

TAXING TIMES



BUDGET 2006

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 May 2, 2006 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 2006

OVERVIEW

On May 2, 2006, Finance Minister Jim Flaherty presented the first budget of the new Conservative administration. Interestingly, it is the first budget in a very long time that did not come down during the busy tax season. It appears that the new government has attempted to keep many of its promises made before and during the election campaign but only time will tell how much of this budget survives the political posturing that accompanies a minority government budget process.

PERSONAL TAX MEASURES

Tax rates

We start with a reversal of the reduction of the lowest tax bracket rate introduced by the previous Liberal government. 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

A series of new tax credits were introduced in the budget.

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.

The **Textbook Tax Credit** will be \$65 for each month a student is eligible to claim the education credit as a full-time student and \$20 for each month a student is entitled to the education credit as a part-time student. 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.

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. Eligible expenses will include costs for operation and administration of the program (program fees), instruction, facility rentals, team equipment used in common including uniforms, referees, judges and incidentals. Parents will be required to obtain a tax receipt in accordance with CRA guidelines (to be announced) and the organizations will have to keep books and records. The amount claimed under 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 credit will be 15.5% of the cost incurred. The transit pass must be for a duration of at least one month. Public transit includes buses, streetcars, subway, commuter trains and local ferries.

Revisions have also been made to several existing tax credit programs.

The existing **Pension Income Credit** will be increased from \$1,000 to \$2,000 effective for 2006.

Child Disability Credit

This credit is available to low and middle-income families who are eligible for the Disability Tax Credit. The budget proposes to increase the maximum annual allowable credit from \$2,044 to \$2,300 starting July 1, 2006. The credit will also be indexed for inflation in future years. Provisions to make the credit available to more families will also be put in place effective July 1, 2006.

Refundable Medical Expense Supplement

It is proposed to increase the current supplement for working taxpayers who have disabilities from \$767 to \$1,000 for 2006.

Flow Through Shares

The 15% Mineral Exploration Tax Credit for investments 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 New Initiatives

Universal Child Care Benefit (UCCB)

The Budget included the much-discussed UCCB of \$100 per month for each child under the age of six years first proposed during the election campaign. The UCCB will commence in July 2006. Although the UCCB will be taxable to the lower income spouse or common-law partner, 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.

There will be transitional provisions for children who attain the age of six years before July 1, 2007 for which no UCCB is received.



Post-Secondary Scholarships

Currently, the first \$3,000 of post-secondary scholarships, fellowships and bursaries are exempt from tax for both federal and provincial tax purposes. The Budget proposes to fully exempt scholarships, fellowships and bursaries received by students who are entitled to the education credit commencing in 2006. It is not known at this time if the provinces will adopt the full exemption.

Tradespeople 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 employer certifies that the tools are being acquired as a condition of employment (Form T2200). This proposal will also affect the current provisions related to apprentice mechanics. 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 mutual funds 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

As a result of the issues raised related to the taxation of income trusts, the budget proposes that the taxation of dividends paid by Canadian corporations will be altered. Dividends will be grossed up by 45% when included in an individual's income, from the current 25%. The federal dividend tax credit will be increased to approximately 19% from 13%. Theoretically this should equalize the tax treatment for a taxpayer 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.

The proposed changes will result in an effective top federal rate of 14.6%, reduced from 19.6% on dividends. It is the intention of the federal budget that the provinces harmonize their rates so that the target combined federal-provincial tax rate on dividends will be 20.3%, down from 32%. To date only Quebec has committed to harmonizing their rates and B.C. and Manitoba have confirmed their intentions to harmonize.

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.

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.

These changes will bring federal limits in line with those in Alberta, B.C., Manitoba and Ontario.

Clawbacks for investment tax credits for scientific research and development and the application of the limits for the calculation of taxable capital will be adjusted to reflect the new business limit.

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.

The current and proposed new federal tax rates are as follows:

	Current rates	2008	2009	2010
Small business rate	13.12%	11.5%	11%	11%
General corporate rate	22.12%	20.5%	20%	19%
Investment income rate	35.79%	34.67%	34.67%	34.67%

Corporate Surtax

Previous legislation eliminated the 4% 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.

Losses and Investment Tax Credits (ITCs) Carry-forward Provisions

The Budget proposes to allow non-capital losses and ITCs to be carried forward for 20 years instead of the current 10 years. This proposal will apply to non-capital losses, farm losses, restricted farm losses, losses, Canadian life investment losses 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 pro-rated for non-calendar taxation years.

Corporations will continue to be able to reduce LCT for the three previous and seven subsequent years by the excess of corporate surtax over LCT in a particular year using a notional computation of LCT.

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.

GOODS & SERVICES TAX (GST)

Rate Reduction

As previously announced the budget proposes to 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 unchanged.

There are a number of transitional rules that will be applied as follows:

- If GST is paid or 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 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 including input tax credits, rebates for public service bodies, GST Streamlined Accounting Methods, financial institutions, importations of goods, services and intangibles, taxable benefits and employee/partner rebates, and Air Travellers Security Charge rates.

The GST on the taxable benefit for automobiles and airplanes will be reduced to 4.5% from 5% for 2006 and to 4% after 2006.

The standby charge calculation is currently 6/106ths of the charge. For 2006 this will be reduced to 5.5/105.5ths and after 2006 to 5/105ths.

EXCISE TAX 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.

BUDGET OUTLOOK

The budget forecasts and spending estimates are an integral part of the process. As such we have attempted to summarize some of the most important issues addressed by the Finance Minister.

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.

INTEREST RATES 2ND QUARTER 2006

The Canada Revenue Agency announced the revised prescribed annual interest rates for the upcoming quarter effective April 1, 2006 to June 30, 2006.

Interest on overdue taxes	8%
Interest paid on overpayments	6%
Interest calculated on shareholder benefits	4%
Interest on overdue and overpaid GST and HST	3.6099%
Interest charged on overdue Excise Tax	8%
Interest on overpaid Excise Tax	6%

