

TAX TALK

2006 FEDERAL BUDGET HIGHLIGHTS

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On Tuesday, May 2, 2006, the Honourable Jim Flaherty, Minister of Finance, presented his first Budget Statement to Parliament. Set out below are highlights of the budget that we believe to be of most interest to you.

ECONOMIC OVERVIEW

	2005/2006 Estimate (\$billion)	2006/2007 Forecast	Growth %
Revenue	220.9	227.1	2.8
Expenditure			
Public debt	33.7	34.8	3.3
Other	179.2	188.8	5.4
Debt reduction	8.0	3.0	
Surplus	0.0	0.6	
Net Public Debt	486.4	483.4	

	2005 Estimate %	2006 Forecast %	2007 Forecast %
Inflation	3.1	2.9	1.8
3 Month Treasury Bill Rate	2.7	4.0	4.1
Unemployment Rate	6.8	6.6	6.6
Real Growth in GDP	2.9	3.0	2.7

As indicated in the tables above, the surplus for the 2005/2006 fiscal year is projected to be \$8 billion, which is to be directed to debt reduction. For 2006/2007, the surplus is forecast to be \$3.6 billion, with \$3 billion of it directed to pay down debt.

This budget contains many tax proposals, a major one being the **reduction in the GST rate from 7% to 6%**. The federal capital tax is eliminated, effective January 1, 2006. In addition, corporate income tax cuts first introduced by the previous government have been re-introduced, and new corporate tax decreases proposed. However, some of the corporate tax cuts **will not come into effect for 3 to 4 years**. If Canada's economic performance were to deteriorate or if the minority government were to fall, these back-ended tax cuts could be in jeopardy.

The Canadian economy has been buoyed by the strong growth in commodity prices. Although the budget forecasts growth to continue, risks to the economy were identified to include uncertainty with respect to commodity prices, the risk of a sudden correction in the U.S. housing market, and the risk that the Canadian dollar may appreciate further.

Although spending was not the focus, this budget contains spending initiatives, largely targeted for education, public transit and families / child care. The announced intention is to restrain the growth in spending.

PERSONAL TAX

In November, the previous government lowered the lowest tax rate for 16 to 15%, starting in 2005. This budget confirms this reduction for 2005, but increases the rate for 2006 and future years from 15% to 15.5%. As the change is to be effective July 1, 2006, this causes the 2006 rate to be 15.25%. This rate also applies to compute various federal tax credits.

The following table summarizes marginal tax rates (on regular income, i.e., salary, interest, etc.) that apply to the income tax brackets for 2006.

Taxable Income*	Federal Rate %	Ontario Rate %	Total %
\$ 8,839 to \$ 34,758	15.25	6.05	21.30
\$ 34,759 to \$ 36,378	15.25	9.15	24.40
\$ 36,379 to \$ 61,205	22.00	9.15	31.15
\$ 61,206 to \$ 69,516	22.00	10.98	32.98
\$ 69,517 to \$ 72,113	22.00	13.39	35.39
\$ 72,114 to \$118,285	26.00	17.41	43.41
\$118,286 and over	29.00	17.41	46.41

* Slight differences in the tax brackets for Ontario purposes have not been taken into account

For 2006, the top tax rate remains at **46.41** %, and will apply when taxable income exceeds \$118,286.¹

Personal Credits

A basic **personal amount** is allowed to individuals - \$8,648 in 2005. This credit eliminates income tax on taxable income up to that amount. This credit amount is to be increased for 2006 to \$8,839. For 2007 through 2008, the credit will be increased annually through indexation plus an additional \$100, and \$200 respectively. For 2009, the amount will be raised to \$10,000.

A similar personal credit is allowed in respect of a **spouse or common-law partner** or a **wholly dependent relative**. This credit may eliminate tax on additional taxable income up to \$7,505 for 2006. The amounts on which these credits are based will similarly be increased with the credit reaching \$8,500 in 2009.

Canada Employment Credit

A new Canada Employment Credit in recognition of work related expenses incurred by employees will take effect July 1, 2006, and will provide relief of up to \$30 for 2006. The value of the credit will increase to \$155, effective January 1, 2007.²

¹ In general, the tax brackets are indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result. For 2006, the brackets have increased by 2.2%. As a result, the top tax rate will apply in 2006 when taxable income exceeds \$118,286 (2005 - 115,739).

² The value of the credit is the federal amount only, as it is uncertain if Ontario will also introduce the credit.

Pension Income Credit

The budget proposes to increase the maximum amount of eligible pension income that may be claimed by pensioners as a non-refundable credit from \$1,000 to \$2,000, effective for 2006 and subsequent taxation years. This increase, the first since 1975, is expected to remove 85,000 pensioners from the tax rolls.

Students

To assist students in continuing education, and with escalating associated costs of post-secondary education, the budget proposes:

- the introduction of a new textbook tax credit with respect to the cost of textbooks, which will provide a tax reduction of approximately \$80 per year to a typical student;
- the elimination of federal income tax³ on all income derived from scholarships, bursaries, and fellowships; and
- to provide expanded eligibility and access to the Canada Student Loans Program, through the reduction of parental contributions required for eligibility.

Families

The budget proposes an additional family benefit, effective July 1, 2006. The Universal Child Care Benefit is to provide families with \$100 per month taxable benefit for each child under the age of six years of age. This benefit will be taxable in the hands of the lower income spouse or common-law partner but will not be taken into account for the purposes of certain other income-tested benefits.

Additionally, the budget establishes a non-refundable Children's Fitness Tax Credit in respect of up to \$500 of eligible fees in order to promote physical fitness for each child under age 16, effective January 1, 2007. Thus, the value of the federal credit in 2007 will be \$77 using a credit rate of 15.5%.

Lastly, for families the government has made changes to the child disability benefit to increase the amount of the credit (to \$2,300 from \$2,044, effective July 2006), and to increase access to the credit.

³ Currently, any bursary, scholarship etc. in excess of \$3,000 per year is subject to income tax.

Apprentices and Trades People

To promote a skilled and educated work force the budget provides the following initiatives:

- a new credit of up to \$2,000 for employers who hire, and train apprentices (discussed in more detail below);
- a grant of \$1,000 for apprentices; and
- a new \$500 tax deduction for trade persons in respect of the cost of tools in excess of \$1,000, necessary as a condition of employment.

Mineral Exploration - Flow-Through Share Investors

The budget proposes to reintroduce the 15% mineral exploration tax credit for specified mineral exploration expenses renounced to flow-through share investors, effective for flow-through share agreements entered into on or after May 2, 2006 and on or before March 31, 2007.

Plan to Reduce Income Tax on Certain Dividends

On November 23, 2005, the previous federal government proposed changes to the taxation of dividend income. The proposal was designed to reduce the income taxes paid on eligible dividend income from Canadian resident corporations.

As proposed, the federal tax reduction was to apply to dividends paid after 2005 by CCPCs⁴, to the extent that the CCPC's income is:

- not investment income (other than dividends from public companies); and
- subject to the federal general corporate income tax rate (i.e., the income is active business income not subject to the federal small business rate, generally active business income exceeding \$300,000 in 2006 and \$400,000 starting in 2007).

⁴ As proposed, the tax reduction will also apply to dividends paid after 2005 by public corporations; and other corporations that are not CCPCs, that are resident in Canada and are subject to the federal general corporate income tax rate (i.e., 22.12% in 2006).

This budget **re-introduces** this proposal.

If Ontario parallels the federal proposals, the top combined federal and Ontario personal income tax rate on qualifying dividends is expected to drop from 31.34% to 19.59%, an aggregate decrease of 11.75%. If Ontario does **not** parallel the federal provisions, the top combined federal and Ontario personal income tax rate on qualifying dividends will drop from 31.34% to 26.26%, an aggregate decrease of 5.08%.

Ineligible dividends will continue to be subject to the current rules that apply to dividends, i.e., the top tax rate on these dividends will stay at 31.34%.

Other Personal Measures

The following other personal proposals were included in the budget:

- a new non-refundable tax credit with respect to the cost of monthly or annual public transit passes, effective July 1, 2006; and
- the capital gains inclusion rate for donations of publicly-listed securities to public charities will be reduced from 25% to nil. This zero rate will also apply to donations of economically sensitive land. The zero rate will apply to donations made after May 2, 2006.

In addition, the government has confirmed that it will proceed with the following personal tax measures announced in 2005 by the previous government:

- a tax credit for adoption expenses;
- enhanced tax measures for persons with disabilities;
- an expanded list of medical expenses eligible for the tax credit; and
- an increase in expenses that can be claimed by a caregiver.

RRSPs and Pension Plans

No changes were proposed to the limits for registered pension plans (RPPs), deferred profit sharing plans (DPSPs) and registered retirement savings plans (RRSPs). Existing limits are illustrated in the table below:

Year	RRSP	RPP and DPSP
2006	18,000	19,000
2007	19,000	20,000
2008	20,000	21,000
2009	21,000	22,000
2010	22,000	Indexed ⁴
2011	Indexed ⁵	Indexed ⁴

Capital Gains and Exemptions

The \$500,000 capital gains exemption available to individuals who dispose of qualified small business corporation shares and/or qualified farm property is not affected by any budget proposals. The budget proposes a \$500,000 exemption for the sale of qualified property used in a family fishing business.

The election platform of the new government included a plan for capital gains deferral. No plan was proposed in this budget in this regard.

BUSINESS TAX

Small Business Deduction

The federal small business income tax rate applies to active business income earned in Canada by a Canadian Controlled Private Corporation (CCPC) up to its annual Small Business Deduction (SBD) limit.

The budget proposes to increase the federal small business deduction limit from \$300,000 to \$400,000, effective January 1, 2007. The federal and Ontario limits will be as follows:

For Calendar Year	Federal SBD	Ontario SBD
2006	\$300,000	\$400,000
2007 & future years	400,000	400,000

The SBD limit is pro-rated for non-calendar taxation years. The federal SBD will continue to be reduced if the prior year's taxable capital (including the taxable capital

⁵ Limits will be indexed to the average wage growth commencing in 2010 for RPPs and DPSPs and 2011 for RRSPs.

of associated corporations) exceeds \$10 million and is eliminated if taxable capital exceeds \$15 million.

Corporate Income Tax Rate Reductions

The budget reintroduces corporate tax cuts first introduced in the 2005 budget. The previous government backed away from these proposed cuts last November. Specifically, this budget proposes to:

- eliminate the corporate surtax (currently 1.12%) for all corporations starting in 2008,
- gradually reduce the *small business* federal corporate income tax rate (currently 12%) in phases.
- gradually reduce the *general* federal corporate income tax rate (currently 21%) in phases.

The following table summarized proposed rates:

Federal Corporate Income Tax Rates	2006 to 2007 %	2008 %	2009 %	2010 %
General corporate rate	21	20.5	20	19
Surtax rate	1.12	-	-	-
Small business rate (incl. surtax)	13.12	11.5	11	11

As the proposals will take effect in later years, corporate tax rates for 2006 remain unchanged. The following table summarizes federal and Ontario corporate tax rates with respect to active business income (ABI) earned by a Canadian controlled private corporation in Ontario:

Based on a December 31 year end for 2006

Income	Federal Rate *	Ontario Rate %	Total Rate %
ABI up to \$300,000	13.12	5.50	18.62
ABI from \$300,001 to \$400,000	22.12	5.50	27.62
ABI from \$400,001 to \$1,128,529**	22.12	18.67	40.79
ABI > \$1,128,529	22.12	14.00	36.12
ABI > \$1,128,529 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

For 2007, the rates are the same, but the income bracket from \$300,000 to \$400,000 will be eliminated, such that the tax rate on ABI up to \$400,000 will be 18.62%.

Proposed total corporate rates (federal and Ontario combined) for 2008 and 2010 are:

Based on a December 31 year end

Income	2008	2009	2010
ABI up to \$400,000	17.00	16.50	16.50
ABI from \$400,001 to \$1,128,529	39.17	38.67	37.67
ABI > \$1,128,529	34.50	34.00	33.00
ABI > \$1,128,529 with M&P	32.50	32.00	31.00

Payroll Taxes

Payroll taxes (i.e., contributions to Canada Pension Plan (CPP) and Employment Insurance (EI)) for 2006 were not changed in the budget. However, due to prior changes, for 2006 the CPP contribution amount has increased,⁶ and EI rates and contribution amounts have decreased.⁷

Non-Capital Losses and Investment Tax Credits

Non-capital losses can currently be carried back up to 3 years and can also be carried forward 10 years. The budget proposes to extend the non-capital loss carry-forward period of all taxpayers to 20 years. This measure will apply to non-capital losses, farm losses and restricted farm losses.

Investment tax credits (ITCs) provide generous incentives for important economic activity such as SR&ED. Currently, ITCs can be carried back up to 3 years and forward up to 10 years. To increase the ability of research intensive companies to use ITCs over a longer period of time, the budget proposes to extend the ITC carry-forward period to 20 years.⁸

The extended carryover periods are proposed to apply to losses incurred and credits earned in taxation years that end after 2005.

⁶ The employee CPP rate for 2006 is 4.95% (same as for 2005) of pensionable earnings. The maximum employee contribution for 2006 is \$1,910.70 (2005 – \$1,861.20). The maximum for self-employed taxpayers in 2006 will be \$3,821.40 (2005 – \$3,722.40.)

⁷ The employee EI rate has decreased from 1.95% in 2005 of insurable earnings to 1.87% for 2006. The maximum employee and employer contribution levels for 2006 have decreased to \$729.30 and \$1,021.02 respectively (from \$760.50 and \$1,064.70).

⁸ This will apply to ITCs earned for SR&ED, Atlantic investment, and mineral exploration.

Federal Capital Tax (Large Corporations Tax)

The federal capital tax is currently levied at a rate of 0.125 per cent on taxable capital in excess of \$50 million. Accordingly, it generally applies to larger corporations. A corporation's taxable capital is generally described as the total of its shareholder equity, surpluses and reserves, as well as loans and advances to the corporation, less certain types of investments in other corporations.

Legislation has already been enacted to eliminate the federal capital tax in 2008. This budget proposes to eliminate the federal capital tax as of January 1, 2006, two years earlier than was originally scheduled. The federal capital tax rate will be pro-rated for taxation years that do not coincide with the calendar year.

Corporations will still be able to apply corporate surtax to reduce their federal capital tax liability, if any, for the three prior years.

Apprenticeship Job Creation Tax Credit

The budget proposes to introduce an Apprenticeship Job Creation Tax Credit in order to encourage employers to hire new apprentices in eligible trades. This measure will provide eligible employers with a non-refundable tax credit equal to 10 per cent of the salaries and wages paid to qualifying apprentices⁹ to a maximum credit of \$2,000 per year per apprentice (i.e., the credit would be available on up to \$20,000 of an apprentice's salaries and wages). The credit will be available to eligible employers in respect of salaries and wages that are paid to qualifying apprentices on or after May 2, 2006.

Capital Cost Allowance for Tools

A portion of the capital cost of depreciable property is deductible as capital cost allowance (CCA) each year, with the maximum CCA rate for each type of property set out in the Income Tax Regulations. Currently, tools that cost less than \$200 are eligible for a 100% CCA rate under Class 12. Tools that cost \$200 or more are generally eligible for a 20% CCA rate under Class 8. The 2006 Federal Budget proposes that the cost limit for access to the 100% Class 12 treatment be increased from \$200 to \$500 for such tools acquired after May 1, 2006.

⁹ A qualifying apprentice will be an apprentice who is working in a qualifying trade in the first two years of his or her provincially registered apprenticeship contract with an eligible employer.

Sales & Excise Tax Measures

The proposed reduction in the GST rate to 6% from 7%, effective July 1, 2006, is a key tax cutting provision in the budget. Detailed transitional provisions are provided for determining the GST rate applicable to transactions which straddle the July 1, 2006 implementation date, including transactions with respect to sales of real property, imported goods and services, taxable benefits and other specific circumstances.

A number of other amendments were also proposed, including changes to the computation of the GST housing rebate, changes to the GST streamlined accounting methods, and further changes to the Air Travellers Charge rates.

To offset reduced GST revenues, the budget proposes increases to the tobacco and alcohol excise duties.

Excise taxes on jewellery, which was being phased out, is proposed to be eliminated altogether, effective May 2, 2006.

Other Measures

Reallocation of Payments made to the Minister of National Revenue

The Income Tax Act currently allows the Minister of National Revenue to reallocate amounts paid by a person to the Minister, but only between specified accounts. The 2006 Federal Budget proposes that the Minister be authorized to reallocate, upon a person's request, amounts paid by the person under the Income Tax Act to amounts payable by that person under the Excise Tax Act (GST and non-GST), the Excise Act, 2001 or the Air Travellers Security Charge Act, with the reallocation taking effect from the date the amount was paid under the first Act.

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.

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