FEDERAL BUDGET 2004

By Samantha Prasad, with comments by David Louis

There is little doubt that Paul Martin's first budget as PM was calculated to show a demarcation from recent Liberal history – most particularly, the cretins that have put his government in a political mess. In a departure from party tradition, the budget did not hand out all sorts of pre-election goodies. It showed that we can forget about tax breaks; they took place while Mr. Martin was at the helm as Finance Minister. The few tax incentives were largely focused on education for those with low incomes, and the like.

If there is a tax theme, it is to continue to crack down on tax "loopholes", particularly in the charitable sector.

GENERAL TAX MEASURES

Regulatory Reforms for Registered Charities

In the hope of "improving" the regulatory framework for registered charities, the budget set out measures to reach that goal, including a new compliance regime, a more accessible appeals regime, more transparency and greater accessibility to information, and changes to the disbursement quota rules. In addition, the budget proposes to introduce new sanctions which the Department feels are more appropriate than revocation for relatively minor breaches of the *Income Tax Act*.

In order to retain registered status, charities must fulfill minimum annual disbursement requirements set out in the *Income Tax Act*. The budget proposes to introduce several changes including:

- Reducing the 4.5% disbursement quota rate on capital assets to 3.5%.
- Reducing the 80% disbursement requirement that applies to the expenditure of proceeds from the disposition of endowments by the lesser of 80% of the capital gain realized on the disposition and 3.5% of the value of all property not used directly in charitable activities or administration.
- Extending the 3.5% disbursement obligation on capital assets to charitable organizations. For existing registered charitable organizations, this measure will apply to tax years beginning after 2008.

Comment:

These proposals, which will be of interest to many readers, constitute a *fundamental overhaul* in the way charities are regulated. Up to now, the government had to resort to an extreme sanction – revocation of registered charity status – for a non-compliant charity. Obviously, this sanction was used sparingly, especially in view of the sensitivities typically engendered. The budget papers contain a list of so-called "intermediate penalties" for infractions, which will potentially allow more extensive enforcement. For example, issuing annual receipts in excess of $20,000 where there is no gift or false information will result in the suspension of receipting privileges and 125% tax on the receipted amounts. (Where taxes and penalties total more than $1,000, the charity will be permitted to satisfy its liability by transferring amounts to eligible donees - "as determined by the Minister of National Revenue.") Proposed sanctions and taxes also include the taxation of gross revenue generated by a registered charity from prohibited activities, and suspension of a registered charity's tax-receipting privileges for using donated funds other than for charitable purposes. The extension of the disbursement quota to all charitable organizations is a significant departure from the current rules, which apply only to charitable foundations.

Trading Charitable Donations

The Budget proposes that charitable donation deductions of a corporation that are unused at the time of the acquisition of control will be claimable only for tax years that end before control was acquired, thereby preventing the trading of charitable donations by corporations. These amendments will apply in respect of gifts made after March 22, 2004.

Income Trusts

Budget 2004 proposes two measures to limit the level of investment that a pension fund can place in business income trusts:

- Restricted investment property holdings of pension funds (RPP trusts, RPP corporations and tax-exempt pension investment corporations) would be limited to no more than 1% of the book value of the fund's assets. Excess restricted investment property holdings would be subject to a 1% per-month penalty tax. This would include direct holdings of business income trusts and investment vehicles such as mutual fund trusts.

- Investment by pension funds will be limited to no more than 5% of the units of any business income trust. Excess holdings in any given business income trust would also be subject to a 1% per-month penalty tax based on the fair market value of the excess units held.

Restricted investment property will not include investments in resource royalty trusts and REITs, given that pension funds can invest directly in the type of property held by those entities. Existing investments by pension funds in business income trusts will be given transitional relief (10 years for direct holdings and 5 years for indirect holdings).

It is proposed that these penalty taxes apply for months that end after 2004.[i]

Comment:

This proposal is carefully designed to stem future revenue losses without interfering with the current markets. Up to now, pension funds have generally avoided investments in business income trusts because it is not completely clear that a trust structure shields these funds from liability. However, provincial legislators have been taking steps to enact remedial legislation, which would have caused a flood of exempt investors. In order not to disturb markets, *the proposals do not apply to RRSPs and RRIFs*. But the sixty-four dollar question is whether there could be further restrictions, especially in a post-election environment if the markets become more robust. One possible clue is a statement in the budget papers that the impact of these investments on tax revenues is estimated to be modest because “most unit holders in income trusts are taxable.” If the Department of Finance perceives there to be an increase in investments by RRSPs and other tax exempt entities, further changes could be in the wings.

General Anti-Avoidance Rule

Budget 2004 proposes to “clarify” that the general anti-avoidance rule applies to a misuse or abuse of the provisions of the Income Tax Regulations, the Income Tax Application Rules (ITARs), and any enactments amending the Act, Regulations or ITARs, as well as to a misuse or abuse of a tax treaty.

Comment:

This amendment overrules a recent tax case, and is intended to end a debate as to whether a treaty overrules GAAR. Interestingly, this “clarifying” proposal purports to apply retroactively – just in time for a test case on offshore freezes.

Fines and Penalties

The budget proposes to deny the deductibility of most fines or penalties imposed by law (whether by a government, government agency, regulator, court or other tribunal). This also includes fines and penalties imposed under the laws of a foreign country.

Comment:

This proposal continues a rather disturbing trend of overturning Supreme Court of Canada cases **[ii]** which (in this case) are premised on fines being part of the income-earning process. While the budget papers do not show a revenue impact from this proposal, my guess is that it should be a good money maker for the government.

Other Proposals . . .

- extend the “affiliated persons” rules to trusts;[iii]

- restrict relief for taxpayer-requested adjustments to returns to taxation years that end in any of the ten preceding calendar years;**[iv]**

- impose new tax in respect of non-residents’ investment through mutual funds. **[v]**

PERSONAL TAX MEASURES

Caregiver Medical Expenses

Budget 2004 proposes to allow caregivers to claim more of the medical and disability-related expenses that they incur on behalf of dependent relatives. Specifically, medical expense claims made on behalf of minor children will be pooled with the medical expenses of the taxpayer and his or her spouse or common-law partner, subject to the taxpayer's minimum expense threshold (the lesser of 3% of the taxpayer's net income and $1,813), without regard to the income of the minor child.

For medical expenses paid on behalf of other dependent relatives (e.g., grandparent, niece, nephew, etc.), taxpayers will be able to claim qualifying medical expenses paid on behalf of such a dependant that exceed the lesser of 3% of the *dependant's* net income and $1,813 (that is, the threshold for the METC that would apply if the dependant claimed the expenses). The maximum eligible amount that can be claimed on behalf of dependent relatives other than minor children will be $5,000.

Comment:

Under pre-existing rules, the amount of the medical *credits* that could be claimed were reduced by a proportion of the amount by which the dependent's *income* exceeded the basic personal amount ($8,012 in 2004 – this reduction was known as the "medical notch"). For individuals who are "income splitting" with these dependents (for example) this could result in a significant reduction in the credits that could be claimed by a supporting individual. The revised method of calculation will result in significantly increased tax credits for higher levels of a dependent's income.

Persons with Disabilities

Budget 2004 proposes to replace the current attendant care deduction with a broader disability supports deduction relating to expenses incurred for education or employment purposes (unless they have been reimbursed by a non-taxable payment, e.g. insurance payment). Certain services or amounts will require a certificate by a medical practitioner in order to be eligible.

Consequential to this proposal, the value of the refundable medical expense supplement (RMES) will, for the 2004 and subsequent tax years, be equal to 25% of allowable expenses claimed under the METC plus the new disability supports deduction, up to a maximum limit of $562 for 2004, indexed for future years. This will ensure that individuals who previously claimed the cost of disability supports under the METC and consequently received the RMES will not see the amount of their RMES reduced if they claim the expenses under the new disability supports deduction.

EDUCATION

Canada Education Savings Plan

The budget proposes changes to the Canada Education Savings Plans (CESG) matching rate for contributions made to RESPs by low- and middle-income families on or after January 1, 2005. The first $500 contributed to the RESP in the year will now attract a 40% CESG matching rate, if the child's family has qualifying net income in respect of the year of $35,000 or less (if the family has net income greater than $35,000, but less than $70,000, the rate is increased to $30%). All other contributions eligible for the CESG will continue to qualify for the 20% matching rate.

The maximum annual CESG contribution room will remain at $2,000 while the maximum CESG payable in respect of a year will be increased to accommodate the enhanced matching rates, effective for 2005. For example, a low-income family contributing $2,000 in a year could receive a CESG totalling $500 - that is, 40% on the first $500 ($200) and 20% on the remaining $1,500 ($300).

Education Tax Credit

The education tax credit ($400 per month of full-time study and $120 per month of part-time study) cannot currently be claimed by students who pursue post-secondary education that is related to their current employment. In order to facilitate the pursuit of job-related lifelong learning, the Budget proposes to remove this restriction, provided that no part of the costs of education is reimbursed by the employer.

Canada Learning Bond

Budget 2004 proposes to introduce, effective January 1, 2004, a new Canada Learning Bond (CLB) to provide a source of education savings for children in low-income families.

CORPORATE TAX MEASURES

Small Business Deduction Limit Accelerated

Budget 2004 proposes that the 2003 Budget proposed increase in the small business limit to $300,000 be accelerated by one year. The small business limit will therefore be $300,000 in 2005 and subsequent years.

Comment:

Starting next year, both the federal and Ontario small business limits will hold steady at $300,000 and $400,000 respectively (barring future tax changes, of course). In this $100,000 zone, the combined rate will be less than 28%, making retention of profits at the corporate level fairly attractive (the rate where both small business deductions apply is 18.62%). However, once income exceeds the provincial small business limit, rates increase to nearly 41% where the provincial “clawback” of the small business deduction applies, after which the tax rate will drop to just over 36% (with private corporation investment income taxed at just under 50%).

Refundable SR&ED Investment Tax Credit—Expenditure Limit

For small CCPCs, the scientific research and experimental development (SR&ED) investment tax credit (ITC) is available at an enhanced rate of 35% subject to the expenditure limit of $2 million per taxation year, which limit must be shared among associated corporations. The Budget proposes to amend the refundable SR&ED ITC rules such that small CCPCs that have a group of common investors that are otherwise unconnected (i.e., venture capital investors) do not have to share the $2 million expenditure limit, simply because two or more investors collectively have a majority interest in the shares of each corporation. However, the Minister of National Revenue must be satisfied that the group of investors was not formed to gain access to multiple expenditure limits.

This change will apply to taxation years that end after March 22, 2004.

Carry-Forward Period for Business Losses

The budget proposes to extend the loss carry-forward period for non-capital losses from 7 to 10 years, thereby bringing the period in line with those periods already applicable to farm losses and restricted farm losses. More precisely, Budget 2004 proposes to extend to 10 taxation years the carry-forward periods for:

- unused foreign tax credits;
- non-capital losses; and
- life insurer’s taxable Canadian life investment losses

This measure applies to losses and credits that arise in taxation years that end after March 22, 2004.

Comment:

Pre-existing losses will not be affected by these proposals – including the huge amounts piled up in the high-tech meltdown. So the benefits of this proposal will not be felt for years to come. However, it may make sense to move losses into the period where the extended carryforward applies.

Capital Cost Allowance Rates for Specific Equipment

Computer Equipment

The Budget proposes to increase the CCA rate for computer equipment acquired after March 22, 2004, to 45% from 30%. The current exemption for computers from the specified leasing property rules will be extended to computer equipment eligible for this higher CCA rate, other than any individual item with a capital cost in excess of $1 million. However, the Budget proposes that the separate class election is no longer available to computer equipment eligible for this higher rate.

Note: A taxpayer who has acquired computer equipment before 2005 may still elect to have the property included in Class 10 and therefore eligible for the separate class election. The proposed election must be filed with the income tax return for the taxation year in which the property is acquired.

Data Network Infrastructure Equipment

Currently, data network infrastructure equipment (i.e. broadband, internet, etc.) is generally depreciated at a 20% CCA rate. Budget 2004 proposes that such equipment acquired after March 22, 2004 be included in a new class, with a 30% CCA rate.

CPP and Restructuring

The budget papers propose to implement legislation announced in late February, designed to prevent doubling up on employer CPP in a restructuring (with similar changes in respect of EI). The announcement indicates that, when an employer is restructured as a result of a winding-up and immediate reconstitution under a different legal structure or the acquisition of all, substantially all or a distinct division of the employer's property by another employer, employees with uninterrupted employment with the employer will be deemed to have continuous employment with the successor employer for the purposes of the CPP.

UPDATE - TAXATION ISSUES

Tax Treatment of Savings

Budget 2003 announced an intention to examine and consult on the question of whether tax pre-paid savings plans (TPSPs) could be a useful and appropriate additional savings vehicle for Canadians. The budget papers state that "in the consultation, the question of whether a new type of savings plan such as a TPSP could be appropriate for Canada, raised a number of important issues which the Department believes require further consideration".

Comment:

Waiting for TPSPs? Don't hold your breath.

Deductibility of Interest and Other Expenses

On October 31, 2003, the Department of Finance announced legislative proposals respecting the deductibility of interest and other expenses which focused not on the deductibility of a particular expense, but rather on the ability of a taxpayer to claim a loss from a business or a property. In doing so, the proposals adopted the concept of the reasonable expectation of profit. Many commentators have expressed concern that the proposals could have unintended far-reaching effects. The Department intends to extend the period for making written submissions on these proposals until the end of August of this year.

Comment:

Taken literally, these proposals could deny interest deductibility for most stock market investments. The government's response – that the provisions would not be administered in this manner - is a disturbing departure from the rule of law.[vi] The proposal should either be scrapped or dramatically overhauled.

Cross-Border Share-For-Share Exchanges

The October 2000 mini-budget announced that the government would undertake to consult with interested parties on the merits and technical design of a tax deferral provision that would, if implemented, apply in respect of cross-border share-for-share exchanges. The 2004 Budget announced the government's intention to release a detailed proposal for public comment in the coming months.

Limitation Periods for the Collection of Federal Tax Debts

On March 4, 2004, the Minister of Finance announced his intention to propose changes to the *Income Tax Act* and other acts that will, among other things, establish a 10-year limitation period for the collection of federal tax debts, in response to a Supreme Court of Canada decision establishing a 6-year limitation period. The Government intends, at an early opportunity, to place before Parliament amendments that would give effect to the changes proposed by the Finance Minister earlier this month

[i] In addition, starting this year, trusts will be required to provide to their beneficiaries information on the composition of distributions received from the trust. Trusts will be required to identify what portion, if any, of a distribution will give rise to an adjustment in the cost base of the beneficiary's interest in the trust.

[ii] In this case, *65302 British Columbia Ltd.*, 99 DTC 5814.

[iii] A trust will be affiliated with any beneficiary who is entitled to a majority of the trust income or capital, and generally also with any person affiliated with such a beneficiary. Further, two trusts will be affiliated if two conditions are met:

- a contributor to one trust is affiliated with a contributor to the other trust; and
- beneficiaries that enjoy a majority of the income or capital of the trusts are affiliated.

In the case of a discretionary trust, these new rules will apply as if any discretion of any person in respect of the trust had been fully exercised (or not exercised, as the case may be) in respect of each person who is a potential beneficiary of the discretion.

[iv] This measure will come into effect after 2004.

[v] The budget proposes the following measures:

1. The distributions that any Canadian mutual fund pays out of its gains on taxable Canadian property will be treated, if the mutual fund is a trust, as Canadian-source trust income or, if the mutual fund is a corporation, as a taxable dividend, subject to the existing non-resident withholding tax (under Part XIII of the *Income Tax Act*). That tax applies at a statutory rate of 25%, but is typically reduced by tax treaty. This measure will apply in respect of distributions of gains realized on dispositions after March 22, 2004.

2. An income tax will be applied, as a tax on capital gains, to certain otherwise tax-free distributions made after 2004 by Canadian mutual funds to their non-resident investors made in respect of units or shares of Canadian mutual funds that are listed on a prescribed Canadian or foreign stock exchange, and the value of which is principally attributable to Canadian real estate or Canadian resource property. The tax, at a rate of 15%, will be withheld from the distribution at source.

A non-resident investor can realize a loss on the disposition of a unit or share in respect of which the investor has paid the new tax on distributions by filing a special Canadian income tax return for the year the unit or share was disposed of.

[vi] For further discussion see *"The Rule of Law" – A Thing of the Past?"* by the author, (published by CCH Canadian Limited), available on our website www.mindengross.com.