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Federal Budget – March 23, 2004

BUDGET HIGHLIGHTS

On March 23, 2004, Finance Minister Ralph Goodale delivered his first budget speech. The Budget proposes certain targeted tax measures, without changing any personal or corporate tax rates. Such tax measures include:

- an earlier phase-in of the \$300,000 business limit for small businesses,
- an increase in the carry-forward period of business losses and foreign tax credits,
- a relaxation of the rules for the availability of enhanced scientific research and experimental development benefits,
- improvements to the tax regime for disabled persons, and
- enhanced education assistance for lower income families.

The Budget is particularly noteworthy for registered charities, as it proposes numerous reforms to their administration and compliance under the Income Tax Act (the “Act”). The Budget also severely curtails the ability of pension funds to invest in the burgeoning business income trust sector.

The highlights of the tax changes announced in the Budget, are summarized below. In addition, this commentary highlights recent Ontario tax changes, recent noteworthy tax court decisions and other items of interest.

BUSINESS TAX MEASURES

Small Business Deduction Limit Accelerates to \$300,000 for 2005

The 2003 federal budget implemented a phased increase in the small business deduction limit, from \$200,000 in 2002 to \$225,000 in 2003, \$250,000 in 2004, \$275,000 in 2005, and \$300,000 in 2006 and subsequent years. This Budget proposes that the increase in the limit to \$300,000 be accelerated by one year; therefore, the limit will be \$300,000 for 2005 and subsequent years. The limit will be pro-rated, where the taxation year of the corporation does not coincide with the calendar year.

The revised combined federal and Ontario corporate tax rates, which reflect both the proposed federal Budget change and the recent Ontario changes, are reflected in the table on page 15.

Association Rules for SR&ED Purposes Relaxed

Currently, the federal government provides significant income tax incentives to smaller Canadian-controlled private corporations (“CCPCs”) performing scientific research and experimental development (“SR&ED”) in Canada. Eligible corporations may earn investment tax credits (“ITCs”) of 35% on qualifying SR&ED expenditures of up to \$2 million. The ITCs can be utilized against the income tax liability of the corporation, or, in certain cases, the corporation may get a refund of the ITCs. The \$2 million expenditure limit, however, must be shared by an associated group of companies.

Two corporations are considered to be associated if one controls the other, or both corporations are controlled (in law or in fact) by the same person or group of persons (whether or not such group of persons are related). This rule may cause unintended results for some SR&ED intensive corporations, that are considered to be associated solely because of independent investments made by the same group of otherwise unconnected investors, such as venture capitalists.

To remove this impediment, effective March 22, 2004, the Budget proposes that, for the purposes of the SR&ED benefits only, two corporations will not be considered to be associated where there is at least one shareholder of the particular corporation who is not a shareholder of the other corporation. In order for this rule to apply, the Minister of National Revenue must be satisfied that the existence of a shareholder of the particular corporation who is not a shareholder of the other corporation is not simply for the purpose of gaining multiple access to the \$2 million expenditure limit. The proposed rule would not, however, apply where a group of persons act in concert to control each of the particular corporations.

Carry-forward Period for Non-capital Losses and Foreign Tax Credits

The Budget proposes to extend the carry-forward period from 7 years to 10 years for non-capital losses that arise in taxation years that end after March 22, 2004. The Budget also proposes a similar extension in respect of unused foreign tax credits.

Increases in Rates for Capital Cost Allowance (“CCA”)

The CCA rates for computer equipment and data network infrastructure equipment have been increased from 30% to 45% and from 20% to 30%, respectively. Data network infrastructure equipment is equipment that supports advanced telecommunication applications (e.g. switches, multiplexers, routers, hubs, modems and domain name servers), but does not include office equipment such as fax machines, telephones or cell phones, or property such as wires, cables or structures. The new rates will apply for assets acquired after March 22, 2004.

The Budget further proposes that the separate class election, which facilitates the recognition of a terminal loss, will no longer be available with respect to the computer equipment eligible for the

increased 45% CCA rate. For computer equipment acquired before 2005, however, taxpayers may elect to include the equipment in Class 10 (which is subject to the 30% CCA rate), in order to be eligible for the separate class election.

Fines and Penalties

The Budget proposes to disallow deductions for fines and penalties imposed after March 22, 2004 under a law of Canada, a province or a foreign state, other than penalty interest imposed under the Excise Act, the Air Travellers Security Charge Act, and the GST/HST portions of the Excise Tax Act.

Trading Charitable Donations

Corporations can carry forward unclaimed charitable donations made in a particular year for up to five subsequent taxation years. In order to counter charitable donation trading between corporations, the Budget proposes that, where control of a corporation has been acquired, its unused charitable donation deductions will not be available to be carried forward to future taxation years ending after its acquisition. In addition, in order to prevent avoidance of this rule, it is proposed that charitable donation deductions not be available to a corporation in respect of a gift made after the time of an acquisition of control, if the gifted property was acquired by the corporation before the acquisition of control, under an arrangement whereby it was expected that control of the corporation would be acquired and the gift would be made. These amendments will apply to gifts made after March 22, 2004.

Affiliated Persons Rules and Trusts

The government believes that the current “affiliated persons” rules, which restrict losses otherwise incurred on transfers between affiliated persons, do not deal comprehensively with trusts. Under the present regime, a taxpayer might be able to prematurely claim a loss on a transfer of property to a trust, of which he or she is the sole beneficiary, but not the trustee. On the other hand, true economic dispositions of property involving trusts may be denied in some situations.

The Budget proposes that, after March 22, 2004, a trust will be affiliated with any of its beneficiaries who is entitled to a majority of the trust’s income or capital, and generally, with any person affiliated with such a beneficiary. Special rules apply to discretionary trusts. The Budget also proposes legislation to have two separate trusts be affiliated for tax purposes in certain situations.

The proposed changes will ensure that the loss deferral rules, as they currently apply to dispositions involving individuals, corporations and partnerships, apply as intended to property dispositions involving trusts.

Restrictions on Ability of Certain Pension Funds to Invest in Business Income Trusts

The Budget proposes to significantly restrict the ability of pension funds, which are tax-exempt entities, to invest in business income trusts. The proposal is in response to the government's concern that impending changes to securities legislation, designed to provide limited liability to investors of income trusts, may make business income trusts more popular with pension funds, resulting in a significant loss of tax revenues.

In recent years, business income trusts have become a popular investment vehicle for taxpayers in Canada. Business income trusts invest in assets that provide a return based on the revenues of an active business, and the trust distributes its earnings to its unitholders to be taxed in their hands, rather than in the trust. Where the unitholder is not a tax-exempt entity, the tax at the unitholder level largely replaces the tax that would have applied had the business been carried on by a corporation. However, where the unitholder is a tax-exempt entity, which is not permitted to invest directly in the business carried on by the income trust, the income distributed to it from the income trust is not subject to tax.

The Budget proposes two measures to limit the investment in business income trusts by a pension fund:

- Firstly, restricted investment property holdings of pension funds will be limited to not more than 1% of the book value of the fund's assets. Excess restricted investment property holdings will be subject to a 1% per month penalty tax. Restricted investment property will include direct holdings (units and debt) of business income trusts, as well as holdings of investment vehicles such as mutual fund trusts, which in turn have invested in business income trusts. Holdings in an investment vehicle will be restricted investment property, if more than 1% of its holdings consist of restricted investment property.
- Secondly, investment by pension funds will be limited to no more than 5% of the units of any particular business income trust. Excess holdings in any given business income trust will also be subject to a 1% per month penalty tax, based on the fair market value of the excess units held.

Restricted investment property will not include investments in resource royalty trusts and real estate investment trusts ("REITs"), since pension funds are permitted to invest directly in the types of properties held by those entities.

The proposals apply to pension funds that are registered pension plan ("RPP") trusts, RPP corporations or tax-exempt pension investment corporations. The proposals do not apply to registered retirement savings plans ("RRSPs") and registered retirement income funds ("RRIFs").

The proposed penalty taxes will apply after 2004. Existing investments by pension funds in business income trusts will be given transitional relief for 10 years in the case of direct holdings in business income trusts, and 5 years in the case of indirect investments, such as pooled investment vehicles and other mutual funds.

Improved Information Reporting by Trusts

To improve income tax compliance by investors, trusts will be required to identify on tax information

reporting slips the portion, if any, of a distribution that will give rise to an adjustment in the cost base of the beneficiary's interest in the trust, commencing with the trust's 2004 taxation year.

Investment Through Mutual Funds by Non-Residents

To ensure that non-residents who invest in taxable Canadian property ("TCP") through a Canadian mutual fund are subject to Canadian tax on gains that would have been taxable in Canada had the non-resident invested in the TCP directly, the Budget proposes to tax TCP gain distributions and certain other distributions, as discussed below. TCP includes real property situated in Canada, shares of the capital stock of private corporations, certain partnership interests, and certain Canadian resource property and timber resource property.

Taxation of TCP Gain Distributions

Distributions of gains on the disposition of TCP after March 22, 2004 by a Canadian mutual fund will be treated as Canadian-source trust income if the mutual fund is a trust, or as a taxable dividend if the mutual fund is a corporation. Therefore, such distributions will be subject to Canada's 25% non-resident withholding tax regime (reduced by a tax treaty, if applicable).

Withholding on Otherwise Non-Taxable Distributions

Certain otherwise tax-free distributions made after 2004 by Canadian mutual funds to their non-resident investors will be subject to withholding tax of 15%. This withholding tax will apply to distributions made on units or shares of Canadian mutual funds that are listed on a prescribed Canadian or foreign stock exchange, where the value is principally attributable to Canadian real estate or Canadian resource property.

Losses on Disposition

Where a non-resident investor realizes a loss on disposing of an investment in an exchange-traded Canadian mutual fund, in respect of which the investor has paid the new tax on distributions, the investor can file a special Canadian income tax return to claim a refund of some or all of the tax withheld.

PERSONAL TAX MEASURES

Fairness Requests

The Budget proposes that Fairness Requests made after 2004 be limited to taxation years that end within the last ten calendar years. This measure applies to Fairness Requests by individuals and testamentary trusts to waive or cancel penalties or interest, to have a late-filed return accepted, to allow a reassessment beyond the normal reassessment period (generally 3 years) in order to provide for an income tax refund, and to allow the late-filing, amending, or revocation of elections. This measure will come into effect after 2004 in order to give taxpayers an opportunity to review their records and, if needed, request adjustments based upon the current law which extends back to the 1985 taxation year.

Mineral Exploration Tax Credit

In October 2000, the Government introduced the mineral exploration tax credit, which is a 15% non-refundable credit of a corporation's "specified grass roots mineral exploration expenses" incurred in Canada and renounced to an individual under a flow-through share agreement. The Budget proposes to extend the expiry date from December 31, 2004 to December 31, 2005.

Tax Fairness for Persons with Disabilities

The Budget proposes to replace the attendant care deduction with a broader disability supports deduction. The disability supports deduction will recognize attendant care as well as other disability supports expenses incurred for education or employment purposes, unless they have been reimbursed by a non-taxable payment, such as an insurance payment. The deduction for disability supports amounts will be limited to the individual's earned income for the year. Currently, such expenses may be claimed under the attendant care deduction, or as a non-refundable medical expense tax credit.

The list of eligible disability supports expenses will include expenses that presently qualify for the attendant care deduction, and will also include certain other disability related supports expenses, such as amounts paid for optical scanners, electronic speech synthesizers, teletypewriters, real-time captioning services, and sign language interpretation services incurred for the purpose of education or employment of individuals who are blind or who have speech or hearing impairments. In addition, certain other devices or services, such as note-taking services, voice recognition software, tutoring services, and talking textbooks, which are used by individuals with mental or physical impairments or learning disabilities, will qualify, provided the need for the device or service is certified by a medical practitioner.

The value of the refundable medical expense supplement ("RMES") will be equal to 25% of allowable expenses claimed under the medical expense tax credit and the new disability supports deduction. For 2004, the maximum limit of the RMES will be \$562, indexed for future years.

The Budget proposes to allow caregivers to claim medical and disability related expenses that they incur on behalf of dependant relatives, without being restricted by a threshold based on the dependant's

income (known as the “notch provision”). The amount of medical expenses that a caregiver is eligible to claim on behalf of a minor child will be pooled with the medical expenses of the caregiver, subject to the caregiver’s minimum expense threshold (the lesser of 3% of the caregiver’s net income and \$1,813 for 2004). For medical expenses paid on behalf of other dependant relatives (e.g. a parent, grandparent, sibling, non-minor child/grandchild, or niece/nephew), caregivers will be able to claim qualifying medical expenses paid on behalf of such dependant that exceed the lesser of 3% of the dependant’s net income and \$1,813. The maximum eligible amount that can be claimed on behalf of dependant relatives, other than minor children, will be \$5,000.

These measures will apply to the 2004 and subsequent taxation years.

Education

Education Tax Credit

The education tax credit cannot currently be claimed by students who pursue post-secondary education that is related to their current employment. In order to facilitate the pursuit of job-related learning, the Budget proposes to remove this restriction commencing in 2004, provided that no part of the education costs is reimbursed by the employer.

Canada Learning Bond (“CLB”)

Effective January 1, 2004, the Budget proposes to introduce the new CLB, to provide a source of education savings for children in low-income families. Each child born on or after January 1, 2004 will be eligible for a CLB in each year that the child’s family is entitled to the National Child Benefit (“NCB”) supplement, which is a component of the Canada Child Tax Benefit.

An initial CLB of \$500 will be provided to each child under 16 years of age for the first year in which the family is entitled to the NCB supplement. Any subsequent CLB will be in the amount of \$100 for each child under 16 years of age, for each year in which the family is entitled to the NCB supplement. Therefore, a child in a low-income family can receive cumulative CLB payments of up to \$2,000.

The CLB will only be payable into an RESP of which the child is a beneficiary. While any person can subscribe to an RESP for the benefit of the child, only the primary caregiver of the child can request that the CLB be payable into the RESP. The CLB will not be taken into account in calculating annual and lifetime RESP or Child Education Savings Grant (“CESG”) contribution limits. No CESG will be paid on CLB amounts placed in an RESP.

CESG

The Budget proposes changes to the CESG matching rate for contributions made to RESPs by low and middle-income families on or after January 1, 2005. Where a minor child is the beneficiary of an RESP, the first \$500 contributed to the RESP in the year will attract:

- a 40% CESG matching rate, if the child's family has qualifying net income in respect of the year of \$35,000 or less, or
- a 30% CESG matching rate, if the child's family has qualifying net income in respect of the year greater than \$35,000 but not exceeding \$70,000.

There is no carry-forward of unused access to the enhanced CESG, and all other contributions eligible for the CESG will continue to qualify for the 20% matching rate.

While it is proposed that these measures be effective starting January 1, 2005, the first payment of the enhanced CESG will be made after Royal Assent is obtained for the enabling legislation, and once delivery systems are put in place.

REFORMS FOR REGISTERED CHARITIES

The Budget proposes the following changes to the administration and compliance of registered charities:

- Currently, the only sanction available against a registered charity that does not comply with the requirements of the Act is the revocation of its registered charity status, no matter how small the infraction is. In order to limit the revocation of a registered charity to more severe cases of non-compliance, the Budget proposes a system of penalties and taxes applicable to registered charities, including the taxation of the gross revenue generated by a registered charity from prohibited activities that generate income, the suspension of a registered charity's tax-receipting privileges for using donated funds other than for charitable purposes, and monetary penalties for failure by a registered charity to timely file its annual information return, together with the publication of the names of late or non-filers. These penalties and taxes will apply to taxation years that begin after March 22, 2004.
- Currently, where a registered charity disagrees with the decision of the Canada Revenue Agency ("CRA"), its only recourse is to appeal the decision to the Federal Court of Appeal. The Budget proposes to make the appeals process more accessible and affordable, by creating an impartial CRA internal reconsideration process for matters affecting charities, and by allowing for appeals to be made to the Tax Court of Canada. In addition, the CRA's existing objection review process will be extended to certain disputes between a charity and the CRA. These measures will generally be effective after the later of December 31, 2004 and 30 days after Royal Assent.
- The Budget proposes that the Minister of National Revenue will be permitted to release additional

information to the public concerning registered charities, as well as disclose information concerning public organizations that have been denied registration as registered charities under the Act.

- Several changes will be made to the calculation of the “disbursements quota” of registered charities and charitable foundations. Firstly, the disbursements quota rate of a charitable foundation will be reduced from 4.5% to 3.5% of the fair market value of its capital assets (such as investments) that are not used directly in charitable activities or administration. Secondly, the 80% disbursements quota rate relating to proceeds from the disposition of capital endowment property, will be reduced by the lesser of 80% of the capital gain realized on the disposition of the property and 3.5% of the value of all property not used directly in charitable activities or administration. Thirdly, funds received by a registered charity from other charities will be taken into account in calculating its disbursements quota (other than for specified gifts and transfers of capital endowments), similar to the rules currently governing charitable foundations. Finally, all charitable organizations (not only charitable foundations) will be subject to the 3.5% disbursement obligation on their capital assets. These measures generally apply to taxation years that begin after March 22, 2004.

In addition to the foregoing, changes to the disbursements quota rules will apply to capital endowments transferred between registered charities, to gifts of RRSPs, RRIFs, or life insurance policies where the charity is a named beneficiary, and to capital endowments that are received and liquidated in the same year, effective for taxation years that begin after March 22, 2004.

OTHER TAXATION MEASURES AND ISSUES

General Anti-Avoidance Rule (“GAAR”)

GAAR as currently set out in the Act, is intended to prevent abusive or artificial tax avoidance schemes, without interfering with legitimate commercial and family transactions. The Budget proposes to clarify that GAAR will apply equally where there has been a misuse or abuse of the provisions of the Income Tax Regulations, Income Tax Application Rules, tax treaties involving Canada, and any proposed amendments thereto.

Tax Treatment of Savings

The 2003 federal budget announced that the government would consult with interested parties the appropriateness of tax pre-paid savings plans (“TPSPs”). The Budget announced that consultations regarding TPSPs are continuing and that a number of important issues have been raised.

Deductibility of Interest and Other Expenses

On October 31, 2003, the Department of Finance released for public comment draft proposals regarding the deductibility of interest and other expenses for income tax purposes. The proposals, if enacted, provide that a taxpayer will be considered to have a loss from a business or property for a taxation year only if, in that year, it is reasonable to expect that the taxpayer will realize a cumulative profit from that business or property, during the time that the taxpayer has carried on or held, or can reasonably be expected to carry on or hold, the business or the property. The proposals specifically provide that profit for this purpose does not include capital gains. These proposals are intended to have effect for taxation years beginning after 2004.

The Department intends to extend the period for making written submissions on these proposals until the end of August 2004.

Cross-Border Share-For-Share Exchanges

The October 2000 mini-budget undertook to consult with interested parties on the merits and technical design of a tax deferral provision that would, if implemented, apply in respect of cross-border share-for-share exchanges. It is intended that a detailed proposal be released for public comment in the coming months.

Limitation Periods for the Collection of Federal Tax Debts

On March 4, 2004, the Finance Minister announced his intention to propose changes to the Act and other acts that will, among other things, establish a 10-year (rather than 6-year) limitation period for the collection of federal tax debts. The government intends to place amendments before Parliament, in order to give effect to the changes proposed by the Finance Minister earlier this month.

ONTARIO TAX CHANGES – NOVEMBER 24, 2003

The Ontario government recently passed legislation that will cancel several tax reductions and tax relief programs that had been implemented by the previous government. The new legislation will generally result in increased corporate tax rates, while maintaining personal tax rates at the 2003 levels.

Ontario Corporate Income Tax

The general Ontario corporate income tax rate will be increased to 14% from the previous rate of 12.5%, and the manufacturing and processing rate will increase to 12% from the previous rate of 11%. The small business rate, however, which applies to active business income of CCPCs, will remain at 5.5% for 2004 and later years, while the income threshold to which this rate applies will be increased to \$400,000, commencing January 1, 2004. These new rates will be pro-rated for corporations whose fiscal year-ends straddle these effective dates.

Ontario Corporate Capital Tax

The previous government had announced, in the 2003 Ontario budget, that Ontario capital tax would be phased out over a five-year period, commencing with a 10% reduction to the capital tax rate (from 0.30% to 0.27%), effective January 1, 2004. This proposed reduction has been eliminated, and the rate will remain at 0.30% of taxable capital for 2004 and later years.

Ontario Personal Tax

The personal income tax rate reductions and the elimination of the first-tier 20% surtax, which were to take effect in 2004, have been cancelled. The Ontario personal tax rates will be maintained at the 2003 levels.

Taxable Income	2003 and 2004 Ontario Tax Rates *
\$ 0 to \$ 32,435	6.05%
\$ 32,436 to \$ 64,870	9.15%
\$ 64,871 and over	11.16%

* These rates do not depict the impact of the Ontario fair share health care levies.

Further personal tax changes include the elimination of both the Ontario Home Property Tax Relief for Seniors (“OHPTR”) and the Equity in Education Tax Credit (“EETC”).

The OHPTR had been passed into law in June 2003 by the previous government, but no payments were made to any individuals. The law was intended to help low or modest income seniors, by reimbursing to these seniors the education portion of their residential property tax. The current government has cancelled the implementation of this credit by revoking the legislation. Seniors will continue to be eligible to receive up to \$ 1,000 in annual tax credits (per household), under the existing Ontario Property and Sales Tax Credit regime, contained in the Ontario Income Tax Act.

The EETC, which came into effect in 2002, allowed parents an income tax credit for tuition paid to private schools. The EETC has been eliminated retroactive to January 1, 2003. In essence, the credit was a one-time tax break for parents for the 2002 calendar year.

RECENT COURT DECISIONS OF INTEREST

Several recent court decisions of interest are discussed below.

GAAR Not Applicable to Rollover of Land Inventory

William H. Loyens and Harry P. Loyens v. The Queen

The Tax Court of Canada (“TCC”) did not invoke the GAAR where the taxpayers transferred land inventory to a pre-existing partnership, then transferred their partnership interests to their corporations, and elected for both transfers to occur on a tax-deferred rollover basis. By transferring the land inventory to the partnership first, the taxpayers were able to circumvent the restriction on the tax-deferred transfer of land inventory to a corporation.

In considering whether the GAAR should apply to deny the tax-deferred rollovers, the TCC concluded that, although the primary purpose of the transactions was to obtain a tax benefit, the transactions were in accordance with normal business practices, and were entered into for bona fide purposes. The TCC also found that the purpose behind the restriction against the tax-deferred rollover of land inventory to a corporation is to prevent a real estate trader from converting income into capital gains. The taxpayers did not convert business income into a capital gain, but rather, utilized existing loss carryovers of the corporation. Therefore, the TCC held that the GAAR did not apply because there was no misuse of the provisions of the Act read as a whole, since the legislative intent behind the restriction had not been violated.

The CRA has appealed the TCC’s decision to the Federal Court of Appeal (“FCA”).

“De Facto” Control Resulted in Loss of the CCPC Status

Mimetix Pharmaceuticals Inc. v. The Queen

Several recent cases deal with the issue of “de facto” control, which is a factually driven concept.

The concept of “de facto” control is relevant in determining whether two or more corporations are associated and whether a corporation is a CCPC, which affects the availability of the small business deduction, the rate and refundability of scientific research and experimental development credits, and the availability of refundable tax on investment income. In addition, the CCPC status affects the ability of the corporation’s shareholders to claim a capital gain exemption in respect of a gain on the disposition of shares, as well as the ability of the corporation’s lenders and shareholders to claim an allowable business investment loss in respect of a loss incurred on the debt or shares of the corporation.

In the Mimetix case, the FCA held that Mimetix, a Canadian corporation, was not a CCPC, since it was factually controlled by its 50% U.S. corporate shareholder (“US Co”). The FCA found that US Co controlled the day-to-day operations of Mimetix, and controlled its fortunes by making all of its significant business decisions. The CEO of US Co was an officer and director of Mimetix, and he implemented decisions that the FCA believed should have been made by Mimetix’s Canadian president and by its board of directors. The FCA found that the Canadian president did not have the expected level of knowledge of Mimetix’s operations. In addition, transactions between Mimetix and US Co did not take place on ordinary commercial terms.

Cost of Client List and Related Interest Expense not Deductible to Employee

Thomas Gifford v. The Queen

The Supreme Court of Canada (“SCC”) recently denied a deduction in respect of amounts paid by an individual, who was employed by an investment brokerage firm, to purchase a client list, together with interest payments on the related debt. The amounts paid for the client list and the related interest expense were held to be non-deductible capital expenditures, made to create an enduring benefit for the taxpayer.

An employee is not permitted under the Act to deduct capital expenditures, by way of the capital cost allowance system (other than in respect of motor vehicles, aircraft, and musical instruments for employment use). In addition, while specific provisions of the Act provide for the deductibility of interest on debt incurred for the purpose of gaining or producing business or property income, there are no provisions permitting the deduction of interest on debt incurred for the purpose of earning employment income (other than interest on debt incurred to acquire a motor vehicle or an aircraft for employment use).

The SCC indicated that, unless a specific provision of the Act permits the deduction of interest expense, interest is generally considered to be a non-deductible capital expenditure. The SCC confirmed that, as a general rule, loan proceeds are considered financial capital of the borrower and interest is considered to be a payment on account of that financial capital, albeit that previous SCC decisions have not always held that interest expense is a capital expense. In the Gifford case, the SCC held that the interest payment was a payment on account of capital, since the borrowed funds were used to acquire a capital asset, namely the client list.

OTHER ITEMS OF INTEREST

Ontario Retail Sales Tax (“ORST”)

Every purchaser of tangible personal property is required to pay ORST at the rate of 8% of the fair value of the property. In most cases, a vendor is required to levy and collect the tax from its customers. In respect of each taxable sale, the vendor must show the tax separately from the sale price on all receipts and invoices. There are a few limited exceptions, whereby the vendor may show the ORST-included sales amount, as follows:

1. Rent charges for commercial parking spaces.
2. Goods and services provided by eating establishments under certain conditions.
3. Admission charges to view indoor or outdoor performances and entertainment.
4. Goods and services provided by any other industry authorized by the Ministry.

As a result, all purchasers of tangible personal property should ensure that all vendor invoices state the amount of ORST separately from the sales price, unless the items purchased fall into one of the exceptions stated above. For example, where material is delivered to a construction job site on a supply-only basis (as opposed to on a supply and install basis, where ORST is not charged provided the material is affixed to real property), the purchaser should ensure that the vendor separately shows the ORST on the invoice, rather than showing an ORST-included amount. If the tax is not shown separately or if the invoice indicates "tax included", the purchaser or the vendor could be held liable for the tax on the total amount.

Full Goods and Services Tax ("GST") Rebate for Municipalities

On February 3, 2004, the Finance Minister announced proposed legislation to provide that the GST rebate (or federal portion of the Harmonized Sales Tax) for municipalities will be increased to 100%. This proposal will be effective for purchases of goods and services by municipalities in respect of which tax becomes payable on or after February 1, 2004.

Most services provided by municipalities, including public transit, water and sewer services and road construction are exempt GST services. Consequently, the municipalities do not charge GST on most of the services they provide, and are not eligible to recover the GST paid on costs incurred in providing such services. Instead, municipalities are currently entitled to claim a 57.14% rebate of the GST paid on such costs. The proposal will increase this rebate to 100% of the GST paid.

In the first year alone, the higher rebate will provide additional funding for municipalities of about \$580 million. This amount will grow over time in line with municipal spending, and is estimated to provide municipalities with an addition \$7 billion over 10 years.

* * *

To discuss the impact of these tax matters on your business, please contact your partner at Goldfarb, Shulman, Patel & Co. LLP.

COMBINED FEDERAL AND ONTARIO CORPORATE TAX RATES

The following combined federal and Ontario tax rates will apply to corporations subject to Ontario tax:

		2003	2004	2005	2006
Small business rate on active income up to \$225,000*	Federal Ontario	13.12% <u>5.50%</u> 18.62%	13.12% <u>5.50%</u> 18.62%	13.12% <u>5.50%</u> 18.62%	13.12% <u>5.50%</u> 18.62%
Small business rate on active income from \$225,000 to 250,000*	Federal Ontario	22.12% <u>5.50%</u> 27.62%	13.12% <u>5.50%</u> 18.62%	13.12% <u>5.50%</u> 18.62%	13.12% <u>5.50%</u> 18.62%
Small business rate on active income from \$250,000 to 300,000*	Federal Ontario	22.12% <u>5.50%</u> 27.62%	22.12% <u>5.50%</u> 27.62%	13.12% <u>5.50%</u> 18.62%	13.12% <u>5.50%</u> 18.62%
Small business rate on active income from \$300,000 to 320,000*	Federal Ontario	24.12% <u>5.50%</u> 29.62%	22.12% <u>5.50%</u> 27.62%	22.12% <u>5.50%</u> 27.62%	22.12% <u>5.50%</u> 27.62%
Small business rate on active income from \$320,000 to 400,000*	Federal Ontario	24.12% <u>12.50%</u> 36.62%	22.12% <u>5.50%</u> 27.62%	22.12% <u>5.50%</u> 27.62%	22.12% <u>5.50%</u> 27.62%
M & P rate	Federal Ontario	22.12% <u>11.00%</u> 33.12%	22.12% <u>12.00%</u> 34.12%	22.12% <u>12.00%</u> 34.12%	22.12% <u>12.00%</u> 34.12%
General rate (active income not eligible for the small business rate)	Federal Ontario	24.12% <u>12.50%</u> 36.62%	22.12% <u>14.00%</u> 36.12%	22.12% <u>14.00%</u> 36.12%	22.12% <u>14.00%</u> 36.12%
Investment income	Federal Ontario	35.79% <u>12.50%</u> 48.29%	35.79% <u>14.00%</u> 49.79%	35.79% <u>14.00%</u> 49.79%	35.79% <u>14.00%</u> 49.79%

* These rates do not take into account the effect of the clawback of the Ontario small business deduction. The clawback applies where taxable income falls between \$320,000 and \$800,000 in 2003, and between \$400,000 and \$1,128,519 in 2004 and thereafter. The Ontario clawback rate is 4.67%.

In addition, the table does not take into account that a corporation's business limit for federal tax purposes is clawed back where the corporation, together with any associated corporations, had taxable capital, as computed for federal Large Corporation Tax purposes, in excess of \$10 million in the preceding year.