GCSE In Touch *with* Tax

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The 2003 Federal Budget

NOT MUCH (TAX)

The Honourable John Manley, Minister of Finance, delivered his first Budget on February 18, 2003. This Budget was presented in a theatre of some political drama. The shadow of Paul Martin, the popular predecessor Finance Minister, and almost anointed next Prime Minister, was cast over the proceedings. Further, this Budget is viewed by many as Prime Minister Jean Chretien's "legacy" Budget.

Generally a budget addresses the government's spending needs and expected revenue (tax) sources. It also proposes tax changes, either as a way to adjust its revenue sources or as in instrument of government policy. Perhaps because of the Chretien "legacy", this Budget can best be classified as a (massive) spending Budget. There are some modest tax changes, which we have highlighted in the comments that follow. Most notable of these changes, for our anticipated readership, are the increase in the small business deduction limit from the current $200,000 to an eventual $300,000, and an increase in the annual RRSP and RPP limits. The Budget perhaps did not contain a significant number of tax changes because of the release of 562 pages of technical tax amendments in December 2002.

With a very large projected budget surplus, the government has announced significant increase in spending for programs ranging from health care, the military, infrastructure spending for cities, child care and child benefits, as well as many other programs.

With so much money being spread around, one might think that many people would be pleased. That does not appear to be the initial reaction. Those from the conservative, lower taxes, pay down the debt constituency, are upset with the magnitude of the spending spree. Most recipients of a portion of the proposed spending or their related interest groups have generally complained that not enough money went to the right place. Provincial governments complained that not enough is directed to health care. Municipal governments complained not enough is earmarked for cities. The same can be said for children's advocates, military analysts, and the list goes on and on.

In a potentially interesting political twist, much of the proposed Budget spending is slated to take place over an ensuing number of years. Years possibly under the leadership of Paul Martin, the champion of spending restraint.

The few tax related Budget provisions are outlined in the following.

PERSONAL TAX CHANGES

RPP and RRSP Contribution Limits

The money purchase RPP and RRSP contribution limits have been frozen at $13,500 since 1996. The maximum pension limit of $1,722 for defined benefit RPPs has not changed since 1976. As many have predicted, the government has finally moved to increase/accelerate these limits to encourage tax-assisted retirement savings.

The limits will be as follows:

	2003 $	2004 $	2005 $	2006 $	2007 $
Money Purchase RPP					
Annual contribution limit					
Existing	14,500	15,500	indexed		
Proposed	*15,500*	*16,500*	*18,000*	*indexed*	
RRSP					
Annual contribution limit					
Existing	13,500	14,500	15,500		
Proposed	*14,500*	*15,500*	*16,500*	*18,000*	*indexed*
Defined Benefit RPP					
Maximum pension benefit (per year of service)					
Existing	1,722	1,722	indexed		
Proposed	*1,722*	*1,833*	*2,000*	*indexed*	

An individual's ability to contribute is still limited to his or her available contribution room. This amount is an accumulation of unused (previously uncontributed) amounts, based on 18% of annual earned income. Although, the annual limits have been increased, the amounts are still limited by 18% of earned income. For example, assuming that an individual has made maximum annual contributions, in order to contribute $14,500 for 2003, an individual must have earned at least $80,556 in 2002 and will need to earn $100,000 in 2005 in order to contribute $18,000 in 2006. The increase in the limits will therefore be beneficial for higher income individuals and have little or no benefit for those at lower income levels. As well, it should be noted that even with the higher limits, an individual would still have to somehow find the money to set aside.

Perhaps the change in RRSP limits would have been more effective had they been combined with an increase in the percentage of earned income on which a contribution is based. Unfortunately the government choose to keep the limit at 18% of earned income. In addition, owner managers who determine their remuneration from their corporations may have paid themselves $75,000 salary in 2002 to maximize their 2003 RRSP contributions. Those individuals will be restricted to a $13,500 maximum contribution for 2003.

For more detailed information about RRSPs and RPPs, we direct you to our In Touch with Tax, Personal Tax Commentary, Battle of the Tax Bands.

RPP Retirement Payment Options

Under current rules, a member of a money purchase RPP has only two options on retirement. Either he or she purchases a life annuity, or the funds can be transferred to an RRSP or RRIF.

Under the budget proposals, a member of a money purchase RPP will be able to receive payments from the RPP under the income stream currently permitted under a RRIF, beginning in the year he or she turns 70. Those members who have previously transferred their money to a RRIF will be able to transfer their money back to the money purchase RPP. The budget documents referred to a similar transfer from an RRSP, but that wording was not included in the Notice of Ways and Means measures.

RRSP/RRIF Rollovers To Infirm Dependent Child

On the death of an annuitant of a RRSP or RRIF, if the funds are transferred to children who were financially dependent on the deceased, the proceeds are included in the income of the children rather than the deceased. Currently, children who have income in excess of the basic personal amount ($7,634 in 2003) must be able to demonstrate, based on their circumstances, that they are in fact financially dependent.

The budget proposes to make it easier for those dependent children who are also infirm. The child will not need to demonstrate financial dependency, if his or her income is no greater than $13,814, for deaths after 2002.This amount will be indexed annually.

Tax Pre-Paid Savings Plans (TPSP)

The government is exploring whether to introduce legislation to permit the establishment of a special type of savings plan. These plans are known as tax pre-paid savings plans, because contributions are not deductible. However, the investment income in the plan and withdrawals are not subject to tax. The government intends to consult with interested parties to determine whether TPSPs could be a useful and appropriate mechanism to provide Canadians with additional savings opportunities.

Interest Deductibility

Much has been said over the last year concerning Supreme Court decisions, which turned the tax department's position on interest deductibility on its head. Interest is now deductible under a variety of circumstances, even if the there is no reasonable expectation of net income. Please refer to our In Touch With Tax, Personal Tax Commentary for more comments on this topic. Although the Canada Customs and Revenue Agency has indicated that it has accepted the Court's decisions, and will amend its assessing policy, the government is concerned that the Court's decisions are inconsistent with what it considers to be appropriate tax policy.

The government has indicated that intends to make legislative amendments to ensure that the interest deductibility rules reflect such tax policy. Draft legislation will be released sometime in the future (no specific time frame) for public consultation before being finalized.

The last time the government released draft legislation dealing with interest deductibility in response to a court case was in 1991. The legislation remains in draft form today. Time will tell if the government will progress further with the current proposal.

Automobile Benefits

When an employer provides an employee with a car, which is available for the employee's personal use, the employee is charged with a taxable benefit for the personal use. This benefit (known as the standby charge) is 2% per month of the original cost of the car, or 2/3 of the lease payments. The standby charge may be reduced only if the employee uses the car less than 10% of the time for personal use, and the total personal driving is less than 12,000 kilometres per year.

The budget proposes to allow a reduction of the standby charge if the total personal use is less than 20,000 kilometres per year, and the car is used at least 50% for business. It will be important to maintain a travel log to support a reduced standby charge.

In addition, extended cab pick-up trucks used in the transportation of goods and equipment to certain jobsites, emergency fire and police vehicles will be excluded from the standby charge rules.

Capital Gain Rollover

In 2000, the government introduced rules that will permit a small business owner to defer the taxation of capital gains realized on the sale of shares of his or her corporation, if shares of another small business corporation were purchased within 120 days. The maximum investment was $2 million. The 120 days restriction made it almost impossible for a small business owner to take advantage of the rules.

The rules have been expanded in this budget. The $2 million cap has been removed. In addition, the owner will now have until 120 days after the end of the year to make a reinvestment. These changes will apply to dispositions after budget date.

Cross-Border Share-For-Share Exchanges

Under current rules, a Canadian cannot exchange shares of a Canadian corporation for shares of a foreign corporation on a tax-free basis. As a result, complex structures involving exchangeable shares are often implemented when a foreign corporation acquires a Canadian corporation, if shares are received as part of the consideration package.

The government had announced in 2000 that it intended to address the issue. In this budget, the government indicates that draft legislation will be released in the near future for public review and comment.

Donation Tax Credit

There has been a proliferation of arrangements in the recent years involving the donation tax credit. The government has decided that these arrangements are in effect tax shelters in disguise, and has proposed that these arrangements must obtain tax shelter registration numbers. If the promoter does not obtain a tax shelter identification number in advance, a tax credit cannot be claimed until the number is obtained. The following types of arrangements promoted or sold after February 18, 2003 are covered by the proposals:

- If a promoter represents that the purchaser will be able to claim, within four years, a combination of deductions or tax credits which equal or exceed the purchaser's cost,
- If under the arrangement, it is reasonable to consider that the purchased property will be donated to a charity or contributed as a political donation, and
- If the arrangement involves a charitable or political donation, the purchaser will incur a limited recourse debt.

The amount of the donation will be reduced by the amount of limited recourse debt associated with the arrangement, and any repayment of the debt will be considered to be a donation in the year the payment is made.

Disability Tax Credit and Medical Tax Credit

Individuals with severe food allergies were pleased with a court decision early in 2002, which allowed a taxpayer to claim a disability tax credit because of the inordinate amount of time required to shop for and prepare suitable food. Another court decision defeated the government's position that a person must have difficulties with both feeding and dressing him or herself before he or she is disabled. The government disagreed with the reach of the first decision, and proposed in August 2002, to exclude food allergy and similar types of impairment from being eligible for the disability tax credit.

The government retreated temporarily due to reaction to the proposals, but has reintroduced these measures in this budget. In addition to the proposed changes, the government has announced that a technical advisory committee will be established to evaluate whether the disability tax credit is achieving its policy purpose.

Beginning in 2003, a person will not be considered disabled merely because he or she spends a great deal of time in identifying, shopping for or otherwise procuring food or clothing. A person may qualify as disabled if he or she has severe and prolonged difficulties with either feeding or dressing oneself. He or she will no longer be required to have both impairments.

As a concession to those with food allergies, it is proposed that individuals who suffer from celiac disease may claim any incremental cost of acquiring gluten-free products as compared to the cost of comparable non-gluten-free products as a medical expense. A doctor must certify that the person has celiac disease, and requires a gluten-free diet.

In addition, the following list of expenses will be eligible as medical expense, beginning in 2003:

- Payment for real-time captioning services to those with a speech or hearing impairment
- Payment for note-taking services to those with a mental or physical impairment
- Cost of voice recognition software

A medical practitioner must certify that the patient requires the note-taking service or the voice recognition software due to his or her impairment. Someone who is in the business of providing such services must provide the captioning and note-taking service.

Flow Through Mining Expenditure Tax Credit

In 2000, the government introduced a 15% tax credit to encourage investments in companies involved in grass roots mineral exploration. The tax credit was scheduled to expire on December 31, 2003. The budget has extended the expiration date by one year, to December 31, 2004.

National Child Tax Benefit Supplement

The "Child Tax Benefit" system includes two components: the basic benefit and the supplementary benefit. The basic benefit is targeted to low and middle-income families, whereas the supplementary benefit provides additional assistance to low-income families.

The supplement benefit is currently $1,293 for one child, $1,087 for the second child and $1,009 for each additional child. These amounts are subject to annual indexation. The budget proposes to increase the indexed supplement by $150 per child in July 2003, $185 in July 2005 and $185 in July 2006. No additional adjustment is proposed for 2004. The supplement benefit will become $1,463 for one child, $1,254 for the second child and $1,176 for each additional child in July 2003.

The supplement is reduced once family income exceeds a certain threshold, currently $22,397, and will be fully phased out if family income is $32,960, which is the level at which the basic benefit begins to be phased out. The budget proposes to maintain the relationship of the phase out thresholds between the two types of benefits. As a result, the supplement will begin to be phased out at a lower family income of $21,529 in July 2003, and will be fully phased at once family income exceeds $33,487.

Child Disability Benefit

A new child disability benefit of $1,600 will be paid to disabled children of low-income families. The full benefit of $1,600 is available if the family income is below the amount at which the child tax benefit supplement is fully phased out (i.e. $33,487 in July 2003). Beyond that income level, the benefit will be reduced by 12.2% for one disabled child, 22.7% for two disabled children, and 32.6% for three or more disabled children. Accordingly, the benefit will be fully phased out as family income reaches $46,602 for one disabled child, $47,584 for two disabled children and $48,211 for three disabled children. The benefit amounts and the income thresholds will be indexed annually for inflation.

The benefit will be effective in July 2003, and will not be paid until March 2004.

Interest on Loss Carry Back

Under current rules, the government starts paying interest the day an application for a loss carry-back is received. It is proposed that interest accrue 30 days after an application is received, for applications received June 2003. This proposal applies to both individual and corporate taxpayers.

CORPORATE TAX CHANGES

Small Business Deduction Limit Increased

A Canadian controlled private corporation (CCPC) pays 12% federal tax (before surtax) on its active business income ("ABI") earned in Canada, up to the small business limit. The small business limit has been $200,000 since 1982. In 2001, the government introduced a 21% federal tax rate (before surtax) for business income between $200,000 and $300,000. Due to the reduction of the general tax rates, the 21% rate will be applied to all business income other than the first $200,000, beginning on January 1, 2004. The higher combined corporate and individual taxes (once after tax corporate earnings are paid to the shareholders as dividends) on income in excess of $200,000 retained in the corporation generally meant that owner-managers would continue to pay bonuses or salaries to reduce corporate income to no more than $200,000.

The budget proposes that the small business limit (i.e. income eligible for the 12% tax rate) will be increased to $300,000 over 4 years. The changes to the small business deduction limit are welcome news, although long overdue.

The small business limit will be increased to $225,000 on January 1 2003. Corporations with year-ends that straddle January 1, 2003 will prorate the small business limit. The limit will increase by $25,000 per year, beginning January 1 of each year, until it reaches $300,000 on January 1, 2006. The 21% tax rate will apply to income over the business limit. For calendar year 2003, the general federal rate of tax that applies to income over $300,000 will be 23%.

The small business limits will continue to be allocated among associated corporations, and will be reduced on a straight-line basis if a corporation's taxable capital is between $10 million and $15 million. This is not affected by the proposed phase out of the federal capital tax. (see comments on large corporation tax in our budget commentary on our web site)

As a result of increasing the small business limit, CCPCs with income above $200,000, but below the new limits, will be able to pay their outstanding tax balances one month later:

i.e. at the end of the third month after the year end, instead of at the end of the second month.

The preceding discussion only reflects the federal component of corporate tax. All provinces impose an additional tax, either part of the federal tax return or through a separate return in Ontario and Quebec. Unfortunately, these latter two provinces have their own rules, thresholds and rates for the taxation of small business income.

Accordingly, planning for the owner manager is made more difficult since optimum planning for federal purposes may conflict somewhat with optimum planning for provincial purposes. This has been the case for income over $200,000. It will now be the case for income over $225,000 and will rise by $25,000 per year until $300,000 is reached. In any event, the combined federal/Ontario tax rate for the first $200,000 of qualifying small business income will be 18.62% commencing January 1, 2003. Unquestionably a very attractive tax rate, however, one should not forget that the 81.38% of after tax earnings are still in the company. If the owner manager wants access to these funds personally, further personal tax will be payable on the dividend to distribute these monies.

The combined federal/Ontario corporate tax rates on income over $225,000 will obviously be higher and will be different at depending on the corporate income level. This is where the planning for federal purposes may differ for Ontario purposes. This is due in part to Ontario's long standing small business deduction claw back, which reduces the benefit of the Ontario small business tax rate for income over the small business threshold.

The above noted divergence in planning could be eliminated if (when) the federal and the provincial governments coordinated their small business tax systems.

Investment Tax Credits

CCPCs earn investment tax credits on up to $2 million of eligible scientific research and experimental development expenditures at a 35% rate. The $2 million expenditure limit is reduced if the previous year's taxable income of the CCPC exceeded $200,000, and is fully phased out if it exceeded $400,000. The thresholds are increased to $300,000 and $500,000 as a result of the change in the small business limit, discussed in the previous paragraph.

Balance Due for Tax On Corporations

A corporation's income taxes are due either two months after year end or three months after year end on its "balance due date". Other taxes due under the Income Tax Act may have different due days. For example, Part IV tax on taxable dividends are due at the end of the third month, regardless of the corporation's balance due date. The budget proposes to change the due day for all taxes imposed under the Income Tax Act to the balance due date, for taxation years beginning after June 2003.

Large Corporations Tax (LCT)

Corporations with a large capital base (generally the total of its shareholder equity, loans to the corporation, and certain types of reserves, less investments in other corporations) face a federal tax of 0.225% on its taxable capital in excess of $10 million. The LCT is reduced by any corporate surtax paid.

The LCT will be eliminated over five years, beginning on January 1, 2004. The current $10 million threshold will be increased to $50 million for taxation years ending after 2003. The LCT rate will be reduced to 0.2% on January 1, 2004, 0.175% on January 1, 2005, 0.125% on January 1, 2006, 0.0625% on January 1, 2007, and completely eliminated on January 1, 2008. The rates are prorated for taxation years that straddle the calendar year.

Federal surtax in excess of LCT may be carried back for three years and carried forward for seven years. Under the budget, the amount that can be carried forward or back will be calculated assuming the LCT rate remained at 0.225%, and the taxable capital threshold remained at $10 million. This will prevent the ability of corporations to benefit from unused surtax credits that arise solely because of the phased elimination of the LCT.

OTHER TAXES

There have been a number of minor changes to the Goods and Services Tax, excise tax and other taxes. We have limited our comments to the Air Travellers Security Charge and the Employment Insurance premiums.

Air Travellers Security Charge (ATSC)

Air travel within Canada will be less expensive, beginning March 1, 2003. The ATSC, will be reduced from $12 to $7 for an one-way flight, and from $24 to $14 for round-trip travel, but only if the trip is paid for on or after March 1, 2003.

There will be no change to the $12 charge for travel to the continental U.S., and the $24 charge for international flights.

Employment Insurance (EI)

Continuing the trend over the last few years, EI premiums will be reduced to $1.98 per $100, beginning in 2004 from the 2003 rate of $2.10 per $100. Assuming that the EI ceiling remains at $39,000, this will mean a maximum savings of $46.80 to each employee, and a maximum savings of $65.52 to the employer for each employee.

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