FEDERAL BUDGET

by Samantha Prasad, with comments by David Louis
Minden Gross LLP

CORPORATE INCOME TAX PROPOSALS

Corporate Tax Rates

The new federal budget proposes to reduce the general federal corporate income tax rate to 19 per cent from 21 per cent by 2010. The rate reductions will apply to all types of corporate income, other than:

- small business income, which is taxed preferentially at a 12 per cent corporate tax rate;
- investment income of Canadian-Controlled Private Corporations, which is subject to a special refundable tax regime;
- income of credit unions eligible for the corporate tax rate reduction under section 137 of the Income Tax Act (the "Act");
- income of mutual fund corporations, mortgage investment corporations, and investment corporations (as defined in the Act), which income already qualifies for special tax provisions.

Corporate Surtax

The budget proposes to eliminate the corporate surtax on January 1, 2008, prorated for taxation years that include that date. Its elimination is equivalent to a 1.12 percentage point reduction in all corporate income tax rates. The following chart illustrates the combined effect of the corporate income tax rate reductions and the elimination of the corporate surtax

	Current Rates as Legislated (includes surtax) 2008	Proposed Rates 2008	Proposed Rates 2009	Proposed Rates 2010
On first $300,000 of CCPCs' active business income	13.12	12	12	12
On other business income	22.12	20.5	20	19

See Comment – end of section (Corporate Rate Reductions)

Capital Cost Allowance

The budget proposes adjustments to increase CCA rates on a number of assets (generally for acquisitions on or after February 23, 2005). These assets include:

- transmission pipelines for petroleum, natural gas or related hydrocarbons, which will be increased to 8 per cent from 4 per cent;
- pumping and compression equipment related to a transmission pipeline for petroleum, natural gas or related hydrocarbons, which will be rationalized at a uniform 15 per cent;
- combustion turbines that generate electricity will increase to 15 per cent;
- transmission and distribution equipment and structures of a distributor of electrical energy, which will increase to 8 per cent;
- wire and cable used for telephone, telegraph or data communication, which will increase to 12 per cent; and
- high-efficiency and renewable energy generating equipment, which will be included in a new class eligible for a 50 per cent CCA rate.

SR&ED Investment Tax Credit

The budget proposes to extend the existing SR&ED incentives to include expenditures incurred in the performance of SR&ED in Canada's "Exclusive Economic Zone", which is considered to include the area within

200 nautical miles from the Canadian coastline. (Currently, SR&ED must be undertaken within the 12 nautical mile territorial sea surrounding Canada.) This measure will apply to expenditures incurred on or after February 23, 2005.

Comment – Corporate Rate Reductions

Earlier in the decade, a majority Liberal government dropped “business rates” for corporations by 7 per cent. Perhaps under Tory encouragement, the last part of the decade will see another 2 per cent drop, which, when added to the repeal of the surtax, will push the rate drop to 3.12 per cent, for a total of 10.12 per cent in a decade. When the corporate tax reductions are fully phased-in, the basic corporate tax rate in Ontario pertaining to business income will be reduced to 33 per cent. While the latest proposed decreases may not seem that significant in themselves, they nonetheless result in a corporate tax rate for business income which is nearly 10 per cent lower than pre-existing levels.

When the rates are fully phased in, Ontario manufacturing and processing income will be taxable at a 31 per cent rate; the tax rate for income qualifying for both the federal and provincial small business deductions will attract a rate of only 17.5 per cent. It is unfortunate that the Ontario Liberals did not have the foresight to follow the lead of their federal counterparts. Promised Alberta provincial corporate rates would reduce the “business rate” to 27 per cent in that province, with the small business rate a mere 15 per cent.

The following strategies should be considered:

- **Bonus policy.** The spread in Ontario between the top personal rate and the “business rate” will increase: it will grow from 10.29 per cent to 13.41 per cent, ignoring Employee Health Tax. Accordingly, there will be a greater benefit from retaining earnings at the corporate level rather than distributing as bonuses.[1] When corporate surplus subject to the 33 per cent rate is eventually distributed as dividends, the degree of under-integration (that is to say, extra tax when compared to the top individual marginal rate) will drop from nearly 10 per cent to well under 8 per cent. If such surplus is realized as a capital gain (e.g., as a result of increased value of the corporation on death), the spread will narrow to only 2 per cent above top personal rates (again ignoring EHT).

For further details on business income and integration, see the Appendix.

- **Investment versus business income.** Ontario corporate tax on investment income will attract a tax rate that is nearly 16 per cent higher than business income. Although the 33 per cent rate does not generate refundable tax, the ability to obtain the “business rate” means a tax savings of nearly one third. Accordingly, if investment income can be restructured to qualify for the 33 per cent business rate, this will result in substantial tax deferral.

- **Sale of a business.** When the rates are fully phased-in, capital gains will be taxable at 24.3 per cent at the corporate level (23.2 per cent for a capital gain at the personal level, such as a sale of shares by an individual). However, the sale of goodwill and other eligible capital will attract a corporate tax rate of only 16.5 per cent. Thus, on the sale of a business, there will be a substantial reduction of corporate tax, vis-à-vis capital gains. While both capital gains and eligible capital potentially generate a capital dividend account in respect of the untaxed 50 per cent of proceeds – so that this amount can be distributed to Canadian residents free of tax - a sale of eligible capital does not result in refundable tax balances in respect of the taxable portion. This means that there will be a degree of under-integration if the after-tax portion of the taxable proceeds is distributed to shareholders (see above for amounts). However, if there is a substantial sale, it might be possible to retain the taxable portion at the corporate level – i.e., because it will not be necessary to defray ongoing personal expenses. Otherwise, it may be possible to elect capital gains treatment under subsection 14(1.01) of the Act – i.e., to obtain refundable tax treatment.

- **Defer, defer, defer.** While structures that defer the incidence of corporate taxation are usually preferred, there will be even more incentive to do this during the phase-in period. For example, land developers should consider carefully the “three-year reserve” available pursuant to paragraph 20(1)(n) of the Act.

PERSONAL INCOME TAX PROPOSALS

Basic Personal Amount

The budget proposes to increase the basic personal amount from $8,012 (for 2004) to $10,000 by 2009, through progressive increases each year. Specifically, the basic personal amount will be increased as follows:

For 2006, by $100.
For 2007, by $100.
For 2008, by $400.

For 2009, by the greater of $600 and the amount required to bring the basic personal amount to $10,000.

The amounts on which the personal credits are based in respect of a spouse or common-law partner or a wholly dependent relative will also be increased from $6,803 as follows:

For 2006, by $85.
For 2007, by $85.
For 2008, by $340.

For 2009, by the greater of $510 and the amount required to bring the amounts on which these credits are based to $8,500.

These increases to the amounts will be in addition to increases that take effect due to indexation of the tax system.

Comment

If there had been no change, but the existing basic personal amount was indexed at 3 per cent, it looks to me that the tax savings in 2010 from the new amounts would be about $130. While this may seem like a chunk of change for some, when it's on an across-the-board basis, it adds up. At $3.5 billion for fiscal 2009-2010, these proposals constitute the largest single tax expenditure in the budget. For those who want to "capital gains split" with low-bracket family members, with the $10,000 basic personal amount, a family member with no other income will be able to have gains of $20,000 without federal tax - a nice round number.

Deferred Income Plans

End of Foreign Content

The big news coming out of the budget relates to the proposal to repeal the foreign property content limit (currently at 30 per cent) for purposes of qualified RRSP investments, effective as of 2005.

See "Comment – End of Foreign Content" - end of section

RPP and RRSP Limits

The budget proposes the following increases in the limits for RPPs and RRSPs:

RPP:

$19,000 for 2006
$20,000 for 2007
$21,000 for 2008
$22,000 for 2009

Corresponding increases will be made to the maximum pension limit for defined benefit RPPs. The DPSP limit will remain at one-half of the money purchase RPP limit.

Due to the fact that RPP limits are based on current year earnings while RRSP limits are based on prior year earnings, the RRSP limits are lagged one year behind the corresponding RPP limits.

Accordingly, the contribution limits for RRSPs will be increased as follows:

$18,000 for 2006 (per existing legislation)
$19,000 for 2007
$20,000 for 2008
$21,000 for 2009
$22,000 for 2010

The proposed limits will be indexed to average wage growth, starting in 2010 for RPPs and DPSPs, and in 2011 for RRSPs.

Qualified RRSP Investments

The budget proposes to add to the list of qualified investments, investment-grade gold and silver bullion coins and bars, and certificates on such investments. These investments must meet certain thresholds in order to be a qualified investment for an RRSP.

These changes will be effective for investments made on or after February 23, 2005.

Persons with Disabilities

Based on the advice of the Technical Advisory Committee on Tax Measures for Persons with Disabilities, the budget proposes a number of income tax changes that will benefit persons with disabilities and those who care for them. The proposals will:

- clarify the legislation with respect to how impairments are conceptualized;
- align the legislative criteria for impairments in mental functions with wording used in the administration of these provisions;
- extend eligibility to include individuals with multiple restrictions where the cumulative effect of those restrictions is equivalent to a marked restriction in a single basic activity of daily living;
- better define the activities that constitute life-sustaining therapy;
- add to the list of health practitioners who can certify eligibility for the Disability Tax Credit;
- extend the maximum period for making contributions to an RESP for a beneficiary who qualifies for the disability tax credit to 25 years (from 21 years) following the year in which the plan was entered into;
- increase the maximum annual Child Disability Benefit to $2,000 from $1,681 (effective July 2005);
- improve the CRA's administration of the disability-related tax measures, including the establishment of a new advisory committee;
- expand the list of eligible expenses for purposes of the Medical Expense Tax Credit, as well as clarify the eligibility of home renovation expenses in respect of same;
- double the maximum eligible amount that can be claimed by taxpayers paying medical or disability-related expense on behalf of a dependant relative, from $5,000 to $10,000.

Comment – End of Foreign Content

With the stroke of a pen, the Liberal minority government removed foreign content restrictions on RRSPs and other deferred income plans, which have been with us as long as RRSPs themselves. If you ask me, this is the **most important single change ever proposed in this area** – and one of the most far-reaching budget proposals in a generation.

To some, the term "foreign content" conjures up visions of high finance and sophisticated planning. But the removal of the restrictions is so fundamental that virtually every reader should consider them carefully, and perhaps make major changes to your RRSP content.

What this means for your RRSP

Assuming the proposals are passed, effective immediately, it is no longer necessary to hold Canadian stocks, bonds and mutual funds. In fact, you don't have to hold Canadian investments at all.

Let me give you a few examples of what this means: With foreign content gone, if you want to get into U.S. exchange traded funds, you can simply go out and buy SPDRs (Standard & Poor's Depositary Receipts™) and the like. There is no reason to invest in more expensive Canadian clone funds. Given the proposals, they are history.

RRSP investment restrictions are now governed only by the "qualified investment" rules. With some notable exceptions (e.g., direct investments in real estate), these rules leave you with a pretty free hand when it comes to international investments. For example, income tax regulation 3201 allows as qualifying investments stocks trading on major exchanges in the US, Europe and Asia – you can even go 100 per cent into any of these if you wish.

Qualified investments also include "investment grade" bonds and similar obligations of foreign countries. So you can go whole hog into U.S. Treasury bills, U.K. or Israel bonds.

Besides the demise of clone funds, Labour-Sponsored Venture Capital Corporations and qualifying small business investments may lose some of their luster, as they permitted increased foreign content.

The Longer Term

Some commentators – and the government itself – feel that these changes may not have a substantial impact. They argue, firstly, that Canadian deferred income plans are well under the foreign content limit, with pension funds invested only in 25 per cent of foreign securities. Suddenly, though, instead of being a mere 5 per cent under the maximum (perhaps a cushion against penalty taxes), they could be 75 per cent under-invested. Others argue that, under the old rules, a properly-structured RRSP could effectively exceed foreign content limits. True enough. But this may involve sophisticated strategies and extra expense. With these new changes, all you have to do is tell your stockbroker to buy Microsoft or IBM and you're finished – it's that simple.

The longer term impact on Canadian markets becomes even more troublesome when you think about mutual fund and pension managers. Most readers will make major portfolio shifts only after a lot of discussion and thought. Institutional managers must be prepared to make these moves in a flash – after all, if they don't, the manager next door may. With Canada accounting for a mere 3 per cent of world market capitalization, I suspect that most managers recognize that it makes little sense to continue to hold 70 per cent of their plans with Canadian content. So in the longer term, at least, expect increased volatility in Canadian markets.

The initial reaction of Canadian markets has been fairly benign. There was a drop in the Canadian dollar, but, at time of writing, the Canadian stock market has been holding up, perhaps due to the weak performance of the U.S. dollar and our strong economy. But my advice is, don't be complacent: If something starts to go wrong, with the ability to instantly shift huge chunks of investment capital out of the country, you should be prepared for the possibility of significant market swings - and if Canadian markets and currency soften, more takeovers may be in store.

With foreign content gone, it is time to rethink where your RRSP should be deployed. You should think globally. For example, stop thinking of Canada's public corporations – even our banks - as "large." The truth is, we are bit players in the world market – and anyone who thinks otherwise should have to be prepared to suffer the consequences.

The other budget proposals in this area are a piffle compared to this one. For example, the increase in RRSP contribution limits to $22,000 at the end of the decade might have been largely matched by indexing on the $18,000 limit, which was to take effect in 2007. It's just the Liberals playing with numbers again.

MISCELLANEOUS PROPOSALS

Directors' Liability for GST/HST Refunds

Although our commentary is largely focused on income tax matters, one GST/HST proposal is worthy of note. The budget proposes to extend directors' liability to GST/HST net tax refund amounts to which corporations are not entitled. Directors will still be afforded the due diligence defence in respect of this liability. The extension of directors' liability to GST/HST net tax refunds will apply in respect of net tax refund amounts paid on or after Royal Assent.

Public Safety Occupations

Special rules governing pension benefits apply to those in public safety occupations, which are defined to include fire fighters, police officers, corrections officers, commercial airline pilots, and air traffic controllers. The budget proposes to expand the definition of public safety occupations to include paramedics and to extend the favourable maximum annual pension accrual rate for RPPs given to fire fighters to all public safety occupations (both effective January 1, 2005).

Adoption Expense Tax Credit

The budget proposes to introduce a 16 per cent non-refundable credit for eligible (non-reimbursable) adoption expenses for the completed adoption of a child under the age of 18 years, up to a maximum amount of $10,000 per adoption, per family. Eligible adoption expenses will include fees paid to licensed adoption agencies and foreign institutions, and reasonable travel and living expenses. The maximum eligible adoption expenses claimable in respect of any particular adoption will be $10,000. This amount will be indexed for taxation years after 2005. The credit may be split between two adoptive parents, but the combined expenses claimed for an adopted child cannot exceed $10,000. This measure will apply for the 2005 and subsequent taxation years.

Comment

This proposal does not seem to provide relief if the parents are unsuccessful in adopting a child. For example, the proposal might provide that persons trying to adopt can deduct qualifying expenses of up to $10,000; once this limit has been reached, there are no credits until they are successful and attempt to adopt a second child.

Canada Deposit Insurance

This is to be increased from $60,000 to $100,000, effective immediately.

TAX ADMINISTRATION

International Tax Enforcement

The budget proposes to invest $30 million annually in enhanced CRA audit and collection activities in the area of international tax. These resources will be used to increase audit and compliance capacity with respect to cross-border and international transactions, using a risk-based approach. Additional revenues generated through increased audit and enforcement are expected to offset this cost.

For more information, please contact the Minden Gross Tax Group.

UPDATE - TAXATION ISSUES

ISSUES STILL PENDING	STATUS
Deductibility of Interest and other expenses	An alternative proposal for comment is to be released at an early opportunity (with a CRA publication addressing administrative questions on deductibility)
Cross-Border Share-for-Share Exchanges	A discussion draft of proposed income tax amendments to implement this initiative will be released in the near future
Income Trusts	In the consultation process; future initiatives, if any, will be taken following consultations
Proposals concerning FIEs and Non-resident trusts	Legislation to be introduced at a suitable time, consistent with other legislative priorities
Draft income tax technical amendments released for public commentary on February 27, 2004 and previously announced sales tax technical measures	Legislation to be introduced at a suitable time, consistent with other legislative priorities

Thanks to Michael Goldberg

APPENDIX

Ontario Corporate Tax Rates for Business Income*

Year	2005	2010		2005	2010		2005	2010
Corporate:								
Non-M&P			**M&P**			**SBD**		
Federal	22.12	19		22.12	19.00		13.12	12

Provincial	14	14	12.00	12.00	5.5	5.5
Total	**36.12**	**33**	**34.12**	**31.00**	**18.62**	**17.5**
After tax income	63.88	67	65.88	69.00	81.38	82.5
Tax thereon - as dividend	20.02	21.00	20.65	21.63	25.51	25.86
Total Tax	56.14	54.00	54.77	52.63	44.13	43.36
Over/(under)integration	**-9.73**	**-7.59**	**-8.36**	**-6.22**	**2.28**	**3.05**
Deferral	**10.29**	**13.41**	**12.29**	**15.41**	**27.79**	**28.91**
Over/(under)integration - realization as capital gains (e.g., on death)	-4.53	-2.14	-3.00	-0.60	8.91	9.77

[1] Where applicable, the Ontario "clawback" will increase the corporate rate; however, the reduction of the overall federal tax rate will, to a large extent, compensate for this.