

WOOTTON
KING &
MULHERN

CHARTERED
ACCOUNTANTS

Federal Budget Commentary

February 18, 2003

Introduction

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.

In a press release issued on February 18, the CICA expressed disappointment about the depth and breadth of program spending proposed in the Budget, and that little attention is being paid to the federal debt. “We have concerns that the amount of program spending and the rate of increase in spending, forecast over several years, doesn’t afford the government enough flexibility should revenue or economic growth slow,” said Pierre Brunet, Chair of the CICA Board of Directors. Noting that the federal government’s debt-to-GDP ratio stands at 44.5 percent and that interest payments on the debt consume almost 22 percent of all federal government revenue, Brunet said that the CICA would also have liked to have seen more of the surplus assigned to the debt than simply the \$3 billion in the contingency fund. “The government is to be commended for its sound fiscal management in producing a surplus – it is unfortunate that the government could not then have followed through and put a greater portion of that surplus towards the debt,” he added.

In his Budget speech, Minister Manley reported that the federal government presents a balanced budget for this fiscal year – the sixth consecutive balanced budget – and forecast balanced budgets “for next year and beyond.” “Keeping a balanced budget, cutting debt and getting the best value for money are a constant challenge and a constant imperative,” he said, noting that the federal debt has been reduced by \$47 billion since 1997 and will continue to be reduced by the \$3 billion a year Contingency Reserve. He also reported that the Canadian economy expanded by 3.3 percent in 2002, faster than the United States and all other G7 countries, and that private sector forecasts are for a similar pace of expansion in 2003 and growth of 3.5 percent in 2004.

As noted, the emphasis of the Budget is on spending to support a social and economic agenda against four broad themes: health care; families and communities; sustainable economy; and Canada in the world. Following are some highlights.

As agreed by the federal and provincial governments in advance of the Budget, health care funding will increase by \$17.3 billion over the next three years and by \$34.8 billion over the next five years. Among other provisions, this total will include \$9.5 billion in transfer payments to provinces; \$16 billion for a Health Care Reform Fund, and \$5.5 billion for

equipment, information technology and the granting of compassionate family care leave under the Employment Insurance program.

Under families and communities, the Budget proposes a \$965 million increase in the National Child Benefit supplement by 2007, and \$935 million over five years to improve access to child care and early learning opportunities. \$320 million will be allocated over five years towards affordable housing, \$256 million for federal housing renovation programs, \$270 million to fight homelessness, and \$3 billion in infrastructure support. Canadian culture and values will be supported by \$150 million over two years for the Canadian Television Fund and \$114.5 million over two years to launch a five-year plan on official languages.

Spending on “a more productive, sustainable economy” will include \$1.7 billion over the next three years to support research and innovation, including a new Canada Graduate Scholarships program, and \$500 million to the Canada Foundation for Innovation for state-of-the-art health facilities. In addition, the Budget provides \$285 million in 2002/03 and over the next two years for skills and learning 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 RRSP annual contribution limit to \$18,000 by 2006, and increase the small business deduction limit to \$300,000 over four years.

Under “advancing sustainable development”, the Budget includes \$2 billion over five years to implement the Climate Change Plan for Canada, \$340 million over two years to address contaminated sites, air quality, toxic substances and endangered species, and \$600 million on water-related programs. In agriculture, the Crop Reinsurance Fund will receive \$220 million this year, and the Canadian Food Inspection Agency \$100 million over the next two years, while \$113 million will be spent to improve Canada’s four veterinary colleges.

Under “Canada in the world,” Canada’s military will receive \$270 million for peacekeeping in Afghanistan, and an increase of \$800 million per year in new funding starting in 2003/04, while \$125 million will be set aside in a contingency fund. To bolster internal security, the government will spend \$75 million over the next two years for a Security Contingency Reserve, and the Canadian Coast Guard will receive \$94.6 million over two years for fleet repairs and infrastructure. Spending on foreign aid programs will increase by 8 percent a year toward an objective of doubling assistance by 2010. This is an increase of \$1.4 billion for this year and the next two years.

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

PERSONAL TAX CHANGES

Retirement Savings

The Budget increases the maximum deductions for registered retirement savings plans (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 pension accrual rate for fire fighters will be increased from 2 percent to 2.33 percent if the defined benefit RPP is integrated with the Canada or Quebec Pension Plan. This is effective for 2003 and subsequent years.

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.

RRSP/RRIF Rollover to an Infirm Child

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.

The Budget proposes to exclude clearly marked police and fire emergency-response vehicles from the definition of an automobile. This will also exclude these vehicles from the standby charge and operating benefit rules where they are available for personal use, effective for the 2003 taxation year.

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.

All of the above amendments apply for 2003 and subsequent taxation years.

The Government will be conducting an evaluation of the DTC to determine whether the DTC is achieving its policy purpose. In addition, a technical advisory committee on tax measures for persons with disabilities will be established to advise the Ministers of Finance and National Revenue.

Canada Child Tax Benefit — National Child Benefit (NCB) Supplement

The Budget proposes to increase this annual supplement by \$150 per child in July 2003, \$185 in July 2005 and \$185 in July 2006. In addition, the income threshold at which this supplement begins to be phased out will be adjusted, keeping the reduction rate for the first child constant at its July 2003 level.

Canada Child Tax Benefit — Child Disability Benefit Supplement

The Budget proposes to introduce a \$1,600 Child Disability Benefit (CDB) as a supplement to the Canada Child Tax Benefit (CCTB) to be paid for children who meet the eligibility criteria for the disability tax credit (DTC). The full \$1,600 CDB will be provided for each eligible child to families with net income below the amount at which the NCB supplement is fully phased out (i.e., \$33,487 in July 2003 for families having three or fewer children). Benefits for families with net income in excess of this amount will be reduced by a percentage of their excess income (e.g., by 12.2 percent for one disabled child). Consequently, the CDB will be reduced to zero as net family income reaches \$46,602 for a family caring for one disabled child. The CDB amount and income thresholds will be indexed to inflation.

The CDB will be effective July 2003 but will become payable and be included with the CCTB payment starting in March 2004.

CORPORATE TAX CHANGES

The 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 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.

Resource Taxation

The Budget proposes two changes to the current resource taxation regime in Canada.

Firstly, the federal corporate tax rate which applies to income from resource activities will be reduced from 28 percent to 21 percent in the same manner as such reduction applies to other business income.

Secondly, the Budget proposes that provincial royalty and mineral charges will be deductible in arriving at net income. In conjunction with this change, the 25 percent resource allowance deduction will be eliminated.

The Department of Finance has indicated that the proposed changes to the resource sector tax regime will be reviewed with industry, the provinces and other interested parties prior to finalization of the proposed legislation. A technical paper will be released in due course.

In the October 2000 Economic Statement, the Government introduced a temporary tax credit mechanism which was intended to apply to certain mining expenditures. The credit is currently calculated at the rate of 15 percent of certain specified surface "grass roots" mineral exploration expenses incurred in Canada by a corporation prior to 2004, where such expenses are renounced to an individual under a flow-through share arrangement.

The Budget proposes to extend the scheduled expiry date for the mineral exploration tax credit from December 31, 2003 to December 31, 2004. In addition, the credit mechanism will apply to eligible expenses incurred by a corporation in 2005, which would in turn be deemed to have been incurred by a flow-through share investor on December 31, 2004 pursuant to the "look-back" rule. The look-back rule enables a corporation which incurs qualifying expenses in a given calendar year to renounce those expenses to a flow-through share investor effective on the last day of the preceding taxation year.

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.

Capital Cost Allowance Class 43.1 (Renewable and Alternate Energy)

The Budget proposes that certain fixed-location fuel cells and ancillary fuel reformation and electrolysis equipment acquired after February 18, 2003 will be eligible for Class 43.1 treatment (i.e., 30 percent CCA rate). In order to qualify, the fuel cells must meet several technical criteria.

Film or Video Production Services Tax Credit

Corporations which carry on, in Canada, a defined film or video production or services business are entitled to a refundable Film or Video Production Services Tax Credit computed in connection with expenditures on production salaries for services rendered in Canada.

The Budget proposes to increase this credit from 11 percent to 16 percent for expenditures incurred after budget day.

The government continues to consult with the Canadian film industry with a view to streamlining the delivery of the Canadian Film or Video Production Tax Credit. This is a refundable credit equal to 25 percent of labour costs.

OTHER TAX MEASURES

Harmonization of 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 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.

Venture Capital

Currently limited partnerships, other than "qualified limited partnerships", are treated as "foreign property" for purposes of the foreign property limitations that have been placed on investments by deferred income plans.

The Budget proposes to relax the rules that determine what constitutes a qualified limited partnership. This will allow more flexibility for deferred income plans to make venture capital investments.

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.

This reduced charge will more closely approximate the revenue required to fund expenditures planned for enhanced air travel security through 2006/07.

Excise Tax Exemption for Bio-diesel and E-Diesel Fuel

Consistent with the excise tax exemption currently afforded non-fossil fuel blended gasoline, relief is now being provided from the four cents per litre federal excise tax on diesel fuel blends. This tax exemption will only apply to the portion of the blended diesel fuel represented by methanol, ethanol or other renewable fuels. This exemption is effective February 19, 2003. This measure is expected to have a positive impact on vehicle emissions and efforts to conserve non-renewable resources.

Exported Fuel Excise Tax Refunds

In response to a recent court decision, Part VII of the Excise Tax Act is being amended to clarify that fuel taken out of Canada in the fuel tank of a vehicle being driven across the border does not qualify as an export. As a result, excise tax rebates filed on such fuel on or after February 18, 2003 will be disallowed.

Contracted Municipal Services

In response to a recent Quebec Court of Appeal decision, legislation will be introduced to clarify that purchases by municipalities of contracted services are subject to GST/HST. These municipalities will continue to qualify for a rebate of 57.14 percent of the GST they pay on such purchases. This amendment is effective from the date of introduction of the GST.

School Transportation Services

A GST/HST amendment will be introduced to ensure that the supply of school transportation services by school authorities will continue to be a GST/HST exempt service regardless of how it is funded. This amendment will ensure that school authorities are eligible for the 68 percent public sector body rebate rather than the full 100 percent GST/HST input tax credit. This amendment is effective from the date of introduction of the GST except for cases already decided by the Federal Court.

Sales Tax Considerations in Institutional Health Care Reform

In recent years, some services formerly provided by hospitals are now being performed in other non-profit institutions. Current GST rules provide for a GST rebate of only 50 percent for these non-profit institutions rather than the 83 percent provided to hospitals. The Department of Finance is undertaking a review of the adequacy of the current health care rebate as it relates to health care functions devolved from hospitals. The target for implementing changes to the eligible rebates is October 1, 2003.

First Nations Taxation

Some First Nations have expressed an interest in being able to levy a more broadly-based tax, similar to the federal goods and services tax. In this Budget the Government reconfirms its willingness to discuss and put into effect direct taxation arrangements with interested First Nations.

Deductibility of Interest and Other Expenses

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.

Cross-Border 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.

NOTICE TO READERS

You are free to reproduce the contents of this letter as you please. Acknowledgement of The Canadian Institute of Chartered Accountants (CICA) is optional.

The CICA wishes to gratefully acknowledge the contribution of those listed below in the preparation of this Federal Budget Commentary:

Richard Colden, CA, CFP, TEP	Richard W. Colden – Chartered Accountant
Ted Finningley, CA, TEP	Catalyst LLP, Chartered Accountants and Consultants
Michael Fremes, CA, TEP	Vottero Fremes McGrath Yee
Glen Pye, CA	Glen Pye – Chartered Accountant
Perry Truster, CA, TEP	Truster Zweig LLP

CICA has acted solely as publisher of this Federal Budget Commentary. Neither it, nor any Provincial Institute or Ordre of Chartered Accountants, nor any committee thereof, accepts any responsibility for its contents or for the use thereof. Furthermore, neither the CICA nor any person listed above involved in the preparation of this Federal Budget Commentary accept any contractual, tortious or other form of liability for its contents or for any consequences arising from its use.