Budget EXPRESS

March 21, 2013

FEDERAL BUDGET SPEECH

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Desjardins

Desjardins Group
Taxation Administrative Department
Economic Studies

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This afternoon, Canada's Finance Minister, Mr. Jim Flaherty, tabled his 2013 budget. This budget contains some very bad news for Desjardins Group: The additional deduction for credit unions will be phased out starting in 2013 and eliminated entirely in 2017. For Desjardins, this additional cost adds to the recent costs of harmonizing the QST and postponing the cut to the compensatory tax. No other changes have been announced with respect to tax rates on businesses or individuals.

MEASURES AFFECTING DESJARDINS

Phasing out of the additional deduction for credit unions (ADCU)

The ADCU allows credit unions to benefit from a lower tax rate on income that is otherwise not eligible for the small-business deduction, up to a maximum combined total amount, which is directly associated with amounts the caisse owes members. This measure was instituted in 1972 to allow Canadian credit unions to capitalize more quickly.

The budget therefore calls for the ADCU to be phased out gradually and linearly over a five-year period, starting in 2013. The ADCU the caisse is entitled to will be equal to 80% of the amount otherwise calculated in 2013, 60% in 2014 and so forth. It will be zero as of 2017.

Taxation of corporate groups

In previous budgets, the Canadian government had pledged to examine the possibility of adopting new rules on the taxation of corporate groups, such as establishing a formal system for transferring losses or consolidated reporting. The government has concluded that this is not a priority at this time and that no changes will be made in the near term.

GST/HST pension plan rules

Currently, an employer that participates in a registered pension plan is deemed to have made a taxable supply, and collected the GST/HST in respect of that supply when the employer acquires, uses or consumes property or services for use in activities relating to the pension plan. The employer must add this GST/HST amount to its net tax.

An employer is required to account for the deemed supply principle even for actual invoiced supplies.

For supplies made after March 21, 2013, an employer participating in a registered pension plan will be permitted to jointly elect with the pension plan's management entity to treat an actual taxable supply by the employer to the management entity as being for no consideration where the employer accounts for and remits tax on the deemed taxable supply. This measure will simplify employer compliance, as employers will no longer be required to account for the tax on actual taxable supplies then subsequently apply a tax adjustment to the net tax.

Correcting RPP contribution errors

Currently, a registered pension plan (RPP) must get Canada Revenue Agency (CRA) approval before refunding over-contributions made by a member.

The budget proposes to authorize RPPs to refund contributions without approval so as to correct reasonable errors if the refund is made by December 31 of the year following the year in which the contribution was inadvertantly made. This measure applies to contributions made as of January 1, 2014 or, if later, on the date of royal assent.

International electronic fund transfers

The budget proposes to require some financial intermediaries to report to the CRA international electronic fund transfers totalling $10,000 or more.

Statements must be made to the CRA within five business days following the date of transfer; financial intermediaries must provide information on the person engaged in the transaction, the funds' recipient, the transaction, and financial intermediaries used in the transaction. The statement requirement is effective as of 2015.

Information requirements regarding unnamed persons

Currently, tax rules allow the CRA to require any person to provide information or documents for the purposes of tax administration or enforcement. At this time, the CRA must obtain judicial authorization before issuing a requirement to a third party to provide information on unnamed persons. According to current tax rules, the CRA may obtain such authorization without being required to inform the third party; however, the third party may seek a review of the issuance of the court order, which can substantially delay obtaining the information.

Henceforth, the CRA must inform the third party when it files for judicial authorization. The third party must then present its arguments, eliminating the need to proceed with a later review. This measure will apply on royal assent.

Leveraged life insurance arrangements (10/8 and "back-to-back)

In a 10/8 arrangement, an investment was made in a life insurance policy whose return was not taxable. A loan secured with the policy was made for an equivalent amount. Interest on the loan was deductible when the proceeds were invested in income-generating assets. The interest rates on the policy (8%) and loan (10%) were linked.

New measures have been instituted to eliminate the use of 10/8 arrangements (including such arrangements that are already in force). As of January 1, 2014, it will no longer be possible to capitalize on the following tax benefits in a 10/8 arrangement:

- Deductibility of the interest paid or payable on the loan
- Deductibility of life insurance premiums
- The addition of a death benefit to the dividend account in a company

Transitional measures have been instituted to allow a tax-free withdrawal from a policy under the terms of a 10/8 strategy, when the amount is used to repay the loan until January 1. 2014.

In the context of back-to-back leverage effects, a life annuity and life insurance policy on the same person were given to secure a loan. The policy's death benefit had to be used to repay the loan. This concept provided tax benefits to the holder, especially when used by a corporation. Henceforth, the premium paid on a policy is not deductible, the death benefit must no longer be credited to the capital dividend account and the annuity contract must be considered in establishing the value of shares upon death. However, the measure does not apply to leveraged-insured annuities for which all loans have been entered into by March 21, 2013.

Taxation Administrative Department, DG

MEASURES AFFECTING INDIVIDUALS

Lifetime capital gains exemption

For individuals, the income tax system currently provides a lifetime capital gains exemption of up to $750,000 for capital gains realized in the disposition of qualified property: qualified small business corporation shares, and qualified farm and qualified fishing property.

The budget proposes to increase the exemption amount by $50,000 to a maximum of $800,000 as of the 2014 taxation year.

The exemption amount will be indexed to inflation for taxation years subsequent to 2014; the new limit will also apply to individuals who have previously used their exemption.

Phasing out of the labour-sponsored venture capital corporations tax credit

The budget proposes the gradual elimination of the federal tax credit on a labour-sponsored venture capital corporation (Fonds FTQ and Fondaction in Quebec) as follows:

Tax year	2013	2014	2015	2016	After 2016
Tax credit rate	15%	15%	10%	5%	0%

As of 2017, only the Quebec credit of 15% (or 25%) will be granted.

Tax credit for non-eligible dividends

The budget amends the gross-up factor that applies to non-eligible dividends, taking it from 25% to 18%. Moreover, the dividend tax credit goes from 13.33% to 11% of the grossed-up dividend. This measure will apply to non-eligible dividends disbursed after 2013. These changes take the maximum marginal federal tax rate from 19.6% to 21.2%.

First-time donor's super credit

To encourage charitable giving by new donors, the budget proposes to introduce a temporary "first-time donor's super credit" in addition to the current donation credit. The new credit will equal 25% of cash donations of up to $1,000 made by a first-time donor. Combined with the current credit, a first-time donor will be entitled to a 40% credit on the first $200 of donations, plus 54% on the portion of donations in excess of $200 and up to $1,000. An individual will be considered a first-time donor if neither the individual nor his or her spouse have asked for a credit since 2008. The new credit will apply to donations made as of March 21, 2013, and may only be requested once, in any year from 2013 to 2017.

Extension of the tax credit for flow-through share investors

The mineral exploration tax credit, offered to individuals who invest in flow-through shares, provides an additional benefit equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors.

The budget proposes to extend eligibility for the mineral exploration tax credit for one year, to include flow-through share agreements concluded prior to April 1, 2014.

Charitable donation tax shelters

To discourage participation in questionable charitable donation tax shelters and reduce the risk that unpaid amounts will ultimately become uncollectible, the budget proposes to modify the rules on taking collection action in these cases. In other words, if a taxpayer objects to an assessment of tax, interest or penalties that results from the disallowance of a deduction or tax credit claimed in respect of a charitable donation, the CRA will be permitted, pending the ultimate determination of the taxpayer's liability, to collect 50% of the disputed tax, interest or penalties.

This measure will apply in respect of amounts assessed for 2013 and subsequent taxation years.

Rental of a safety deposit box

The cost of renting a safety deposit box from a financial institution will no longer be deductible for income tax purposes. This measure will apply to taxation years that begin after March 20, 2013, i.e. starting in 2014 for an individual. This expense is currently not deductible in Quebec.

Restricted farm losses

Currently, the restricted farm loss (RFL) rules apply to taxpayers who have incurred a loss from farming, unless their chief source of income for the year is farming or a combination of farming and some other source of income. The budget proposes to modify the chief source of income test: a taxpayer's other income sources must be subordinate to farming for all of the farming losses to be deductible from income from these other sources.

Moreover, RFL rules limit the amount that can be deducted as farming losses to $8,750 per year ($2,500 plus half of the next $12,500). Farm losses incurred in excess of that maximum deductible amount can be carried forward for 20 years. The budget proposes to raise the annual limit from $8,750 to $17,500, that is, $2,500 plus half of the next $30,000.

These measures will apply to taxation years ending as of March 21, 2013.

Adoption expense tax credit

To make adoption expenses incurred by adoptive parents before they are matched with a child eligible for the adoption expense tax credit, the budget proposes to extend the adoption period by treating the time at which the adoption period begins as the time that an adoptive parent makes an application to register with a responsible entity or, if earlier, the moment when a Canadian court receives the adoption application. This measure will apply to adoptions completed after 2012.

Extended reassessment period – Tax shelters

After the initial assessment, the CRA normally has three years to verify the tax payable and establish a new assessment. The budget proposes to extend the normal reassessment period for an individual with respect to a tax shelter or reportable transaction if the information return is filed late. More specifically, the normal new reassessment period for the tax shelter or reportable transaction will be extended to three years after the date on which the relevant information return is filed. This measure will apply to taxation years ending after March 20, 2013.

GST/HST on home and personal care services

Government-supported home care services are exempt from GST/HST. The budget proposes to extend the GST/HST exemption for home care services to personal care services that receive a subsidy or public financing as of March 22, 2013.

GST/HST on reports and services for non-health care purposes

The budget states that the GST/HST applies to reports, examinations and other services that are not performed for the purpose of protecting, maintaining or restoring the health of a person.

The international tax evasion prevention program

The CRA will launch the Stop International Tax Evasion Program under which it will pay rewards to individuals with knowledge of major international tax non-compliance when they provide information that enables the collection of taxes due.

Assets held abroad

As of the 2013 taxation year, the CRA will remind individuals in their notice of assessment that they must produce form T1135 if they checked "yes" in their tax return, to indicate whether they had specific foreign property costing more than $100,000. Moreover, the instructions on form T1135 will be set out more clearly. A revised T1135 form will be used to collect more detailed information on each specified foreign property.

Moreover, the budget proposes to extend the new normal reassessment period for a taxpayer's taxation year by three years if the taxpayer has failed to report income from a specified foreign property on his or her annual income tax return and form T1135 was not filed on time by the taxpayer, or if a specified foreign property was not identified or improperly identified. This measure will apply to the 2013 and subsequent taxation years.

OTHER MEASURES

Corporation and Trust loss trading

In the context of an acquisition of control, losses accumulated within a corporation can be lost if some conditions are not met. To avoid losing these losses, certain strategies have been developed over the years, so that partial changes of control are created in order to keep the postponed losses. The government deems corporation loss trading as an aggressive tax avoidance strategy. It has therefore instituted an anti-avoidance rule that will make it more cumbersome to transfer losses when the new investor has acquired more than 75% of the fair market value of all shares without acquiring control, if one of the main reasons for the lack of control taking involves the use of accumulated losses.

Similarly, by making the appropriate changes, the budget proposes to apply to trusts the rules on loss pools and related rules that currently apply in the acquisition of control of a corporation, including the limited exemption for the use of losses other than corporate capital losses.

Extension and expansion of the hiring credit for small businesses

The budget plans to improve and extend the temporary hiring credit for small businesses. The temporary credit could reach $1,000 under the increase in employment insurance contributions by a small company in 2013 compared with the contributions paid in 2012, in the case of employers whose employment insurance contributions totaled up to $15,000 in 2012.

R&D program

The budget institutes measures to equip the CRA with tools to better deal with specialists submitting statements on research and development (R&D) programs.

Specialists must provide more detailed information on themselves and their billing terms. A new $1,000 penalty may apply to any R&D application that is deemed incomplete with respect to the information on specialists and terms of billing.

Consultation on graduated rate taxation of trusts and estates

Estates and trusts created by testament (testamentary trusts) will generally compute federal income tax using the graduated tax rates applicable to individuals. Non-testamentary trusts generally pay federal tax at a flat rate of 29%, which is the highest federal tax rate for individuals.

This tax treatment raises questions of both tax fairness and neutrality in comparison to the treatment of beneficiaries of ordinary inter vivos trusts and taxpayers receiving equivalent income directly.

The government is also concerned with potential growth in the tax-motivated use of testamentary trusts.

The budget announces the government's intention to consult on possible measures to eliminate the tax benefits that arise from taxing at graduated rates grandfathered inter vivos trusts, testamentary trusts and estates (following a reasonable period of estate administration). A consultation paper will be publicly released to provide stakeholders with an opportunity to comment on those possible measures.

Other fiscal measures

- Extension until December 31, 2014 of the accelerated two-year deduction for manufacturing and processing machinery and equipment
- Gradual elimination of the accelerated depreciation awarded to the mining sector
- Elimination of the option to claim a deduction for amounts received to finance future reclamation obligations, which are taxable in that year
- Changes to attribution rules and deemed residence rules for non-resident trusts

Budget Analysis

Desjardins Economic Studies
www.desjardins.com/economics

March 21, 2013

CANADA: 2013 BUDGET

Obstacles aside, the federal government stays on course

Finance Minister Jim Flaherty maintains the deadline for balancing the budget in fiscal 2015–2016. Using a variety of revenue and expenditure measures, the Minister managed to offset the dip in receipts triggered by a weaker-than-forecast economy. However, he has attacked a number of tax loopholes and credits, increasing the tax burden on some taxpayers, a situation that could cause some resentment among those who were benefiting from these advantages. Overall, Minister Flaherty remains focused on his goals of supporting employment and economic growth, as much as possible.

Table 1
Summary statement of transactions

	Actual	*Projections*					
In $B	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018
Budgetary revenues	**248.8**	**254.2**	**263.9**	**279.6**	**294.9**	**308.1**	**318.9**
- Change (%)	4.9	2.2	3.8	5.9	5.5	4.5	3.5
Program spending	**-244.0**	**-251.0**	**-252.9**	**-256.0**	**-262.6**	**-270.4**	**-278.1**
- Change (%)	1.8	2.9	0.8	1.2	2.6	3.0	2.8
Debt charges	**-31.0**	**-29.0**	**-29.7**	**-30.2**	**-31.5**	**-33.8**	**-35.7**
- Change (%)	0.3	-6.5	2.4	1.7	4.3	7.3	5.6
Adjustment based on risk[1]	**0.0**	**0.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**
Budgetary balance	**-26.2**	**-25.9**	**-18.7**	**-6.6**	**0.8**	**3.9**	**5.1**
Federal debt[2]	582.2	608.7	627.4	634.0	633.2	629.3	624.2
- Change (%)	5.8	4.6	3.1	1.1	-0.1	-0.6	-0.8
In % of GDP							
Budgetary revenues	14.1	14.0	14.2	14.4	14.5	14.5	14.4
Program spending	13.8	13.8	13.6	13.2	12.9	12.7	12.5
Public debt charges	1.8	1.6	1.6	1.6	1.5	1.6	1.6
Budgetary balance	-1.5	-1.4	-1.0	-0.3	0.0	0.2	0.2
Federal debt	33.0	33.5	33.8	32.6	31.1	29.6	28.1

[1] Reserve contained in budget revenues; [2] Debt representing the accumulated deficits including other comprehensive income.
Source: Department of Finance of Canada

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

WORSENED ECONOMIC CONDITIONS

In the last few quarters, the economy's growth has come in well below expectations. At this time last year, real GDP was forecast to grow 2.1% in 2012, with growth of 2.4% forecast for 2013. However, the recession in Europe, fiscal problems in the United States and some slowing by Canadian domestic demand have clouded the economic outlook in recent months. 2012 ended with real GDP growth of just 1.8%; the forecast for 2013 has just been dropped to around 1.5%. With price growth also weaker than forecast, nominal GDP growth could be just 3.3% in 2013, fairly sluggish, historically speaking.

Overall, the economic and financial projections used in developing the 2013 budget are fairly consistent with our latest forecasts. However, the risks are tilted to the downside. The real estate market has just begun a downtrend, the rise by business investment in non-residential structures is weaker, and consumer spending will be hampered by the effort to clean up household balance sheets. The uncertainties about the situation abroad remain extensive, as events in Cyprus reminded us this week. The forecast acceleration by economic growth in 2014 is far from certain given that much of the rise will depend on exports. The balanced budget expected by March 31, 2016 is largely based on the spinoffs of improved economic conditions.

THE BUDGET IS STILL SLATED TO BE BALANCED IN 2015–2016

The deterioration in economic conditions in recent quarters has had major repercussions for the Canadian government's finances, among other things, representing a $3.4B shortfall for 2013–2014 budget revenues. However, inflation has also been weaker, with a smaller rise by personal transfers. The economic slowdown's total impact on the budget balance for fiscal 2013–2014 is thus assessed at -$1.8B. Factoring in the new measures announced in today's budget, the deficit could reach $18.7B in 2013–2014, compared with the $16.5B projected in November, and the $10.2B anticipated in last year's budget.

Despite deteriorating public finances, the government is maintaining its course, slating the return to a balanced budget in 2015–2016. To get there, the Finance Department will have to keep tightening, with an additional $8.4B in cuts by March 31, 2018. Projected growth for program spending is just 0.8% for 2013–2014. This is an ambitious target, and there is reason to wonder whether the Canadian government can achieve it. For example, last year's budget called for program spending to rise by 1.4% for 2012–2013. However, that fiscal year is almost over and today's budget shows growth of 2.9% for the period, more than double the initial forecast.

Thankfully, the government's budget projections still include an adjustment based on risk equal to $3B per fiscal year as of 2013–2014, thus giving the Canadian government some leeway.

RE-ENGINEERING TO INVEST

The current economic environment is not making the situation any easier for the government, which recorded a $25.9B deficit for fiscal 2012–2013, and is striving to balance the budget. The solution involves re-engineering and tighter control over its operating expenses, with the goal of freeing up money to be invested in the private economy. In doing so, the government hopes to create more jobs and economic growth than it is eliminating elsewhere as a result of its decisions. In all, the net cost of the measures announced today would approximate $900M for the next two fiscal years. However, the Minister would have a lot of difficulty meeting his commitments without increasing revenue.

Table 2
Economic and financial forecasts

	2012			2013f			2014f		
Average annual growth in %	Nov. '12 update	2013 Budget	Desjardins Group	Nov. '12 update	2013 Budget	Desjardins Group	Nov. '12 update	2013 Budget	Desjardins Group
Real GDP	2.1	1.8	1.8	2.0	1.6	1.5	2.5	2.5	2.5
GDP deflator	1.3	1.3	1.3	2.0	1.7	1.8	2.1	2.1	2.3
Nominal GDP	3.4	3.1	3.1	4.0	3.3	3.3	4.7	4.7	4.8
Treasury bills – 3-month	1.0	1.0	1.0	1.2	1.0	1.0	1.8	1.3	1.2
Federal bonds – 10-year	1.9	1.9	1.9	2.2	2.1	2.0	2.9	2.8	2.5
Unemployment rate	7.3	7.2	7.2	7.2	7.1	7.1	6.8	6.9	6.9
Exchange rate (US¢/C$)	100.2	100.1	100.1	101.1	98.9	98.8	100.1	100.7	102.5
U.S. real GDP	2.2	2.2	2.2	2.0	1.9	2.0	2.9	2.9	2.8

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

Table 3
Federal Support for Provincial-Territorial-Municipal Infrastructure

In $M (on a cash basis)	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021	2021-2022	2022-2023	2023-2024	Total
Community Improvement Fund	2,890	2,910	3,035	3,060	3,200	3,245	3,295	3,445	3,495	3,650	32,225
New Building Canada Fund	210	210	780	1,000	1,500	2,000	2,000	2,100	2,100	2,100	14,000
National Infrastructure Component	15	15	195	325	500	575	575	600	600	600	4,000
Provincial-Territorial Infrastructure Component	195	195	585	675	1,000	1,425	1,425	1,500	1,500	1,500	10,000
P3 Canada Fund	200	225	275	275	275	0	0	0	0	0	1,250
Sub-total	3,300	3,345	4,090	4,335	4,975	5,245	5,295	5,545	5,595	5,750	47,475
Existing program funding	1,858	1,672	1,208	810	484						6,032
Total new Building Canada plan	5,158	5,017	5,298	5,145	5,459	5,245	5,295	5,545	5,595	5,750	53,507

Source: Department of Finance of Canada

Aside from the rise in the excise tax on manufactured tobacco, which will add $75M to government coffers in fiscal 2013–2014, the tax rates on individuals have not really changed. Some tax loopholes and credits are being eliminated or reduced. For example, the effective tax rate on a non-eligible dividend will be increased. The tax credit for a labour-sponsored venture capital corporation will also be gradually eliminated starting in 2015, dropping to zero in 2017. For businesses, the additional deduction for credit unions will gradually be eliminated starting in 2013 over a period of five years. In the end, that is, in 2017–2018, eliminating this deduction will bring in an additional $75M to the government's coffers.

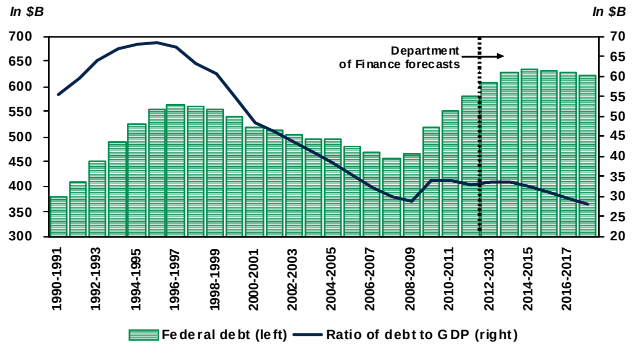
The most spectacular news in this budget is likely the new Building Canada plan, which sets out an investment of more than $53B over 10 years, staring in 2014–2015, for provincial, territorial and local infrastructures. The government states that $47B of this amount comes from new funds; however, this is apparently not the case. In fact, nearly $32B of the money comes from the indexed Gas Tax Fund, and the additional reimbursement to municipalities of the Goods and Services Tax (GST), money which already exists and is to be transferred to the new Community Improvement Fund. The fresh money invested will primarily come from the new Building Canada Fund, which will inject $14B over 10 years, but just $210M in 2014–2015 and 2015–2016. Overall, support for infrastructures will total about $5B per year over the next 10 years, a situation that will stave off a drop in public investment.

Some of the additional government spending announced today deals with the labour market. The Minister will institute an employment subsidy program, which will attempt to build stronger ties between skill-based training, employment and employers. He will also try to renegotiate agreements on labour market development with the provinces, which may not feel good about these developments. $177M has been put aside for 2013–2014, while $677M has been earmarked in 2014–2015 for these programs. For 2014–2015, $382M has been set aside to strengthen manufacturers' competitiveness, particularly by adding two years to the deduction for accelerated depreciation for new investments in machinery and equipment. Lastly, nearly $609M will be channelled to communities over the next two years, much of which will be dedicated to investments in affordable housing and combating homelessness.

DESPITE THE DEFICITS, LENDING WILL BE DOWN

As budget deficits will continue in the next few fiscal years, the debt, which represents accumulated deficits, will keep increasing, hitting $634B as at March 31, 2015. The debt to nominal GDP ratio could start to shrink as of 2014–2015, thanks to more robust economic growth. That said, debt instruments taken out in the markets should edge down in 2013–2014, when they could total $648B compared with

The size of the debt is projected to peak soon



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

$665B at March 31, 2013. This astonishing outlook stems from a cash inflow valued at $41.3B in 2013–2014 due to the maturing of insured mortgage loan assets purchased by the Canadian government during the financial crisis. Moreover, in a desire to capitalize on exceptionally low interest rates, the government will continue to favour the issue of longer term debt instruments.

A BUDGET WITH LIMITED MEANS

All in all, the 2013 budget is not offering much in the way of new features to Canadians. Even the new multi-year infrastructure program announced today is primarily financed from existing funds. The Finance Department clearly intends to invest new amounts, but these amounts will primarily be available as of 2016–2017, which is when the federal government will be returning to a balanced budget.

Note that, given the deteriorating economic conditions, the federal government had no leeway. Under these circumstances, managing to stay on track for balancing the budget by March 31, 2016 is remarkable, even though some additional budget cuts had to be introduced. Clearly, the uncertainties remain numerous. Major risks are still associated with the economic forecasts, and the weak spending growth forecast for 2013–2014 is daring. The March 31, 2016 deadline is looming and the government does not have much latitude in the event of another shock. For now, the federal government's plan to get back to equilibrium is holding up.