Canadian Banks Face Special Tax on Pandemic Profits: What Should You Do?

Description

Nothing comes for free, and neither did financial support during the pandemic. The Justin Trudeau government released generous stimulus packages to people and businesses that created a stock market bubble. But veteran investors knew that all this came at a cost that everyone had to pay through taxes. Canadian banks got their cost estimate on April 7, when Finance Minister Chrystia Freeland announced the budget. The budget announced two taxes on banks and life insurers:

- A one-time 15% tax on banks and insurers' 2021 taxable income above $1 billion. This special tax is called the Canada Recovery Dividend and is payable over five years.
- A 1.5% increase in the corporate income tax rate for financial institutions from 15% to 16.5% on taxable income above $100 million.

The government expects to generate $6.1 billion from the above taxes, with $445 million in recurring tax revenue coming from a 1.5% hike. The banking community criticized these changes, while analysts found the new taxes better than their expectations.

The government and banks on new taxes

The budget document stated that the government is collecting dividends on the $350 billion federal pandemic support provided to people and businesses. The document added that this support helped Canadian financial institutions make significant profits and recover faster than other sectors.

> "Many sectors of the economy benefited from the federal government bailing out the economy. Investors and workers too. Somehow only the banks and life insurance companies are subject to a special tax."
> *Jack Mintz, the president's fellow at the University of Calgary's School of Public Policy*

The Canadian Bankers Association (CBA) highlighted that the Big Six banks are among the largest corporate taxpayers, with over $12.5 billion paid in taxes in 2020. It accused the government of "singling out" the financial services industry. **Scotiabank** (TSX:BNS)(NYSE:BNS) CEO Brian Porter called the tax hike a “knee-jerk reaction that sends the wrong message to the global investment community.”

What does the new bank tax regime mean to investors?

The Big Six banks announced strong dividend hikes in 2022 on the pandemic profits. The special tax could redirect bank profits from shareholders to the government, according to the CBA. This could impact their dividend-growth rate in the next five years. As for the 1.5% hike in the corporate tax rate, banks could most likely pass on the cost to customers. Jack Mintz said, “Banks … can shift income offshore and try to put more costs like overhead/interest into the amount.”

The new taxes will impact bank profits, but to what extent? Analysts got number crunching and found that the impact won’t be significant. According to a *BNN Bloomberg* article, RBC Capital Markets analyst Darko Mihelic estimates the new taxes to hit banks’ fiscal 2023 profit by an average of 1.4%.

Morningstar senior equity analyst Eric Compton expects the above taxes to have less than a 2% impact on the fair value estimates partially because of the Big Six banks’ diversified revenue streams. They earn revenue from the United States and other countries, and the taxes are focused on their domestic revenue.

You can get a clear picture when banks update their earnings guidance to reflect the impact of the tax in their next quarterly earnings.

Should you buy bank stocks?

Canadian banks are used to policy changes. The tax policy will impact banks’ net earnings, but they will figure out a way around it and continue to focus on profits. The tax impact could partially offset the gains from rising interest rates.

You should take advantage of the current dip in bank stocks. Among the Big Six bank stocks, I am bullish on Scotiabank, as it has the largest international presence; hence, it could face a lower impact from the new taxes.

Scotiabank increased the dividend by 11% to $4 for fiscal 2022 after keeping it unchanged for 2020 and 2021. The new tax could see another two to five years of stable dividends. The stock has fallen 5% since the budget announcement. This is a good time to lock in a 4.66% annual dividend yield.

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