

March 23, 2004

2004 FEDERAL BUDGET COMMENTARY

Introduction

Finance Minister Ralph Goodale's first Budget, and the first from Prime Minister Paul Martin's government, was presented to Parliament on Tuesday, March 23. It contained few surprises. The government's seventh balanced budget in succession, it proposes little of what might be called "pre-election spending," such as tax cuts or new social programs. Instead, it seems designed to reassure taxpayers that the public purse is being managed responsibly. Program spending is projected to increase by about \$3 billion, but much of it will be financed through re-allocation of funding from existing programs.

In his Budget speech, Minister Goodale said that social and economic policies must be "mutually reinforcing," and that "underlying this must be the prudence of balanced budgets that comes with living within our means." He forecast balanced budgets over the next two fiscal years and announced a goal of reducing the federal debt-to-GDP ratio from 42% in 2003-04 to 25% within ten years. Also, the \$3 billion Contingency Reserve will be maintained and \$1 billion in "economic prudence" restored, for both 2004-05 and 2005-06.

In his Budget speech, the Minister forecast economic growth of 2.7% in 2004 and 3.3% in 2005. The main risks, he said, were associated with impacts of a rapidly-rising Canadian dollar, and the sustainability of the U.S. economic recovery.

The Budget focuses most of its proposals in the areas of health, education, communities, "knowledge and commercialization" and "Canada's relationship with the world." Major measures include:

- An additional \$2 billion for the provinces and territories for health.
- Establishment of a new Canada Public Health Agency as a focal point for disease control and emergency response.
- Funding of \$665 million over three years to improve Canada's readiness to deal with public health emergencies.
- In total, the Budget directs more than \$1 billion to public health initiatives.
- Introduction of a new Canada Learning Bond, to provide up to \$2,000 for children in low-income families for post-secondary education, as well as grants of up to \$3,000 for first-year, post-secondary students from low-income families.
- Substantial additional funding for research and commercialization.
- New funding of \$270 million to enhance access to venture capital financing for promising new companies.
- \$7 billion over ten years in GST/HST relief for municipalities.
- \$1 billion over seven years for the development and commercialization of new environmental technologies.

- An additional \$250 million to cover the costs of peacekeeping in Afghanistan and the fight against terrorism, along with \$50 million for peacekeeping in Haiti.
- A further \$650 million to address security issues.
- An increase of \$248 million, or 8%, in international assistance in 2005-06.

In addition, the Minister said that program costs will be reduced through such measures as cancelling plans for a political history museum, foregoing capital expansion by VIA Rail, terminating the controversial Sponsorship Program and the National Unity Reserve, reducing advertising and trimming departmental budgets across the board. The government also announced that it intends to sell its 19% interest in Petro-Canada.

Tax changes proposed in the Budget are discussed in the following sections.

PERSONAL TAX CHANGES

Tax Fairness for Persons with Disabilities

The attendant care expenses deduction will be replaced by a disability supports deduction for the 2004 and subsequent taxation years. This Budget proposal provides for a broader deduction for disability supports incurred for purposes of employment or education. Certain costs that were eligible for the medical expense tax credit will now qualify instead for the disability supports deduction. The deduction will be based on the current limits for the attendant care deduction, except that the two-thirds factor will not be applied.

The list of eligible disability supports expenses includes sign-language interpretation services, real time captioning services, teletypewriters, electronic speech synthesizers, Braille printers and optical scanners and large-print on-screen devices to allow visually-impaired individuals to read. In addition, where the need is certified by a medical practitioner, the following services or devices will also be eligible: note-taking services for persons with mental or physical impairment; voice recognition software for those with a physical impairment; tutoring services for individuals with a learning disability or a mental impairment; talking textbooks for individuals with a perceptual disability; and attendant care services.

For 2004 and subsequent taxation years, 25% of the amounts that can be claimed as disability supports will be eligible for the refundable medical expense credit.

Caregiver Expenses

The Budget proposes to allow a credit for qualifying medical expenses incurred by an individual in respect of a minor child, without regard to the current "notch provision," which can significantly reduce the claim based on the child's net income. For medical expenses paid on behalf of other dependent relatives (a parent, grandchild, grandparent, brother or sister, uncle or aunt, and niece or nephew), the supporting individual will now be able to make a claim to the extent that they exceed the dependent's normal threshold for medical expenses. The maximum amount which can be claimed is limited to \$5,000 per dependent. These proposed changes will apply to 2004 and subsequent taxation years.

Education Tax Credit

The education tax credit is presently not available to students who pursue post-secondary education which is related to their current employment. The Budget proposes to remove this restriction for 2004 and subsequent taxation years as long as the education costs are not reimbursed by the employer.

Taxpayer-Requested Adjustments

The "Fairness Package" was originally introduced in 1991, applicable to the 1985 and subsequent taxation years, to allow an individual or testamentary trust to request that the Minister of National Revenue accept a late-filed return, late-filed, amended, or revoked elections, or reassess an income tax return beyond the normal reassessment period. It also allows all taxpayers and partnerships to request the waiver or cancellation of penalties or interest. The Budget proposes to limit such requests to any such issues in the previous ten years, commencing for requests made in 2005. Consequently, any requests for taxation years more than ten years ago should be made by December 31, 2004.

Canadian Forces Personnel and Police

The Budget proposes that, for 2004 and subsequent taxation years, a deduction be available to members of the Canadian Forces or a Canadian police force for employment income earned in a high-risk military or police mission outside Canada. In order to qualify the individuals must be eligible for a risk allowance at level three or higher. This proposal will exempt such employment income from tax up to the maximum rate of pay earned by a non-commissioned officer (approximately \$6,000 per month).

Mineral Exploration Tax Credit

Individuals can claim a 15% tax credit for investments in flow-through shares of companies engaged in certain mineral exploration. This tax credit has been extended for another year to the end of 2005.

CORPORATE TAX CHANGES

Small Business Deduction

The Budget proposes to increase the business limit for the small business deduction to \$300,000 for that part of a Canadian-controlled private corporation's taxation year that ends after December 31, 2004. This accelerates the change that was to have occurred after 2005.

Scientific Research & Experimental Development (SR&ED)

The Budget proposes that certain otherwise associated corporations will not be associated for purposes of determining eligibility for the 35% investment tax credit rate for SR&ED. The associated corporation rules provide that any two or more shareholders that own shares in two corporations constitute a group that may control, and therefore associate, the corporations. This would be the case even if each group contains one or more different minority shareholders. For taxation years ending after March 22, 2004, if there is at least one shareholder that does not own shares in both corporations, this definition of group control will not apply for purposes of determining the \$2 million SR&ED expenditure limit. An anti-avoidance provision will prevent taxpayers from artificially structuring companies to benefit from this change.

Carryforward Periods

Effective for losses incurred in taxation years ending after March 22, 2004, the time period for applying non-capital losses against future income will be extended from seven years to ten years. A similar extension to ten years will be provided where non-capital losses are applied to reduce Part IV tax, for unapplied business foreign tax credits and for certain losses of life insurers.

Capital Cost Allowance (CCA)

The CCA rate for computer equipment acquired after March 22, 2004 will increase from 30% to 45%. In addition, the CCA rate for data network infrastructure equipment will increase from 20% to 30%.

Currently, computer equipment is eligible for a separate class election which allows a terminal loss to be claimed when the computer is disposed of. This election will be eliminated. However, taxpayers may elect to include computer equipment purchased in the period March 23, 2004 to December 31, 2004 in a separate 30% class rather than combining all such equipment in the higher 45% class.

Fines and Penalties

It is proposed that any fine or penalty imposed, after March 22, 2004, by law, whether by a government, government agency, regulator, court or other tribunal, or any other person with statutory authority to levy fines and penalties, will no longer be deductible for income tax purposes. This will include fines and penalties under the laws of foreign countries. If the law does not classify the amount paid as a fine or penalty, it may be deductible if it is otherwise incurred for the purpose of earning income. Pending further review, penalties under the Excise Act, the Air Travellers Security Charge Act and the GST/HST portions of the Excise Tax Act will continue to be deductible. The change will also not apply to penalties or damages under a private contract.

Affiliated Persons

Many rules that prevent or defer the realization of losses are based on whether the parties to a transaction are affiliated persons. The Budget proposes to expand the affiliated person rules to determine when a person is affiliated with a trust. A person, referred to as a "majority interest beneficiary," who is entitled to more than 50% of the trust income or more than 50% of the capital of the trust, is affiliated with the trust. When determining the entitlement to either income or capital, a discretionary beneficiary will be considered entitled to the maximum discretionary allocation. Two trusts will be affiliated if a person who lends or transfers property to one trust, in other than an arm's length commercial transaction, is affiliated with a person who lends or transfers property to the other trust and if the majority interest beneficiaries of each trust are also affiliated. In determining the affiliation of trusts, the position of trustee is no longer relevant.

General Anti-Avoidance Rule (GAAR)

The Budget clarifies that GAAR applies not only to the Income Tax Act but also to the Income Tax Regulations, the Income Tax Application Rules, including any amendments to them, and Canada's tax treaties.

INCOME TRUSTS

Publicly traded income trusts have become increasingly popular investments in the last number of years.

In theory, such investments will result in a greater after-tax return than will shares of a public corporation because there is only one level of taxation. If the trust distributes all of its income annually, such income is taxed only to the unitholders. To the extent that income is retained by the trust, it is taxed in the trust at the highest personal rate, but the after-tax income can be distributed tax-free to unitholders.

The government is concerned that registered pension plans (RPPs) will invest heavily in income trusts when, as is anticipated in the near future, provincial legislation clearly protects unitholders from trust liabilities. This would result in all income taxes associated with the income earned by the trust being deferred until pensions are paid.

To counter this possibility, subject to certain exemptions and transitional rules, the Budget proposes two measures which will apply after 2004.

If a RPP invests more than 1% of the book value of its investments directly or indirectly in income trust units, the excess will be subject to a 1% per month penalty tax.

Also, if a RPP holds more than 5% of the units of a particular income trust, the fair market value of excess holdings will be subject to a 1% per month penalty tax.

MUTUAL FUNDS

The government has decided to address the fact that non-residents can escape Canadian tax on dispositions of "taxable Canadian property" (TCP) by investing in mutual funds which hold TCP rather than by acquiring it directly.

Taxable distributions, by mutual fund trusts or corporations, of gains on TCP realized after March 22, 2004 will be subject to withholding tax.

A special new withholding tax of 15% will also apply to certain previously tax-free distributions to non-residents. Such distributions are those made after 2004 by Canadian mutual funds that are listed on a prescribed Canadian or foreign stock exchange if the value of the fund is principally attributable to Canadian real estate or Canadian resource property. Non-residents who are subject to this new tax and incur losses on the disposition of units of such funds, can utilize such losses to recover the special tax otherwise payable. These losses can be carried back three years and forward indefinitely but only to recover the special tax.

CHARITIES

Currently the only sanction against charities which fail to comply with the income tax rules is revocation of registration. The Budget proposes to replace this harsh result with monetary sanctions for specific minor infractions. These sanctions will apply to taxation years that begin after March 22, 2004.

A charity's "disbursement quota" is the amount it must disburse annually based generally on 80% of its tax-receipted donations, other than endowments, received by it in the previous year. A charitable foundation is also required to disburse 4.5% of the fair market value of its capital assets which are not used directly in charitable activities or administration.

The Budget proposes to reduce the current disbursement quota rate on certain capital assets from 4.5% to 3.5% for taxation years commencing after March 22, 2004. However, this 3.5% requirement will be extended to charitable organizations. This proposal will only apply to existing charitable organizations in taxation years beginning after 2008.

The Budget papers outline a number of other proposals which are intended to address specific issues applicable to charities.

OTHER MEASURES

GST/HST Rebate for Municipalities

As previously announced in the Throne Speech and a March 9, 2004 press release, the GST rebate for municipalities of all sizes will be increased from the current 57.14% to 100%. This expanded rebate, which also includes the federal portion of the HST, applies to acquisitions made by municipalities after January 31, 2004.

Gasoline Tax Revenues

As stated in the Throne Speech, the Budget indicates that it is the government's intention to share a portion of gas tax revenues with municipalities. Although details are not included in the Budget, the government has committed to hold discussions with the provinces and municipalities over the coming months.

Air Travellers Security Charge

The Air Travellers Security Charge was introduced on April 1, 2002 to fund enhanced air travel security systems. As part of the government's review to ensure revenues remain in line with planned expenditures, the following adjustments will take effect for air travel purchases made after March 31, 2004:

- for one-way air travel within Canada the charge will be reduced from \$7 to \$6
- for round-trip air travel within Canada the charge will be reduced from \$14 to \$12
- for trans-border air travel the charge will be reduced from \$12 to \$10
- for other international air travel the charge will be reduced from \$24 to \$20

NON-TAX MEASURES FOR STUDENTS

Canada Learning Bond

For children born after 2003, whose family is entitled to the National Child Benefit, the government will provide a Canada Learning Bond. The Bond will be \$500 in the first year of entitlement and \$100 for each subsequent year of entitlement until the child turns 15. The first year of entitlement for the Bond can be any year up to age 15, depending on which year the family is first entitled to the National Child Benefit. The Bond can be transferred into a Registered Education Savings Plan (RESP) of which the child is the beneficiary at any time before the child reaches 18 years of age. When making the first payment of a Bond into a RESP, the government will contribute an additional \$25 to cover administration costs.

Canada Education Savings Grant

The government currently provides a \$20 grant for every \$100 contributed to a RESP, subject to a maximum. Effective in 2005 this 20% grant will be doubled to 40% for the first \$500 contributed to a RESP by families with incomes up to \$35,000. For families with incomes between \$35,000 and \$70,000 the grant will be increased to 30% for the first \$500 contributed to a RESP. There is no carry-forward of unused access to the enhanced matching rates, thereby limiting matching to a maximum of \$500 in RESP contributions in any given year.

Post-Secondary Education Grants

Effective with the 2005-06 school year, eligible first-year post-secondary students from low income families will qualify for a grant equal to one-half the cost of tuition, to a maximum of \$3,000.

Also effective with the 2005-06 school year, disabled students who are eligible for post-secondary student loans will receive an additional up-front grant of up to \$2,000.

Canada Student Loans

Beginning with the 2005-06 school year, the federal ceiling for student loans will be increased from \$165 per week to \$210 per week.

To increase eligibility for student loans, the parental contribution expected from middle-income families will be reduced.

To assist with the repayment of student loans, the income thresholds used to determine eligibility for interest relief will be increased by 5%.

For borrowers who remain in financial difficulty after the application of interest relief, the maximum amount of debt reduction will be increased to \$26,000 from \$20,000.