fully deductible in the calculation of pre-tax income. This has the effect of lowering the banks' taxable income, particularly in periods of rising interest rates when the cost of deposits increases faster than the yield on loans at one-half the prime lending rate.

4.3 IMPLICATIONS OF AFTER-TAX FINANCING

After-tax financing is very effective, as a method of lowering a borrower's interest costs, however, the large volume of these loans has created problems with respect to several aspects of a bank's operation. One of the most important has been the decline in the amount of taxable domestic income. In this respect "domestic" refers to income on which taxes are to be calculated and paid to the Canadian government. Several Canadian banks ceased to have any taxable domestic income over the last two years.

If a bank is engaged in after-tax financing, this reduces the amount of its taxable income. Now if the same bank is in business abroad, with its own bank branches, what it owes the Canadian government in taxes can be reduced by the amount of tax paid to the government of the foreign country where it is operating. The dilemma for the banks is that the tax concessions (termed "foreign tax credits") are deductible only in the year in which the foreign tax was paid. If no domestic taxes are payable, the bank will lose the use of the foreign tax credit.

For this reason, many banks have voluntarily deferred deductions regarding loan losses and capital cost allowances, in order to increase taxable domestic income and receive full credit for the "foreign tax credits". This has the effect of increasing the banks' future tax liabilities. If these credits cannot be claimed within the five year period allowed by the Canadian government, they will be lost. In such a case, the amount will be deducted from shareholders' equity and, ultimately, it will be the bank shareholders, as opposed to the government, who subsidize certain classes of borrowers using after-tax financing.

4.4 HIDDEN TAXES

Two major areas have been noted whereby the Canadian chartered banks pay "hidden taxes", not readily apparent to the general public. These include the cost of maintaining reserves with the Bank of Canada and capital taxes paid to provincial governments.

Bank of Canada Reserve Costs

Under the provisions of the Bank Act, Canadian chartered banks must hold cash reserves with the Bank of Canada. In 1981, cash reserves averaged over $7.0 billion on which the Bank of Canada is not required to pay any interest. The lost revenue on these "loans" to the Bank of Canada represents an opportunity cost to the chartered banks, since these funds are not available to lend to paying customers. The banks state in their briefs to the Committee that they, in effect, paid over $500 million to the government through the Bank of Canada, in addition to all other taxes.