

Fasken Martineau Alert

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Fasken Martineau DuMoulin LLP

Economic Update - A "Mini-Budget" for All Seasons

It was clear long before Finance Minister Ralph Goodale took his seat at the House of Commons Finance Committee meeting on Monday¹ afternoon that this year's federal Economic and Fiscal Update ("Economic Update") would have as much to do with election politics as with delivering a report card on the economic health of the nation.

The Liberal government is hanging in the balance between a recently forged opposition consensus on an early election and an electorate ambivalent at best about going to the polls this winter. For some time, senior Liberal officials have been eyeing this fall Economic Update as a critical moment on the federal political calendar. It would be either an opportunity for a good news review of a well-managed economy - broad in scope and theme, but otherwise slim on specifics. Or it would have to be a "mini-budget" or an "economic update on steroids" as one government operative suggested, laying out an economic blueprint and election platform - long on detail and announceables.

With the possibility of a non-confidence vote rising and the opportunity for a February budget falling in equal measure, this Liberal government opted for more, not less, sooner not later. Not since Paul

Martin's 2000 Economic Update², has an economic update been so replete with new tax cuts and spending initiatives.

Taking on the NDP

On its face, the 2005 Economic Update seems targeted at NDP and left-leaning Liberal voters: significant new spending on post-secondary education, students and university-based research; major new investments in workplace-training and economic integration for Aborigines, persons with disabilities and immigrants; and new spending on the resettlement and integration of new arrivals to Canada (in total: more than \$10 billion in new program spending over five years).

At the same time, as if to underscore the end of the NDP-Liberal marriage of convenience, the Finance Minister is reintroducing the planned two per cent corporate tax cut abandoned last spring to appease the NDP and forestall the toppling of the government.

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Vancouver

Calgary

Toronto

Montréal

Québec City

New York

London

Johannesburg

¹ November 14, 2005

² <http://www.fin.gc.ca/toce/2000/ec00e.htm>

Targeting "Main Street" and Tory Support

But if the corporate tax cuts are a swipe at the NDP, the announced cuts to personal income taxes for low and middle income Canadians is a shot in the direction of the Conservative Party's small "c" voting base. Much more than a Bay Street budget, this Economic Update is directed at "Main Street."

Initiatives such as increasing the amount of the basic personal exemption, reducing the lowest personal tax rate by one per cent and raising the threshold for the top tax rate in Canada to \$200,000 within five years are being sold as voter-friendly measures aimed at shoring up the Liberal government's bona fides for fiscal responsibility.

If the Liberal government has one, unchallenged strong suit for the next election it is a reputation for sound management of the economy. Conservative, NDP and Bloc Quebecois critics have repeatedly attacked government credibility over ballooning surpluses and poor fiscal forecasting. But the salvos have never really hit their target.

Recent federal Liberal government's have calculated that most Canadians, struggling as they do to balance their own accounts, take some pride in federal governments that don't overspend while paying down their debts. The introduction of new personal and corporate tax cuts fills out the picture - a balanced approach, with a little something for everybody: debt relief, tax cuts and new social spending.

Income Trust Issue

If there is one disappointment for Bay Street in the Economic Update, it is the absence of any clear signal on the income trust issue. While the corporate tax cuts will be welcome, they are not nearly enough to offset the tax preferred position of income trusts versus traditional corporate structures.

Uncertainty over Federal Government policy on income trusts remains. Some observers had predicted that with an Economic Update boosted by tax initiatives the Finance Minister might take the opportunity to signal a preference for tax cuts over other measures to address some of the government's tax leakage and productivity concerns caused by the rapid growth in the income trust sector.

The income trust sector (valued at approximately \$180 billion in Canada) has lost more than \$18 billion in market value since Ottawa released its consultation paper on "flow through entities" on September 8, 2005. Several planned income trust conversions have since been either scrapped, scaled-back or postponed pending "clarity" in government policy. Understandably, the Federal Government, and in particular the Finance Department and Minister, have come in for sustained criticism from various quarters in the financial community. The Economic Update might have been used to blunt some of that political fallout.

It is felt that the Federal Government is considering three policy responses:

- Limiting the deductions of interest expenses by income trust operating entities;
- Taxing income trusts in a manner similar to corporations; and/or
- Better integrating the personal and corporate income tax system to make the tax more neutral between all forms of business.

Clearly the third option is the preferred course of action for many Bay Street observers. And it was hoped that some combination of corporate and dividend tax reductions would be hinted at, if not announced, as the government's preferred solution. The two per cent corporate tax cut notwithstanding, observers are left to ponder the possibility of new taxes on income trusts or the reintroduction of limits on pension fund income trust ownership sometime in the new year.

Election Timing

But income trust policy, like the implementation of initiatives announced in this Economic Update, will now be servants to the will of Parliament and the timing of the next Federal election.

The Opposition resolve to force a January 2006 election call or topple the minority Liberal Government in November 2005 appears to be holding. The Prime Minister has announced he will not yield to the opposition pressure and continues to

press for a Spring election, less so with the Opposition and more directly with Canadian voters. The endgame appears to be on.

By issuing a “mini budget” the Federal Liberals are not taking any chances. If an election is unavoidable, Liberals will campaign on a carefully crafted track record of fiscal responsibility as the offset to charges of corruption, waste and entitlement. How voters react will provide judgment on two starkly contrasting political strategies.

Economic and Fiscal Update 2005 - Overview

Backdrop

The 2005 Economic Update was presented against the backdrop of continued economic growth with private sector economists expecting the economy to grow between 2.8 and 3.1 per cent per year over the next three years. Despite a continued appreciation of the Canadian dollar, exports and domestic demand have continued to grow, contributing to the growth of the economy. Finance Minister Ralph Goodale points to continued export growth as a sign that Canadian firms are adjusting to the challenges of a rising dollar.

The Liberals will happily take credit for their eighth consecutive budgetary surplus of \$8.2 billion in 2005-06. Moreover, the Liberal government predicts continued fiscal surpluses over the next five years, totalling over \$54 billion to be divided between social spending, tax relief and debt payments.

This rosy fiscal future is not surprising as corporate profits are at their highest level in recent memory. Specifically, increased energy prices have filled the Federal treasury with additional income tax revenue.

Moreover, personal income receipts are also rising as the Liberals reported that the Canadian economy has created 204,000 jobs so far this year, with

October's unemployment rate reaching the lowest point in three decades.

Finally, debt service charges as a share of budgetary revenues are the lowest since the 1970s. These conditions have had such a swift and dramatic effect on the size of the Federal surplus that the Ministry of Finance has had to triple their estimate of the surplus within the last nine months.

A massive budgetary surplus on the eve of an election has allowed the Liberals to develop a plan that focuses on tax cuts and social spending. There is little doubt that these measures are designed to influence a broad spectrum of Canadian voters.

Personal Tax

The Liberal plan includes the following personal income tax measures, which will impact all Canadians:

- An immediate \$500 increase to the basic personal amount—the amount of income all Canadians can earn without paying federal income tax—retroactive to January 1, 2005
- A reduction of the lowest personal income tax rate from 16 per cent to 15 per cent retroactive to January 1, 2005, and 1-percentage-point reductions to each of the two middle rates by 2010
- An increase of the income level at which the top tax rate begins to apply from \$115,734 to \$200,000 starting in 2010, to make Canada more attractive to highly skilled and mobile workers

FEDERAL PERSONAL INCOME TAX RATES			
TAXABLE INCOME	CURRENT TAX RATE	PROPOSED TAX RATE RETROACTIVE TO JAN. 1, 2005	PROPOSED TAX RATE JAN. 1, 2010
First \$35,595	16%	15%	15%
Over \$35,595 up to \$71,190	22%	22%	21%
Over \$71,190 up to \$115,739*	26%	26%	25%
Over \$115,739*	29%	29%	29%

* The upper income level at which the top tax rate begins to apply will be increased to \$200,000 starting in 2010.

Corporate Tax

Backtracking on an earlier commitment to the NDP to shelve corporate tax cuts in exchange for NDP support, the Liberal plan to reintroduce corporate tax cuts with the following measures:

- Cut the general corporate income tax rate from 21 per cent tax rate to 19 per cent by 2010 and eliminate the corporate surtax for all corporations by 2008
- Eliminate the federal capital tax as of 2006, two years ahead of schedule
- Extend carry-forward periods for business losses and investment tax credits
- Accelerate the capital cost allowance to encourage bio-energy in the pulp and paper sector

The Liberals believe that both personal and corporate tax cuts will amount to **\$30 billion** in tax relief over the next five years.

PROPOSED FEDERAL CORPORATE INCOME TAX RATES (RECONFIRMED FROM 2005 BUDGET)						
	2005	2006	2007	2008	2009	2010
General Corporate Income Tax Rates	21.0%	21.0%	21.0%	20.5%	20.0%	19.0%
Corporate Surtax	1.12%	1.12%	1.12%	0.0%	0.0%	0.0%

Education

There is a considerable focus in this Economic Update on new post-secondary education spending with over \$5 billion over the next five years spread out among the following initiatives:

- More than \$2.1 billion over five years to improve student financial assistance for lower- and middle-income Canadians
- \$1 billion in 2005–06 for provinces and territories for the Post-Secondary Education Innovation Fund
- More than \$2.1 billion in additional funding, beginning in 2005–06 and over the next five years, for university-based research
- Almost \$200 million over the next five years to create up to 3,500 internships and up to 500 scholarships for natural and health sciences and engineering graduates

Training and Immigration

To deal with Canada's skilled worker shortage and backlogged immigration system, the government is proposing to spend:

- \$1.3 billion over five years to improve settlement and integration services for new immigrants to Canada
- \$3.5 billion over the next five years to increase workplace-based training programs, and to enhance the participation of Aboriginal people, immigrants and persons with disabilities in the Canadian economy

A Plan for Growth and Prosperity

In addition to the Economic Update, the government also released *A Plan for Growth and Prosperity*, a 143-page policy document that the government says will guide its policy “over the coming years in fostering employment, economic growth and prosperity.” The plan focuses on Canadian's

standard of living with the goal of making the quality of life in Canada second to none.

The report sets the backdrop for the Economic Update and outlines four themes centered on the building of a successful and sustainable 21st century economy. The four themes are: (1) creating opportunity for all Canadians; (2) advancing an innovative economy; (3) positioning Canada at the centre of a global commerce and networks; and (4) building the right investment environment.

This new “economic framework” attempts to respond to the rapid growth of new economic giants such as China and India and the challenge posed by the retiring baby boom generation. It will serve as the Liberal's policy framework for future budget decisions.

For more information please contact the author of this report:

Daniel Brock

416 865 4513

dbrock@tor.fasken.com

Alternatively, feel free to contact any of the following members of the Strategic Counsel Practice Group:

Guy Giorno

(416 865 5149, *ggiorno@tor.fasken.com*),

Pierre Meunier

(514 397 4380, *pmeunier@mtl.fasken.com*);

Peter Hyndman

(604 631 4899, *phyndman@van.fasken.com*);

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Vancouver 604 631 3131 info@van.fasken.com	Calgary 403 261 5350 info@cgy.fasken.com	Toronto 416 366 8381 info@tor.fasken.com	Montréal 514 397 7400 info@mtl.fasken.com
Québec City 418 640 2000 info@qc.fasken.com	New York 212 935 32 03 info@nyc.fasken.com	London 44 20 7382 6020 info@lon.fasken.com	Johannesburg 27 11 685 0800 info@jnb.fasken.com