

TaxTalk

2005 FEDERAL BUDGET HIGHLIGHTS

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On Wednesday, February 23, 2005, the Honourable Ralph Goodale, Minister of Finance, presented his Budget Statement to Parliament. Set out below are highlights of the budget that we believe to be of most interest to you.

ECONOMIC OVERVIEW

	2004/2005 Estimate	2005/2006 Forecast	Growth %
Revenue	195.8	200.4	2.35
Expenditure			
Public debt	34.7	35.1	1.15
Other	158.1	162.3	2.02
Contingency	3.0	3.0	-
Surplus	0.0	0.0	-
Net Public Debt	501.5	501.5	-

	2004 Estimate %	2005 Forecast %	2006 Forecast %
Inflation	3.3	2.0	1.9
91-Day Treasury Bill Rate	2.2	2.7	3.5
Unemployment	7.2	7.2	7.0
Real Growth in GDP	2.7	2.9	3.1

The tone of this budget follows a familiar trend. As in recent budgets, conservative estimates have been used and the budgets have been balanced, but only after providing for contingency and economic prudence reserves. The 2005 budget maintains the annual \$3 billion Contingency Reserve. It also includes an additional amount for economic prudence to provide greater assurance that the balanced budget targets will be met.

Without these reserves, there would be a surplus, as has occurred in recent years. The budget proposes to apply any funds from the contingency reserve that are not

otherwise spent to reduce federal debt. As indicated in the table, the federal debt still exceeds \$500 billion, with annual interest charges amounting to \$35 billion.

If the government continues on its course, there could be little contingency reserve to reduce the debt as the funds will have been spent. In the 2004 budget, general spending was forecast to be \$147.9 billion for 2004/2005. In this budget, the estimate for spending for 2004/2005 is \$158.1 billion; that is, estimated spending is more than \$10 billion higher than budgeted.

This budget contains more spending initiatives, largely targeted for health care, the environment, municipalities and the military. Tax cuts are modest, and **most will not come into effect for 3 to 4 years**. If Canada's economic performance were to deteriorate, these back-ended tax cuts could be in jeopardy.

Growth in the economy is expected to be solid, and inflation is expected to decline. However, the growing U.S. budget deficit could have a negative impact on the Canadian economy.

PERSONAL TAX

Although the budget contains no proposals to change personal tax rates for 2005, tax credits and the income thresholds for tax brackets will increase. For 2005, the top tax rate remains at **46.41%**, and will apply when taxable income exceeds \$115,739.¹

¹ In general, the tax brackets are indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result. For 2005, the brackets have increased by 1.7%. As a result, the top tax rate will apply in 2005 when taxable income exceeds \$115,739 (2004 - 113,804).

The following table summarizes marginal tax rates (on regular income, i.e., salary, interest, etc.) that apply to the income tax brackets for 2005.

Taxable Income*	Federal Rate %	Ontario Rate** %	Total %
\$ 8,148 to \$ 33,375	16.00	6.05	22.05
\$ 33,376 to \$ 35,595	16.00	9.15	25.15
\$ 35,596 to \$ 58,452	22.00	10.98	32.98
\$ 58,453 to \$ 66,752	22.00	14.27	36.27
\$ 66,753 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

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

** Ontario rates and brackets may change due to future Ontario budgets.

Personal Credits

A basic **personal amount** of \$8,148 is allowed to individuals in 2005. This credit eliminates income tax on taxable income up to that amount. The budget proposes that, by 2009, the basic personal amount will increase to at least \$10,000. Specifically, the basic personal amount will be increased by the annual indexation factor, plus \$100 for 2006 and 2007, \$400 for 2008, and the greater of \$600 and the amount required to bring the basic personal amount to \$10,000 for 2009.

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 \$6,919 for 2005. The amounts on which these credits are based will similarly be increased by the annual indexation factor, plus \$85 for 2006 and 2007, \$340 for 2008, and the greater of \$510 and the amount required to bring this amount to \$8,500 for 2009.

RRSPs and Pension Plans

The budget proposes to increase the limits for registered pension plans (RPPs) and deferred profit sharing plans (DPSPs) in 2006, and for registered retirement savings plans (RRSPs) in 2007. Existing and proposed limits are illustrated in the table below:

Year	RRSP	RPP and DPSP
2004	\$15,500*	\$16,500*
2005	16,500*	18,000*
2006	18,000*	19,000
2007	19,000	20,000
2008	20,000	21,000
2009	21,000	22,000
2010	22,000	Indexed ²
2011	Indexed ²	Indexed ²

* Existing limits

² Limits will be indexed to the average wage growth commencing in 2010 for RPPs and DPSPs and 2011 for RRSPs.

These tax-deferred retirement plans are currently limited to holding not more than 30% of their assets in foreign property. The budget proposes to eliminate the **foreign property limits**, effective as of 2005.

Disability and Medical Relief

The budget includes several proposals that will benefit persons with disabilities and/or high medical costs, and their caregivers. The proposals include:

- to expand the eligibility for the disability tax credit,
- to broaden the list of eligible expenses for the disability supports deduction,
- to expand the list of eligible expenses for the medical expense credit,
- to raise the maximum for medical expenses eligible for tax credit from \$5,000 to \$10,000 for certain dependants on whose behalf the taxpayer paid the medical expenses,
- to increase the Canada Child Tax Benefit for disabled children,
- to increase the refundable medical expense supplement from \$571 to \$750 for 2005, and
- to extend the contribution period to 25 years and lifetime period to 30 years for registered education savings plans with a beneficiary who is disabled.

In response to recent court cases, the budget does, however, propose to limit claims for home renovations required for a person who lacks normal physical development or has a severe and prolonged mobility impairment.

Adoption Expense Tax Credit

The budget proposes to introduce a new credit for certain adoption expenses, to apply for 2005 and future years. Eligible expenses, such as fees paid to a provincial or territorial adoption agency, court costs, legal fees, and reasonable travel/living expenses, will be allowed, to a maximum of \$10,000 for an adopted child.

Capital Gains Exemption

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.

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.

No changes to the federal SBD limit were proposed in the budget. The federal and Ontario income limits remain as follows:

For Calendar Year	Federal SBD	Ontario SBD
2004	\$250,000	\$400,000
2005 & future years	300,000	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 of associated corporations) exceeds \$10 million and is eliminated if taxable capital exceeds \$15 million.

Corporate Income Tax Rate Reductions

The budget proposes, starting in 2008, to *eliminate* the corporate surtax (currently 1.12%), and gradually reduce the *general* federal corporate income tax rate (currently 21%) in phases, as per the following table:

Federal Corporate Income Tax Rates	2005 to 2007 %	2008 %	2009 %	2010 %
General corporate rate	21	20.5	20	19
Surtax rate	1.12	-	-	-
Small business rate (incl. surtax)	13.12	12	12	12

These changes are intended to allow Canada to keep pace with tax rate reductions in the U.S.

As the proposals will take effect in later years, corporate tax rates for 2005 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 years 2005 to 2007

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%

** Ontario corporate income tax rates may change for future years based on future Ontario budgets.

*** includes clawback of Ontario small business deduction

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

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 \$300,000	17.50	17.50	17.50
ABI from \$300,001 to \$400,000	26.00	25.50	24.50
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

Higher Capital Cost Write-off

Capital cost allowance (CCA) is depreciation of capital assets for tax purposes. Several changes to the CCA rates have been proposed to better reflect the useful lives of various capital assets. It is hoped that these changes will encourage investment in efficient and renewable energy generation technologies.

These changes are effective for purchases made on or after February 23, 2005. The following table summarizes the broad categories of capital assets and their current and proposed CCA rates:

Type of Assets	Current CCA rates	Proposed CCA rates
Oil and gas transmission pipelines compression equipment	8% or 20%	15%
Oil and gas pipelines	4%	8%
Electricity generating combustion turbines	8%	15%
Electricity transmission and distribution assets	4%	8%
Efficient and renewable energy generation equipment in Class 43.1	30%	50%
Telecommunication infrastructure cables	5%	12%

SR&ED Incentives

The Canadian income tax system provides generous incentives for the performance of scientific research and experimental development (SR&ED) in Canada. The budget proposes to extend the SR&ED incentives to include expenditures incurred in Canada's Exclusive Economic Zone, which is the area within 200 nautical miles from the Canadian coastline. This change will benefit Canada's fishing industry as well as off-shore oil and gas activity, and will apply to expenditures incurred on or after February 23, 2005.

Payroll taxes

Payroll taxes (i.e., contributions to Canada Pension Plan (CPP) and Employment Insurance (EI)) for 2005 were not changed in the budget. However, due to prior changes, for 2005, the CPP contribution amount has increased,³ and EI rates and contribution amounts have decreased.⁴

³ The employee CPP rate for 2005 is 4.95% (same as for 2004) of pensionable earnings. The maximum employee contribution for 2005 is \$1,861.20 (2004 – \$1,831.50). The maximum for self-employed taxpayers in 2005 will be \$3,722.40 (2004 -\$3,663.00.)

⁴ The employee EI rate has decreased from 1.98% in 2004 of insurable earnings to 1.95% for 2005. The maximum employee and employer contribution levels for 2005 have decreased to \$760.50 and \$1,064.70 respectively (from \$772.20 and \$1,080.30).

Sales and Excise Taxes

Directors' Liability for GST/HST Rebate

Currently under the Excise Tax Act, if corporate directors have not exercised due diligence to ensure any GST/HST amounts are remitted, they can be held personally liable for the corporation's unremitted net GST/HST. The budget proposes⁵ to expand the liability of corporate directors to include GST/HST refunds that the corporation received, but was not entitled to.

GST/HST Web Registry

All GST/HST registrants are obligated to ensure that input tax credits are claimed only with respect to GST/HST paid to suppliers who are registered for GST/HST purposes. Currently the only way to ensure that a supplier is a valid GST/HST registrant is to contact the Canada Revenue Agency. The budget proposes⁶ to put in place a publicly accessible web registry to facilitate the verification of a supplier's GST/HST registration.

Excise Tax on Jewellery⁷

The budget proposes to reduce the excise tax on jewellery from the current rate of 10% to 8%, effective February 24, 2005. This rate will continue to decrease annually by 2% from 2006 to 2009 (effective March 1 each year) until it is eliminated in 2009.

OTHER MEASURES

Reasonable Expectation of Profit

As discussed in TaxTalk 2004, Issue 4 - *Cases of Interest*, the Department of Finance issued proposals regarding the deductibility of interest and other expenses. These proposals were controversial – they were to apply to deny

⁵ This proposal will be effective once the budget measures have received Royal Assent.

⁶ It is expected that, within 12 months of this measure receiving Royal Assent, that the web registry will be implemented.

⁷ The excise tax applies to jewellery manufactured and sold in, or imported into, Canada.

a taxpayer a loss from a business, property or other source of income if they did not have a reasonable expectation of cumulative profit over the expected life of the business, property, etc. In response to public criticism that the proposals were 'draconian', the Department plans to release an alternative proposal in the near future.

Foreign Investment Entities and Non-Resident Trusts

The government has a number of legislative proposals concerning foreign investment entities and non-resident trusts that remain outstanding. The budget states that legislation to implement these proposals will be introduced at a "suitable time, consistent with other legislative priorities".

Cross-Border Share-for-Share Exchanges

Previous budgets have indicated an intention to develop rules that will allow for a tax deferral when Canadian resident shareholders exchange shares of a domestic corporation for shares of a foreign corporation (or vice versa). The budget indicates that a discussion draft of proposed income tax amendments to implement this initiative will be issued in the near future.

Tax Treatment of Income Trusts

The 2004 budget proposed to limit the level of pension fund investment in business income trusts. Public feedback expressed concern about the impact of the proposals. As such, the proposals have been suspended, pending further consultations on tax issues related to business income trusts and other flow-through entities.

Increased enforcement

To fight international tax evasion with respect to cross-border and international transactions, the budget proposes to invest over \$30 million annually in enhanced Canada Revenue Agency audit and collection activity. Canada currently has treaties with over 80 countries which contain exchange of tax-related information in order to assist in international tax compliance, enforcement and collections.

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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