Intelligence MEMOS

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To: Finance Minister Chrystia Freeland

Date: June 13, 2023

Re: **A New Bad Idea: Financial Institution Dividend Taxes**

This year's federal budget included one very troubling tax policy change. It will end up costing many hardworking Canadians who have invested in Canadian banks and other financial institutions, whether directly or indirectly through their pension funds or RRSPs.

The budget included a proposal to impose double taxation (or worse) on dividends received by financial institutions. This proposal completely contradicts several fundamental principles of our tax system, affecting all shareholders and likely hitting pensioners disproportionately.

Not only do pension funds hold stocks of financial institutions, but Statistics Canada's Survey of Financial Security indicates that seniors in Canada hold a larger proportion of financial assets and stocks compared to younger individuals. While we do not have specific data on that proportion, it is worth noting that financial institutions typically pay consistent dividends, a desirable feature for retirement portfolios.

To understand why this new tax is bad, we need to understand the basic principles of our tax system. In brief, income should be taxed on a consistent and progressive basis.

This requires that income earned through corporations should be taxed, ultimately, at the same progressive rates as income earned directly by individuals. This, in turn, requires that taxes paid by corporations on profits should be credited against taxes otherwise payable by individuals when those after-tax profits are distributed as dividends. This is why individual taxpayers are entitled to claim the "dividend tax credit," which is meant to offset taxes already paid at the corporate level, to prevent double taxation, in order to respect the principles of consistent and progressive taxation.

But often there are many layers of corporations in the chain of ownership – as one corporation may hold shares of another corporation, and so forth. Thus, before corporate profits ultimately reach individual shareholders, there may be dividends paid by one corporation to another. How should these be taxed? The short answer is that inter-corporate dividends shouldn't be taxed, because the profits being distributed have already been subjected to corporate tax. Any additional tax on inter-corporate dividends would result in double taxation, and would violate the principles of consistent and progressive taxation.

The mechanism to prevent double taxation of inter-corporate dividends is called the "dividends received deduction" (DRD). This applies in general to all corporations, not just dividends received by financial institutions. It is absurd to call this a subsidy. The 2023 Department of Finance Report on Tax Expenditures makes clear that preventing double taxation is not a subsidy.

Consider what would happen if our income tax system didn't include the DRD, as the Budget proposes for financial institutions. In a basic example, let's say an individual owns shares in a financial institution, and the financial institution in turn owns shares in another corporation – let's call them Finco and Profitco. This is a common situation because stocks of other corporations, including other financial institutions, are among the financial assets typically held by financial institutions.

Now let's assume that Profitco earns profits of $100, pays corporate tax on those profits, and then distributes the after-tax profits to Finco, which in turn distributes them as dividends to individual shareholders.

With the DRD, there would be corporate tax of about 25 percent at the level of Profitco, because there would be no additional corporate tax on the inter-corporate dividends. That leaves $75 to be distributed by Finco to shareholders. With the dividend tax credit at that level, individuals taxed at the highest marginal rates would pay additional taxes of about $30 on those dividends, bringing the combined effective tax rate to about 55 percent, which is about the same as if the underlying profits had been earned directly by the individuals. Consistent progressive taxation is achieved.

Without the DRD, there would be additional corporate tax of about $21 at Finco, resulting in a total corporate tax rate of 46 percent. This double taxation leaves $54 to be distributed by Finco to individual shareholders. After all is said and done, individual shareholders would pay another $21 of taxes, bringing the combined effective tax rate to about 67 percent, far exceeding the rate payable if the underlying profits had been earned directly by an individual. Consistent progressive taxation is violated.

And imagine if we add a few more layers of financial institutions in the chain of ownership between the individual shareholders and Profitco, each of which has to pay this new tax. The combined effective tax rate very quickly approaches 100 percent. This is no longer taxation – it becomes outright confiscation.

The best way to pay for government programs, whether new or existing, is to encourage investment in Canada, or at least not to discourage it through unfair double taxation. Many people don't realize that taxing corporations is, ultimately, just an indirect way of taxing individuals. Corporations are legal fictions – only individuals are the real taxpayers. Governments should not perpetuate such misconceptions, nor any others.

We need to strike a balance between collecting enough revenue to fund public services and creating an environment that encourages investment in our economy. Tax rates should be reasonable, coherent and predictable, not random depending on how many layers of corporations there may be in the chain of ownership, and whether any of those may be financial institutions. If we fail to respect these fundamental principles, we risk harming our economy and the very people we are trying to support.

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