

TaxTalk

2003 FEDERAL BUDGET HIGHLIGHTS

On Tuesday, February 18, 2003, the Honourable John Manley, 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 our clients.

ECONOMIC OVERVIEW¹

	2002/2003 Estimate	2003/2004 Forecast	Growth %
Revenue	178.7	184.7	3.4
Expenditure			
Public debt	37.2	37.6	1.0
Other	138.6	143.0	3.2
Contingency	3.0	4.0	
Surplus	0.0	0.0	0.0
Net Public Debt	507.7	507.7	0.0

	2002 Estimate %	2003 Forecast %	2004 Forecast %
Inflation	1.1	2.2	1.9
91-Day Treasury Bill rate	2.6	3.3	4.5
Unemployment	7.6	7.3	7.0
Real Growth In GDP	3.3	3.2	3.5

As the tables indicate, balanced budgets are projected, factoring in the proposed new spending initiatives and tax cuts. Without these spending and tax measures, the budget surplus was expected to be \$6.4 billion for 2002/2003 and \$4.8 billion for 2003/2004.

¹ The revenue and expenditure amounts are based on a change in accounting from a modified accrual system to the full accrual basis of accounting.

As indicated, the budget includes a contingency reserve of \$3 billion in 2002/2003 and \$4 billion for 2003/2004. The contingency is to provide "a buffer against unforeseen circumstances." If the "buffer" is not needed, then the federal debt will be reduced. There have been surpluses in the last five years, which have been applied to reduce the federal debt by \$47.6 billion.

Canada's economic performance has been favourable as compared to other countries in the G7. Canada is the only G7 country that had a surplus in 2002, and is expecting a surplus in 2003, ignoring the contingency. The Canadian economy is projected to grow by 3.2% in 2003 and 3.5% in 2004.

There are commitments in the budget for substantial increases in spending. Federal support for health care will increase by \$17.3 billion over the next three years, and by \$34.8 billion over the next five years. These amounts include federal transfers to provinces and territories. Other areas where spending will increase include defence, research and development, education, children's welfare and security.

The budget contains no significant personal or corporate tax changes. However, the five-year plan to reduce taxes, announced in October 2000, was not curtailed or deferred and is to continue as planned.

PERSONAL TAX

Income Tax Rates

The budget contains no proposals to change personal tax rates. However, tax credits and tax brackets for 2003 will be indexed for inflation using an indexation factor for 2003 of 1.6 per cent. For 2003, the top tax rate remains at **46.41** percent, and will apply when taxable income exceeds \$104,648.²

² The tax brackets are now fully indexed for inflation to protect taxpayers from automatic tax increases that would have otherwise resulted from inflation. As a result, the top rate will apply in 2003 when taxable income exceeds \$104,648 (2002 - \$103,000).

The following table summarizes marginal tax rates that apply to the income tax brackets for 2003, giving effect to a 1.6 percent indexing³ of the brackets.

2003			
Taxable Income*	Federal Rate %	Ontario Rate** %	Total %
\$ 7,756 to \$ 32,183	16.00	6.05	22.05
\$ 32,184 to \$ 57,060	22.00	9.15	31.15
\$ 57,061 to \$ 64,368	22.00	10.98	32.98
\$ 64,369 to \$ 67,223	26.00	13.39	39.39
\$ 67,224 to \$104,648	26.00	17.41	43.41
\$104,649 and over	29.00	17.41	46.41

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

** Rate includes Ontario surtax, which starts to apply in 2003 when taxable income exceeds approximately \$57,000.

Capital Gains and Losses

The capital gains inclusion rate will **stay at 50** percent. 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 budget proposals.

Capital Gains Deferral

Individuals who realize gains on the sale of an eligible small business investment can **defer recognition** of some or all of their gain when they reinvest some or all of their proceeds in another eligible small business. Under current rules, the deferral is only available in respect of the first \$2 million of the vendor's original investment/reinvestment. For dispositions that occur after February 18, 2003, the budget proposes to remove the \$2 million thresholds, and extend the period⁴ in which a qualifying reinvestment can be made. As proposed, reinvestments will be eligible for rollover treatment if made at any time in the (calendar) year of sale or within 120 days after the end of the year.

RRSPs and Pension Plans

The RRSP contribution limit has been frozen at \$13,500 per year since 1996. The budget proposes to increase the annual RRSP contribution limit in stages to \$18,000 by

³ Personal credits for 2003 will also rise due to indexation. For instance, the basic personal credit will increase by 1.6% to \$7,756 from \$7,634 in 2002.

⁴ Under current rules, the replacement investment must be purchased in the year of the qualifying disposition or within 60 days after the end of the year, but no later than 120 days after the sale.

2006.⁵ Contribution limits for money purchase Registered Pension Plans (RPP) will also rise. The following table summarizes the revised limits:

Year	RPP	RRSP
2002	\$13,500	\$13,500
2003	15,500	14,500
2004	16,500	15,500
2005	18,000	16,500
2006 ⁶	18,000	18,000

For defined benefit RPPs, the maximum pension limit will increase from \$1,722 per year to \$1,833 for 2004, and to \$2,000 for 2005. For deferred profit sharing plans (DPSP), annual limits will rise as the limit will remain at one-half of the money purchase RPP limit.

Automobile Benefit and Expense

Where an employer provides an employee with an automobile, the employee receives a benefit for their personal use and enjoyment of the automobile. This benefit is taxable to the employee. There are two components to the benefit, one being the 'standby charge' which relates to the employer automobile being made available to the employee. Under current rules, there may be a reduction in the standby charge benefit otherwise calculated, but only if the annual personal use of the automobile is less than 12,000 kilometres **and** personal use represents less than 10% of the total use of the automobile.

The budget proposes, beginning in 2003, that the reduced standby charge be available to more employees, to the extent that annual personal driving does not exceed 20,000 kilometres per year (increased from 12,000 kilometres) and personal use of the automobile represents less than 50% (increased from 10%) of the total use of the automobile. For many taxpayers, this will reduce taxes that they will incur related to a company car.

Benefits and Credits

The budget proposes to introduce a \$1,600 Child Disability Benefit, to become effective in July 2003 and payable starting in March 2004. In addition, the National Child Benefit Supplement, aimed at low to middle income families, will increase by \$150 per child in July 2003, \$185 in July 2005 and by \$185 in July 2006.⁷

⁵ At a contribution rate of 18%, an annual limit of \$18,000 implies earned income of \$100,000 would be required in the preceding year.

⁶ The RRSP limit will be indexed to the average wage growth commencing in 2007. The RPP and DPSP limits will be indexed one year earlier in 2006.

⁷ With these increases and annual indexation, the maximum child tax benefit for the first child will increase to \$2,632 in July 2003, and \$3,243 (projected) in July 2007.

The budget also proposes to expand the list of medical expenses eligible for the medical expense tax credit.

Other Personal Matters

No changes were proposed with respect to the taxation of **life insurance** products. An exempt life insurance product can provide insurance coverage together with investment income that will benefit from tax-deferred growth under certain circumstances.

BUSINESS TAX

Small Business Deduction

The current small business deduction (SBD) limit has been in place since 1982, and has never been indexed for inflation. Currently, the first \$200,000 of active business income earned by a Canadian controlled private corporation (CCPC) is taxed at the low **federal** rate of 12%, plus surtax. The budget proposes to (finally) increase the annual amount of active business income eligible for SBD from \$200,000 to \$300,000 over the next 4 years. The table below indicates the phase-in of the increased threshold, and compares the proposed limits to the Ontario Small Business Rate limits.

For Calendar Year	Federal SBD	Ontario SBD
2002	\$200,000	\$280,000
2003	225,000	320,000
2004	250,000	360,000
2005	275,000	400,000
After 2005	300,000	400,000

The SBD limit will be 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 of associated corporations) exceeds \$10 million. The SBD will continue to be reduced to zero if taxable capital exceeds \$15 million.

The budget also proposes to adjust the corporate income thresholds for the **Scientific Research and Experimental Development (SRED) expenditure limit** to coincide with the proposed changes to the federal SBD limits. As proposed, the \$2 million SRED expenditure limit will be phased out if taxable income in a previous year is between \$300,000 and \$500,000 (an increase of \$100,000 from the current income thresholds of \$200,000 to \$400,000).

Corporate Income Tax Rates

The budget contained no proposals to change corporate tax rates. However, as announced in 2000, the federal corporate income tax rate will decrease from 25% to 23%, **effective January 1, 2003** with the reduction being pro-rated for fiscal years that straddle this date.

The following table summarizes corporate tax rates with respect to active business income (ABI) earned by a Canadian controlled private corporation in Ontario, and reflects the increased federal SBD threshold:

Based on a December 31, 2003 year end

Income	Federal Rate * %	Ontario Rate %	Total Rate %
ABI up to \$225,000	13.12	5.50	18.62
ABI from \$225,001 to \$300,000	22.12	5.50	27.62
ABI from \$300,001 to \$320,000	24.12	5.50	29.62
ABI from \$320,001 to \$800,000**	24.12	17.17	41.29
ABI > \$800,000	24.12	12.50	36.62
ABI > \$800,000 with M&P ***	22.12	11.00	33.12

- * including federal surtax of 1.12%
- ** includes clawback of Ontario small business deduction
- *** M & P – manufacturing and processing tax credit

Federal Capital Tax

Federal Capital tax, also known as Large Corporations Tax (LCT), is currently imposed at the rate of 0.225% on a corporation's taxable capital employed in Canada in excess of its capital deduction threshold. In order to promote investment, the budget proposes to reduce the LCT rate starting January 1, 2004,⁸ so that the LCT will be eliminated in 2008. Also, the budget proposes to increase the current capital deduction threshold from \$10 million to \$50 million beginning in 2004.

The following table summarizes the LCT changes:

Taxation Year	Federal Capital Tax Rate	Capital Deduction Threshold
2003	0.225%	\$10 million
2004	0.200%	\$50 million
2005	0.175%	
2006	0.125%	
2007	0.0625%	
2008	Eliminated	

The LCT rates will be pro-rated for non-calendar taxation years. The increased \$50 million capital deduction threshold will **not** be pro-rated but will apply to all taxation years ending after 2003.

Resource Taxation

The budget proposes to make several changes to reduce the corporate taxation of resource income. These proposals include reductions in tax rates, improvements to the calculation of resource income and the introduction of and enhancement to certain tax credits.

⁸ The LCT is to remain in place for financial institutions.

Film and Video Production Services Tax Credit

The budget proposes to increase the current 11% refundable tax credit rate to 16% of qualified Canadian labour expenditures, applicable to expenditures incurred after February 18, 2003. The refundable Canadian Film or Video Production Tax Credit will remain at 25% of labour costs incurred.

Renewable and Alternative Energy

Assets that promote more efficient fossil fuel use and provide renewable and alternative energy sources are included in class 43.1, and can be written off using an accelerated depreciation rate of 30%. The budget proposes to broaden the list of assets which will qualify for class 43.1 to include certain fixed location fuel cells and ancillary fuel reformation and electrolysis equipment acquired after February 18, 2003.

Payroll taxes

Payroll taxes (i.e. employer contributions to Canada Pension Plan [CPP] and Employment Insurance [EI]) for 2003 were not changed in the budget. However, due to prior changes, for 2003, CPP rates and contribution amounts have **increased**,⁹ and EI rates and contribution amounts have **decreased**.¹⁰

This budget proposes a further decrease in the EI rate to 1.98% in 2004, with annual maximums for employees and employers to be \$772.20 and \$1,081.08 respectively.

⁹ The employee CPP rate has increased from 4.7% in 2002 to 4.95% of pensionable earnings, and the maximum employee contribution has increased from \$1,673.20 in 2002 to \$1,801.80 in 2003. The maximum CPP for self-employed taxpayers in 2003 will be \$3,603.60.

¹⁰ The employee EI rate has decreased from 2.2% in 2002 to 2.1% of insurable earnings. The maximum employee and employer contribution levels for 2003 have decreased to \$819 and \$1,146.60 respectively.

Sales and Excise Taxes

There were no significant changes to the Goods & Services Tax. The rate remains at 7% of taxable supplies.

Other Consumption Taxes

There were no major changes to other federal excise taxes, including tobacco and gasoline taxes.

Other Measures

For airline tickets purchased after February 28, 2003 for travel within Canada, the **Air Travellers' Security Charge** will be reduced from \$12 to \$7 for one-way travel and from \$24 to \$14 for round-trip travel.

Tax shelter syndications are subject to registration requirements which 'alert' CCRA to the tax shelter. The existing definition of a tax shelter relates to deductions and/or losses that the shelter will generate. The budget proposes to extend the definition of a tax shelter to include certain arrangements that will generate tax credits, including charitable donation credits, to apply to property acquired or arrangements entered into after February 18, 2003. In addition, it is proposed that certain tax rules that can apply to restrict deductions will apply to restrict certain credit claims.

The Government announced that draft legislation related to **cross-border share-for-share exchanges** will be released in the near future for public review and comment. These proposals will deal with issues relating to tax deferred cross-border share-for-share exchanges, which are currently allowed for exchanges of shares of Canadian companies.

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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