2003 FEDERAL BUDGET TAX HIGHLIGHTS

On February 18, 2003, the Minister of Finance released a number of proposed tax changes. We summarize the more significant ones in this commentary.

Standby Charge for Cars

When an employee uses a corporate car, a taxable benefit (called the standby charge) is applied to the employee to represent the personal benefit of having the use of that car. This applies whether the car is owned or leased. The annual taxable benefit is 24% of the corporation's cost of the car or two-thirds of the lease cost.

At present, the standby charge may be reduced when the personal use of the car is less than 12,000 km per year and the car is used all or substantially all (generally meaning 90% or more) for business purposes. This is a high threshold, since a trip to work and back is considered to be personal not business usage. Most persons are therefore unable to reduce the standby charge, leading to a far greater taxable benefit than is deserving.

The Budget proposes to correct this. The standby charge will be reduced on a pro-rata basis if the annual personal driving does not exceed 20,000 km and the automobile is used primarily (more than 50%) for business purposes.

This will completely change the economics of employees using company cars, especially for luxury vehicles.

We will include a comprehensive article on the company car in the next edition of Tax Perspectives.

Small Business Deduction

Canadian-controlled private corporations (CCPC) have enjoyed a reduced federal tax rate on up to $200,000 of active business income annually. The amount eligible for this so-called small business deduction was set at $200,000, and has not been increased since the 1980's. The budget proposes to increase this amount by $25,000 per year, starting in 2003, to reach $300,000 by January 1, 2006. For taxation years straddling January 1, the increased amount will be pro-rated.

It has been general practice to keep active business income of a CCPC to under $200,000 annually. Now, the practice will be to match the increased limits. The Province of Ontario currently has a threshold of $300,000 for its small business deduction. Therefore, as of January 2006, the federal and Ontario rates will be in harmony. Other provinces have similarly higher thresholds, with British Columbia and Saskatchewan at $300,000; Alberta, at $350,000 (moving to $400,000); and Manitoba and New Brunswick moving to $400,000.

Clearly, the federal change was long overdue and is welcome. A bolder approach would have been even more welcome.

Federal Capital Tax

At present, there is a federal capital tax of .225%. While this is a small percentage, the tax is $225,000 on taxable capital of $100 million. This tax is not deductible. Capital taxes have long been criticized as an impediment to business, especially in capital intensive industries, because they are payable regardless of profitability.

The Budget proposes to eliminate the federal capital tax over five years. The rate will be decreased by .025% per year, from 2004 to 2007, and from there will be eliminated entirely as of January 1, 2008.

At present, corporations have an exemption of $10 million of taxable capital. This exemption will be increased to $50 million effective for taxation years ending after 2003, so that if a corporation's taxable capital is less than $50 million, there will be no federal capital tax.

Corporations with taxable capital over $10 million could consider a change of year-end. If the fiscal year finishes in 2004 not 2003, the $50 million exemption will be available to reduce capital tax. The savings is up to $90,000.

Note that a corporations' taxation year does not necessarily have to coincide with its fiscal year for accounting purposes. This could apply in situations where there are subsidiaries with high taxable capital that have different year-ends than the parent company.

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Interest Deductibility

In the Budget, it states that legislative amendments are going to be considered with regard to interest deductibility. It appears that the government is not pleased with recent Supreme Court cases such as Ludco and Singleton, where the taxpayer was able to claim interest expense as a deduction. In Ludco, interest was held to be deductible where it was used to finance an offshore tax shelter, the income from which was not taxable except indirectly as a capital gain. In Singleton, a home mortgage was made tax-deductible by a sequence of financing transactions.

The Budget states that the results of these cases are not "consistent with appropriate tax policy." At this point, no specific amendments have been proposed. However, amendments were drafted about 10 years ago to deal with these issues but they have been held in limbo since their release and were never passed into law. Perhaps these amendments will now be acted upon.

Share-for-Share Exchanges

If a Canadian resident owns shares of a Canadian corporation and exchanges these for shares of an other Canadian corporation (say in a takeover bid), this can be done on a tax-free basis. Ironically, shares of a foreign corporation may be exchanged for shares of another foreign corporation (or of a Canadian corporation) tax-free as well. In both cases, tax is paid when the shares are ultimately sold (e.g., sold in the market for cash). However, shares of a Canadian corporation cannot be exchanged for shares of a foreign corporation without immediate tax. This has made it difficult for Canadian corporations to enter world markets through share for share exchange transactions, especially where the shares are closely held by Canadian residents.

The government is proposing to look at rules to allow a Canadian/foreign share-for-share exchange on a tax deferred basis in specific situations as long as it still protects Canada's tax base. Look for draft legislation in the near future.

Tax Shelters

At present, a tax shelter is defined as any property in respect of which it is represented that a potential purchaser will be able to claim, within four years, deductions from taxable income which equal or exceed the net cost of the property. If a property is deemed to be a tax shelter, then there are a number of filing requirements for the promoter of the tax shelter. The Budget has proposed to expand the types of arrangements that would be considered tax shelters.

The main target of this is donation tax credit schemes. These have evolved in a number of ways, including the use of loan arrangements. Perhaps the government now believes that it will be more difficult to challenge donations schemes than was once believed, and that new legislation is the only answer.

The amendments to tax shelter rules apply to gifts, contributions and representations made after February 18, 2003.

Other Proposals

Listed below are some other brief points of interest.

- RRSP limits will be increased in 2003 to $14,500 and will then increase by $1,000 per year until 2005, and increase $1,500 in 2006.

- There was some easing of the rules on the capital gains rollover for small business shares. These rules allow a gain on the sale of small business shares to be deferred if the proceeds are reinvested. The rules are very stringent and not applicable to most situations.

- For R&D investment tax credit purposes, the 35% tax credit rate is currently phased out where taxable income in the previous year exceeds $200,000. Now it will be phased out where taxable income in the previous year is between $300,000 and $500,000. This will apply to taxation years that end after 2002. This offers more flexibility to corporations and their shareholders in planning a corporation's income level, and is consequential on the increase in the small business deduction.

The ***2003 Federal Budget Tax Highlights*** is a supplement of ***Tax Perspectives*** which is published quarterly by the Tax Specialist Group (TSG). The TSG Web site address is www.taxspecialistgroup.ca. Enquiries may be directed to any member firm.