

Budget

EXPRESS

February 26, 2008

FEDERAL BUDGET SPEECH

- *Tax Measures*

A new Tax-Free Savings
Account

- *Budget Analysis*

Could the surplus turn into a
deficit?

Federal leeway could be
inadequate if the economic
slowdown is harsher



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Minister of Finance Jim Flaherty tabled his 2008–2009 budget this afternoon. This budget includes very few tax measures. Certainly the main item is the newly established Tax-Free Savings Account to which up to \$5,000 in savings can be contributed per year, and the income accrued on those savings will never be taxable. While it seems to be straightforward in principle, the Government has yet again done its best to steer clear of simplicity!

MEASURE AFFECTING DESJARDINS – CORPORATE

Tax-Free Savings Account (TFSA)

Budget 2008 proposes to introduce the Tax-Free Savings Account (TFSA). Starting in 2009, this account should be offered by financial institutions currently eligible to issue RRSPs, including Desjardins caisses and branches through Desjardins Trust.

Contribution limits

Individuals will be able to make TFSA contributions up to their available "contribution room." under this program. Any individual who is at least 18 years of age will acquire \$5,000 in TFSA contribution room each year. The \$5,000 limit will be indexed annually. As with RRSPs, any unused contribution room will be carried forward to future years with no limit on the number of years that it can be carried forward. Furthermore, any amounts withdrawn from an individual's TFSA will be added to his or her contribution room for the following year. Any individual who is resident in Canada and 18 years of age or older will be eligible to establish a TFSA in his or her name and use the amounts in it for any purpose.

Tax rules

Amounts contributed to a TFSA will not be deductible. However, returns on amounts deposited in the TFSA, as well as amounts withdrawn from the TFSA, will not be taxable. Similarly, any losses on investments held in a TFSA will not be deductible. Unlike amounts held in an RRSP, TFSA assets can be used as collateral for a loan without any tax consequences.

This new type of account will allow for income splitting between spouses because the attribution rules do not apply to amounts deposited in TFSAs.

The TFSA tax rules no longer apply upon the holder's death, unless the TFSA goes to holder's spouse. Thus, unless the spouse has been named the beneficiary account holder upon death, investment income and gains that accrue in the account after the holder's death will be taxable, while those that accrued before death will remain exempt.

The Canada Revenue Agency (CRA) will determine TFSA contribution room for each eligible individual who files an annual income tax return.

Financial institutions will be required to file annual information returns to report, for example, the amount of contributions, withdrawals and transfers made in the year.

Interest paid on a loan taken out to invest in a TFSA will not be deductible.

Qualified investments

Investments that qualify for the TFSA will generally be the same as the current RRSP qualified investments. However, a TFSA will be prohibited from holding investments in any entities with which the account holder does not deal at arm's length. Generally this means the account holder and the non-arm's length persons hold a 10% or greater interest.

MEASURES AFFECTING INDIVIDUALS

Tax-Free Savings Account (TFSA)

As described in the "Measure Affecting Desjardins – Corporate" section, with the new Tax-Free Savings Account individuals will be able to grow their savings from investment income tax free.

Registered Education Savings Plan (RESP)

Extension of certain time limits

Currently, contributions to an RESP can be made for 21 years following the year in which the plan is entered into. Also, an RESP must be terminated by the end of the year that includes the 25th anniversary of the opening of the plan. Finally, no contributions may be made to a family plan for a beneficiary who is 21 years of age or older.

To provide additional flexibility to parents who save in RESPs, and to students who later use these savings to help finance their post-secondary studies, Budget 2008 proposes to increase each of these limits by an additional 10 years, starting in 2008.

Educational Assistance Payments (EAPs)

To provide more flexibility for a beneficiary to access RESP savings, Budget 2008 proposes to allow a six-month grace period for receiving EAPs. Under this measure, an RESP beneficiary whose studies end after 2007 will be eligible to receive EAPs for up to six months after ceasing to be enrolled in a qualifying program, provided that the payment would have qualified under the rules for EAPs.

Northern Residents Deduction

The northern residents deductions provide taxpayers with a basic residency deduction to each member of a household of up to \$7.50 per day. Alternatively, one member of a household can claim a maximum of \$15 per day if no other member of the household claims this basic amount.

Budget 2008 proposes to increase the residency reduction to \$8.25 and \$16.50, respectively, as of the 2008 taxation year.

Medical Expense Tax Credit (METC)

Budget 2008 proposes to add to the list of eligible medical expenses the cost to purchase, operate, and maintain the following devices prescribed by a medical practitioner:

- altered auditory feedback devices for the treatment of a speech disorder;
- electrotherapy devices for the treatment of a medical condition or a severe mobility impairment;
- standing devices for standing therapy in the treatment of a severe mobility impairment; and
- pressure pulse therapy devices for the treatment of a balance disorder.

In addition, Budget 2008 proposes to extend eligibility criteria under the METC to recognize eligible expenses for service animals specially trained to assist an individual who is severely affected by autism or epilepsy to cope with the individual's impairment. Currently, the only expenses that are eligible for the METC are those incurred for a service animal that is specially trained to assist an individual who is blind, deaf or has a severe impairment that markedly restricts the use of the individual's arms or legs.

All of these measures will be effective as of 2008.

Furthermore, recent court decisions have interpreted medical expenses to include the cost of vitamins, supplements and drugs that could otherwise be purchased without a prescription, which goes beyond the government's initial intention of the METC. Budget 2008 therefore proposes to clarify the wording for eligible drugs and medications to ensure that those that may be purchased without a prescription remain ineligible, for purchases made after February 26, 2008.

Mineral Exploration Tax Credit

The mineral exploration tax credit is an additional benefit, available to individuals who invest in flow-through shares, equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to them. The credit is currently scheduled to expire at the end of March 2008.

Budget 2008 proposes to extend eligibility for the mineral exploration tax credit to flow-through share agreements entered into on or before March 31, 2009.

Tax Credit for Eligible Dividends

Since 2006, eligible dividends have been subject to a 45% gross-up and provide a 19% tax credit. Given the previously announced cuts in corporate tax rates, the dividend gross-up and tax credit rates will be adjusted as follows:

	2008	2009	2010	2011	2012
Gross-Up (%)	45	45	44	41	38
Tax Credit (%)	19	19	18	16.5	15

Increased flexibility for federal LIF

The Budget proposes three provisions to significantly enhance the flexibility to withdraw funds from **federal** LIF :

- LIF holders 55 or older with small holdings of up to \$22,450 will be allowed wind up their accounts entirely, with the option to convert to an RRSP or RRIF. The \$22,450 limit will be indexed annually;
- LIF holders 55 or older will be entitled to a one-time conversion of up to 50 per cent of LIF holdings into an RRSP or RRIF;
- LIF holders facing financial hardship will be entitled to unlock up to \$22,450. This amount will be indexed annually.

Various Sales Tax Measures

Budget 2008 proposes various measures to reduce the GST for health care services, applicable to supplies made after February 26, 2008.

The principal measures are as follows:

- exemption for basic disability training;
- exemption for nursing services regardless of where the services are performed;
- expansion of the zero-rating of drugs prescribed by health professionals, even those not recognized as medical practitioners;
- addition of certain sophisticated devices to the list of zero-rated medical devices;
- exemption of eligible professional services supplied through a corporation.

Similarly, an amendment to the Act will enable long-term residential care facilities to benefit from a partial GST rebate for new residential properties, effective February 27, 2008.

CORPORATE TAX MEASURES

Investment Tax Credit for R&D Expenses

Scientific research and experimental development (SR&ED) expenditures are eligible for an investment tax credit (ITC) if they are incurred in Canada. There are two rates of ITCs for SR&ED. The general rate is 20% and there is an enhanced rate of 35% for small Canadian-controlled private corporations (CCPCs).

Currently, the 35% rate applies to the first \$2 million of expenses incurred annually.

Unused ITCs are fully refundable in respect of the first \$2 million of current expenses per year.

Unused ITCs earned in respect of current expenses exceeding the \$2-million limit, and in respect of capital expenditures, qualify for a 40% refund. The \$2 million expenditure limit is phased out for CCPCs whose taxable income for the previous taxation year is between \$400,000 and \$600,000 or whose taxable capital employed in Canada for the previous taxation year is between \$10 million and \$15 million.

The budget proposes to increase the eligible expenditure limit to 35%, and increasing the phase-out ranges on taxable income and taxable capital as follows:

	Current	Proposed
Expenditure Limit	\$2 M	\$3 M
Phase-Out Range		
Taxable Income	\$400,000 to \$600,000	\$400,000 to \$700,000
Taxable Capital	\$10 M to \$15 M	\$10 M to \$50 M

The proposed modifications will be applicable for taxation years that end on or after February 26, 2008, pro-rated based on the number of days in that taxation year that are after February 25, 2008.

In addition, the budget proposes to recognize, under certain conditions, certain salary or wages incurred in respect of R&D performed outside Canada, effective February 26, 2008.

Manufacturing and Processing Equipment – Accelerated Capital Cost Allowance

The capital cost allowance (CCA) rate that applies to manufacturing and processing equipment (Class 43) acquired after March 18, 2007 and before 2009 was enhanced under the 2007 Budget, from a 30% declining balance rate to a 50% straight-line accelerated CCA treatment. The budget proposes to extend accelerated CCA treatment for three additional years. This will include a one-year extension of the 50% straight-line accelerated CCA for assets acquired in 2009, followed by a two-year period during which accelerated CCA will be provided on a declining basis for assets acquired in 2010 and 2011.

The 30% declining-balance rate will apply to all Class 43 assets acquired after 2011.

The "half-year rule" will apply to the assets that are subject to this measure.

Budget Analysis

February 26, 2008



CANADA: FEDERAL BUDGET

Could the surplus turn into a deficit?

Federal leeway could be inadequate if the economic slowdown is harsher

As anticipated, the budget tabled today by Minister of Finance Jim Flaherty confirms that the 2007-2008 budget should show a \$10.2B surplus, marking by the same token the third consecutive surplus over \$10B. This amount will go entirely to paying down the Federal debt and the debt-to-GDP ratio will fall to 29.9% as of March 31, 2008, its lowest level since 1980-1981. However, the budget surpluses could be much smaller over the next two fiscal years when the Department's estimates are expected to drop under \$3B. It must be said that the economic environment has deteriorated significantly over the last few months, which affects public finances and encourages the government to be reasonably careful. In this context, today's budget has little to offer as far as new measures are concerned, all the more since significant cutbacks in the tax burden of individuals and to some extent corporations had already been announced last fall in the government's economic statement. Nevertheless, Minister Flaherty proposes a reform of Employment Insurance, the establishment of a tax-free savings account (TFSA), help for the manufacturing sector and communities as well as several targeted measures for infrastructures.

Table 1
Summary statement of transactions

In \$B	Actual		Projection				
	2006-2007	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013
Budgetary revenues	236.0	244.5	241.9	252.0	263.5	273.9	283.2
- Variance (%)	6.2	3.6	-1.1	4.2	4.6	3.9	3.4
Program spending	188.3	201.2	208.1	218.3	226.8	235.4	244.8
- Variance (%)	7.5	6.9	3.4	4.9	3.9	3.8	4.0
Debt charges	33.9	33.1	31.5	32.4	33.7	33.8	33.2
- Variance (%)	0.5	-2.5	-4.8	2.9	4.0	0.3	-1.8
Budgetary balance	13.8	10.2	2.3	1.3	3.1	4.7	5.3
Planned debt reduction	14.2 ¹	10.2	2.3	1.3	3.0	3.0	3.0
Federal debt ²	467.3	457.1	454.8	453.5	450.5	447.5	444.5
% of GDP							
Budgetary revenues	16.3	16.0	15.3	15.3	15.2	15.1	15.1
Program spending	13.0	13.2	13.1	13.2	13.1	13.0	13.0
Public debt charges	2.3	2.2	2.0	2.0	1.9	1.9	1.8
Federal debt ²	32.3	29.9	28.7	27.5	26.0	24.7	23.6

¹ Including \$479M from other elements of the comprehensive income.

² Debt representing the accumulated deficits.

Source: Department of Finance of Canada, February 2008

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Director and Deputy Chief Economist

Benoit P. Durocher
Senior Economist

514-281-2336 or 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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MORE PESSIMISTIC ECONOMIC FORECASTS

To no surprise, the worsening economic environment and the triggering of the liquidity and credit crises since last fall led to a downward revision of the Department of Finance economic growth projections. The Canadian dollar remains close to par with its American counterpart (it even reached \$1.10 for a time last fall) and the growth of the American economy slowed down significantly. Canadian manufacturers were then affected in two ways with foreign trade curbing economic growth even more at home. If domestic demand remains strong, some signs that the economy is running out of steam have appeared recently, especially in consumer spending and residential investment. In addition, the liquidity crisis in financial markets caused many financial institutions to tighten their credit conditions, offering less support for consumer spending and investment. Finally, the growth outlook for real Canadian GDP is accordingly weaker this year than in 2007.

In this context, the economic forecasts used in the 2008-2009 budget seem realistic from our standpoint. Anticipated growth of only 1.7% for 2008 implies that the first quarters of the year will be relatively weak, in line with our own economic scenario. In Canada, the chances of going into the negative for more than six months, and as a result in recession, are however limited. It has to be recognized that many parts of the country are still benefiting from the high prices for raw materials and that many governments (federal and some provinces) have recently introduced tax cuts as well as accelerated infrastructure spending.

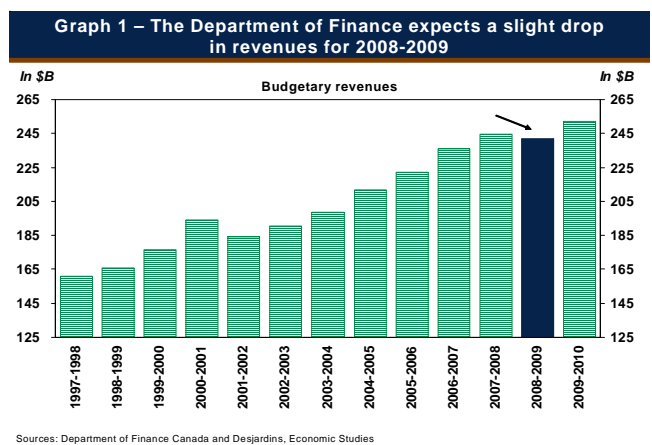
The growth of real GDP as expected by the Minister of Finance for next year is a little lower than our own estimates. Minister Flaherty is obviously assuming that the economic recovery will come later than what we expected in our reference case. This is also reflected in the lower estimates for inflation and higher unemployment rates. As a result, the gap between the Department's estimates and those of

Desjardins on the increase of nominal GDP would be close to 0.8% for 2008. The cautiousness of the government of Canada is however justifiable in the current context of great uncertainty as the risks are clearly on the downside (both in Canada and the rest of the world).

As far as interest rates are concerned, the Department of Finance projections are very similar to our own. The lower interest rates expected this year should be followed by gradual increases, particularly next year when the economic growth outlook will gradually improve.

THE SMALLEST SURPLUS SINCE 1997-1998

For financial 2008-2009, the government anticipates that the economic slowdown will slash \$2.6B from its budget revenues, a 1.1% drop (Graph 1). It must be noted that the growth of fiscal revenues for 2008-2009 had been greatly reduced by the lower GST and the tax cuts that came into effect in January. The revision of the GDP growth estimates for 2008, from 2.4% to 1.7% since the last statement, will bring about a decline in revenues. However, according to the Department of Finance information, the effects of the economic slowdown should have cut its budget revenues by



**Table 2
Economic and financial forecasts**

	2007f*			2008f			2009f		
	October stat.	Budget	Desjardins Group	October stat.	Budget	Desjardins Group	October stat.	Budget	Desjardins Group
Average annual growth in %									
Real GDP	2.5	2.6	2.6	2.4	1.7	1.9	2.7	2.4	2.8
GDP deflator	3.3	3.1	3.0	2.4	1.8	1.8	2.0	1.9	2.3
Nominal GDP	5.9	5.7	5.6	4.8	3.5	3.7	4.7	4.3	5.1
Treasury bills – 3-month (1)	4.2	4.2	4.2	4.4	3.2	3.1	4.7	3.8	3.7
Federal bonds – 10-year (1)	4.3	4.3	4.3	4.6	3.6	3.8	5.0	4.2	4.3
Unemployment rate (1)	6.1	6.0	6.0	6.2	6.3	6.1	6.2	6.4	5.8
U.S. real GDP	1.9	2.2	2.2	2.2	1.5	1.3	2.9	2.4	2.4

* Estimates only on the first three elements; f: forecasts; (1) Annual average in %.

Sources: Department of Finance of Canada, Statistics Canada and Desjardins, Economic Studies

only \$2.2B, in comparison with the figures presented in last fall's economic statement.

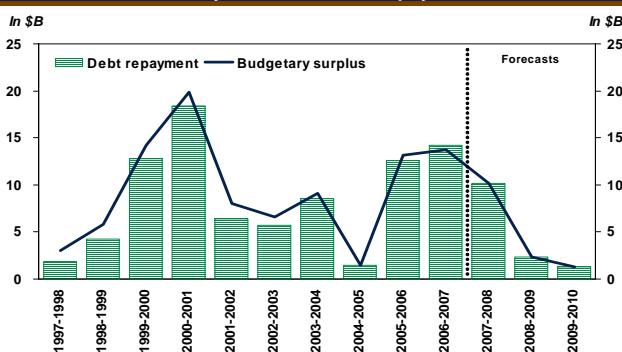
True to its form, the government remains very conservative in estimating its revenues. Past experiences show that the government continually underestimates its budgetary revenues. Corporate tax (-13.1%) and GST (-10.2%) revenues are especially affecting the budgetary revenues of the Federal government. Despite the individual tax cuts, these revenues will still increase by 5.4% because of the progressive nature of the tax system and higher individual income.

The projections for budgetary spending for 2008-2009 are in line with those presented during last October's statement. They only increased by \$500M. Yet, the government is saving \$2.2B on debt servicing, which is a rather large difference in comparison to its estimates in the statement considering that this item is relatively easy to anticipate. The budgetary balance should reach \$2.3B, which constitutes the smallest surplus since fiscal 1997-1998.

UNDER \$3B ON DEBT IN 2008-2009

According to its projections, the government will show a surplus of only \$2.3B in 2008-2009. It will all be allocated to debt, which is consistent with its line of conduct over the last few years. Any surplus of under \$3B must be directly allocated to paying down the debt (Graph 2). We support this policy, a good management sign. For this fiscal year (2007-2008), the surplus should reach approximately \$10B, which will also go to the debt. Yet, this decision is somewhat disappointing.

Graph 2 – The budgetary surpluses are almost entirely allocated to the repayment of the debt

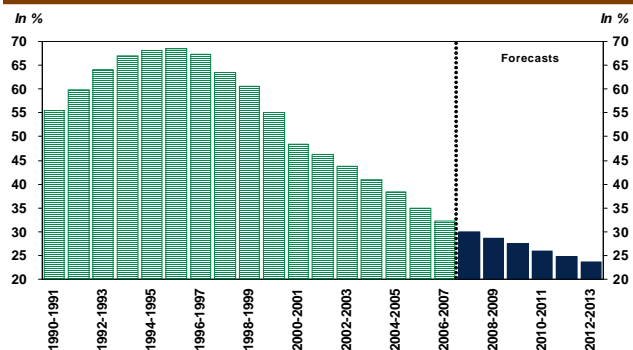


Sources: Department of Finance Canada and Desjardins, Economic Studies

In the *Economic Viewpoint* published last February 19, we wished that part of or all surpluses above \$3B per year would be channelled back into the economy to improve our competitiveness, help provinces and even municipalities or to return directly into the pockets of taxpayers. In fact, the

debt load of the Federal government has greatly improved over the last ten years and compares favourably with that of the other large industrial countries. The Federal objective of showing a debt-to-GDP ratio of 25% will be reached during fiscal 2011-2012, i.e., earlier than anticipated initially. It will settle at 28.7% at the end of fiscal 2008-2009 (Graph 3).

Graph 3 – Federal debt-to-GDP ratio



Sources: Department of Finance Canada and Desjardins, Economic Studies

The government has included \$2.7B in new measures for fiscal 2007-2008, but we feel that the \$500M dedicated to infrastructures for instance should be increased. There is also very little money going to the environment, scientific research and higher education. In our minds, there is where lies the greatest disappointment in the 2008-2009 budget. An investment of \$3B to \$6B in priority projects with strategic impact could have been implemented without jeopardizing the financial integrity of the government. If paying down the debt prevents the government from implementing productive expenditures or making investments needed to support our international competitiveness and ensure future economic prosperity, then challenging the use of all surpluses to this end is justified.

FINANCIAL MARKETS WERE ALREADY EXPECTING AN IMPORTANT SURPLUS

The anticipated surplus of \$10.2B announced for fiscal 2007-2008 is the eleventh consecutive one. In this context, the financial markets should not react strongly to today's budget even if the size of the surplus is far greater than the initial target of \$3B developed in last year's budget. Granted, the Department of Finance had already done the groundwork by announcing last fall that the surplus would be at least \$10B.

Yet the gradual repayment of the Canadian government debt, when most budgetary surpluses are allocated to it every year, adds to the scarcity of Federal securities. So, the amount outstanding of marketable bonds and Treasury bills will go from a high of \$441.0B in 1996-1997 to \$395.0B as of

VARYING BUDGETARY MEASURES... BUT LIMITED IN SIZE

Many broad-based tax cutting measures (including another cut in the Federal GST) had already been announced when the economic statement came out last fall. So the expectations for today's budget were rather limited. If the 447-page 2008-2009 budget plan is in effect proposing new measures, we have to admit that the amounts involved are rather small. The 2008 budget incorporates a total of only \$5.9B in new measures spread out over close to two years, i.e., until March 31, 2010, most of which had already been announced over the last few weeks and months. Even so, here is a partial summary of the main measures:

Employment insurance

The Department of Finance joins in the other political parties in reforming the management of Employment Insurance. The plan will now be managed through a separate bank account in which any surplus will be held and invested until program costs need to be paid. The rate setting mechanism will also be improved to take into account the fluctuations in the plan balance. A \$2B reserve is initially established for it to operate.

Tax-free saving account (TFSA)

To stimulate savings in the country, the government proposes to establish a TFSA in which Canadians will be able to deposit up to \$5,000 per year and carry forward any unused portion in future years. The investment income, including the dividend or capital gains, will not be taxable and the money accumulated could be used for any purpose.

Help for the manufacturing sector

The manufacturing sector will benefit from \$1B in added assistance thanks to three additional years for temporary measures concerning the accelerated capital cost allowance for new investments in machinery and equipment. This should help increase business productivity to offset the negative effects of the high Canadian dollar.

Community development trust

The government increases the help announced in January 2008 for workers and communities facing changes in the international economy. The Development Trust will distribute up to \$1B. These new measures specifically target older workers as well as the forestry, farming and aquaculture industries.

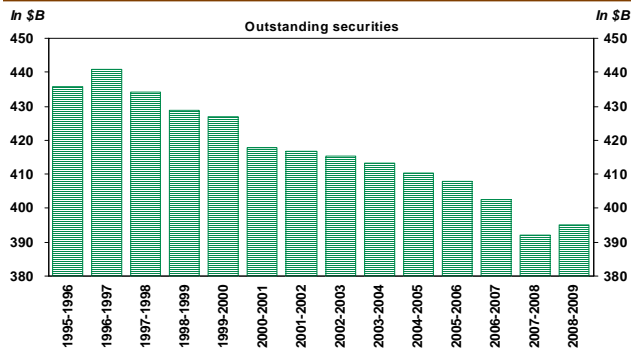
Infrastructures

The Gas Tax Fund that will be worth \$2B in 2009-2010 will be transformed into a permanent measure, which will allow municipalities to better plan and finance their infrastructure investments. In addition, \$500M will be used to support Federal capital investments aimed at improving mass transit.

An efficient financial sector

In the current context of turbulence in financial markets, the government proposes, in addition to the recent launch of an expert panel on securities regulation, to modernize the authorities of the Bank of Canada to support the stability of the financial system. An update of the treasury risk guidelines is being contemplated to ensure that Federal entities continue to adhere to leading practices in financial risk management.

Graph 4 – The offer for Federal debt securities is decreasing



Sources: Department of Finance Canada and Desjardins, Economic Studies

March 31, 2009 according to Department of Finance projections, i.e., a decrease of nearly 10% (Graph 4). This decrease in the offer of government bonds on financial markets pushes prices higher, which creates a downward pressure on Federal bond and Treasury bill rates, a situation that favours maintaining tight interest rate spreads between Canada and the United States.

The furious pace of debt repayment observed over the last few years could however slow down in the future. Public finances have improved appreciably and the weight of public debt had decreased significantly since the mid-90s. The need to pay down the billions of dollars of debt per year is not as pressing today. Not only could the slowdown of the economic growth shrink the surpluses that the Federal government has been showing, but the pressures to lessen the fiscal burden of taxpayers even more, increase transfers to provinces and territories and boost public investment in the infrastructures should be even greater.

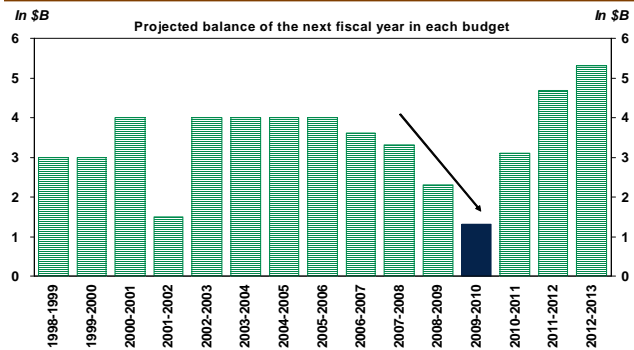
The objective of the Federal government of trying to eliminate the net debt of all public administrations by 2021 (by cutting down its own debt) deserves praise but have we not reached the point where this is counterproductive for other government levels? The question begs an answer.

GREATER CAUTION WOULD HAVE BEEN BETTER

After last fall's tax relief, the economic slowdown expected for 2008 demanded some restraint for fiscal 2008-2009, especially as far as expenditures are concerned. In fact, few new measures or programs are announced in this budget. We note however that the Federal government's flexibilities may not be adequate if the slowdown is more important than expected (Graph 5).

In this context, it is disappointing to see that the government has once again allocated most of this year's surpluses to paying down the debt. The overall debt situation of the

Graph 5 – The anticipated flexibilities are decreasing



Sources: Department of Finance Canada and Desjardins, Economic Studies

government is enviable when compared to that of other large industrialized countries. The objective of a debt-to-GDP ratio of 25% has almost been reached. Part of the \$10.2B recorded in 2007-2008 could have been set aside to mitigate the effects of the impending economic slowdown and another part to the priority projects with strategic impact for all the Canadian economy. A contingency reserve could have been set up with this year's surplus to ward off a more severe economic slowdown.

Some interesting elements can even so be noted in this budget. The new tax-free savings account (TFSA) is an obvious savings incentive, but in a world where only 26% of Canadian taxpayers manage to contribute to their registered retirement savings plan (RRSP), one can wonder if the proceeds will only benefit to high income individuals. Municipalities will surely be happy to learn that the Gas Tax Fund will become permanent. However, the \$500M allocated to mass transit are in our view rather modest given the needs. As for the manufacturing sector, it will benefit from three additional years in the deduction for accelerated cost allowance applicable for new investments in machinery and equipment. It is an effort to improve business productivity, but profits need to be made to be able to benefit from this advantage.