effective tax rate equal to the minimum tax payable if the income had been earned in Canada. In other words, if the foreign income tax rate was 62 per cent, the bank would pay only the foreign tax, since that rate is higher than the Canadian tax rate. However, if there were a 20 per cent tax rate, the tax would be raised from 20 per cent to the full tax rate applied as if the income were earned in Canada, with the Canadian government receiving the difference. It should be stressed that these adjustments would only take place if the banks operated through branches.

Banks may establish separate subsidiary companies in certain foreign countries. Such companies are then residents of those countries and the treaty networks established for residents apply to the subsidiaries. Several countries such as the United Kingdom, the Netherlands, and the United States are particularly favourable for carrying on an international lending business because there is generally no withholding tax on loan interest crossing their borders.

Dividends paid by foreign subsidiaries and affiliates to their Canadian parent banks are tax-exempt in Canada. This forms another source of after-tax income for the banks. The only dividends taxed in Canada are those paid by subsidiaries in countries that do not have a comprehensive tax treaty with Canada.

Effective Tax Rates

The effective tax rate of a chartered bank is determined by applying the statutory tax rate to the taxable income of a bank. The result is the tax payable. When it is divided by the banks' total income before tax, it produces the "Effective tax rate". These concepts will be discussed in considerable detail in the following section so as to illustrate that the banks' lower effective tax rate has not been caused by a lowering of the statutory tax rate.

4.2 AFTER-TAX FINANCING

As noted, the principal reason for the decrease in the chartered banks' effective tax rates over the last five years is related directly to the acquisition of a large amount of tax-exempt securities, principally term-preferred shares and income debentures. The basic characteristic of these "loan substitutes" is that the income from them, whether interest or dividends, is deemed to be non-taxable for the chartered banks. Thus, based on the statutory tax rate as previously discussed, banks have been able to structure these loans on the basis of one half the prime lending rate plus a risk-adjusted margin.

The sharp rise in tax-exempt income from the "loan substitutes" began approximately 18 months before the Federal budget restrictions on the tax-exempts, initiated on November 16, 1978. The budget attempted to stop further new investment in these instruments by preventing the banks from treating the income as tax-exempt. Furthermore, disqualification was also to result from any alterations in the terms of the issue after that date, such as extensions of the term, or the holder waiving his right to redeem. Subsequent legislation amended the November 16, 1978 budget, placing strong limitations on the issuance of new income debentures and preferred shares.