Tax Bulletin

March 2004

Canadian Minister of Finance Tables 2004 Federal Budget

On March 23, 2004, the Canadian federal government tabled its 2004 Budget. This year marks the seventh year in a row that the federal government has successfully balanced its books.

The contents of this year's Budget were strongly influenced by the current Canadian political climate. The Budget was released in the wake of a government spending scandal, complete with allegations of corruption and gross financial mismanagement. The federal government is also expected to call an election later this year and no doubt did not want to further raise the ire of the Canadian electorate by introducing a large number of controversial new initiatives.

The highlights of the Budget include the following:

Investment in Income Trusts Restricted

Over the last several years, business income trusts have assumed a prominent position on the Canadian public markets landscape. The increasing popularity of income trusts has been fuelled by the desire on the part of investors for yield-based investments offering improved tax efficiencies relative to traditional equity market investments.

Recent academic studies have estimated federal government revenue losses at Cdn$500 million per year as a result of the proliferation of income trusts (although internal estimates prepared by the Canadian Department of Finance indicate that the annual loss in tax revenue attributable to the emergence of business income trusts currently falls somewhere between Cdn$40-60 million).

To date, relatively few tax-exempt pension funds have invested in business income trusts because of lingering uncertainty over whether unitholders may be liable for the debts and obligations of a trust. However, given the anticipated introduction of legislation granting limited liability to unitholders of trusts, the federal government apparently felt it necessary to guard against the increased revenue losses that would arise if pension funds became active investors in the business income trust market.

Accordingly, beginning after 2004, registered pension funds will generally be required to abide by the following investment limitations:

(a) The total book value of all investments held by a registered pension fund in business income trusts must not exceed 1% of the book value of all of the pension fund's property; and

(b) The fair market value of investments in any particular class of units of a business income trust held by a registered pension fund must not exceed 5% of the fair market value of the entire class of units of the trust.

The value of investments in business income trusts that exceed either of the above thresholds will be subject to a monthly penalty tax equal to 1% of the value of all such excess amounts. Temporary relief will be granted to registered pension funds that held investments in business income trusts prior to the date of the Budget and certain types of business income trusts, including real estate investment trusts, will be excluded from the ambit of the new rules.

Taxation of Investments in Mutual Funds by Non-Residents

The government has asserted that non-residents that invest in "taxable Canadian property" (e.g., real property situated in Canada) should be taxed in a uniform manner, regardless of whether they invest directly in "taxable Canadian property" or in a Canadian mutual fund that owns "taxable Canadian property". New rules introduced in the Budget will provide that distributions made by a mutual fund to non-resident investors out of gains earned on the disposition of "taxable Canadian property" will be subject to Canadian withholding tax. Similarly, tax-free distributions made to non-resident investors by mutual funds that are listed on a prescribed stock exchange and derive their value principally from Canadian real property, Canadian resource property or timber resource property will generally be subject to a 15% withholding tax at source. Special rules will allow for a refund of the latter withholding tax where interests in the mutual fund are subsequently sold at a loss by a non-resident investor.

Capital cost allowance rates increased

The *Income Tax Act* (Canada) (the "**Tax Act**") permits taxpayers to claim capital cost allowances ("**CCA**") in respect of capital property used in carrying on a taxpayer's business. CCA serves as the functional equivalent of a depreciation deduction and is computed by applying a prescribed rate to the undepreciated capital cost of an asset.

The Budget proposes to increase the CCA rate applicable to computer equipment from 30 to 45 per cent and the rate applicable to broadband, Internet and other data network infrastructure equipment from 20 to 30 per cent.

Business loss carry-forwards extended

The Tax Act permits taxpayers to "carry-forward" certain losses and credits incurred in past taxation years to offset taxable income earned in a current year.

The Budget proposes to extend the period in which most taxpayers can carry-forward certain amounts, including non-capital losses and unused foreign tax credits, from 7 years to 10 years.

Clarification of the General Anti-Avoidance Rule

A general anti-avoidance rule was added to the Tax Act in 1988 (the "**GAAR**"). The GAAR is designed to distinguish between legitimate and abusive tax planning and serves to disallow tax benefits derived from avoidance transactions.

The Budget clarifies that the GAAR also applies to disallow tax benefits that result from a misuse or abuse of the provisions of the Income Tax Regulations, the Income Tax Application Rules, and Canada's tax treaties.

Deductibility of fines and penalties disallowed

Recently, the Supreme Court of Canada affirmed that a taxpayer was entitled, when computing its taxable income, to deduct fines and penalties that it incurs in the course of conducting its business activities. The government has asserted that to allow a deduction for a fine or penalty imposed on a taxpayer by a public authority diminishes the disincentive to engage in the impugned activity and, therefore, is contrary to public policy.

Accordingly, the Budget proposes to deny the deductibility of any fine or penalty imposed by law (including federal, provincial, municipal and foreign laws) after March 22, 2004.

Mineral exploration credit extended to end of 2005

In October 2000, the federal government introduced a temporary 15% tax credit for mineral exploration to moderate the impact of the global downturn in exploration activity on mining communities across Canada. The Budget proposes to extend the tax credit program until December 31, 2005.

Further tax reductions for Canadian–controlled private corporations

The government announced that it will accelerate the scheduled increase in the small business deduction limit applicable to Canadian-controlled private corporations ("**CCPCs**") from $250,000 in 2004 to $300,000 in 2005 and later taxation years. The small business deduction reduces (to 13.1 per cent) the basic federal corporate income tax rate that is applied to qualifying portions of the active business income of a CCPC.

Regulatory Reforms in the Charitable Sector

The Budget introduces a new, comprehensive regulatory framework aimed at solidifying public trust in the integrity of the charitable sector. The new framework announced in the Budget includes a new compliance regime, a more accessible appeals regime, enhanced transparency through improved disclosure, and changes to the disbursement quota applied to charitable organizations.

Tax Changes for Individuals

The Budget introduces further tax measures that will specifically affect individual taxpayers. These measures relate to deductions for disability support and attendant care, education tax credits, and the improved tax treatment of registered education savings plans and the Canada Education Savings Grant.

Cross-Border Share for Share Exchanges

Consistent with the federal government's initial announcement in October, 2000, the government re-iterated in the Budget that it intends to release detailed proposals permitting tax-deferred, cross-border share for share exchanges.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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