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The Federal Budget: It's all about the tax cuts

Stephen Harper's minority Conservative government unveiled its first budget this week. The focus was on tax reduction. "There is more tax relief in this one budget than in the last four federal budgets combined," said Finance Minister Jim Flaherty.

The budget laid out 28 separate tax reductions worth an estimated \$20 billion in tax savings for Canadians over two years. As well as the 28 tax reductions, there was only one tax hike, raising the lowest personal income tax rate half of one percentage point to 15.5% effective July 1, 2006.

The most widely anticipated tax break is the reduction on July 1 of the Goods and Services Tax from 7% to 6% fulfilling Prime Minister Stephen Harper's promise during the election campaign. The GST cut represents an estimated 33% of the dollar value of the tax reductions. Tax savings to business account for another 8%.

The Action

Of the 28 tax measures, these appear to have the most implications for capital markets in Canada:

- The lowering the general corporate income tax rate from 21% to 19% by 2010.
- The elimination of the federal capital tax this year, two years earlier than expected.
- The elimination of the corporate surtax for all corporations by January 1, 2008. This will mean the equivalent of a 1.12% reduction in the corporate tax rate.
- The reduction in the effective tax rate on dividends. This matches a proposal by the previous Liberal government to level the playing field between income trusts and other corporations.
- The reintroduction of the mineral exploration tax credit to solidify recent exploration gains.
- The exemption from capital gains tax on donations of publicly listed securities to public charities.

The Impact

The budget is likely to be positive for Canada's economic growth and supportive of the Canadian dollar. The Canadian dollar has gained 45% against its American counterpart in the past four years reaching more than 90 U.S. cents. As a result, Canadian manufactured goods have become more expensive in the U.S. Exports to the U.S. represent about one third of Canada's \$1.1 trillion economy. After the corporate tax cuts, Canada's manufacturing tax rate will be 5.1 percentage points lower than the U.S.

The impact for bonds is mildly positive as the budget pledges to reduce the federal debt by \$3 billion each year. The debt-to-GDP ratio will continue to fall, hitting 33.3% this year with a new target of 25% in 2013, one year ahead of expectations. "From my viewpoint, the move from unrelentingly large spending increases averaging 8% the last four years to a projected 5.4% this year and 4.1% in 2007/2008 is the big change," says John Braive, Vice Chairman of CIBC Asset Management.

The impact is also positive for equities, thanks to the cuts in corporate income taxes, the capital tax, and taxes on dividends. Another impact for equities, not tax related, comes from the change in rules to allow companies with defined benefit pension plans to eliminate deficits in the plans over a ten year period, instead of five years as is the current situation. Last year, 72% of defined benefit plans did not have the assets to cover future liabilities.

The change would apply to companies in federally regulated industries such as transportation, financial services and communications. Shares in many of these large companies are held in the value-oriented portfolios, such as the Renaissance Canadian Core Value Fund and the CIBC Balanced Fund, managed by CIBC Asset Management First Vice President, Gaelen Morphet. "This is good news for my unit holders," she says. "The proposed change will give these companies breathing room and a chance to flourish again."

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