

February 23, 2005

2005 FEDERAL BUDGET COMMENTARY

INTRODUCTION

Finance Minister Ralph Goodale's second Budget, presented to Parliament on Wednesday, February 23, was the first to be tabled by a minority government in 25 years. As such it appeared to reflect the government's aim of pleasing almost everyone while offending as few as possible by combining increased program spending with tax cuts while forecasting balanced budgets over the next five years. In fact, the Budget was unique in that it contemplates a five-year framework rather than the traditional two years.

Noting that in 2004-05 Canada will record its eighth consecutive balanced budget, Minister Goodale characterized his Budget as delivering on the government's commitments to "maintain our unparalleled fiscal success, invest in our people, achieve a more productive and environmentally sustainable economy, and bolster Canada's role in global affairs."

In his speech, the Finance Minister forecast economic growth of 2.9% in 2005 and 3.1% in 2006. He emphasized, however, that the US budget deficit could curtail growth by causing interest rates to rise in both countries. At the same time, further depreciation of the US dollar against the Canadian dollar would put additional pressure on Canadian exporters.

Major spending initiatives proposed in the Budget included \$13 billion of increased funding for the military and security, \$3.4 billion over five years in additional international assistance, \$5 billion over five years for early learning and child care initiatives, and a minimum of \$4 billion over five years for action on climate change, as well as a further \$1 billion for "other environmental priorities."

Other significant proposals included:

- An additional \$805 million over five years to deliver on the government's earlier commitments on health care.
- \$735 million over five years to strengthen aboriginal communities.
- An additional \$668 million for arts and culture.
- \$398 million over five years for immigration and settlement programs.
- An additional \$800 million for regional economic development.
- \$375 million in additional funding for federal research councils.
- Raising Sport Canada funding from \$70 million in 2004-05 to \$170 million in 2005-06.

Among other significant proposals, Guaranteed Income Supplement benefits for low-income seniors will be increased by \$2.7 billion over five years through increased monthly benefits of \$36 a month for singles and \$58 a month for couples by January 1, 2007. The government will also implement an earlier pledge to share \$5 billion in gasoline tax revenues with cities and communities.

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

PERSONAL TAX CHANGES

Non-refundable Tax Credits

The Budget proposes to increase certain non-refundable tax credits above the annual indexed amounts.

The indexed basic personal amount, to which all taxpayers are entitled, is \$8,148 for 2005. The Budget proposes that the indexed amount be supplemented by \$100 for 2006, \$100 for 2007, \$400 for 2008 and, for 2009, the greater of \$600 and the amount needed to bring this amount to \$10,000. Thus, for 2009, the basic personal amount will be a minimum of \$10,000.

The Budget proposes that the indexed amount for the spousal, common-law partner and wholly dependent relative credits be supplemented by \$85 for 2006, \$85 for 2007, \$340 for 2008 and, for 2009, the greater of \$510 and the amount needed to bring this amount to \$8,500. Thus, for 2009, these amounts will be a minimum of \$8,500. The Budget also proposes parallel changes to the income threshold amounts above which the credits are reduced.

Retirement Savings

Limits

The Budget proposes that the maximum annual contribution amounts for money purchase registered pension plans and registered retirement savings plans be as follows:

	RRSP	RPP
	\$	\$
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
2011	Indexed	Indexed

The maximum annual contribution to deferred profit sharing plans, which is 50% of the registered pension plan limit, will therefore change as well.

Plan Investments

Currently, the foreign content of deferred income plans, such as registered retirement savings plans, is restricted to a maximum of 30% of the cost of the plan's assets. If the 30% limit is exceeded, a penalty tax is exigible. The Budget proposes to repeal the foreign content restriction, effective January 1, 2005.

The Budget also proposes to allow registered retirement savings plans to invest in certain investment-grade gold and silver bullion coins and bars, and related certificates. This change is effective for investments made on or after February 23, 2005.

Disabled Taxpayers

In 2003, the Technical Advisory Committee on Tax Measures for Persons with Disabilities was established. Its final report was released in December, 2004. The Budget makes a number of proposals designed to implement the committee's recommendations.

Disability Tax Credit

The Budget proposes several changes to the eligibility criteria for the disability tax credit, including:

- Clarification of the legislation with respect to conceptualization of impairments.
- Alignment of legislative criteria for mental impairments with administrative practice.
- Extension of eligibility to individuals with multiple restrictions that, in the aggregate, equate to a marked restriction in a single basic activity of daily living.
- Improved definition of life-sustaining therapy activities.
- Expansion of the types of health practitioners eligible to certify taxpayers for credit eligibility.



These changes are effective January 1, 2005.

#### Disability Supports Deduction

The disability supports deduction was introduced in the 2004 Budget. It provides for the deduction of certain supports incurred for purposes of employment or education. The 2005 Budget proposes to expand the list of expenses qualifying for this deduction. Eligible expenses will now include deaf-blind intervening services, job coaching services, reading services for the blind or severely learning disabled, Bliss symbol boards for speech impaired individuals, Braille note-taker devices and page turning devices. These changes are effective January 1, 2005.

#### Refundable Medical Expense Supplement

The Budget proposes to increase the maximum refundable medical expense supplement to \$750 from the current \$571. This measure is effective January 1, 2005.

#### Registered Education Savings Plans (RESPs)

Changes are proposed to RESPs which are intended to better meet the needs of students with disabilities. For a RESP whose beneficiary is eligible for the disability tax credit after the 20th anniversary of the RESP, the maximum period for which contributions can be made is increased from 21 to 25 years and the maximum life of the plan is increased from 25 to 30 years.

These changes are effective January 1, 2005 and are limited to single beneficiary plans. A disabled beneficiary's share of a family plan may be transferred to a separate single beneficiary plan to meet this criterion.

#### Canada Child Tax Benefit

The maximum Child Disability Benefit Supplement to the Canada Child Tax Benefit is increased to \$2,000 annually, effective for benefits paid after June, 2005.

#### Medical Expense Credit

The list of expenses qualifying for the medical expense credit has been expanded to include: phototherapy equipment for skin disorders, oxygen concentrators, deaf-blind intervening services, reading services for the blind and marijuana under certain restricted circumstances. These changes are effective January 1, 2005.

In addition, the Budget proposes to tighten the rules for medical expense eligibility for home renovation expenses in order to limit the credit to expenses that do not increase the value of the home and would not be incurred by unimpaired individuals. These changes are effective for expenses incurred after February 22, 2005.

Currently, the maximum amount a caregiver may claim in respect of medical expenses for a dependent relative is \$5,000. The Budget proposes to double this limit to \$10,000, effective January 1, 2005.

#### Adoption Expense Tax Credit

The Budget introduced a non-refundable adoption expense tax credit effective January 1, 2005. The credit will be 16% of eligible expenses to a maximum of \$10,000 of expenses. Eligible expenses include: adoption agency fees, court and legal costs, travel expenses and the like. The maximum of \$10,000 will be indexed after 2005.

#### Emergency Medical Services Vehicles

The definition of automobile will exclude clearly marked emergency medical services vehicles used to carry paramedics and their emergency medical equipment. This will ensure that the taxable benefit for employee personal use of such vehicles will be determined on a reasonable basis, rather than under the onerous standby charge rules. This change is effective January 1, 2005.

#### Agricultural Cooperatives

The taxation of patronage dividends paid in the form of eligible shares by qualifying agricultural cooperatives will be deferred. This measure is effective for eligible shares issued after 2005 and before 2016.

Charitable Donations

The Budget codifies the previously announced special rules for donations made in respect of Tsunami relief. Cash gifts made after 2004 and before January 12, 2005 qualify for the donation tax credit in 2004 if they were made to a specified charity and were designated for Tsunami relief.

CORPORATE TAX CHANGES

Corporate Surtax Elimination and

Corporate Tax Rate Reduction

The Budget proposes to eliminate the corporate surtax in 2008 and reduce the general corporate income tax rate starting in 2008 in accordance with the following chart.

	2005/7	2008	2009	2010
General income tax rate(%)	21.0	20.5	20.0	19.0
Surtax rate(%)	1.12	-	-	-

The Federal small business rate of 12% is unchanged.

R&D Investment Tax Credit

Eligibility for investment tax credits in connection with scientific research and experimental development (R&D) carried on in Canada, will be extended to include R&D activities performed within "Canada's Exclusive Economic Zone", or, in other words, within 200 nautical miles of Canada's coastline. This change is effective for expenditures made after February 22, 2005.

Capital Cost Allowance Rate Modifications

The Budget proposes to adjust CCA rates for the following types of assets:

	Current CCA Rate	Proposed CCA Rate
Electricity-generating combustion turbines	8%	15%
Electricity transmission and distribution assets	4%	8%
Oil & gas pipelines	4%	8%
Oil & gas pipelines compression equipment	8%or20%	15%
Certain energy generation equipment in CCA class 43.1	30%	50%
Telecommunications infrastructure cables	5%	12%

These changes are generally effective for assets acquired on or after February 23, 2005 that have not been used or acquired previously. Changes are also being proposed to the separate CCA class election with respect to some of the above assets.

The specified energy property rules limit, to the amount of income from such properties, the CCA deductions that may be taken by passive investors in respect of certain property that is subject to incentive CCA rates. These rules will be extended to some of the above assets.

## Tax Amendments in Progress

### Interest Deductibility

The Department of Finance issued proposals regarding the deductibility of interest and other expenses in October, 2003, originally to be effective January 1, 2005. In addition, draft amendments dating back to 1991 appear to still be on hold. The October, 2003 proposals intended to legislate the requirement of a reasonable expectation of cumulative profit over the expected life of the business or property before interest and other expenses could be deducted. The government has indicated in this Budget that it has sought to develop a "more modest" legislative initiative that would respond to taxpayers' concerns while still achieving the intended objectives. However, it is not clear how these proposed changes will be integrated or on what dates they will be effective.

### Tax Treatment of Flow-Through Entities

The government will undertake consultations on tax issues related to business income trusts and other flow-through entities such as limited partnerships. The Budget indicates that future initiatives, if any, will be taken following these consultations and in full consideration of the costs and benefits.

### Cross-Border Share-for-Share Exchanges

The government's October, 2000 mini-budget announced that it would undertake consultations on the merits and technical design of a tax deferral provision for Canadian resident shareholders who exchange shares of a domestic corporation for shares of a foreign corporation. The 2005 Budget announced that a detailed proposal regarding cross-border share-for-share exchanges will be released for public comment in the "near future".

## Foreign Investment Entities (FIEs) and Non-Resident Trusts (NRTs)

Draft tax legislation affecting FIEs and NRTs was previously tabled with an effective date of January 1, 2003. However, these proposals have not yet been passed into law and further amendments are being considered. The Budget indicated that legislation to implement these proposals will be introduced "at a suitable time, consistent with other legislative priorities".

### Other Measures

#### Air Travellers Security Charge

This Budget proposes the third consecutive reduction to the charge since it was introduced in 2002:

- For air travel within Canada, the charge will be reduced from \$6 to \$5 for one-way travel and from \$12 to \$10 for round-trip travel.

- For Canada-U.S. air travel, the charge will be reduced from \$10.00 to \$8.50.

- For other international travel, the charge will be reduced from \$20 to \$17.

These changes are effective for tickets purchased on or after March 1, 2005.

#### Excise Tax on Jewellery

The Excise Tax on jewellery, currently 10%, will be phased-out through a series of rate reductions as follows:

- Effective February 24, 2005, the rate will be 8%

- Effective March 1, 2006 the rate will be 6%

- Effective March 1, 2007 the rate will be 4%

- Effective March 1, 2008 the rate will be 2%

- Effective March 1, 2009 the tax will be fully eliminated

## GST/HST Web Registry

The Budget proposes the establishment of a GST/HST Web Registry in order to facilitate identification of GST/HST registrants. This Web site will allow for confirmation of the registrants' business numbers.

## GST/HST Directors' Liability

In certain circumstances, directors of a corporation are jointly and severally liable, together with the corporation, to pay any unremitted GST/HST along with the associated penalties and interest. The Budget proposes to extend such liability to net tax refunds, along with the associated penalties and interest, to which the corporation is not entitled. This measure is effective upon Royal Assent.

## GST/HST Health Care Rebates

Eligible charities and non-profit organizations that provide health care services similar to hospitals will qualify for the 83% rebate of GST and the federal portion of HST paid on eligible purchases. This change is effective January 1, 2005.

## Increased International Tax Enforcement

The Budget proposes to provide an additional \$30 million in funding to the Canada Revenue Agency for increased international tax enforcement. The use of audits and compliance checks on cross-border and international transactions will be expanded, using a risk-based approach. The government anticipates that this additional enforcement will provide sufficient revenues to fund the program.