff training, and distribution of public information. Revenue Canada may also have to expand its data-processing operations. The number of forms filed may increase, since individuals who do not currently file a return for dividend

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[92] In the United States, private surveys conducted in 1980 showed that the estimated costs of implementing the proposed 15 percent withholding tax on interest and dividends ranged from tens of thousands of dollars to $1 million or $2 million per bank per year, and that the estimate for ongoing banking industry costs ranged from $2.9 billion to $5.8 billion per year. In contrast, the US Treasury estimated total startup costs for the banking industry to be between $600 million and $700 million. See Severt, supra footnote 58, at 688.

[93] For example, if the "waiting" period is one month and the withholding rate is 25 percent, the payer's benefit will be the rate of return for one month on 25 percent of interest and dividends paid. In 1988, the amount of interest and dividends reported by taxpayers was about $29.5 billion. See Revenue Canada, *Taxation Statistics 1988*, supra footnote 90, at 84-107. If the rate of return were 10 percent, the amount that withholding agents could gain would be approximately $29.5 × 30% × 10% divided by 12 = $73.7 million.

and interest income will do so to obtain any refund due in respect of amounts withheld. Although it is impossible to quantify these costs accurately, they are unlikely to be significant relative to the amount of additional revenue that will be generated by the proposed withholding system.

Regressivity of Overwithholding

Although withholding is simply a collection mechanism, its effect can be regressive in that overwithholding will be more common in lower tax brackets. Taxpayers in lower brackets will lose the use of overwithheld amounts from the time of withholding until the payment of a refund by the government after a return for the year has been filed. This inequity can be avoided if the government pays interest on refunded amounts or if persons who are not taxable (especially senior citizens who have fixed incomes) are exempt from withholding. Exemptions are discussed below in the context of proposals for the design of the withholding system.

Impact on the Investment and Banking Industries

The introduction of a withholding tax on payments of interest and dividends is sometimes challenged on the ground that it will discourage saving and investment. It is important to remember that withholding is not a new tax. Rather, it is a method of collecting taxes that are owed under the existing system and would be paid if that system required full compliance. In a sense, the existing system may be viewed as offering an incentive to saving, in that it permits underreporting of income or evasion of tax; however, this result is clearly unintentional and undesirable from the government's viewpoint.

Withholding may serve as a disincentive to saving to the extent that the return on investment is reduced as a result of the shifting to investors of the increased compliance costs incurred by payers of interest and dividends. Financial institutions, for example, may decrease rates of return to depositors, or increase interest rates on loans, or charge higher service fees. It is difficult to predict the effects on overall savings. Another disincentive to saving might be the loss of the time value of money to investors. However, as noted earlier, such costs to savers will be very small for the majority of individuals.[94]

The competitiveness of Canadian financial institutions, brokerage firms, and corporations is not likely to be jeopardized by the proposed withholding requirement. The domestic withholding obligation should be imposed on all entities that pay interest or dividends to Canadian resident individuals. Consequently, withholding should have no effect on domestic investment decisions. Canadian investors are unlikely to move capital out of Canada to avoid withholding, since interest payments from abroad may well be subject to withholding tax imposed by the foreign country. Nor

[94] See supra footnote 91 for an estimate of these costs.

will domestic withholding discourage Canadian banks, other financial institutions, or corporations from raising capital overseas. Payments to non-residents of Canada will not be affected by domestic withholding.

PROPOSALS FOR THE DESIGN OF AN EXPANDED DOMESTIC WITHHOLDING REGIME

The preceding analysis supports the extension of withholding to domestic interest and dividends in Canada. This section sets out some design proposals for the expanded withholding system. It addresses the types of payments that should be subject to withholding, obligations to withhold tax, exemptions from withholding, withholding rates, special issues related to withholding on interest payments, and some administrative issues.

The design of the system will be guided by the government's policy objectives in implementing the proposed withholding regime and also by certain practical considerations. The government's main objectives are to achieve the maximum level of tax compliance and tax equity, without substantially increasing the costs of tax administration. From the taxpayers' perspective, the system should be comprehensive and non-discriminatory; the method of compliance should be simple and the cost affordable; and taxpayers should not be penalized by excessive overwithholding. There is clearly an element of conflict among these requirements; consequently, some compromises will be necessary in the detailed planning of the withholding regime.

Broadly, the proposed system will work as follows. The responsibility to deduct withholding tax will fall largely on Canadian banks and other financial institutions, brokerage firms, and corporations that make interest or dividend payments to individual Canadian residents. Tax will be deducted from the gross amount at the time of payment, and amounts withheld will be credited against the tax liability of recipients, as is the case with wage withholding. In the case of overwithholding, the government will issue a refund following the filing of a claim with the taxpayer's annual income tax return. The details of this system are discussed below.

Payments Subject to Withholding

The scope of the proposed withholding system reflects a tradeoff between conflicting objectives. To reduce tax evasion and to provide a level playing field for all Canadian residents that make domestic interest and dividend payments on investments, it is desirable to have a comprehensive withholding regime. However, the compliance costs associated with such a regime might be prohibitive. The coverage of the proposed withholding system should be sufficiently comprehensive to minimize non-compliance without imposing onerous compliance costs. Therefore, withholding will be required principally in areas where there are significant compliance problems and where the additional reporting requirement is not excessive.

Interest

The term "interest" is not defined in the Act. For the purposes of the proposed withholding system, interest should include amounts that meet the traditional definition of interest[95] and amounts that are deemed to be interest for income tax purposes.

Withholding should generally apply to amounts that are currently subject to information reporting.[96] These amounts include

- interest on a registered bond or debenture;
- interest in respect of money on loan to, money on deposit with, or property of any kind deposited or placed with a corporation, association, organization, or institution;
- interest in respect of an account with an investment dealer or broker;
- interest paid by an insurer in connection with an insurance policy or an annuity contract;
- interest on an amount owing in respect of compensation for property expropriated; and
- interest on the unpaid purchase price of property (that is, the amount taxable as interest under subsection 16(1) of the Act).[97]

In addition, in order to minimize avoidance through the use of sophisticated financial products, withholding should apply to amounts of interest that are not currently subject to information reporting, such as certain discounts, premiums, and bonuses,[98] accrued interest on investment

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[95] "Interest" has been interpreted by the courts to have the following characteristics: it must be compensation for the use of the principal sum or the right to the principal sum; it must be calculated on a principal sum or a right to a principal sum; and it must be calculated on an accrual (day-to-day) basis. See *Reference as to the Validity of the Saskatchewan Farm Security Act, 1944, of the Province of Saskatchewan*, [1947] SCR 394; and *Attorney-General for Ontario v. Barfried Enterprises Ltd.* (1963), 42 DLR (2d) 137 (SCC). "Interest" is statutorily defined in some countries. Section 2 of the New Zealand Income Tax Act, for example, defines "interest" to mean "every payment (not being a repayment of money lent and not being a redemption payment), whether periodical or not and however described or computed, made to a person (the 'first person') by any other person (the 'second person') in respect or in relation to money lent to the second person making the payment or to any other person." This definition is broader than that normally adopted in the case law since the computation of interest on a day-to-day basis is not necessary. It is expanded further for the purposes of resident withholding tax (section 327A of the New Zealand Income Tax Act) to include redemption payments, in order to deal with original issue discounts and other forms of income that are not traditionally treated as interest.

[96] See regulation 201(1)(b). Persons liable to file information returns have both the means and the necessary information to comply with the withholding requirement.

[97] Where the recipient is a non-resident, the paragraph 16(1)(a) amount is subject to withholding tax under paragraph 212(1)(b).

[98] A discount is generally regarded as interest where the discount arises on the original issue of the obligation and the debt either was a non-interest-bearing obligation or carried

(The footnote is continued on the next page.)

contracts held by individuals,[99] and amounts paid in lieu of, in satisfaction of, or on account of interest. Of course, tax should not be withheld until an interest payment is made.[100]

Dividends

Withholding should apply to all dividends paid in cash or in kind[101] and deemed dividends under section 84 of the Act.[102] As in the case of non-resident withholding, the proposed domestic withholding should also apply to payments that are deemed to be dividends for withholding purposes, such as shareholder benefits under section 15 and indirect payments under subsection 56(2).[103]

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98 Continued . . .
an interest rate substantially lower than the market rate at the time of the issue. The courts have held consistently that there are essential differences between interest and discounts, although in certain circumstances the true nature of a discount may be interest for tax purposes. See *Willingale v. International Bank*, [1978] AC 834 (HL). Revenue Canada seems to take a similar view that a "true discount" is not interest because it does not accrue from day to day. See "Revenue Canada Round Table," in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 53:1-188, at 53:15. For further discussion, see Arthur R.A. Scace and Michael G. Quigley, "New Developments in Debt Financing," in *Report of Proceedings of the Thirty-Fourth Tax Conference*, 1982 Conference Report (Toronto: Canadian Tax Foundation, 1983), 579-615; Arthur R.A. Scace and Michael G. Quigley, "Zero Coupon Obligations, Stripped Bonds, and Defeasance—An Update" (1984), vol. 32, no. 3 *Canadian Tax Journal* 689-705, at 689-94; John M. Ulmer, "Taxation of Interest Income," in *Report of Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 8:1-30; and Robert Raizenne, "Accrual of Interest Income," in the 1988 Conference Report, supra, 23:1-11.

99 Regulation 201(4) requires every person or partnership that is indebted under certain investment contracts to which subsection 12(4) applies to file an annual information return.

100 See below under the heading "Withholding and Accrual Taxation of Interest."

101 "Dividend" is defined in subsection 248(1) but only to include a stock dividend. Any distribution not in the course of liquidation made by a company to shareholders on a pro rata basis is considered a dividend. See *Hill v. Permanent Trustee Company of New South Wales, Ltd.*, [1930] AC 720, at 731 (PC). Revenue Canada has stated its view in *Interpretation Bulletin* IT-67R3, "Taxable Dividends from Corporations Resident in Canada," May 15, 1992. Dividends may be paid in cash or in kind. For income tax purposes, certain payments made by a corporation to its shareholders are deemed to be dividends under section 84 of the Act.

102 Regulation 201(1)(a) requires that an information return be filed for both dividends and deemed dividends.

103 Under paragraph 214(3)(a), shareholder benefits and indirect payments are deemed to be dividends for the purposes of part XIII withholding tax. The non-resident shareholder is subject to part XIII tax. The Canadian corporation, on the other hand, is not deemed to have made a payment to the non-resident for the purpose of subsection 215(1). It is thus arguable that the corporation is not under any obligation to deduct tax from the payment. For the purpose of the proposed domestic withholding tax, the obligation to withhold tax can be limited to cases where a payment is made or where the amount and timing of an payment can be easily determined.

Withholding Obligations

Persons Liable To Withhold Tax

The primary responsibility to deduct tax from taxable payments of interest or dividends should be on payers that are residents of Canada or non-residents carrying on a business in Canada through a permanent establishment. All financial institutions and their competitors that borrow from the public at large should thus be responsible for withholding tax from each amount of interest paid to a Canadian resident.

As in the case with wage withholding and non-resident withholding, payers of interest or dividends should include agents and trustees.[104] An agent or trustee should, however, be obliged to withhold tax from a payment only if the original payer of that payment was liable to withhold and either failed to do so or did not withhold the full amount. In such cases, the agent or trustee should be obliged to withhold tax (or the amount of deficiency of that tax) at the time the payment is received.

Timing of Withholding

Tax should be withheld when interest or a dividend is paid to a resident of Canada. In other words, the payer is required to deduct tax only when an amount is paid.

What Constitutes "Payment"

The concept of "payment" is not defined in the Act. The ordinary dictionary meaning of "pay" is "to give (a person) what is due for services done, goods received, or debts incurred."[105] The jurisprudence indicates that the term does not have a technical meaning.[106] Revenue Canada, not surprisingly, has taken an expansive view of the word "payment" for withholding purposes, especially in the context of employment benefits under section 153. However, Revenue Canada recognizes that it would be unreasonable,

[104] Agents and nominees are currently required to file information returns where a nominee or agent receives an interest payment for another person or where a person is indebted under, or holds as a nominee or agent for a person resident in Canada, an interest in an investment contract (other than a Canada savings bond or a debt obligation in bearer form). See regulations 201(2), (3), and (4).

[105] *The Concise Oxford Dictionary*, 1990 ed. *Black's Law Dictionary*, 5th ed. defines the word "payment" to mean "the performance of a duty, promise, or obligation, or discharge of a debt or liability, by the delivery of money or other value by a debtor to a creditor, where the money or other valuable thing is tendered and accepted as extinguishing debt or obligation in whole or in part."

[106] *Fraser Companies, Limited v. The Queen*, 81 DTC 5051, at 5058 (FCTD). In *Blais et al. v. MNR*, 90 DTC 1499, at 1502 (TCC), per Garon, the court held that the verb "to pay" in the context of an alimony payment under paragraph 60(b) of the Act means to transfer money, to hand over funds. In the context of section 153, it has been held that "[u]sually money is not paid until the debtor seeks out his creditor and puts it in the hands of the creditor, but it does not necessarily mean that; under some circumstances and some contracts, or in the course of practices adopted by the debtor and the creditor, the money may be paid as soon as it is mailed by post, properly addressed to the creditor": see *The Queen v. Kern's Motor Town Sales Ltd.*, 68 DTC 5141, at 5142 (BC CA).

and indeed impossible, to insist upon deductions from non-cash benefits when there is not an accompanying cash payment. Withholding is generally required when non-cash benefits are accompanied by cash payments.[107]

Payments may be made in cash, in kind, by setoff, or by the transfer in the books of a bank of a sum of money from the account of the debtor to that of the creditor, made with the consent of both parties.[108]

When a Payment Is Made

Since the proposed withholding occurs at the time of payment, it is crucial to determine when a payment is made. In general, an amount is paid when cash or property is transferred from the payer to the payee[109] or when the amount is credited to the account of the payee.[110] When a new term deposit certificate is issued for interest earned on a matured certificate, interest is paid when a new certificate is issued.[111] In the case of payment by setoff, payment is made at the time of the setoff.[112]

Deemed Payments

For the purposes of the proposed withholding system, payments should include deemed payments. Tax should be withheld from a deemed payment of taxable interest or dividends.[113] The obligation to withhold should, however, be limited to situations where the amount and timing of the deemed payment can be easily determined, as in the case of deemed dividends under subsections 84(1), (2), (3), (4), and (4.1), indirect payments under subsection 56(2), or shareholder benefits under paragraph 15(1)(a).[114]

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107 See Howard G. Ladd, "Verification and Collection Issues," in *Report of Proceedings of the Thirty-Fifth Tax Conference*, 1983 Conference Report (Toronto: Canadian Tax Foundation, 1984), 771-83, at 772 and 774.

108 *Halsbury's Laws of England*, 4th ed., vol. 9, paragraph 493 and vol. 23, paragraph 766.

109 Cash payment should include cheques and other monetary media of exchange. For further discussion, see B.J. Arnold, *Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes*, Canadian Tax Paper no. 71 (Toronto: Canadian Tax Foundation, 1983), 110-20.

110 Interest on a bank deposit is considered paid or credited only when the payee withdraws it or the payer credits it. For example, a bank computes interest on savings account deposits by compounding the interest on a daily basis but credits to the savings account the amount of interest that has accrued during a calendar quarter on the last day of the quarter. Interest is paid and tax must be deducted by the bank when the bank credits interest to the accounts at the end of each quarter.

111 *Interpretation Bulletin* IT-396R, "Interest Income," May 29, 1984, paragraph 2.

112 In *Kinnee et al. v. MNR*, 81 DTC 771 (TRB), patronage dividends receivable by a taxpayer were transferred in payment of a debt owed by the taxpayer. The taxpayer was held to have received the dividends.

113 See, for example, subsection 214(3.1).

114 For a discussion of the application of part XIII tax to deemed payments, see Rossiter, supra footnote 1.

Exemptions from Withholding

In principle, under a comprehensive withholding regime, all interest and dividends paid to Canadian residents should be subject to withholding, and all payers of such amounts should be obliged to withhold tax at the time of payment. In view of the compliance costs, however, some exemptions are necessary. These should be limited to cases where the problem of tax evasion is not serious or where the imposition of the withholding obligation is impractical. Withholding should be imposed mainly on payments of interest and dividends to individuals.

Exempt Payments

Payments of interest and dividends should be exempt from withholding where

• compliance costs will be excessive, as in the case of interest paid by individuals on personal debts such as home mortgages, consumer loans, and the like;[115]

• there is no compliance problem, as is the case for amounts exempt from tax,[116] patronage dividends,[117] and amounts paid to large corporations and institutions;[118] and

• interest is paid by small businesses in the ordinary course of the business.[119]

Exempt Payers

In general, persons responsible for withholding should be corporations, banks, other financial institutions, and other organizations that pay interest or dividends to resident individuals. Individuals will be exempt from the obligation to deduct tax from interest payments on personal debts.

"Small payers" also may be exempt from the withholding requirement. "Small payers" could be defined to include only "Canadian-controlled

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[115] Both the New Zealand resident withholding tax and the US domestic withholding tax exempt such interest from withholding. See supra footnotes 52 and 53.

[116] See, for example, paragraphs (a) and (b) of the definition of "taxable dividend" in subsection 89(1).

[117] Patronage dividends are payments made by a taxpayer to its customers pursuant to allocations in proportion to patronage for the year (which is essentially the amount of business done by the taxpayer with the customer in the taxation year). The Act requires the payer of patronage dividends to deduct tax from the amount paid at the rate of 15 percent in the case of residents and 25 percent in the case of non-residents. See subsection 135(3), paragraph 212(1)(g), and subsection 215(1). Information returns must also be filed by the payer pursuant to regulation 218.

[118] For example, interest described in paragraph 81(1)(m).

[119] For instance, a store owner who purchases supplies under a 30-day credit facility in the ordinary course of business and incurs an interest penalty on payment after 30 days will not be liable to deduct tax from that payment of penalty interest. The New Zealand resident withholding tax has such an exemption: see section 327M of the New Zealand Income Tax Act 1976.

private corporations" that pay less than a certain amount of interest or dividends annually.[120] Such an exemption would remove the liability to withhold tax for a large number of payers who pay relatively small amounts of interest or dividends in a year. Considering how small businesses are treated under the Act, the relatively high compliance cost that would be borne by small businesses, and the political resistance that would certainly be mounted by small business against the withholding, it would be fanciful to consider imposing the obligation to withhold on small payers.

Exempt Recipients

Exempt recipients are persons who receive payments of taxable interest and dividends free of withholding. Revenue Canada should issue a certificate of exemption to such persons so that the certificate can be presented to the payer, relieving the payer from any obligation to withhold tax.

Individuals should be exempt recipients if their tax liability under part I is below a specified amount in a year.[121] This exemption will ensure that taxpayers in low-income groups are not subject to withholding. A trust may be treated as an exempt recipient if all the beneficiaries are exempt recipients and the trust is required by its terms to distribute all of its income currently.

Payments made to medium and large corporations[122] may be exempt from withholding. The compliance record of such corporations is generally satisfactory. Similarly, payments made to tax-exempt organizations, government agencies, and Crown corporations also may be exempt from withholding.

Anti-Avoidance Rules

In general, a payer should deduct tax from all taxable payments of interest or dividends unless it can be established that the recipient is an exempt

[120] An exemption is provided for small payers under the New Zealand resident withholding tax.

[121] Under the German withholding tax, for example, a basic exemption from the withholding tax is provided. The exemption threshold is a tax liability of DM6,000 for an individual and DM12,000 for a married couple filing a joint return. A taxpayer can submit an exemption form to the withholding agent to have withholding tax waived. Otherwise, the withholding tax is creditable against the taxpayer's income tax. No withholding tax is imposed where the debtor is an individual. Also, interest on accounts that earn interest at a rate of 1 percent or less is not subject to the withholding tax. See Kramer, supra footnote 49, at 854.

[122] The size of the corporation could be determined by the amount of capital or assets of the corporation. The reason for limiting the exemption to medium and large corporations is that individuals may incorporate their investment to avoid withholding. Alternatively, all companies can be exempted from withholding, provided that there are adequate anti-avoidance rules. For example, if a taxpayer incorporates his or her investment for the purpose of avoiding the withholding tax, the corporation's exempt status may be denied or revoked. A corporation can be treated as an individual for purposes of withholding if the amount of interest or dividends paid by it in the preceding year is below a minimum amount. Large corporate recipients are exempt from withholding under the New Zealand resident withholding tax and the US domestic withholding tax.

recipient. Since some corporations will be exempt recipients, certain anti-avoidance rules will likely be necessary to prevent individuals from deferring withholding through the use of an exempt corporate agent. These rules may include rules to deem a corporate agent to be a withholding agent with respect to payments received on behalf of individuals, to look through the agency relationship and deem the payments to be made to individuals, or to treat the corporation as an individual rather than an exempt recipient. The first approach seems to be the simplest. For example, if company X issues a debt obligation to individual A, company X should be required to withhold tax on the payment of interest to A. If the obligation is held by a brokerage firm for the benefit of A and the firm has established to the satisfaction of company X that it is an exempt recipient, company X will not withhold tax from its payment to the brokerage firm. The brokerage firm must, however, withhold and remit tax from the amount received upon receipt of the payment. Therefore, withholding of tax will not be deferred until a payment is made by the firm to A.

Anti-avoidance rules are also necessary in order to prevent taxpayers from transferring debt obligations with accrued interest to an exempt recipient immediately before the payment of interest by the debtor. These rules should be similar to the rules in subsections 214(6), (7), and (7.1), which are designed to prevent a non-resident holder of a debt obligation from circumventing non-resident withholding tax by transferring a debt obligation with accrued interest to a Canadian resident before the interest is payable.[123]

Rates of Withholding

In designing the rates for the proposed withholding system, three questions must be considered:

1) Should the rates be progressive so that the amount of tax deducted approximates the tax liability that will eventually be due, or should the rate be a flat rate?

2) Should the rate be the same for interest and dividends?

3) What are the appropriate rates?

These decisions will be governed by three key requirements of the withholding system: improved compliance, avoidance of excessive over-withholding, and administrative simplicity.

[123] Under subsection 214(6), where the resident transferee has become entitled to interest in respect of a period commencing before the time of transfer and ending after that time and that interest is not payable until after the time of transfer, the resident is deemed to have made a payment of interest to the non-resident at the time of the transfer. The amount of interest is deemed to be equal to the amount of interest accrued to the date of transaction.

Progressive Rates Versus a Flat Rate

Initially, it appears that a progressive rate schedule of withholding, such as that applicable to wage withholding, would result in the greatest degree of compliance and minimal overwithholding, since the amount of tax withheld should approximate the final tax liability of the income earner. However, such a system would be difficult to implement, costly, and perhaps not as effective as it seems.

It would be difficult to design a graduated rate schedule that would allow withholding rates to vary with the taxpayer's income, marital status, and available tax credits. In addition, the amount of taxable income under the proposed withholding system may not be ascertained as easily as in the case of wage withholding. Wages or salaries are generally paid by one employer, and employment income constitutes the sole or major source of income for most taxpayers. Interest and dividend income, on the other hand, typically comes from a number of different sources and accrues to individuals with various other kinds of income. Frequently, those individuals have little contact with the payer. If the recipient's taxable income cannot be accurately determined by the payer of interest or dividend income, it will not be clear what rate should apply, and there will be considerable risk of under- or overwithholding.

A flat rate tax on the gross amount would be much easier to implement; payers would deduct tax at the prescribed rate without reference to the actual tax liability of the recipient. However, a flat rate withholding tax would not ensure full compliance or prevent overwithholding. Because personal income is taxed at progressive rates under the Act, the amount of tax withheld at a flat rate may not always equal the amount of tax payable. Taxpayers who are taxed at a rate higher than the withholding rate might still have financial incentives (albeit reduced) not to report income, whereas taxpayers who are taxed at a rate lower than the withholding rate would be subjected to overwithholding.

Despite these drawbacks, in general, a flat rate is preferable to progressive rates. It is easier to design a flat rate. Tax compliance should be improved, even with respect to high-income groups, since a large portion of the tax owing would be withheld by the payer at the time of payment. In addition, for taxpayers with no or minimal tax liability, the exemption provisions described above would eliminate the penalty of overwithholding. For other low-income taxpayers, as suggested earlier, interest may be paid on refunds of overwithheld tax.

Same Rate for Interest and Dividend

Should the withholding rate be the same for interest and dividend payments? The effective tax rate on dividends received by resident individuals from taxable Canadian corporations is lower than the rate on interest because of the dividend tax credit.[124] The proposed withholding system

[124] Subsection 121(1).

could accommodate these differences by imposing a higher rate for interest,[125] but a single rate is preferable for a number of reasons:

- a single rate applies to non-resident withholding and may be easier to comply with;
- it might be perceived by taxpayers to be simpler and fairer; and
- it will be simpler to implement for corporations that must withhold from both interest and dividends.

Proposed Rate

The proposed rate of withholding should be a flat rate set anywhere between the basic tax rate and the top marginal rate. The advantage of choosing the top marginal rate is that withholding would eliminate any opportunity for underreporting or non-reporting of income by the recipient of interest or dividend payments. The disadvantages are that it would result in serious overwithholding for taxpayers who are subject to lower rates[126] and that the top marginal rate would vary from province to province.

I recommend a flat rate lower than the marginal rate, but the rate should not be too low. If it were too low, overwithholding would be minimized, but the tax would fail to remove all financial incentives to non-reporting for taxpayers who are taxed at higher rates. It might be considered advantageous to match the rate for domestic withholding with the non-resident withholding rate (25 percent), so that it would no longer be necessary for the payer to determine the recipient's resident status. However, in many cases, residence would in fact have to be ascertained since most of Canada's tax treaties provide for a reduced rate on payments to non-residents.

No matter what the withholding rate is, there will always be overwithholding for certain taxpayers. The combination of low-income exemptions and compensatory interest on refunds, recommended above, would provide considerable relief from this inequity.

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[125] The New Zealand domestic withholding tax provides for different rates for interest and dividends (24 percent on interest and 33 percent on dividends) because of the imputation system in respect of dividends. Subsection 153(4) of the Act may serve as a useful reference for determining appropriate withholding rates. Subsection 153(4) deals with situations where the beneficial owner of interest or dividends is unknown to the person who receives the amounts (generally a broker or dealer in securities). The broker or dealer is required by subsection 153(4) to withhold and remit to the government an amount equal to 33.33 percent of the unclaimed amount of dividend and 50 percent of the unclaimed amount of interest. The rates were obviously designed to approximate the highest rate payable for each type of income. The amounts deducted and remitted by the broker or dealer are deemed by subsection 153(5) to have been received by the beneficial owner.

[126] In calculating tax payable, an individual taxpayer would be entitled to a dividend tax credit under subsection 121(1) and a credit for tax withheld under the proposed withholding system.

Special Issues Related to Interest Withholding

Withholding and Accrual Taxation of Interest

A withholding system works well only in cases where the amount from which tax is deducted is taxed on a cash basis, such as wages and salaries, dividends, or amounts paid to non-residents of Canada. Recipients can credit the amount of tax withheld against their tax liability for the same taxation year. Under the proposed withholding system, tax should be deducted at the time of payment of domestic interest or dividends; where no payment is made, no tax should be deducted.

Interest income is taxed either on a cash or receivable basis under paragraph 12(1)(c),[127] or on an accrual basis under subsection 12(3)[128] or (4).[129] In the case of interest income earned on a receivable or accrual basis, there may be a timing difference between the inclusion of interest in income and the withholding of tax under the proposed system. For example, assume that a taxpayer acquires an investment certificate redeemable for $1,000 in 10 years at a cost of $269.74. The yield to maturity is 14 percent compounded annually. At the end of year 1, the interest accrued ($37.76) must be included in the taxpayer's income for that year under subsection 12(3) or (4). Similarly, interest accrued in years 2 to 9 must be included in the taxpayer's income for each of those years. Under the proposed withholding system, however, tax will be withheld only on the maturity date, when the interest is actually paid.

The timing difference will cause a problem if the amount of tax withheld is creditable only against the recipient's tax liability for the same year. In effect, the taxpayer must pay tax on the accrued but unpaid inter-

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[127] Paragraph 12(1)(c) requires a taxpayer to include in computing income for any year any interest or any amount on account of, in lieu of payment of, or in satisfaction of interest either on a received (that is, cash) basis or on a receivable basis, depending upon the method regularly followed by the taxpayer in computing his or her profit for the year. Under the receivable method, the interest is included in income in the year in which the taxpayer is entitled to receive the payment, whether or not the payment has actually been received. An amount is receivable by a taxpayer when there is an absolute or unconditional legal right to receive it. See IT-396R, supra footnote 111, at paragraph 4.

[128] Subsection 12(3) requires that a corporation, a partnership, a unit trust, or a trust in respect of which a corporation or a partnership is a beneficiary to include, in computing income for a taxation year, interest on a debt obligation that accrued to the end of the year, or became receivable or was received by it before the end of the year (other than interest in respect of income bonds, income debentures, small business development bonds, and small business bonds), to the extent that such interest was not included in its income for a preceding year.

[129] Subsection 12(4) requires an individual who holds an interest in an investment contract (defined in paragraph 12(11)(a)) on any anniversary day of the contract to include in his or her income for the year interest that accrued to the end of that anniversary day unless the interest was otherwise included in income for the year or a preceding year. Subsection 12(9) and regulation 7000 provide, for the purposes of subsections 12(3) and (4), that where an obligation is a prescribed debt obligation, the amount determined under regulation 7000 shall be deemed to accrue to the creditor of the obligation in each taxation year during which the creditor holds an interest in the obligation. Prescribed debt obligations are discussed in the text below.

est in years 1 to 9 and will be entitled to a credit only for tax withheld in year 10. The problem could be resolved by permitting taxpayers to reopen their returns of previous years when accrued interest is taxed. This method is not recommended because it would cause too many administrative difficulties. In addition, it would not compensate taxpayers for loss of the time value of money unless the government paid interest on the earlier payments of tax. This too is an unattractive solution from the viewpoint of tax administration. Alternatively, the taxpayer could be allowed to credit a proportion of the withholding tax against the tax liability paid in each year. The appropriate proportion of withholding tax to be credited would be easy to calculate if tax were withheld at a flat rate; the amount of the credit available each year would be the amount of accrued interest multiplied by the withholding rate. This approach, however, is not realistic, since the government would lose revenue by permitting a current credit for taxes to be collected in the future. Consequently, some other solution to the problem of timing will have to be devised.

Prescribed Debt Obligations

Zero coupons,[130] stripped coupons,[131] and other kinds of financial instruments have long been considered a source of compliance problems. Nevertheless, except for the prescribed debt obligation rules,[132] there are no detailed provisions in the Act dealing with these instruments. The only tax compliance measure is a limited information-reporting requirement under regulations 201(4) and 211.[133]

The proposed withholding system should apply to prescribed debt obligations; tax should be deducted from interest when interest is paid. Where the debt is an interest-bearing obligation, the debtor should withhold tax from the amount paid to the creditor. For indexed debt obligations[134] and debt obligations that provide for increasing yearly

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[130] Debt obligations within the meaning of regulation 7000(1)(a).

[131] Debt obligations within the meaning of regulation 7000(1)(b).

[132] Subsection 12(9) and regulation 7000.

[133] Reporting is not currently required for stripped coupons, except for the completion of an ownership certificate whenever a bearer coupon is cashed. Regulation 201(6) does not apply to stripped coupons because stripped coupons are "prescribed debt obligations" under regulation 7000 and are therefore excluded from the definition of "debt obligation in bearer form" by regulation 201(7). Regulation 211, which deals with the redemption of bonds and other securities, does not apply because stripped coupons are simply clipped and cashed while the bond remains to be redeemed.

[134] See subsection 248(25). In cases where the inflation-adjusted obligation is not a prescribed debt obligation as defined in regulation 7000(1) and the purchasing power of money has declined or increased, the amount of interest taxable is computed under proposed regulation 7001. Generally, an increase in the payment of interest resulting from an increase in the inflation rate is treated as interest; a decrease in the payment of interest resulting from an increase in the purchasing power of money is treated as negative interest deductible under paragraph 20(1)(c). The amount of interest subject to withholding will be the amount of stated interest plus or minus the adjusted payment, depending upon the fluctuation of the inflation index.

interest[135] or contingent payments,[136] the amount subject to withholding should be the amount of interest deemed to be paid. For non-interest-bearing debt obligations, the amount of interest subject to withholding should be deemed to be the difference between the stated redemption amount and the cost of acquisition to the investor.[137]

The proposed withholding regime should not apply to secondary market transactions of debt instruments. Under subsection 20(14) of the Act, where a debt obligation is transferred from the original holder, the transferor must include in income the amount of interest accrued to the date of transfer. Under the proposed withholding regime, the transferee should not be required to deduct tax from the purchase price. It would be impracticable to require withholding on the accrued interest in secondary market transactions since the transferee may not have sufficient information to determine the amount of interest accrued to the transferor. Tax should be deducted by the issuer of the debt.

For example, assume that on February 1, 1993, individual A purchased a treasury bill with a maturity of 52 weeks at the original issue price of $8,700. At maturity on January 31, 1994, A may redeem the bill for $10,000. The amount of interest subject to withholding on the date of maturity is $1,300 (the difference between the stated redemption price at maturity and A's purchase price for the obligation). If A sells the bill on

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[135] Debt obligations are prescribed debt obligations under regulation 7000(1)(c) where interest payable in a subsequent year is higher than interest payable in an earlier year and this can be determined at the date on which the taxpayer acquires the obligation. These obligations may include real estate mortgages that provide for escalating interest rates determined by the real estate's projected ability to generate a cash flow sufficient to service the debt; obligations that provide for an additional payment on maturity; and guaranteed investment certificates that provide for a lesser rate if redeemed before maturity. Instruments that provide for an interest payment to be determined at fluctuating rates also may fall within regulation 7000(1)(c). Pursuant to regulation 7000(2)(c), the amount of interest accrued on instruments that provide for increasing yearly interest is computed on the basis of the higher of two rates: the interest rate payable under the instrument in the year; and the constant actuarial yield of the instrument to the holder based on a present value of the future payments of the instrument equal to its principal amount.

[136] Debt instruments are prescribed debt obligations under regulation 7000(1)(d) where payment of interest depends on a contingency existing after the year. In cases where these obligations are zero coupon bonds, stripped bonds or coupons, or obligations that provide for increasing yearly interest, regulation 7000(1)(a), (b), or (c) may apply. Debt obligations that fall within regulation 7000(1)(d) are indexed obligations and equity derivative instruments, under which the amount of interest is based on a consumer price index, a stock exchange index, an objective interest rate, or the prime rate of a major chartered bank. The amount of interest that is deemed to accrue on contingent obligations under regulation 7000(2)(d) is equal to the maximum amount of interest that would be payable in the year.

[137] Withholding with respect to stripped coupons may present problems, since the payer-issuer will need information regarding the date of purchase and the cost of the coupon in order to compute the amount of deemed interest. Where such information is not readily available, the withholding requirement will be difficult to meet. If the obligation is registered, the issuer or broker will have a record of the purchaser of the bond and the stripped coupons.

April 1, 1993 to B and B pays $9,000 for it, B is not liable to withhold tax from the $9,000 payment. When the bill is redeemed on January 31, 1994, the issuer of the debt will withhold tax from the $1,300 interest payment without regard to the subsequent transfer of the bill to B. A and B will contract as to the tax liability with respect to the interest accrued, and B will receive a payment less the amount of tax deducted from the payment by the issuer.

Administrative Issues

Remittance of Tax

Regulation 108 currently requires that, in general, persons who are liable to withhold tax under subsection 153(1) must remit the amount deducted to the receiver general on or before the 15th day of the month following the month in which the amounts were deducted. Under the proposed withholding regime, tax should be deducted and remitted on a similar monthly or semimonthly basis. In cases of undue hardship, the minister may extend the period between the time of deduction of tax and the time of remittance.[138]

Effect of Withholding

The effect of withholding under the proposed withholding regime will be the same as that for wage withholding. Where tax is deducted, the amount deducted should be deemed to have been received by the recipient at that time. Amounts withheld should be credited against the recipient's tax liability. The receipt of the amount of tax by the minister is a sufficient discharge of the payer's liability to the recipient. No action should lie against the payer for withholding tax.

Returns

Every payer who withholds tax from a payment of interest or dividends to a Canadian resident should be required to file an annual return. The return could be based on the T5 information return, adding information on the amount of tax deducted during the year. Returns should be sent both to Revenue Canada and to the recipient of payments from which tax has been deducted. The recipient may be required to file a copy of the return with his or her annual return to Revenue Canada.

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[138] See subsection 215(6). In the case of a payer's underdeduction of tax, the payer should be allowed to deduct the amount from any subsequent payment of interest or dividends to the same recipient in the same year or otherwise to recover from the recipient a sufficient amount to correct the deficiency. Alternatively, the payer should be allowed to use funds from another source authorized by the recipient. In the case of overdeduction owing to the payer's error, the payer may pay the excess to the recipient before tax is remitted. If the amount of tax deducted has been remitted to the government, Revenue Canada will refund to the recipient an amount equal to the excess tax.

Certificate of Exemption

As discussed earlier, payments of interest or dividends should be exempt from withholding where the recipients are exempt recipients, such as individuals in low income brackets, large corporations, tax-exempt organizations, or government organizations. Exempt recipients should be required to apply to Revenue Canada for a certificate of exemption. The validity of the certificate can be reviewed periodically. If a holder of the certificate no longer qualifies for the exemption, or has evaded or avoided tax, the certificate should be revoked. The certificate of exemption should be presented by the exempt recipient to the payer to ensure that payments of interest or dividends are free from withholding. A payer should be relieved from the responsibility of withholding on being presented with a valid certificate of exemption.

CONCLUSION

Withholding undoubtedly has been an important tool in the administration of the Canadian income tax system. Although it imposes costs on all participants, withholding is the most effective compliance mechanism and a valuable component of the self-assessment system. There seems to be no reason to limit withholding to employment income and payments to non-residents. In view of the problem of non-compliance in respect of investment income and the difficulty of increasing Revenue Canada's enforcement activities as a result of reductions in government expenditures, it is appropriate for the government to consider seriously the introduction of a withholding tax on domestic interest and dividend payments.

Expanding withholding to domestic interest and dividends would minimize non-compliance by eliminating the opportunity for taxpayers to evade or avoid tax payments and would improve fairness in the tax system by removing the discrimination against wage and salary earners. Withholding will return increased tax revenues to the government without increasing the tax burden for individual taxpayers. Although the imposition of a withholding obligation may increase the compliance costs of payers of interest and dividends, the increase need not be excessive. Given the information-reporting system that is already in place and the significant advances in computer technology that have been made during the past decade, the administrative cost to Revenue Canada should be insignificant relative to the amount of revenue that could be recovered through extended withholding.

The proposed expansion of the withholding regime supports the government's policy objective of improving the efficiency, effectiveness, and equity of the tax system. Moreover, the fact that a broad-based withholding system has been successfully implemented in many other OECD countries indicates that the introduction of a similar system in Canada is both feasible and worthy of serious consideration.