

Tax Highlights of the Federal budget – May 2, 2006

Today the new conservative government tabled their first federal budget. The budget estimates a surplus of \$8 billion for 2005-06 and includes federal debt reduction of \$3 billion in each of the next two years. The budget delivers \$20 billion in broad-based tax relief over the next two years, including two key campaign promises: a 1% reduction in the Goods and Services Tax (GST); and, a \$100 per month child care allowance for each child under 6 years of age.

The budget also includes focused spending on priority areas, including infrastructure, the military, policing, border security and public safety, affordable housing, agriculture, aboriginals, child care and education.

The following is a summary of the tax measures as proposed in the budget. Please note that these measures are not yet law and may undergo revisions prior to receiving Royal Assent.

Business Measures

Corporate tax reductions:

As part of the November 2005 Economic and Fiscal Update, the Liberal government announced that it would:

- Reinstatement of the reduction in the general corporate tax rate from 21% to 19% (by 2010) originally announced in the 2005 federal budget;
- Eliminate the corporate surtax for all corporations effective January 1, 2008; and
- Eliminate the federal capital tax by January 1, 2006, two years earlier than originally scheduled.

None of the above tax reductions were passed into law before the January 23, 2006 election. Today's budget confirms that the government intends to follow through on all of the above measures. Specifically, the general corporate income tax rate will be reduced to 20.5% effective January 1, 2008, 20% effective January 1, 2009, and 19% effective January 1, 2010. All of the above measures will be prorated for taxation years that straddle the effective dates.

Small business limit and tax rate:

As part of their election campaign, the Conservatives promised to raise the small-business tax threshold from \$300,000 to \$400,000 and reduce the small business tax rate from 12% to 11%.

These changes are confirmed in today's budget. Specifically, the small business limit will increase to \$400,000 effective January 1, 2007 and the federal small business tax rate will be reduced to 11.5% for 2008 and 11% effective January 1, 2009.

The following table illustrates the combined impact of the above changes to

federal tax rates:

	Current		Proposed		
	2006	2007	2008	2009	2010
On income qualifying for small business deduction	13.12%	13.12%	11.5%	11.0%	11.0%
On other business income	22.12%	22.12%	20.5%	20.0%	19.0%

As a result of the above changes, consequential changes will be made to the scientific research and experimental development (SR&ED) expenditure limit.

Non-capital losses and investment tax credits:

Non-capital losses can currently be carried back 3 years and forward 10 years. Today's budget confirms that the government will follow through on the former Liberal government's proposal to extend the non-capital loss carry-forward period for all taxpayers to 20 years. It is also proposed that the investment tax credit carry-forward period will be extended to 20 years.

These measures will apply to losses incurred and credits earned in taxation years that end after 2005.

Minimum tax on financial institutions:

The federal capital tax on financial institutions is currently levied at a rate of 1% on taxable capital employed in Canada between \$200 million and \$300 million, and at a rate of 1.25% on taxable capital employed in Canada in excess of \$300 million. This tax is in addition to the federal large corporations tax. Today's budget proposes to increase the threshold to \$1 billion and to adopt a single tax rate of 1.25% on taxable capital employed in Canada over that threshold. These changes will apply starting July 1, 2006, prorated for financial institutions with taxation years that include that date.

Apprenticeship job creation tax credit:

The budget proposes a new Apprenticeship Job Creation Tax Credit that will provide eligible employers with a non-refundable tax credit equal to 10% of the salaries

and wages paid to qualifying apprentices, to a maximum credit of \$2,000 per apprentice per year. Unused credits may be carried back 3 years and forward 20 years.

A qualifying apprentice will be an apprentice who is working in a qualifying trade in the first two years of his or her provincially registered apprenticeship contract with an eligible employer.

This new tax credit will be available to eligible employers in respect of salaries and wages that are paid to qualifying apprentices after May 1, 2006.

Capital cost allowance for tools:

Currently, tools, kitchen utensils and medical and dental instruments that cost less than \$200 are eligible for a 100% CCA rate under Class 12 of the Income Tax Regulations. Tools costing \$200 or more are generally placed in Class 8 and eligible for a 20% CCA rate,

Today's budget proposes that the cost limit for access to the 100% Class 12 treatment be increased from \$200 to \$500 for such items acquired after May 1, 2006.

Accelerated capital cost allowance for forestry bioenergy:

The budget confirms the government's intention to proceed with measures originally proposed in the November 14, 2005 Liberal Economic and Fiscal Update to extend eligibility for Class 43.1 (30% rate) and Class 43.2 (50% rate) to cogeneration systems that use a type of biomass used in the pulp and paper industry referred to as "black liquor".

This measure will apply to eligible assets acquired after November 13, 2005.

Personal Measures

Reduction in the lowest tax rate:

The previous Liberal government proposed to reduce the lowest rate of personal tax from 16% to 15%.

Although this measure had not yet received Royal Assent prior to the January 23rd federal election, the CRA had been assessing 2005 personal tax returns on the basis that the rate reduction had been enacted. Today's budget confirms that the new government intends to enact this measure for 2005 only.

Effective July 1, 2006, it is proposed that the lowest tax rate will increase to 15.5%, resulting in an effective rate of 15.25% for 2006 (applicable to taxable incomes up to \$36,378 – indexed for taxation years after 2006). The rate for 2007 and subsequent years will be 15.5%.

Increase in basic personal amounts:

The November 2005 Liberal Economic Update proposed the following changes

to basic personal amounts, retroactive to January 1, 2005:

- A \$500 increase in the basic personal amount (to \$8,648);
and
- A \$425 increase in the federal spouse or common-law partner or wholly dependent person amount (to \$7,344).

The new government will enact these measures for 2005. It also proposes the following changes for the years 2006 to 2009, inclusive:

	Basic amount	Spouse/common-law partner- wholly dependent person
2006	\$8,839	\$7,505
2007	\$8,639 (indexed) + \$100	\$7,335 (indexed) + \$85
2008	Indexed + \$200	Indexed + \$170
2009	\$10,000	\$8,500

The amounts reported above for 2006 are a blended amount resulting from an initial increase in the personal amounts to June 30, 2006 followed by a reduction on July 1, 2006.

Reduced tax rate on dividends:

On November 23, 2005 the former Minister of Finance announced that the government intended to reduce the rate of tax on certain dividends to make the effective rate of tax on dividends comparable to that paid on income flowed through an income trust.

Today's budget confirms that the government intends to proceed with the above measures. In general, dividends that will be subject to this preferential treatment ("eligible dividends") will include dividends paid after 2005 by public corporations (and other corporations that are not Canadian-controlled private corporations (CCPCs) that are resident in Canada and subject to the general corporate income tax rate. In addition, CCPCs will be able to pay "eligible dividends" to the extent that their income (other than investment income) is subject to tax at the general corporate income tax rate (currently 21% federally). Eligible dividends will be grossed up by 45% and the federal dividend tax credit will approximate 19% of the grossed-up dividend (reflecting the general corporate income tax rate that will apply beginning in 2010).

Universal child care benefit:

As expected, today's budget has introduced a \$100 per month child care allowance for each child under six years of age. Although this allowance will be taxable in the hands of the lower-income spouse or common-law partner, amounts received will

not be taken into account for the purpose of calculating income-tested tax benefits.

This new measure is effective July 1, 2006. Therefore, the maximum credit for 2006 is \$600 per eligible child.

Deferral of capital gains tax for reinvested proceeds:

During the election campaign, the Conservatives promised to defer any tax on capital gains from real estate or portfolio investments, provided the profits were reinvested within six months. No measures were announced in today's budget to enact this change.

Tax relief for fishing property:

Enhanced \$500,000 capital gains deduction-

Currently, only shares of a qualified small-business corporation (QSBC) and qualified farm property, qualify for the enhanced \$500,000 capital gains deduction. It is proposed that this deduction be extended to include qualifying dispositions of fishing property. The budget proposes a number of tax relief measures relating to dispositions by an individual of property used in a family fishing business to provide benefits similar to those available with respect to small business shares and family farm businesses. These benefits will include intergenerational rollovers, access to the lifetime capital gains exemption and a 10-year reserve on the disposition of fishing assets, for dispositions and transfers of eligible fishing property after May 1, 2006.

Mineral exploration tax credit:

The budget proposes a reintroduction of the mineral exploration tax credit (15% of Canadian mineral exploration expenses renounced to investors) that expired for flow-through share agreements entered into after 2005. The proposal is effective for agreements entered into after May 1, 2006, and before April 1, 2007.

Donations of publicly-listed shares to charities:

Under current rules, if you donate "eligible property" to a charity (other than a private charitable foundation), you are entitled to special tax relief. For such donations, any taxable capital gain resulting from the disposition of the property is reduced by 50%, so that only 25% of the gain is taxable. Eligible property includes securities, such as shares and bonds – listed on a prescribed stock exchange – as well as mutual fund units. Today's budget proposes to eliminate capital gains tax entirely on such donations made after May 1, 2006.

This measure will also apply to individuals who make a qualifying donation of listed publicly-traded securities that were acquired with employee stock options.

Other personal tax measures:

The following personal tax measures were also proposed:

- A Canada Employment Credit* to offset up to \$500 of employment income. The credit is effective July 1, 2006 so that the maximum amount on which the credit is calculated is \$250 for 2006. The maximum amount will increase to \$1,000 for 2007 and subsequent years (indexed after 2007).
- Effective for the 2006 taxation year, an increase from \$1,000 to \$2,000 in the amount of pension income eligible for the non-refundable pension tax credit.
- Effective for public transit travel after June 30, 2006, a non-refundable federal credit* for the cost of eligible public transit travel on local bus, streetcar, subway, commuter train, commuter bus or local ferry. For this purpose, an eligible public transit pass is a pass that is valid for a period of at least one month of public transit (there is no maximum limit). Individuals making claims will be required to retain their receipts to support the claim.
- Effective for 2007 and subsequent taxation years a non-refundable Children's Fitness Tax Credit* for up to \$500 per child under age 16 for the cost of registration in an eligible physical fitness program. Amounts claimed as child care expenses will not qualify for this credit.
- The introduction of a new non-refundable Textbook Tax Credit* for post-secondary students equal to \$65 for each month the student qualifies for the full-time education tax credit; and \$20 for each month the student qualifies for the part-time education tax credit. Unused textbook tax credit amounts will be added to the unused tuition and education tax credit amounts for the purposes of the carry forward to a future year, as well as the transfer of unused amounts to a spouse or common-law partner, parent or grandparent.
- Effective for 2006 and subsequent taxation years, there will be a complete exemption from tax for scholarship, fellowship or bursary income received by a taxpayer for post-secondary education or occupational training. To qualify for the full exemption, the amount must be received in connection with the student's enrolment in a program that qualifies for the education tax credit.
- A new tax deduction of up to \$500 for the cost of new tools in excess of \$1,000 (indexed after 2007) purchased by an employed tradesperson as a condition of their employment. This measure applies to new tools, other than electronic communication devices and electronic data processing equipment, acquired after May 1, 2006. Eligible employees will also be eligible for a rebate of the GST/HST paid on the portion of the equipment that is eligible for deduction.
- An increase in the annual Child Disability Benefit to \$2,300 from \$2,044, effective

July 1, 2006. It is also proposed to reduce the rates which phase-out the benefit as family income increases, thereby allowing more families to qualify.

- An increase in the refundable medical expense supplement to \$1,000 (indexed for inflation) from \$767 for the 2006 taxation year.

* The non-refundable credit is calculated by reference to the lowest personal tax rate.

GST/HST and Excise tax measures

Reduction in the GST:

The budget has reduced the rate of the GST from 7% to 6%, effective July 1, 2006. The budget also proposes to maintain the GST credit at current levels for low and modest income taxpayers and to retain the existing GST rebate rates for new housing. The existing rebate percentages used to calculate GST rebates for charities, qualifying non-profit organizations and selected public service bodies will not change.

The budget proposes transitional rules for determining the GST rate applicable for transactions that straddle the July 1, 2006 implementation date. The general transitional rule is as follows:

- If GST becomes payable, or is paid without having become payable, before July 1, 2006, the rate of 7% will apply;
- If GST becomes payable on or after July 1, 2006, without having been paid before that day, the rate of 6% will apply;
- If GST is paid on or after July 1, 2006, without having become payable before that day, the rate of 6% will apply.

Certain types of transactions will have specific transitional rules. These include the sale of real property, imported goods and taxable benefits. The budget also proposes anti-avoidance rules, which are intended to prevent inappropriate tax savings in cases where transactions are undertaken between non-arm's length parties to obtain the benefit of the rate reduction.

A number of other amendments are proposed as a result of the GST rate reduction:

- The maximum allowable GST new housing rebate will be adjusted to reflect the lower rate of GST;
- The percentage of tax to be remitted will change to reflect the 1% rate reduction for those registrants using a Streamlined or Quick Method of accounting for the GST. The new percentages will apply to reporting periods that begin after June 30, 2006. For reporting periods that straddle July 1, 2006, the existing percentages will apply to consideration that becomes due, or is paid without

having become due before July 1, 2006, and the new percentages will apply to the remaining consideration.

Other measures:

Excise taxes on jewellery, which were being phased out, are proposed to be repealed completely as of May 2, 2006.

Tobacco and alcohol excise levies will be increased to offset the impact of the GST rate reduction, and the Air Travellers Security Charge will be adjusted to accommodate the reduction in the GST rate.

Excise duties on beer and wine are proposed to be reduced for small and medium-sized Canadian vintners for beer or wine packaged after July 1, 2006.

Reallocation of remittances:

The budget proposes that amounts paid under the Income Tax Act may be transferred to amounts payable under the Excise Act (GST and non GST), the Excise Act, 2001 or the Air Travellers Security Charge Act, with the reallocation taking effect from the date the amount was paid under the first Act.

Non-deductibility of interest and penalties:

The prescribed penalty interest imposed under the Excise Act and the Air Travellers Security Charge Act and the GST/HST portions of the Excise Act will no longer be deductible for income tax purposes.

These measures will apply to taxation years that begin on or after the later of April 1, 2007, and the date that legislation is given Royal Assent.

Measures announced in the 2005 Budget:

The budget confirms the government's intention to proceed with various measures announced in the 2005 budget, including a tax deferral relating to patronage dividends payable by agricultural cooperatives, introducing a new tax credit for adoption expenses, matters relating to the disability tax credit and medical expenses tax credit, and changes to the capital cost allowance provisions.

Disclaimer

The information provided is of a general nature and is not intended to construe an opinion. As each taxpayer's situation is unique, no one should act upon any of the above without first obtaining professional advice, from a Chartered Accountant, concerning the particular facts of their situation.