Intelligence MEMOS

From: Angelo Nikolakakis

To: Finance Minister Chrystia Freeland

Date: January 2, 2024

Re: **Here's How Ottawa's Financial Institution Tax Will Really Work**

Tucked into November's 500-page **Notice** of Ways and Means motion is an unwise measure that urgently needs to be withdrawn.

First announced as part of Budget 2023, it imposes an additional **$3 billion** of federal income tax on "financial institutions" over the next five years. We all know how popular financial institutions are. A tax imposed on big banks and insurance companies will appeal to many people. But who really will pay this tax is: everyone – despite the government's cynical attempt to try to convince us that someone else will ultimately bear its burden.

It is a fundamental principle of Canadian income taxation that corporate profits should be taxed only once at the corporate level, which is why dividends paid from those after-tax profits by one corporation to another are normally not taxed again in the recipient corporation. That would be double taxation of the same corporate profits, which is both unfair and inefficient.

The technical mechanism for eliminating this form of double taxation is the "dividends received deduction." It works like this: Corporation A earns $100 of profits and pays tax on them of $25. It then pays a dividend of $75 out of its after-tax profits. If the dividend is paid to Corporation B, there is no additional corporate tax on the dividend: Corporation B claims the "dividends received deduction."

If there were no such deduction, Corporation B would have taxable income of $75, and thus a tax liability of $18.75. If it then paid its after-tax profits (i.e., $75 minus $18.75 yields $56.25) as a dividend to Corporation C, then Corporation C would have taxable income of that amount, and a third (yes, third!) layer of corporate tax would arise, equal to roughly $14. Together, the three layers of corporate tax would impose tax of $57.75 on the original $100 of profit. That's an unfair and uncompetitive rate of corporate income tax. And there's no reason it couldn't go to a fourth or fifth layer, paring the profit almost down to zero.

Avoiding that multiple taxation is why it's important that the dividends received deduction should be available when financial institutions receive dividends. Individuals get the "dividend tax credit," for the tax already paid at the corporate level, thus preventing double taxation. Both the "dividends received deduction" for corporations and the "dividend tax credit" for individuals are necessary to eliminate double or even multiple taxation on the same underlying corporate profits.

In contrast to this logical and coherent approach, legislation now at second reading in the House of Commons would require dividends received by financial institutions from other corporations to be taxed a second time.

In theory, this measure targets the financial institutions that receive the dividends. But who will really bear the burden of this double taxation? Everyone. Financial institutions don't just swallow higher taxes. They do their best to pass them along. The result is higher banking costs and insurance premiums and lower returns to savings. Adding further stress on the financial system is undesirable at a time when it will translate into stress around the dinner table, as families struggle to meet rising mortgage obligations.

The financial system is critical social infrastructure that allows millions of us to borrow from and lend to each other and to share risks with the help of professional and competent financial intermediaries. In a sense, all funding is crowd-funding, but funding arranged through a formal financial system delivers efficiencies that benefit everyone. Any tax on financial institutions is a hidden tax on depositors, borrowers, holders of insurance policies, pensioners and savers, as well as business customers. In brief, a tax on everything and everyone.

We all have to pay tax. Public services require it. But this type of selective double taxation of the financial system and of corporate profits is cynical. In the real world, it simply cannot be true for everyone that someone else will bear the burdens of taxation. Magical thinking of that sort distorts perceptions and expectations and undermines our collective social contract. In the real world, somebody – some real person – will ultimately bear the burden of the tax. Since financial intermediation represents critical social infrastructure – it is not some niche product or service that caters only to the few – tax burdens imposed on that sector will inevitably be borne by everybody.

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