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Ontario Budget – May 11, 2005

BUDGET HIGHLIGHTS

On May 11, 2005, Ontario Finance Minister Greg Sorbara delivered the 2005 Ontario budget (the “Budget”). The Budget contains no broad based tax rate changes and projects a balanced budget by 2008-09 at the latest. The Budget proposes substantial increases to funding for post-secondary education and training. Other measures include promising more doctors and nurses, reduced waiting times for health care, and more funding for education from preschool to high school. In addition, major new investment initiatives in infrastructure include plans for roads, public transit, hospitals, schools, colleges and universities, 15,000 units of affordable housing and a proposed Research Council of Ontario to lead the province in research and innovation.

In summary, the Budget proposes the following tax and related changes:

- To allow non-voting shares of professional corporations of doctors and dentists to be owned by non-professionals (for example, family members), in order to facilitate income-splitting and estate freezes.
- To review and address aggressive arrangements designed to shift income from Ontario to lower tax provinces.
- To enhance tax credits for Ontario film and television production, computer animation, interactive digital media, sound recording and book publishing.
- To parallel recently announced federal measures to enhance the capital cost allowance rates on certain oil and gas equipment, assets used to generate efficient and renewable energy, and certain other assets.
- To parallel federal proposals to enhance the medical expense and disability tax credits, and to allow a non-refundable tax credit for adoption expenses.

- To introduce an optional method to calculate retail sales tax for small software businesses.

The highlights of the tax changes announced in the Budget are summarized below. In addition, this commentary highlights other items of interest.

BUSINESS TAX MEASURES

Professional Corporations

In 2001, the right to incorporate was extended to all regulated professionals. Under existing provisions, only professionals can own shares in a professional corporation.

Recent negotiations with the Ontario Medical Association have resulted in the Ontario government's commitment to extend the share structure of physician professional corporations to allow non-voting shares to be held by non-physicians, such as family members. The Budget also proposes to implement this change for dentists who operate their practices through professional corporations.

Tax Avoidance

The Budget indicated that the Ontario government is reviewing arrangements that are designed to avoid Ontario corporate income tax. This could occur, for example, where a transaction is undertaken to shift corporate income from Ontario to another province with a lower corporate tax rate. While there is a comprehensive set of federal income tax rules that address such arrangements in the international context, a limited set of tax rules exist at the provincial level. The Ontario government intends to discuss this issue with the other provinces and the federal government, with the objective of developing common rules to address aggressive inter-provincial tax planning arrangements.

Treatment of Corporations Incorporated Outside Canada

A corporation's liability for Ontario tax is based, in part, on whether the corporation is incorporated inside or outside Canada. The federal government and the other provinces apply a residency test, rather than basing liability for tax on the jurisdiction of incorporation.

To curb the avoidance of provincial tax that can result from this difference, it is proposed that the Ontario corporate tax liability will now be determined with reference to whether the corporation is a resident of (rather than incorporated in) Canada, effective for taxation years ending after May 11, 2005.

Ontario Film and Television Tax Credit ("OFTTC")

The OFTTC provides Ontario-based, Canadian-controlled production companies with a refundable tax credit on qualifying Ontario labour expenditures incurred in making eligible film and television productions.

To further encourage production activities in Ontario, the Budget proposes that the OFTTC rate be increased from 20% to 30% for labour expenditures incurred after December 31, 2004 and before January 1, 2010. The 10% regional bonus will continue to be available for filming outside the Greater Toronto Area (“GTA”). The enhanced credit for first-time producers on the first \$250,000 (up from \$240,000) of qualifying labour expenditures incurred after December 31, 2004 and before January 1, 2010 will be increased from 30% to 40%.

Ontario Production Services Tax Credit (“OPSTC”)

The OPSTC is a refundable tax credit for Ontario labour expenditures incurred by foreign-based and domestic film and television productions that are ineligible for the OFTTC.

The Budget proposes that the OPSTC rate be increased from 11% to 18% for labour expenditures incurred after December 31, 2004 and before April 1, 2006. The 3% regional bonus for filming outside the GTA will be eliminated for labour expenditures incurred after December 31, 2004.

Ontario Computer Animation and Special Effects Tax Credit (“OCASE”)

The OCASE is a 20% refundable tax credit for Ontario labour expenditures incurred by corporations in respect of digital animation and digital visual effects carried out in Ontario for use in film and television productions. At present, the OCASE tax credit is based on the lesser of Ontario labour expenditures and 48% of the cost of the production net of certain government assistance.

Effective for eligible expenditures after May 11, 2005, the Budget proposes to base the credit only on the Ontario labour expenditures in excess of certain government assistance reasonably related to those expenditures.

Ontario Interactive Digital Media Tax Credit (“OIDMTC”)

The OIDMTC is a 20% refundable tax credit, which is available to eligible corporations for qualifying expenditures incurred to create and market original interactive digital media products in Ontario.

To improve accessibility to the OIDMTC, the Budget proposes to relax the requirement that eligible corporations have a minimum 90% copyright ownership of an eligible product completed after May 11, 2005, provided that the product is not developed under a fee-for-service arrangement.

Ontario Sound Recording Tax Credit (“OSRTC”)

The OSRTC is a 20% refundable tax credit available to eligible Ontario sound recording companies for qualifying expenditures related to an eligible Canadian sound recording by an emerging Canadian artist or group. The Budget proposes to broaden the availability of the OSRTC for taxation years ending after May 11, 2005.

Ontario Book Publishing Tax Credit (“OBPTC”)

The OBPTC is a refundable tax credit for qualifying expenditures on literary works by new Canadian authors. The Budget proposes to allow an OBPTC to an eligible children’s author for his/her first three published works in each of the following categories: fiction, non-fiction, poetry and biography.

Capital Cost Allowance (“CCA”) Rate Changes

Ontario proposes to parallel recently announced federal changes to align the CCA rates with the useful life of assets, subject to federal implementation, as follows:

Asset Type	Current CCA Rate	Proposed CCA Rate
Hydrocarbon transmission pipelines	4%	8%
Petroleum pumping and natural gas compression equipment	20%	15%
Combustion turbines	8%	15%
Electricity transmission and distribution assets e.g. power lines, transformers and substation equipment	4%	8%
Wire and cable for telephone, telegraph or data communication (other than fibre-optic cable)	5%	12%
High-efficiency and renewable energy generation equipment, acquired before 2008 ¹	100%	100%
High-efficiency and renewable energy generation equipment, acquired after 2007 and before 2012	30%	50%

Distribution equipment of a district energy system and biogas production equipment will become class 43.1 assets, eligible for a 30% CCA rate. If acquired before 2012, the enhanced 50% CCA rate shown in the chart above will be available.

Resource Allowance

The resource allowance is a special deduction provided to corporations in the oil & gas and mining sectors. It is generally equal to 25% of resource profits, and is provided instead of allowing deductibility of Crown royalties.

The Budget proposes to clarify that income computed for Ontario purposes must be used in determining Ontario resource profits, effective for taxation years beginning after May 6, 1997. This amendment will prevent corporations from obtaining a double benefit, as a result of claiming both an Ontario incentive deduction and an additional resource allowance on that incentive.

¹ The 100% CCA rate applies only for Ontario purposes. For Federal purposes, the 2005 federal budget proposes to increase the CCA rate from 30% to 50%.

PERSONAL TAX MEASURES

Medical Expense Tax Credit (“METC”)

The Budget proposes to parallel the 2005 federal budget proposal to expand the list of expenses eligible for the METC. Please refer to the GSP 2005 Federal Budget Highlights for details.

Medical Expenses Incurred for Dependent Relatives

The Budget also proposes to parallel the 2005 federal budget to increase to \$10,000 (currently the limit is \$5,000) the amount eligible for the 6.05% non-refundable Ontario tax credit that may be claimed in respect of medical or disability-related expenses of each dependent relative, effective for the 2005 and subsequent taxation years.

Adoption Expense Tax Credit

The Budget proposes to follow the federal budget to allow a 6.05% non-refundable Ontario tax credit for eligible adoption expenses (to a maximum of \$ 10,000 in 2005, and indexed for future taxation years) incurred for adopting a child under age 18. Please refer to the GSP 2005 Federal Budget Highlights for a list of eligible adoption expenses.

Persons with Disabilities

The Budget proposes to implement a number of income tax changes contained in the 2005 federal budget that will benefit persons with disabilities and those who care for them. Please refer to the GSP 2005 Federal Budget Highlights for details.

Ontario Property and Sales Tax Credits for Seniors

The Budget proposes to increase the income threshold for eligibility for the full Ontario Property and Sales Tax Credit for seniors in 2005, in order to ensure that seniors receiving the guaranteed minimum level of Old Age Security income and other government supplements retain their full Ontario Property and Sales Tax Credits benefit.

ONTARIO RETAIL SALES TAX (“RST”) MEASURES

RST Simplified Calculation for Small Software Businesses

RST applies to the provision of non-custom computer software and certain software services. Where a software supplier enters into a contract which includes a combination of both taxable and non-taxable services, the supplier must determine the RST liability of the taxable components of the service contract.

To simplify the RST determination and collection for small software businesses, the Ministry of Finance will be proposing a pilot project that allows for an optional method of tax calculation for contracts that include both taxable and non-taxable services. Under this pilot project, participating businesses and purchasers may opt to apply a blended RST rate to the total contract price.

RST Exemption for Destination Marketing Fees

The Budget proposes that the temporary RST exemption for destination marketing fees on accommodations be extended for fees billed on or before June 30, 2006. The eligibility rules will remain unchanged.

Updating the RST Exemptions for Publications Purchased by Charitable Organizations and Educational Institutions

The Budget proposes that the RST exemption for publications produced or purchased by religious, charitable or benevolent organizations be updated to include CD-ROMs and DVDs used to promote the objects of such organizations. The exemption will also be extended for educational DVDs purchased by schools, school boards, community colleges, universities and public libraries. These changes will be effective for purchases made after May 11, 2005.

RST Exemption for Booster Seats

The Budget proposes to expand the current RST exemption for child car seats to include booster seats.

Use of Appraisals for Multijurisdictional Vehicle Tax

The Budget proposes that vehicle owners be permitted to use appraisals to establish a vehicle's value for RST purposes, when transferring their vehicles from multijurisdictional use to Ontario use. This proposal will apply to vehicles purchased after September 30, 2001 which are owned by the same person for more than 60 months, and where the pro-rated multijurisdictional vehicle tax was paid in lieu of the RST.

OTHER MEASURES

Initiatives to Encourage the Redevelopment of Brownfields

Crown liens have been identified as one of the barriers to the remediation of brownfields (i.e., underutilized industrial and commercial sites with potential environmental contamination). The Budget indicates that the Ministry of Finance will develop criteria for the removal of outstanding provincial tax liens on brownfields properties, and will also work closely with the federal government to co-ordinate the removal of outstanding federal liens. In addition, the Ministry of Finance will undertake proposed amendments to clarify program requirements for the Brownfields Financial Tax Incentive Program.

Tax Increment Financing

At the request of a number of municipalities, the government will explore the feasibility of introducing Tax Increment Financing as a new financial tool to promote urban regeneration.

Streamlining of the Tax Remissions Process

Currently, tax remissions must be considered by cabinet, upon the recommendation of the Minister of Finance. The Budget proposes to provide the Minister of Finance with the authority to approve tax remissions under \$10,000 that would be in the public interest. The Budget also proposes that the Minister of Finance be able to invoke a provision under the Ontario Income Tax Act that, if mutually agreed upon, would enable the federal Minister of National Revenue to grant remissions of Ontario personal income tax in certain circumstances.

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To discuss the impact of the Budget on your business, please contact your advisor at Goldfarb, Shulman, Patel & Co. LLP.

OTHER ITEMS OF INTEREST

Goods and Service Tax (“GST”) and Real Property Joint Ventures

It is common in the real estate sector for real property to be legally owned in the name of a corporation acting as "nominee" or "bare trustee" for the beneficial owner(s). This nominee corporation will generally take all action necessary to facilitate the acquisition, financing, leasing and sale of the particular property as an agent of the beneficial owner(s).

The Canada Revenue Agency ("CRA") will consider a corporation to be a "bare trustee" if the corporation's only function is to hold legal title to the real property, the corporation has no independent or discretionary powers in the decision-making related to the real property held in trust, and its only responsibility is to carry out the instructions of the principals. If all powers and responsibilities to manage the real property are those of the beneficial owner(s), the nominee corporation would not be permitted to register and account for the GST/Harmonized Sales Tax ("HST"), as it would not be engaged in a commercial activity in respect of the real property.

Under the general rules of the GST, a joint venture is not a person, and therefore, each of the participants in a joint venture must separately account for their pro rata share of the GST collected and paid in respect of the joint venture's sales and purchases. Alternatively, if a joint venture has elected to designate an operator for GST purposes, the operator would be responsible for the collection and remittance of GST/HST on behalf of the joint venture; consequently, the operator's GST number would be used on all of the joint venture's invoices and contracts.

It has recently become common practice for the vendor's lawyer to verify the purchaser's GST registration on the closing of the purchase and sale of real property that is subject to the GST (generally all real estate, other than used residential real property). If the bare trustee corporation is shown as the purchaser in the purchase and sale agreement, yet the GST number reflected belongs to the joint venture operator, the vendor's lawyer may determine that the GST number does not match the name of the purchaser, which could create a delay in the closing. This problem will likely intensify on the establishment of the publicly accessible web-based GST/HST registry that was announced in the 2005 federal budget.

If your business uses bare trustee corporations, please contact your advisor at Goldfarb Shulman Patel & Co. LLP to discuss this issue.

Common RST Issues

RST can apply in many situations which are commonly overlooked, particularly by businesses that are not required to charge RST. However, the failure of a business to properly address RST issues can lead to unfavourable assessments, interest, and penalties, in addition to the costs of dealing with such assessments. The following is a list of some common RST issues:

Out of Province Purchases

When a business purchases goods from an out-of-province vendor, which is not registered for Ontario RST, the purchaser must self-assess the RST for those purchases that would otherwise have been subject to the RST.

Inventory Taken for Own Use

Goods purchased for resale purposes are exempt from the RST at the time of purchase. A business, however, must self-assess and remit the RST on any goods removed from its inventory for its own use.

Obtaining Purchase Exemption Certificates (“PEC”)

PECs are used by organizations that are entitled to claim an exemption from RST on the purchase of taxable goods, taxable services, or entering into a contract of insurance or benefits plan. The most common use of a PEC is to enable a business to purchase goods and services for resale to others on a tax-exempt basis.

A vendor of taxable goods or services is required to obtain a PEC from its customer, prior to making RST exempt sales to that customer. Care must be taken to ensure a valid PEC is obtained, or the vendor may be assessed the RST on such sales. Where a blanket PEC is obtained from a customer, the PEC must be referenced in each contract or purchase order. The blanket PEC is valid for four years or until cancelled, whichever occurs first.

Incorrect Use of PECs

RST applies to purchases of equipment and other items (e.g. promotional material) that are for a business’s own consumption, unless it is specifically exempt (e.g. manufacturing equipment). Sometimes businesses mistakenly rely on their PECs to purchase such items RST exempt.

Sale of Fixed Assets

The disposal of fixed assets or non-inventory items to employees or third parties is considered to be a sale of tangible personal property (“TPP”). Consequently, a business is required to collect and remit the RST on such sales.

Out of Province Sales

Generally, Ontario vendors must register, collect and remit RST on the sale or license of TPP or the provision of taxable services to consumers in Ontario. While Ontario RST does not apply to out of province sales, the vendor should ensure that adequate evidence of delivery outside the province is retained, otherwise the vendor may be assessed the RST on such sales.

Out of Province Contractors

Where a contractor performs a real property construction contract in Ontario, the contractor is responsible for the payment of RST on the materials and labour used by the contractor to fulfill the Ontario contract. A purchaser is generally not required to pay RST on such contracts. However, as discussed below, where the contract is performed by a contractor located outside Ontario, the RST onus can shift to the purchaser.

A non-Ontario contractor is required to post security with the Minister of Finance (the “Minister”) for 4% of the total amount of a construction contract to be undertaken in Ontario. Upon receipt of the bond or deposit, the Minister will issue a letter of compliance to the non-Ontario contractor. If the non-Ontario contractor fails to comply with such requirements, the onus is on the contract principal (that is, the purchaser) to withhold and remit an appropriate amount from payments made to the non-Ontario contractor, in order to satisfy the non-Ontario contractor’s RST liability. If the purchaser fails to withhold from the contract payments, the purchaser then becomes liable for all taxes owing by the contractor on the project. Therefore, in dealing with non-Ontario contractors, it is advisable to have an agreement that requires the contractor to provide a copy of the compliance letter from the Minister.

Upon completion of the contract, a final accounting of the tax due by the non-Ontario contractor is required to be filed with the Minister, who will then issue a clearance letter to the contractor. A clearance letter must be obtained by the purchaser, prior to the release of the last contract payment. If the final payment is released by the purchaser without first having obtained the Minister’s clearance letter, the purchaser will become liable for any unpaid amount of the contractor’s estimated RST. Therefore, in dealing with non-Ontario contractors, it is also advisable to have an agreement that requires the contractor to provide a copy of the clearance letter from the Minister to the purchaser upon completion of the project.

Sales to First Nations Customers

Status Indians and Indian bands are generally exempt from paying RST on TPP and taxable services provided on or delivered to an Indian reserve. Sales tax authorities (both provincial sales tax and GST) have aggressively challenged vendors who have relied on their customer’s First Nations exemption. Therefore, businesses should ensure that such sales qualify for the exemption, that adequate evidence is retained to prove that the sales were being made to status Indians or Indian bands, and that the goods were delivered to the reserve or that the services were provided on the reserve.

Other

In addition to RST, care must be taken to ensure compliance with the sales tax regimes of other provinces (i.e. PEI, Saskatchewan, Manitoba, British Columbia and Quebec), the HST which applies to Nova Scotia, Newfoundland, and New Brunswick, and those of the individual US states and other jurisdictions where one's business operates. Where an Ontario vendor makes sales to customers in a jurisdiction outside of Ontario, such jurisdiction may require the vendor to register, collect and remit its local sales tax. The sales tax legislation of each jurisdiction must be reviewed to determine the requirements for non-resident vendors. Some jurisdictions require persons to register where, in the course of business or in the course of "continuous or successive acts", they sell or lease TPP or taxable services for consumption or use. Other jurisdictions focus on whether the vendor solicits orders in the jurisdiction, or whether the vendor has significant presence in the jurisdiction, before registration is required.

In addition to the foregoing, it should also be noted that businesses must generally self-assess provincial sales tax on the fair market value of equipment brought into a province for permanent or temporary use or consumption, unless the equipment is specifically exempt (e.g. manufacturing equipment). This requirement exists, even if provincial sales tax was previously paid to another province on the initial purchase of the equipment.

Please contact your advisor at Goldfarb Shulman Patel & Co. LLP, regarding any sales tax issues that may potentially affect your company.

COMBINED FEDERAL AND ONTARIO CORPORATE TAX RATES

The following combined Federal and Ontario tax rates continue to apply to corporations subject to Ontario tax:

		2004	2005 to 2007	2008	2009	2010
Small business rate on active income up to \$250,000*	Federal	13.12%	13.12%	12.00%	12.00%	12.00%
	Ontario	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>
		18.62%	18.62%	17.50%	17.50%	17.50%
Small business rate on active income from \$250,000 to 300,000*	Federal	22.12%	13.12%	12.00%	12.00%	12.00%
	Ontario	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>
		27.62%	18.62%	17.50%	17.50%	17.50%
Small business rate on active income from \$300,000 to 400,000*	Federal	22.12%	22.12%	20.50%	20.00%	19.00%
	Ontario	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>
		27.62%	27.62%	26.00%	25.50%	24.50%
M & P rate	Federal	22.12%	22.12%	20.50%	20.00%	19.00%
	Ontario	<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>
		34.12%	34.12%	32.50%	32.00%	31.00%
General rate (active income not eligible for the small business rate)	Federal	22.12%	22.12%	20.50%	20.00%	19.00%
	Ontario	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>
		36.12%	36.12%	34.50%	34.00%	33.00%
Investment income (other than dividend income from taxable Canadian corporations)	Federal	35.79%	35.79%	34.67%	34.67%	34.67%
	Ontario	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>
		49.79%	49.79%	48.67%	48.67%	48.67%

* These rates do not take into account the effect of the clawback of the Ontario small business deduction. The clawback applies where taxable income of the corporation and those corporations associated with it, falls between \$400,000 and \$1,128,519. 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.

The rates are presented on a calendar-year basis. Where a corporation's fiscal year straddles two calendar years, its corporate income tax rate will be pro-rated for the number of days in its fiscal year that falls into each calendar year.