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Canadian tax alert

Bill C-60 Economic Action Plan 2013 Act - impact on cooperative financial institutions

August 14, 2013

Tax rates to rise more than expected

The March 21, 2013 federal budget included a surprise for the credit union and caisse populaire system. (See our **Canadian tax alert** of March 25, 2013.) The government announced the phase-out of the additional deduction for credit unions and caisses populaires over five calendar years. Such entities will be entitled to deduct only 80% of the amount of the additional deduction otherwise calculated for 2013, 60% for 2014, 40% for 2015 and 20% for 2016. The additional deduction will be eliminated as of 2017. However, the technical amendments implementing the change that were enacted on June 26, 2013 do not achieve the policy objective set out in the budget.

The government's stated purpose of eliminating the additional deduction is to improve the neutrality and fairness of the tax system. Specifically, the additional deduction for credit unions and caisses populaires provides access to a preferential income tax rate that is not available to other corporations. The legislative intent is to increase the tax rate applicable to most credit unions and caisses populaires from a federal rate of 11% to a federal rate of 15% on income in excess of the small business limit.

However, there is a technical deficiency in the legislation that adversely impacts credit unions and caisses populaires. The deficiency relates to the way "full rate taxable income" of a credit union or caisse populaire is determined for purposes of the "general rate reduction". The result is that the federal rate applicable to income that is not eligible for additional deduction is subject to a 28% federal tax rate rather than 15%. This results in a tax rate 13% higher than expected.

The general rate reduction was introduced in 2001 for all corporations to reduce the federal tax rate from 28% to 15%. The reduction was implemented by way of a formula whereby a corporation claims a deduction from its taxes owing equal to its full rate taxable income multiplied by the general rate reduction percentage. The result is that most corporations are subject to an effective federal tax rate of 15% on their income that is not otherwise eligible for a preferential tax rate.

The definition of "full rate taxable income" was modified by Bill C-60. The modification, however, is specific to credit unions and caisses populaires. Under the old definition, a credit union or caisse populaire would start with its taxable income and then reduce it by the amount of income eligible for the additional deduction. The

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result was that any income not eligible for the additional deduction was still eligible for the general rate reduction.

The new definition of "full rate taxable income" does not yield the same result. Under the new definition, a credit union or caisse populaire would start with its taxable income and then reduce it by the amount eligible for the additional deduction before the phase-out or the annual small business deduction. However, the phase-out percentage is included in a separate part of the formula. The result of this technical deficiency is that income not eligible for the additional deduction due to the phase-out is also not eligible for general rate reduction.

Example (post 2016)	Previous Legislation	Intended Legislation	Actual Legislation
Taxable Income ($'000)	10,000	10,000	10,000
Income eligible for Small Business Deduction	(500)	(500)	(500)
Income eligible for additional deduction	(9,500)	(9,500)	(9,500)
Income subject to phase-out (100% for 2017)	-	9,500	-
Full Rate Taxable Income eligible for General Rate Reduction	-	9,500	-
Income Taxes at Full Rate (28%)	2,800	2,800	2,800
Small Business Deduction (first $500K)	(85)	(85)	(85)
Additional Deduction for Credit Unions	(1,615)	-	-
General Rate Reduction	-	(1,235)	-
Total Taxes Payable	1,100	1,480	2,715
Overall Effective Rate	11.0%	14.8%	27.2%

The error in the implementation of the amendments will result in credit unions and caisses populaires paying federal tax at 28% on 20% of their income earned after March 20, 2013. This will rise to 40% of their income commencing January 1, 2014, 60% of their income commencing January 1, 2015, 80% of their income commencing January 1, 2016, and 100% of their income commencing January 1, 2017.

Response from Department of Finance

Deloitte has discussed this technical deficiency in the current legislation with representatives of the Department of Finance. The Department is aware of the deficiency and is working towards fixing the problem. However, our contacts would not provide any assurance that the legislative fix would be enacted prior to the end of 2013 or whether the fix would be retroactive to budget day. Any legislative change is subject to parliamentary approval.

Provincial impact

Federal tax rate decisions are generally independent of provincial tax policy. Most provinces, including British Columbia, Saskatchewan, Manitoba, Ontario and Prince Edward Island mirror the federal treatment. However, Quebec eliminated the unique tax rate in 2003. The provincial impact is currently unknown as it will be up to each province to decide whether to end its tax support of credit unions and caisses populaires in similar fashion.

The gap between the full and small business federal tax rates is 17%. However, the impact could be even greater if provincial legislation incorporates the federal tax change as currently drafted. The cost to credit unions and caisses populaires would significantly increase.

Financial reporting under IFRS - change in future rates

With the requirement to report under IFRS by Canadian credit unions and caisses populaires, this proposal may have an impact on their financial statements for the second quarter of 2013. Under IFRS, deferred tax balances are calculated using the future tax rates that are expected to apply, based on tax rates and tax laws enacted or substantively enacted at the end of the reporting period.

Bill C-60 received royal assent on June 26, 2013. As such, the higher rates will apply to any taxable (deductible) temporary differences that are expected to reverse after budget day.

What does this mean?

Credit unions and caisses populaires were adversely impacted by the change in policy announced in the budget. Federal income tax rates were expected to rise over the next five years, from an effective rate of 11% to an effective rate of 15% for most credit unions and caisses populaires. However, the technical deficiency in the legislation, if not corrected, will increase the federal tax rate from the expected 15% to 28%. The increased rate will apply starting in 2013 for a portion of taxable income not eligible for the additional deduction. In the absence of a legislative fix, the federal tax burden of credit unions and caisses populaires will more than double in the next five years.

The credit union and caisse populaire systems will also have a reporting challenge for 2013 if corrective action is not taken. A literal reading of IAS 12 requires such entities to adjust their deferred income tax balances for the change in future rates. They may also pay a higher rate of tax on current income. The impact of this technical deficiency may be felt through changes in capital adequacy ratios as the change to deferred tax balances impacts regulatory capital in most provinces. Entities that would be affected by these changes should, in consultation with their auditors and their regulators, determine the best approach to address the impact of the technical deficiency.

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