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Finance Minister Presents 2005 Federal Budget

by Steve Suarez

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Finance Minister Presents 2005 Federal Budget

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Canadian Minister of Finance Ralph Goodale on February 23 delivered the government's 2005 budget.

Following the federal election of June 28, 2004, the federal budget is the product of a minority government for the first time in more than 20 years, and as such, it will require the support of at least some opposition members to pass the House of Commons. (The House of Commons currently has 133 members of the Liberal Party, 99 Conservatives, 54 members of the Bloc Quebecois, 19 New Democratic Party members, and 2 Independents, with 1 seat vacant.)

The government had been negotiating to some extent with opposition parties before the budget's introduction, and the opposition Conservatives have already announced their intention to support it.

In general, the Canadian economy remains strong (a 2.9 percent growth rate is predicted for 2005), and the government continues to run modest surpluses despite pressure from the provinces and municipalities for increased transfer payments and some new spending initiatives (in particular, several billion dollars over five years for Canada's military forces, ever-increasing healthcare expenditures, and a new child-care program). The government anticipates continued balanced budgets (or modest surpluses) over the next several years, and sets the further target of reducing Canada's debt-to-gross-domestic-product ratio from the current 38.8 percent to 25 percent by 2014-2015 (it had been as high as 68.4 percent in 1994- 1995). However, Canada's accumulated federal debt remains quite significant at about C $500 billion.

At one time, federal budgets were used by the finance minister as the primary way of announcing most significant tax initiatives. That aspect of the federal budget has declined in recent years as the Department of Finance has made greater use of separate technical amendment bills and (in some cases) press releases to announce changes in tax policy and legislation. However, the federal budget usually contains some tax initiatives, and this year's version is no exception.

Corporate Income Tax Measures

The budget includes some modest tax reductions for corporations. First, it would reduce the general corporate tax rate (not including the corporate surtax described below) from 21 percent to 19 percent. However, the reduction would be phased in, and would not begin until 2008, when the rate would be reduced by 0.5 percentage point to 20.5 percent. The remainder of the reduction would occur in 2009 (0.5 percentage point) and 2010 (1 percentage point), thus leaving the tax rate at 19 percent for 2010 and thereafter. Given that there will almost certainly be an election between now and 2008, prospective rate cut beneficiaries can be forgiven for curbing their enthusiasm.

The proposed reductions would not apply to some forms of income that are already preferentially taxed, such as income earned by some credit unions, investment corporations, mortgage investment corporations, or mutual fund corporations and, in the case of Canadian-controlled private corporations, business income that is eligible for the small-business deduction or that is investment income.

The proposed rate reductions appear to be a response to recent reductions in U.S. corporate tax rates, reflecting Canada's need to offer tax rates that are competitive with those of its closest neighbor. Hopefully, provincial governments will resist the temptation to divert the forgone federal tax revenue to their own coffers by increasing provincial corporate income tax rates.

Also, the existing corporate surtax would be eliminated, beginning in 2008. The surtax, which is equivalent to 1.12 percentage points in the corporate tax rate, originally was introduced in 1987 as a means to reduce the federal deficit.

While that budget proposal is certainly welcome, with the federal deficit having been eliminated many years ago, there is no obvious tax policy reason for the initiative to be deferred until 2008. It appears that the current government is not quite ready to give up the additional revenue that the surtax generates.

Changes also have been proposed to the tax depreciation system (capital cost allowance or CCA), which allows businesses to deduct the cost of most capital property over time on a declining-balance basis. In addition to some environment-related initiatives discussed separately below, the following adjustments to the CCA rate (thereby affecting how quickly most expenditures on such property are deducted for income tax purposes) were announced in the budget, generally effective for equipment acquired on or after February 23, 2005, that has not been used or acquired for use before that date:

- the rate for electricity transmission and distribution assets would increase from 4 percent to 8 percent;
- the rate for electricity-generating combustion turbines would increase from 8 percent to 15 percent;
- the rate for oil and gas transmission pipelines would increase from 4 percent to 8 percent, with a 15 percent rate for compression and pumping equipment on those pipelines; and
- the rate for telecommunications infrastructure cables would increase from 5 percent to 12 percent.

The adjustments are meant to more closely align the rate of depreciation with the useful lives of those assets. Some expenditures, if incurred in Canada, on scientific research and experimental development also would entitle taxpayers to tax incentives. Otherwise-qualifying expenditures made after the date of the budget and within the 200-nautical-mile limit off Canada's coastline, which Canada claims as its Exclusive Economic Zone, would also qualify for those incentives.

Tax Compliance

Canadian tax authorities are showing increasing interest in tax leakage through international tax avoidance or evasion, as illustrated in the 2004 federal budget that included a proposal that brought a misuse or abuse of the provisions of a tax treaty (as opposed to the domestic tax legislation) within the scope of Canada's general antiavoidance rule (GAAR). That proposal, made on a retroactive basis and allegedly "for greater certainty" (notwithstanding some jurisprudence and the view of most practitioners to the contrary), still does not clearly resolve the relationship between GAAR and tax treaties (and in particular whether Canada can unilaterally amend its treaty obligations by denying treaty benefits based on an amendment to GAAR). In any case, however, it demonstrates the direction Canadian tax authorities are taking in dealing with perceived tax avoidance involving international issues.

The 2005 budget announces that C $30 million per year will be allocated to increased audit and collection activities in the area of cross-border and international transactions. No further elaboration is included on what forms of cross-border tax planning is being targeted, but it is noteworthy that the government indicates that it expects to recoup that annual expenditure through "additional revenues generated through increased audit and enforcement."

Environmental Initiatives

After committing itself to the Kyoto Accord some time ago, the Canadian government has been struggling with how to meet the environmental targets set for it under that agreement. The 2005 budget contains several spending announcements regarding that, including funding to reduce greenhouse gases and expenditures in support of alternative energy sources.

The environment-related fiscal measures in the budget illustrate the use of the tax system for purposes other than simply raising revenue. The budget includes tax incentives designed to induce Canadian businesses and consumers to reduce their output of greenhouse gases. Accelerated CCA is being introduced for equipment used in environmentally friendly forms of energy production such as cogeneration (the simultaneous generation of heat and electricity from the same fuel) and renewable energy generation (such as wind or solar power or geothermal energy). The annual rate at which qualifying equipment acquired on or after February 23, 2005, and before 2012 may be depreciated for tax purposes will increase from 30 percent to 50 percent. The write-off rate is being accelerated as an incentive, rather than simply matching the useful life of the asset as is more typically the case. Also, that favorable CCA treatment will be extended to qualifying equipment used in some additional forms of environmentally friendly energy generation, such as biogas production systems.

Foreign Property Restrictions

Various pension plans and similar tax-deferred retirement entities (collectively, "plans") that are otherwise generally exempted from income tax are nonetheless subject to restrictions and potential penalty taxes based on the type of property they invest in. One such restriction is the limit on how much "foreign property" plans may hold without incurring a penalty tax. Under the current rules, in any given month plans are subject to a tax of 1 percent of the amount by which the cost of their foreign property exceeds 30 percent of the cost of all of their property at month-end. Hence, plans are generally unwilling to hold more than 30 percent of their property in foreign property, and prefer investments that do not count toward their 30 percent foreign property limit.

Foreign property generally includes interests in foreign corporations, equity interests in most partnerships and some trusts, and property situated outside Canada. Shares and debt of Canadian corporations can also constitute foreign property, if the value of the Canadian corporation's shares is derived primarily from other foreign property. The foreign property rule was originally introduced in 1971 with a 10 percent limit, which was subsequently increased to 20 percent and later 30 percent. The stated purpose of the rule was to require plans to invest primarily in Canadian entities and capital markets, thereby lowering the cost of capital for Canadian businesses.

The 2005 budget calls for the elimination of the foreign property rule, effective as of 2005. Hence, plans would no longer be required to invest any specific proportion of their assets in nonforeign property. According to the government, the increased ability of Canadian companies to access global capital markets over the years has made the foreign property rule unnecessary.

The repeal of the foreign property rule was not entirely unexpected. While taxpayers were certainly obliged to respect the rule and plan around it (although it is doubtful that much, if any, revenue was being raised from the penalty tax), Canadian tax authorities had to some extent been taking a benign approach to the rule for some time. For example, the Canada Revenue Agency had ruled favorably on some structures created to plan around those provisions, and the rule itself allowed interests in Canadian corporations that held primarily foreign property not to constitute foreign property when the Canadian corporation simply incurred C $250,000 of expenditures annually on qualifying Canadian-source services. Nonetheless, the elimination of the rule will make life much simpler for plans. Some plans have other tax restrictions on the type of property that they hold (for example, personal retirement savings vehicles are generally required to hold only "qualified investments," as defined in the Income Tax Act (Canada)), which remain in place unaffected by the repeal of the separate foreign property rule.

Canadian capital markets have recently seen a proliferation of business income trusts, which (as discussed below) essentially serve as tax flow-through vehicles to allow the income of the business to be received by investors without any corporate tax leakage. The repeal of the foreign property rule will affect the structure of many income trusts, some of which include an intermediary trust solely for the purpose of dealing with foreign property restrictions (which can now be dispensed with). One issue that the removal of the foreign property rule creates is the potential for increased use of partnerships as investment vehicles, including for plans. Because virtually all interests in partnerships were deemed to be foreign property, they were generally unattractive investments for plans (some plans also have other tax-related restrictions involving investments in partnerships), and public investment vehicles are often structured to accommodate investment by plans. To the extent that tax-exempt investors such as plans are now more able to invest in limited partnerships (which are generally a better flow-through entity for Canadian tax purposes than trusts), this may have important implications for the Canadian tax system. Some tax impediments to the widespread use of public limited partnerships (particularly as regards nonresident investors) remain, which is likely giving the Department of Finance some comfort as to the risk of potential tax leakage. However, one expects that the Department of Finance will be watching the reaction of plans and other tax-exempts closely.

Previously Announced Income Tax Initiatives

The status of a number of important income tax initiatives that have been the subject of prior announcements (either in previous budgets or otherwise) was updated in the latest federal budget. While most of the updates offered little in the way of substantive information, it is nonetheless interesting to note the apparent priority of the different initiatives from the wording used by the government in its update.

Deductibility of Interest and Other Expenses

In response to some court decisions that it felt produced unacceptable changes in the law, the Department of Finance released draft legislation in October 2003 denying a taxpayer's loss from a business or property for a particular year, unless it is reasonable in that year to expect that the taxpayer will realize a profit (excluding capital gains) from that business or property on a cumulative basis. Hence, if a particular business or property generated a loss in a tax year, that loss could not be deducted against other income unless there was a reasonable expectation that at some point the business or property would generate a profit, taking prior years' losses into account. In particular, Finance was concerned with the creation of losses on activities that generated gross income but no net income (after expenses), and generated losses in the expectation of ultimately producing capital gains (which are taxed at 50 percent of normal income).

The tax community was extremely concerned with those proposals, which appeared to change the law significantly beyond what it had been before the court decisions in question, and numerous representations were made to the Department of Finance. To its credit, Finance appears to have acknowledged those concerns, and in the budget it is stated that an alternative proposal based on "a more modest legislative agenda" will be released "at an early opportunity," for further comment. It is anticipated that this proposal will take a more targeted approach to the government's concerns, hopefully in a way that does not impair ordinary commercial transactions in the way that the October 2003 proposals could have.

Cross-Border Share-for-Share Exchanges

In October 2000 the government announced its intention to introduce specific provisions to allow a Canadian-resident shareholder to exchange shares of a Canadian corporation for shares of a foreign corporation on a tax-deferred basis. No details were forthcoming as to the terms and conditions of such a rollover transaction, which could obviously have important implications for cross-border mergers and acquisitions. Subsequent federal budgets reiterated the government's intention to follow through on the proposal, and the 2005 budget does the same, indicating that draft legislation detailing the proposal will be released "in the near future."

At present, many foreign corporations acquiring the shares of a Canadian corporation in a share-for-share exchange use an "exchangeable share" structure to provide tax-deferred treatment to the Canadian corporation's Canadian-resident shareholders. Essentially, the Canadian shareholder exchanges the share of the existing Canadian corporation for an "exchangeable" share of a Canadian subsidiary of the foreign corporation. The exchange can occur on a tax-deferred basis for Canadian purposes (since the exchangeable share is issued by a Canadian corporation), and the exchangeable share is the economic equivalent of a share of the foreign corporation, entitling the holder to the same dividends as are paid on the foreign corporation's share and to exchange the exchangeable share for a share of the foreign corporation on demand. The Canadian-resident shareholder can thereby defer Canadian taxation of accrued gains until the exchangeable share is exchanged for the share of the foreign corporation.

Enactment of the new proposed rollover (plus the repeal of the foreign property rules announced in the budget) would take away some but not all of the benefit associated with exchangeable share structures. In particular, exchangeable share structures provide favorable tax treatment to Canadian holders receiving dividends from a Canadian corporation, compared with dividends from a foreign corporation. It is unclear whether that proposed rollover (in whatever form it ultimately takes) would eliminate the use of exchangeable share structures.

Income Trusts

As noted above, income trusts have dominated Canadian capital markets in the past few years. All manner of businesses have been effectively removed from corporate form for tax purposes and put into business income trusts, such that the income from the business is paid out to investors without corporate-level tax having been paid. The 2004 federal budget contained various proposals directed at the potential for tax revenue loss as a result of the proliferation of income trusts, and in particular sought to limit the investment of pension funds and similar tax-exempt entities in income trusts.

After vigorous opposition from pension funds and the income trust industry, the most serious proposals in the 2004 federal budget were deferred, pending further study and consultation. The 2005 budget reiterates that further study of income trusts "and other flow-through entities" will continue and that Finance will release a consultation paper shortly for further comment and discussion. Clearly the government is concerned about the potential for erosion to the corporate tax base through the use of income trusts and limited partnerships (which as noted above are particularly efficient flow-through vehicles from a tax perspective). The tax community will be interested to see what the Department of Finance has in mind in that area.

Other Pending Legislative Proposals

Finally, the 2005 budget refers to a number of other previously announced tax measures, in particular the fourth draft (dated October 30, 2003) of proposals dealing with "foreign investment entities" and nonresident trusts, which proposals were originally announced in 2000, and the second draft of various tax technical amendments (including important changes to the foreign affiliate and foreign accrual property income rules) released on February 27, 2004. The new budget states that legislation implementing those proposals will be introduced at a "suitable time, consistent with other legislative priorities" — wording that does not suggest imminent activity.

Personal Income Tax Measures

Canada's income tax system for individuals is a progressive one, with federal rates increasing from 16 percent up to 29 percent as taxable income increases. Effectively, no tax applies below a specific threshold of taxable income (the "basic personal amount"), which is being increased under the 2005 budget from about C $8,000 to C $10,000 by 2009. The budget would also increase the tax credit for dependent spouses, common-law partners, and wholly dependent relatives. The government estimates that those proposals (when fully implemented) will remove over 800,000 low-income individuals from the tax rolls.

To encourage individuals to save for their retirement, the tax system also allows individuals to claim a tax credit for contributions they make to tax-exempt personal retirement savings accounts (RRSPs), up to a limit of C $16,500 per year. The 2005 budget would increase the contribution limit to C $18,000 for 2006, with subsequent increases to C $22,000 by 2010 (thereafter the limit will be indexed to inflation). Corresponding changes are proposed for similar retirement savings vehicles. RRSPs (along with various other tax-exempts) will also benefit from the elimination of the foreign property limitation described above. Moreover, RRSPs and similar entities are also now being permitted to purchase investment-grade gold and silver coins, bars, and certificates.

Other personal tax proposals in the budget include:

- various enhancements to the tax credit for disabled individuals;
- expansion of the range of expenses eligible for the medical expense tax credit and a doubling of the maximum amount of tax-credit-eligible expenses for caregivers paying medical or disability-related expenses on behalf of dependent relatives; and
- a new tax credit for expenses incurred in the course of adopting a child.

Goods and Services and Excise Taxes

The 2005 budget also includes relatively minor changes to the federal goods and services tax, which will also generally apply to those provinces whose sales taxes have been harmonized with the federal GST. Most notably, as an extension of the existing rule making a director of a corporation personally liable for a corporation's unremitted net GST, the budget would expand director liability to any GST net tax refund amounts (but not rebates) received by the corporation to which it is not entitled, applicable to refunds received after the passage of legislation. Personal liability applies only when the director has failed to exercise due diligence.

Also, a publicly accessible Web-based GST registry will be established, allowing users to verify a supplier's GST registration. The 83 percent GST rebate for hospitals will be expanded to eligible charities and nonprofit organizations that provide healthcare services similar to those traditionally performed in hospitals effective January 1, 2005. Finally, the 10 percent excise tax on jewelry will be eliminated, with an immediate 2 percentage point reduction followed by successive 2 percentage point rate reductions over the next four years. ◆