TaxTalk

2004 FEDERAL BUDGET HIGHLIGHTS

On Tuesday, March 23, 2004, the Honourable Ralph Goodale, 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

	2003/2004 Estimate ($billion)	2004/2005 Forecast ($billion)	Growth %
Revenue	181.1	187.2	3.4
Expenditure			
Public debt	35.8	35.4	-1.0
Other	143.4	147.9	3.1
Contingency	1.9	3.0	
Surplus	0.0	0.0	0.0
Net Public Debt	508.7	505.7	-0.06

	2003 Estimate %	2004 Forecast %	2005 Forecast %
Inflation	3.4	1.4	1.7
91-Day Treasury Bill rate	2.9	2.2	3.1
Unemployment	7.6	7.5	7.2
Real Growth in GDP	1.7	2.7	3.3

A balanced budget is projected for 2004/05, factoring in the proposed new spending and tax initiatives. However, the budget includes net revenues of $2 billion from the planned sale of the government's shares of Petro-Canada, and a contingency reserve of $3 billion, plus a $1 billion economic prudence reserve for 2004/2005.

These reserves are to provide "a buffer against unforeseen circumstances". If the "buffer" is not needed, then the federal debt will be reduced. Last year was the first time in six years in which the contingency reserve was not available to be applied towards reducing the federal debt.

Canada's economic performance in 2003 fell well short of the forecast. The real growth in GDP was forecast to be 3.2% in 2003; however, the actual increase was only 1.7%. Factors contributing to this lower than expected growth included the blackout in Ontario and the health 'scares' – SARS and "mad cow" disease. In addition, the appreciation of the Canadian dollar caused exports to decrease relative to 2002. Nonetheless, for a second consecutive year, Canada again was the only G7 country with a budget surplus in 2003. The Canadian economy is projected to grow by 2.7% in 2004 and 3.3% in 2005.

The budget includes spending initiatives, largely targeted for health care, and tax incentives mostly directed at education.

PERSONAL TAX

Income Tax Rates

Although the budget contains no proposals to change personal tax rates for 2004, tax credits and income thresholds for tax brackets in 2004 will increase. For 2004, the top tax rate remains at **46.41** percent, and will apply when taxable income exceeds $113,804.[1]

The following table summarizes marginal tax rates that apply to the income tax brackets for 2004.

2004

Taxable Income*	Federal Rate %	Ontario Rate** %	Total %
$ 8,012 to $ 33,375	16.00	6.05	22.05
$ 33,376 to $ 35,000	16.00	9.15	25.15
$ 35,001 to $ 58,452	22.00	10.98	32.98
$ 58,453 to $ 66,752	22.00	14.27	36.27
$ 66,753 to $ 70,000	22.00	17.41	39.41
$ 70,001 to $113,804	26.00	17.41	43.41
$113,804 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 2004 when taxable income exceeds approximately $57,000.

[1] In general, the tax brackets are indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result. However, for 2004, the brackets have increased by 9%. As a result, the top tax rate will apply in 2004 when taxable income exceeds $113,804 (2003 - 104,648).

Education Tax Incentives

The budget proposes several measures to promote learning and education.

Canada Education Savings Grant Enhancement

Currently, each child earns annual contribution room of $2,000 eligible for a Canada Education Savings Grant (CESG) of 20% of a Registered Education Savings Plan (RESP) contribution; this contribution room is cumulative. Starting in 2005, for families with low to moderate income, the budget proposes to increase the Canada Education Savings Grant (CESG) on the first $500 of RESP contribution from 20% to 40% where family income does not exceed $35,000, and 30% where family income is between $35,000 and $70,000.[2]

Canada Learning Bond

The budget proposes to introduce a new Canada Learning Bond (CLB), to be available to families qualifying for the National Child Benefit (NCB) supplement, i.e. family income of below $35,000 in 2003 will entitle the family to the CLB in 2004. Each child born after 2003 will be eligible. For the first year that the family qualifies for the NCB supplement, the CLB is $500, and $100 thereafter in each year that the family qualifies for the NCB supplement, until the child turns 15. The maximum CLB per child will be $2,000. The CLB will be payable to an RESP, and will be taxable in the hands of the student at the time of withdrawal from the RESP.

Grants and Loans

A new grant of up to $3,000 will be available for the first year of post-secondary studies for students from low-income families (i.e., income generally less than $35,000). As well, an annual grant of up to $2,000 will be provided to post-secondary students with disabilities. The budget also proposes to increase the Canada Student Loans Program maximum loan from $165 to $210 per week of study. These measures are expected to be in place by August 1, 2005.

Education Tax Credit

The Education Tax Credit[3] is available to full-time and part-time students to mitigate the cost of education over and above tuition, e.g. textbooks etc. Effective January 1, 2004, individuals enrolled in post-secondary studies relating to their current employment will also be entitled to the education tax credit if such costs are not reimbursed by their employer.

Disability Supports Deduction

In a move to support individuals with disabilities, the budget proposes to replace the current Attendant Care Deduction with a Disability Supports Deduction for 2004 and subsequent years. This deduction will broaden amounts previously eligible for the Attendant Care Deduction to include the cost for sign-language interpretation services, voice recognition software, talking textbooks as well as other similar expenses.

Caregiver Expenses

Currently a medical expense credit may be claimed by a supporting person for expenses incurred on behalf of a dependent relative, subject to a reduction based on the dependent relative's income. The budget proposes that, commencing in 2004, this reduction be adjusted so that more of the expense is eligible for the medical expense credit. However, the medical expense credit will be limited to a maximum of $5,000.

RRSPs and Pension Plans

The budget does **not** change the contribution limits for money purchase registered pension plans (RPP) or RRSPs.[4] The following table summarizes the limits:

Year	RRSP	RPP
2004	$15,500	$16,500
2005	16,500	18,000
2006	18,000	Indexed[5]
2007	Indexed[5]	Indexed[5]

Taxpayer-requested Adjustments

Current legislation, effective for 1985 and subsequent taxation years, allows an individual or testamentary trust to late file a return, and the Canada Revenue Agency (CRA) accept a late-filed, amended or revoked election. The budget proposes to limit the period of relief. For applications after 2004, adjustments will be restricted to taxation years that end in any of the ten preceding calendar years.

[2] However, unlike, the base 20% CESG, the enhanced grant amount is not cumulative and can only be accessed by making a contribution in the current year.

[3] Currently, the education tax credit is $400 per month for full-time study and $120 per month for part-time study.

[4] 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.

[5] The RRSP limit will be indexed to the average wage growth commencing in 2007. RPP and Deferred Profit Sharing Plan (DPSP) limits will be indexed one year earlier in 2006.

BUSINESS TAX

Small Business Deduction (SBD)

The 2003 budget increased the annual amount of active business income eligible for SBD from $200,000 to $300,000 by 2006. This budget proposes to accelerate the increase to $300,000 by 2005.

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
2003	$225,000	$320,000
2004	250,000	400,000
After 2004	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 and is completely eliminated when taxable capital exceeds $15 million.

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, 2004** 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 (CCPC) in Ontario, and reflects the increased federal SBD threshold:

Based on a December 31, 2004 year end

Income For ABI:	Federal Rate * %	Ontario Rate %	Total Rate %
up to $250,000	13.12	5.50	18.62
from $250,001 to $300,000	22.12	5.50	27.62
from $300,001 to $400,000	22.12	5.50	27.62
from $400,001 to $1,128,529**	22.12	18.67	40.79
> $1,128,529	22.12	14.00	36.12
> $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

Refundable SR&ED Investment Tax Credit – Expenditure Limit

Currently, SR&ED expenditures of up to $2,000,000[6] are entitled to a 35% refundable investment tax credit. The credit may be reduced if the income of a Canadian-controlled private corporation (CCPC) exceeds $300,000 or its taxable capital is over $10 million.[7]

The budget proposes that two (or more) small CCPCs owned by a group of common investors, who are generally not otherwise connected, will not have to share the $2 million expenditure limit solely because two or more investors collectively have a majority interest in the shares of each corporation. This exception will *not* apply where the CRA cannot satisfy itself that the group was not formed to gain access to multiple expenditure limits.

In such eligible cases, each small business will have access to its own $2 million expenditure limit, effective for taxation years that end after March 22, 2004.

Donations

Under current rules, where control of a corporation is acquired, certain losses can no longer be carried forward. The budget proposes to similarly restrict unused charitable donation deductions of a corporation in respect of gifts made after March 22, 2004 when an acquisition of control occurs. The purpose of the proposal is to ensure that unused charitable donation deductions cannot be traded.

Payroll taxes

Payroll taxes (i.e., employer contributions to Canada Pension Plan "CPP" and Employment Insurance "EI") for 2004 were not changed in the budget. However, due to prior changes targeted, for 2004, CPP rates and contribution amounts have **increased**,[8] and EI rates and contribution amounts have **decreased**.[9]

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[6] This expenditure limit must be shared with associated corporations.

[7] These thresholds are shared by associated corporations.

[8] The employee CPP rate for 2004 is 4.95% (2003 – 4.95%) of pensionable earnings. The maximum employee contribution for 2004 is $1,831.50 (2003 – $1,801.80). The maximum for self-employed taxpayers in 2004 will be $3,663.00.

[9] The employee EI rate has decreased from 2.1% in 2003 of insurable earnings to 1.98% for 2004. The maximum employee and employer contribution levels for 2004 have decreased to $772.20 and $1,080.30 respectively.

Higher Capital Cost Write-off

For computer equipment acquired after March 22, 2004, the budget proposes to increase the Capital Cost Allowance (CCA) rate to 45 percent from 30 percent. In addition, for acquisitions after 2004, a taxpayer will no longer be able to elect to put each computer in a separate class to compute CCA, terminal losses and recapture.[10]

The budget also proposes that data network infrastructure equipment acquired after March 22, 2004 be included in a new class, with a 30 percent CCA rate. Such equipment is currently included in Class 8 with a 20 percent CCA rate.

Sales and Excise Taxes

Effective February 1, 2004 and as announced in the Speech from the Throne, the Government proposes that the rebate in respect of the goods and services tax (GST) and the federal portion of the harmonized sales tax (HST) for municipalities be increased to 100 per cent from 57.14 percent. Budget documents indicate that this relief for municipalities will total $7 billion over the next 10 years.

OTHER MEASURES

Non-capital Loss Carry-forward Period

Currently, a taxpayer can carry forward a non-capital loss for seven taxation years. The budget proposes to extend the carry-forward period to ten taxation years[11], for losses that arise in taxation years ending after March 22, 2004.

General Anti-avoidance Rule (GAAR)

Legislative proposals include amendments to ensure that GAAR, which applies to any misuse or abuse of the provisions of the Income Tax Act (the Act), will extend to the Income Tax Regulations, the Income Tax Application Rules (ITARs), any enactments amending the Act, Regulations or ITARs, and tax treaties.

[10] The election to apply the current separate class rules can be made for computer equipment bought before 2005.

[11] This extension also applies to unused foreign tax credits.

Trusts and Affiliated Persons

Current tax rules restrict losses that arise on transfers of property between affiliated persons. Legislative proposals will expand the scope of the affiliated persons rules to deal more fully with trusts. The new rules for trusts will generally be consistent with the rules applicable to partnerships.

Income Trusts

The use of business income trusts has proliferated in recent years, partly due to the fact that trusts are flow through vehicles which can allow for tax savings when compared to a corporation.

The budget proposes two measures to limit the investment a pension fund can place in business income trusts: (i) to restrict investment property holdings of pension funds to no more than 1 percent of the fund's assets, and (ii) to limit a holding to no more than 5 percent of the units of any one income trust.[12]

Deferred income plans that are not RPPs, such as RRSPs and registered retirement income funds (RRIFs), will not be affected by these proposals.

Government Fines and Penalties

Effective March 22, 2004, the proposed legislation will disallow the deduction of any fine or penalty imposed by domestic or foreign law - whether imposed by a government, government agency, regulator, court or other tribunal, or any other person with statutory authority to levy fines or penalties.[13]

[12] The pension fund will be subject to a 1 percent per month penalty tax based on the fair market value of the excess units held. The penalty provisions will only start to apply for months that end after 2004. Pension funds with existing investments in business income trusts will be given a 10 year transitional relief for direct holdings and a 5 year transitional relief for indirect holdings.

[13] This proposal will not apply to penalties or damages paid under a private contract, or to those related to GST.

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