Facts & Tax

From Hilborn Ellis Grant LLP

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Legacy and leadership — as in the Prime Minister's legacy and the race to succeed him as leader — may have been the underlying themes of Finance Minister John Manley's first Budget, presented to Parliament on February 18, 2003. As was widely predicted, the Budget is characterized by a dramatic increase in federal program spending, to the tune of 11.5 percent in 2002/03. Measures announced in the Budget will cost $17.6 billion over fiscal years 2003/04 through 2004/05 and are primarily in the areas of health care, social and community programs, a "sustainable economy," and military programs.

The Budget also reaffirms the government's intent to deliver on its five-year tax cut plan, and adds provisions to increase the National Child Benefit supplement, increase the registered retirement savings plan (RRSP) annual contribution limit to $18,000 by 2006, and increase the small business deduction limit to $300,000 over four years.

A number of the tax changes proposed in the Budget are discussed in the following sections.

Personal Tax Changes

Retirement Savings

The Budget increases the maximum deductions for RRSPs, money purchase registered pension plans (RPPs) and deferred profit sharing plans (DPSPs) for 2003 and subsequent years. The new limits are:

	RRSPs	RPPs	DPSPs
2003	$14,500	$15,500	$7,750
2004	$15,500	$16,500	$8,250
2005	$16,500	$18,000	$9,000
2006	$18,000	indexed	indexed

For RPPs and DPSPs the above amounts will be indexed to average wage growth for years after 2005. RRSPs will be indexed for years after 2006.

The maximum pension benefit payable by a defined benefit pension plan has been frozen, since 1976, at $1,722 for each year of service with the employer. The Budget proposes to increase this limit to $1,833 for 2004 and $2,000 for 2005 and then indexed to the average wage growth. Limitations will be placed on upgrades to pension plans for past service as a result of these changes.

The retirement alternatives available for members of money purchase pension plans are currently restricted to a life annuity or transferring their benefits to an RRSP or a registered retirement income fund (RRIF). The Budget proposes that after 2003, a money purchase RPP be allowed to pay benefits in the same manner as a RRIF. This allows the pensioner the same flexibility as an RRSP holder but allows the investment decisions to continue to be made by the pension plan. Further, the Budget proposes that pensioners that have transferred funds to an RRSP or a RRIF be allowed to transfer the funds back to the pension plan and receive pensions under the new scheme.

The government has stated that it will study a new kind of retirement savings plan called a tax pre-paid savings plan (TPSP). The concept is that contributions to these plans will not be eligible for a tax deduction but the investment income and withdrawals from the plans will not be subject to tax.

Registered Retirement Savings Plan Rollover

On the death of a parent or grandparent, a financially dependent infirm individual is entitled to rollover proceeds from the deceased's RRSP or RRIF into their own RRSP. Currently, an individual is presumed to be financially dependent if their income does not exceed the basic personal amount. The Budget proposes to increase this income threshold by $6,180 to $13,814. This proposal applies to the 2003 and subsequent taxation years. A child with income above this amount may still be considered to be financially dependent, but only if the dependency can be demonstrated based on the particular facts of the situation.

Automobiles

Currently the taxable benefit for the use of a corporate-owned or corporate-leased vehicle can be reduced if the automobile is used all or substantially all (generally 90 percent or more) for business purposes and personal use is less than 1,000 kilometres per month (12,000 kilometres per year).

The Budget proposes that the reduced standby charge be available where the automobile is used primarily (generally greater than 50 percent) for business purposes and personal use is less than 1,667 kilometres per month (20,004 kilometres per year). This is effective for 2003 and subsequent years.

The Budget proposes to amend the income tax definition of an automobile to exclude extended cab pick-up trucks that are used primarily for the transportation of goods, equipment, or passengers for income earning purposes at job sites that are at least 30 kilometres from the nearest town with a population of at least 40,000. This will eliminate the restriction on the deductibility of lease payments, capital cost allowance, and interest on loans to purchase these vehicles. It will also exclude these vehicles from the standby charge and operating expense benefit provisions where they are also used for personal purposes. This is applicable to taxation years commencing after 2002.

Capital Gains Rollover

In 2000, rules were introduced to allow an investor in certain eligible small businesses to defer taxation of the capital gain resulting from the sale if a replacement investment was made before 120 days after the sale. The gain could only be deferred on the first $2 million of the original investment and the maximum cost of each replacement investment was limited to $2 million.

The Budget proposes to eliminate both the restriction to $2 million for the cost of the original investment and the limitation of $2 million for each eligible replacement investment.

The Budget also extends the time period in which a replacement investment can be acquired to 120 days after the end of the year.

These proposals are effective for dispositions after February 18, 2003.

Tax Shelters

The significance of a "tax shelter" is that no one can claim a deduction in respect thereof unless the promoter obtains a tax shelter identification number.

A "tax shelter" is currently defined as a property in connection with which representations are made that its acquisition will result in deductions, within four years after the acquisition, at least equal to the cost of the property.

The Budget proposes to amend these rules for property acquired after budget day, as follows:

- Federal tax credits will now be taken into account along with tax deductions in determining whether or not a property is a tax shelter
- Any arrangement under which property acquired will be the subject of a charitable gift or political donation will be made, will be considered to be a tax shelter
- Any arrangement involving a charitable gift or political contribution under which a person will incur limited-recourse debt will be considered to be a tax shelter

The amount of the charitable gift or political donation will be reduced by the amount of limited-recourse debt. Payments on account of such limited-recourse debt will be treated as a gift or political donation in the year of payment.

Medical Expense Tax Credit

The Budget proposes to add the following expenses to the list of expenses eligible for the medical expense credit for 2003 and subsequent years:

- Amounts paid for real-time captioning services for an individual with a speech or hearing impairment if the payment is made to a person who is in the business of providing such services
- Amounts paid for note-taking services for an individual with a mental or physical impairment if the payment is made to a person who is in the business of providing such services and the individual is certified by a medical practitioner to require these services because of their impairment
- The cost of voice recognition software for an individual with a physical impairment if the individual has been certified by a medical practitioner to require that software because of their impairment
- The incremental cost of gluten-free food products for an individual who suffers from celiac disease if the individual has been certified by a medical practitioner to require a gluten-free diet because of that disease

Disability Tax Credit (DTC)

In order to expand the availability of the DTC, the phrase "feeding and dressing oneself" is proposed to be replaced with the phrase "feeding or dressing oneself". The term "feeding oneself" will be amended to exclude the activity of preparing food, to the extent that the time associated with the activity would not have been necessary in the absence of a dietary restriction or regime, as well as any of the activities of identifying, finding, shopping for or otherwise procuring food. Consequently, individuals who are markedly restricted in their ability to prepare a meal for reasons other than a dietary restriction (e.g., with severe arthritis) will continue to be eligible for the DTC. The term "dressing oneself" will be amended to clarify that it excludes any of the activities of identifying, finding, shopping for or otherwise procuring clothing. These amendments apply for 2003 and subsequent taxation years.

Corporate Tax Changes

Small Business Deduction

The business limit for purposes of the small business deduction will be increased to:

2003	$225,000
2004	$250,000
2005	$275,000
2006 and later years	$300,000

These limits will be pro-rated for non-calendar year-ends.

Although, as discussed below, the large corporations tax will be eliminated in the 2004 taxation year for many smaller corporations by raising the “capital deduction” from $10 million to $50 million, the business limit will still be eroded where taxable capital exceeds $10 million and eliminated when it reaches $15 million.

Because of the different business limits in the next few calendar years, the manner of allocating the business limit among associated corporations will be changed to a percentage basis. The change is purely mechanical.

For taxation years commencing before 2004, eligible Canadian-controlled private corporations (CCPCs) will continue to benefit from the reduced corporate income tax rate, which applies to active business income up to $300,000. Commencing in 2004, the reduced general corporate rate will apply to all active business income.

Large Corporations Tax

Beginning with the 2004 taxation year, the large corporations tax will be eliminated immediately for many small corporations and ultimately for all corporations. This will be achieved in two ways.

Firstly, the $10 million “taxable capital” threshold below which the tax does not apply will be increased, in the 2004 taxation year, to $50 million.

Secondly, the rate of tax (currently 0.225 percent) which is applied to taxable capital in excess of $50 million will be reduced to:

2004	0.2000%
2005	0.1750%
2006	0.1250%
2007	0.0625%
2008	0

These rates will be pro-rated for non-calendar year-ends.

The following provisions will continue to operate as if the rate had remained at 0.225 percent and the threshold at $10 million:

– The carryover of corporate surtax credits to offset other years’ large corporations tax

– The erosion of the small business limit

– The harsher collection procedures applicable to large corporations

Investment Tax Credit (ITC)

Currently, CCPCs can claim ITCs at a rate of 35 percent (rather than 20 percent) on $2 million of eligible expenditures, provided that, in the preceding year taxable income was less than $200,000 and taxable capital was less than $10 million. The $2 million was eroded if taxable income exceeded $200,000 and eliminated when taxable income reached $400,000.

The Budget will increase the range of allowable taxable income to $300,000 – $500,000 in the preceding year, for preceding years ending after 2002. The $10 million threshold will not change.

Employment Insurance (EI)

The Government will reduce the EI contribution rate from $2.10 per $100 of insurable earnings for 2003 to $1.98 per $100 of insurable earnings for 2004. In addition, the Budget expands employment insurance benefits to provide a six-week compassionate care leave for individuals to care for gravely ill or dying family members.

Other Tax Measures

Administrative Procedures

For several years the Government has been working on an initiative to harmonize various accounting, interest and penalty provisions of federal tax laws. This Budget proposes to begin implementation by harmonizing a number of accounting, interest, penalty and related administrative and enforcement provisions of the Excise Tax Act (non-GST) and the Income Tax Act.

The following changes are proposed to the Income Tax Act:

– Interest on an individual's income tax refund currently accrues from the later of 45 days after the return is filed or 45 days after the return's due date. This period will now be reduced to 30 days. This measure applies to filing periods that end after June 2003.

– Where a taxpayer has paid interest or a penalty that is subsequently cancelled under the Canada Customs and Revenue Agency's (CCRA's) Fairness Program, interest currently accrues from the day the Minister of National Revenue receives the application. This Budget proposes that interest will begin to accrue only 30 days after the application is received. This measure will apply to applications received after June 2003.

– Where a corporation is late in filing its corporate tax return, interest on refunds will accrue beginning 30 days after the return is filed. This measure is effective for filing periods after June 2003.

– All taxes imposed under the Income Tax Act will become due on the corporation's balance-due day, effective for taxation years beginning after June 2003.

– The instalment threshold provisions for cooperative corporations and credit unions will be harmonized with those of other corporations, effective for taxation years beginning after June 2003.

– Interest on loss carry-back applications will accrue beginning 30 days after an application is received rather than the currently used day of application, effective for applications received after June 2003.

– Where the Minister of National Revenue extends the filing deadline and the taxpayer files their return later than the extended deadline, the penalty will apply based upon the normally required deadline.

Air Travellers Security Charge

The government will reduce the Air Travellers Security Charge by over 40 percent for flights within Canada. The charge on one-way flights is reduced from $12 to $7 and from $24 to $14 for round-trip flights. This reduction is to take effect for tickets purchased after February 28, 2003.

Deductibility of Interest

Recent court decisions have allowed taxpayers interest deductions in circumstances which the Government feels are inappropriate. Consequently, legislative amendments will be considered. Such proposals will be released for public consultation before being implemented.

Share-For-Share Exchanges

A Canadian resident shareholder who exchanges shares of a Canadian corporation for shares of a foreign corporation does not qualify for rollover treatment. Although there are indirect means of accomplishing such a rollover (e.g., through the use of exchangeable shares), these types of transactions can be complex and costly. The Government will release a draft of legislative proposals in the near future for public review and comment. The objective of these draft proposals will be to provide the rollover for such share exchanges while, at the same time, protecting Canada's tax base.

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Hilborn Ellis Grant LLP
Chartered Accountants
Since 1930

401 Bay Street
Suite 3100, P.O. Box 49
Toronto, Ontario
M5H 2Y4
Tel: (416) 364-1359
Fax: (416) 364-9503