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## **Ontario Budget – March 23, 2006**

### **BUDGET OVERVIEW**

On March 23, 2006, Ontario Finance Minister Dwight Duncan delivered the 2006 Ontario budget (the “Budget”). The Budget, which contains no personal or corporate income tax rate changes, projects an interim deficit of \$1.4 billion for the 2005-06 fiscal year, and projects a balanced budget by 2008-09 at the latest. The Budget proposes a new \$1.2 billion investment in Ontario's public transit systems and municipal roads and bridges. Other spending measures include further funding for post-secondary education, health care, skills training, research, and “at-risk” youth and vulnerable adults.

The Budget proposes the following significant tax changes:

- To accelerate the capital tax rate reductions.
- To parallel recently announced federal measures to extend the non-capital loss carry-forward period to 20 years, if enacted by the federal government.
- To enhance tax credits for Ontario production services and interactive digital media.
- To ensure the deferral and cancellation of land transfer tax for unregistered transfers of land between affiliated corporations does not apply to registered transfers of land between affiliated corporations.

The highlights of the tax changes announced in the Budget are summarized below. In addition, our commentary highlights recent tax cases of interest.

## BUSINESS TAX MEASURES

### Capital Tax Rate Cut Acceleration

The Budget proposes to accelerate the capital tax rate cut, originally slated for January 1, 2009, to apply as of January 1, 2007. The following table sets out the proposed capital tax rate changes for corporations which are not financial institutions:

Effective date	Capital Deduction (Unchanged)	Current Rate (%)	Proposed Rate (%)
January 1, 2005	\$7.5 Million	0.3	0.3
January 1, 2006	\$10 Million	0.3	0.3
January 1, 2007	\$12.5 Million	0.3	0.285
January 1, 2008	\$15 Million	0.3	0.285
January 1, 2009	\$15 Million	0.225	0.225
January 1, 2010	\$15 Million	0.15	0.15
January 1, 2011	\$15 Million	0.075	0.075
January 1, 2012	Eliminated	Eliminated	Eliminated

The proposed reductions to the capital tax rate will be pro-rated for taxation years straddling the effective dates. Similar reductions in the capital tax rates have also been proposed for financial institutions.

The government also announced that it intends to eliminate the capital tax in 2010, rather than 2012, provided the province's fiscal position at that time permits.

### Carry-Forward Period for Non-Capital Losses

The November 2005 federal Mini-Budget proposed to extend the carry-forward period from 10 years to 20 years for non-capital losses incurred in taxation years ending after 2005. The carry-back period of 3 years remains unchanged. The carry-forward period for non-capital losses is 7 years for taxation years that end prior to March 23, 2004.

Subject to federal implementation, the Budget proposes to parallel the federal extension and effective date.

### Ontario Production Services Tax Credit ("OPSTC") Extended

The Budget proposes to extend the 18% refundable OPSTC for Ontario labour expenditures incurred up to March 31, 2007 by foreign-based and domestic film and television productions that are ineligible for the Ontario Film and Television Tax Credit.

**Ontario Interactive Digital Media Tax Credit (“OIDMTC”) Expanded**

The Budget proposes to increase from 20% to 30% the refundable OIDMTC, which is available to eligible corporations, with annual gross revenue of up to \$20 million and total assets of up to \$10 million, for qualifying expenditures incurred to create and market original interactive digital media products in Ontario. The Budget also proposes to extend eligibility for the OIDMTC at a rate of 20% to larger multimedia developers that exceed the current size test, and to fee-for-service contractors (such as a video game developer creating a product under a contract with a publishing company) that develop all or substantially all of an eligible product in Ontario under contract with an arm’s length party. These proposed changes will be effective for expenditures incurred after March 23, 2006 and before January 1, 2010.

**Expenses Incurred in Issuing Shares, Options and Other Interests**

On November 17, 2005, the federal government released proposed legislation to limit the deduction for certain expenses, such as share issuance costs, to the taxpayer’s actual cash outlay, effective November 17, 2005. The proposed legislation responds to a recent Tax Court of Canada (“TCC”) decision, whereby a corporation was allowed to treat the value of shares issued under an employee stock option plan in excess of the exercise price, as an expenditure qualifying for a scientific research and experimental development tax credit.

The Budget proposes to parallel the federal provisions and their effective dates, if implemented federally.

**PERSONAL TAX MEASURES****Dividend Tax Credit**

On November 23, 2005, the federal government announced that it had completed its review of income trust structures and proposed a reduction in the personal income tax rates on dividends to level the playing field between corporations and income trusts with respect to the total federal income tax paid on income earned and distributed through them. In order to achieve this objective, it is proposed that eligible dividends would be grossed up by 45% (currently 25%) and the federal dividend tax credit would be 19% (currently 13.33%) of the grossed-up amount of the eligible dividends. The personal income tax rate reduction would not apply to dividends paid by a Canadian-controlled private corporation (“CCPC”) to the extent of its investment income and active business income that has been subject to tax at the small business deduction rate.

The Budget indicates that the Ontario government will review the federal legislation once it is released and will respond accordingly.

### **Income Threshold of the 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 2006, 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.

### **Labour-Sponsored Investment Funds (LSIFs)**

On September 30, 2005, the Ontario government announced that it will phase out its provincial LSIF tax credit commencing in 2009. The credit will be reduced from the present 15% rate to 10% in 2009, 5% in 2010, and nil thereafter.

In order to encourage LSIFs to continue to support the portfolios of companies in which they have invested, the Budget proposes to amend the current legislation to expand the types of investments LSIFs can hold, to parallel the federal program's investment rules and restrictions, and to create wind-up rules.

### **LAND TRANSFER TAX ("LTT") MEASURES**

The LTT Act provides for the deferral and cancellation of LTT for unregistered transfers of land between affiliated corporations, subject to certain conditions. Certain court interpretations, however, have regarded certain registered transfers of land between affiliated corporations as also being exempt from LTT. To counter this, the Budget proposes the following amendments to the LTT Act:

- Deferred LTT would become payable, if the transfer is registered during the deferral period.
- LTT would become payable, if the transfer is registered after the cancellation of the LTT.
- The interpretation of the term *affiliate* would be clarified to not extend beyond the specified criteria.

### **ONTARIO RETAIL SALES TAX ("RST") MEASURES**

#### **RST Exemption for Destination Marketing Fees**

The Budget proposes that the temporary RST exemption for destination marketing fees on accommodations be extended to fees billed on or before June 30, 2007.

#### **Complimentary Admission Tickets**

Owners or operators of places of amusement have been able to donate admission tickets to registered charities, on an RST-exempt basis, since June 17, 2002. In order to encourage additional donations, the Budget proposes to expand the list of potential donees to also include community colleges, schools, universities and those non-profit organizations specifically defined by the Ontario government. The proposal would be effective for tickets donated after March 23, 2006.

### **Hybrid Electric Vehicles**

The Budget proposes to increase the maximum RST rebate for qualifying purchases of hybrid electric vehicles from \$1,000 to \$2,000, for vehicles delivered to purchasers after March 23, 2006, and to eliminate the rebate entirely after March 31, 2012.

### **Clearance Certificates**

A clearance certificate is required when assets are sold in the course of a sale of a business to which the Bulk Sales Act applies. Under present legislation, once a clearance certificate has been issued, the Ontario government has no further recourse against the vendor for the collection of RST. The Budget proposes to amend the legislation to permit the government to collect outstanding RST from a vendor, even after the issuance of the certificate. The proposed measure would not affect the purchaser's protection associated with a clearance certificate.

## **OTHER MEASURES**

### **Combining Corporate Tax Collection and Audits with the Federal Government**

In an effort to reduce administrative costs, the Ontario government has been actively working with the federal government to combine the corporate income tax collection and processing systems. The Budget indicates that Ontario intends to conclude a memorandum of agreement with the federal government to implement a single corporate tax administration. Ontario also intends to delegate the collection of other corporate taxes, such as capital tax, to the federal government.

To further Ontario's collaboration with the federal government in reducing corporate tax compliance costs for taxpayers, legislation will also be proposed to permit an early integration of federal and Ontario tax audits. The proposed legislation would enable the Canada Revenue Agency to audit a corporation's Ontario taxes for taxation years ending before the commencement of a corporate tax collection agreement.

## **RECENT COURT DECISIONS OF INTEREST**

Several recent court decisions of interest are discussed below.

### **Cost of Food or Entertainment Vouchers Subject to the 50% Limitation**

#### ***Mark Stapley v. The Queen***

The deduction of food, beverage, and entertainment expenses incurred for business purposes is limited to 50% under section 67.1 of the Income Tax Act (Canada) ("ITA"). In this recent case, a self-employed real estate agent promoted his business by providing food and entertainment vouchers

to his clients, to be used at their discretion. The CRA applied the 50% limitation on the basis that the amounts were paid for “the human consumption of food or beverages, or the enjoyment of entertainment”. The taxpayer, on the other hand, argued that the 50% limitation did not apply, because he did not derive any personal benefit when his clients redeemed the vouchers.

The Federal Court of Appeal (“FCA”) found that even though the expenditures in issue may have been strictly for business purposes, they were nevertheless paid in respect of the human consumption of food and the enjoyment of entertainment. The FCA held that the wording of section 67.1 covers the widest possible scope of food, beverages or entertainment expenses, and applies even where the taxpayer did not consume any part of the food or enjoy any part of the entertainment. Consequently, the FCA concluded that the voucher costs fell within the scope of the 50% limitation in section 67.1.

The FCA pointed out that if the taxpayer had purchased books or flowers for his clients, or had provided commission rebates to his clients, then the cost thereof would have been fully deductible. The broad application of the 50% limitation may discourage businesses from spending their promotion budgets on food, beverages or entertainment.

### **Corporation Holding Vacant Land Not a Small Business Corporation**

#### ***Carlo Venneri v. The Queen***

On June 3, 1993, the taxpayer became the sole shareholder of a numbered company, whose sole business consisted of holding vacant land. On July 31, 1998, the corporation sold the land at a loss. In computing his income for 1998, Venneri claimed an allowable business investment loss (“ABIL”) in respect of uncollectible advances he made to the corporation. The Minister disallowed this deduction on the ground that the corporation was not a *small business corporation*, but instead permitted the taxpayer a less generous capital loss deduction.

One of the conditions of being classified as a small business corporation is that the corporation must have carried on an *active* business in Canada. The issue before the TCC was whether the holding and sale of vacant land constitutes the operating of an active business. The TCC held that, since the property was acquired by the corporation for the purpose of developing a residential housing project, rather than for the purpose of reselling the land itself at a profit, the corporation’s business was never actively carried on. Consequently, the TCC held that the corporation was not a small business corporation, and therefore, Venneri’s ABIL claim was denied.

The TCC’s decision that the holding of vacant land did not constitute the “carrying on of an active business” is surprising. The term “active business” is defined in subsection 125(7) of the ITA to include an adventure or concern in the nature of trade. Accordingly, the passive holding of real estate for speculative purposes would appear to constitute an active business. Case law confirms that profits realized from real estate speculation or real estate development will give rise to active business income, and that a taxpayer may be “carrying on business” even though the business is not continuously active. In the Venneri case, the sale of the land by the corporation would appear to have been sufficient to constitute the carrying on of an active business. The taxpayer has appealed the TCC’s decision to the FCA.

## **General Anti-Avoidance Rule (“GAAR”) Cases Decided by the Supreme Court of Canada (“SCC”)**

In October 2005, the SCC released its first two decisions related to the GAAR contained in section 245 of the ITA. The cases provide important guidance to both taxpayers and lower level tax courts to assess the potential applicability of the GAAR in other situations. The requirements for the application of the GAAR are that:

1. There is a tax benefit,
2. There is an avoidance transaction (that is, a transaction that was not undertaken primarily for bona fide purposes other than to obtain the tax benefit), and
3. The transactions result in a misuse of a provision of the ITA, or an abuse of the ITA read as a whole.

### ***Canada Trustco Mortgage Company (“CTMC”) v. The Queen***

The CTMC case involved a cross-border circular sale-leaseback transaction that allowed CTMC to claim substantial capital cost allowance (“CCA”) in respect of certain trailers, for which CTMC did not have an economic cost. The facts in this case are as follows: In December 1996, CTMC used its own money and a loan of approximately \$100 million to purchase trailers from a vendor at fair market value of \$120 million. CTMC leased the trailers to an offshore company, who in turn subleased them to the vendor. The vendor then prepaid all amounts due to the offshore company under the sublease. The offshore company placed on deposit an amount equal to the loan for purposes of making the lease payments and a bond was pledged as security to guarantee a purchase option payment to CTMC at the end of the lease. These transactions allowed CTMC to substantially minimize its financial risk.

Under the transactions, CTMC’s interest expense and CCA from the trailers exceeded the leasing revenue, resulting in substantial tax losses without any “economic” loss. The Minister of National Revenue (the “Minister”) disallowed the CCA deductions on the basis that CTMC had not acquired title to the trailers, or, in the alternative, that the GAAR applied to deny its CCA deductions.

The SCC dismissed the first argument raised by the Minister. With respect to the GAAR issue, the taxpayer conceded the first two requirements indicated above with respect to the application of the GAAR. Accordingly, the only issue was whether the transactions resulted in a misuse of a provision of the ITA, or an abuse of the ITA read as a whole. The SCC concluded that the GAAR did not apply. In analyzing the abusive tax avoidance issue, two steps are required: a unified textual, contextual and purposive analysis of the provisions of the ITA giving rise to the tax benefit must be conducted and, based on the facts of the situation, the Court must determine whether the avoidance transaction frustrated the object, spirit or purpose of the provisions of the ITA. In this case, the SCC held that the transaction was not so dissimilar to an ordinary sale-leaseback transaction to cause it to be considered beyond the object, spirit or purpose of the ITA. The Minister’s argument that the taxpayer did not have any real financial risk or economic cost did not cause the GAAR to prevail over the CCA provisions. The CCA regime allows taxpayers to deduct CCA in respect of the legal

cost of capital assets, not the economic cost. Accordingly, CTMC was entitled to its CCA deductions.

*Mathew et al v. The Queen*

The Mathew case involved the transfer of business losses to unrelated persons through the use of a partnership, thereby enabling the taxpayers to substantially reduce their income by deducting these losses. The facts of this case are as follows: An insolvent trust company transferred a portfolio of mortgages with unrealized losses to a non-arm's length partnership, in exchange for a 99% interest in the partnership. The trust company relied on a stop-loss rule that denied the loss on the transfer of property between parties not dealing at arm's length, and related tax provisions that provided that the amount of the denied loss be added to the partnership's tax cost of the mortgage portfolio. The second step involved the trust company selling its 99% partnership interest to an arm's length party. Under the third step, the arm's length party transferred its 99% interest in the partnership to a second partnership. The taxpayers became members of the second partnership and each taxpayer claimed its proportionate share of the losses from the eventual sale or write-down of the mortgaged properties. The Minister denied the losses on the basis that the GAAR applied.

Similar to the CTMC case, in determining the applicability of the GAAR, the taxpayers and the Minister agreed that the only issue was whether the transactions resulted in a misuse of a provision or an abuse of the ITA as a whole. Unlike the CTMC case, however, the SCC concluded that the third condition of the GAAR applied. The SCC stipulated that the purpose of the stop-loss rule is to prevent arm's length taxpayers from trading losses, and that the purpose of the partnership rules is to allow profit/loss sharing between partners who carry on business in common. The SCC held that Parliament could not have intended that the combined effect of the stop-loss rule and the partnership rules would preserve a loss and allow it to be realized by a taxpayer who deals at arm's length with the person who incurred the loss. Consequently, the series of transactions resulted in abusive tax avoidance, and hence, the GAAR applied to deny the deduction of the partnership loss.

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

## COMBINED FEDERAL AND ONTARIO CORPORATE TAX RATES

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

		2005 to 2007	2008	2009	2010
Small business rate on active income up to \$300,000*	Federal	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>
		18.62%	17.50%	17.50%	17.50%
Small business rate on active income from \$300,000 to 400,000*	Federal	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>
		27.62%	26.00%	25.50%	24.50%
M & P rate	Federal	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>
		34.12%	32.50%	32.00%	31.00%
General rate (active income not eligible for the small business rate)	Federal	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>
		36.12%	34.50%	34.00%	33.00%
Investment income (other than dividend income from taxable Canadian corporations)**	Federal	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>
		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.

\*\* These rates apply to investment income earned by a CCPC, and include refundable dividend tax of 26.67%.