

TaxTalk

2005 ONTARIO BUDGET HIGHLIGHTS

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On Wednesday, May 11, 2005, the Honourable Greg Sorbara, Ontario's Minister of Finance, presented the 2005 Budget.

Set out below are highlights of the budget that we believe to be of most interest to our clients.

ECONOMIC OVERVIEW

	2004/ 2005 ¹ (\$billion)	2005/ 2006 ² (\$billion)	Growth (%)
Revenue	77.1	81.7	6.0
Expenditure			
Public debt interest	9.6	9.8	2.1
Other ³	<u>70.5</u>	<u>74.7</u>	6.0
Deficit	<u>3.0</u>	<u>2.8</u>	
Net Provincial Debt	142.2	146.0	2.7

	2004 (%)	2005 ¹ (%)	2006 ² (%)
Inflation	1.9	2.1	1.9
Unemployment rate	6.8	6.7	6.5
Real Growth in GDP	2.6	2.0	2.8

The estimated deficit of \$3 billion for 2004/05 is substantially less than the 'true' deficit projected last year of \$6.1 billion⁴.

¹ Estimate, for the fiscal year ending March 31, 2005.

² Forecast, for the fiscal year ending March 31, 2006.

³ Includes contingency reserve of \$1 billion in 2005/2006.

⁴ The 2004 budget forecast a deficit of \$2.2 billion including a one-time revenue gain of \$3.9 billion with respect to hydro purchase agreements – adjusted for this one-time gain, the expected deficit was \$6.1 billion.

This reduced deficit is largely due to: i) higher revenues from corporate taxpayers of approximately \$1.2 billion and ii) higher transfer payments from the federal government of \$1.2 billion.

Expenditures for the 2004/2005 year are in line with amounts budgeted. Higher than budgeted spending in health care and in assistance to farmers was mitigated by a lower than expected interest cost on the provincial debt due to interest rates being lower than budgeted over the past year.

A balanced budget is forecast by 2008-09 at the latest. This is one year later than was outlined in the 2004 budget. The deficit could be eliminated by 2007-08 if the contingency reserve of \$1.5 billion is not needed in that year.

The budget does not change personal or corporate income tax rates, but taxes will increase for most individuals, as the Ontario Health Premium will apply for a full year in 2005. Tax proposals in this budget target certain industries.

Spending will rise, particularly for health care (an increase of \$1.8 billion in 2005-06) and for education. Much of the spending targeted for education will be for post-secondary needs, and is scheduled to occur in future years.

Growth in the economy was 2.6% for 2004, and is expected to remain moderate (2% increase for 2005), due to the higher Canadian dollar, elevated oil prices, and a slow-down in growth of the U.S. economy. The rates of inflation and unemployment are projected to remain relatively stable as indicated in the table above.

PERSONAL TAX MEASURES

Personal Income Tax Rates

The 2005 budget does not introduce any new tax rate changes. The **top marginal rate for individuals remains at 46.41%**. This rate starts to apply when taxable income exceeds \$115,739.

The income tax brackets and combined federal and Ontario marginal tax rates (excluding the Ontario Health Premium discussed below) for 2005 and future years are as follows:

2005 and Future Years

Taxable Income (Ontario Brackets) ⁵	Federal Rate %	Ontario Rate %	Total %
\$ 8,196 to \$ 34,009	16.00	6.05	22.05
\$ 34,010 to \$ 35,595	16.00	9.15	25.15
\$ 35,596 to \$ 59,880	22.00	9.15	31.15
\$ 59,881 to \$ 68,020	22.00	10.98	32.98
\$ 68,021 to \$ 70,560	22.00	13.39	35.39
\$ 70,561 to \$ 71,190	22.00	17.41	39.41
\$ 71,191 to \$115,739	26.00	17.41	43.41
\$115,740 and over	29.00	17.41	46.41

The table above includes the effect of the **Ontario surtax**. The surtax increases the top marginal tax rate by 6.25% from 40.16% to 46.41%. Ontario's surtax is two-tiered⁶ and is calculated as a percentage of basic Ontario tax in excess of specified amounts.

The following table⁷ provides the top marginal tax rates (excluding the Ontario Health Premium) for an Ontario taxpayer for 2005 and future years on regular income, dividends and capital gains.

Type of Income	(%)
Regular Income ⁸	46.41
Dividends	31.34
Capital Gain	23.21

⁵ In general, the tax brackets are indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result.

⁶ For 2005, the first-tier surtax is 20% of Ontario tax in excess of \$3,929 (applies when taxable income exceeds \$59,880); and the second-tier surtax is 36% of Ontario tax over \$4,957 (applies when taxable income exceeds \$70,560).

⁷ These tax rates generally apply when taxable income exceeds \$115,739 in 2005 (this income threshold is to be indexed annually for inflation).

⁸ For example: salary, pension, interest and business income.

Ontario Health Premium

The 2004 budget introduced the Ontario Health Premium; all premiums collected are dedicated solely to healthcare. The premium started July 1, 2004⁹, and is calculated in reference to taxable income - thus, it is an income tax. It starts to apply on taxable income in excess of \$20,000. Although the premium generally increases in increments of \$150, at each threshold there is a phase-in as indicated in the following table:

Taxable Income	Premium After 2004
Up to \$ 20,000	Nil
\$ 20,000 - \$ 25,000	6% of income >\$20,000
\$ 25,000 - \$ 36,000	\$300
\$ 36,000 - \$ 38,500*	\$300 + 6%* of income >\$36,000
\$ 38,500 - \$ 48,000	\$450
\$ 48,000 - \$ 48,600	\$450 + 25% of income >\$48,000
\$ 48,600 - \$ 72,000	\$600
\$ 72,000 - \$ 72,600	\$600 + 25% of income >\$72,000
\$ 72,600 - \$ 200,000	\$750
\$200,000 - \$ 200,600	\$750 + 25% of income >\$200,000
Over \$200,600	\$900

* The original budget proposal in 2004 showed this transition rate at 25%. The rates were changed when this 'tax' was passed into law.

The maximum premium is \$900 - this is per taxpayer, so a two-income family will have two people subject to the premium/tax.

Tax credits

Effective for 2005, the budget proposes to parallel the following income tax measures announced in the 2005 federal budget as follows:¹⁰

- enhancements for amounts that can be claimed for dependants through the Medical Expense Tax Credit;
- a non-refundable tax credit for eligible adoption expenses; and
- various enhancements to the Disability Tax Credit and the Medical Expense Tax Credit.

Please refer to TaxTalk 2005 Issue 1, "2005 Federal Budget Highlights" for more details on these enhanced credits.

⁹ The premium for 2004 commenced July 1, and was limited to 50% of the annual amount.

¹⁰ The adoption of the federal changes is subject to the passage into law, which is uncertain with the current minority federal government.

BUSINESS TAX MEASURES

Corporate Tax Rates

This budget introduces **no changes to corporate tax rates**. Changes had already been made by the new government in November 2003 when it stopped or reversed previously legislated rate reductions. Under previous legislation, Ontario's general corporate rate was to decrease from 12.5% to 11% for 2004, with further reductions for 2005 and 2006. The newly elected government cancelled these rate reductions, and increased the general Ontario rate to 14% for 2004 and subsequent years.

Ontario's small business rate had also been legislated to be reduced from 5.5% to 5% for 2004 and to 4% for 2005. The new government cancelled the rate reductions to maintain the 5.5% rate for 2004 and subsequent years.

For corporations that claim the Ontario small business deduction (SBD), a surtax (clawback) is levied to reduce the benefit of the SBD where corporate income exceeds certain levels. For 2005, the range of income where the clawback applies continues to be between \$400,000 and \$1,128,519.

The following table summarizes corporate tax rates with respect to active business income (ABI) earned by a Canadian-controlled private corporation (CCPC) in Ontario:

Based on a December 31, 2005 year end

Income For ABI:	Federal Rate * %	Ontario Rate %	Total Rate %
up to \$300,000	13.12	5.50	18.62
from \$300,001 to \$400,000	22.12	5.50	27.62
from \$400,001 to \$1,128,519**	22.12	18.67	40.79
> \$1,128,519	22.12	14.00	36.12
> \$1,128,519 with M&P ***	22.12	12.00	34.12

*including federal surtax of 1.12%

**includes clawback of Ontario small business deduction

***M & P – manufacturing and processing tax credit

2005 Federal Budget CCA Proposals to Apply in Ontario

The budget proposes to parallel the income tax measures announced in the 2005 federal budget¹¹ to align the capital cost allowance (CCA) rates to better reflect the useful lives of various capital assets, specifically for assets used to generate efficient and renewable energy.

¹¹ The effective dates of these measures for Ontario will be consistent with the effective dates as announced in the federal budget. Please refer to TaxTalk 2005 Issue 1, "2005 Federal Budget Highlights". The Ontario changes will occur only if the federal proposals are implemented.

Assets acquired before January 1, 2008, and used to generate electricity from clean, alternative or renewable sources, will continue to be eligible for a CCA rate of 100% in Ontario.

Capital Tax Reductions

The 2003 budget originally proposed to eliminate capital tax by 2008. The 2004 budget contained a revised plan, to gradually reduce capital tax rates and **eliminate capital tax** altogether by **2012**. Pursuant to the 2004 budget, the capital tax exemption will increase in increments of \$2.5 million over four years until the exemption reaches \$15 million as detailed in the following chart:

Year	Exemption (\$Millions)
2004	5
January 1, 2005	7.5
January 1, 2006	10.0
January 1, 2007	12.5
January 1, 2008	15

Also, pursuant to the 2004 budget, the current capital tax rate of 0.3% will be reduced annually by 0.075%, commencing January 1, 2009, until the rate reaches zero in 2012.

It should be noted that the federal government still plans to eliminate the federal large corporations (capital) tax by 2008.

Tax credits

The budget contains proposals to enhance or increase various tax credits (many related to the film industry), including:

- Ontario Film and Television Tax Credit;
- Ontario Production Services Tax Credit;
- Ontario Computer Animation and Special Effects Tax Credit;
- Ontario Interactive Digital Media Tax Credit;
- Ontario Sound Recording Tax Credit; and
- Ontario Book Publishing Tax Credit.

Resource Allowance

Ontario currently allows a resource allowance to corporations in the oil and gas and mining sectors. The allowance is generally equal to 25% of resource profits. The 2004 budget indicated that Ontario would keep this resource allowance, even though these provisions are being phased out by the federal government.

The 2005 budget clarifies that the still undrafted regulations, to preserve the deduction in Ontario, will dictate that taxpayers use income computed for Ontario purposes to compute the resource allowance. This amendment will prevent corporations from claiming both an Ontario incentive deduction and additional resource allowance on that incentive, and will *apply retroactively* for taxation years beginning after May 6, 1997.

OTHER TAX MEASURES

Ontario Sales Tax - Simplified Calculation for Small Software Businesses

Businesses are required to determine the sales tax (PST) liability on the components of a software services contract, as these contracts often include both taxable and non-taxable services. To simplify the calculation of PST on such contracts for small software businesses, the budget proposes a pilot project. The project will allow an optional method for the tax calculation, whereby participating businesses and purchasers will be allowed to apply an unspecified blended tax rate to the total contract price.

OTHER MEASURES

Professional Corporations

Under current rules, professionals in Ontario can incorporate. However, ownership of shares is restricted so that only a professional can hold the shares of a professional corporation (PC). As part of the recent negotiations with the Ontario Medical Association, the government agreed to relax these rules for doctors so that

other family members can hold non-voting shares in the PC. In this budget, the government has announced that this new expanded ownership rule will also apply to dentists. No effective date was announced, but presumably these rules will not become effective until the necessary legal and regulatory changes have been made. Also, presumably there will be pressure to allow for expanded ownership of shares of PCs of other professions.

Tax Avoidance

Like all governments, Ontario is concerned about tax leakage. As such, the government announced that it is reviewing arrangements designed to avoid Ontario provincial corporation taxes. Under current rules, corporations can arrange their affairs to take advantage of different provincial corporate tax rates, i.e. Alberta has lower rates so corporations would prefer to pay income tax in Alberta. The government believes that these rules can be manipulated, and indicated its intention in the budget to discuss this issue with other provincial governments and the federal government.

In addition, under current rules, a corporation's liability for Ontario tax is based in part on whether the corporation was incorporated inside or outside Canada. The government announced that this rule will be changed, effective *for taxation years ending after May 11, 2005*. Under the change, Ontario tax will be based on whether a corporation is resident inside or outside Canada. This rule will make Ontario's rules consistent with the federal rules, and rules for the other provinces.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

Offices 10 Bay Street, Suite 900
 (Bay Street and Queen's Quay)
 Toronto, Ontario M5J 2R8
 Phone: 416-362-0515
 Fax: 416-362-0539

8501 Mississauga Road, Suite 100
 (Steeles Avenue and Mississauga Road)
 Brampton, Ontario L6Y 5G8
 Phone: 905-451-4788
 Fax: 905-451-3299

TaxTalk is prepared by our Tax Group (taxtalk@mgca.com) Please visit our website at www.mgca.com