

TaxTalk

2004 ONTARIO BUDGET HIGHLIGHTS

On Tuesday May 18, 2004, the Honourable Greg Sorbara, Ontario's Minister of Finance, presented the 2004 Budget.

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

ECONOMIC OVERVIEW

	2003/ 2004 ¹ (\$billion)	2004/ 2005 ² (\$billion)	Growth (%)
Revenue	68.3	78.4	14.8
Expenditure			
Public debt interest	9.8	10.3	5.1
Other ³	<u>64.7</u>	<u>70.3</u>	8.7
Deficit	<u>6.2</u>	<u>2.2</u>	
Net Provincial Debt	139.4	142.4	2.2

	2003 (%)	2004 ¹ (%)	2005 ² (%)
Inflation	2.7	1.9	2.1
Unemployment rate	7.0	6.7	6.5
Real Growth in GDP	1.3	2.3	3.2

As expected, the deficit for 2003 is large - \$6.2 billion. For 2004/2005, a deficit of \$2.2 billion is forecast, but this amount reflects a one-time revenue gain of \$3.9 billion due to an accounting shuffle in respect of hydro power purchase agreements – the more accurate deficit amount is \$6.1 billion. This is the first year since 1999 in which a deficit has been forecast, and cabinet members will incur a financial penalty.⁴

¹ Estimate, for the fiscal year ending March 31, 2004.

² Forecast, for the fiscal year ending March 31, 2005.

³ Includes contingency reserve of \$1 billion in 2004/2005.

⁴ Pursuant to the Balanced Budget Act, a cabinet member making \$136,000 a year is imposed a penalty of \$9,000 for not submitting a balanced budget.

Growth in the economy was only 1.3% in 2003, which was much lower than the forecasted growth of 3.0%. Several unforeseen circumstances, such as the SARS outbreak and the power blackout, hampered growth in 2003. For 2004, growth is forecast to increase by 2.3%, reflecting the effects of the sluggish US economy, as well as the impact of the situation in Iraq.

Caught between conflicting election promises to increase health care and education spending without increasing income taxes, the government has decided to raise 'sin' taxes and introduce a new tax, dubbed 'the Ontario Health Premium.' The higher taxes will be needed for increased spending initiatives, primarily in health⁵ and education.

PERSONAL TAX MEASURES

Over the last few years, the Ontario Government has promised certain tax relief measures, only to defer or take them away altogether at a later date.

The **2001 budget** contained proposals to: i) reduce tax rates for taxpayers in the low and middle-income brackets, ii) eliminate the first tier of the Ontario surtax, and iii) provide an education tax credit for independent school tuition fees. In its **2002 budget**, citing economic uncertainty, the government deferred the implementation of these three items from 2003 to 2004. The **2003 budget** re-introduced these tax rate reductions and credits, only to have them cancelled altogether on November 24, 2003 by the new government.

Personal Income Tax Rates

The 2004 budget does not introduce any new tax rate changes (with the exception of the Ontario Health Premium discussed further below) nor does it revive any of the previous tax rate cuts initially announced in 2001. **The top marginal rate for individuals remains at 46.41%.**

⁵ Although health spending will increase, certain services – chiropractic care, physiotherapy (with the exception of seniors receiving physiotherapy through home care and long-term care facilities), and routine eye exams (other than for seniors and individuals under 20) - will no longer be covered by OHIP.

The income tax brackets and combined Federal and Ontario marginal tax rates (including all surtaxes, but excluding the new Ontario Health Premium) for 2004 and future years are as follows:

2004 and Future Years

Taxable Income (Ontario Brackets) ⁶	Federal Rate %	Ontario Rate %	Total %
\$ 8,044 to \$ 33,375	16.00	6.05	22.05
\$ 33,376 to \$ 35,000	16.00	9.15	25.15
\$ 35,001 to \$ 58,774	22.00	9.15	31.15
\$ 58,775 to \$ 66,752	22.00	10.98	32.98
\$ 66,753 to \$ 69,250	22.00	13.39	35.39
\$ 69,251 to \$113,804	26.00	17.41	43.41
\$113,805 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 tiered⁷ and is calculated as a percentage of basic Ontario tax in excess of specified amounts.

The following table⁸ provides the top marginal tax rates for an Ontario taxpayer for 2004 and future years on regular income, dividends and capital gains.

Type of Income	(%)
Regular Income ⁹	46.41
Dividends	31.34
Capital Gain	23.21

Ontario Health Premium

The budget introduces the **Ontario Health Premium**; all premiums collected are to be dedicated solely to healthcare. The premium is to start July 1, 2004, and will be calculated in reference to taxable income - thus, it is effectively an income tax.¹⁰ It will start to apply on taxable income in excess of \$20,000. The following table, provided in the budget papers, generally outlines the amount payable based on taxable income:

Taxable Income	Premium	
	For 2004 ¹¹	After 2004
Up to \$ 20,000	nil	nil
\$ 20,000 to \$ 36,000 ¹²	\$150	\$300
\$ 36,000 to \$ 48,000	\$225	\$450
\$ 48,000 to \$ 72,000	\$300	\$600
\$ 72,000 to \$200,000	\$375	\$750
Over \$200,000	\$450	\$900

Although the premium will generally increase in 2005 in increments of \$150, at each threshold there is a phase in. The increase in the premium in each bracket [above \$36,000] is to be phased in at a rate of 25% of the first \$600 of taxable income in that bracket. To illustrate, for 2005, the tax will be \$450 [\$300 plus (\$600 times 25%)] when taxable income is \$36,000, and will remain at \$450 until taxable income reaches \$48,000. The maximum premium proposed is \$900 - this is **per taxpayer**, so a two-income family will have two people subject to the premium/tax.

For employees, the Ontario Health Premium will be collected through payroll withholdings, starting July 2004. Individuals subject to income tax instalments are not required to increase their remaining 2004 instalments for the health premium.

Property Tax Relief for Seniors

To provide relief to seniors, the budget proposes to enhance the property tax credit for 2004 and future years by increasing the basic credit to \$625 from \$500 and the maximum eligible credit to \$1,125 from \$1,000.

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 new government cancelled the 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.

⁶ In general, the tax brackets are indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result.

⁷ For 2004, the first-tier surtax is 20% of Ontario tax in excess of \$3,856 (starts to apply when taxable income exceeds \$58,774); and the second-tier surtax is 36% of Ontario tax over \$4,864 (starts to apply when taxable income exceeds \$69,250).

⁸ These tax rates generally apply when taxable income exceeds \$113,804 in 2004 (this income threshold is to be indexed annually for inflation).

⁹ For example: salary, pension and interest income.

¹⁰ An increase in income taxes is contrary to the Taxpayer Protection Act, which requires a referendum before taxes can be raised.

¹¹ The premium for 2004 commences July 1, and will be limited to 50% of the annual amount.

¹² The premium will be phased in at a rate of 6% on taxable income in excess of \$20,000 reaching \$300 when taxable income reaches \$25,000.

The changes made by the new government in November 2003 were not all bad for corporate taxpayers. They accelerated the increase in the small business income threshold. The threshold was originally legislated to increase to \$360,000 for 2004 and to \$400,000 for 2005. The new government increased the income threshold to \$400,000, effective January 1, 2004.

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. Under the new rates, the range of income where the clawback will apply has been increased to between \$400,000 and \$1,128,519.

The following table reflects the changes that have occurred and 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, 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 \$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

Capital Tax Elimination

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

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

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.

Capital Tax Extension

In the QEW 427 Dodge Chrysler (1991) Inc. court case, the government was unsuccessful in its attempts to assess auto dealerships capital tax on lien notes. The court ruled that current accounts payable, which are not subject to capital tax, include amounts owed not just to suppliers but also to creditors, including financial institutions.

The budget amends the definition of “current accounts payable” for capital tax purposes. Effective for taxation years ending after May 18, 2004, the definition of current accounts payable is amended so that it applies only to amounts payable to a **supplier** for purchases of goods and services.

Other amendments were introduced to clarify that liabilities incurred in connection with the purchase or trading of shares, bonds or other securities will not be considered to be current accounts payable. This change is to be effective retroactively for taxation years ending after May 19, 1993.

2004 Federal Budget Proposals to Apply in Ontario

The budget proposes to parallel the following income tax measures announced in the 2004 federal budget¹³ re:

- the extension of the carry-forward period for business losses from seven to ten years;
- the increase in the CCA rates for acquisitions after March 22, 2004 of computer equipment (to 45% from 30%), and data network infrastructure equipment (to 30% from 20%);
- the limits on deductions of fines and penalties, patronage dividends and unused charitable donations;
- the change to clarify the ‘affiliated persons’ rules as they apply to trusts;
- the relaxation of the associated corporations rule for scientific research and experimental development (see TaxTalk 2004 Issue 2 for more details). Ontario will adopt this measure to apply to the Ontario Innovation Tax Credit; and
- the change to clarify that the General Anti-Avoidance Rule (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.

¹³ The effective dates of these measures for Ontario will be consistent with the effective dates as announced in the federal budget – refer to TaxTalk 2004 Issue 2.

Apprenticeship Training Tax Credit (ATTC)

The budget proposes a new 25% refundable tax credit¹⁴ to encourage the hiring of apprentices in specific skilled trades. The maximum tax credit available will be \$5,000 per year per eligible apprentice,¹⁵ with a maximum of \$15,000 over the first 36 months of the apprenticeship. To be eligible, salaries and wages must be paid after May 18, 2004 and before January 1, 2011 to an eligible apprentice in a specified skilled trade, i.e. apprentices in designated industrial, construction, motive power trades and certain service trades that qualify under the present apprenticeship part of the Co-operative Education Tax Credit.

Employer Health Tax Act (EHT)

The budget proposes to simplify the process of remitting EHT instalments effective January 1, 2005. Payments will be based on the actual payroll for each month and will be due on the 15th day of the following month. No instalment will be required in January 2005; rather, the first instalment in 2005, based on remuneration for January 2005, will be due on February 15, 2005.

The budget proposes to clarify the EHT rules, *retroactive to January 1, 1990*, with respect to the following:

- all of an employee's remuneration is subject to EHT, if that individual reports to a permanent establishment in Ontario, and
- income of an employee pursuant to sections 5, 6 or 7 of the *Income Tax Act* (Canada) is subject to EHT. Examples of amounts subject to EHT are automobile benefits, low interest employee loans, and employee group term life insurance.

To improve EHT compliance, the budget proposes to increase the EHT penalties levied for late-filed returns effective for taxation years ending after May 18, 2004.

¹⁴ The ATTC will be 30% for businesses with payrolls not in excess of \$400,000.

¹⁵ Apprentices must be in their first 36 months of training in a qualifying skilled trade on or after May 19, 2004, or must have commenced employment before January 1, 2008.

Late-filing penalties of up to 17 % of the tax owed (and increasing to 50% for repeat late-filers) could be levied.¹⁶

OTHER TAX MEASURES

Ontario Sales Tax

The budget proposes to expand the existing retail sales tax rebates for solar energy systems to other environmentally friendly systems for residential premises, namely wind energy, micro-hydroelectric and geothermal heating and cooling systems. Purchases, made after March 27, 2003 and before November 26, 2007, will be eligible for the rebate.

The budget announced, effective May 19, 2004, the rate of **tobacco tax** will be 11.1¢ for each cigarette, tobacco stick or gram of cut tobacco. The increase in tax will result in an increase of \$2.50 per carton of 200 cigarettes.

Commencing June 21, 2004, many alcohol fees and levies on **spirits, wine and beer** will be increased.

Property Taxes for Small Business

Currently municipalities may reduce property taxes of small businesses (with properties of lower value) by either i) applying lower or graduated rates or ii) setting up optional property classes. Recognizing the needs of small business, the budget proposes more flexibility in providing rate reductions to those small businesses, by allowing municipalities to use a combination of these measures.

Labour Sponsored Investment Funds

The Labour Sponsored Investment Fund (LSIF) program has been in existence since 1999. Due to the inability of some of the more recent LSIFs to raise sufficient capital, effective May 18, 2004, a moratorium has been proposed on new LSIF registrations. It is still possible to make contributions to existing LSIFs.

¹⁶ This penalty is consistent with penalties levied under the Corporations Tax 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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