

TAXING TIMES



BUDGET 2005 and other matters

NOTICE TO READER

The following commentary has been prepared by Parker Garber & Chesney, LLP based on the budget papers presented by the Minister of Finance on February 23, 2005 and information available to the public on the date of publishing.

Readers are cautioned that this commentary is informational only and that any issues specific to the reader's needs be addressed with the appropriate tax professional.

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BUDGET 2005

Finance Minister Ralph Goodale tabled a budget on February 23 that has been consistent with budgets for the last few years that is conspicuous by the lack of content or impact. The Federal government seems to reserve its more substantial budgetary matters to obscure press releases made immediately before a holiday or long weekend. Mr. Goodale announced a reduction in tax rates and then, almost as an after-thought, indicated that the changes would not take effect until 2010. Very optimistic for a minority government.

Since the announcement it has been speculated that, assuming the government does not fall during the next year, the next budget will contain significant tax breaks that will preface the immediate call by the Prime Minister for an election.

RRSP FOREIGN PROPERTY LIMITS

Likely the most popular announcement removes the limit of 30% foreign content for RRSPs effective for 2005. These limits will also be removed for other tax-deferred retirement plans such as RPPs and PPPs. The rules regarding qualified investments are also being revised to include gold and silver bullion and certificates.

RRSP CONTRIBUTION LIMITS

It is proposed that the limits be indexed beginning with 2007. The current scheduled limits are \$16,500 for 2005, \$18,000 for 2006 and indexing beginning in 2007. The changes will increase the limits as follows:

Year	Maximum Contribution	Earned income Required
2007	\$19,000	\$105,556
2008	20,000	111,111
2009	21,000	116,667
2010	22,000	122,222
2011	indexed	indexed

Changes are also expected to past-service contribution limits for RPPs and PPPs beginning in 2006.

PERSONAL INCOME TAX

The basic personal amount will be increased by \$100 in each of 2006 and 2007, \$400 in 2008 and at least \$600 in 2009. This will result in a Federal tax saving of \$296 in 2009 over 2005. There will be a small increase in the spousal and wholly-dependant relative credits that will be phased in over the next 4 years.



CORPORATE INCOME TAX

The corporate surtax of 1.12% will be eliminated in 2008 and the general corporate rate will be reduced from 21% to 19% by 2010. This rate reduction will not affect income eligible for the reduced small-business tax rate on the first \$300,000 of eligible income. Therefore this rate reduction will benefit large corporations and not small businesses.

CAPITAL COST ALLOWANCE

Rates have been increased for assets used in oil and gas and electricity transmission and generation and telecommunications.

DISABILITY TAX CREDITS

Some improvements are being made to the credits available for individuals with disabilities but they are somewhat limited in scope and application.

Rules for home renovations related to medical conditions will be tightened up to disallow costs that increase the value of the home or for items that may also be used by unimpaired individuals. This is to counteract the recent court decisions allowing expenses for such things as hot tubs. This change takes affect February 22, 2005.

The caregiver claim is increased from \$5,000 to \$10,000 effective for 2005.

ADOPTION EXPENSE TAX CREDIT

This is a new credit for 2005 for 16% of \$10,000 for the cost of obtaining an adoption including agency fees, court and legal fees and travel expense. The \$10,000 amount will be indexed for years after 2005.

PREPARE TO BE AUDITED

The good news is... CRA's budget for audit and enforcement is being increased by \$30 million per year. At least this is good news for the people getting the jobs.

FUTURE TAX CHANGES

The Department of Finance has proposed changes to some existing legislation that have still not been proposed in law. These matters are still under study and some are awaiting public comment. These proposed changes include limiting interest deductibility for investment in business or property, the tax treatment of income trusts and limited partnerships, a proposal to allow cross-border share-



for-share exchanges and finally the draft legislation on foreign investment entities and non-resident trusts has been delayed yet again.

OTHER MEASURES

The limit for deposit insurance has been increased from \$60,000 to \$100,000 effective with the date of the budget.

NEWS FROM THE COURTS

A PROMISE IS NOT A PROMISE ...

When Dalton McGuinty was running for Premier of Ontario in 2003 he told Ontarians that he would not increase taxes. In September of 2003, McGuinty signed a document called "Taxpayer Protection Promise" in which he repeated his commitment not introduce new taxes or increase existing tax rates without the explicit consent of taxpayers. In May 2004, the McGuinty government, in their first budget, introduced the "Ontario Health Premium" (OHP) adding \$900 per year to each taxpayer's personal tax bill. According to the government this was not a tax but a premium. (In an effort to support this government initiative we will not be charging fees anymore but our premiums may be increasing to service clients' needs).

The Canadian Taxpayers Federation filed a suit in the Ontario Superior Court of Justice asking the court to enforce the contract Mr. McGuinty made with the people of Ontario and striking down the OHP until such time as the taxpayers would give consent. The government position was that the election of Mr. McGuinty was defacto consent and further that the "promise" was not binding.

The court ruled that an election pledge is not a contract and, even though Mr. McGuinty declaration, he was not bound by it.

It appears that a promise is only a promise until the election is over at which time it is no longer a promise and the taxpayers, lied to once again, have no recourse except to dump the liars at the next election. Mr. McGuinty learned well at the knee of Mr. Chretien. Hopefully Ontario voters will have a longer memory the next time Mr. McGuinty makes a promise.

A DEDUCTION IS A DEDUCTION

From the courts in The Netherlands comes the recent decision related to an armed robber who was being required to surrender his illegal proceeds. The court ruled that he could deduct the cost of the gun used to commit the robbery because it was a business expense directly related to the proceeds. At least the Dutch have clarity in determining their deductions.



ALL OR SUBSTANTIALLY ALL

A recent informal decision of the Tax Court (*Watts v. The Queen*) has put into question CRA's application of the 90% rule when dealing with the legislative phrase "all or substantially all". The Agency has always maintained that this phrase, although never defined by Parliament, meant 90%. This has been applied to vehicle usage (prior to the 2004 changes to those rules) along with the meaning for application of the capital gains exemption and, in the case at hand, for the claim of personal tax credits for non-residents.

The court ruled that "it would be absurd to conclude that the appellant's rights under the Income Tax Act should depend on the assignment of an arbitrary percentage to the words "all or substantially all". This mechanical exercise runs counter to common sense". The Court added that the use of this measurement would then beg the question of 90% of what? The Court stated that the words were "elastic and ambiguous" and best applied based on the facts of each case.

U.S. TAX ISSUES

VACATION PROPERTIES

Many Canadians own vacation properties in the U.S. The ongoing problem has been the conflict between Canadian capital gains tax on death and U.S. estate tax. Prior to the changes to the Canada-U.S. Tax Treaty, the conflict resulted from the fact that the treaty did not recognize U.S. estate tax as an income tax and so it was not available for an off-setting credit against the tax on the capital gain in Canada.

Until now, Canadians, with the administrative guidance of the Canada Revenue Agency (CRA) incorporated single-purpose corporations to hold title to the U.S. property. Although the IRS did not approve of the practice, many Canadians used this technique to protect themselves from onerous U.S. estate taxes.

As the result of recent changes to the Canada-U.S. Tax Treaty CRA has determined that they will no longer accept these single-purpose corporations although the full benefits of the estate tax exemption is not likely available to a Canadian resident. As noted in our *Winter 2004* issue, the exemption is pro-rated so that a \$1 million property in the U.S. forming part of a \$5 million estate (the balance located outside of the U.S.) would only get a 20% exemption.

It should be noted that existing single-purpose corporations holding a property in the U.S. will continue to be accepted for Canadian tax purposes. This will include corporations set up to deal with property under construction in 2004. However, if the corporation were to sell the existing grand-fathered property any replacement property could not be purchased by the single-purpose corporation.



Purchasers of property after 2004 will have to consider a number of ownership options.

JOINT OWNERSHIP

In this case, each member of the family (parents and adult children) could purchase an interest in the property.

Pros: This would allow the joint owners to divide the property between them and the estate tax exposure to the value of \$60,000 per owner. This means that the value of the property to be purchased may be calculated to be exempt from U.S. estate tax by multiplying the number of eligible owners by \$60,000 (i.e. four owners would make it possible to purchase a \$240,000 property without any estate tax consequence).

Cons: If the property increases in value then there could be an estate tax on the death of an owner and the subsequent death of other owners will continue to increase the potential estate tax. Also, all owners must contribute funds to the purchase of the property, proportionate to their ownership.

If funds are being provided to one or more of the joint owners by way of gift, the gift must take place outside of the U.S. Also, any joint ownership arrangement should be documented by an agreement.

FAMILY TRUST

Usually used to freeze estate assets, a Canadian discretionary trust may provide protection from U.S. estate tax. In this case, the property would be gifted by the settlor to the trust for the use of the beneficiaries. It is imperative that the trust remain a Canadian trust in order to avoid U.S. taxes.

Pros: There is no taxable benefit in Canada or the U.S. for the use of the property by beneficiaries.

Cons: Beneficiaries must pay for the ongoing costs of maintaining the property. The settlor, who gifted the property or cash to purchase the property, cannot have a right under the trust to use of the property. This could result in the property being included in the estate of the settlor and attracting U.S. estate tax.

This structure will likely be subject to a tax rate of 15% in the U.S. on the sale of the property. This tax would be eligible for a credit in Canada against Canadian tax on the sale.



NON-RECOURSE DEBT

Under U.S. estate tax rules, liabilities are deducted from the value of assets. When the debt is recourse (the lender can enforce collection against other assets of the borrower) than the debt must be pro-rated against all assets. This is the most likely form of debt used, often with a personal guarantee over and above the security against the property. If you had a \$1 million property in the U.S. with a \$600,000 mortgage and a total estate of \$5 million (the balance not located in the U.S.) then under U.S. tax law the debt would be allocated pro-rata against all of the assets. Therefore the amount subject to U.S. estate tax would be \$880,000 (20% of estate located in U.S. x \$600,000 = \$120,000) less the exemption of \$300,000 for a net estate value of \$580,000.

Pros: If the debt is non-recourse, secured only by the U.S. property without any other security, than the whole amount of the debt would be deducted from the U.S. property to determine the value subject to U.S. estate tax. In the above example the value of the U.S. estate would be \$400,000. The exemption would be based on $\$400,000 / \$4.4 \text{ million} \times \1.5 million (2005 exemption) = \$136,364. Although this would not eliminate the U.S. estate tax, the net estate value would be \$263,636 resulting in a savings of about \$148,000 in estate tax.

Cons: Until now finding a financial institution that would give a non-recourse loan has been difficult. However, recent discussions with some institutions have indicated that they are very interested in this business and will be pursuing it more actively in the future.

An interesting tax-planning initiative may be available for those purchasing a property for cash and now wishing to reduce their exposure to U.S. estate tax. If the non-recourse funds are used to reinvest in investments such as a portfolio, the interest paid on the loan could be tax deductible at the same time as the debt works to reduce the estate tax exposure.

PARTNERSHIP

The owners, usually a family group, could establish a partnership, to own the property. Funds do not have to be provided on an equal basis. There is no taxable benefit in Canada to the partners for the use of the property. The partnership can elect whether or not to operate as a corporation in the U.S.

Pros: If the partnership does not elect to be treated as a corporation then the partnership interest should be excludable from the U.S. estate, particularly if it is a limited partnership. On the sale of the property the withholding tax would be 15% which would be creditable in Canada.

Cons: If it elects to be a foreign corporation (known as the “check the box option”), the U.S. estate tax is avoided as is any taxable benefit in the U.S. The



partnership would have to file a tax return in the U.S. and the sale of the property would result in a 35% tax on the gain.

It is imperative that the partnership be documented by an agreement to ensure that all tax and legal issues are addressed.

SUMMARY

There are a number of options, as noted above, so it is important to consider all of them in concert with the family dynamics and the facts of each situation. Family members moving to the U.S. or other countries may affect the decision as well as the value of the property and the long-term intentions for its disposition. All of the factors should be presented to your professional advisors in order to ensure the most appropriate structuring.

INTEREST RATES 2ND QUARTER 2005

The Canada Revenue Agency announced the revised prescribed annual interest rates for the upcoming quarter effective April 1, 2005 to June 30, 2005.

Interest on overdue taxes	7%
Interest paid on overpayments	5%
Interest calculated on shareholder benefits	3%
Interest on overdue and overpaid GST and HST	2.4066%
Interest charged on overdue Excise Tax	7%
Interest on overpaid Excise Tax	5%

