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2006 Federal Budget Commentary

May 2, 2006

BUDGET OVERVIEW

On May 2, 2006, one day after this year's income tax filing deadline, federal Minister of Finance Jim Flaherty tabled his Conservative government's first budget. As was widely expected, the budget follows through on several campaign promises such as reducing the GST and introducing a monthly child care allowance. The primary focus of the budget, however, is on broadly-based tax relief, with proposals including employment and apprenticeship tax credits, changes in basic personal tax credits and lower taxes for small businesses. The budget also specifically allocates \$3 billion per year to pay down the federal debt.

By far the largest single tax-related initiative in the budget is a reduction in the GST from 7% to 6%, effective July 1, 2006. This is expected to save consumers \$5.2 billion over a 12-month period. Other tax-related proposals are explained later in this analysis.

On the spending side, major proposals in the budget include:

- \$3.7 billion over two years for the Universal Child Care Benefit, along with \$250 million to create new child care spaces.
- \$800 million to provinces and territories for affordable housing programs, along with \$450 million to aboriginal communities to upgrade reserves and facilities.
- \$5.5 billion over four years on infrastructure programs, notably in highways and borders, municipalities and transit.
- \$1.1 billion per year for five years to strengthen Canada's armed forces, along with \$303 million to implement a North American border strategy, \$101 million to arm border officers, \$161 million for more RCMP officers, \$133 million for air transport security, and \$64 million to combat money laundering and terrorist financing.
- \$460 million (\$1 billion over five years) to improve Canada's pandemic preparedness, along with \$320 million in foreign aid in 2005-06 to help cope with disease and other disasters.

On the fiscal outlook, the Minister estimated the federal surplus for 2005-06 at \$8 billion, of which \$3 billion will be allocated to debt reduction. He forecast that program spending as a share of GDP will decline from 13.7% in 2004-05 to 13.0% in 2007-08. The debt-to-GDP ratio is projected to fall to 31.7% by 2007-08, with the objective of 25% by 2013-14.

GOODS & SERVICES TAX (GST)

Rate Reduction

Consistent with their election promise the government will reduce the GST rate by 1 percentage point to 6% effective July 1, 2006. The budget also indicates that the rate will be reduced to 5% in a future budget. A corresponding 1% rate reduction (to 14%) will take effect in the provinces (Newfoundland, Labrador, Nova Scotia and New Brunswick) applying the Harmonized Sales Tax (HST).

The GST credit available to low and modest income Canadians will remain at current levels even though the GST rate is being reduced.

The July 1, 2006 implementation date was chosen to provide business with sufficient notice to implement the change. The date also coincides with filing periods for both monthly and quarterly filers.

The general transition rules to determine the applicable rate will be as follows:

- If GST becomes payable, or is paid without becoming payable, before July 1, 2006, the 7% rate will apply.
- If GST becomes payable on or after July 1, 2006, without having been paid before that day, the 6% rate will apply.
- If GST is paid on or after July 1, 2006, without having become payable before that day, the 6% rate will apply.
- A special transitional provision will be provided for new residential housing. Where ownership or possession is transferred to the buyer before July 1, 2006 the 7% rate will apply. Where ownership and possession are transferred to the buyer on or after July 1, 2006:
 - The 6% rate will apply if the agreement of purchase and sale is signed after May 2, 2006.
 - Where the purchase agreement is signed on or before May 2, 2006, and the 7% rate is applied, the purchaser will be able to claim a tax adjustment which effectively reduces the rate to 6%.

The government will increase federal excise levies on alcohol and tobacco effective July 1, 2006 to offset the effect that the rate reduction will have on the taxes applied to these commodities. The excise tax adjustments will also apply to alcohol and tobacco inventories held on June 30, 2006.

The broad application of the GST results in the rate reduction impacting numerous other areas of tax application. Measures will be implemented to provide consistent treatment in areas such as:

- Input tax credits
- Rebates available for public service bodies
- GST Streamlined Accounting Methods
- Financial institutions
- Importations of goods services and intangibles
- Taxable benefits and employee/partner rebates
- Air Travellers Security Charge rates

GST Application on Debt Collection Services

This budget confirms that debt collection services provided by collection agencies to financial institutions are not financial services for GST/HST purposes, and are therefore taxable.

EXCISE MEASURES

Excise Tax on Jewellery

The Excise Tax applied on deliveries or importations of jewellery, clocks and articles made of semi-precious stones is repealed effective May 2, 2006.

Excise Duty Reductions for Vintners & Small and Medium Sized Brewers

Effective July 1, 2006 the first 500,000 litres of wine produced from 100% Canadian grown agricultural products will be exempt from Excise Duty.

Effective July 1, 2006 brewers will have reduced Excise Duties applied on their first 75,000 hectolitres of beer, provided they do not produce more than 300,000 hectolitres in a calendar year.

CORPORATE INCOME TAX MEASURES

Canadian-Controlled Private Corporations (CCPCs)

The "business limit" for the small business deduction will be increased from \$300,000 to \$400,000 effective January 1, 2007. In addition, the federal tax rate applicable to qualifying active business income of a CCPC will be reduced from the current 12% to 11.5% effective January 1, 2008 and to 11% effective January 1, 2009. These changes will be pro-rated for corporations with non-calendar taxation years.

CCPCs currently earn investment tax credits at an enhanced rate of 35% on up to \$2 million of scientific research and experimental development expenditures (SR&ED) annually. This \$2 million expenditure limit is reduced by \$10 for every dollar by which the taxable income for the previous year exceeded the business limit. The business limit was previously \$300,000 and will now be \$400,000 for an associated group of companies. In addition, the business limit is reduced where the taxable capital for large corporations tax purposes exceeded \$10 million in the prior year.

General Corporate Income Tax Rate

The general corporate income tax rate, after the 10% provincial abatement, will be reduced from 21% to 20.5% effective January 1, 2008, to 20% effective January 1, 2009 and to 19% effective January 1, 2010. The rate will be pro-rated for non-calendar taxation years. These rate reductions do not apply to income already subject to special tax treatment such as small business income and investment income of CCPCs.

Corporate Surtax

Previous legislation eliminated the corporate surtax (equivalent to a 1.12% rate reduction) for small and medium-sized corporations effective January 1, 2008. The budget proposes to extend this measure to all corporations effective January 1, 2008.

Non-Capital Losses and Investment Tax Credits (ITCs)

The budget proposes to allow certain losses to be carried forward for 20 years instead of the current 10 years. The carry-forward period for ITCs will also be extended to 20 years from the current 10 years. This proposal will apply to non-capital losses, farm losses, restricted farm losses, losses applied under Part IV of the Income Tax Act (ITA), Canadian life investment losses under Part XII.3 of the ITA and ITCs earned for SR&ED, Atlantic investment, and mineral exploration. This measure will apply to losses incurred and credits earned in taxation years which end after 2005.

Large Corporations Tax (LCT)

Previous legislation eliminated LCT effective January 1, 2008. The budget proposes to accelerate this elimination to January 1, 2006 subject to proration for non-calendar taxation years.

Corporations have been able to reduce LCT for the three previous and seven subsequent years by the excess of corporate surtax over LCT in a particular year. This will still be possible in the three preceding years based on a notional computation of LCT.

It is important to note that notwithstanding the elimination of LCT, the computation of taxable capital is still relevant in connection with certain other provisions including those discussed above under "Canadian Controlled Private Corporations".

Minimum Tax on Financial Institutions

The Federal capital tax on financial institutions is a minimum tax for banks, trust companies, mortgage loan companies and life insurance companies. The tax is currently 1.0% on taxable capital employed in Canada between \$200 million and \$300 million and at a rate of 1.25% on such taxable capital in excess of \$300 million. The budget proposes to increase the threshold above which the tax begins to apply to \$1 billion and to adopt a single tax rate of 1.25% over that threshold. These proposals will apply commencing July 1, 2006 and will be pro-rated for financial institutions with taxation years which include this date.

OTHER BUSINESS INCOME TAX MEASURES

Apprenticeship Job Creation Tax Credit

The budget introduces an Apprenticeship Job Creation tax credit which is equal to 10% of salaries paid to qualifying apprentices after May 1, 2006 to a maximum of \$2,000 per apprentice per year. A qualifying apprentice must be working in a qualifying trade in the first two years of their provincially registered apprenticeship contract. Although unused credits are not refundable, they may be carried back three years and forward twenty years.

Capital Cost Allowance (CCA) Tools

Tools which cost less than \$200 are currently eligible for the 100% CCA rate allowed by Class 12 (without regard to the half-year rule) while tools which cost \$200 or more are generally eligible for the 20% rate allowed by Class 8. The budget proposes to increase the cost limit from \$200 to \$500 for tools acquired after May 1, 2006. In addition, the budget proposes to clarify that electronic communication devices and electronic data processing equipment are not tools.

PERSONAL TAX MEASURES

Universal Child Care Benefit

As anticipated, the budget introduced the Universal Child Care Benefit (UCCB) of \$100 per month for each child under the age of six years. The UCCB will commence in July 2006. Although the UCCB will be taxable to the lower income spouse, it will not be included in income for purposes of income-tested benefits under the income tax system or for the claw-back of Old Age Security or Employment Benefits. It will also not reduce the amount of expenses claimable under the child care deduction.

The supplemental benefit under the Canadian Child Tax Benefit for children under the age of seven will generally be eliminated on July 1, 2006. However, for children who attain the age of six years before July 1, 2007, the supplemental Canadian Child Tax Benefit will continue for those months prior to July 1, 2007 for which no UCCB is received.

Tax Rate

The tax rate in the lowest tax bracket is used to calculate most of the tax credits available to individuals and to calculate alternative minimum tax.

The November 2005 Economic Statement decreased the lowest rate from 16% to 15% effective January 1, 2005. The budget proposes to increase the rate to 15.5% effective July 1, 2006. The effective rate will therefore be 15.25% for 2006 and 15.5% for future years.

Changes to Tax Credits

The budget continues to tinker with the basic personal amount and the spouse/common-law partner (SCLP) amount. These amounts for 2006 and 2007 are as follows:

	<u>2006</u>	<u>2007</u>
Basic personal amount	\$ 8,839	\$ 8,739
SCLP amount	\$ 7,505	\$ 7,420

The budget proposes a number of new tax credits.

For 2006, the Canada Employment Credit will be based on the lesser of \$250 and the amount of the individual's employment income for the year. In 2007, the base for this credit will increase to \$1,000.

Also for 2006, the Textbook Tax Credit will be based on a \$65 amount for each month a student is eligible to claim the education credit for full-time students and on a \$20 amount for each month a student is entitled to the education credit for part-time students. Unused amounts will be added to unused tuition and education credits that can be transferred to a supporting person or carried forward to future years.

Starting in 2007, the Children's Fitness Tax Credit may be claimed by either parent for up to \$500 of eligible fees relating to the enrolment of a child under the age of sixteen in an eligible program of physical activity. The government will consult with experts on the definition of an "eligible program of physical activity". Parents will need to obtain a tax receipt and the organizations will have to keep books and records. The amount claimed to generate this tax credit will not be eligible for the child care deduction.

Effective July 1, 2006, individuals will be entitled to a non-refundable Tax Credit for Public Transit Passes for the individual, the individual's spouse or common-law partner and dependent children under the age of 19. The transit pass must be for a duration of at least one month. Public transit includes a bus, streetcar, subway, commuter bus, commuter train and a local ferry.

The pension income credit will be increased from \$1,000 to \$2,000 effective for 2006.

Flow Through Shares

The 15% Mineral Exploration Tax Credit for individual investors in flow-through shares has been reintroduced for agreements entered into between May 2, 2006 and March 31, 2007 for exploration that is conducted before December 31, 2008.

OTHER DEDUCTIONS AND EXEMPTIONS

The budget proposes to fully exempt scholarships, fellowships and bursaries received by students who are entitled to the education credit commencing in 2006. Previously, only the first \$3,000 was exempt from taxation.

Tradespeople who are employees will be entitled to a deduction, to a maximum of \$500, for the cost of previously unused tools in excess of \$1,000 acquired after May 2, 2006 if the tradesperson's employer certifies that the tools are being acquired as a condition of employment. Adjustments will be made to the deduction currently available to apprentice mechanics to integrate this measure with the deduction already available. In addition, the employee will be entitled to a GST/HST rebate on the amount of the deduction.

Eligible tools will not include electronic communications devices or electronic data processing equipment. Rules will be introduced to reduce the cost of tools acquired by the amount of the deduction and recapture the deduction if tools are sold for more than the reduced cost. The tools will be eligible for a tax-deferred transfer to a corporation in the future.

DONATIONS

Currently, capital gains realized on the donation of publicly-traded securities and certain other securities such as mutual fund units to charitable organizations and public foundations are included in income at a reduced inclusion rate of 25%. Effective May 2, 2006, the capital gains inclusion rate for donated securities will be reduced to zero. The donation receipt will continue to be issued for the value of the securities donated. Similar adjustments will be introduced to increase the deduction for donated securities acquired under employee stock option plans, to eliminate the income realized on the exercise of the option.

The inclusion rate for the capital gain realized on the donation of ecologically-sensitive land will also be reduced to nil.

DIVIDEND TAX CREDIT

The budget reiterates the Conservative government's intention to introduce the new dividend gross-up and tax credit originally proposed in November 2005. Under the proposal, dividends will be grossed up by 45% when included in an individual's income. The federal dividend tax credit will be increased to approximately 19%. The intention is that an individual be indifferent to receiving a dividend from a public company or receiving a fully taxable distribution from an income trust. The increased gross-up and credit applies to dividends from Canadian public corporations, other Canadian corporations that are not CCPCs, and CCPCs to the extent that income, other than investment income, is subject to the general corporate tax rate. Although a few additional comments were provided concerning this measure, most of the specifics were not released.

Some provinces have agreed to harmonize with these proposals while others have not. Ontario has yet to make a commitment.

FISHERS

New rules will be introduced to put fishers on the same footing as farmers with respect to intergenerational transfers, the \$500,000 lifetime capital gains exemption and certain other rollover provisions. These rules will allow for an intergenerational transfer of "fishing property" with no income inclusion either during the lifetime of the fisher or on death. Where a capital gain is realized on the intergenerational transfer of fishing property and the full amount of the proceeds is not received in the year, a portion of the gain may be deferred for up to ten years. Additional rules will be introduced to allow capital gains on dispositions of "qualified fishing property" to be eligible for the \$500,000 lifetime capital gains exemption.